Speeches

Thriving in the New Millennium

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I am indebted—once again—to Brad Currey for the invitation to join you this morning.

Brad was on the Board of the Atlanta Fed for six years in the '80s and served as its chairman for half of them. When he became our chairman in 1987, GDP was $4.7 trillion; the Dow had just passed 2000; and you could get a blazing-fast, 16 MHz PC for only $7,000.00. The economy was, we might have thought, just about as good as it could get.

From the vantage point of 1999—when GDP has nearly doubled to $8.4 trillion, when the Dow is closing in on 10,000, when you can get a 350 MHz PC for $500.00—it's pretty clear that we underestimated the U.S. economy. It's clear that we underestimated the innovation of the American financial system, that we underestimated the evolution of technology and its contributions to productivity growth, and that we underestimated the extent to which the economies of the world would begin to integrate. But I suspect that way back then, before just about everyone else, Brad saw what was coming. That just like always, he knew a little more than he was letting on.

So if you really want to know about the theme of this conference—"thriving in the new millennium"—you should ask Brad Currey! I know I will.

For the next few minutes I'd like to talk about the challenges economic policymakers must address as we enter the new millennium. Frankly, the upside challenge —inflation—is not particularly new. Policymakers have been trying to contain it since at least the third century of the first millennium. The downside challenge, as I see it, is understanding and anticipating the vulnerabilities of the U.S. in a global economy.

But before I get to the next millennium, let me briefly discuss the outlook for the last few months of the current one.

The expansion will complete its eighth year next month. It is already the longest *peacetime* expansion in post-War history, and I fully expect it to surpass the 106-month *Vietnam* era-expansion about this time next year. The economy continues to amaze everyone who observes it, having produced generational lows in inflation and unemployment over the last year and truly staggering GDP growth numbers in the last quarter. At this point, there seems to be no stopping the U.S. economy.

The economy's overall strength has been underscored by its performance in the face of the various international economic and financial crises over the last 18 months. While it's true that the United States is much less exposed to the international economy than many other industrial nations, it's also true that Asia's ongoing retrenchment and the financial turmoil catalyzed by Russia's default last August were two very serious economic shocks. It is no exaggeration to say that things might have turned out very differently for the United States in the absence of its three sources of economic strength.

The economy's first source of strength is its fundamental *balance*. Previous expansions, including the 1982 -1990 expansion that preceded the current one, ended when too much corporate and consumer debt and overbuilding in commercial real estate were exposed by the economic shock that was the Persian Gulf War. Had any serious imbalances accumulated during the current expansion, the economic shocks we experienced last year would have tended to bring them to light.

The economy's fundamental balance is all the more gratifying considering the second source of strength, its *momentum*. Consumer spending last year was much more typical of an early recovery year, when pent-up demand for durable goods is a major source of spending. And business investment, while not quite as unrestrained as consumer spending, grew at a commensurately high rate.

The economy's third source of strength is its *monetary and fiscal policies*. I'll elaborate on what I think they ought to be shortly, but for now I'll just say that monetary policy—with a big assist from energy prices and low import prices—has managed to wring most (but certainly not all) vestiges of inflation from the economy. And that low inflation—combined with balanced fiscal policies—has allowed interest rates to fall as well.

As the expansion begins its ninth year next month, all three sources of economic strength remain firmly in place. As for how they manifest themselves in the economic aggregates in the period ahead, I think we'll see a little more inflation but a little less GDP and employment growth this year. But when it comes to the duration of the current expansion, I think it can be said that less will indeed be more.

Consumer spending should begin to cool off this year. This is not an entirely unwelcome development: consumer spending actually grew faster than incomes last year, so slower growth will help prevent imbalances from developing in a sector that consumes 2/3 of U.S. output. Business investment should also continue to increase, but at a lower rate than we've seen over the last several quarters.

International developments will continue to cut both ways for the U.S. economy. After posting a decline last year for the first time since 1985, exports should move back into positive territory in 1999, although they will not begin to approach previous levels for some time. *Imports* will continue to grow rapidly, however, providing more competition for some American firms and lower input costs for others.

