Mr McDonough comments on the implications for the strong US growth for the world economy

Speech by Mr William J McDonough, President of the Federal Reserve Bank of New York, before the Japan Center for Economic Research, Tokyo, on 30 March 2000.

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Good afternoon, ladies and gentlemen. It is a great pleasure to be invited to speak before such a distinguished audience. My thanks to the Japan Center for Economic Research for extending such a kind invitation.

This afternoon I would like to share with you some of my thoughts on the US and the world economies as we move forward into the 21st century. To do so, it is helpful to step back and take a somewhat longer-term view of how the stage was set for much of the current strong economic performance the US economy has enjoyed in recent years. In addition, I would like to comment on the implications of the strong US growth for the world economy.

The United States is now experiencing the longest economic expansion in its history. This expansion, which began in April 1991, not only has reached record length, but also has done so in a far stronger manner than had been expected. Most notably, inflation has been subdued, notwithstanding the most favorable labor markets that the United States has experienced in a generation, and the country's fiscal accounts are in surplus. There is no question that this expansion reflects some remarkable changes in the US economy. Before turning to some of the deeper trends that may help account for the remarkably good performance in the past several years, I think some key points are worth noting.

As 2000 gets under way, the US economy continues to enjoy astonishing job growth. Payroll employment growth has been fluctuating around 250,000 jobs per month since early 1996. Although job growth in February was considerably more modest, when figures for December and January are included, it looks as though the trend of roughly 250,000 jobs per month is still in place.

The counterpart to strong job growth has been a steady decline in US unemployment rates. In January, unemployment in the United States fell to a 30-year low of 4%. This level held roughly steady in February. What is particularly noteworthy is that the percentage of the population employed, at 65%, is the highest it's been in the postwar period.

Of considerable importance is the fact that job growth in the last few years has been increasingly centered in the segments of the population in which unemployment has been most stubborn: the more disadvantaged parts of US society, including the inner cities. The unemployment rate for 16-19 year-olds, for example, was about 20% in 1992. It is now about 13-14%. Similar trends hold for decreases in minority unemployment rates. In addition, recent years have witnessed sharp gains in labor force participation rates for minorities.

Along with strong employment growth have come gains in personal income. Real disposable income in the United States, for example, has risen roughly 4% a year over the past two years.

In addition, there has been considerable vigor in household demand. Indeed, the question is whether household demand is growing too quickly. In constant dollar terms, consumer spending grew more than 5% in 1999, the fastest rate since the mid-1980s. Housing has also been surprisingly strong, due to the best affordability conditions in a generation. In fact, the home ownership rate reached a record 67% in the second half of 1999.

A number of commentators have expressed concerns that the United States cannot sustain these current measures of prosperity. To support their view, they point to the declines in recent years in personal saving rates.

However, these declines in personal saving rates may be misleading in that they may be due in some respects to technical measurement issues, such as the exclusion of realized capital gains from the income and saving data. More relevant is the fact that household credit quality has not deteriorated over the past several years. On the contrary, it appears to be improving. Delinquency rates on mortgages and consumer installment debt have been falling, as have the number of new bankruptcies reported.

Driving these positive trends, to be sure, has been strong growth in employment and income. At the same time, I cannot suggest that the Phillips curve - which holds that there is a predictable trade-off between achieving price stability and employment gains - is dead. Notably, it is true that as the unemployment rate has come down, the pace of wage gains has increased. But what is different in the current environment is that productivity growth has increased roughly in tandem with the rate of compensation growth, thereby negating the inflationary impulses of these wage gains.

Thus, probably the most notable feature of the remarkable expansion in the US economy over this past decade has been a rebound in the growth rate of productivity. Whereas the productivity growth rate had languished at the 1½% level throughout most of the 1970s and 1980s, it rose steadily over the decade of the 1990s, reaching an astonishing 5.7% annual growth rate in the second half of 1999. The question that remains unanswered - and troublesome - is whether this significant improvement in productivity growth, which has made the US economy one of the most competitive in the world today, is temporary or permanent.

