The US Economy in 2000

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For the third straight year I can begin my remarks by saying that the U.S. economy has just completed an extraordinary year. In the land of the Philadelphia Flyers, I believe we call that a hat trick! This morning I am pleased to again be with you to share my views about the remarkable economy and the outlook for the coming year.

Recent U.S. and Regional Economic Performance

The U.S. economy has grown at an average rate of more than 3-1/2 percent per year since 1991 when our current expansion began. Growth has accelerated since the end of 1995, averaging about 4-1/4 percent per year. The strong pace of economic growth has been matched by the strong growth of employment. Since 1991, the U.S. has added about 2.5 million workers to payrolls each year, and the unemployment rate has fallen from above 7 percent to a 29-year low of just over 4 percent.

The Philadelphia area was somewhat late joining the party at the beginning of this expansion. Job growth was fairly anemic through 1995, and the area's unemployment rate remained somewhat higher than the national average. But in the second half of the decade we fully participated in the good times.

By that I do not mean we outperformed the nation. As a matter of fact, since 1995 jobs in the Philadelphia area have increased only about three-fourths as fast as jobs in the country as a whole. But since we also had slower population growth, job growth in the Philadelphia area was strong enough to keep the unemployment rate at the national average or somewhat below. In fact, the unemployment rates in Montgomery and Chester counties have been 3 percent or lower for the past year. And Delaware County's unemployment rate has been below 4 percent. So you will find our region's employers searching just as hard for qualified workers as employers in the rest of the country. Some of the areas with the tightest labor markets in the Philadelphia region are right here along the Main Line.

Not only have companies in the Philadelphia suburbs been scouring the landscape for workers, they have also been taking up more and more office space. The office vacancy rates in the Philadelphia suburbs dropped into single digits about two years ago and have remained there. And in some areas, such as the Main Line, Conshohocken, and King of Prussia, vacancy rates are under 8 percent.

Job growth has been very good in some of our traditionally strong sectors, like private education and chemicals and pharmaceuticals. But much of the recent job creation in the Philadelphia area has been in business services like advertising, computer programming, and data processing, and in financial services such as securities firms and mutual funds. The region has also seen its share of growth from new companies in computer and Internet technologies. Local names like Internet Capital and VerticalNet are popping up more and more in the national business press. These companies are part of the new economy that is driving a great deal of our national growth.

Inflation

Twenty, or 15, or even 10 years ago, the combination of rapid economic growth and tight labor markets would have led to a substantial acceleration of inflation. But that has not been the case in recent years. Even though inflation was higher in 1999 than in 1998, the increase largely reflected higher oil prices. Core inflation, which excludes volatile energy and food prices, did not rise in 1999, contrary to what many forecasters had predicted.

Why isn't strong economic growth in the U.S. generating higher inflation? The answer to that question requires some basic economics -- namely, what is going on with total or aggregate supply and demand. What I mean by aggregate demand is simply the sum of domestic and foreign demand for American-made goods and services. Aggregate supply refers to our economy's capacity to produce those goods and services.

Inflation largely depends on the degree to which demand presses on supply. Looking back at the last century, we find that aggregate demand usually grew more rapidly than aggregate supply during the later years of economic expansions; that imbalance contributed to rising inflation. In recent years, however, our economy's capacity to produce goods and services has grown rapidly, nearly as rapidly as aggregate demand. And in many industries, firms were able to cut production costs as they expanded capacity. That favorable combination has allowed strong growth and low inflation to coexist.

Some of the recent improvements on the supply side are probably temporary, but others seem to be more permanent. In 1997 and 1998, the U.S. benefited from the fall in the prices of oil and other commodities following the Asian financial crises, because it lowered U.S. firms' production costs and boosted aggregate supply. As Asian and other economies improved last year, oil and other commodity prices reversed course. Nevertheless, the U.S. economy continued to grow rapidly, with no increase in core inflation. That indicates the story on the supply side is not the result of temporary factors alone. What else has been happening? I believe the economy's favorable performance in recent years also reflects major advances in technology, better economic policies, and strong entrepreneurial activity.