Now I realize that many of you represent firms that are being squeezed on *both* ends by the Asian and Latin American downturns—export revenues are down because of flagging demand overseas, and domestic revenues are under pressure because of increasing foreign competition. For you there must be little joy in the latest GDP or inflation announcements, and I understand how you must feel. But for the economy as a whole, the crisis overseas has indeed had a very healthy impact on inflation.

As we approach the next millennium, then, I expect that very low levels of inflation, combined with solid but more restrained spending by consumers and businesses, will continue to produce healthy gains in real GDP. We are, in short, very well positioned between the upside and downside risks.

Now for those of you who are wondering, let me clarify: Yes, I did say upside risk; and, no, the expression is not some verbal tic peculiar to monetary policymakers. In fact, upside risk—inflation—still exists. And in fact it remains, as it has since human beings began recording prices, the single greatest threat to an economy's long-term health. I know this argument sounds particularly incongruous at a time when measured inflation approaches zero. Why worry about inflation indeed? The reason is that inflation is not an event to be put behind us but, instead, a process to be managed.

Eight times a year, the FOMC meets to evaluate economic growth and the level of purchasing power in the economy. Every meeting, we face the same three choices: add purchasing power, remove it, or leave it the same. This is the process through which inflation enters the economy, and it occurs when the economy's purchasing power exceeds its output, when, as our high school economics teacher used to put it, "too much money chases too few goods." So inflation, when it arises, arises because of the decisions of monetary policymakers. Sometimes—as in the 1970s—inflation is chosen over an equally difficult or worse alternative. More often, though, it's simply a mistake. That's why when monetary policymakers talk about the threat of inflation, they're not necessarily being alarmist. They are, instead, simply being factual about economics and their own humanity.

Well, so what? When you make a mistake, you fix it. When you approach a curve too fast, you hit the brakes. And when you inject a little too much purchasing power into the economy, you take it right back out before inflation gets too firmly rooted. As enticing as this reasoning may be, the entire history of economics—including the United States' own recent history—instructs us otherwise.

The unfortunate truth is that inflation is much easier to create than it is to rein in, and the reason is that the economy is built on the decisions and expectations of human beings. So when the general level of prices starts to rise, employees begin to demand annual cost of living adjustments, businesses load up on inventory and supplies and lenders build an inflation premium into interest rates. Of course, none of these devices provides any lasting measure of protection to the parties who employ them. They do, however, serve to hardwire inflation into the economy. It becomes the most destructive kind of vicious cycle, and—as our experience in the early 1980s demonstrates—is very painful to correct. Better, then—from my perspective—to prevent inflation from occurring in the first place.

I suspect the judgment that inflation is dead is yet another legacy of our 1970s inflation experience. Popular analysis of that era tends to make two mistakes. The first projects the movement of a single, relative price—petroleum—upon general prices. The second mistake assumes that that one price increase was the *cause* of inflation. In fact, the inflation of the 1970s resulted from monetary policy choices intended to mitigate the impact of consumers' having to spend more money on petroleum and less on other goods. Countries that made a different choice in responding to the oil shocks—including Germany and Japan, both of which import a far greater share of petroleum—experienced less inflation, but also more serious recession.

In many respects, 1999 is almost a mirror image of the 1970s. Oil prices have fallen dramatically, giving consumers more money to spend on other things. But some of the analysis I hear, especially where it concerns the death of inflation, is eerily familiar. It confuses relative prices with general prices. And it assumes that the decline of those prices—rather than the choices of monetary policymakers—will cause general prices to fall, too.

So with assurances that monetary policymakers remain aware of our role in the inflation process, let me point out that as of the most recent CPI report, more prices were up than down. Service prices—accounting, legal, computer and business consulting—continue to grow briskly. Medical care was up. College tuition is *always* up. As for tobacco products—well, let's just say the Surgeon General ought to consider adding bankruptcy to his health advisory. Of course, all of these products are given considerably less weight in the CPI than other goods whose prices have declined or risen much more slowly, and that's why inflation has been lower. But an examination of some of the categories that comprise the CPI demonstrates that lower prices across the board are not representative of the economy.

