

Speeches

The Role of Economic Policy in Current Economic Performance

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Good morning to each of you! It's always a special treat for me to come home to New Orleans, where I have so many fond memories. I say home, because for over 33 years and six moves with the Fed, I've spent 10 years in New Orleans. But coming back to New Orleans goes beyond "home," because it has given me a chance to address such a respected and influential group as NABE.

What I Will Talk About and Why

This morning, I want to take advantage of having such a well-informed audience, one that is on top of the economic outlook, the latest data revisions, and the newest estimation techniques. Since a knowledge of all these areas is essential for more fully understanding policy issues, and you already possess this, we can skip over the numbers and quickly get to the substance of my policy discussion.

This morning I want to focus on the role of economic policy, both monetary and fiscal policy, in the current economic expansion. The economy has performed surprisingly well over the last several years. I'm going to argue that the conventional explanations for those good times do not recognize the central role of the monetary policy decisions the Fed has made over the past 17 years and the more recent contribution of improved fiscal policy.

Surprises of the Current Expansion

When we reflect on the current expansion, we see first and foremost a combination of robust economic growth, low unemployment, and modest inflation. This combination, while not unprecedented, is the best in a generation. The current expansion is now in its seventh year and, to date, is the third-longest in the post-World War II period. It shows no signs yet of slowing significantly, and we see few of the imbalances that suggest either speculative excess or developing vulnerabilities. The job growth we have experienced over the last six years has pushed the unemployment rate down to a level not seen in over 23 years. Even this impressive unemployment statistic conceals, in part, the true strength in the labor market, for, as you know, it reflects both a technical adjustment in the household survey (made in January 1994), as well as unprecedented peacetime increases in labor force participation. Both of these developments tend to raise the measured level of the labor force and, other things being equal, the measured unemployment rate. Without these two adjustments, the unemployment rate would almost certainly be flirting with 4-1/2 percent by now. At the same time that the unemployment rate has declined, the inflation rate, by any measure, has fallen and is now lower and more stable than at any time since the mid-1960s, while GDP growth has averaged about 3 percent in real terms.

I have just said that the economy has performed **surprisingly well**. It's a familiar comment, and one that I have made before. I'm sure many of you have heard it and probably said it. **But what are the surprises of the current environment? And importantly, should we really be surprised?**

The main surprise has been the economy's ability to simultaneously sustain good conditions in three measures of performance--GDP growth, unemployment, and inflation--and to continue to improve on them over the last several years. A number of developments have been used to explain this happy outcome. These include the low price of oil, the strong dollar, slack economic activity outside the United States, increased globalization that has intensified international competition, and the productivity payoff from investment in computers. These have certainly boosted the level of real GDP. However, many analysts have gone further and asserted that these factors are responsible for keeping inflation low. I think those claims about inflation may miss the boat, as I'll explain later. Interestingly, there has been less notice, and perhaps less appreciation, of the role of economic policy in all this. But before I talk about that, let me take a moment and examine what I think the factors I have just enumerated have really meant for the economy.

First, let's think about the low price of oil. Because inflation followed quickly upon the major oil price increases in the 1970s, a **rise** in the price of oil is seen by many people as inflationary. However, the price of oil is just a relative price. It is, of course, an important one, given the few close substitutes for oil in the short run.

What happens when oil costs rise? The CPI almost immediately reflects a higher price for an important component, but this change is temporary, lasting only until the substitution and income effects kick in, since that change in the CPI is a function of its fixed-weight design. What's really happening is that higher oil prices give us less money to spend on other things but not less total income. After the major oil price shocks of the 1970s, the Fed eased monetary policy to try to mitigate the effect of having so much less to spend on other things, and the inflation that ensued was entirely predictable.

But it was the monetary policy response, not the oil price increase, that led to inflation. The effects of an oil price decline are simply the other side of this story. A decline in the price of energy, like the drop we saw earlier this year, leaves us better off in the aggregate, but there are no consequences for inflation if the Federal Reserve, as we saw in recent periods, keeps monetary policy unchanged.

In exactly similar ways, I can argue that, by lowering import prices relative to domestic prices, the strong dollar and increased global competition each increase our buying power, leaving us more to spend on other goods, but they do not increase or decrease our total income. Spending will be reallocated, and a given budget that includes imports will buy more; our standard of living is improved. However, there are no inflation or deflation consequences as long as the Federal Reserve keeps policy steady. In the case of globalization, it's true that more domestic goods have import competition, and this shift is clearly a factor restraining price increases. But this effect is limited to the relative prices of those goods and services. As you can see, this is just a variation on the strong dollar story. Without the restraint imposed by an overall anti-inflationary monetary policy, the price containment effects of import competition would be offset by other price increases, and the inflation rate would not be any lower than without globalization.

