

Speeches

Why Is the Economy Doing So Well?

Remarks by Jack Guynn
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
Business Development Board of Palm Beach County
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It's a pleasure to be here today. It's been some months now since Janet Harris-Lange called to ask me to address this group of "who's who" in Palm Beach County. I was glad to say yes since I owe her for all the time she spent giving us at the Fed her views on the economy as a member of our Small Business, Agriculture, and Labor advisory group. Thanks, Janet, and it's good to see you again.

As I've been out in the Southeast talking with business people and community leaders during the nearly two years I've been president of the Atlanta Fed, there's one question that always seems to come up, and I'll bet you can guess what that is--What's going to happen with interest rates? But I've noticed a change in the last six months or so. Everywhere I go people are now puzzling over something they haven't had a chance to think about in a long time. Instead of asking me about interest rates, they're more often asking, **What in the world is going on with the economy? Why is it doing so well, and how long can it last?**

Why Are Things Going So Well? Four Reasons

As I think you might guess, I've been thinking about these same things myself, and, today, I'd like to give you my personal answers to these important questions. Before I deal with those very fundamental questions, let me tell you how I see the economy at the moment and in the period immediately ahead. In short, the economic outlook is very good. We're now more than halfway through 1997, and I expect to see continued moderate growth--with more low inflation and low unemployment. Second-quarter growth data showed that the economy slowed some (blessedly) from the torrid first-quarter growth rate of nearly 5 percent to a little over 2 percent. Considering how the remainder of the year is likely to unfold, it now looks like 1997 will significantly exceed last year's 2-1/2 percent annualized growth. **GDP** growth for 1997 should be around 3-1/2 percent on an annual average basis, although it should be tapering as the year goes on; **unemployment** should come in at around 5 percent, even lower than it's averaged over the last two years; and **inflation**, as measured by the CPI, should average about 2-1/2 percent for the year, compared with an annual average of more than 3-1/2 percent for the last 10 years.

And there's more to add to this pretty picture. This economy has been a virtual job-creation machine. Look at the strong employment figures--just in July, businesses added 316,000 new jobs to the economy, which is a remarkably good showing considering that June had also been a strong month with 228,000 new jobs being added. Hand in hand with this strong job growth has gone strong income growth. And the combination of strong job and income growth has given the consumer both the means and the confidence to continue spending, and since consumer spending is about two-thirds of the economy, that has been a major factor propelling economic growth. In addition, with the benefit of low interest rates, consumers have also been able to invest in new homes, creating a very strong housing industry in this nation--so strong that it will inevitably have to slow down as the pent-up demand for housing is met.

All of these positives come within the context of an economy that is now in its seventh year of expansion, the third-longest expansion since the end of World War II. So, I'm not surprised that people are asking me, **Why are things so good now?** and **How long can they last?** Economists, politicians, and academics could probably come up with dozens of reasons, but I've narrowed my own answers down to four basic reasons why the economy is doing so well.

Reason No. 1--Low Inflation

In my view, the No. 1 reason why things are so good now is low inflation. Since I'm a central banker, you're probably not surprised to hear me say that there's just nothing more important than that. We've had a number of years now of low and relatively stable inflation, which has created an environment that allows business people and consumers to allocate their resources most efficiently. In plain English, that means that people like you and me spend less time trying to deal with rapid and frequent price changes. Moreover, we can better evaluate the true return to various initiatives and plan with greater certainty.

Low and stable inflation has given businesses the incentive and the confidence to build new plants and invest in new equipment, and that capital spending, in turn, has helped to create more jobs and more growth. We've seen clear evidence of these developments in the data on both business spending and consumer spending. For instance, we're expecting the growth in overall business spending to come in at about 9 percent for all of 1997. That's very strong investment spending for this stage of the business cycle.

In my mind, these very positive developments are the payoff for low inflation. And what has made the picture that has emerged all the more interesting is that it also seems to fly in the face of the old notion that low inflation can be achieved and maintained only with substantial sacrifice in employment and output growth. So, as I look at the economy as a whole, I have to believe that the most important reason for the excellent economic performance we're seeing is that inflation has been low and stable--and that there is confidence that the Fed is committed to holding the gains that have been made on inflation.

Now, I know what I've just said may sound like I'm "horn blowing" for the Fed and monetary policy, especially since Congress has just had some important debates and just made a major step toward achieving a balanced budget in the next five years. I certainly applaud these recent efforts to begin addressing some of the important issues on the fiscal side of economic policy because monetary policy has a much harder time achieving macroeconomic stability when fiscal policy is too stimulative. However, the recent congressional debate on strategic fiscal policy issues is just a beginning, and very large and difficult issues remain with regard to longer-term fixes to the Social Security and Medicare programs. The cynic in me worries that the incredibly strong economy we have been enjoying might, in fact, be masking the tough issues in this area that must eventually be addressed.

