Cambridge Chamber of Commerce Fall Community Business Forum

by Cathy E. Minehan, President & Chief Executive Officer
October 27, 1999

Good morning. It's a pleasure to speak here at the Cambridge Chamber of Commerce about the remarkable U.S. economy and challenges for monetary policy.

Today we stand on the threshold of record economic prosperity. If the current expansion continues until February, it will become the longest in recorded U.S. history. Growth is strong. Unemployment, inflation, and interest rates are low. Asset markets are ebullient. Even the Federal budget has achieved a surplus position after the deficits of the '80s.

This outlook appears exceedingly bright to many observers, and in many ways it should. But, as former Fed chairman Paul Volcker recently said, "Central banks [must be mindful of] what they are wont to warn others about: excesses of zeal and confidence"

Today, then, I'd like to share with you my view of the current economic picture, which, in heeding former Chairman Volcker's counsel, is sprinkled with healthy doses of caution and risk assessment even in light of the solid economic picture we currently enjoy. I also want to address three fallacies that seem to shape how some view the domestic scene: 1) that inflation is dead; 2) that asset prices only go up; and 3) that business cycles are a thing of the past. Finally, I'd like to spend a little time on that now all-important topic, Y2K readiness, and its implications for the economy.

Let me start with the current state of the U.S. economy. Not since the early 1960s have we seen a period of similar economic success. After a brief growth slowdown in 1995, real GDP has increased at an average of 3-3/4 percent per year through mid-1999 - well above what most economists believe is sustainable in the face of resource constraints over longer periods. Growth has been exceptionally steady, and even now shows no major signs of slowing as the expansion ages. Reflecting this strong growth, another 2-1/2 million new jobs were added during the most recent 12 months and the U.S. unemployment rate continued to fall. It now stands at its 30-year low of 4.2 percent.

Here at home in New England, the economy also is performing well. At 3.0 percent, our unemployment rate is well below the national average. Traditionally New England's job growth is below that of the nation's, largely because of demographic trends, and recent years have been no exception. However, job growth regionally has been above its average trend since 1970, and some believe it may be constrained currently by a lack of available labor supply.

The fastest growing industry is construction, which could cause some worry given the region's experience in the late '80s. Unlike that period, however, construction's share of total employment is not out of line with historical patterns nor is it larger than that of the nation as a whole. New England is also benefiting from concentrations of fast-growth industries such as money management, business services (especially computer-related activities), and engineering and management services. Even one source of weakness, manufacturing - that is, merchandise exports in the wake of the Asian crisis - has turned around in the last couple of quarters.

Surprisingly, we see almost no signs of increasing price pressures even though historical patterns suggest that this long period of low unemployment and above-trend growth would bring higher inflation as well. Year-over-year core price inflation (that is, consumer price inflation excluding the volatile food and energy components) actually trended downward during the past year, falling from about 3 percent to 2 percent. And upward pressures on wages, which would normally show up in price inflation sooner or later, also seem to have abated a bit recently.

This robust growth has been all the more remarkable in light of the widespread international economic crises that occurred last year. Despite considerable financial market turmoil, and a significant slowdown in the manufacturing sector caused by sagging exports, the top line U.S. economic numbers were largely unaffected. Now, as much of Asia recovers, as other trouble spots at least get no worse, and as manufacturing revives, the threat of a global recession seems a thing of the past. Indeed, a stronger world economy runs the risk of putting even more pressure on U.S. resources.

Two bulwarks underpin the economy's current success: the consumer, and the drive of U.S. business to become more competitive. On the consumer side, spending continues unabated. Growth in real consumption spending has outpaced real GDP growth by more than 1 percentage point on average during the past year and a half. In particular, spending on home furnishings, motor vehicles, and other durable goods has surged beyond expectations. Despite an increase in long-term rates of more than one percentage point over the past year, nominal rates remain low historically. Moreover, consumers say they are confident about the economy. Thus, residential investment remains both attractive and affordable, and housing expenditures have not slowed significantly, despite forecast assumptions that they would.

Almost surely, some of this consumption growth is driven by large and rapid increases in asset prices, especially stock prices. Asset appreciation has increased household wealth enormously, and the wealthier people are, the more they are willing to spend. In fact, households apparently feel so wealthy now that they are spending more than they bring home in income, in the process incurring rising levels of consumer debt. Reflecting this, the personal savings rate which normally is positive has plunged to a negative 1.3 percent in the second quarter of this year.

