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Testimony by

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Mr. Chairman and members of the Committee, I am pleased to have the opportunity to present an update on economic conditions in the United States.

Such an assessment cannot be made in isolation but rather depends critically on what is happening in the rest of the world and how those developments affect the performance of the American economy. In my previous appearance before this Committee last October, my remarks focused mainly on the turbulence that was then evident in world financial markets and, in particular, on the problems that had emerged in a number of Asian economies. The tentative assessment offered then was that the economies of Asia were in for some trying times but that the situation did not seem likely to threaten the expansion of this country's economy.

That assessment, I believe, still is essentially correct, although uncertainties about the degree of restraint that will be coming from abroad remain substantial. Earlier this year, the situations in most of the Asian countries seemed to be stabilizing in some respects, but, as the events of the past few weeks have demonstrated, the restoration of normally functioning economies will not necessarily go smoothly. In some cases, the adjustments that are needed to improve external balances and to correct existing misallocations of resources have been accompanied by sharp increases in inflation, rising unemployment, abrupt cutbacks in living standards, and increases in uncertainty and insecurity. The heightened social and political pressures that can develop in such circumstances not only introduce added complications into economic policymaking but also make it even more difficult to foresee how the processes of adjustment will play out across the afflicted economies.

That the American economy would be affected to some degree by spillover from the problems in Asia was never in doubt, even though the timing and magnitude of the impact have been difficult to predict with much confidence. Many months ago, businesses in this country began anticipating a worsening of our trade balance with the Asian countries, and incoming economic data have since confirmed those expectations. Meanwhile, other influences on trade--such as the strength of demand growth in the United States and a dollar that has been strong against a wide array of currencies--have persisted. In total, U.S. exports of goods and services turned down in real terms in the first quarter of 1998, the first such decline in four years, and real imports of goods and services continued to rise very rapidly. The combined effect of these changes exerted a drag of 2-1/2 percentage points on the annual growth rate of real GDP last quarter. Weaknesses in Asia appear to account for approximately one-half of that deterioration. Not only have export volumes been affected, but producers in both industry and agriculture also are having to adjust to the lower product prices that have come with slower economic growth abroad and the increase in the competitiveness of foreign producers induced largely by depreciations of their currencies.

But even with substantial drag from the external sector, the U.S. economy has continued to expand at a robust pace. In the first quarter, real GDP grew even faster than it had in 1997. Employment has continued to increase rapidly this year, and the unemployment rate has fallen further, reaching its lowest level since 1970. Incomes have continued to climb, and gains in household and business expenditures have been exceptionally strong. Although the data on hours worked suggest that growth of the economy has likely slowed this quarter from the first quarter's torrid pace, the degree of slowdown remains in question. Evidence to date of a moderation in underlying domestic spending still is sparse.

The strength of domestic spending has been fueled, in part, by conditions in financial markets. Although real short-term interest rates have been rising, equity prices have moved still higher, credit has been readily available at slender margins over Treasury interest rates, and nominal long-term interest rates have remained near the lowest levels of recent decades. Rapid growth of money this year is a further indication that financial conditions are accommodating strong domestic spending, although we still are uncertain how reliable that relationship will prove to be over time.

In short, our economy is still enjoying a virtuous cycle, in which, in the context of subdued inflation and generally supportive credit conditions, rising equity values are providing impetus for spending and, in turn, the expansion of output, employment, and productivity-enhancing capital investment. The hopes for accelerated productivity growth have been bolstering expectations of future corporate earnings and thereby fueling still further increases in equity values.

The essential precondition for the emergence, and persistence, of this virtuous cycle is arguably the decline in the rate of inflation to near price stability. Continued low product price inflation and expectations that it will persist have brought increasing stability to financial markets and fostered perceptions that the degree of risk in the financial outlook has been moving ever lower. These perceptions, in turn, have reduced the extra compensation that investors require for making loans to, or taking ownership positions in, private firms.

To a considerable extent, investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of per share earnings growth over the longer term have been undergoing continuous upward revision by security analysts since 1994. These rising expectations have, in turn, driven stock prices sharply higher and credit spreads lower, perhaps to levels that will be difficult to sustain unless economic conditions remain exceptionally favorable--more so than might be anticipated from historical relationships. In any event, primarily because of the rise in stock prices, about $12 trillion has been added to the value of household assets since the end of 1994. Probably only a few percent of these largely unrealized capital gains have been transformed into the purchase of goods and services in consumer markets. But that increment to spending, combined with the sharp increase in equipment investment, which has stemmed from the low cost of both equity and debt relative to expected profits on capital, has propelled the economy forward. The current economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observation of the American economy.

