

Speeches

The Role of Economic Policy in Current Economic Performance

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Good afternoon! I'm really delighted to be here with you at this major gathering of Nashville's business community. As you know, the Atlanta Fed has a branch here in Nashville, and so I get to this great city fairly often. But even though I come here frequently, I'm still surprised at how vibrant the pace of business activity has been and how strong the economy is. That growth, of course, is, in large part, a reflection of the way all of you in this room have operated and expanded your businesses in recent years. It's also a reflection of your sense of civic duty that you haven't rested on your laurels as your own companies have succeeded but have worked hard to promote economic development in the metro area generally.

Today, I hope to give you a somewhat different perspective on the solid performance businesses have been experiencing here in Nashville--and around the Southeast and, really, the nation as a whole. Since the tools of my trade are in the realm of macroeconomic policy--in particular, monetary policy--the perspective I bring is that of the larger, national context. But beyond trying to fill in the details of the larger landscape in which all U.S. businesses are trying to turn a profit, I hope to give you some insights into what's been going on at the macroeconomic level, insights that I don't see getting the kind of attention they deserve, given what I think is their importance.

Now I'm sure some of you would really like for me to talk about what happened last week in the stock markets around the world, and I understand that interest. But financial markets have settled down quite a bit over the last week, and I want to tell you up front that I'm not going to spend much time talking about just those recent events. I think it's much more important for me and for all of you to instead think about some of the underlying fundamentals that have given us such a strong economy in recent years.

I'll begin by talking about the economic performance we've had since the end of the last recession at the beginning of the '90s, both here in Nashville and the Southeast, as well as nationally. Then, I want to make the case that a basic reason the economy is doing so well is that we've had a better mix of monetary and fiscal policy than we've seen in this country for a generation. In making this argument, I hope to show how this mix is not some ivory tower phenomenon significant only to us at the Fed, or economists sitting in their university offices, or to some Congressional staff in Washington, D.C. but, rather, that it's a matter of fundamental public policy that is directly relevant to the way you do business and the way metro areas like Nashville are able to promote economic development. While I can't give you a prediction of future policy directions, I will conclude by drawing out the implications of this argument for the future. That's a pretty ambitious amount to accomplish in the time allotted, so let me begin by reviewing some interesting aspects of our economy's performance in recent years.

Economic Conditions

As you might guess, the Federal Reserve gathers an enormous array of statistics, and our economists study and model that data to try to get the best sense possible of how the economy is doing and where it's headed. We also spend a lot of time talking with our directors and with business people like you to give us a reality check, so to speak. However, there are really three broad measures that we often focus on in assessing the overall performance of the economy. These are the pace of output growth (as measured by changes in gross domestic product, or GDP), employment, and inflation.

When we look retrospectively at GDP, we find that 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 three quarters of this year, we saw GDP growth that averaged almost 4 percent. Even assuming some slowing in the last quarter of the year, it now looks like we'll 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 1990-91 recession, six years ago, GDP growth has averaged 2.7 percent per year.

Where's this recent 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 it has engendered are at the heart of the solid performance in consumer spending. And although it's difficult to judge how big a factor it has been, the run-up in stock prices and other financial assets we've seen over the last three years has probably boosted consumers' 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. This fact may be no surprise to you who are running businesses, but it has been at times to many of us who forecast overall business investment. Capital spending by businesses has been growing on average about 8-1/2 percent for the past five years, and we have to go back to the 1960s to find a five-year run like that.

Much of the investment spending we've been getting has been for new productivity-enhancing technology--and we're seeing it in large and small businesses. In fact, 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 factors--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, the third major component of output, 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**, the fourth component of demand for the goods and services we produce, 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.

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 helps determine the pace of sustainable growth.

And here the picture has been extraordinary. Job growth over the past four years has averaged about 2 million jobs per year. Since that rate is considerably faster than the one million new workers coming into the workforce each year, the unemployment rate has fallen significantly. We have seen the unemployment rate fall from almost 8 percent in mid-1992 to a little over 6 percent in 1994 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 were made a few years ago in the way 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, but these have 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 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 sizable number of retirees, have come into the workforce 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.

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 consumer price index, or CPI, has averaged 2.7 percent, and it looks like it will come in at about 2-1/4 percent this year.

