Speeches

The Role of Economic Policy in Current Economic Performance

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The Economic Club of Florida
Tallahassee, Florida
October 17, 1997

It's a really special treat for me to be invited to address your Economic Club of Florida and to share some thoughts on the economic issues of the day with such a prestigious group. But before I turn to the more serious business of economics, let me congratulate you and your Florida Marlins on making it to the World Series. I don't know that I can speak for all the other disappointed Atlanta Braves fans, but I'll be rooting for your team. I and my colleagues in the Federal Reserve System spend a significant part of our lives out in our regions talking with business, government, and community leaders like you--sharing what we are seeing, thinking, and doing at the Fed, and trying to get some grass-roots sense as to whether the data we track and what our economists are telling us reflect what's really happening in the real world.

In recent years, there seems to have been an exponential growth in interest in what the Fed is doing. The truth of the matter is that our Fed policy actions do directly or indirectly affect every individual and every business in the country, and that's good reason for people to want to better understand what we are doing and why. And, for those of us who are presidents of the regional Federal Reserve Banks and who sit around the FOMC table with Alan Greenspan every six to eight weeks to set Fed monetary policy, we welcome chances like this to share views.

Where Are We With the Economy and Why Are Things Going So Well?

Let's begin by thinking together about where we are with the economy and what has brought us to where we are. And I want to do that by talking about the three broad measures we often focus on in assessing the economy--the pace of output growth (as measured by GDP), employment, and inflation.

The Pace of Growth: The current economic expansion is now in its seventh year and to date is the third longest in the post-World War II period. Over the first half of this year, we saw GDP growth that averaged just over 4 percent with some slowing in the second quarter. Even assuming some further slowing in the last half of the year, it now looks like we will have GDP growth for the year of something like 3-1/2 percent, almost a full percentage point above the pace last year and considerably stronger than I expected as we went into 1997. Since we came out of the 1990-1991 recession, six years ago, GDP growth has averaged about 3 percent, although there have been significant swings from quarter to quarter.

Where's this good growth coming from? First, one always has to look at consumer spending, since it accounts for about two-thirds of GDP, and there we see excellent fundamentals--good income growth with spending to match. Clearly, the strong job market and the very high levels of consumer confidence that has engendered are at the heart of the solid performance in consumer spending. And although it is difficult to judge how big a factor it has been, the run-up in stock prices and other financial assets has provided a "wealth effect" that has boosted consumers' ability and willingness to spend. Although some caution flags have been raised with regard to consumer loan delinquencies, especially in the credit card area, consumer debt levels, while high, have dipped recently and do not yet appear to be a major factor that will deter spending.

Aside from healthy consumer spending, **investment spending** by business has been very strong, and overall business investment has frequently exceeded the forecasts of many of us. It has been growing on average about 8½ percent for the past five years, and we have to go back to the 1960s to find a five-year run of capital spending like that. Investment in producers' durable equipment grew at an amazing 23 percent rate in the second quarter of this year, and much of the investment spending we've been getting has been for new productivity-enhancing technology--in large and small businesses. Investments in computers have accounted for a full percentage point of the recent growth in real GDP. We believe this investment is being driven by a combination of intense competition; constraints on the availability of labor; and the desire to cut costs to maintain profit margins, since competition appears to have limited the ability of most companies to raise prices for the goods and services they produce.

Government spending, thankfully, has been flat or declining, and as I'll discuss in a moment, this trend has helped push the federal budget deficit down.

The **international trade sector** has actually been a modest drag as we've been importing more than we export, and that gap has been widening mainly because of slow growth in the economies of many of our important trading partners and the relative strength of the dollar.

Employment/Unemployment: A second set of measures we use to gauge the health of the economy is employment. Employment, of course, produces the income to fuel spending, and is one of the important inputs that help determine the pace of sustainable growth.

And here, too, the picture has been extraordinary. Job growth in the first nine months of 1997 has averaged about 226,000 per month, and over the past four years has averaged about 2 million jobs per year. Since that rate is considerably faster than the 1 million new workers coming into the work force each year, the unemployment rate has fallen significantly. We have seen the unemployment rate fall from a little over 6 percent in 1994 to about 5-1/2 percent in 1995 and last year, to a low of 4.8 percent earlier this year. As you know, it currently stands at a very low 4.9 percent and would actually be closer to about 4-1/2 percent were it not for some technical adjustments that have been made in how the rate is computed. Certainly, in the past quarter century, the unemployment rate has been low at times, but the last time it was as low as it has been for the last three years was in the late 1960s.