Reason No. 2--Productivity Gains

The second reason I would give for our strong economy is not one that can be documented with statistics, by me or by anybody else. It has to do with the gains we're seeing in productivity, thanks to new technology and the willingness by business to invest. The reported numbers for productivity growth are pretty flat, so the gains are not showing up there. But the business profitability story tells us something different. It goes back to what I was just saying about how low inflation is making businesses willing to invest in the kind of equipment that increases productivity. And much of this investment has been taking place in various service industries, where it's difficult to measure productivity. All things being equal, you would not expect increased investment in industries that are experiencing declining productivity. Nor would you expect profits to stay up as employees begin to receive higher wages--unless, again, productivity was also increasing. So it seems to me that we're seeing something positive happen that our traditional measures don't gauge very well.

Reason No. 3--International Trade

Aside from the dynamics of low inflation and productivity-enhancing investment, the third reason I would cite for the economy's great performance pertains to international trade. Developments like NAFTA and GATT that support free trade have created a boom for exporters of business services, including travel, telecommunications, and information-processing services. The role of expanding international trade for the nation can be seen in real export figures, which have been growing at an average of about 8 percent over the past three years. Real exports are estimated to be growing at over 10 percent this year. Here in Florida, exports to Latin America and Southeast Asia are increasing rapidly. Much of this increase is being driven by economic turnarounds and moves toward privatization in many Latin American countries.

Now, it's true that real imports have been averaging growth of about 9 percent the past three years, and they should grow about 11 percent this year. With imports growing slightly faster than exports, the simple arithmetic tells us that our trade deficit has been worsening moderately. The reasons relate to a stronger dollar and the health of our economy. As the United States continues to prosper and grow and national income increases, we tend to buy more things from abroad, whereas our trading partners are experiencing more moderate growth on average. It's also significant that the United States tends to import more, relative to its trading partners.

Perhaps more important than the macroeconomic effects of international trade in any one year are the microeconomic effects. I've talked to some people in the Southeast who tell me that this competition with foreign goods and services has made life difficult for them and their companies. And yet, overall, as a nation, we're still creating more products to sell abroad, and consumers are getting more choices on what to buy. That's because this increasing trade is creating healthy competition that keeps prices down and productivity up. I can relate to you two examples that show the different effects of this competition. Several weeks ago, I visited with the CEO of a major apparel manufacturer, and he looked me square in the eye and said, "Business is really tough." Now, of course, he's in an industry that has been dealing with the effects of lower-cost foreign competition for quite a while, so he knows what "tough" means.

On the other end of the spectrum, we can look at how this healthy competition due to international trade has helped to make the U.S. auto industry even stronger. It's taken quite a while, but I think we're seeing the effects of competition in the creative ways car companies are improving their products. Not too long ago, I was at the new Mercedes-Benz factory in Alabama where they're building their newly designed sports utility vehicle to compete with the U.S. automobile manufacturers who created this market. I was impressed with the new management team and the ideas they have brought together from the "best" of the U.S. and foreign auto companies. I am equally impressed with the way they do things at the Saturn factory in Tennessee. Here's a company that's tried an experiment in using what they might call a more "personal" way of producing cars. When I visited the Saturn factory and spoke with their management team, I learned first-hand how they are meeting the challenge of competition from Japan and Europe by delivering quality cars at a lower price.

I see this global competition going hand in hand with U.S. businesses' meeting the domestic challenge of imported goods--not through trade barriers but through better products. At the same time, we're finding new markets around the world for our products as we try to deliver the kinds of goods and services that consumers everywhere will consider to be a good value.

Reason No. 4--Deregulation

My fourth reason for our long-running healthy economy has to do with deregulation. Some people argue that technology and competition bring about a sort of de facto deregulation, and I've certainly seen that in the banking industry with the move toward interstate banking well ahead of Congress's changing the law in this area. Over the past 25 years, we've also seen lots of formal deregulation as the government decided to get out of the business of regulating some of our major industries, including transportation and communications. And there's more to come as utilities such as the natural gas industry begin to operate in a less regulated world. One of my head office directors is the president and CEO of what used to be known as Atlanta Gas Light, and he talks about the extraordinary changes he and his competitors are expecting in the years ahead in their business. And how many phone calls do we all get at dinner time from the fierce competitors in the telephone business? I don't think there's any way to measure and evaluate the massive changes that deregulation has brought about in this nation. For those of us in those industries coping with ongoing rapid change, we sometimes lose sight of the effects these changes are having for the better in the economy as a whole.

