The Federal Reserve Board

Remarks by Governor Laurence H. Meyer

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The Economic Outlook and Challenges Facing Monetary Policy

Recent economic performance has been hailed on Wall Street as "paradise found" and the "best of times." And, on Main Street, there is ample survey evidence suggesting that consumers are feeling very upbeat about the prospects for the economy. I call the remarkable combination of healthy growth, low unemployment, low inflation, a soaring stock market, and declining federal budget deficit the "good news" economy.

But there are challenges even in the "good news" economy and I want to focus on three of them this afternoon. The first challenge is to avoid complacency and appreciate the policy challenges that remain. The second is to explain how we have been able to achieve such favorable performance, given that it is better than almost anyone predicted and better than historical regularities suggested was even possible. And the third challenge is to assess the risks in the current environment and determine how monetary policy should be positioned to keep the good news coming.

Two themes will become evident as I address these challenges. First, there are limits -- limits on what policy can accomplish and limits on what the economy can achieve. Second, in assessing the current environment and its implications for monetary policy, uncertainties require us to balance historical regularities and newer possibilities.

Expansions, to an important degree, have common properties, what I shall refer to as regularities. Both forecasters and policymakers rely on these. Forecasters make predictions about future developments based on regularities. The same regularities allow policymakers to act preemptively -- changing policy today in anticipation of developments tomorrow. Yet each expansion has its own signature that reflects the specific set of transitory influences and longer-lasting structural changes in play at the time.

The current episode features the following players. Cyclical regularities clearly in evidence include accelerator effects, changing tolerances for risk, and cyclical swings in the unemployment rate and in profits. Two other regularities that I especially want to focus on today are the Phillips Curve and the trend growth in output. The latter regularities define limits -- limits to the sustainable level of output, at any moment, and, once that level of capacity is reached, to the growth of output over time. If these limits are exceeded, as typically happens during a cyclical expansion, the economy eventually overheats, inflation increases, and the expansion is undermined as policy is forced to rein in demand. Transitory influences, clearly among the stars of the current episode, feature a coincidence of favorable supply shocks that have restrained inflation. Finally, structural adjustments, in this episode, hint at a decline in NAIRU and/or an increase in trend growth. The central question in interpreting the recent experience is whether the old limits on economic performance are no longer binding, having been replaced by new possibilities, or are just being temporarily overruled by transitory influences.

Before moving to the substance of my talk, let me remind you that my remarks on the outlook and monetary policy, today and always, are my views. I do not speak for the FOMC.

Near-Term Prospects in the Good News Economy

Before addressing the challenges and developing these themes, let me briefly review the surprisingly favorable features of recent economic performance and comment on the near-term outlook. For this audience, I can summarize recent performance in a single sentence. We have been recently blessed with relatively strong cyclical growth, the lowest unemployment rate in 24 years, the lowest inflation in 31 years, an impressive investment boom, soaring equity prices and a 5-year decline in the federal budget deficit that may take the deficit to below 1/2% of GDP in fiscal 1997.

But this conference is about the next chapter in this story. And the key in the near term may be crosscurrents that appear likely to both moderate output growth and keep inflation relatively well contained.

In the case of output growth, the crosscurrents are the continued strength in demand and the expected slowing in inventory investment. In the second quarter, the economy slowed to an upward revised 3.6% rate, from a 4.9% rate in the first quarter, a much more modest slowing than originally reported and widely anticipated during the quarter. This, by the way, has been a recurring pattern in the expansion -- every time I thought the economy had or was about to slow to trend, it has surprised with its continued strength.

The fundamentals continue to look very positive. In particular, households as a group are wealthy and optimistic, businesses are profitable and confronted with dramatic technological opportunities, and financial conditions remain supportive. There appear to be few imbalances that are a threat to continued expansion. As a result, demand is expected to remain strong in the second half of the year, paced by a rebound in consumer spending and complemented by continued strength in business fixed investment.