Based on past experience, some economists have been voicing considerable concern that this sustained low unemployment rate is almost certain to bring troublesome inflationary pressures (and I'll come back to that in a moment), but this has not yet become evident. In fact, there have been some very positive consequences of tight labor markets. Hundreds of thousands of job seekers, including many coming off of welfare, have found work and have new income that has contributed to total spending and economic growth. Also, new workers who had not been actively seeking employment and who were not counted among the unemployed, including a sizeable number of retirees, have come into the work force and helped to meet the demand for new workers. With trained workers harder and harder to find, employers have predictably boosted their capital spending, substituting capital for labor in an effort to increase productivity and hold down costs. At the same time, the lack of skills often seen in the remaining job seekers has raised our consciousness as a nation on the fundamental long-term issue of better K-12 education.

Inflation: A third barometer of economic performance is the level of prices, and the inflation data have continued to come in at lower levels than most forecasters have been expecting. The inflation rate, by any measure, has fallen and is now lower and more stable than at any time since the mid-1960s. Over the last five years, the CPI has averaged 2.7 percent and it looks like it will come in at about 2-1/4 percent this year, after averaging about 3 percent last year. While there have been quarter-to-quarter swings (up and down) as price changes in broadly consumed products like oil and food work their way through the indexes that measure inflation, one has the sense that decision-makers, both businesses and individuals, are now more confident that economic policymakers are committed to holding the gains that have been made. As a result, managers are able to make resource allocation decisions without considering the effects of inflation and with a higher degree of certainty that the returns from investments will not be eroded by inflation.

The Role of Economic Policy

So, overall, the fundamentals of economic growth, employment, and inflation are giving us the best combination of outcomes that we have seen in a generation. Clearly, there have been some outside influences, or favorable "shocks" as economists would call them, that have contributed to our good experience. The relatively low and steady price of oil, compared to the devastating negative oil "shocks" of the 1970s, has been a plus. Expansion of free trade and the additional international competition it has brought have worked to discourage price increases. The strong dollar has held down the cost of imports. And as I mentioned earlier, new technology has fostered important productivity gains and has helped to hold unit labor costs in check. But I want to suggest there is something else probably more important--and more fundamental--going on.

Economic policy, in recent years--both monetary and fiscal--has been better than in any period since the 1960s. Monetary policy has helped to create a low-inflation environment essential for the efficient allocation of resources. Fiscal policy, after more than 20 years of excess stimulation, is more recently focused on achieving a balanced budget, and that pressures us to weigh our government spending decisions against our ability to pay for them in our lifetime. At various times in the past, when monetary policy was excessively easy and fiscal policy was unsustainably loose, economic activity accelerated to unsustainable levels and inflation followed. We saw that pattern during both the Korean and Vietnam Wars. More recently, monetary and fiscal policy have been pulling in the same direction and that confluence of good policy should not be overlooked or undervalued as we think about how we sustain the good results we have been enjoying. Let me explain my view of these fundamental changes in economic policy a bit further.

Monetary Policy: First, in the case of monetary policy, sometimes, as in the case of the huge oil "shocks" of the 1970s, easier 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, and in hindsight, we should not be surprised that our accommodative monetary policy left us with higher levels of inflation.

We all know inflation carries efficiency costs. It also distorts economic incentives and resource allocation. It reallocates otherwise productive resources to inflation-avoidance activities. Importantly, it also increases uncertainty and risk. 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 inflation-adjusted income.

In retrospect, I think many people would suggest that monetary policy was too accommodative during the 1970s. In contrast to that experience, more recent monetary policy has helped to move us to a new period of relatively low and steady inflation. Over the course of the current seven-year period of economic expansion, there has been confirmation of the Fed's commitment to price stability. Between February 1994 and February 1995 the Fed undertook seven tightening moves, raising the fed funds rate some 300 basis points. Again in March of this year, when the pace of growth looked to be unsustainable and the risk of a run up in inflation looked to be unacceptable, there was a modest tightening to lean against those pressures.

The low and stable inflation we have achieved over this expansion has reduced 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. There is growing evidence that this commitment to maintaining low and steady inflation has been a major contributor to individuals and businesses' confidence and willingness to spend and invest. Increased 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 fully measuring) have been the result of investment encouraged by the low, stable inflation of this expansion.

My concern is that, as a country, we may still not fully understand or appreciate how significant this commitment to low inflation is to our current economic good times. We recently held a meeting of our own Bank's Board of Directors in another part of Florida--the so-called space coast. In touring the Kennedy Space Center, we were reminded of how significant our space program has been in broader economic terms, given the flow of very practical technologies and products that have come from our space program investment--things like cordless tools, insulin pumps, laser heart surgery, and MRI and CAT scanning equipment. The sad thing is that we've almost come to take the space program for granted, unless some kind of crisis brings it to the center of our national attention. I worry that the same can be said about low inflation. I'm afraid we may be a little complacent about the low inflation we've achieved, or at least not as aware of the good things that have come from it. That's why I think it's important for people like me, who spend our days, and sometimes our nights, worrying about the health of the overall economy to get up on our soap box whenever we have a chance.

