

Key Issues in the Economic Outlook

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Recent U.S. economic performance has been remarkable. Our economy has been growing for eight straight years, making this expansion the second longest of the century. Output and employment have grown robustly for the past three years, bringing the unemployment rate down to a 29-year low. Even areas of the country that have tended to have persistently high unemployment for decades have benefited from this very long expansion.

Strong growth has been accompanied by low inflation. Consumer prices rose less than two percent in each of the past two years, and average consumer price inflation during this expansion is as low as during the long expansion of the 1960s. Broader price indexes have shown even lower inflation.

In assessing the outlook, I see three key factors continuing to influence the economy's performance this year, as they did last year: economic weakness abroad; economic strength at home; and vulnerabilities in both foreign and domestic financial markets.

Three Key Issues

The outlook for U.S. growth has been clouded by the weakness abroad for some time, beginning with the onset of the Asian crisis in the last half of 1997. The expectation that problems in Asia would adversely affect U.S. growth in 1998 was realized to a large extent. During the past year, the slumping Asian economies depressed our (real net) exports. Manufacturing has borne the brunt of the impact, both nationally and in our region. Jobs have declined in manufacturing for nine of the past ten months, for a cumulative job loss of about 285,000 jobs. A similar pattern of manufacturing job losses has occurred in the Philadelphia area as well.

The slump in Asian economies also depressed world commodity prices, including the price of oil. This helped to reduce U.S. consumer price inflation in 1998 to only 1.5 percent. This year many of the Asian economies will be recovering, while others will shrink less rapidly than they did last year. Consequently, we can expect that our exports to Asia won't fall as much this year, and we can expect some firming in oil and other commodity prices as Asian nations recover.

But our overall exports may be adversely affected this year from a different part of the world -- this time from weakness in Brazil and other Latin American nations. Certainly recessions in Latin America would not be good news for U.S. exporters, especially if such weakness were to spread to Mexico, one of our major trading partners.

We must also remain alert to continuing problems in Russia, Japan, and other parts of Asia, especially if problems in Brazil intensify and threaten some of the Asian nations' recoveries that began during the second half of last year.

Fortunately, economic strength at home has offset, so far, the weakness abroad. 1998 in particular was an extraordinary year for the U.S. economy. Payrolls expanded by nearly 3 million jobs; unemployment fell to 4.3 percent of the labor force; the consumer price index rose just 1.5 percent; and the stock market had another good year -- at least for those who held large-cap or Internet stocks. You will recall that there were times last year when it was not at all clear that outcomes would be so favorable. Last summer, the collapse of the Russian ruble threatened U.S. financial markets as well as those of other countries. Fortunately, both our domestic economy and our financial markets were resilient; they absorbed that shock and bounced back.

To some extent we have been lucky. Stronger-than-expected growth in domestic demand for goods and services offset shrinking foreign demand; and falling prices for oil and other imported goods contributed to lower-than-expected inflation. But the economy's favorable performance in 1998 also reflected good economic policies. Fiscal policy that constrained growth in federal spending helped to produce the first budget surplus in nearly 30 years, and that meant that more of our national saving was available to finance productive investment. Regulatory policy that fostered competition has led to greater efficiency and innovation. Trade policy that has focused on opening markets abroad rather than closing our markets gives U.S. companies new opportunities to export while giving U.S. consumers the benefits of a variety of foreign goods. And monetary policy that has brought inflation down to levels we had not seen since the first half of the 1960s has provided a financial environment that has helped sustain the expansion.

Because our economic policies are basically sound, I expect that our economy will continue to grow and that inflation will remain under control. But I don't expect output and employment to grow as strongly as last year, nor do I expect inflation to be quite as low. Putting foreign and domestic factors together, I come to the conclusion that this year the economy will grow at a more moderate pace than last year. I expect the pace of the economy will moderate in almost all sectors, including autos, housing, equipment spending, and consumer spending. Last year's strong gains in consumer spending 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.

