

South Shore Chamber of Commerce Women's Business Connection, Annual Conference

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Good afternoon. It's a pleasure to speak here at the South Shore Chamber of Commerce. Today, I'd like to touch on three important topics.

First, I will outline the solid economic picture we currently enjoy. Second, I want to address three fallacies that seem to shape how some view the domestic scene. Finally, I'd like to spend a little time on that now all-important topic, Y2K readiness.

Let me start with the current state of the U.S. economy. We are experiencing one of the longest periods of sustained growth, low inflation, and low unemployment in the post-war period. Indeed, one has to go back to the early 1960's to see periods of similar success.

For the last five years, real GDP as measured from the end of one year to the end of the next, grew by an average of 3.5 percent, well above what most economists believe is sustainable over longer periods. Moreover, growth accelerated toward the end of the period, with 1998 ending up over 4 percent. Reflecting this strong growth, a net of nearly 3 million new jobs were added during 1998, causing the U.S. unemployment rate to fall about half a percentage point, reaching 4.2 percent in March.

This robust growth was all the more remarkable, since it occurred despite a sharp, though ultimately temporary, drop in stock prices of about 20 percent last fall, considerable financial market turmoil, and a significant slowdown in the manufacturing sector caused by sagging exports. These, of course, reflected the economic crises in Asia and Russia.

Moreover, historical patterns would suggest that the current low unemployment rate in the context of growth that remains above its long run trend would signal higher rates of inflation ahead. But, as yet, we see almost no signs of increasing price pressures. Core inflation (or consumer price inflation excluding the volatile food and energy components) has continued to inch down; and from March 1998 to March 1999 it was only 2.1 percent. Even upward pressures on wages, which would normally show up in price inflation sooner or later, seem to have abated a bit in recent months.

Two bulwarks are critical to the economy's current success: the consumer, and the drive of U.S. business to become more competitive. On the consumer side, spending on houses and motor vehicles and other durable goods has surged beyond expectations. People are employed at an historically high level, interest rates are low, and confidence about the current situation, and the future, while bouncy, has been high.

Some of this consumption growth is likely driven by the behavior of asset prices. Arguably, people feel wealthier when their assets are worth more, and the wealthier people feel, the more they are willing to spend and the less they believe they need to save out of current income. Thus, we see the personal savings rate falling from almost 6 percent in the early '90s recession years to nearly zero currently.

Strong domestic consumption has led businesses to hire more workers; and compensation growth has picked up.

However, global competitive pressures have intensified as well, and businesses have responded by increasing productivity. They have invested in technology to reduce costs and improve product offerings; they have restructured business processes, merged or divested less than stellar operations; and they have turned to ever more creative compensation practices, linking pay directly to performance. Thus, compensation cost increases have been cushioned, at least for the present, and have not been reflected in higher prices.

This is not to say that everything is rosy. Obviously, a war rages in Kosovo; this is tragic, but at least for now the economic consequences of this situation to the U.S. seem small. Earlier international developments in Asia and Russia continue to plague us as well. Their impact has been largely felt in three areas: declining net exports with their marked effects on the manufacturing sector, plummeting commodity prices, and increased volatility and risk in financial markets.

The U.S. trade deficit continues to set new records, reflecting the combination of economic problems internationally, which dampen foreign demand and buying power, and the relatively much healthier U.S. economy. Also, an increase in the trade-weighted value of the dollar may have made U.S. exports relatively more expensive. The drag on growth from worsening trade has been fairly large—about 1.4 percentage points for 1998. However, given the strength of U.S. domestic demand, the softness in the external sector, while reflecting enormous problems in the countries involved, has not been altogether a bad thing.

Similarly, slack conditions abroad drove commodity prices to extraordinary lows. In particular, at year-end 1998 the price of crude petroleum was down 40 percent from the previous year, while agricultural product prices languished as well. These prices have since recovered somewhat, but are still depressed. Even oil prices, while up substantially from recent lows, are below what they were in 1996. This certainly helps on the inflation front, but commodity producers—like farmers in Iowa, or copper miners in Chile—have certainly felt the pinch.

In the financial markets, the turmoil of late last summer caused a flight to quality of some proportion. Liquidity dried up, credit spreads widened, and the real economy in the U.S. seemed truly threatened. The Fed eased, and conditions improved more rapidly than most observers expected.

Thus, the domestic economy is strong right now, though not without significant challenges. The major question is how long can it stay that way? Part of the answer involves how we react to the three fallacies I noted earlier.

First fallacy - inflation is dead. As tempting as this is to believe, I don't think it is likely. Moreover, to act as if inflation were dead is dangerous, as events have proven in the past. In my view, the traditional logic that tight labor markets produce higher labor costs, which lead to rising prices still makes sense.

How then to explain why labor markets have been tight for some time now, but the rate of overall price growth has declined, not risen? I would argue that there are a number of reasons why the U.S. has had such a long period of declining inflation rates even in the face of strong growth. 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, in the early years of this expansion, 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 in the health care industry. This helped keep overall compensation growth from accelerating even as labor markets tightened.

