Speeches

The Economic Outlook for 2000

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Thank you, John, for that introduction, and good afternoon, everyone.

I'm pleased to be speaking to my toughest—and favorite—audience again this year. I'm also a little relieved that my turn before you arrived three weeks later than usual. Not that I thought I'd have much to comment on after the Y2K weekend—actually, the century rollover turned out pretty much like we hoped and expected it would. It's just that I wasn't looking forward to greeting the first business day of the New Year with predictions about What the Next Thousand Years Will Bring for the U.S. Economy. And anyway, the current expansion offers more than enough excitement for the average central banker. So for those of you who've just emerged from some Y2K bunker, let me recap.

The current expansion and the newest economic indicator

The current expansion, which began around April 1991, is about three months shy of completing its ninth year. It is already the longest *peacetime* expansion in the post–World War II period and will surpass the 106-month long Vietnam-era expansion in the next couple of months.

As for 1999, it was a year in which most of the benchmarks set in 1997 and extended in 1998 were exceeded yet again. Which leads me to propose that my Fed colleagues and others in the economics business ought to consider a brand new economic indicator. I would call it the *superlative indicator*. The superlative indicator would track the number of times my colleagues and I use the following terms to describe the expansion or the economy:

Longest—with regard to months of consecutive growth. You just heard me use this one.
Highest—in terms of levels of sustained growth in real gross domestic product at this stage of an expansion: 4½ percent in 1997, 4.3 percent in 1998, and right around 4 percent for 1999.
Lowest—with respect to unemployment: just over 4 percent in 1999, the lowest rate since 1969.
Mildest—regarding inflation as measured by the consumer price index: 1.6 percent in 1998 and 2¼ percent in 1999, the mildest consecutive years of inflation since the early 1960s.
Strongest—with respect to consumer confidence, the strongest in 31 years, according to the Conference Board.

If you didn't know better, you might think the superlative indicator was stuck. After all, for the last couple of years now my colleagues and I have been saying the economy is the best it's ever been. And that's a real tribute to the depth and breadth of this expansion: the economy has excelled not in one area, but in them all. And it's been doing it for a long time.

As for 2000

The question for 2000, of course, is whether the economy can continue to post such impressive numbers. I think it can—but with the qualification that the superlative indicator will move from "best" to "very good." As for how that will show up in the indicators, I anticipate that real GDP will grow at nearly the same rate for 2000, between 3½ and 4 percent. I expect that civilian unemployment will remain basically unchanged, at somewhere around 4 percent. And I think inflation may tick up a bit and be around the levels we saw earlier in the current expansion—between 2½ and 2¾ percent as measured by the consumer price index. As in 1999, the primary sources of economic momentum this year will be consumer spending, business investment, inventory stock rebuilding and government spending.

Consumer income and spending are likely to be strong again in 2000, and so far appear to be basically in balance. Business investment—if the anecdotal information we're receiving is correct—is likely to maintain the 1999 pace, and to date shows few signs of any Y2K-related setbacks. Finally, while inventory-to-sales ratios are at historic lows, there is every indication that they will continue at their current levels. Additional inventory building will be strong enough to replace current sales but is not likely to be as robust as we might have expected from past experience.

The central challenge for monetary policy

Against this very positive backdrop, the central challenge for monetary policy this year will be keeping inflation low. For the last several years, the international economic environment has helped keep prices low in the United States. As economies across Asia contracted, demand for—and prices of—commodities fell. Finished goods from countries with depreciated currencies were imported at lower U.S. prices and created additional competition in domestic markets. And a bottoming out of energy prices pushed down prices at the gas pump and across the board.

These developments widened the trade deficit. Usually, they would also have contributed to a decline in the value of the dollar. However, uncertainties associated with the crises in Asia and Latin America prompted foreign investors to seek the dollar as a safe haven. The result was an appreciation of the dollar, an inflow of funds and a decline in U.S. interest rates. All of these events helped support business investment and growth.

