Greater Manchester Chamber of Commerce Economic Forecast Luncheon

by Cathy E. Minehan, President & Chief Executive Officer
December 13, 1999

Good morning. It is a pleasure to be here in Manchester for your Chamber of Commerce luncheon. It is also great to be here at this time of year. The holidays provoke both reflections on the past, and anticipation of the future. They are a time to sit back and take stock of things. That is what I hope to do today in my comments -- take the pulse of the U.S. and regional economies, and reflect a bit on the forces that have taken us to what is, by nearly all measures, a very favorable economic position. Looking forward, we have the very keenly anticipated Y2K event facing us, and I'd like to close with a few words on that as well.

By most any measure the performance of the U.S. economy over the last years of this decade has been remarkable. Since 1995, GDP growth has averaged about 4 percent; over 13.6 million jobs have been created, and the unemployment rate has declined to a 30 year low of just over 4 percent. We are on the verge of the longest expansion in U.S. history. Real incomes have risen for everyone, and the gap between the bottom of the income distribution and the top, which widened in the '80s, has at least stopped growing. And most surprising of all is that this has occurred in an environment in which inflation has been very well-behaved, reaching very low levels last year, and even now with oil prices much higher, holding rather steady in the mid 2's over the past few months. The $64 million question for me right now is how long can this very favorable picture be sustained? The answer is important; if the economy can continue to grow without inflation, the progress that's been made in creating jobs and improving standards of living can be maintained. If inflation rises precipitously this progress is threatened.

To address this question of economic capacity for myself, I often think about the economy as a machine. Like any machine, it has an optimal running speed; too slow and it lugs along, performing inefficiently; too fast, and it overheats and ultimately breaks down. Similarly, if the economy is growing too slowly, resources are underutilized at a substantial cost in foregone income and employment. Alternatively, if the economy is growing too fast it can overheat; it can draw too strongly on available resources, thereby provoking an acceleration in prices. You can tell when the economy is running too slowly--unemployment is high, price pressures are low--and you can tell when it is running too fast--inflation grows at times in highly visible ways. One has only to remember the late '80s and the housing markets here in Manchester to know what it feels like when the economy is running too fast. The more difficult question is what is the optimal running rate for the economy and how do we know when we are there?

This is a very difficult question to answer, particularly since the economy can grow at very different speeds during the various phases of a business cycle. Coming out of a recession, the economy can grow very rapidly without experiencing any strain; there are plenty of workers to employ and lots of spare capacity. But as this capacity is used up, as more and more workers are absorbed, the economy eventually has to slow to "cruising speed"--or to use economic jargon--its potential rate of growth--if the signs of overheating--inflation in particular--are to be avoided.

How fast is this potential rate of growth? In concept, the answer to this question is simple. The economy's potential equals the sum of the growth in the labor force--that is the number of people who are able and ready to work--and the rate of growth in productivity--that is how labor, technology and capital work together. In reality, however, assessing the potential rate of economic growth is much more difficult. The problem is that both the growth in the labor force and productivity growth can change independently, and they can change with growth in the economy itself.

Growth in the labor force is largely driven by demographic factors--population growth and other factors affecting people's willingness to work. But if the economy is growing fast, and people perceive jobs as easy to get, they may

decide to work rather than stay at home or go to school. In recent years, however, the fraction of the population that has chosen to work--that is be in the labor force--has been pretty stable. So population growth has been the primary factor in labor force growth, and that's been running at 1% or so.

In the late '80s and early '90s, productivity growth--the other factor in our potential equation--also seemed to be running at about 1% or so, so the commonly held view was that the potential rate of economic growth was somewhere between 2 and 2-1/2 percent. If the economy ran below that rate for a significant period, resources would be underused again at a substantial cost; if it runs above that rate for a substantial period of time and inflation would rise.

But more recent economic performance has called into question this estimate of the economy's potential. Beginning in 1996, productivity growth picked up, and in the last four years it has averaged about 2-1/2 percent, with data for 1998 and 1999 even faster than that. A critical question is whether this pick up represents a permanent or structural increase in productivity, or whether it is cyclical--a function of the fact that the economy has been growing at the rapid pace of 4 percent or better over this period.

I like to think about this distinction between structural and cyclical productivity change by using an example from our own operations at the Boston Fed. As some of you know, on a daily basis, we process 2 million or so checks in Boston--an effort that is labor intensive and driven by very tight time frames. Over short periods of time, however, we can process many more checks if we have to, by working that much harder, and, literally, running cart loads of check bundles to the elevators to make the delivery deadlines. Obviously, productivity--the amount of work accomplished per hour--goes up. But this type of productivity increase is short-lived and brings with it the potential for control problems. It cannot be sustained without significant changes in technology or organizational infrastructure. Cyclical productivity change is running checks to the door; structural productivity change is getting them there on time in new and innovative ways.

So is the productivity growth the economy has witnessed since 1996 structural or cyclical? Is it a function of the enormous business investment we have seen, much of it in information technology? After all, annual real growth in spending on information processing equipment and software has averaged 21 percent since 1996. Or is it simply a reflection of the overall speed of the economy--everyone running their own version of checks to the door? The answer to this all-important question is not clear. Obviously much has changed in our economy due to technological innovation. One cannot escape the fact that information technology has and is likely to continue to have a powerful impact on business organization and efficiency as well. Many people believe that we have only begun to tap the potential of the new technologies and that the recent productivity boost is here to stay. They would argue that the rate of trend productivity growth might even continue to increase, a prediction that should, I think, be taken with great care.