Finally, now that compensation growth has picked up somewhat, final prices have been kept low by another couple of factors that are probably at least partly temporary. Earlier, I noted that business spending to improve productivity and competitiveness is one mainstay of our current favorable economic picture. Productivity growth has allowed firms to increase compensation without incurring higher unit labor costs. But questions abound. Is the productivity growth we have experienced partly cyclical, reflecting the economy's current strength? If so, it could be temporary. Or is this productivity growth secular, reflecting the fruits of investments in information technology, as well as more efficient labor market practices? If it is, then higher productivity growth may be lasting. Even very close scrutiny of the data does not reveal the answer to these questions, creating a puzzle about which much has been written of late.

As I noted earlier, falling commodity prices are helping to hold the rate of inflation down. However, commodity prices cannot fall forever. What happens when they stabilize, and world markets recover?

If labor markets remain as tight as they are now and productivity growth does not accelerate, 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 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 tradable goods, firmly believe they have no pricing power. But this could change as international conditions firm. Clearly, central bank vigilance is important here.

This takes me to the second fallacy. "Asset markets always go up". 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 good feelings they induce convince consumers to maintain higher spending rates than they would otherwise. If asset prices were to level off or decline, a reverse "wealth" effect could become evident. For businesses, a soaring stock market makes the cost of equity capital low; if this changes, investment spending could change as well.

Some indicators of valuations in equity markets, price earnings ratios, in particular, seem high by historical standards. Moreover, after several years of rising corporate profits, 1998 saw a leveling off or an actual decline in profits, depending upon the group of companies examined. Although plausible arguments have been made as to why such high valuations are justified, the combination of historically high PEs and faltering profit growth raises the possibility of a decline. Asset markets can't always go up, and a decline or even a persistent leveling off 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 use. 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 picked up, and monetary 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, depends on how the threat of overshooting is handled. Again, a case for central bank vigilance.

Looking forward I have some confidence that fiscal discipline and central bank vigilance will continue to pay off. The domestic economy remains vital, but I believe growth will settle into a more sustainable pace. The drag from the external sector remains, though Asia seems poised for a much better 1999 than '98. Financial markets remain somewhat volatile. Consumers may see reasons to resume more traditional patterns of saving and rein in consumption spending. Finally, businesses may be likely to restrain their spending in the face of weaker profit growth and a slower economy.

To be a bit more specific, I expect growth in real GDP to run somewhere between 2-1/2 - 3 percent in 1999, though it was probably a bit faster than that in first quarter. I expect unemployment to stay at a relatively low level given this level of economic growth. Given labor market tightness and the rise in oil prices, inflation risks remain. I expect there will be a modest tick-up here.

But this forecast is not without its risks. On the downside, GDP could slow by a greater amount than expected if international growth disappoints, or financial market volatility returns. At the same time, the domestic situation holds the potential for upside surprise, especially considering the continued strength in the incoming data. Thus, there are challenges for monetary policy - striving to maintain a balance between upside and downside risks, even in the face of what is a very good current picture, and a reasonably benign standard forecast.

Now let me discuss what some perceive as yet an additional risk. That is the challenge presented by the new millenium and its potential impact on computer systems worldwide.

I am becoming increasingly confident that, as it regards the U.S. financial world, and the variety of systems that support

it, the transition to the new millennium will be smooth--not problem-free necessarily, but not a crisis either.

I want to focus the rest of my comments on why I have this level of confidence, and what I believe some of the remaining issues are.

First, a quick definition of the problem. The Y2K problem started as a short-term solution to the high cost of computer memory in the 1950s and '60s. This problem was addressed by using only the last two digits of a 4-digit date in the record--68 for 1968, for example. This became the convention, and, until quite recently, this short cut was used even when systems were completely redesigned and memory costs were lower. The problem posed by the short cut is simple. After December 31, 1999 two-digit dates could mean dates in either of two different centuries and cause errors of uncertain proportion. No concerted effort was made to address this problem until recently. Now we can no longer wait. The Y2K short cut has to be eliminated, and it is not proving easy or cheap to do so.

That said, how are we doing? I think we're doing pretty well. That's based on extensive oversight of our efforts within the Federal Reserve System to make our own systems Y2K compliant, our experience in testing our connections with 12,000 depository institutions around the country, and our supervisory oversight of those institutions, and by several private and public sector surveys and assessments.

Another reason for confidence in the financial industry's readiness for Y2K lies in the industry's generally impressive record of coping with operational challenges. From blizzards to power outages to major software failures, the industry has coped, learned from its errors, built sophisticated and expensive back-up capabilities, and gone on to create a record of virtually error-free operation. The industry knows how to solve problems when they occur, and how to resume operations as quickly as possible.