Forecasters know, however, that the composition or mix of output in one quarter -- specifically the mix between final demand and inventory investment -- often provides an important hint of what is to come. While I interpret the strength of inventory investment in the first half -- including the upward revised rate of about $78 billion in the second quarter -- as largely voluntary, principally reflecting a response to the strength in past and prospective sales, the flow rate of accumulation in the second quarter is almost certainly unsustainable. That is, stocks may be in equilibrium, but the flow rate will have to slow to keep them there. The resulting slowdown in inventory investment is likely, therefore, to be a significant drag on production in the second half of this year, offsetting, at least in part, the expected rebound in final demand.

On the inflation side, there are also important crosscurrents at work. I have been concerned about two considerations that suggest that inflation may well rise over time: the possibility that the economy is operating today beyond its sustainable capacity and the likelihood that the transitory factors that have, on balance, been restraining inflation will diminish in importance over time. However, three other influences that, in my view, have gradually become more significant considerations, are likely to moderate the tendency for inflation to rise in the near term. First, lower-than-expected overall and core inflation and continued modest pace of wage change over this year will encourage more restrained increases in wages and prices over the coming year. Lower inflation leads to lower inflation expectations, reinforcing the prospect for low inflation ahead. In this case, inertia is our friend and the result is a virtuous wage-price spiral, at least for a while. Second, some of the transitory factors, especially the appreciation of the dollar and resulting decline in import prices, appear to have longer legs and are likely to contribute more toward restraint on inflation in coming quarters than earlier appeared likely. Third, the upward adjustment to profits in the July NIPA revisions suggests there is more of a profit cushion that could delay the pass-through of higher compensation to price increases.

While these crosscurrents suggest moderation in both output growth and inflation, crosscurrents don't necessarily balance. With respect to output growth, the crosscurrents do point toward slower growth in the second half compared to the first half, but is important whether the slower growth turns out to be near trend, holding utilization rates constant, or above trend, pushing utilization rates still higher. At the very least, the slowdown in inventory investment is likely to be accommodated with minimal disturbance to the continued expansion. But there is a risk that growth will continue to be above trend, pushing utilization rates up, from already high levels.

With respect to inflation, the netting of the crosscurrents suggests a modest increase in inflation in 1998, albeit from a steadily downward-revised and very low rate in 1997. I will pay very close attention to the source of any rebound in inflation, specifically the degree to which it reflects simply the dissipation of some of the favorable supply shocks that have contributed to the very low inflation this year and the degree to which it reflects the more persistent effect of high utilization rates. As a result, I will be focusing more on core than overall inflation rates and paying particularly close attention to labor costs, given that labor markets appear tighter than product markets and therefore more likely to be the source of any increase in inflation pressures. Still, any increase in inflation would begin from a lower base and may be more modest than previously appeared likely.

The bottom line is that past performance, in several important dimensions, has been extraordinary and that prospects look favorable for continued expansion and relatively low inflation. Still, monetary policy must be alert to the potential of a developing upward trend in inflation in an economy that may already be operating beyond its sustainable capacity and possibly still growing at an above-trend rate. And, as always, there are challenges, even in the good news economy.

Limits on What Monetary Policy Can Do

The first challenge is to avoid becoming complacent. Even as there are good reasons for celebrating recent economic performance, there are good reasons for avoiding complacency. Specifically, there are dimensions of economic performance which are less stellar, such as the slow average growth rate in GDP in the 1990s, a continuation of the effects of the productivity slowdown that began in the early 1970s. There are, in addition, obvious longer-run problems that deserve to be confronted today, such as those related to the aging of the population and resulting pressures on entitlement programs. And there remain lingering social strains associated with a gradual increase in income inequality, interacting with the low average growth rate in productivity to produce a long period of relatively stagnant real income for the median income family.

This less rosy perspective on the current state of the economy was suggested by several members of Congress during the recent oversight hearings on monetary policy. I think the point is an important one and I agree that we should not let the recent favorable performance of inflation, unemployment and equity prices distract our attention from the importance of confronting a slow average rate of increase in living standards and lingering social problems that both reflect and are exacerbated by a widening in income inequality. However, other than through its pursuit of its legislative mandates of price stability and maximum sustainable employment, monetary policy cannot make a major contribution to the resolution of these problems. Monetary policy, in particular cannot remedy increases in income inequality, raise the trend rate of increase in living standards, or combat inadequate opportunities for upward mobility out of poverty. It is, as always, important that we carry out our traditional responsibilities well, accommodating the maximum sustainable growth and achieving the maximum sustainable level of employment. But we cannot do more.

