Connecticut Business and Industry Association Economic Summit and Outlook

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Good morning. It is a pleasure to be here once again at the annual economic summit and outlook to help the CBIA and the Metro Hartford Chamber of Commerce and all of you get a head start on the new year. I'd also like to be among the first to congratulate the as yet undisclosed winners of the Chamber's PRIDE Award for companies that have excelled in community and employee involvement and in innovation and quality. These corporate attributes are vital to success in our increasingly competitive business scene.

Well, we made it! With relatively few glitches locally, nationally or internationally we survived the long awaited and, for some, dreaded transition to the year 2000. I know I am not alone in this gathering in having spent most of the last weekend either on the phone, or in my office monitoring events as they occurred. And I also know I am not alone in this room in having spent a lot of time over the last couple of years overseeing Y2K preparations and making sure, as far as it could be done, that the rollover to the new century would be as smooth as possible. Failure to meet the Y2K challenge was simply not an option, given the computer dependent nature of our businesses and the U.S. economy and the importance of that economy not missing a beat.

Yet many in the United States had barely opened their eyes on New Years Day and U. S. financial markets were still more than 24 hours away from opening, when some were already questioning whether the time and effort spent on Y2K readiness had been worthwhile. Nothing truly bad happened-the lights stayed on, airplanes flew, phones worked, streetlights gleamed, hospitals stayed in business. Was the effort necessary or was it just hype?

To me, anyway, this is similar to asking a parent whether a vaccination against a disease was worth the time and money? Of course it was. Without the "vaccination" of Y2K preparedness, many aspects of life over the past weekend, and this week and beyond would have been vastly different. Let me give you just two examples from a Reserve Bank perspective. The first relates to the availability of cash for consumers worried about Y2K problems. All of you probably know that Reserve Banks spent a lot of effort accumulating cash in their own vaults, encouraging commercial banks to add to cash resources, and locating cash in off-site secure inventory locations so that no depository institution in the United States would be more than eight hours driving time from a supply of cash if needed.

In addition, many of us talked about cash availability publicly even when some tried to say that speaking out only highlighted the potential for problems. But we were confident that if U.S. consumers knew that cash was available if they wanted it, their fears would subside. Sure enough, as we commissioned public opinion polls throughout the year, we found that the more knowledgeable people became the less concerned they were.

As it turned out, we didn't need to use the cash in the emergency locations and most banks will be returning their unused supplies to us still in the sealed packages in which they received it. For the Reserve Banks, both the processes of getting the cash out and taking it back in involved some costs, though they were relatively modest. Commercial banks, of course, handled the cash at a considerable inconvenience and expense to themselves, and we commend them for doing so. But if together we hadn't done this, consumers would have been more nervous and exactly the reaction we worked to prevent-large precautionary withdrawals of cash with related serious risks to depositors-would have happened.

Let's take another example-electronic deposits to people's accounts through the automated clearing house or ACH. January 3 was a social security payment date-nearly 33 million Americans were scheduled to receive a social security payment through direct deposit to their bank on that date. The flow of these ACH payments, which totaled almost $22 billion, required that the Social Security Administration, the U.S. Treasury, the Reserve Banks, and individual depository institutions all be Y2K compliant. Based on Social Security's records, the Treasury had to create the payment for each individual recipient and send a file of these payments to the Reserve Banks for handling. The Reserve Banks delivered these payments to depository institutions, or their processing service bureaus, for deposit to customer accounts.

As the "middle man" in this payments flow, Reserve Banks made software changes to our own applications and tested repeatedly with the Treasury to ensure that payments could be created with correct dates, and transmitted properly. Reserve Banks also tested several times with virtually every depository institution in the country to make certain that those institutions could make and receive payments, particularly those initiated in 1999 but settled in 2000. We even went so far as to offer low-cost, used PCs to institutions whose own equipment would not operate in the year 2000, and eighty-seven of these PCs were placed in New England depository institutions alone.

Through testing, we found that even if the Treasury could have created a social security file with a year 2000 date, our own systems would not have processed the file correctly-it would have been rejected as an error. So, was the Y2K remediation cost necessary? Did 33 million social security recipients need their money on January 3? The answer to both these questions in my view in undeniably yes.

