Speeches

The Business Outlook for 1998

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Good afternoon. President Shatto, Steve Kemp, Romans and other north Georgians, thank you for inviting me to share my thoughts on the 1998 economy. It's good to be back in your city of seven hills, three rivers and three colleges.

I'm honored to share the podium today with Commissioner Shackelford and Randy Tullos. As I talk about our recent economic performance, I'm going to discuss the role of increasing productivity. Much of those productivity gains spring from improvements in transportation, communications, and information processing. So I don't think it's an accident that the commissioner, Randy and I were invited to share your program.

At the macro level—as an economist might say—the three institutions we represent are inseparable. The Fed's decisions influence the revenues reported in the tax returns Randy files, and those influence the commissioner's infrastructure planning. His plans ultimately affect the movement of people, goods and services, and they determine what we at the Fed do. That's an oversimplification, of course, but you get the idea. The business outlook for 1998 isn't necessarily what I, the commissioner or Randy decides it is. In large measure, the outlook is what *you*—individual businesses and consumers acting together—decide it is.

At the Fed we try to predict what your economic decisions will be and why. Lately, of course, these decisions have been very good, so we've also been asking how much longer they will last. We can begin to answer those questions by looking backwards.

Painting without numbers
The current economic expansion began seven years ago next month and will be the second longest in the post-war period by the end of the year. Economic growth last year, as measured by gross domestic product, exceeded almost everyone's expectations, and the unemployment rate is the lowest it has been in a generation. Inflation has been under control for a while now but in recent months has brought interest rates down with it.

I've avoided using numbers here because they've become so familiar with business audiences. But I also don't believe that the economy can be reduced to or summarized by numbers. Numbers are, after all, indicators. The question is, what do they indicate?

Demanding consumers and businesses
First and most important, the numbers indicate a current economy in which demand and supply are fundamentally "balanced." Demand, of course, is comprised of business and consumer spending, government purchases, and net exports. But at more than 75 percent of total demand, business and consumer spending are by far the most important. Since I'm trying to avoid numbers today, I'll summarize by saying that it is very unusual—in fact, it's unprecedented—for consumers and businesses to spend and invest at the levels we're seeing at this point in an economic expansion. By year six, consumers and businesses are usually ready to take a break. They weren't last year, however, and while we don't think consumer and business spending will grow as fast in 1998, we don't see any major pauses in the period ahead, either. Should we be worried about this? As long as no major "imbalances" cloud the picture, we shouldn't worry too much. When it is well balanced, the economy is less susceptible to what economists call "shocks." Still, because shocks are unpredictable—and I'll get to this shortly—I can always justify a little anxiety.

Government accounts for a significant part of overall demand. What matters to me as a central banker, however, is that revenues finally match outlays. I'll elaborate on that shortly, but I should note that the total level of government spending and its composition of economic output are ultimately political decisions.

Net exports—exports minus imports—have acted as a drag on our economy for years. Since we know the Asian crisis is going to aggravate our trade deficit, the question here is how serious a drag the net export category will be this year. We don't think it will be too serious, for a couple of reasons. First, the most important components of demand—consumer and business spending—are simply too strong to be much affected; were they weaker, the Asian crisis might be a road block instead of a speed bump. Second, export markets outside of Asia remain very strong. Canada, Mexico and the European Union account for more than half of all U.S. exports, and each is expected to post strong economic gains in 1998. Exports to these markets will more than offset any losses to Asia. So, even with the current Asian problems, we think exports will post a healthy gain this year.

The impact of the Asian crisis on the Southeast is mitigated by the fact that the Southeast is proportionately less exposed to Asia than other regions. Less than 15 percent of our region's exports go to the Asian crisis nations, compared with more than 40 percent of West Coast exports.

Imbalances
At the national level, then, demand remains strong where it matters most. But what's also significant on the demand side is the absence of any significant imbalances. Imbalances can be temporary, as retail inventories might be during a particularly bad Christmas season, for example. But they can also grow into an expansion-consuming maw, as we've occasionally seen in the real estate sector. For economists, imbalances are the economy's dashboard warning lights: you can usually get a few more miles down the road, but sooner or later you'll wish you had paid attention. Economic "shocks" usually force you to take notice.

The previous economic expansion, from late 1982 to mid-1990, is a good example of what I'm talking about here. It's also a good illustration of why you have to look beyond current GDP, inflation and unemployment for a real picture of the economy. Like the current expansion, the previous expansion saw seven-plus years of solid GDP gains, although inflation and unemployment never came close to current levels.

