

The Rosy and Not-So-Rosy Economy

Presented by Edward G. Boehne, President
Federal Reserve Bank of Philadelphia

Berks County Chamber of Commerce
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The economic news has sounded quite rosy recently. The national unemployment rate has fallen to its lowest level in almost 30 years. Consumer confidence has remained very high and housing activity has remained very strong. And the stock market has been simply extraordinary.

Indeed, the news has been so rosy that people sometimes seem to forget our economic picture contains several not-so-rosy parts. The most obvious one is that slumping foreign economies have certainly hurt some sectors in the U.S. Just a year ago the big story was that recessions in many Asian nations would lead to a sharp drop in U.S. exports. Indeed, agriculture and manufacturing suffered the most from the decline in our export markets. And even though other parts of our economy grew very rapidly last year, they did not prevent the agriculture and manufacturing sectors from experiencing the pain of the downturn in foreign economic activity.

Not only did demand for U.S. exports decline, but a rise in the value of the dollar made imported goods less expensive for U.S. buyers. This made imported manufactured goods more competitive **within** the U.S., and that, too, reduced demand for U.S.-made products. Last year's drop in demand for U.S. manufactured goods resulted in an associated decline in manufacturing jobs in the U.S.

The Regional Economy

This region certainly felt the impact of the slump in foreign economies and the rise in the value of the dollar in foreign exchange markets, because manufacturing makes up a large share of this area's economic base. Manufacturing in the Berks County region declined in the second half of last year, in concert with the overall weakness in national manufacturing activity. Nationwide, jobs declined in manufacturing in nine of the past ten months, for a cumulative loss of about 285,000 jobs. In relative terms, manufacturing job losses were even more severe in the Reading area than they were at the state and national levels. And although nonmanufacturing jobs increased in Berks County, the increases were not sufficient to overcome the losses in manufacturing, so total employment fell slightly last year.

Consequently, for the first time since 1993, the Reading area economy underperformed the state's. Another sign of the slower job market in this region is the area's unemployment rate, which rose from 4.0 percent in the first half of last year to about 4.5 percent in the second half. But Reading's unemployment rate is still quite low and is close to the national average.

Although manufacturing has been the weakest sector of our economy, we may now be seeing the light at the end of the tunnel. In the Philadelphia Fed's Business Outlook Survey, which is a survey of our District's manufacturers, respondents are reporting that activity is picking up in the region. Our index of current activity has risen for two months in a row, after slumping last fall. So the outlook for some recovery in manufacturing in this region is better now than it was just six months ago.

Another positive factor for this region's outlook is construction activity. Nationally, housing activity has been very strong, and homebuilding also continues at a high level in Berks County. Nonresidential construction contracts in the region are also up. This strong pace of construction will support the region's economy in the coming year, although it doesn't offer much near-term relief from the pressure on roads and other infrastructure that the county has been wrestling with in recent years.

More Shocks from the Foreign Sector?

A big question in the outlook for the coming year is whether we will experience more shocks from abroad. 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.

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, but the severity of the impact on the U.S. depends in large part on the extent to which problems in Brazil spread to other countries. By itself, Brazil -- or even Brazil and the rest of South America -- would not have as large an impact on the U.S. as last year's downturn in Asia. But if weakness in South America were to spread to Mexico, one of our major trading partners, the impact on the U.S. would be much more significant.

We must also remain alert to continuing problems in countries like Russia and Japan. Unpleasant surprises in financial markets both here and abroad could throw our economy off track. Last year, capital flight from emerging markets spread financial turmoil from Asia to Eastern Europe, and then to Latin America. Especially after Russia defaulted on its debt, we saw 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.

It was in response to this turmoil, and the associated increased downside risk to the U.S. economy, that the Fed reduced short-term interest rates in several steps last fall. Those actions helped calm markets, and now financial markets are functioning more normally. But considering the degree of uncertainty we face about the health of foreign economies and financial markets, the possibility of a similar shock occurring again can't be ruled out. A sharp financial market correction could suddenly and significantly change consumer and business attitudes. This is why I believe monetary policy must remain particularly alert and flexible this year.

Upside Risks Too?

But I don't want to leave you with the impression that all the risks to the economy this year are on the downside. Recent U.S. economic growth has been remarkably strong, despite the weakness of our exports. 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. And the job market will remain tight this year, so pressures on compensation should continue to be a major challenge for businesses.

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. There is enough uncertainty about this year's economic outlook that we cannot rule out the possibility that the economy could overheat this year.

My own view, however, is that our economy will continue to grow this year and that inflation will remain under control. 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 moderation in the growth of 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.

Despite strong economic growth in recent years, inflation has been low. 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. 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 still 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.

The economy's favorable performance in recent years reflects to a large extent the fact that we have been following good economic policies. Monetary policy has brought inflation down to levels we have not seen since the early 1960s, and that has provided a financial environment that has helped sustain the expansion. Fiscal policy has constrained growth in federal spending and produced the first budget surplus in nearly 30 years, which has meant that more of our national saving is available to finance productive investment. Regulatory policy has fostered competition that has led to greater efficiency and innovation. Trade policy has focused on opening markets abroad rather than closing our markets. And that has given U.S. companies new opportunities to export while giving U.S. consumers the benefits of a variety of foreign goods.

Because our economic policies are basically sound, I am generally optimistic about the economic outlook. Looking to the year ahead, I don't 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

One thing we are doing to stay on that path of prosperity is ensuring that the banking system is prepared for the year 2000 (or Y2K). 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. 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. No one can guarantee a perfect rollover into the millennium, but through Y2K preparedness the financial and business communities can do their 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 of this century. I believe the expansion will continue throughout 1999 and into 2000, thereby making this the longest expansion of modern times. And I expect this will occur while inflation remains low.

Nevertheless, the economy faces both downside and upside risks. The Federal Reserve will need to be especially alert this year to changing developments -- domestic and global -- and act accordingly to help keep the economy on a path of sustainable prosperity.