Technology and Productivity

Major changes in technology have spurred strong, and accelerating, growth in labor productivity, which in turn has contributed to strong U.S. economic growth. We have perhaps been experiencing the greatest advances in technology since the Industrial Revolution. Though all of the reasons for the recent improvements in productivity growth are not entirely clear, certainly rapid changes in computer, telecommunications, and medical technology have contributed to this development.

U.S. businesses have been buying high tech equipment at a torrid pace in recent years. In fact, industrial capacity (and hence aggregate supply) has risen at a faster pace than demand for industrial outputs. This is evident from the fact that the capacity utilization rate in U.S. industry is lower than it was in 1995, despite the rapid growth of aggregate demand in the U.S. economy.

Since late 1995, labor productivity (i.e., output per worker) has been growing at an average rate of 2.7 percent per year. That is almost twice as fast as its average growth rate during the previous 20 years. The faster pace of productivity growth in recent years has meant that businesses have been able to keep prices from rising while paying higher wages to workers.

Economic Policies

Technological changes and the consequent improvements in productivity are not the only factors that have helped alter the supply side of the U.S. economy. Changes in U.S. economic policies with regard to regulation and trade have also helped to increase competition and productive capacity -- capacity that can be used to meet an increased demand for goods. U.S. trade policy, for instance, has generally focused on opening markets abroad rather than closing our markets. Greater globalization of markets has increased the ability to use capacity abroad to meet domestic demand, and has thereby undercut businesses' power to raise prices. And regulatory policy in the U.S. (or should I say de-regulatory policy) has fostered competition that has led to greater efficiency and innovation.

On the demand side, the U.S. in the 1990s followed better economic policies in terms of fiscal and monetary policies. Fiscal policy constrained growth in federal spending during the past decade and produced the first budget surpluses in 30 years. That has raised national saving, making more funds available to finance productive investment.

Monetary policy during the 1990s brought inflation down to levels we had not seen since the early 1960s, thereby providing a financial environment that has helped sustain the expansion. I believe 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. Low inflation is a friend, not an enemy, of maximum sustainable growth of the economy and jobs. And it is an important reason why I am basically optimistic about our economy's prospects.

Entrepreneurial Infrastructure

More rapid growth of productivity in the United States has been closely tied to the rapid development and deployment of new computer and telecommunications technologies. Although these new technologies are being implemented in old-line companies as well as in new ones, much of the impetus for the introduction of new technologies has come from newly formed companies -- that is, from greater entrepreneurial activity.

There have always been new inventions and new ways of doing things. What is different in the U.S. economy today is the fact that we have developed an extensive **infrastructure** to help entrepreneurs bring new products, services, and processes to the market. This infrastructure consists of several elements. Let me mention just a few. First, we have developed mechanisms for financing new ventures. Second, we have developed institutions for technical and managerial support of new ventures. And third, we have created the role of the professional entrepreneur in the U.S. economy. Let me make a few comments about each of these elements of the **entrepreneurial infrastructure**.

First, the financial element. Start-up firms in untested markets are not good candidates for direct financing from commercial banks. This is especially true for service firms that often have few or no tangible assets. So start-up firms normally get their financing from wealthy individuals, appropriately called angels, or from venture capital funds whose major sources of money are pension funds, insurance companies, and university endowments. Venture funds and angels look for startups that have a very high expected rate of return because they know that some will inevitably fail.

The more than $6 billion in new funds committed annually to venture capital funds in the U.S. in recent years is small compared with the total amount spent on research and development. But the amount of venture capital was less than $1 billion annually before 1979, and it has doubled since the 1980s. Moreover, the venture fund industry has had a disproportionate effect on innovation in the U.S. economy.

A second element in the entrepreneurial infrastructure in the U.S. is the institutions that provide technical and managerial support. The two major institutions that provide this kind of support are small business development centers and business incubators. At the prompting of the Small Business Administration, 10 business schools at universities on the East Coast started *small business development centers* in 1980. These centers are designed to give technical, managerial, and financial advice to small business owners, and they draw on the expertise of various members of the university. From the original 10 small business development centers in 1980, their number has grown to more than 900.