In total, we estimate Reserve Banks will have spent about $125 million over three years getting ready for Y2K. Most of this expenditure involves the cost of existing staff working on Y2K instead of other projects. They will soon be hard at work completing the efforts set aside while Y2K was being addressed. Other costs largely relate to hardware and software that would have been purchased over time in any event; these acquisitions served to bring Reserve Bank systems to a state of simultaneous readiness that is beneficial in and of itself.

In fact, we have only begun to document all the benefits of having focused so much time and effort on Y2K. These benefits will be long lasting, in my view. They occur in four areas. First, our systems are now both better documented and stronger. We have a much more in-depth understanding of each system, all its components and its processing timeframes and deadlines. This expanded inventory will be invaluable in planning new systems, and dealing with future operational problems. Moreover, the opportunity to upgrade systems more or less simultaneously as I noted before, has resulted in better, more productive overall platforms on which to build in the future.

Second, our Bankwide contingency plans have been thoroughly updated and tested in ways never done before. This can only help us in future challenges. Third, we have created a cadre of staff with a broad-based understanding of each area of the Bank, how those areas work together, and what their importance is both internally in the Federal Reserve System and externally. Finally, the "esprit de corps" that developed among the staff in the Bank, and between our Bank and the banks and other businesses here in New England as we all worked together to ensure the worst of Y2K would never happen was remarkable. In many ways, it was a management development experience without parallel.

In sum, Y2K was a necessary job, and it appears to have been a job well done. There were few problems of any note, not because the task was trivial, but because so much hard work and dedication went into ensuring problems would not occur. In many ways, the response to the Y2K challenge reflected the best of industry and government both here at home and worldwide, and I, for one, believe we will benefit from our efforts for some time to come. Finally, I have never subscribed to the belief that Y2K would be a major factor creating swings in economic growth between 1999 and 2000, and I think events are proving this to be the case. In particular, the so-called Y2K shut-down on electronic equipment orders in the fourth quarter, or the widely expected build-up of inventory more generally simply haven't happened.

So Y2K is largely behind us. We can now turn with a clear eye to the new year, the new century and even a new millennium-though I recognize we won't actually be there until 2001. In that regard, I thought I would share some perspectives with you on where we've been, and where we might go in the regional and national economy.

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. 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 in 1998. Even now, with oil prices much higher, inflation is holding rather steady in the mid 2's. The $64 million question for me 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 New England 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. In recent years, 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 ran above that rate for a substantial period of time 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 growth is running checks to the door; structural productivity growth 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 and commodity prices are picking up, especially prices for oil. Asia and the rest of the world are growing. Demand for U.S. exports is strengthening bringing U.S. manufacturing increasingly back to a position of strength. 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 quite strong fed by appreciating though volatile 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 in addressing these risks are a number of things. First, we are running large budgetary surpluses at the federal, state and local levels. Second, there continue to be strong creative and competitive forces at work in our economy; everywhere I go, I hear about the lack of pricing power. Third, the stance of monetary policy has firmed over recent months and that has not yet had time to fully kick in. And finally, there are very small recent signs of slowing in interest sensitive markets though these are far from a trend. But, in my view, monetary vigilance will continue to be crucial 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 one question for the region is how different is our current pace of expansion from that of the late '80s. As it turns out, while things look similar, they really are quite different.

Like the end of the '80s, unemployment rates in New England are very low. Some of this is because the region's labor force--including Connecticut's--grows more slowly than the nation's 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. This can cause wages to rise fairly rapidly, as they did in the '80s. However, we don't see that

currently, for many of the reasons that apply nationally.

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, however, while construction job growth is rising, as are real estate prices, 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 in Boston, and lots of other business and residential construction, total employment levels in this industry 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 1980'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 wage or 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 reasonable for continuing favorable growth rates with some slowing from the current four plus percent pace, due both to tighter monetary policy and to natural slowing given the age of this economic expansion. Risks remain, and monetary vigilance is absolutely necessary, but overall prospects both nationally and regionally seem solid. Our machine may have to slip back a gear or two, but chances are reasonable it won't come to a halt.

In sum, we should be feeling pretty upbeat. Even Y2K, a source of concern and media hype earlier this year has come and gone, leaving us with a legacy of better systems, better contingency backup, and more knowledgeable staffs. What better way to start the new year.

Thank you.

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