

The Economy in the New Year

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Another Extraordinary Year of Growth

It's a pleasure to be with you again. Last year when I was here I told you that we had just finished an extraordinary year in 1997. This year I guess I will have to use another superlative to characterize the economy's performance in 1998. The good news is that the economy has proven to be very resilient to financial turmoil: output again expanded at a strong pace last year, the unemployment rate fell to a 29-year low, and inflation remained very low. The bad news is that the downside risks to the economy from the international sector that I discussed a year ago all came to pass.

My remarks a year ago focused on how the slumping Asian economies would impact the US by depressing our (real net) exports and by lowering import prices. Those impacts certainly occurred, as a sharp decline in (real net) exports slowed US manufacturing activity, and as falling import prices helped reduce consumer price inflation to about 1.5 percent in 1998.

But last year I also mentioned the risk that Asian problems could spread to Eastern Europe and Latin America, and that such contagion would pose more serious downside risks to the US economy. That, unfortunately, is what happened during the last half of 1998, as financial problems in Russia led to capital flight that spread to Latin America. The resulting financial turmoil spread quickly around the world, including to US stock and bond markets. Recognizing the increased downside risk to the US economy from continuing problems abroad and from the widespread flight to quality and liquidity that began to disrupt our financial markets, the Fed reduced the federal funds rate and the discount rate in several steps last fall. These actions have helped calm markets, and at this point financial markets are functioning more normally.

I noted earlier that the US economy has been very resilient to financial turmoil. Clearly, the continued strong growth of employment and the economy during the last half of 1998 is a sign of this resilience. I find it striking that we have had very large monthly job gains at the same time that we have had large numbers of layoffs announced. This, too, is a sign of our economy's resilience.

That doesn't mean we aren't seeing any effects from the economic slumps that have been occurring in Asia, Brazil, and elsewhere. Manufacturing has borne the brunt of the impact. Both nationally and in our region, manufacturing activity has weakened. For instance, our regional Business Outlook Survey, which polls manufacturers in our Federal Reserve District, has been in negative territory for four of the past five months. Figures on national industrial production and the survey of the National Association of Purchasing Managers show that a slowdown in manufacturing activity is widespread around the nation. Jobs have declined in manufacturing for eight of the past nine months, for a cumulative job loss in manufacturing of about 275,000 jobs. A similar pattern of manufacturing job losses has occurred in the Philadelphia area as well.

But the weakness in manufacturing and in (real net) exports during the past year was offset by strong growth of housing and consumer spending on motor vehicles and other durable goods, along with continued strong growth of business spending on computers and other equipment. Consequently, overall economic growth held up well last year and was even above expectations.

Inflation

Even though economic growth was strong and labor markets remained very tight, inflation last year was benign and, in fact, somewhat lower than what was generally expected. Oil and other commodity prices fell sharply last year and businesses continued to find ways to increase productivity to keep costs down as wages rose.

I anticipate that inflation will remain quiescent in 1999 as well, even though import and oil prices probably will not show the same downward trend this year. Holding inflation down is a key ingredient in fostering maximum sustainable economic and job growth. 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 recent experience, we have been largely successful in achieving price stability.

We should be pleased but not complacent about the outlook for inflation. Certainly there are downside risks to the economy this year. But upside risks remain as well. Whenever the economy is operating as close to full capacity of its labor resources as it has been recently, we must stay alert to the potential for inflationary pressures to reassert themselves, just as we must be watchful for signs that problems in Asia and Latin America are leading to a more severe slowing of the US economy. Both inflation and deflation are undesirable and we must guard against both.

The Outlook

With labor markets remaining tight, pressures on compensation should continue to be a major challenge for businesses this year. During the past several years businesses have been very effective at finding ways to increase productivity growth to keep rising wages from spilling over to rising prices. Some of this increased productivity has come from investment in new equipment--especially in computer-related equipment--and I expect such investment to continue this year, but at a more moderate pace because of the slowdown in manufacturing activity.

I also expect some moderation in the growth of consumer spending this year, following last year's very strong gains. Last year's gains reflected sizable employment gains, rising incomes, and another year of strong stock market performance that led consumers to increase their spending at the expense of their personal saving rate. Now that the saving rate has fallen to about zero, consumers are unlikely to increase their spending as rapidly as they did last year.

On balance, then, I expect the economy will continue to expand in 1999, although somewhat less rapidly than last year. The job market will remain tight and inflation will stay in check.

Region

In several respects, our region mirrors the nation. The Greater Philadelphia region has also been doing very well during the past year. The region's unemployment rate is the lowest it has been in a decade and is lower than the national rate. In fact, some parts of the region, including along the Main Line, have unemployment rates of 3 percent or less. A major problem businesses are facing is finding qualified workers. Despite the tight job market, however, businesses do seem to be finding workers somewhere, since 1998 marked the sixth consecutive year of job growth in the region. The strongest job growth has been in the suburbs. But the City of Philadelphia also added about 4,000 jobs last year--the city's first significant gain in jobs in a decade.

Like other parts of the nation, our region has experienced its share of industry consolidations--the most notable examples being in the banking and the health care industries. So despite strong labor markets and continued overall job growth, we are experiencing a lot of job turnover.

Historically, our region has tended to slow sooner than the rest of the nation, and we can expect fewer new jobs to be created this year than were created last year. As I said earlier, we have already seen signs that manufacturing activity has been weakening in our District, although we don't anticipate a general downturn in the region's economy this year. Overall, the Philadelphia region should mirror the nation again in 1999, with growth continuing and labor markets quite tight.