Business incubators offer some of the same resources as small business development centers. In addition, start-up companies are often housed in a business incubator and share some services such as secretarial help, copy centers, and conference facilities. These incubators are most often sponsored by state and local government and nonprofit organizations. The University City Science Center in Philadelphia, founded in the 1960s, was one of the earliest business incubators. It is owned by a group of 30 academic and scientific institutions. The center has launched more than 215 successful start-up organizations. Nationally, the number of business incubators has grown from 12 in 1980 to about 600 today.

A third element in the development of an infrastructure for entrepreneurship in the U.S. has been the emergence of the professional entrepreneur. Thirty or 40 years ago when someone had a new idea or new invention, he or she might have founded a company, seen it grow to maturity, and remained CEO for the rest of his or her career before leaving the company to the children. Today we are seeing more and more people who start one company, sell it after a number of years, and then start another company and perhaps

several more. They are, in effect, professional entrepreneurs. These individuals are willing to take a substantial amount of risk to start up a new enterprise because of the potential rewards -- not only in terms of their annual salaries but also in various types of incentive pay, such as bonuses and stock options.

American entrepreneurs can also get encouragement and support in a number of other ways. There are a number of journals and magazines devoted to entrepreneurship, and several hundred colleges and universities in the U.S. offer courses on entrepreneurship. Around the U.S., a variety of organizations have been formed at the local level to provide entrepreneurs with opportunities to obtain advice. At the Federal Reserve Bank of Philadelphia, we host the monthly meetings of an entrepreneurs forum that brings together entrepreneurs and service providers to discuss common issues.

Let me caution that the development of this entrepreneurial infrastructure in the U.S. economy has not eliminated the risk of new ventures; it has simply made it easier for more people to take that risk. A few numbers illustrate this point. In 1997 there were more than 160,000 business startups in the U. S., but there were also more than 80,000 business failures. Every year *INC.* magazine publishes a list of the 500 fastest growing, privately owned companies in the U.S. Of the 500 companies on the list in 1985, almost 20 percent had disappeared or failed by 1995. The competitive marketplace continues to perform its role of testing new ideas and products. The new infrastructure for entrepreneurship doesn't eliminate that test; it simply allows more new companies to take the test.

A "New" Economy in 2000?

In short, the U.S. has enjoyed a prolonged period of high economic growth, low unemployment, and quite low inflation because of developments on both the demand and supply sides of the economy. We've had a better mix of fiscal and monetary policies. The supply side has been stimulated by more open and competitive markets, by deregulation, and by technological advances that have increased productivity. And a vibrant entrepreneurial infrastructure has fostered innovative start-ups that have put new technology to work and helped produce impressive gains in productivity.

Having strong growth and low unemployment is highly desirable -- 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. How confident can we be that the U.S. has a new economy or a new paradigm in which inflation will remain low despite strong economic and job growth?

My own sense is that the recent improvements in productivity growth likely will continue for some time, so that both the nation and our region should continue to enjoy relatively high economic growth, low unemployment, and relatively low inflation for the coming year at least, and probably longer. Nevertheless, since we cannot be completely confident about how long the sources of this recent favorable economic mix will persist, the Fed must remain alert to significant increases in inflationary pressures while at the same time fostering maximum sustainable growth in the remarkable U.S. economy.

So, I am persuaded that faster productivity growth **has** raised the sustainable growth rate in the U.S. -- at least for now. But will **increases** in productivity growth continue forever? -- Not likely. Whenever the growth rate of productivity levels off or declines -- and no one knows when that will occur -- the risk of rising inflation will increase and monetary policymakers will have to act in a timely fashion to prevent inflationary pressures from undermining this extraordinary economic expansion.

Conclusion

In conclusion, I believe that what is "new" about the new economy is really rather old -- it is the resurgence of the supply side. The economy has become increasingly more productive in its use of labor and capital. This is wonderful news for the average American, because it ultimately translates into a higher standard of living. Next month our current economic expansion will become the longest in U.S. history, with an average inflation rate that is as low as it was in the expansion of the 1960s. Even so, the current remarkable economy -- while welcome -- is more challenging for monetary policymakers because the traditional uncertainties on the demand side are made more complicated by "new" developments on the supply side.