What is less often taken into account is that the US productivity boom of the 1990s has taken place against a background of very low inflation in the United States and rapidly decelerating inflation in almost every region of the world. Through much of the 1990s, weak economic performance elsewhere in the world has held down commodity price inflation and strengthened the dollar.

As a result of both productivity growth and the favorable world inflation environment, core consumer price inflation (CPI) - excluding the more volatile food and energy sectors - has been running about 2% recently, down from 3% in 1995. As measured by the personal consumption expenditures deflator (PCE), core inflation is even more subdued, rising by only 1½% a year over the past few years.

As a central banker, however, I cannot help but register concerns about some recent developments. As the expansion has progressed, signs of imbalance or strain have begun to appear in the US economy, especially in relation to the world economy. Commodity prices, for example - and not just oil prices - have increased rapidly in recent months, as world growth has bounced back sharply in 1999. For example, on a year-over-year basis, prices for crude materials, excluding food and energy, were up 15% as of February.

In addition, strong consumption growth in the United States has been fueled in part by an inexorable decline in the personal saving rate. As I have noted, however, these declines in personal saving rates may to some extent be due to technical measurement issues.

Moreover, the US current account deficit has also widened markedly over the past several years, with corresponding large surpluses in Asia and Europe. The outlook is for continued worsening in the deficit that had already reached a record last year, at about 4% of GDP. History tells us that such imbalances can persist for some time, but increase in risk as they widen. History also tells us that current account imbalances eventually require macroeconomic adjustment - adjustment that is smoother and more orderly the earlier and more coordinated the policy response.

While I am not one to second-guess the markets, I also believe that we in the United States must ask ourselves whether the surge in the stock market over the past several years will continue to be accompanied by commensurate growth in output and earnings. To date, consumer spending increases spurred by the growth in the stock market have not been exceptional compared with the growth in wealth, but the growth in wealth has certainly been astonishing.

Let me turn now to some of the longer-term trends driving the US economy in recent years. It is these trends that have led many to question whether the structure of the US economy has changed and to ask whether, in fact, the United States is a "new economy" today.

While the bottom line is that there is not a consensus on this issue, no one disagrees that the performance of the US economy has changed dramatically in recent years. Annual real GDP growth over the past four years is higher than it has been in decades, averaging 4% a year in comparison with average annual GDP growth rates of roughly 3% in the 1970s and 1980s. Over the same period, core CPI inflation has fallen from average annual rates of over 6% to 2%.

One important sign of underlying change is that the volatility of economic fluctuations has declined since the mid-1980s, evidenced by the fact that there has been only one recession in the United States in the past 17 years. Improved macroeconomic policy management and such positive supply factors as generally lower commodity prices certainly have contributed to the strong performance of the US economy in recent years.

Also critical has been the emergence of new technologies, specifically the adoption of "just-in-time" inventory systems, which we copied from Japan. Research at the Federal Reserve Bank of New York suggests that these new inventory systems have helped account for a significant reduction in the magnitude of inventory swings and hence less volatile growth of the US economy. The spate of recent announcements of new resource management systems by auto companies, retailers, and others suggests that we have not yet exhausted the potential benefits from such inventory and production systems.

These inventory and production management techniques are just one aspect of the most significant factor that has characterized the improved performance of the US economy, which is non-farm business productivity growth. As I have noted, this had averaged about 1½% a year over the previous 20 years, but since 1995 has improved steadily. It has been the impressive growth in productivity that has been the fundamental factor behind the stunning improvement in the output/inflation mix we have been observing these past several years.

What accounts for this improvement in productivity, and is it sustainable? These questions are really at the heart of the debate as to whether the United States is or is not a "new economy". No one disagrees that the surge in the production of computers and software has been integral to the recent upswing in productivity. Where the differences in view enter is over the deeper sources of productivity growth and the sustainability of the productivity improvements - that is, whether they are temporary or permanent.