But by the end of the 1980s, as growth in consumption and investment began to slow, a few significant imbalances began to emerge. Inventories began to accumulate when production (of houses and cars, for example) outpaced demand. LBOs, mergers and junk bonds weighed corporations down with too much high-risk debt. And too much commercial real estate chased far too few commercial tenants. By 1989 it was apparent that the economy had some serious imbalances. The only question was when they would start to matter. Saddam Hussein, of course, provided the answer in August 1990. The subsequent oil shock forced a quick economic retrenchment.

None of those conditions exist today—except Saddam Hussein, of course. Still, I think we should remain vigilant about two favorite pitfalls from the "bad old days." The first is consumer debt. Recent advances in computer and data processing technologies make it possible for you to buy securities backed by high-risk credit cards, for example. Yes, this is a great example of targeting credit to those most in need and risk to those best able to bear it, and the economy is better off for it. My concern is that that too many financial institutions are shooting at the same targets and that the most vulnerable consumers won't be prepared for the next economic downturn. My second area of concern is recent signs of excess speculation in commercial real estate, but this concern is confined largely to metro Atlanta.

Shocks

Economic shocks differ from imbalances in a few key respects. First, shocks are singular, explosive events. Unlike imbalances, they're not created by the interaction of supply and demand. Rather, they emanate from either the supply or the demand side and reverberate throughout the economy. Shocks rarely result from any sort of gradual accumulation, and their consequences can almost never be postponed. Shocks usually act as a catalyst for some sort of economic retrenchment, but their timing is almost always coincidental and never related to the presence or absence of imbalances. Finally, shocks can sometimes have a favorable effect on economic growth. That is never the case with imbalances.

What, specifically, are we talking about here? The most obvious example from the supply side is an oil shock. Most Americans remember the negative oil shocks of the 1970s, but it might interest you to learn that some economists think we're currently benefiting from positive oil shocks. A sudden change in the price of farm products can also act as a supply shock—again, either positive or negative, usually depending on the weather. Technology can also be a supply shock: some economists think positive technology supply shocks are driving the current expansion. On the demand side, sudden developments in export markets—if they're sufficiently widespread—can reverberate through the economy. And, of course, policy movements by the Federal Reserve to expand or withdraw credit can have implications.

The difficult thing about shocks is that—unlike imbalances—you usually don't see them coming. But that doesn't stop us from guessing what they might be. This year, most people are worried that conflict in the Persian Gulf region could develop into another negative oil shock. The Fed is obviously not in the business of predicting if or when that might happen. If it does, however, we are well positioned to weather a shock because of the relatively balanced nature of the current expansion. (Imbalances tend to amplify shocks.) The absence of serious imbalances also explains why the Asian crisis has been less a shock than a tremor. Unless that crisis spreads to other regions—which I don't expect to happen—we don't think the Asian turmoil will take much more than a half percent off our overall U.S. growth rate.

Supply

So far I've described an economy driven by strong but balanced demand. But I haven't yet mentioned any possible limits to our growth. Nor have I discussed what's behind the truly unprecedented combination of strong growth, strong employment and low inflation. To begin answering those questions, let's turn to the supply side of the economy.

Like any individual business, the economy's growth is limited by the number of people entering the workforce and how much their output increases. This implies that when the unemployment rate gets very low the supply side of the economy must be approaching full capacity unless productivity is also increasing. That's why some economists associate low unemployment with inflation: if everyone's working, the thinking goes, we soon won't be able to meet demand and prices will go up.

But unemployment has been low for a while now, and inflation has continued to decline. And at the Federal Reserve Bank of Atlanta, we don't see either going up very much in the foreseeable future. The question is why.

Productivity (and its limits)

One partial answer is that productivity—output per worker—is increasing. We did see so-called "measured productivity" increase sharply in the latter part of 1997 for the first time in years, but economists don't put a whole lot of stock in those numbers for the simple reason that we just don't measure productivity very well. Our economy is now much more service-oriented than manufacturing-oriented, and it's harder to measure the output of an investment banker or Web page designer than a carpet-mill worker.

The better evidence for increasing productivity is the unprecedented combination of low unemployment and increasing corporate profits. If corporations are making more money with comparatively fewer workers, it must be because those workers are more productive. A lawyer will tell you that that is circumstantial evidence. An economist, however, will tell you that that's a lot more convincing than the direct evidence, which in this case is official productivity statistics.

