

Greater Lowell Chamber of Commerce

by Cathy E. Minehan, President & Chief Executive Officer
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Good afternoon. It's a pleasure to be here with you today. Chambers of Commerce have an important role to play in facilitating the interaction of business and government. They often help to marshal the business community to close the gaps in public services that government cannot address, such as summer jobs. Equally important, Chambers often bring a private sector perspective to issues of public importance. This is a quintessentially American form of private collaboration toward public ends and, in my view, is key to a well-functioning town or city. Chambers also provide forums for discussion of issues of importance to the political body, whether they be transportation, education, tax levels, or development issues. Thus, I feel honored that you have asked me to speak, and I look forward to hearing what's on your mind after I finish my remarks.

In considering the recent evolution and current state of the national and regional economies, some have used literary metaphors. According to this view, over the past several years we've moved from an economic environment that could be characterized by the fairy tale of "Goldilocks," to one resembling Dickens' "A Tale of Two Cities." More recently, however, things have been so volatile financially but strong on Main Street that it's hard to find the right metaphor. Perhaps that tribute to free markets, "Atlas Shrugged" would do. Let me provide some insight into why those particular literary titles seem appropriate.

First, the Goldilocks economy. From 1993 to the early part of 1998 the economy grew at an average annual rate just a bit above 3 percent. During the same period, well over 16 million jobs were created, bringing the unemployment rate to its lowest level in 25 years. Yet even with this strain on labor capacity, the rate of inflationary growth dropped, from around 3.5 percent in 1993, to its current rate of below 2 percent overall, and about 2.5 percent excluding the volatile food and energy sectors. By the end of this period, workers' wages were rising faster than inflation, after barely keeping pace for many years, reflecting productivity increases that were most obvious from the data in nonfinancial businesses, but probably existed more broadly.

This era of prosperity fueled, and was fueled by, a stock market that nearly tripled in value regardless of the index. At the same time, long-term interest rates reached 25 year lows, making credit relatively inexpensive. Banks added to their capital, strengthened their balance sheets, and fought with each other to meet the borrowing needs of customers. Business' ample cash flows, coupled with the reduction in the cost of equity, fueled spending on capital equipment that dramatically expanded their capacity to produce goods and services. Relatively lower interest rates helped propel the economy by fostering a low nominal debt burden for firms and consumers alike.

For the first year since 1960, the federal government registered a budget surplus--a seeming impossibility only five years before the start of this period. The only cloud on the horizon was a widening trade deficit, which while worrisome for the long run, was largely a reflection of the strength of our economy relative to that of many of our trading partners.

That was our "Goldilocks" economy--not too cold, not too hot, just about right. The only question was whether we could keep it that way.

That brings us to the "Tale of Two Cities," or more accurately, continents--the United States and the developing world. Starting in 1997 with the currency crisis in Thailand, it began to be very clear that much of Southeast Asia was unraveling, economically if not politically and socially as well. Currency, and equity values plummeted, banking

systems carrying a heavy load of foreign-denominated liabilities collapsed, and interest rates rose to levels that brought economic activity to a screeching halt. These areas, comprising 17% of world trade, and 19% of U.S. trade, ground to an economic standstill.

Here in the U.S., the surface of economic activity barely rippled. It was easy to see the problems in Asia, while tragic for the countries involved, as a necessary brake on U.S. economic activity. After five years of above trend growth, almost every forecaster saw inflation on the horizon, and many were worried about the speculative activity that could so easily be the outcome of the country's expansive financial markets.

But even as Asia slowed, the U.S. remained strong. Despite sharp drops in exports to Asia, the U.S. GDP grew at a rate of about 3.7 percent in the first half of 1998. Employment continued to grow, adding 240,000 jobs per month in the first half of the year, and just under 200,000 per month in the third quarter. Unemployment remained low, and inflation by almost any measure either stabilized or declined. Readings on the real economy were complicated by the GM strike, which shifted employment and production from July to August, but indicators of consumer spending, housing, and business investment remained strong, and the overall economy vibrant.

Thus, globally, it was "the best of times (here), and the worst of times (there)". But it soon became evident that while the U.S. seemed impervious, it might not be. As Chairman Greenspan warned, it might not be possible for the world's largest economy to remain "an oasis of prosperity in a wider sea of global turmoil."

The wisdom of these remarks became evident in the aftermath of the simultaneous default and devaluation in Russia. Beginning in early August, domestic financial markets here in the U.S. were roiled by an almost overnight reappraisal of risk by participants, and fears of a major negative effect on the real economy grew. Deflation, recession began to dominate some discussions of the economy. Now, however, we are seeing the continued strength of the consumer, the "Atlas" of this growth period, "shrugging" off potentially bad news and continuing to bolster the economy's strength, at least for now. The speed with which this has happened, however, has been unsettling to say the least.