The consequences for the American worker have been dramatic and, for the most part, highly favorable. A great many chronically underemployed people have been given the opportunity to work, and many others have been able to upgrade their skills as a result of work experience, extensive increases in on-the-job training, or increased enrollment in technical programs. Welfare recipients appear to have been absorbed into the work force in significant numbers.

Government finances have improved as well. The taxes paid on huge realized capital gains and other incomes related to the stock market, coupled with taxes on markedly higher corporate profits, have joined with restraint on spending to produce a unified federal budget surplus for the first time in nearly three decades. April’s budget surplus of $125 billion was the largest monthly surplus on record. Widespread improvement also has been evident in the financial positions of state and local governments.

The fact that economic performance strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to invest in productive capital diminish as product prices become more stable. But the extent to which strong growth and high resource utilization have been joined with low inflation over an extended period is nevertheless extraordinary. Indeed, the broadest measures of price change indicate that the inflation rate moved down further in the first quarter of this year, even as the economy strengthened. Although declining oil prices contributed to this result, pricing leverage in the goods-producing sector more generally was held in check by rising industrial capacity, reduced demand in Asia that, among other things, has led to a softening of commodity prices, and a strong dollar that has contributed to bargain prices on many imports. Some elements in this mix clearly were transitory, and the very recent price data suggest that consumer price inflation has moved up in the second quarter. But, even so, the rate of rise remains quite moderate overall. At this point, at least, the adverse wage-price interactions that played so central a role in pushing inflation higher in many past business expansions--eventually bringing those expansions to an end--do not appear to have gained a significant toe-hold in the current expansion.

There are many reasons why the wage-price interactions have been so well-contained in this expansion. For one thing, increases in hourly compensation have been slower to pick up than in most other recent expansions, although, to be sure, wages have started to accelerate in the past couple of years as the labor market has become tighter and tighter.

In the first few years of the expansion, the subdued rate of rise in hourly compensation seemed to be, in part, a reflection of greater concerns among workers about job security. We now seem to have moved beyond that period of especially acute concern, though the flux of technology may still leave many workers with fears of job skill obsolescence and a willingness to trade wage gains for job security. This may explain why, despite the recent acceleration of wages, the resulting level of compensation has fallen short of what the experience of previous expansions would have led us to anticipate given the current degree of labor market tightness. In the past couple of years, of course, workers have not had to press especially hard for nominal pay gains to realize sizable increases in their real wages. In contrast to the pattern that developed in several previous business expansions, when workers required substantial increases in pay just to cover increases in the cost of living, consumer prices have been generally well-behaved in the current expansion. Changes this past year in prices of both goods and services have been among the smallest of recent decades.

In addition, the rate of rise in the cost of benefits that employers provide to workers has been remarkably subdued over the past few years, although a gradual upward tilt has become evident of late. A variety of factors--including the strength of the economy and rising equity values, which have reduced the need for payments into unemployment trust funds and pension plans, and the restructuring of the health care sector--have been working to keep benefit costs in check in this expansion. But, in the medical area at least, the most recent developments suggest that the favorable trend may have run its course. The slowing of price increases for medical services seems to have come to a halt, at least for a time, and, with the cost-saving shift to managed care having been largely completed, the potential for businesses to achieve further savings in that regard appears to be rather limited at this point. There have been a few striking instances this past year of employers boosting outlays for health benefits by substantial amounts.

A couple of years ago--almost at the same time that increases in total hourly compensation began trending up in nominal terms--evidence of a long-awaited pickup in the growth of labor productivity began to show through more strongly in the data; and this accelerated increase in output per hour has enabled firms to meet workers' real wage demands while holding the line on price increases. Gains in productivity usually vary with the strength of the economy, and the favorable results that we have observed during the past two years or so, when the economy has been growing more rapidly, surely overstate the degree of pickup that can be sustained. But evidence continues to mount that the trend has picked up, even if the extent of that improvement is as yet unclear. Signs of a major technological transformation of the economy are all around us, and the benefits are evident not only in high-tech industries but also in production processes that have long been part of our industrial economy.

