Greater Providence Chamber of Commerce Business Expo 2000

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It is a great pleasure to join you today for the Greater Providence Chamber of Commerce's Economic Outlook Lunch. Trying to discern the future is surely one of the greatest challenges any business leader or policymaker faces. And it is perhaps an even greater challenge when things are at a relative high point, as they are right now. It is tempting to extrapolate forward from all the good news of the past half decade, but, in my view, it would be foolhardy to do so. Instead, we must focus our thoughts on the forces that hold the potential to change the direction of the economy and assess how we can address them.

By almost any measure, a review of our recent past is highly encouraging. The performance of the U.S. economy over the past four years has been extraordinary. Since 1996, GDP growth has averaged an exceptionally strong 4-plus percent; over 8 million jobs have been created, and the unemployment rate has declined to 30-year lows. In February, the current expansion became the longest in U.S. history. Most people are enjoying rising real incomes, and the gap between the bottom and top of the income distribution, which grew in the '80s, has stopped widening.

Most remarkable of all, during this long, vigorous expansion, inflation has remained very well behaved, with core inflation (excluding volatile food and energy prices) averaging close to 2 percent for the last two years. Of course, with oil prices having tripled from unusually low levels early last year, the total CPI has risen somewhat faster in recent months.

So now, the $64-billion or possibly -trillion question is how long can this favorable combination last? Is the recent spike in oil prices a symptom of growing imbalances between supply and demand? Or will the factors that have allowed rapid growth and moderate inflation to last for five years continue to prevail? The answer is important, for if the economy can go on growing without rising inflation, we can continue to create new jobs and improve standards of living. But if inflation rises sharply, this progress will be threatened. So, today I plan to consider whether the factors that have made this good performance possible show signs of abating. I will also point to some symptoms of growing imbalance that warn against taking the good times for granted.

To explain our recent record of modest inflation in a lengthening period of strong domestic demand, analysts have pointed to three developments: 1) the deceleration in the growth of the cost of employee benefits; 2) the months of slow world growth and dollar strength that followed the Asian crisis; and 3) a new four-year spurt in U.S. productivity growth. To start with employee benefits, reflecting the advent of managed care and increased competition in the health care industry, the rise in benefits costs fell from 9 percent a year in the early '90s to 2 percent in 1997 and '98. But, for now, the good news on health care costs seems to be over. Last year, benefits costs grew 3 percent and anecdotal reports suggest that health care costs in 2000 are poised for further acceleration.

As for the impact of the Asian crisis, weak foreign currencies and weak foreign demand led to declines in prices for commodities and other imports used by U.S. producers. Most notably, by early 1999, in real, inflation-adjusted terms, oil prices had fallen to their lowest levels since the early 1970s. But the impact of the crisis was far broader, as increased competition from overseas pushed some U.S. producers to curb or cut domestic prices as well. Now, however, most of our major trading partners have resumed vigorous growth -- some are already facing capacity constraints -- and month by month, forecasters are boosting their estimates for this year's foreign GDP. Thus, prices for imported goods have started rising, and a second restraint on U.S. inflation is weakening.

What about the third factor, the recent improvement in the growth in U.S. productivity, or output per hour worked? Is this pickup also likely to be temporary or does it herald a lasting increase in U.S. potential growth -- the average pace at which the U.S. economy can grow over the long run without triggering a surge in inflation?

In thinking about the economy's capacity for sustained, non-inflationary growth, I like to picture 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 overheats, running into resource constraints and provoking inflation. You can tell when the economy is running much too slowly--unemployment is high, price pressures are low-and, eventually, you can tell when it has been running way too fast--inflation picks up and becomes widespread. The more difficult question is, what is the optimal running rate for the economy, and how quickly can we tell if it has changed?

These are hard questions to answer, particularly since the economy can safely grow at very different speeds during the various phases of a business cycle. Coming out of a recession, the economy can run fast without strain since workers are plentiful and spare capacity abounds. But as excess capacity and unemployed workers are absorbed, the economy eventually has to slow to its optimal or potential rate of growth--if overheating is to be avoided.

How fast is this potential rate of growth? In concept, the answer is simple. Potential growth equals the sum of the growth in the labor force--that is, the growth in the number of people able and ready to work--and the rate of growth in productivity -- or output per hour. In reality, however, assessing the potential rate of growth is not easy. The main problem is that while growth in productivity may reflect structural changes in the economy, it also tends to accelerate or decelerate with the pace of overall economic growth. Disentangling cyclical and structural influences is extremely hard.