What happened to credit markets in the early fall and what are we to make of it? Well, to start with, in September, in the wake of the Russian default, a reappraisal of the risk in foreign positions and U.S. equities propelled a flight to safety and liquidity. The safest and most liquid of securities available are U.S. Treasuries. This surge in demand for U.S. government issues caused a substantial decline in their yields, which had several disruptive effects.

First, a number of bank and nonbank financial institutions that had positions that depended on the stability of Treasury yields were caught short as prices rose rapidly and yields fell. They soon found themselves unable to unwind those positions in a market that had a heightened appetite for liquidity.

At the same time, the fall in Treasury yields made corporate debt issuance less attractive, both to firms wishing to raise funds and to underwriters. The potential issuers took rising spreads of debt over Treasuries as a signal to look elsewhere for financing, and they did so (largely at banks). Underwriters were uncomfortable with taking on the increased risk of placing corporate securities even as rising Treasury prices increased their cost of financing such deals.

As a result, for a month or so in October, corporate debt issuance slowed markedly, and many feared that we were finally seeing the influence of the rest of the world on the previously impervious U.S. The flight to liquidity had initiated a drought of credit supply, and the real economy might soon suffer as a result. Now it is true that some of the retreat from risk was a healthy reaction to spreads that were at historically low levels early in the summer. But there was also a potential for significant damage to the real economy, and recognizing that, the Fed cut interest rates three times from late September to mid-November.

Recently, Treasuries have risen back to their pre-panic levels, spreads have narrowed, and corporate debt issuance has resumed though not at the same rates for higher risk borrowers. While we are probably not entirely out of the woods, the debt markets seem to have calmed, and with some luck, are well-positioned for the new year. Even more surprising is the fact that the stock market is back to hitting new highs. The consumer and U.S. businesses apparently never stopped spending during the turmoil, so that GDP for third quarter came in just below 4%, and fourth quarter seems likely to be close to that. Questions remain on the international side, in Brazil especially, but on the home front, the picture at year end was better than most anyone thought it could be in the dark days of the fall.

In sum, we have moved from the almost too good to be true "Goldilocks" state, through a period of seeming invincibility in the face of external turmoil, to a time of very solid domestic growth but uncertainty about the future. Certainly this is a period that demands central bank vigilance and caution. In that regard, I'd like to discuss three of what I might term as "fallacies" that effect popular conceptions about the domestic economy. I believe these are topics about which the Federal Reserve should be particularly vigilant.

First fallacy--inflation is dead. As tempting as this is to believe, I don't think it is likely. Moreover, to act as if it might be is dangerous as events have proven in the past. In my view, the traditional logic that tight labor markets produce higher labor costs, which further induce rising prices still makes sense. After all, labor input remains about 60 percent of final goods prices. But labor markets have been tight for some time now, and the rate of overall price growth has declined, not risen.

I would argue there are a number of reasons why this has happened. First, some credit has to go to the credibility achieved by the Federal Reserve in its battle against inflation since the early '80s. Expectations of inflation are low, as far as we can measure them, and this feeds back in many ways to price-setting in the economy. Second, for at least the early part of the period since the last recession, growth was slower than normal. Arguably this slow growth and corporate restructuring helped hold down labor costs when unemployment rates began to fall. In addition, benefit cost growth, especially medical benefits, slowed dramatically in response to increased competition and restructuring. This also kept overall compensation growth from accelerating even as labor markets tightened. Third, now that compensation cost growth has picked up more or less in line with traditional models of unemployment levels and wages, a couple of at least partly temporary factors continue to keep broad price growth low.

Earlier I noted the positive impact of business spending to improve productivity and competitiveness as one mainstay of our current economic picture. Such productivity growth has allowed firms to increase compensation without incurring higher unit labor costs. But questions abound. Is such productivity growth in part cyclical as well, reflecting the economy's current strength? If so, it could be temporary. Or is this productivity growth secular, reflecting investments in information technology and more efficient labor market practices? If it is, then productivity growth may be lasting. I don't know the answers to these questions, but recent data suggest productivity increases are starting to be overtaken by continued compensation gains.

Commodity prices are also holding the rate of inflation down. The crisis in Asia and its spillover have reduced demand for commodities, and new technologies have made them ever more plentiful. Thus, prices of oil and other raw materials and agricultural products have tumbled--for example, crude oil prices at year end were 40 percent below those of a year ago. However, commodity prices cannot fall at this pace forever. What happens when they stabilize, and world markets recover?