Notwithstanding a reasonably optimistic interpretation of the recent productivity numbers, it would not be prudent to assume that rising productivity, by itself, can ensure a non-inflationary future. Certainly wage increases, per se, are not inflationary. To be avoided are those that exceed productivity growth, thereby creating pressure for inflationary price increases that can eventually undermine economic growth and employment. Because the level of productivity is tied to an important degree to the physical stock of capital, which turns over only gradually, increases in the trend growth of productivity probably also occur rather gradually. By contrast, the potential for abrupt acceleration of nominal hourly compensation is surely greater. Still, a strong signal of inflation pressures building because of compensation increases markedly in excess of productivity gains has not yet clearly emerged in this expansion. Among nonfinancial corporations, our most reliable source of consolidated costs, trends in costs seem to have accelerated from their lows, but the rates of increase in both unit labor costs and total unit costs are still quite low.

Nonetheless, as I have noted in previous appearances before Congress, I remain concerned that economic growth will run into constraints as the reservoir of unemployed people available to work is drawn down. The annual increase in the working-age population (from 16 to 64 years of age), including immigrants, has been approximately 1 percent a year in recent years. Yet employment, measured by the count of persons who are working rather than by the count of jobs, has been rising 2 percent a year since 1995 despite the acceleration in the growth of output per hour. The gap between employment growth and population growth, amounting to about 1.2 million a year on average, has been made up, in part, by a decline in the number of individuals who are counted as unemployed--those persons who are actively seeking work--of approximately 700,000 a year, on average, since the end of 1995. The remainder of the gap has reflected a rise in labor force participation that can be traced to a decline of more than 500,000 a year in the number of individuals (age 16 to 64) wanting a job but not actively seeking one. Presumably, many of the persons who once were in this group have more recently become active and successful job-seekers as the economy has strengthened, thereby preventing a still sharper drop in the official unemployment rate. In May, the number of persons aged 16 to 64 who wanted to work but who did not have jobs was 9.7 million on a seasonally adjusted basis, slightly more than 5-1/2 percent of the working-age population. This percentage is a record low for the series, which first became available in 1970.

The gap between the growth in employment and that of the working-age population will inevitably close. What is crucial to sustaining this unprecedented period of prosperity is whether that closing occurs in a disruptive or gradual, balanced manner. The effects of the crisis in Asia will almost certainly damp net exports further, potentially moderating the growth of domestic production and hence employment. The strength of domestic spending that has been been bolstering output growth and the demand for labor also could ebb if recent indications of a narrowing in domestic profit margins were to prove to be the forerunner of a reassessment of the expected rates of return on plant and equipment. Reduced prospects for the return to capital would not only affect investment directly but could also affect consumption as stock prices adjusted to a less optimistic view of earnings prospects. Finally, the clearly unsustainable rise of inventories that has been evident in recent quarters will be slowing at some point, perhaps abruptly. An easing of the demand for labor would be an expected consequence of a slowdown in either final sales or inventory accumulation. Of course, the demand for labor that is consistent with a particular rate of output growth also could be lowered if productivity were to continue to accelerate. And, on the supply side of the labor market, faster growth of the labor force could emerge as the result of delayed retirements or increased immigration.

If developments such as these do not bring labor demand into line with its sustainable supply, tighter economic policy may be necessary to help guard against a buildup of pressures that could derail the current prosperity. Fortunately, fiscal policy has been moving toward restraint to some degree, although recent budgetary discussions do not appear to be focused on extending that tendency. Monetary policy might need to tighten if demand were to continue to exhibit few signs of abating noticeably, thereby threatening to place still further strains on our labor markets. We at the Federal Reserve, recognizing the powerful forces of productivity growth and global restraint on inflation, have not perceived to date the need to tighten policy in response to strong demand, beyond what has occurred through falling inflation’s upward pressure on the real federal funds rate and the modest increase in the nominal rate that we initiated in March of 1997. But, we are monitoring the evolving forces very closely to determine whether the recent acceleration of costs, albeit moderate, is likely to prove transitory or the start of a more worrisome pattern that may well require a response.

In summary, Mr. Chairman, our economy has remained strong this year despite evidence of substantial drag from Asia, and, at the same time, inflation has remained low. As I have indicated, this set of circumstances is not what historical relationships would have led us to expect at this point in the business expansion, and while it is possible that we have, in a sense, moved “beyond history,” we also have to be alert to the possibility that less favorable historical relationships will eventually reassert themselves. That is why we are remaining watchful for signs of potential inflationary imbalances, even as the economy continues to perform more impressively than it has in a very long time.