Nashville and the Southeast

Just as the U.S. economy has been flourishing, so too has the Southeast, including Nashville. The Southeast really led the nation in recovery, outpacing U.S. growth in the early years of this expansion, with job growth in the 2 to 4 percent range compared with 1 to 3 percent nationally. More recently, the rate of growth has slowed to about the same pace as the rest of the nation. Job growth in our region in the past 12 months has averaged just over 2 percent, about the same as the United States.

This pattern of growth in the Southeast--strong early in the business cycle--has a lot to do with the structure of the region's economy. Demand for housing and related products is a major driver of the economies of most states in this part of the country. First, we have a major lumber industry that supplies basic building materials for residential housing around the country. Second, we have a number of industries that supply products for the construction industry. These range from flooring and furniture, made in large part from hardwoods grown in parts of Tennessee as well as the Carolinas, to textiles that are used for draperies, carpets, upholstery, and other home furnishings. We also are a major producer of home appliances like refrigerators, stoves, and air conditioners. So the strength in the housing industry during this business cycle has been very positive for the Southeast.

Another important development that's helped this region is the auto industry, which has been undergoing a long-term shift away from concentration in the Midwest to more southeastern production. The Southeast has attracted not only major assembly plants to Tennessee, Alabama, South Carolina, Georgia, and Kentucky but also hundreds of suppliers. Thus, as demand for autos rose, as it usually does during the early years of a business expansion, this industry boosted manufacturing activity in the region, especially in Tennessee, where production of transportation equipment is now the largest factory employer.

Finally, our region of the country has benefited from in-migration. People and companies are relocating to the Southeast, especially to Florida and Georgia. While Tennessee hasn't had above-average population growth, Nashville has benefited from considerable in-state migration. These demographic shifts have boosted the service sector, especially business services like accounting, architectural, medical, and other professional services whose "products" are needed by the new firms and households that are moving in.

All these dynamics have helped to produce above-national-average job growth, strong manufacturing activity, and a booming building industry and service sector locally, not to mention very healthy state revenues.

In Nashville the story has been even more positive. Job gains have averaged close to 4 percent over the last five years. In fact, the kind of tightness in labor markets that we've been hearing more and more about nationally really began in Nashville. In a sense, what you've gone through here was a precursor of the kinds of response we've seen nationally--very creative ways of bringing more people into the workforce, including increased use of immigrant workers, as well as more use of technology.

In the last year job growth in the region has slowed, but the slowing is no surprise since nationally the housing and auto industries have decelerated as pent-up demand has been met. Since a fifth of Tennesseans work in manufacturing, the effects have been felt in overall job growth, especially since service-sector growth has been slowed substantially from last year. However, the important point is that the baseline of economic activity both regionally and locally remains very strong. Thus, we have been enjoying very good growth in the Southeast, and at the national level the combination of output growth, labor market performance, and news on the inflation front is the best in a generation.

The Role of Economic Policy

The fact that we've had such good performance naturally raises the questions, Can it continue? and What's next? To answer those questions we really need to understand what underlies the good performance we've had. Clearly, at the national level 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. In addition, the expansion of free trade and the additional international competition it has brought have worked to discourage price increases. The strong dollar has also 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 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 discipline pressures us to weigh our government spending decisions against our ability to pay for them in our lifetime. 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've been enjoying. Let me explain my view of these fundamental changes in economic policy a bit further.

First, in the area 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 that 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. 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.

I believe the low and stable inflation we have achieved over this expansion has reduced distortions and costs and thus contributed to better growth. There is growing evidence that the Fed's 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 that people like you face as you're trying to run your businesses as efficiently as possible. Business 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. 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.

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 also for changes in fiscal policy. 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. While that fiscal discipline may have eliminated some economic development incentives for places like the Nashville metro area, I would maintain that the city, especially given its location advantage relative to the country's major population centers, is actually better off in an environment that broadly fosters investment, and in turn relocations, than it would be if development depended primarily on federal subsidies.

What Lies Ahead?

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. Certainly the stock market drop that occurred last week represented a concern that many people had voiced for some time.

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," I believe that 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.

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. Complacency is always a danger, but broad awareness and understanding of this relationship, which forums like this one today foster, 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 ten 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 purely from dumb luck (that is, positive shocks or nothing bad happening) but rather from our willingness to make tough policy decisions. The effects are being felt not only nationally but also in the Southeast and right here in

Nashville. A better understanding of this relationship, which I hope I've contributed to, 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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