Those suggesting that there is no "new economy" argue that the recent improvement in US productivity growth is easily explained: it is a combination of a normal cyclical reaction to a surge in demand and a pickup in the growth of the capital stock, most notably high-technology equipment and software. Once growth in demand settles down, this view holds, and investment in high technology slows, productivity growth will moderate. Even proponents of this view recognize, however, that the rapid increase in productivity and output growth in the computer industry will likely increase the growth rate of the economy over the longer term.

By contrast, those supporting the idea of a "new economy" tell us that what we are witnessing in the US economy is the fruition of some longer-term trends in information technology, deregulation, globalization and labor markets. More specifically, proponents of a "new economy" contend that advances in computer power and software - combined with deregulation in the telecommunications, transportation and financial industries - have produced many new profitable business opportunities. Using advances in technology and tapping into highly liquid world capital markets, many new and existing firms have been able to exploit these opportunities quickly.

Furthermore, the proponents of a "new economy" argue, information technology has produced numerous cost savings for business operations. The growing role of the internet as the medium to exchange large volumes of information and conduct efficient transactions - among businesses as well as between businesses and consumers - will lead to a further acceleration of productivity growth. Thus, this view concludes, the increase in the output of the computer/software industry is both a cause and an effect of these deeper trends.

We are just at the early stages of understanding the surge in productivity growth. But recent empirical work is beginning to grapple with some of these issues. It appears that a significant part of the increase in productivity relates to increased quantities of capital per worker, primarily computers and software. However, the largest part of the improvement in productivity growth has yet to be fully understood.

We can not yet resolve the “new economy” debate. Nevertheless, I am persuaded that the longer productivity improvement continues, the harder it becomes to view this improvement merely as a cyclical phenomenon. Certainly, it seems to me that the accompanying low levels of inflation, together with relatively high rates of resource utilization, suggest that something more than normal cyclical forces is at work.

The ability to develop and deploy these technological advances rests on underlying changes in our labor and financial markets, changes that have been occurring over the last two decades. With respect to labor markets, two main changes have occurred.

First, large corporations have been increasingly willing to lay off workers and restructure their businesses during the expansion phase of the business cycle rather than waiting for a recession to do so. This process has been under way in the United States for over a decade and it has not been accomplished without pain. A crucial unanswered question in the current environment is how to identify the point at which labor market tightness becomes sufficiently severe for workers to demand more permanent pay increases.

Second, there appears to be a shift in the structure of compensation toward variable pay that includes, but is not confined to, stock options. This shift away from wages and traditional benefits has allowed for greater flexibility in labor costs and by this means has made it easier for new firms to add labor. Employees compensated through incentive pay take on some of the risks of capital. And in highly competitive goods and services markets, consumers’ benefits show up in the form of lower prices, rather than entirely in higher pay, with important, not yet fully understood, implications for the distribution of benefits in our economy.

Let us not forget the financial and corporate side of this picture as well. There is no doubt that the banking system in the United States has been far stronger in the 1990s than it was in the previous two decades. At the same time, capital markets have deepened significantly. Expanded equity markets have served as important sources of finance for new businesses, while venture capital markets have provided increased access to risk capital. By some measures, new financing from these and related markets has tripled the flow of new equity capital to business in the last five years.

Also important has been the increased liquidity of financial assets. Today, asset portfolios of loans and credit cards are easily transferable through securitization or outright sale.

As a result, the corporate sector, too, has witnessed significant change over this past decade, with the formation of many new businesses and the transformation of many old ones. Many of the household names today were formed sometime in the last 25 years, while a number of the corporate giants of 25 years ago still in operation today have changed dramatically. To remain competitive, many have had to shed some business lines that no longer fit their overall strategies and to invest in new lines. They also have had to pay more attention to evaluating business opportunities by using more sophisticated risk/return analysis than they previously did, a strategy financial firms have been particularly aggressive in pursuing.