This 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 this has pushed businesses to increase productivity. They have invested in technology to reduce costs and improve product offerings; they have restructured business processes, and merged or divested their less than stellar operations; and they have turned to ever more creative compensation practices that link pay directly to performance. Indeed, productivity growth during the past four years has been double that of the previous two decades, although some of this increase has probably occurred just because growth is strong. In any case, compensation cost increases have been cushioned, at least for the present, and have not been reflected in higher prices.

All of this is not to say that everything is rosy. And here is where I put on my central banker hat and encourage avoidance of "excesses of zeal and confidence".

Let me first focus on the consumer spending and debt binge. Rapid accumulation of debt can, and often has, come back to haunt us. Right now, household debt service payments, as a percentage of income, are nearing historically high levels. Increasing indebtedness relative to the ability to pay can't continue forever. Furthermore, the creditworthiness of borrowers, both households and firms, rests heavily on balance sheets that are buoyed by high asset prices.

Another major concern is that high rates of consumption are fueling record increases in the U.S. trade deficit. Measured in nominal terms relative to GDP, the U.S. current account deficit is now larger than it was at its previous low in 1987. Put simply, this means that U.S. consumers and businesses are spending well beyond the nation's ability to produce. We are being financed by the rest of the world--a trend that is not sustainable long-term. To be sure, a combination of international economic problems has contributed to the deficit as well. Weakness in foreign economies has dampened demand for U.S. exports, although this situation is easing as of late. Also, increases in the real trade-weighted value of the dollar during recent years have made U.S. exports relatively more expensive. Reflecting these factors, the worsening trade deficit has been a drag on economic growth, and given the strength of U.S. domestic demand this external softness has not been altogether a bad thing.

The adverse effects of international economic crises are beginning to wane, however. Our major trading partners - most European countries, Canada, and Mexico - are growing steadily. And, except for Japan, front-line Asian countries seem to be rebounding more or less nicely. The health of the Japanese economy continues to be a question mark despite some good news in the most recent statistics, but in general rising worldwide growth is expected. Recent increases in U.S. exports reflect this fact, as does a weaker dollar. Slowly, but surely, the external drag is likely to dwindle, with all that could imply for increased resource constraint.

Finally, the favorable commodity prices we enjoyed in the last several years due to slack conditions abroad are now in the process of unraveling. The major, though by no means the only example of this is oil. At year-end 1998, the price of crude petroleum was less than half what it was when the Asian crisis broke out in 1997. But since then the price has doubled and is now approaching 1996 levels. Where oil prices go from here is a matter of speculation, but wariness is clearly prudent. Other commodity prices, especially metals, are also rebounding toward pre-crisis rates of growth.

In sum, the domestic economy is very strong right now but not without important challenges. The major question is, "How long can it stay that way?" Part of the answer to that question involves how we react to the three fallacies I noted earlier.

First fallacy - inflation is dead. As tempting as this is to believe, and as apparent as it may seem in the data, I doubt it. 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, and rising prices, still makes sense.

How then can we explain why it is that labor markets have been extremely tight for some time now, but inflation has declined, not risen? I would argue that there are a number of reasons. First, some credit has to go to the credibility achieved by the Federal Reserve in its battle against inflation since the early 1980s. Expectations of inflation are low, as far as we can measure them, and these expectations feed back in beneficial ways to wage and price setting in the economy.

Second, in the early years of this expansion, growth was slower than during the typical recovery from recession. Arguably, this relatively slower growth and corporate restructuring helped hold down labor costs once unemployment rates began to fall. Also the growth of benefit costs, especially of the costs of medical benefits, slowed dramatically after the late 1980s 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. But growth in benefit costs has resumed rising the last two years, and this fall medical insurance companies are announcing unusually hefty premium increases for next year.

Finally, now that compensation growth has picked up somewhat, the prices of final goods have been kept low by several other temporary factors. 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. Certainly some of this productivity growth is related to capital deepening, particularly evidenced by recent growth in real spending on computing and telecommunications equipment at annual rates in excess of 35 percent. To the extent that such spending, combined with business restructuring and a sheer determination to do more without raising prices, has improved the structural rate of productivity growth in the U.S., the ability of the economy to grow rapidly without running into capacity constraints on resources has increased. This provides some insurance against inflation. But some of the recent pickup in productivity may simply reflect strong overall growth, and may be temporary. The $64,000 question right now is whether structural productivity change will continue to be an insurance policy against inflation as the economy slows, and as other temporary restraints on costs abate.

