1998 Economic Outlook

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We have just finished an extraordinary year. The nation's economy grew at a rapid rate last year, keeping this economic expansion going for a seventh straight year. With strong growth, the unemployment rate fell to 4.7 percent, its lowest level in 24 years. And all of this was accomplished without a resurgence in inflation. In fact, consumer price inflation slowed to a little less than 2 percent last year, after rising over 3 percent in 1996.

The Philadelphia region shared in this good fortune, as job growth continued and our metropolitan area's unemployment rate fell to about the national average. Here along the suburban Main Line, job growth has been even stronger and the unemployment rate has reached even lower levels.

Yet as we begin 1998, the risks facing the economy are more balanced and less one-sided than a year ago. Last year the primary focus was on the possibility of too rapid growth that could lead to overheating of the economy. Today, there is less concern that overheating will occur. In fact, downside risks to the economy loom much larger in the period ahead than they have for the past two years. And in a testimony to the growing globalization of our economy, the concern about downside risks to our nation's economy stems not so much from domestic developments, but more from international ones. Specifically, the economic situation in Asia has raised the possibility of a weakening of the pace of economic growth in the US this year.

The Nation

The Asian situation will affect the US economy in several ways. Some are more clear than others. For instance, since over 25 percent of our nation's exports are to Asia, the expected slump in many Asian economies this year is going to translate into fewer shipments of our goods to that region of the world. On the other side of the trade coin, the decline in the value of many Asian currencies against the dollar means that Asian goods will look quite cheap to US consumers, and that will tend to increase our imports of those goods. At the same time, lower import prices will reduce the prices paid by US consumers for such products or for similar goods produced by US firms. The result will be both lower net exports, which will translate into slower growth in the US, and less consumer price inflation. We have already begun to see declines in the prices of some internationally traded goods because of the Asian situation.

A potential, but less clear, impact of the Asian situation involves whether problems in Asia spread to other developing nations, such as those in Latin America and Eastern Europe. So far the impact of Asia's problems on other developing countries has been quite limited. And if that continues to be the case, the impact on the US will also be modest. But if more substantial adverse effects spread to other developing countries that are major markets for US exports, the adverse effect on our trade sector will be that much larger, and the depressing effect on US growth in 1998 could become more significant. Fortunately, such a scenario seems unlikely at this point.

On the basis of what we know now about the likely decline in US net exports, the nation's economy, while continuing to operate at a high level, is likely to grow more slowly in 1998 than it did last year. More specifically, I believe the nation's economy is entering 1998 with a fair amount of momentum that will keep this year's pace of economic growth at a moderate rate of around 2.5 percent, with the unemployment rate remaining between 4.5 and 5 percent.

Reductions in import prices, however, along with the recent reductions in the price of oil on world markets, are likely to help keep consumer price inflation at around 2 percent or a little less this year. This represents the lowest annual level of inflation we have seen since 1986, when a sharp decline in oil prices kept consumer price inflation between 1 and 1-1/2 percent.

Despite the tightness of labor markets and the recent increases in average hourly earnings, I have been impressed by how businesses have found a variety of ways to improve productivity and keep their unit labor costs down. And I have also been impressed by how rapidly businesses have been expanding their effective capacity, so that capacity utilization rates in industry are now generally lower than they were three years ago. The deceleration of consumer price inflation during the past year has helped to keep the longer-run average inflation rate during this business cycle expansion at about 2.7 percent -- the lowest cyclical level of inflation since the long business expansion of the 1960s.

As I have said many times, monetary policy's primary long-run objective is to pursue price stability as a means of fostering maximum sustainable economic and job growth. Doing so helps ensure that living standards improve over time. Maintaining an environment of stable prices means that there is so little inflation that expectations about inflation do not have a significant influence on the decisions of households or businesses.

On the basis of our experience last year and the outlook for inflation this year, I suspect we are very close to achieving this primary objective of monetary policy. But that ought not make us complacent about the risks of a resurgence of inflation. Certainly there are downside risks to the economy this year. But significant upside risks remain as well. Whenever the economy is operating as close to full capacity of its labor and industrial resources as it has been recently, any sharp rise in aggregate demand is likely to lead to a resurgence of inflationary pressures. So we must remain on guard against inflation as well as be watchful for signs that problems in Asia are leading to a more severe slowing of the US economy. Both inflation and deflation are undesirable and we must guard against both.