Regularities

The second challenge is to explain why performance has been so favorable, at least in terms of inflation and unemployment. Before exploring explanations of the puzzle, I want to focus on common features of cyclical expansions. In doing so, I will focus on cyclical expansions that have not been dominated by dramatic external shocks, such as the two episodes that were marked by steeply rising world oil prices -- first in the early 1970s and again in the late 1970s and early 1980s. While even these expansions share many of the patterns I emphasize later, their endings are dominated by the effects of the powerful supply shocks and policy responses to the shocks.

Expansions, by definition, begin with considerable economic slack, inherited from the previous recession. The economy typically makes a rapid transition from declining output (the definition of recession) to above-trend growth. In a loose way, trend growth refers to the growth in the economy's productive capacity. When growth is above trend, production is expanding faster than the economy's productive capacity and, as a result, resource utilization rates rise. Rising capacity utilization rates and falling unemployment rates are thus a typical feature of an expansion period.

The natural dynamic of an expansion is for above-trend growth to continue until demand overtakes capacity, despite the best efforts of policy to avoid cyclical excesses. The end of the story is particularly important. Expansions do not die of old age or lethargy, a spontaneous weakening of aggregate demand, but rather of an accumulation of imbalances, specifically with demand outstripping the limits of sustainable level of input utilization and growth of output. The resulting rise in inflation becomes a threat to the continued expansion. Preventive medicine is therefore the best course of treatment.

In this story, NAIRU sets a limit to how far the economy can expand before overheating sets in and inflation rises, and the Phillips Curve traces out an important part of the dynamics of inflation, how fast it responds to excess demand. Of course, the Phillips Curve framework has always been much easier to describe than to implement, given uncertainties about the estimates of NAIRU, given the fact that empirical regularities between inflation and unemployment always left much of the variation in inflation unexplained, and given the importance of supply shocks with significant, though transitory, effects on the inflation-unemployment nexus. Nevertheless, the regularity in the cyclical sensitivity of inflation, as embedded in the Phillips Curve, has proved to be an important guide to both forecasters and monetary policymakers in the past.

Transitory Influences

The consensus estimates of NAIRU as this expansion began -- about 6% -- did not prepare us for the recent surprisingly favorable performance. It is possible that the Phillips Curve and NAIRU is simply the wrong analytical framework, but I doubt it and am not aware of another model of inflation dynamics that is ready to take its place. So my response is to update my estimate of NAIRU and add other explanations consistent with this framework, but not to abandon this concept.

One possible explanation is that one or more transitory factors, for the moment, are yielding a more favorable than usual outcome. A coincidence of favorable supply shocks is clearly, in my judgment, an important part the answer to the puzzle. I won't talk at length about these factors, as I have done so in previous talks. I would just note that these favorable supply shocks include an appreciation of the dollar and consequent decline in import prices; a slowing in the rate of increase in benefit costs, concentrated in a slowdown in costs for health care insurance; a faster rate of decline in computer prices than earlier, reflecting the quicker pace of innovation; and more recently, a decline in oil prices and a slower rate of increase in food prices.

A Cyclical Anomaly

Let me include in my list of explanations for the current favorable economic performance an intriguing cyclical anomaly. One regularity of past expansions has been the close relationship between two widely used measures of resource utilization -- the capacity utilization and unemployment rates. They have traditionally moved together over a cycle and tended to mirror one another. In this case, it did not matter which one was used as a proxy for excess demand; and the unemployment rate could be used interchangeably as a measure of labor market demand pressures and overall economy-wide demand pressures. In the current episode, however, these two measures are sending different signals. The unemployment rate is flashing a warning of a very tight labor market. The capacity utilization rate, in contrast, suggests a reasonably balanced configuration of production and capacity in the product market, at least in the manufacturing sector.

Why has this divergence developed and what are its implications for the relationship between inflation and unemployment? The divergence mirrors one of the other defining features of this expansion -- the boom in business fixed investment. The result is a high level of net investment, a more rapid rate of increase in the capital stock and hence in industrial capacity.