Largely reflecting demographic factors, labor force growth has averaged 1 percent per year for some time. In the late '80s and early '90s productivity growth -- the other factor determining potential -- also seemed to be running at 1 percent a year; thus, at that time the consensus view held that our potential, sustainable rate of economic growth was somewhere between 2 and 2-1/2 percent. But revised data and our recent economic performance have called this estimate of the economy's potential into question. In 1996, productivity growth picked up, and over the last four years it has averaged over 2-1/2 percent, with the figures for 1998 and 1999 even higher. Does this pickup represent a structural, and thus more lasting, increase in productivity growth, or is it merely cyclical--a function of our unusually rapid 4-plus percent output growth over this period?

I like to visualize this distinction between structural and cyclical productivity growth by thinking of our own operations at the Boston Fed. As some of you may know, on a daily basis, we process 2 million or so checks in Boston under tight time constraints. Over short periods, we can process many more checks if we have to, by working harder, and, literally, running cart loads of checks to the elevators to make the delivery deadlines. Obviously, productivity--the amount of work done in an hour--goes up. But this type of productivity increase is short-lived and brings potential control problems. The gain is not sustainable without some technological or organizational change. So, for me, cyclical productivity growth is running the checks to the door; structural productivity growth is getting more checks delivered on time by doing things in new, more technologically sophisticated ways.

Is the recent rise in productivity growth structural or cyclical? Does it represent the return on our enormous capital investments in information technology? After all, real spending on information processing equipment and software has grown over 20 percent a year on average since 1996. Or does it simply reflect our rapid economic growth -- with everyone relying on their own form of running the checks to the door? The answer to this all-important question is not clear. Obviously, information technology is spurring major changes in the way business is organized; it is clearly producing efficiency gains as well. Indeed, we may have just begun to tap the potential of these new technologies and the recent pickup in productivity growth may be here to stay. Some would even argue that the rate of productivity growth could continue to rise indefinitely, a prediction that should, I think, be viewed as premature. And, after bowing in the direction of the "New Economy," I should also point out that it is possible to interpret the recent increase in productivity growth as largely cyclical, and thus temporary.

But even assuming that all of the rise in productivity growth since 1996 has been structural, given our high rates of labor

force use, it seems likely that the economy has been growing faster than its sustainable pace. GDP growth has been averaging 4-plus, not 3-plus, percent. And over the two most recent quarters, the rate of GDP growth has actually topped a scorching 6 percent.

To date, as you know, signs of the pickup in inflation that would usually accompany such a long period of rapid growth have been scant. Naturally, the tripling in the nominal price of oil has fed into the overall consumer and producer price indexes. But energy has a small and shrinking weight in our economy. Currently, energy costs account for just 7 percent of the total CPI. And thanks to our increased energy efficiency, the economy's energy dependence-the amount of energy required to produce each dollar of real GDP-has fallen almost in half since the early 1970s. Another way to assess the impact of the recent run up in oil prices is to note that while the current nominal price of oil is not far from the peaks of the '70s, the "real" cost-adjusted for inflation over the period-is about one-third. Both of these facts-the reduced sensitivity of the economy to oil prices and the lower real oil price-lead most analysts to believe the impact of high oil prices on our economy will not be great; especially if such increases are also short-lived.

Of course, New England is much more dependent on oil than is the nation. For instance, while the nation gets just 3 percent of its electricity from oil-fired generating plants, in this region, the share is more like one-third. But given the oil exporters' recent decision to increase production, oil prices should be at more comfortable levels by late summer, and their impact on inflation even here in the region should dwindle. Beyond oil, signs of a possible pickup in inflation are confined to the early stages of production - crude and intermediate materials - and to consumer services, a part of the economy that is relatively shielded from international trade. Producers of finished goods further up the supply chain still claim that they have limited ability to raise prices.

Nevertheless, just when some of the factors that have been damping down inflation -- like subdued health care costs and weak foreign demand -- are losing force, other signs that our economic machine may be running too hot are beginning to accumulate. The labor market is increasingly tight; the rapid growth in wealth relative to income is encouraging consumption and discouraging other savings; and the U.S. balance of payments deficit is reaching new and possibly unsustainable heights relative to GDP.