Good economic policies have helped us achieve the strong economic results we have been enjoying this past year, and we must continue making good economic policy to keep the economy strong. By that I don't mean just good monetary policy. We have also had widespread deregulation of various industries that has spurred competition and helped reduce prices to consumers and costs to businesses. And we have had much improved fiscal policy that has restrained federal spending and reduced the budget deficit. Last year the country began to address the longer-term federal budget deficit by passing the Balanced Budget Act. In fact, with federal tax receipts continuing to exceed expectations during the past few quarters, we may very well see a slight federal budget surplus this year -- four years ahead of the targeted surplus in the year 2002! Just as monetary policy ought not reflect complacency about our success in restraining inflation, fiscal policy ought not reflect complacency about fiscal discipline. We still have several major, long-term budget issues to address -- such as Social Security and Medicare financing -- and looking for ways to spend this year's possible surplus may be misguided.

The Region

Just as we can't become complacent about the nation's economic policies, we can't afford to become complacent about the region's either. Yet we certainly enjoy a much stronger economic environment as we enter 1998 than we have had for a long time. The Greater Philadelphia region has become better positioned to compete for businesses and jobs during the past year. We have been helped, of course, by the long national economic expansion. Our region needed a long economic expansion in order to catch up with the rest of the country. During the past year we have done much better at doing so as our region's unemployment rate is now close to the nation's.

Our region has also been helped by state and local efforts to make both the state of Pennsylvania and the Philadelphia area more business-friendly. Because of efforts to reduce regulations and taxes, we are now better positioned to attract and retain businesses. Since our region has had some of the highest electricity costs in the nation, the plan to increase competition in the electric utility industry, for example, is helping to overcome one of the big barriers we have faced in attracting firms that use a lot of electric energy.

We also have begun to see progress in attracting new firms to the Delaware Valley and retaining older firms that are expanding. This includes the plans for the American headquarters of the German business-software producer, SAP, in Newtown Square and the location of the Kvaerner shipbuilding facility in the old Naval Shipyard in Philadelphia. Also within the city of Philadelphia, SmithKline Beecham has announced an expansion of its US headquarters. Although these companies are engaged in very different businesses, there is a common thread. They are all involved in parts of the high-tech sector that generates a great deal of value added to the region's economy and provides high-paying jobs.

With continued moderate growth in the nation during this year, our region is likely to continue to expand at a healthy pace, with solid gains in employment and a continuing, relatively low level of the region's unemployment rate. Even within the city of Philadelphia, job levels have stabilized during the past year. The suburban areas of Philadelphia, such as here along the Main Line, have enjoyed strong job growth and lower unemployment rates than the region as a whole. Suburban unemployment rates in our region, for instance, are generally below 4 percent. These favorable trends in job growth and unemployment are likely to continue during the coming year.

But, again, we must not become complacent. Many challenges remain. Even though state and local authorities are taking action to make Pennsylvania and Philadelphia more attractive to businesses, this will be a continuing challenge. Other communities, both in Pennsylvania and in other states, are also looking for ways to make their regions more attractive for businesses to locate there.

What's more, some of the deregulation that has helped to keep our nation's economy dynamic has also led to some significant disruptions in local communities. We can see this in the banking industry, where the deregulation of interstate branching is leading to many bank mergers. In the Philadelphia region, the CoreStates-First Union merger will mean substantial disruptions for many bank employees and their families. In addition, such major bank mergers raise questions about where the region's future business leadership will come from. As I'm sure your organization is finding, this region's Chambers of Commerce will have holes to fill as both banks and industrial firms continue to restructure during this economic expansion.

Let me add one other concern with regard to industry restructuring. Chambers of Commerce work hard to ensure that their communities are economically vibrant. And many of them have relied on banks to assist in community development efforts. As bank and other industry consolidation continues, I do worry that some of the focus of our financial institutions on community development will be lost in the transition. I'm not sure how to address that concern, since banks and other firms seem to be on a steady path of restructuring and consolidation for understandable reasons. But I suspect that Chambers of Commerce such as yours are concerned about these issues as well, and may turn out to be on the front line of any solution.

Conclusion

In sum, I expect 1998 will be a year of more moderate growth than 1997, but one that will see this economic expansion continue through an eighth straight year with continued low inflation. Our region has benefited from having such a long national expansion, and it will continue to do so in 1998 with another year of healthy growth. The challenge this year will be to continue the good economic policies that have helped produce this low-inflation, low-unemployment, strong-growth economy. Making sound policy decisions at the national, state, and local levels will help keep both the nation and this region vibrant in the coming years.