Fiscal Policy: Of course, monetary policy can't claim exclusive credit for where we are today. We wouldn't be where we are if it weren't for changes in fiscal policy too. In the late 1970s and early 1980s, fiscal policy, as measured by the annual Federal budget deficit, became more and more unbalanced. For many years it appeared that large government deficits would have to be financed into the indefinite future. Government spending was absorbing our savings at a significant rate. Since early in the 1990s, however, we have made substantial progress on reducing the deficit. It's true that the end of the Cold War provided a unique opportunity to substantially curtail defense spending, but the Budget Enforcement Act of 1990 and the 1993 budget deal, which extended some of the restrictions and spending caps from the 1990 legislation, marked a formal commitment to improved fiscal policy. More recently, we saw the balanced budget legislation, although the strong economy, and consequently strong federal revenues, made that package of spending and tax cuts more palatable.

Future Challenges - Can The Good Times Last?

Given this picture of the best economic fundamentals in a generation and my argument that we owe this development to the happy combination of favorable economic "shocks" and better economic policy, the most important questions of the day are "Can it continue?" and "What can we do to improve our chances of prolonging the current period of steady growth, low unemployment, and low and steady inflation?"

Of course, many people would argue that, even with the good balance we see in the economy at the moment, at some point some imbalance, or bottleneck, or negative "shock," or policy error will knock us off track. Am I worried that could happen? Well, as a central banker, it is my duty to worry, and there are always things to worry about. In fact, as policy makers, after developing our best forecast for the period ahead, we always force ourselves to think about, and evaluate, the risks to our forecast--both on the upside and on the downside.

Currently, the availability of labor and the threat of a run-up in the cost of labor are at or near the top of many peoples' worry list. So far, we have been pleasantly surprised at how new entrants into the labor force, a not-fully-measured increase in productivity, and the forces of market competition have helped to militate against the development of labor bottlenecks. Looking forward, it's probably unrealistic to think we can continue to make up a 1 million a year deficit between the number of jobs being created and new entrants into the labor force by continually enticing more and more of the population into the workforce. The dramatic investment that has been made in new technology should continue to give us good gains in productivity and should help to make up some of the shortfall. And individual companies may have to make some hard choices between absorbing any wage increases in their profit margins or slowing the growth in their output in the face of an inability to raise prices.

A second concern is whether the recent pace of business investment can be maintained. Many believe that it will not, and this view lies behind many of the forecasts for a slowdown in 1998, albeit from high levels of output and employment.

A third risk for the period ahead is in the area of consumer spending. You may recall that after very robust spending in the first quarter of this year, consumer spending fell off sharply in the second quarter. The most recent data suggest that the consumer may be resuming spending at the pace we saw earlier in the year. As I suggested earlier, what happens with the stock market and with the level of indebtedness could push consumer spending higher or lower in coming months.

While I could tick off other potential imbalances, bottlenecks, or risks that could jeopardize the good performance we'd like to see continue "forever and ever," a firm commitment to good monetary and fiscal policy is clearly the most fundamental requirement to keep the good times going. Moreover, the credibility that comes from such a commitment makes it easier to weather any storm that may come along. If favorable shocks are not principally responsible for the improved inflation environment we find ourselves in, then we need not fear that their reversal threatens the low, stable inflation we've experienced over this expansion.

My Fed colleagues and I must be ready, again, to adjust monetary policy promptly if and when that is called for. Fortunately, I think it has become clearer and clearer that low and steady inflation, along with the expectation of policies that assure such an environment, is a precondition for our other economic goals of maximum growth and employment. Broad awareness and understanding of this relationship should make hard monetary policy decisions more palatable when they are necessary.

On the fiscal side, which is the purview of Congress with leadership from the administration, there is clearly a need to hold to the new commitment to fiscal discipline and deficit reduction that has been made. And doing so means that our elected representatives face the very difficult task of hammering out solutions to the daunting financing requirements of the aging "baby-boom" generation--the much publicized Social Security and Medicare problems. We all now know that these issues will not go away and have to be addressed in the not-so-distant period. We can't dodge them forever. We can't even dodge them for another 10 years. To address these knotty problems, we as a nation, will have to make some difficult decisions about allocating resources.

Conclusion

So, in conclusion, as I see it, much of our good economic performance in this recent period has not come 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, whatever they might turn out to be. Thank you again for the invitation to be with you today.

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