However, even if one assumes that all the growth in average productivity since 1996 is structural, given the current very high rates of labor utilization there is a case to be made that the economy has been growing beyond what is sustainable. GDP growth has been 4 plus percent, not 3 plus; the unemployment rate has fallen over the past year, and labor markets continued to tighten. What we haven't yet seen is the pick up in inflation that would usually accompany such an extended period of high growth and resource utilization.

Why is this? Well, for one thing, our economic machine had been experiencing a series of factors that have acted to temporarily increase its capacity to grow without price pressures. World economic growth outside the U.S. had been slow, so capital had come here for investment opportunity and helped to finance the growing trade deficit. As a result, the dollar had been strong, which has kept import prices low and put pressures on U.S. producers to keep domestic prices low as well. Slow world demand for resources had kept commodity prices in check. Domestically, restructuring in the health care industry reduced the benefits portion of compensation growth.

But the effect of these temporary factors is now turning the other way. Health premiums are rising; commodity prices are picking up, especially prices for oil; Asia and the rest of the world are growing and demand for U.S. exports is strengthening. Other markets are increasingly attractive to investors throwing into question the sustainability of the large current account deficit. Those extra sources of capacity that helped our machine run for so long without overheating in the face of tight labor markets are diminishing. At the same time domestic demand remains strong fed by appreciating asset markets that arguably add to consumers' wealth and spending habits.

In this environment continuing to operate beyond potential carries increasing inflation risk, and risk that this long, benevolent period of U.S. economic growth will come to an end. Working in our favor are a number of things. First, we are running large budgetary surpluses at the federal, state and local levels. Second, there are strong creative and competitive forces at work in our economy. Third, the stance of monetary policy has firmed over recent months. And finally, there are very small recent signs of slowing in housing and durable goods markets. But monetary vigilance is necessary if we expect our economic machine to continue to cruise along rather than overheating.

Turning to the regional scene, we saw our local machine go through a period of overheating in the late '80s. And we also saw the economic hardship that can result from that overheating. So the major question for the region is how different is our current pace of expansion from that of the late '80s.

Answering that question ends us being pretty interesting. Like the end of the '80s, unemployment rates in New England are very low, with the region's jobless rate lower than the nation's for more than the past four years. New Hampshire's unemployment rate has been consistently at the low end of the region's, and more than a percentage point below the national rate for most of the last six years. Some of this is because the region's labor force--including New Hampshire's--grows more slowly than the nation because of a variety of demographic and immigration trends. Thus, when the regional economic machine is humming, as it has been, there are fewer new workers to turn to. With joblessness this low, almost all the people who want a job have one, and it has become extremely difficult for employers to find workers of any sort. Indeed, there have been concerns that regional growth is being constrained by the lack of workers and that wages and prices will rise more here, as they did in the late '80s.

One area where the region's recent history would teach us to regard with most caution is growth in construction jobs and the related area of real estate prices. In the late '80s, everyone who could became a construction worker or a real estate agent, masking real difficulties in the region's manufacturing base. Today, construction job growth is rising, as are real estate prices. The big difference between then and now is that these increases are not out of line with those for the nation as a whole, nor is our pattern of job growth in the manufacturing area. Indeed, despite the Big Dig down in Boston, and the fact that construction job growth has outpaced that of most other industries recently, total construction employment levels today are only about two-thirds to three-quarters of their 1988 peak. Similarly, manufacturing job losses in the region track national patterns, and reflect both continuing growth in manufacturing efficiency as well as specific shared problems most notably the Asian crisis. Today the diversity of regional service and manufacturing businesses, unlike the '80s, and similar to the nation, is a real strength.

During the l980's boom the New England economy was definitely overheating, while the national economic machine cruised at a more moderate pace. By contrast, today both the region and the nation are experiencing the same trends--strong growth, low unemployment and as yet few price pressures. And our vulnerabilities are similar--the pressures brought about by a diminishing supply of capacity, especially labor shortages. Thus, to forecast the region, focus on the nation. In that regard, as I look forward, I believe the chances are good for continuing favorable growth rates with some slowing from the current four percent pace, due both to tighter monetary policy and to natural slowing given the age of this economic expansion. Inflation risks remain, and vigilance is certainly necessary, but overall prospects both nationally and regionally seem solid. Our machine may have to slip back a gear or two, but chances are good it won't come to a halt.

Things aren't likely to come to a halt 18 days from now as we move from this century to the next either. All of us in the Federal Reserve System, like all of you, have had Y2K preparations squarely on our radar screen for some time now. We have worked hard to ensure all of our own systems are ready--which is important considering that these systems process or settle for more than $2 trillion a day. And we have worked to ensure that the systems of depository institutions that interface with us are ready as well. Together with the other federal regulators, we have examined every depository institution for Y2K readiness, and the system is ready to go. We have developed contingency scenarios; and practiced ways to manage the actual event. We've set in place processes so that liquidity will be available, in the form of cash for individual consumers and in the form of market liquidity through the discount window and the open market desk. In short, I believe we're as ready as we can be, and while there will undoubtedly be glitches in both the domestic and international financial arenas, I think they will be short-lived and not likely to bring with them systemic concerns.

In sum, this holiday pause for reflection should leave us all feeling pretty upbeat. The national and regional economic

machines are running at top speed; there is some risk of overheating, but care and careful taps on the brakes may, if we are vigilent enough, be sufficient to keep us on course at least in the short run. Even Y2K, a source of concern and media hype earlier this year, will, I think, be just another milestone by this time next month. Usually central bankers are thought of in terms similar to the "Grinch that Stole Christmas". Clearly, that is not the essence of my message today. Thank you.

Related Links