What lessons might other countries thus draw from the US experience and what are the implications of the strong economic performance in the United States for other countries? One lesson seems clear. With the advances in technology, all countries that move toward more open and transparent markets stand to benefit from the universally available strides that have been made in information technology.

I want to emphasize that the processes I am speaking about do not call for just onetime efforts. Quite the contrary. They demand ongoing attention and adaptation to new circumstances.

Second, it is not just that productivity growth is being driven by technological advances. It is also a question of how these technological advances are applied. At the end of the day, I believe, the United States has had such strong economic performance because of the high degree of flexibility and adaptability that has been built into the US labor, product and financial markets over the past decade.

These lessons seem to be gaining a following, as many countries across the globe have begun to record substantial progress in liberalizing and deepening their capital markets, deregulating their state-owned enterprises, and easing existing labor market rigidities. In so doing, these countries position their economies to capture the manifold benefits technological advances allow them to enjoy.

To be sure, these efforts are not necessarily being undertaken with equal commitment and intensity in every country. Nor should they be. No country is like any other. We all recognize that countries differ in their histories, traditions and ways of doing business. This is not a question of thinking that there is only one correct model and that each country must adapt to that model.

What is at issue, however, and what is desirable is that all countries grow. What the US experience has shown is that productivity gains driven by new technological advances, coupled with the flexibility to shift resources quickly into high-growth areas and the ability to apply the technology in productive ways, can help contribute significantly to this goal.

The United States has no wish to be an island of growth in a sluggish global economy. The costs to the US of being strong when others are weak are very real. One has only to look at the weakness of the US current account deficit in recent years to understand why it is in the interest of the United States for the rest of the world's economies to be strong and competitive with us. The United States cannot indefinitely be the engine of growth for the world economy - the importer of first and last resort - and sustain ever-mounting current account deficits without running the very real risk of economic and financial difficulties that could well weigh on many of the world's economies. No one wants that.

Moreover, I am firmly convinced that growth in an economy is what ultimately underpins a healthy society. It is simply not possible to have a strong society with a permanent underclass. No society - not our own nor any other - can hope to flourish if its youth are left unemployed and a large segment of its population remains poorly educated and inadequately housed. Nor can an economy grow without a basic infrastructure that enshrines the rule of law and the accountability of the government to its people.

As I survey the world economy today, I am pleased that there seems to be broad-based recognition of these fundamental precepts. World economic conditions are considerably more benign than they have been in years as we begin the new millennium.

How do things look outside the United States? Let's start with Japan. When we look at Japan's growth in the 1990s, we really see two patterns. One is the sluggish growth since 1992, the other is the steep recession in 1998. The 1998 recession stemmed from the financial crisis in a number of other countries in Asia, leading to a collapse in corporate profits and business fixed investment, and essentially a credit crunch as financial restructuring got under way. Japan today is in the difficult phase of restructuring, with high unemployment as balance sheets are being cleaned up in the corporate and banking sectors. Moreover, business investment was slow up to the fourth quarter of 1999 and consumers have been restrained in their spending.

I believe that changing private sector expectations and reducing microeconomic constraints on the economy are key in Japan today. Japan historically has had a tremendous ability to capitalize on technological innovation. While productivity growth has been choppy - the result of cyclicality in the economy - there has been overall moderate growth. In the first half of 1999, in fact, GDP growth was unexpectedly strong, but it fell back in the second half of the year, owing largely to weaker private consumption. In 2000, most forecasters expect a renewal in growth, supported by a new round of fiscal stimulus, announced in November, and a broad-based recovery in business fixed investment.

Developments in the euro area are very interesting. The bold and historic effort of 11 of the European community countries coming together to unite their economies in a common currency and to form a single market appears to be bearing fruit.

In the run-up to the introduction of the euro, many of the euro area countries struggled to bring down their fiscal deficits and reduce inflation to a low level. These efforts were preceded throughout the 1980s and 1990s by measures to break down trade barriers and harmonize some regulations while eliminating others. Not surprisingly, these developments have coincided with both strong business fixed investment and labor productivity growth in manufacturing. Today, we see the euro markets starting to coalesce and expand.