If labor markets remain as tight as they are now, an increase in inflationary pressure seems inevitable at some point. I do not believe inflation is dead at current levels of labor market tightness. It is quiescent-- quiescent because of the combination of cyclical timing and what may be partly temporary factors. It is true that most U.S. businesses, especially those that produce tradeable goods, firmly believe they have no pricing power. But this could change as international markets firm. Clearly, central bank vigilance is important here.

This takes me to the second fallacy. "Asset markets always go up," and its corollary "I don't have to save because the stock market will provide for my retirement." I don't have to tell a group of New Englanders about the dangers of inflated asset prices; the '90s recession lingers in our memory as proof of the dangers of asset inflation. Arguably, rising asset prices and the related feedback to consumer confidence convince consumers to maintain higher spending rates than they would otherwise. Thus, in the face of a booming stock market, the personal savings rate fell from 6% or so in the early '90s recession years to a very low level today--hardly a good development in my view. When asset prices level off or come down, a reverse "wealth" effect could become evident as negative savings rates turn positive and consumption spending slows. Not a bad thing for sure, but the speed and size of such a correction presents uncertainties. For businesses, a soaring stock market makes the cost of equity capital low; if this changes, investment spending could change as well.

After several years of rising corporate profits, 1998 saw a leveling off or an actual decline in profits, depending on the

index used. Some indicators of valuations in equity markets, price earnings ratios, for example, seem high by historical standards. Plausible arguments have been made as to why such indicators are justified, though overall market volatility has increased. Asset markets can't always go up, and this indeed could have consequences for the real economy.

Finally, there is the fallacy that the business cycle is dead. Don't bet on it. This recovery started slowly, but has gained sizeable momentum. But there comes a time when consumers neither desire nor can afford another house or car, and businesses have invested as much as they reasonably can employ. Things slow down and, if all has been handled well, growth can continue at a slower and more sustainable pace. This is not the traditional pattern, however. In recent decades the growth phase of most business cycles has come to an end typically because growth got out of hand, inflation surged, and policy had to be tightened. To be sure, we've had a stronger economy with less inflation than most observers, myself included, expected. Still the capacity of the economy is not unlimited. Thus, in my view, some of the answer to whether or not this expansion continues, albeit at a slower pace, relies on how the threat of overshooting is handled. Again, a case for central bank vigilance.

Looking forward to 1999, I have some confidence that fiscal discipline and central bank vigilance will pay off. The domestic economy remains vital, and there will be considerable momentum from fourth quarter growth. However, there are reasons to believe growth will settle in to a more sustainable pace. The drag from foreign economic problems remains, though it is not expected to be as large for the year as a whole as it was in 1998. Financial markets remain volatile and are a continuing area of concern. Just a leveling out of stock prices would give consumers good reasons to resume more traditional patterns of saving and rein in consumption spending. Finally, businesses seem likely to restrain their spending in the face of weaker profit growth and a slower economy. As the economy moves into a more sustainable and, in my view, desirable pace, the Federal Reserve's three rate reductions provide a bit of insurance against downside risk.

Thus, I expect overall GDP to run somewhere around 2-1/2 percent in 1999, and for unemployment to stay at a relatively low level. Not as upbeat as 1998 to be sure, but far from problematic. Given labor market tightness, inflation risks remain. I expect there will be a modest tick-up here, if only because it is hard to imagine oil prices continuing to decline at a 40 percent pace the way they have this year. Now, I should point out that if it is realized, this forecast is almost the definition of the proverbial soft landing. Or, in other words, it doesn't get much better than this, particularly after the uncertainties of the last half of 1998.

But there are risks. The international situation could present significant issues. Brazil most obviously comes to mind here, but Japan remains at a standstill, and forecasts for the countries of Euroland have recently weakened somewhat. On the other hand, the strength of the domestic situation holds the potential for surprise as well. Consider the fact that while a domestic slowdown is expected, there is little yet in the incoming data to suggest it has started in earnest. Moreover, asset markets seem heady at best. Continued strength here could keep the pressure on labor markets and further test the economy's resistance to inflation, while a bout of weakness in asset markets obviously has a potential for downside uncertainty.

These risks present challenges to monetary policy, challenges that remain even in the face of the economy's current strength, and a remarkably benign forecast. But setting monetary policy is always challenging. I often ask myself how best to deal with these challenges as I approach the task of serving as a member of the FOMC. Clearly, careful study of all the incoming data is needed, but equally important is interaction with people like yourselves, immersed in the businesses that are at the heart of state and regional growth. Thus, I thank you for this opportunity to share some thoughts with you today, and I look forward to your comments and questions.

Thank you.

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