As I noted earlier, falling commodity prices had been helping to hold the rate of inflation down. However, the latest data show that commodity prices are rising again. If declining commodity prices contributed to declining inflation, rising commodity prices are likely to contribute to rising inflation. More and more manufacturers are reporting that they are paying higher prices for their input materials, and core producer prices contain inklings of upward pressures "in the pipeline".

If labor markets remain as tight as they are now, if productivity growth does not continue to accelerate, and if other costs continue to grow, 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.

And now the second fallacy - asset prices only go up. I'm sure I don't have to tell a group of New Englanders about the dangers of inflated asset prices! The 1990-91 recession lingers in our memory as proof of the dangers of asset price

inflation. Arguably, rising asset prices and the good feelings they generate can 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, are very high by historical standards. Moreover, after several years of strong rising corporate profits, profit growth rates slowed in 1998 and 1999. Although plausible arguments have been made as to why such high valuations are justified, the combination of historically high PE ratios and weaker profit growth raises the possibility of a decline in stock prices. Asset prices can't always go up, and a persistent decline or even leveling off could have consequences for the real economy.

Finally, there is the fallacy that the business cycle is a thing of the past. Don't bet on it. Certainly, recessions around the world last year demonstrated once again the potential vulnerability of market economies. This recovery started slowly, has gained sizeable momentum, and weathered a major international economic crisis. 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.

Such is not the traditional pattern, however. In recent decades, the growth phase of most business cycles has typically come to an end 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, have 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.

Looking forward, the domestic economy seems vigorous. Most forecasts, our own included, anticipate a small slowdown to a rate of GDP growth of 2.5 to 3 percent in 2000, down from the 3.5 pace of 1999. But we've been forecasting a slowdown for sometime now, and one has yet to occur. Financial markets, though volatile, continue to provide a basis for consumer confidence and spending and recent data show little slackening in this trend; businesses continue to invest in technology, and exports to a recovering and expanding world are on the rise. Clearly we are a long way away from the turmoil and anxiety of last fall, and monetary policy is less accommodative now than it was in the depths of the Asian crisis. But whether recent steps will be sufficient to avoid the problems of the past remains a question.

In closing, let me briefly discuss what some perceive as yet an additional risk. That is the challenge presented by the new millenium, its potential impact on computer systems worldwide, and, by extension, its impact on the U.S. economy.

By now, talk about a worst-case scenario of an economic meltdown with financial market collapse, bank runs, and widespread panic has, thankfully, subsided. Now, most of the discussion is about "timing effects" on the economy. By that I mean that the primary macroeconomic effect is likely to come from individuals and businesses buying more now (in 1999) and less later (in 2000).

As far as we can tell, to date households have been doing some stockpiling of goods and preparing for contingencies, and they are expected to do more as January 1 draws near. Businesses have been expected to build up inventory in response to this stockpiling, as well as hedging against last-minute buying sprees. Early next year, however, as households consume their stockpiles and buy less from businesses, any inventory buildup that occurred likely would diminish quickly.

In principle, this substitution of spending across time could make for choppy GDP growth. So far, however, the data show little evidence of a significant inventory buildup by businesses. Businesses seem to be growing increasingly confident that last-minute buying sprees will be modest. Consequently, the closer we get to 2000 the weaker it appears the effect of an inter-year spending shift will be on economic data. Recently, one out of four forecasters said they expect negative GDP growth in the first quarter of next year, but frankly I just don't see that as very likely. In fact, I am now quite 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 necessarily problem-free, but not a crisis either.

In closing, let me reiterate. The U.S. economy remains strong, reflecting a record combination of strong growth, low

unemployment and low inflation. Speaking for myself as a central banker, I'd like to see it stay that way, and avoid the excesses of "zeal and over confidence" that have ended so many expansion periods in recent U.S. history. To do this, caution and vigilance are necessary as is monetary policy that is oriented toward avoiding economic overshooting. But if we're careful, and lucky, both the U.S. and the world should enjoy very favorable economic growth as we enter the new millenium.

Related Links