The tired old new paradigm

While I do believe that gains in productivity have contributed to the economy's recent performance, I'd hate for anyone to think I now subscribe to the so-called "new economic paradigm." What is the new paradigm? In a very small nutshell, the new paradigm argues that increasing global competition keeps prices from increasing, while increasing productivity allows profits to grow even as unemployment falls. The new paradigm is to its proponents what El Niño is to meteorologists, except that nothing bad ever happens, and lately I've seen it invoked to explain or argue for everything from stock prices to increasing the minimum wage.

Most economists will tell you that there are a number of flaws with the new paradigm. In the first place, while it's true that any number of technology shocks have made us more productive, it is not true that they can replace other productivity-enhancing activities. There's a reason, after all, that the leadership of this city has advocated a direct route to Memphis for so many years. Moreover, it's not entirely clear that all the high-tech, productivity-enhancing features included in a typical office work station are being fully exploited: if all you want to do is send e-mail, for example, it doesn't matter that your computer will run an instant regression analysis. But the biggest problem with the new paradigm is that it is premised not only on continuing productivity increases but also on continuing globalization. I believe that we are, in fact, benefiting from technology shocks in the personal computer, information processing and telecommunications industries. But I am not willing to bet the economy that they'll continue ad infinitum.

So what are we to believe: the new paradigm or our own eyes? Our own eyes ought to be pretty convincing. The problem is that recent economic history clouds our vision.

Disco, bell-bottoms and other mistakes

The idea that inflation is a substitute for growth had been around for a while. But like so many bad ideas, it gained popularity in the 1970s, when the Fed loosened monetary policy to cushion the recessionary blows of that decade's oil shocks. The resulting inflation was unavoidable, but it was accompanied by economic stagnation instead of growth. The lesson we should have drawn from the 1970s is that the relationship between inflation and growth is determined largely by circumstances and policy choices. It's these circumstances and policy choices—and not the new paradigm's promise of endless positive shocks—that we need to look at now.

The very happy current economic environment, in my view, is mainly the result of old-fashioned, anti-inflation monetary and fiscal policies. Actually, the Federal Reserve has had an anti-inflationary stance since the early 1980s. What's different is that in recent years the Fed's actions on the monetary side have been matched by Congress and the Bush and Clinton Administrations on the fiscal side.

First the convictions, then the courage

It wasn't like this just a decade ago. Yes, the Fed was able to hold inflation more or less in check, but where it mattered most—in interest rates—nothing happened. The reason is that the market built an "inflation premium" into interest rates. It was all well and good, the thinking went, for the Fed to keep the reigns on inflation. But it didn't really matter as long as Congress and the administration kept the fiscal spigots wide open. As long as the government was borrowing more and more, resources were being diverted from their most efficient uses, and the price of those resources was going to be higher. Thus did interest rates remain substantially higher than inflation.

All that began to change with the Budget Enforcement Act of 1990. That law was signed in the middle of a recession, but it sent a powerful signal that Congress and the Bush Administration were committed to fiscal restraint. The Clinton Administration reiterated that commitment in 1993. And last year, of course, Congress and the administration agreed to a balanced budget bill that should produce an $8 billion surplus this year—if they don't decide to give it away, first. The point is that our monetary and fiscal policies now have credibility with the market, and the market is acting on that credibility. We still have low inflation, of course; but now we also have low interest rates.

Why does this matter? We know that inflation causes uncertainty and risk. We know it distorts incentives and resource allocation and that it increases inefficiencies. We know that eliminating these impediments by sustaining the attack on inflation ought to allow growth to continue. And that is exactly what has happened.

So if we know all this, why are we surprised? Well, we shouldn't be. We ought to have the courage of our convictions. We ought to realize that growth doesn't cause inflation and that the assertion that it does belongs in the museum of bad ideas along with disco, bell-bottoms and other relics of the 1970s.

When you leave today, I hope you'll take away the notion that the economy is not an accident. Neither is it a high-tech perpetual motion machine. The economy is you, individual consumers and businesses, acting together to determine the most efficient allocation of scarce resources. Monetary and fiscal policies help shape the economic environment by making more or less of those resources available. Commissioner Shackelford and Randy Tullis make them more productive. But it is you who ultimately put those resources to work. You've made excellent decisions these last seven years, and I think you'll continue to make good decisions in the year to come.

And that, ladies and gentlemen, is a very bright outlook indeed.

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