What about the effects of slack economic activity outside the United States? This situation is seen as keeping inflation down in two possible ways: either by tempering import price increases or by keeping global capacity utilization low. I've just talked about how I believe we should think about the impact of lower import

prices. As for capacity, you know as well as I do that there has been little correlation between either domestic or global capacity utilization and inflation for over 15 years. That's because the Federal Reserve has pursued a policy of restraint when the economy was operating at a high level of utilization. Higher utilization may mean that some prices will rise, but again, these are relative price changes that will be offset by relative price declines of other goods or services as long as the policy stance does not allow a general increase in all prices.

What about the arguments that businesses are more fully reaping the productivity rewards of investment in computers and other technologies? Indeed, investment, especially in equipment, has remained strong over this business cycle. Rising productivity can lower the cost of capital relative to labor, stimulate the substitution of capital for labor, and act to restrain or lower unit labor costs. However, to draw any direct implications for overall inflation from this process is a mistake since all we're doing is tracing through the effects of relative price changes.

These price changes are necessary to produce an efficient allocation of resources in a market economy; they are not the same thing as a change in the general price level. Higher productivity may produce higher profits, or be translated into higher labor compensation, or the gains may be shared among workers and shareholders—but, either way, there are no implications for inflation if the policy stance is not inflationary.

The real puzzle here is why all the investment in technology has not yet shown up in the productivity statistics, especially given the size of the investments that have occurred. For example, investment in computer technology alone has accounted for about one-third of the real economic growth since 1994, and this investment has accelerated the past two years. More broadly, technology investment has significantly compressed lead times between the order process and deliveries. The ratio of unfilled orders to shipments has declined 30 percent in the last six years. Additionally, there is the well-known switch to just-in-time inventory management, which has significantly reduced inventory-sales ratios, not to mention the use of satellite technology to target portions of even a small farmer's field for additional water or fertilizer.

I would like to suggest a couple of interpretations for the delay between investment and observed payback. The first is the fact that, to date, much of the technology investment has been concentrated in back-office activities that historically have tended to be low value-added functions. It's this technology that paves the way for subsequent changes in the way that business is done. Second, reflecting upon our own experience with computer-related investments, it's clear that capabilities have far outstripped our ability to exploit the potential that is now in place. The power of desktop computers has increased exponentially, but the investment in ensuring that our people are sufficiently trained to take advantage of that technology has lagged sorely. Put another way, we have put in place technology potential that, if judiciously utilized, may promise a future round to productivity improvements that we can only begin to contemplate.

Certainly, all of these developments that many of us have talked about and thought about at one time or another have contributed to producing the superior economic performance of the last several years. But I would argue that their particular contribution has been to expand output and not to reduce inflation. **Why then did this combination of strong growth with low inflation seem so elusive throughout the 1970s and early '80s?** Actually, I'm not sure there is any mystery here.

The Role of Economic Policy

Most of us would agree that inflation is a monetary phenomenon. And so we need to look to monetary policy to explain that part of the picture. It's the stance of monetary and fiscal policies that distinguishes this expansion from those of the last 25 years. At various times in the past, when monetary policy was excessively easy and fiscal policy was unsustainably loose, economic activity accelerated and inflation followed. This sequence happened during both the Korean and Vietnam Wars.

Sometimes, as in the case of the huge oil price shocks of the 1970s, monetary policy helped to cushion the economy, and the recessions that followed those shocks were arguably less severe than they would have been otherwise. Unfortunately, the inflationary consequences of this cushioning were unavoidable. The economic performance following the bad shocks of the 1970s and the monetary and fiscal policy choices of the last generation produced an apparent trade-off between inflation and economic growth that really did not reflect a structural relationship **but only the circumstances and choices of that time**. However, that history is firmly imbedded in our collective memory and it has influenced our judgment about the sustainability of the current good economic performance. And I think it goes a long way in explaining why we tend to think of good growth combined with low inflation as remarkable.

So policy choices are central to determining economic performance. The consequences of lowering inflation and making a commitment to maintaining low inflation cannot be underestimated. We all know inflation carries efficiency costs. It distorts economic incentives and resource allocation. Importantly, it also increases uncertainty and risk. It reallocates otherwise productive resources to inflation avoidance activities. In the extreme, a hyperinflation often leads to a near-complete breakdown in payments, production, and distribution.

Even moderate inflation (at least by international standards) of the sort we suffered through in the late 1970s and early 1980s carries a cost, especially in the presence of a tax code that bases assessments on nominal rather than real income. The point I want to make this morning is that it is entirely reasonable and sensible to say that the low and stable inflation we have achieved over this expansion has reduced these distortions and costs and thus contributed to better growth. This is the other side of the cost of inflation: the gain associated with inflation reduction and the maintenance of a low inflation rate. The behaviors of the 1970s and 1980s, which were engendered by a persistent inflation environment, have been slowly reversed, and the resulting reallocation of resources has made possible some of our better economic performance. As of 1997, inflation is probably not eliminated completely, but if we stick to our current policies, it will not worsen.

There is an important assumption in that last statement—if we stick to our current policies—and I do mean "policies" in the plural. The stance of both monetary **and** fiscal policy and the policy mix are both critical for economic performance. Good monetary policy alone or good fiscal policy alone is insufficient to produce the best outcome. Let's consider again our recent history.