The resulting absence of excess demand in the product market is, in my view, an important factor explaining the frequently reported absence of pricing leverage by firms. Nothing gives a firm pricing leverage like excess demand. In addition, the resulting inability of firms to pass on higher costs in higher prices likely has altered the way firms operate in the labor market, making them more reluctant to bid aggressively for workers, contributing to a slower rate of increase in wages than we would otherwise have expected at prevailing labor utilization rates. It is possible that the gap that has opened between the unemployment and capacity utilization rates may be a factor that has, in effect, lowered NAIRU in this expansion. This explanation has potential, but there is no historical precedent and it is, therefore, difficult to judge its importance.

Possibilities
The most intriguing explanations for the recent favorable performance are structural changes, which may have relaxed the capacity constraints that are the core of the cyclical regularities story, or made these constraints more flexible than in the past, or tempered the ability and/or willingness of firms to respond to excess demand by raising wages and prices. I refer to these collectively as "possibilities," as they suggest an optimistic period of improved economic performance, contrasting with both the pessimism of the previously perceived limits in the cyclical regularities story or the grudging "for the moment" concession of explanations relying on transitory influences. There are two possibilities that have been widely discussed: that the economy can now sustain a lower unemployment rate without rising inflation (i.e., that NAIRU has declined) and that, once capacity has been reached, the economy is now capable of faster growth, compared to the estimates of trend growth reported earlier. A lot of the discussion about this episode focuses on sorting out the relative importance of the two possibilities -- specifically, whether the recent favorable performance is due more to labor market structural change, as reflected in a lower NAIRU, or to product market structural change, as reflected in a higher rate of growth in productivity.

Has there been a decline in NAIRU?
Time varying parameter estimates of the Phillips Curve and the more casual eye both suggest a decline in NAIRU. Robert Gordon's work, for example, suggests a decline in NAIRU, from 6% in the decade prior to 1994, to about 5 ½% by the end of 1995, with NAIRU stabilizing at this level since that time.

One possible explanation for the more moderate rate of increase in compensation per hour than would have been expected from historical experience is an increase in worker insecurity as a consequence of the rapid pace of technological change and/or the rapid pace of restructuring and downsizing. As a result, workers may have been willing to trade off some real wages for increased security, resulting in a more modest increase in compensation per hour than otherwise would have been expected. The result is a slower rate of increase in compensation at any given level of unemployment, equivalent to a decline in NAIRU. Another possible explanation is the divergence between the unemployment and capacity utilization rates in this expansion that I discussed earlier.

Although a decline in NAIRU is a story of relaxed limits, the worker insecurity explanation is not itself an optimistic story. Some workers, to be sure, gain, by opportunities for employment that otherwise would have been denied. But a broader group of workers suffer a slower increase in living standards, relative to what otherwise would have been "possible."

Has there been an increase in trend productivity?
Another possibility is that the trend rate of increase in productivity -- and hence the economy's sustainable rate of growth in GDP -- has recently increased.

There is some confusion in many discussions of productivity growth about the implications of measurement bias. It is widely accepted that there is a downward bias in measured productivity growth, the mirror image of the upward bias in measured inflation. But it is also widely accepted that a similar bias has been present over the entire postwar period. The measurement issue is relevant to explaining the inflation-unemployment experience in the current episode only if the bias has recently become more serious. An increase in measurement bias could be under way, perhaps related to an acceleration in technical change, but it will be a long time before we are able to establish this with a reasonable degree of certainty. Note also that if the measurement bias has increased, this would imply that both actual and potential output growth are higher than reported, with no obvious implication for the gap between actual and potential output, and hence for inflation pressures.

Sources of higher productivity growth, all of which should show up in measured productivity, include a return on years of corporate restructuring and the increase in capital per worker associated with the current investment boom, much of which is linked to technological change, specifically the information revolution.

There are a couple of reasons why this is an attractive explanation. No other explanation has the ability to explain as many features of the current experience as an increase in trend productivity. Technological change, according to this view, has resulted in new profit opportunities which in turn have resulted in an investment boom (heavily concentrated in high technology equipment), increased corporate earnings, and a soaring stock market. In addition, this explanation is consistent with many anecdotes from businesses about efficiency gains as new technology is put into place.