How Long Can It Last?

Now that I've given you my four reasons why the economy is doing so well, let me try to answer the next logical question, which is, How long can it last? I don't have a simple answer to that question. But I do have an answer: the duration of this economic expansion will depend in large measure on good policy--both fiscal and monetary.

We need to have continued success on the fiscal policy front, which as I mentioned earlier means that, even with the recent budget accord, we need to have the political will and wherewithal to go beyond talk and tax cuts and move on to actions to put our entitlements programs on a solid footing for the longer term. In order to keep the deficit and the national debt under control as we head into the period when the baby-boomer generation that is retiring will be much larger than the generation coming behind it in the workforce, we must change the way we fund our social programs. And now is a particularly good time to take on the tough issue of revamping entitlements because, in a sense, it's the most pressing problem we have to deal with since there are few imbalances in the economy.

Few Imbalances

Let me explain what I mean about having few imbalances to deal with at the moment, imbalances that at other times have diverted our attention from crucial, long-term issues like the deficit and the national debt.

In the 1980s, real estate speculation first created imbalances in certain regions of the country that then spread to banks and savings and loans on a national basis.

This kind of imbalance in the real estate market is pretty much absent today, especially in the big-bucks commercial arena. The same holds true for inventories, which is an area where imbalances have often shown up in past business cycles. Just-in-time inventorying methods have been a big help in this area. We're also not seeing major imbalances in our capacity utilization.

And then we can also look at debt--an obvious imbalance on anyone's balance sheet when it becomes too large--and notice that we're in pretty good shape in most every sector. The big fact that leaps out is that people are not spending beyond their means. Real spending has been growing at a pace less than personal income, which means that consumers have been paying down their debt and increasing their wealth, both real and financial, through the stock market, for example. They are not financing their consumption by running down their wealth or by borrowing undue amounts. While there are some concerns about consumer debt, most of those problems seem to be limited to the less-than-prime market, and lenders seem to be pulling back from this market a bit.

On the corporate side, companies have come through a severe period in the early '90s of reorganization, downsizing, and merging to report stronger earnings and profits. Taking a look at banks, in particular, profitability as measured by return on assets has been record-making. In fact, 1996 was the second most profitable year--next to 1993--since the FDIC began to keep bank data in the 1920s. About three-quarters of all banks reported higher earnings in 1996 than in 1995, and nearly two-thirds reported return on assets of 1 percent or higher, a number that may sound low to other businesses but which is very good for banks. Other profitability measures also indicate that, clearly, the bottom line for the banking industry is in good shape. This performance bears out what we have seen previously--that is, banks tend to do well when interest rates are low, not when they are high.

So overall, then, we're living with an economy that has few imbalances in the consumer, corporate, banking, and real estate sectors and that increases the odds that this healthy expansion will be able to continue.

What Monetary Policy Must Do

Now that I've talked briefly about fiscal policy and the lack of imbalances in the economy, let's turn to what monetary policy can do to help to make this expansion last.

First, we must not let ourselves lose sight of how this economy has benefited from the interplay between low inflation and productivity. As I argued earlier, it seems to me that the low and stable inflation we've been experiencing--thanks to effective monetary policy--has contributed substantially to gains in productivity. And I believe productivity is the key to the puzzle of our long-lived economic expansion. I think that this good outcome should suggest that we mustn't let inflation creep back up, and I hope you will agree with me. I as much as anyone want to see this expansion continue so that it beats our last record of just over 100 months by a mile; we're at 76 months and counting right now.

Second, we need to avoid making policy mistakes, which are usually caused by waiting too long to tap the brakes. Most policy errors in the past have been made by not acting soon enough, and so we need to be willing and ready to respond with appropriate policy actions if we find ourselves, at some point, where the level of economic activity becomes unsustainable.

Third, we need to continue to question and test the conventional wisdom that seems to assume that you can have either low inflation or strong growth, but not both. Recent experience suggests that we can have low inflation, low unemployment, and strong real growth, and I think there is growing evidence that low inflation is a precondition for achieving our other economic goals. I hope that people besides policymakers and economists--people like you--are noticing the multiple benefits of working in a low-inflation environment that allows your businesses to grow and prosper.

Conclusion

Let me stop now to take your questions. I hope I've talked about some things you care about and that I've raised your interest in some thorny issues we at the Federal Reserve are dealing with. Thanks for your interest, and thank you again for the invitation to be with you.

CONTACTS

Jean Tate
404-498-8035