Taken alone, any one of these developments would have provided a powerful assist to the Fed's goal of sustained economic growth and price stability. Taken together, they constitute a central banker's wildest anti-inflationary dreams. Now, of course, they're mostly gone. And that means that for the expansion to continue and inflation to remain low, fiscal and monetary policymakers have to work even harder to make the right decisions.

This matters because expansions don't usually die natural deaths. They are usually done in by adverse external shocks and policy mistakes. But this year we're not facing an oil crisis, and on the fiscal side, the Federal budget surplus has dampened aggregate demand and made a significant contribution to national savings and the goal of low inflation by offsetting the decline in the personal savings rate. I remain concerned, however, about the numerous proposals to spend the surplus down.

All of which leaves for monetary policymakers this key question: Is the current rate of growth sustainable and consistent with a low-inflation environment? If it isn't, monetary policy adjustments will be needed to ward off the inflation that will inevitably result. But if it is, we can afford to let things run a bit without significant policy adjustments. Part of the answer to this question requires us to take a stand on the new economy.

What's new—and what's not—in the economy

The new economy—you'll also hear it called the new economic paradigm—is one of those concepts that can mean just about all things to all people. Its central principle, however, is that globalization, productivity and any number of other things have dramatically extended the U.S. economy's capacity for sustainable growth. And while I have no doubt that productivity has recently and dramatically improved—more on that shortly—we still have a lot to learn about the various effects of globalization and its implications for the conduct of monetary policy.

Now, you've heard me make the case for free trade and globalization here before—comparative advantage, labor market mobility, price competition and all the rest. And I hope that in the hometown of UPS, Delta, Coca-Cola, Home Depot and BellSouth, no one needs to be convinced that in the long run we Americans benefit more from globalization and free trade than anyone else. I don't have any doubts about that.

What I do struggle with, however, is the idea that globalization has permanently rid the economy of inflation. Yes, globalization creates relentless price competition. And yes, globalization has indeed played a role in keeping inflation low in the U.S. economy the last couple of years. But we need to keep in mind that the extraordinary loss of pricing power that many U.S. firms experienced was intensified by slack demand in many of our trading partners and by an appreciating dollar. Moreover, it's also worth remembering that just as globalization can more quickly transmit a positive shock to the U.S. economy, it can just as easily transmit negative shocks that exert upward pressure on prices. To what extent, I'm not sure. But it is entirely possible that globalization has not changed the economy quite as much as the last several years' experience might suggest.

But now let's consider where *it is clear* that things have changed. In the first place, we now know that productivity—the simple definition is output per worker per hour—has, in fact, improved dramatically in the last four years. I say "in fact" because for years economists who study productivity seemed to have appropriated that old Groucho Marx line: "Who are you going to believe, me or your own eyes?" Anecdotally, it seemed obvious enough to most of us that productivity was improving. And even though the statistics told us otherwise, we could see it in our own homes and offices.

When productivity increases, unit costs at the company level fall as output per hour climbs, and firms are able to increase earnings, hire more employees and pay them better without raising prices. At the national level, increased productivity simply means that the economy is able to accommodate stronger growth without inflation.

When businesses talk about productivity improvements, they usually mean that they're "working smarter." They're talking about assessing daily demand for their own products and employing just-in-time methods to manage inventories and deliveries to key markets. They're talking about managing their own supply chain in real time. And, of course, they're talking about empowering their own employees to produce more goods, more efficiently. In order to do all of these things, firms have invested hundreds of billions of dollars in computers, data processing, networks, telecommunications and other equipment.

Productivity improvement has been at work in the financial sector too. Not too many years ago, businesses had basically one option for meeting their capital needs: banks. Yes, banks offered a range of products, but they were priced almost exactly the same from bank to bank, and the only choice most businesses had was whether to sign in black or blue ink. Today, as funds move over millions of miles at the click of a mouse, most financial products have become like commodities, and the balance of power has shifted almost completely.

