

The Canadian Investment Fund CEO Conference

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**Vanderbilt Hall,
Newport, Rhode Island**

April 26, 2000

It is a great pleasure to join you. I'm going to focus the majority of my remarks this evening on the current state of the U.S. economy, and the variety of risks it faces. I do so recognizing that all of you are Canadian—but that most of your mutual funds have substantial U.S. holdings. Moreover, the Canadian and the U.S. economies now are performing in quite similar ways, with similar risks and uncertainties. That should be helpful as we assess things together.

By almost any measure, a review of the U.S. economy's recent past is highly encouraging. Its performance over the past four years has been extraordinary. Since 1996, GDP growth has averaged an exceptionally strong 4-plus percent; over 9 million jobs have been created, and the unemployment rate has declined to a 30-year low. 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 fifth of the family 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. This bears some watching, however, and not solely because of the feedback from the tripling of oil prices from their usually low levels of last year. Recent increases in core CPI, though relatively new, may be the harbinger of problems, as I'll discuss more later.

But now, the \$64-billion or possibly -trillion question is how long can this favorable combination in both our countries last? Will the obvious imbalance between domestic supply and demand ensure an upward surge in prices? 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, it can continue to create new jobs and improve standards of living. But if inflation rises sharply, this progress will be threatened. So, tonight 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 this country's recent record of modest inflation in a lengthening period of strong domestic demand, analysts have pointed to three developments. First, the deceleration in the cost of medical benefits paid by employers in the wake of the restructuring of the U.S. health care industry. Second, following the Asian crisis, the slow world growth and dollar strength which dampened demand for exports and reduced import prices. And third, a spurt in U.S. productivity growth over the past 4 years.

The trend in employee health benefits reflects the advent of managed care and increased competition in the health care industry. Health care costs fell from 9 percent a year in the early '90s to 2 percent in 1997 and '98. But the good news on health care costs seems to be over. Last year, total benefits costs grew more than 3 percent, propelled by a 5 percent increase in employer-paid medical benefits. Anecdotal reports, as well as recent CPI data, 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 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, like Canada, are already facing tightening 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? Is this pickup also likely to be temporary or does it herald further increases 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 it 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. If the economy is growing too slowly, resources become underutilized, at a substantial cost in foregone income and employment. And if the economy is growing too fast, it will eventually run into resource constraints and overheat; at that point inflation begins to rise.

Of course, there are times when the economy operates at very high speeds without a problem. 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 do we know when the economy is running at a speed other than its potential? Certainly, it is easy to tell when the economy is running much too slowly--unemployment increases,

and growth is slow. It is also clear when the economy is running way too fast—resource constraints begin to bite and inflation picks up.

The issue is knowing exactly what the optimal running rate is. What is our current best guess of this 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. 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 grow at very different speeds during the various phases of a business cycle. It tends to accelerate or decelerate with the pace of overall economic activity. Thus, disentangling cyclical and structural influences is extremely difficult.

Largely reflecting demographic factors, labor force growth has averaged slightly above 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 about

1 percent a year; thus, at that time the consensus view held that the U.S. sustainable rate of noninflationary economic growth was somewhere between 2 and 2-1/2 percent. But revised data and the economy's 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 the economy's unusually rapid 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. 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 will continue to rise, 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 the unemployment rate has declined. And over the two most recent quarters for which we have data, the rate of GDP growth has actually averaged a scorching 6 1/2 percent.

To date, signs of the pickup in inflation that would usually accompany such a long period of rapid growth have been slow in coming, but this may be changing—and not solely from the source you might expect, rising oil prices. 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 the U.S. economy. Currently, energy costs account for just 7 percent of the total CPI. And thanks to 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. Oil prices themselves, while at their recent peak not far from the highs of the '70s on a nominal basis, are only about one-third as high when adjusted for inflation over the period. Both of these facts—the reduced sensitivity of the economy to oil prices and the lower real oil price—lead me to believe that the impact of oil prices on the U.S. economy will not be great, especially now that such price increases seem short-lived.

Beyond oil, however, signs of a possible pickup in inflation have recently become a bit more evident. March price data showed an uptick in the core data, and while it's hard to make anything out of one month's data, this does tend to confirm price pressures in expected, non-oil areas. In particular, inflation in both health care and shelter cost is rising, as are service costs more broadly. Core goods prices still remain subject to strong

competition from imports, but non-oil import prices themselves are now rising, likely reflecting an increase in foreign demand. Finally, there are signs that executives in many industries expect their own prices to increase in the next quarter, signaling that there may be some diminution in the pricing power constraints of earlier months and years. I don't think the change will be swift or dramatic, but it seems clear that the days of declining inflation growth are behind us. Moreover, other signs the economic machine is running too hot are accumulating. The U.S. labor market is increasingly tight; the rapid growth in wealth relative to income that comes from surging asset markets 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, the unemployment rate has continued to edge down over the past year to hit a 30-year low. One question to ask is how much lower can it go. Labor force participation rates are at an all time high, and pools of available workers currently not in the labor force are shrinking faster than

the pool of the unemployed. But, moreover, labor markets are clearly tight when the AFL-CIO officially embraces a positive stance on immigration and when one of the Bank's 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—in both of our countries, I should note. Here, wealth in the form of corporate equities has risen from 76 percent of income in 1990 to 266 percent of income by 1999. 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. Buoyant asset markets clearly have helped propel consumption. Further, as wealth has risen sharply relative to income, the U.S. 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.

Another 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. This country is spending more than it produces, and it must import the goods and services needed to fill the gap.

Since foreigners must be willing to lend us the funds to pay for 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, others 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. Indeed, U.S. export growth has been quite healthy. But this country's rapid growth, its relatively big appetite for imports, and its 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 the U.S. personal savings rate, and soaring consumer debt as well as the worsening current account deficit -- are continuing to accumulate. In the end, it may be 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.

Will this be enough? That's anyone's guess right now, but a lot will depend on how soon signs of diminishing demand appear. So far they have been slight, and the recent uptick in price data could indicate building problems. In both of our countries, vigilance against inflation has had many beneficial effects, not the least of which is an environment in which productivity improving investment is rewarded. I, for one, believe that vigilance now is ever more important. Thank you.