To start with the labor market, as you must be acutely aware, the unemployment rate has continued to edge down over the past year to hit a 30-year low. Here in Rhode Island and in Massachusetts, unemployment rates are well below the 4.1 percent national average. Further, two additional pools of available workers, individuals who say they would like a job but are not actively looking and individuals who are working part-time and would like to work more hours, are shrinking even faster than the pool of the unemployed. In addition, the share of the population aged 16 and older that is in the labor force, working or ready to work, has inched higher during the '90s, recently reaching an all-time high. Since we are in uncharted territory, we really don't know the upper limit on the labor force participation rate. But labor markets are clearly tight when the AFL-CIO officially embraces a positive stance on immigration and when one of our manufacturing contacts reports that an agency hired to help with recruiting began stealing the client's workers.

While strong employment gains have clearly boosted consumer confidence and spending, so too has a decade of large gains in financial wealth. Wealth in the form of corporate equities has risen from 50 percent of income in 1990 to 140 percent of income by 1998. Gains in housing prices, though much more moderate than equity prices or than their own record in the late 1980s, have also begun to accelerate in the past two years. Here in New England housing prices have risen somewhat faster than in the rest of the country, although this difference is small compared to the one that existed in the 1980s.

Buoyant asset markets clearly have helped propel consumption. Further, as wealth has risen sharply relative to income, the personal savings rate has fallen to a current all-time low of less than 1 percent of disposable income and consumer debt has risen rapidly.

A closely related symptom of overheating is this country's record-high balance of payments deficit relative to GDP. The U.S. current account deficit, the broadest measure of the balance of payments, worsened by over $100 billion last year and reached 4.2 percent of GDP in the fourth quarter. The ratio is expected to rise even higher this year. A U.S. balance of payments deficit indicates that this country is consuming more than it produces, and that it is importing the goods and services needed to fill the gap.

Since foreigners must be willing to lend us the funds to pay for our net imports, a U.S. deficit is sustainable only for as long as foreign investors want to hold U.S. assets. In recent years, with growth robust in this country and subdued overseas, foreigners have eagerly flocked to U.S. investments. But, as overseas growth prospects improve, foreigners may be less eager to hold dollars and dollar-denominated assets. Most likely, given the expected pickup in foreign demand, the U.S. trade balance will show a gradual improvement over the next year or two. But our rapid growth, our relatively big appetite for imports, and our low savings rate leave us open to a more abrupt correction.

So far I have suggested that two of the factors that have helped to moderate inflation -- health care costs and import prices -- are showing signs of reversing, and that it may be too early to assume that the third, a continuing increase in productivity growth, is here to stay. Meanwhile, other symptoms of imbalance between the forces of supply and demand -- ever-tighter labor markets, the decline in our savings rate, and soaring consumer debt as well as our worsening current account deficit -- are continuing to accumulate. In the end, we may discover that these trends are readily sustainable, but at this point we cannot be certain of that outcome, and history suggests caution.

In the context of monetary policy, caution involves trying to recognize early symptoms of excess demand or excess supply and setting monetary conditions to keep such imbalances from reaching the point where abrupt correction is likely. Accordingly, faced with growing imbalances, since last June the FOMC has raised the fed funds rate in five 25-basis-point steps to 6 percent. The first three increases simply reversed the cuts made in the fall of 1998 to counter the threat of a serious liquidity shortage here and abroad; the remaining two were made in the face of booming domestic demand and dwindling supply.

To date, the evidence that these increases are having an impact is scattered and modest. While several indicators, including employment, retail sales ex autos, consumer sentiment, and building permits, have weakened a bit in the past month or two, the January-February average typically remains quite strong. For example, orders for nondefense capital goods, excluding aircraft, have recorded a relatively sharp slowdown, declining over 7 percent in February; yet, the January-February average for these orders was over 5 percent above the fourth-quarter level. Still, as you know, monetary policy operates with a time delay. Thus, it seems far too soon to say, as have some have suggested, that the New Economy is immune to monetary tightening. After all, the New Economy must do business with the whole economy, including its most interest-sensitive parts.

All in all, then, U.S. economic growth should and most likely will slow modestly to a more sustainable pace over the course of the year. Nevertheless, with some of the factors that have recently restrained inflation reversing direction, core inflation could edge a bit higher. Moreover, as long as we must accept uncertainty, not knowing whether or when the increasing imbalances in our labor markets, our trade balance, and our savings/investment ratio might turn unsustainable, policymakers must stand ready to encourage moderation.

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