Think about this: in 1998, more than one-third of small business loans in Georgia were originated by banks with no presence here. In Florida last year, not a single Florida-based bank ranked in the top 10 in terms of market share. Throughout the 1990s, General Electric has been one of the nation's leading industrial lenders. And when was the last time you heard about a venture capital firm—whose dozens of failed investments can be spectacularly redeemed by a single blockbuster —declaring insolvency? What we're witnessing, of course, is what economists call disintermediation—the elimination of the banker as the financial middleman. Investors and entrepreneurs—the capitalists and creative types who have unleashed something new and great but still mostly unknown in the United States—can find each other with greater ease and at lower cost than at any time in history.

The productivity improvements we've witnessed at the company level and in the financial sector are the primary sources of strength in the current expansion. Is this productivity shift permanent? I'm not sure. But in November the Department of Labor issued revised productivity statistics that actually confirmed what some of us have suspected for a while. The revisions say that from the mid-1970s to 1995, productivity in the nonfarm business sector grew only around 1¾ percent per year. Since 1996, however, productivity growth has accelerated to an average of 2¼ percent, and in the last two years it has averaged more than 2¾ percent.

The accelerated productivity growth we've seen since 1996, combined with labor force growth, does explain how the economy has been able to grow with negligible inflation over the last two years. And in my view, productivity gains show no signs of slowing down in the short run. In the long run, however, if productivity gains or labor force growth should slip (as they have in the past), then the economy cannot continue to grow as quickly without a rise in inflation or a corresponding change in monetary policy. And in that respect, the labor market is at least as great a source of concern as the long-term sustainability of productivity growth.

Everyone in this room knows that labor markets are extremely tight. But just as important, the pool of available workers has shrunk to a historic low. Now, while putting more and more people to work is surely one of the great dividends of the current expansion, there absolutely *are* limits. And when we are finally unable to bring new workers into the labor pool, growth will have to slow. Unless, of course, productivity can continue to accelerate. And it's here where low inflation is absolutely vital.

Investment and the entrepreneurial spirit: the role of low inflation

Between 1960 and 1990, inflation was mostly higher than it is today; the result was that business investment in durable equipment grew at an average rate of about 6 percent per year and real growth averaged around only 2 percent. In the low-inflation environment of the 1990s, however, durable equipment investment doubled to more than 12 percent per year, and real economic growth climbed with it to an average of around 3 percent.

Now, if you think the lesson here is don't let productivity statistics determine your investments, you're partially right. But to me, the more important lesson is that low inflation encourages businesses to persist—and prevail—in their quest to create value through investment. At the national level, businesses doubled durable equipment investments in the 1990s because they thought those investments would substantially improve productivity. It took a while for the results to show up in the numbers, but they were right. In an inflationary environment, though, those additional investments never would have been made. And I wouldn't be standing here

anticipating the ninth straight year of economic growth.

Quite apart from its impact on investment, though, low inflation has also played a critical role in nurturing the entrepreneurial spirit that so characterizes our economy. Low inflation encourages entrepreneurs and businesses to have the courage of their convictions; to pursue their dreams; and above all, to take sensible risks. If you're like me, you probably know one or two young people (and maybe even a few 40-year olds) who've recently traded the security of a familiar job for the chance to create something new and, of course, strike it rich. Most of the folks I know who have taken this leap have done it with their eyes wide open: they know that the odds are long and the hours horrendous. But they also know they've got something solid to fall back on if things don't work out: a small nest egg, usually, and the prospect that they'll find another job in a red-hot employment market.

These folks are, of course, the foundation of our economy and the envy of the world. But if you ask them what they think about inflation, what you get is the definition of a blank stare. And that's exactly the way it ought to be. Because if you think your savings are going to evaporate overnight, if you think the landlord's going to double the rent next year, if you think your investment's going to generate a negative return . . . well, then, you quit taking risks altogether.

All of this takes me back to the question I asked a few minutes ago: Is the current rate of economic growth sustainable and consistent with a low-inflation environment? The answer is that it is *only* sustainable in a low-inflation environment. Yes, much about our economy is new: productivity, the financial sector and the capacity for entrepreneurial risk. But they're all a product of a low inflation environment. And as I participate with my colleagues in the FOMC policy deliberations this year, I assure you that I will work to keep inflation low and our vigorous, old expansion on track.

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