Finally, very rapid recent growth in the monetary aggregates suggests that inflation has not yet been vanquished. To be perfectly clear here: the money growth we're seeing is not necessarily inconsistent with low inflation *in the short term*. It may or may not be. And as those of you who follow this debate know, the chief reason the FOMC stopped targeting money supply growth several years ago is that it is not useful for short-term, operational decisions. In the long term, though, we know that there is absolutely a direct relationship between money supply growth and inflation. So the dramatic growth in the aggregate money supply over the last few years remains a real concern to me, even though it has slowed down in 1999.

Still, for the most part, the economy's upside risk—inflation—is the devil we know. What concerns me about the economy's downside are the things we *don't* know; the things that could draw us into an international economic quagmire despite our limited exposure to the global economy.

What exactly am I talking about here? As a monetary policymaker, I think the first challenge is simply understanding how the economy—and even more basically, how our policies—work. Most of the models our forecasters work with were constructed when the U.S. economy was much more closed that it is today. Events outside our borders need not have been considered to any great extent. But in a global economy, everything matters. So identifying and anticipating the millions of international balances and imbalances that can have an impact on the U.S. economy is the first challenge for monetary policymakers.

The second challenge for monetary policymakers is what I'll call making sense of rational markets. Over the last 18 months, trillions of dollars have fled developing Asian countries. Much of that was to be expected, of course, as markets meted out their own brand of discipline for the region's bad policies, corruption, excesses, etc. What wasn't expected, though, was that funds would refuse to go back, even after some of the Asian countries implemented serious reform measures. The entire region and emerging markets in general have been painted with the same red brush. Now, to be sure, the U.S. benefited in some ways from all this uncertainty: At the height of the crisis last summer, the demand for safety and liquidity brought the yield on the U.S. long bond to its lowest level ever, and that brought borrowing costs down, too. But the market's actions last summer raise the troubling possibility that doing the rational thing doesn't always bring about the optimal result for everyone. So as monetary policymakers, we still have a lot to learn about financial crises and their economic implications.

But the Fed's job is to foster economic stability, and monetary policy is only one way we do that. We also supervise banks and bank holding companies, and we operate the payments systems over which the majority of the nation's financial transactions take place. Obviously, these functions aren't nearly so well known as our monetary policy duties, but—just to be clear about it—no economy can grow without a functioning banking or payments system in place *first*. So when I think of economic stability, I think about all three areas. And in the other two areas—call them the first two—we're taking steps toward mitigating uncertainty even as we speak.

As for banking, I would call your attention to financial reform legislation currently pending before the House and Senate. The Financial Services Modernization Act, as it's called, is one of the most important legislative measures considered by Congress in decades. Among its most significant provisions, it would make the Federal Reserve System the so-called umbrella regulator for the nation's banking system. Considering the fact that the Fed is the only institution also involved in economic policy and the payments system, we think this would add a considerable measure of stability—yes, of certainty—to the economy and the banking system. And while I hate to sully today's proceedings by mentioning politics, I think you really ought to know about this legislation. It's important.

Finally, as for the payments systems, I doubt that most of you have ever given them a second thought—or even a first. That's probably a good thing. To notice the payments system would be to notice that it wasn't working, and if it shuts down, the economy shuts down, too. I want you to know that as I speak this morning, all of the Fed's electronic payments systems are fully Y2K compliant.

I'll close by reiterating that this is truly an extraordinary period in our economic history. What we don't know about the global economy remains a downside risk, but here in the United States the economy is well balanced and continues to grow impressively without significant measured inflation. As long as my Fed colleagues and I remain vigilant toward the upside risk and continue to make good policy choices, the economy does indeed seem prepared to thrive in the new millennium.

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