There are, however, some problems with this story as the principal explanation for the favorable inflation performance. First, a productivity explanation would resonate better if the puzzle were why higher wage change was not being passed on in higher prices. But the greater puzzle is the slow pace of increase in compensation per hour at prevailing unemployment rates. This is more clearly the case after the downward revision in compensation in the July NIPA revisions, bringing that measure of compensation per hour more in line with the Employment Cost Index. Given the rate of increase in compensation, an unchanged trend growth in productivity of 1.1%, for example, seems quite consistent with recent price performance.

Although not without some serious shortcomings, the published productivity data provide little encouragement to the view that there has been a significant improvement in underlying productivity growth. The growth in measured productivity over this expansion has, in fact, been disappointing. Over 1994 and 1995, in particular, measured productivity was nearly flat. Although it has accelerated over the last two years, this is consistent with another cyclical regularity, the tendency for productivity to accelerate with economic activity. And the rate of growth over the last year, even with the sharp upward revision in the second quarter, is 1.2%, just above the 1.1% average rate of increase over the period from the early 1970s up to the beginning of this expansion.

Still, there are other pieces of data and interpretations of the published data that provide some support to a more optimistic assessment. For example, the acceleration in productivity to a 1.2% rate over the last year, at a time when the unemployment rate was dropping to a level that would suggest less productive workers were being drawn on, leaves open the possibility that the productivity trend has quickened. Perhaps the strongest case for an increase in the productivity trend comes from the higher rate of growth over the past two years if productivity is measured from the income side of the national accounts.

Balancing regularities and possibilities
In my testimony at the Congressional oversight hearings, I presented a range of estimates for NAIRU and trend growth from the CBO, Council of Economic Advisers, DRI,

Macroeconomic Advisers and Professor Robert Gordon. The range for NAIRU was 5.4% to 5.9% and for trend growth, 2.1% - 2.3%. Since my testimony, both DRI and Macroeconomic Advisers have revised down their estimates of NAIRU - DRI from 5.8% to 5.6% and Macroeconomic Advisers from 5.8% to 5.4%. The range of estimates is now therefore more tightly concentrated around 5 ½%. I presented these estimates in my testimony to emphasize the continuing importance the profession attaches to NAIRU, the central tendency of current NAIRU estimates, and the absence of significant upward adjustments to estimates of trend growth.

In short, some updating in the regularities may be appropriate, especially in the case of NAIRU, but continued attention to their message of limits remains critical for disciplined policy. We should remain open minded and alert to the possibility of structural change, but cautious about reaching the conclusion that the regularities that have been so important in the past no longer set limits that policy must respect.

The Challenge for Monetary Policy
Some day we shall look back on this episode with historical perspective and perhaps -- and only perhaps -- have a better ability to sort out what contributed to the favorable outcome and the extent to which the prevailing coexistence of low unemployment and stable low inflation proved permanent or transitory. Monetary policy, however, is made in real time.

The appropriate stance of monetary policy should reflect both the increased uncertainty surrounding the failure of historical regularities to predict the better-than-expected outcome in terms of inflation and unemployment and the best judgment about regularities as we update our estimates of NAIRU and trend growth in response to current data.

At one extreme, the uncertainty about the source of the recent performance might be viewed as so great that the best course for monetary policy is a reactive posture, waiting for clear signs that inflation is rising and only tightening in response to such evidence. I agree that the current uncertainty encourages caution, but not to the point of paralysis.

A prudent approach would continue to lean against the cyclical winds by adjusting policy in response to persistent increases in utilization rates as well as in response to changes in underlying inflation.

Summing Up
We should always have problems like today's, struggling to explain unexpectedly good performance. And it is important to keep in perspective any questions about how tight labor markets might be or whether near-term growth might remain above trend. The economy is very healthy and the prospects continue to be bright. But as we celebrate the exceptional present, we should not forget the lessons of the past. There are limits. They may not be the old limits that disciplined policy in the past. But even if the limits are new, they must be respected. Overheating is a natural product of expansions that overtax these limits. Recessions typically follow overheating. Good policy must therefore balance regularities and possibilities.

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