Although unemployment has been stubborn, the key challenge expressed by many Europeans is to make labor markets more flexible, and indeed, some change is evident. This past year, unemployment in the euro area finally seems to have started to trend down, falling to 9.6% in January, a seven-year low and almost 1 percentage point below its level a year earlier.

Further, output growth has begun to revive from the falloff in 1998, and the outlook is for solid growth in the 11 euro countries to continue into 2000. Core inflation throughout the euro area has also been subdued, although with rising energy prices, it may edge up a bit. Producer prices for finished goods show no signs of inflation pressure. Growth elsewhere in the industrial world - the United Kingdom and Canada - also appears to be strong, with no signs of accelerating inflation. In both countries, strong private consumption - and in Canada an unemployment rate that is the lowest since 1981 - continues to keep GDP growth on a reasonably steady path.

More broadly, there is active debate within Europe today about what kinds of labor and financial market changes will accelerate technological change. Countries have taken different approaches in addressing these issues. The diversity of experiences among the European countries allows each to assess the impact of the various approaches others have taken and to draw lessons from which it may benefit.

Among the emerging market countries, those in Asia in particular have long been considered engines of vitality and technological adaptation in the world economy, and this recognition had been reflected in very high rates of GDP growth until the financial crises of 1997 and 1998. One problem those crises revealed is that in many countries, economic resources, notably capital inflows, had been misallocated. In the Asian countries, financial market and corporate sector reforms are widely viewed as necessary.

It is encouraging to see that some progress has been made on financial restructuring, although the extent to which markets - as opposed to governments - have been the main shaper of change differs across countries. Other reforms appear to be less far along, and the greatest risk is that the sharp recovery so many of these countries have enjoyed will reduce the impetus to undertake and follow through on needed reforms.

When we turn to Latin America, we observe an example of how important internal labor market and corporate sector reforms are. In the 1980s and early 1990s, many countries in this region made enormous strides in achieving sounder fiscal and monetary policies, especially in bringing down inflation and strengthening reliance on market mechanisms. However, in several countries, internal reforms were incomplete, with banking systems left in need of further strengthening, labor markets still remaining too rigid, and fiscal policies requiring more attention, starting with the need to ensure that all public sector spending be brought under control.

This past year, many countries in Latin America - other than the major oil exporters - faced the further shock of a worsening in their terms of trade, as commodity prices declined in the wake of the crises in Asia and Russia. However, a number of countries in Latin America have begun to see a resurgence of growth, following sharp falloffs in 1998.

As we look ahead to the next decade, I am convinced that many of the developments we have witnessed over this past decade have greatly widened the opportunities for strong growth in the years ahead. Inflation in the global economy appears subdued, fiscal deficits have been widely reduced - and we have gained a much better understanding of how solid, non-inflationary growth can be achieved.

The economic and financial crises of the 1990s, while having very adverse macroeconomic implications for the countries involved, nonetheless have reinforced the importance of sound monetary and fiscal policies for all countries and the desirability of market reforms. In addition, these crises have laid the foundation for renewed attention to structural reforms for the banking and corporate sectors as well as to the need for strengthened regulatory and supervisory measures.

The challenge going forward will be to execute the necessary strategies to realize these goals. When economic times are reasonably favorable, as they are now, the risk is that complacency sets in and the steps needed to address the more deeply rooted structural problems are harder to take. Not to act, however, would be to squander the lessons of the past decade and mortgage our futures. It is simply not an acceptable option.

We face today probably the best macroeconomic environment in decades to put our economies on a sound economic and financial footing to meet the surprises we will inevitably face in the new century. The opportunities provided by rapid technological change are available to all in the global marketplace. The flexibility and adaptability we build into our respective economies today will ultimately determine the success we are able to achieve for the generations that follow us. The challenge could not be more important.