The job market will remain tight this year, so pressures on compensation should continue to be a major challenge for businesses. Inflation should stay in check this year, although it will be slightly higher than last year as oil and other import prices rise after falling last year. That may not precisely be price stability, but it's the lowest sustained inflation we have seen in 30 years. I think the historical evidence shows that long-run economic growth is maximized by maintaining an environment in which there is so little inflation that expectations of future inflation have little or no influence on the decisions made by households and businesses. That pretty much describes the U.S. today. It is an important reason why I am basically optimistic about our economy's prospects.

Forecasting the economy, however, must be done with a strong dose of humility. There is enough uncertainty about this year's economic outlook that we cannot rule out the possibility that 1999 will look as good as 1998. On the other hand -- and economists always have that other hand -- we also can't rule out the possibility of adverse developments.

For instance, the vulnerability of financial markets both here and abroad to unpleasant surprises could throw our economy off track. In 1998, capital flight from emerging markets spread financial turmoil from Asia to Eastern Europe and Latin America. What's more, Russia defaulted on its debt. The combination generated a widespread flight to quality, a heightened aversion to risk, and a dramatic increase in preference for the most liquid assets, which disrupted U.S. financial markets as well as those abroad. Recognizing the increased downside risk to the U.S. economy, the Fed reduced the federal funds rate and the discount rate in several steps last fall. These actions helped calm markets, and now financial markets are functioning more normally. Nevertheless, given the heightened awareness of financial market participants to global developments, and considering the lofty heights reached by our own stock markets, it is easy to conceive of such a shock occurring again. A sharp market correction could suddenly and significantly change consumer and business attitudes. But such shocks are not predictable, and the fact that we recognize that our current domestic and foreign environment could spawn such shocks simply means that monetary policy must remain alert and flexible.

In assessing the future direction of monetary policy, it's very difficult to know where the balance of risks lies among these three issues: the strong domestic economy; weakness abroad; and vulnerable financial markets. Certainly we don't want to tighten monetary policy simply because the economy is growing strongly and unemployment is low. Having strong growth and low unemployment is terrific -- as long as it is sustainable. What we don't want is for strong growth to cross over into a boom, because we know that booms are followed by busts.

Some argue that we are in a new era -- that technological advances, global competition, and whatever other factors have led to our recent high growth/low inflation economy are permanent. Others argue that the factors generating this favorable combination are temporary, including such influences as lower commodity prices and a stronger dollar. I believe both temporary and permanent factors are probably at work, with the relative sizes of each uncertain. I wouldn't want to bet the economy on the belief that we are in a permanently better situation, so I don't think we can afford to take our eyes off indicators of potential overheating or inflation. But I don't think a rigid policy approach that responds mechanically to strong growth and low unemployment is appropriate either. We need to be flexible in the current circumstances until we see more evidence about how the mix of temporary and permanent factors is influencing our economy.

Need for Flexibility in Policy

Let me underscore that what we have been experiencing 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.

Because the economy is not behaving as it did in the past, policymakers 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 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.

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 affect it. 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 the financial industry is the one most likely to suffer from Y2K problems. In fact, the financial industry is doing one of the best jobs to ensure that the arrival of the year 2000 is a manageable event. Let me briefly explain what the Federal Reserve and banks are doing to prepare.

We at the Federal Reserve have tested, updated, and re-tested our own major systems and made sure they will work in the year 2000. Now we are working to test the interaction of 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.

You should also know that the Federal Reserve is working closely with foreign 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 by a large amount, just in case. And we will make sure our cash operations are staffed around the turn of the year so that 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 1, 2000 -- would 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. This is important for all segments of the financial industry, because confidence is at the heart of our economic and financial system. You can expect media attention about this issue to intensify as the year progresses. It would be wise for all of us in the financial industry to be prepared to answer reporters' questions about Y2K preparedness honestly and reassuringly. No one can guarantee a perfect rollover into the millennium, but through Y2K preparedness the financial industry can do its part to maintain confidence in our economy and keep glitches -- should they occur -- manageable.

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 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; long economic expansions have proven to be highly beneficial for the Philadelphia region.

The three key issues I see in the economic outlook are our economic strength at home; economic weakness abroad; and the vulnerability of financial markets to external and internal shocks. It's very difficult to know where the balance of risks lies among these three issues. Hence, I believe monetary policy will need to be especially alert this year to changing developments -- domestic and global -- that could alter the outlook.