

Speeches

The Role of Low Inflation in the Current Expansion

Remarks by
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It's been an interesting few weeks for the economy and for those of us whose work is tied directly to it. Three weeks ago tomorrow, as I'm sure most of you know, my Fed colleagues and I raised the fed funds target rate 50 basis points to 6 1/2 percent. It was the sixth meeting in which we've raised interest rates in the last 12 months, and I'll argue shortly that it was the right decision—that the economy cannot continue to grow without sustained low inflation. Still, though, our decision has not been without its critics, and it probably won't surprise you to learn that my phone calls and e-mails have been less “Fed friendly” the last three weeks.

So I'd like to begin by observing that this period of tighter monetary policy demonstrates why Congress and President Wilson made the Fed independent back in 1913, more than 85 years ago. The Fed is independent because doing the *right thing* for the economy in the long run sometimes means doing the *hard thing* in the short run. And doing the hard thing—raising interest rates—is not the kind of platform that wins you the immediate thanks of a grateful constituency or another term in office, even if it helps extend the longest economic expansion in modern U.S. history.

But independence does not mean we're not accountable to the public we serve. Chairman Greenspan testifies twice a year before Congress about our policy objectives and our thinking on the economy. The chairman and the other six members of the Board of Governors are appointed by the president and confirmed by the Senate. And I hold my job at the discretion of the Atlanta Fed's board of directors, who are bankers and other community and business leaders from across the Sixth Federal Reserve District's six Southern states.

All of these accountability measures are essential for preserving the Fed's policy credibility. But I prefer the direct method—making the case for our policy choices to the people directly affected by them. And that's why I accepted your invitation to be here today.

So in the next few minutes I'll talk about where we are with the current economy, how we got here, and what I think it will take to keep moving forward.

Where we are

Sometime in April, the current expansion entered its *10th year*. This is a modern record, for peacetime or wartime: the previous record of almost nine years was set in the 1960s and received a powerful assist from the stimulus of the Vietnam War.

But not only is current economic growth not slowing down—it has actually *accelerated*.

Real GDP growth in 1997, 1998 and 1999 exceeded 4 percent.

And the 7.3 percent GDP growth that came in the fourth quarter of last year was so astounding that it actually made the 5.4 percent growth of the first quarter of 2000 look rather modest.

The other economic benchmarks have been strong, too:

Civilian unemployment has been below 5 percent since July 1997, and hit a 30-year record low of 3.9 percent in April before ticking back up to 4.1 percent for May.

And despite pretty dramatic price increases in energy and for some other goods and services, inflation as measured by almost any of the price indices remains quite low by historical standards and has been increasing only slowly.

What accounts for our good fortune? What distinguishes the current expansion from previous expansions? Indeed, what makes our economy different from every other economy in the industrial world?

How we got here

I attribute the economy's extraordinary performance to four fundamental factors. And while I believe the *first three* are unique to our economy and new to varying degrees, I do not believe they add up to some profoundly “new” economy. Indeed, in the absence of the *fourth*, long-established factor, I doubt the first three—and therefore the 10th year of the expansion—would be here at all.

The *first factor* that distinguishes the U.S. economy is our *willingness to live with uncertainty*. Let me explain what I mean by that.

Across the United States, some of the very best companies have recently experienced some very public and very painful restructuring measures. It seems ironic that prosperous and profitable corporations are laying off employees at the apex of the longest and strongest expansion in history. I think it's fair to ask, If the economy is so strong, why are these companies and their employees enduring these layoffs?

I think the answer is that our economy is so strong because companies are willing and able to restructure. Throughout Western Europe, some of the best jobs at some of the best companies are being sent overseas (many to the United States) despite lingering double-digit unemployment. As I understand it, the objective of labor practices in many of these countries is to provide workers with *certainty*—with the assurance that their jobs and their paychecks will be there tomorrow, no matter what.

The problem is that markets offer no such assurances. And if companies are prohibited from responding to market signals, they either move someplace where they can (like the United States) or they shut down for good.