Need for Flexibility in Policy

Let me underscore that what we have been experiencing in monetary policy during the past couple of years is different from what we have typically experienced in recent decades. Normally at this stage of the business cycle, the tight labor markets we have enjoyed would have been leading to greater inflationary

pressures. But we haven't seen inflationary pressures during the past two years, despite an unemployment rate that has fallen to its lowest level in almost 30 years.

The Fed will have to be especially alert to unfolding developments during the coming year, as we were last year, and it must be flexible and prepared to look beyond the usual economic statistics. For instance, in the first half of last year a case could have been made for tightening monetary policy. But the Fed didn't tighten. Last spring many of us in the Fed heard from business people that competition was preventing them from raising prices, even though the economy was very strong. Although wages were under upward pressure, many businesses were telling us that they were offsetting these costs elsewhere. I concluded from these stories that the Fed did not have to tighten monetary policy to hold inflation in check. I believe that turned out to be the correct decision.

Then in the fall of last year, as the international outlook was deteriorating, the Fed had reason to ease monetary policy to calm financial markets and to take out some insurance against a cumulative weakening of the U.S. economy. That strategy, too, seems to have paid off--financial markets appear to be functioning more normally and the economy is entering 1999 with considerable momentum instead of the gloom and doom talk we heard last fall.

Looking to the year ahead, I do not know what adjustments to monetary policy, if any, will be needed to help keep the economy on a trend of sustainable growth and benign inflation. The U.S. economy is too complex and dynamic to be guided by pat formulas, and monetary policy is but one influence among many that impact it. Like you in your businesses, we in the Federal Reserve need to stay alert, be as forward-looking as possible, and act accordingly to help keep our economy on a long-run path of prosperity.

Preparing for Y2K

Before concluding, let me say a few words about the year 2000 (or Y2K) issue. This year began with many news stories about potential problems with computer systems when the year 2000 arrives. So-called Y2K problems will receive even more attention as we move through the year. Many of the scarier stories being told about Y2K involve the banking and financial system. The impression one gets from these stories is that Americans believe the financial industry is the one most likely to suffer from Y2K problems. In contrast to this view, I think the financial industry is doing one of the best jobs to ensure that the arrival of the year 2000 is a manageable event. So let me briefly explain what the Federal Reserve and banks are doing to prepare.

We at the Federal Reserve have tested our own major systems and made sure they will work in the year 2000. Now we are working to test our automated systems with those of banks--not just the large banks, but community banks as well. Our objective is for banks to have tested with us, or to be scheduled to test with us, by the end of March. Bank regulators have been raising the heat on banks about preparing for the year 2000 for more than a year now. Regulators are also pushing banks to make sure that their business customers are ready for Y2K.

For companies doing business internationally, you should know that the Federal Reserve is working closely with international bank supervisors and others to encourage Y2K readiness worldwide. We are working to encourage public disclosure and transparency of Y2K preparations in all countries, so that companies can better evaluate their ability to conduct operations in various parts of the world when the year 2000 arrives.

We are also preparing for the possibility that some individuals may decide to hold extra cash during the century rollover. Some consumers may be concerned that other payment methods may not work well around the turn of the year, and we want to be prepared to meet larger-than-normal demands for cash. So we plan to increase our inventory of currency available to meet such demands by a large amount, just in case. And we will staff our cash operations around the turn of the year to make sure banks can obtain currency on a timely basis. For that matter, we will have a lot of staff from many of our departments available around the turn of the year, just to handle any unusual developments in the payments system. And we will be prepared to lend funds to financial institutions under appropriate circumstances.

Y2K testing, some people complain, is a pain in the neck and is costly. But the alternative--NOT testing and then learning there is a problem on January 3, 2000--will be even MORE costly to both banks and businesses. There are, for instance, issues of legal liability that go beyond simple customer complaints.

Beyond the technical side of fixing the century date change problem lies the issue of educating the public and the media about what the true situation is rather than letting anxiety build through a lack of knowledge. It is going to be important for bankers and business leaders to build up confidence within their communities about their ability to solve Y2K operational problems. Confidence is at the heart of our economic and financial system. If the public loses confidence in our ability to handle the century date change, the whole business community will lose. You can expect media attention about this issue to intensify as the year progresses. It would be wise for bankers and business leaders to be prepared to answer reporters' questions about Y2K preparedness honestly and reassuringly.

Fortunately, the Commonwealth of Pennsylvania is one of the states furthest along in ensuring that government computer systems are ready for Y2K, and that level of attention has spread to local governments and businesses. Pennsylvanians have generally avoided being complacent about Y2K issues so far, and they must focus on completing their preparations during the coming months. We all have to earn the confidence of our customers and communities by doing our homework, testing our systems, actively telling our story about Y2K preparedness, and being well prepared to answer customers'--and reporters'--questions.

Conclusion

In conclusion, we are completing the eighth year of this economic expansion, which is now the second longest expansion of this century. I believe the expansion will continue throughout 1999 and into the year 2000, thereby making this the longest expansion of modern times. And I expect this will occur while inflation remains low. Our region will continue to expand as well, although our manufacturing sector is being adversely affected by international developments.

The biggest risks to our economy are coming from the international sphere. Monetary policy will need to be especially alert this year to changing developments--domestic and global--that could alter the outlook. That means grass-roots input about economic developments is likely to continue to play a significant role in policy decisions because it gives us insights we cannot get from economic statistics alone.