In the late 1970s and early 1980s, the stance of monetary policy became increasingly anti-inflationary, and throughout the 1980s inflation declined. However, fiscal policy, as measured by the annual federal budget deficit, became more and more unbalanced. Even as inflation declined, both the persistently high real interest rates and the slow reduction in inflation expectations probably reflected a healthy skepticism about the ability on the Fed's part to carry out a commitment to a low inflation policy, given the demands of financing large government deficits for what then appeared to be the indefinite future. Since early in the 1990s, the substantial progress on reducing the deficit surely contributed to the improved performance of the economy by lowering interest rates, reducing uncertainty, and contributing to the credibility of our low inflation policy. Note that it wasn't until both policies were well positioned (beginning in the early 1990s, with the Budget Enforcement Act of 1990, the quick return to an anti-inflation monetary stance after the recession of 1990-91, and, in the first Clinton administration, the 1993 budget deal, which extended some of the restrictions and spending caps from the 1990 legislation) that we observed economic performance that could be called surprising. The recent passage of balanced-budget legislation gives me even more confidence that this good path may be sustainable for the coming decades, if we can deal with some of the tough issues I'm going to talk about in a moment.

So far, I've argued that there has been a substantial role for economic policy in our good economic performance. These policies have clearly been abetted by positive shocks, but I would go so far as to argue that **some** of those shocks can themselves be attributed to the low inflation environment. Let's look at two examples:

First, consider the strong dollar. The most compelling argument relating the value of the dollar and inflation is one in which the causation runs from inflation to the dollar. The dollar's rise reflects, in large part, lower expected inflation and stronger growth in the United States relative to our trading partners, making dollar-denominated assets more attractive.

Another example is productivity-enhancing investment. The willingness of investors to commit to projects that yield returns over the long run is, in part, a function of how certain they are of those returns. Confidence in the Fed's ability to keep inflation low and stable reduces uncertainty about the real value of returns to investments. To my way of thinking, a substantial fraction of the gains in productivity we're obviously enjoying (although perhaps not measuring) have been the result of investment encouraged by the low, stable inflation of this expansion.

My point is not to minimize the role of what we call "shocks" but to acknowledge the contribution of better monetary and fiscal policies. If favorable shocks are not principally responsible for the improved inflation environment, we need not fear that their reversal threatens the low, stable inflation we've experienced over this expansion. There is no doubt that those shocks, which we don't control, have been a bonus. But, with the benefit of hindsight, when we are able to more fully sort through and study what has been going on during this most recent period, I believe we may be able to conclude that it has been the economic policy environment (which we can control) that has been the central factor in that better performance.

Challenges for Future Policy

This leaves me to discuss the challenges ahead. Now that I have made an argument for the central role of economic policy in good economic performance, I have to admit that actually demonstrating this connection in a rigorous way is extremely difficult. Those of you who have worked on macro models probably understand better than I the frustration of trying to identify the effects of monetary policy in an economy as complicated as ours. The Fed's actions both cause and respond to changes in the economy. Monetary policy operates in the money market, where monetary aggregates, the federal funds rate, and reserves are affected by our moves and by the decisions of the market participants. In this setting, disentangling the precise role of the Federal Reserve's actions is an enormous challenge.

At the Atlanta Fed, we are working on this assignment. Our economists, working jointly with several of our visitors from universities, report some preliminary success with a new model that provides both an explicit probability structure and an explicit identification of policy behavior, which we believe will allow us eventually to measure the quantitative impacts of policy in a rigorous way. This new work is helping us talk with more precision about the probability of various forecasts, about the uncertainty of our forecasts, and about the reasonableness of alternative forecasts. But we have a long way to go before we have a model capable of helping us answer a question as simple as, **What happens to inflation in two years if we raise the fed funds rate by 50 basis points tomorrow?**

Even as we continue to study policy effects, we are aware that the current challenge is to continue to provide the low, stable inflation environment that we are convinced is a critical necessary condition for good economic performance. **Am I worried?** Well, as a central banker, it's my duty to worry--not because I sense any lack of commitment to maintaining low inflation but because we have made mistakes in the past. Also, and more ominously, I worry because of our inability so far, on the fiscal side, to address the approaching financing requirements of the aging baby-boom generation--the medicare and social security problems. You well know this looms large on the not-so-distant horizon. We can't dodge this forever. We can't even dodge it for another 10 years. To address this knotty problem, we, as a nation, will have to make difficult decisions about allocating scarce resources. Nonetheless, I remain optimistic when I consider how far we have come. We have made many hard decisions already--we fought inflation and we remain vigilant; we have made substantial progress in reducing the federal budget deficit--and we have a good economy to show for it.

Conclusion

So, in conclusion, as I see it, much of our good economic performance in this recent period has come not from dumb luck (that is, positive shocks) but from our willingness to make tough policy decisions. This knowledge should give us the courage to move ahead and deal with the next set of challenges.

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