And we're already gaining expertise in analyzing and fixing Y2K problems. For example, credit card expiration dates after 2000 when first encountered could not be processed--now they can. As one report put it, Y2K problems have already been occurring, continue to occur, will occur on January 1, 2000, and will continue to occur throughout 2000 and into 2001. Indeed, Gartner Group expects that only about 8% of Y2K affected code will actually be at issue on January 1, 2000.

Reserve Banks began Y2K project efforts more than two years ago. By the middle of 1998, all of the systems the Banks use to interface electronically with depository institutions had been made Y2K compliant and were ready for testing with customers. The vast majority of those systems are now fully tested and in operation, as are most systems used by Reserve Banks for internal purposes. This means that all but a very few of the systems that Reserve Banks use in the provision of financial services today are Y2K compliant and function exactly as they will in the new century.

To date, about 8,300 of the 12,000 depository institutions that connect electronically with Reserve Banks, including virtually all major banks, have tested their connections with us, and the vast majority will be required to do so by mid-year. The banking supervisory agencies have established objective milestone dates for depository institution completion of all phases of Year 2000 preparations--from the inventory of systems for Y2K problems and the development of plans to replace those systems, to remediation and testing, to the implementation of Y2K compliant systems and the completion of contingency plans--by June 30 of this year. Through multiple on-site examinations of all institutions, federal supervisors have found that banks are making excellent progress in meeting these milestone dates.

What about financial services firms beyond commercial banks? Much is being done there as well. Major securities firms actually began Y2K efforts somewhat before the banking industry and have successfully conducted at least two extensive end-to-end street-wide tests. We've brought insurance and mutual fund companies in the First District together at the Federal Reserve Bank of Boston. Their comments on both their own and their industries' readiness were reassuring, and this was validated as well in other surveys. All states have initiated a survey or examination effort for domestic insurance companies, and June 30 has been established as the date by which mission-critical systems should be Y2K compliant.

None of us will function very well without the variety of public utilities--power, water, transportation and telecommunications--that make modern life possible. At the national level, the efforts of these utilities to become Y2K compliant are being closely tracked. There is considerable confidence about large providers of service; less is known

about smaller providers. Officials from the Boston Fed met recently with suppliers of power to New England. We were told that steps are being taken not only to make those suppliers' systems Y2K compliant, but also to insulate New England from failures elsewhere more fully than it is today. In a sense, we may be more protected from power failure during the century changeover than we are currently.

U.S. Government agencies have been seen as challenged in several reports, and some are thought to be behind schedule in fixing some mission-critical systems. However, those systems that most directly affect the financial world--those in the Treasury and Social Security--seem to be in good shape. Social Security systems are renovated and tested, and are now fully in production in Y2K mode.

Less clear is the state of foreign entities, financial firms and governments. Here the various report results are mixed and data is more limited. In general, foreign entities are seen to be behind their U.S. counterparts in both the private and public sectors. Not surprisingly, developing countries are seen to be behind the developed world. Considerable effort is being made to bring this situation into better resolution.

On an optimistic note, I view the relatively glitch-free implementation of the Euro as an indication that at least Europe is likely to be ready for Y2K. A number of systems in some institutions were made Y2K compliant when the changes needed for the Euro were made. More importantly, institutions demonstrated the ability to meet a time bound, technologically complicated deadline, albeit one with a more narrow impact. In my view this augurs well for Y2K, but clearly risks are higher in the foreign arena.

In sum, then, our own assessments, and reports and surveys done by others on the state of Y2K readiness all point in the same direction. The financial sector-especially domestically-and the needed utilities that support it-are highly likely to succeed in making a smooth transition to the new century. Risks remain-most clearly in the foreign sector-and glitches are inevitable, but with every passing day the likelihood of success is greater.

That likelihood of success should not lull us into a false sense of security. We must continue to make progress and that requires continued work, testing, and attention to those things that can go wrong.

To address contingencies, much Reserve Bank attention has been devoted to the matter of liquidity--for individuals in the form of cash, and adequate funding for financial institutions. While the nation's major ATMs are generally compliant now, and the likelihood of bank problems is small, we have recognized the public may choose to hold more cash as a precautionary measure. To address that, Reserve Banks will have extra cash to increase the amount in circulation. In addition, we have written to all depository institutions about the availability of discount window loans in appropriate circumstances during the changeover.

Finally, despite all my reassuring words, and all the work that has been and will be put into this effort, something can and will go wrong. However, the impact of problems, even large ones, will vary depending on public perception. On one end of the spectrum, the failure of one ATM could cause a crisis if people are nervous enough; on the other end, the stoicism that gets us through snowstorms and other calamities will be the reaction if people are calm. Communication is critical here, and we are encouraging banks and other businesses to convey to their customers the progress being made.

There is no doubt that Y2K presents significant challenges, and that we are far from finished with the effort needed to address those challenges. However, the U.S. economy remains strong, providing the critical base of jobs, income, and confidence needed to weather the inevitable problems. I, for one, am looking forward to this time next year when we can look back on the transition, and forward to all the promises of a new century.

Thank you.

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