In the United States, where unemployment is at a 30-year low, there are almost no guarantees that you'll have your job next month. If you do lose it, though, the odds are pretty good that you'll be able to find a new one quickly. But that's about as firm an assurance as you can get.

Because companies and employees in the United States are willing to live with uncertainty—because they have very little choice about it—our economy is much better positioned to respond to market signals. This first factor is a *competitive advantage* that has served us well in a hyper-competitive global economy.

The *second factor* that distinguishes the current expansion is an *increased capacity for entrepreneurial risk*. Here's what I mean by that.

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.

It is absolutely true that many—maybe even most—high-tech startups won't amount to much in the long run. But the point is not that 999 startups fail for every one that succeeds. The point is that 1,000 try something completely new, completely different—and that in terms of innovation and value creation, the successes redeem the failures, thousands of times over. These folks are making venture capitalists of us all—and the United States the envy of the world.

Businesses and markets have brought about the *third distinguishing factor* of the current expansion. That factor, of course, is a dramatic improvement in *productivity*.

Last fall, after several years of speculation, a new batch of statistics confirmed that output per worker—the most general definition of productivity—has, in fact, increased substantially in the last few years. This new growth in productivity helps explain the two most remarkable features of the current expansion.

First, at the firm level, an increase in productivity brings unit costs down. Declining unit costs allow profit margins to improve without an increase in prices. Second, at the national level, rising productivity allows firms to meet growing demand for their products without hiring more employees. In the current expansion, productivity growth at both levels has produced record profits and stable prices, a remarkable and historic achievement, especially in an economy with nearly full employment.

So far I've argued that the current expansion is distinguished by three fundamental factors:

The first is the willingness of businesses and workers to live with uncertainty and to respond to markets. The second is a dramatic increase in the nation's capacity for entrepreneurial risk. The third factor is improved productivity; businesses and markets have produced that one.

Taken together, all three factors are far more fully developed in the United States than anywhere else in the world. But they no more add up to a new economy than a big new engine and upgraded disc brakes make my Buick a Boeing. Yes, it's faster and safer and can haul a lot more stuff—but it's still just a car. Likewise, the economy can accommodate much stronger demand and much lower unemployment than it could just a few years ago. But there are still physical constraints on how much the economy can produce, and if either the labor supply or productivity falls, or if other bottlenecks develop, we will reach those constraints sooner rather than later.

For the first three factors to remain—for our economy to continue to grow—the fourth factor must continue to prevail. That factor, of course, is low inflation. Let's consider for a moment how low inflation affects the first three factors.

The difference is low inflation

First, low inflation ensures that our willingness to live with uncertainty accrues to our benefit. I'll talk more about this in a moment, but the United States is—and has been for some time—the safe haven for the world's investors. The reason is that low inflation reduces uncertainty: Whether it's an automobile factory or government bonds, investors know that the Fed will not allow their investments to be eroded by inflation.

Second, low inflation encourages entrepreneurs to have the courage of their convictions. In an inflationary environment—even an early 1990s-era environment of moderate inflation—risks are greater. The rent jumps higher and more frequently. The real value of your savings account—the nest egg you fall back on if things don't work out—gets smaller faster. And it's much harder to raise capital when a U.S. Treasury bond—the safest investment on earth—offers a pretty decent return. In an inflationary environment, it's easier just to play it safe.

Finally, low inflation made possible the tremendous growth in productivity we've witnessed the last several years. In 1996, productivity growth accelerated from about 1 3/4 percent (where it had been stuck for about two decades) to around 2 1/4 percent. In 1998 and 1999, it accelerated again to 2 3/4 percent. These productivity gains were the product of a surge in investment that began in the early 1990s, when durable equipment investment growth doubled from around 6 percent (where it had been stuck for nearly 30 years) to around 12 percent. But these investments would not have been made in an inflationary environment, primarily because inflation increases uncertainty—and therefore risks—about an investment's "real" returns.

Low inflation, then—while not sufficient by itself—has been the one essential factor in the economy's record performance. Without it, I suspect, the economy would've slowed down three or four years ago. Instead, it sped up. At this rate of economic growth, though, we've got to be a lot more vigilant about the potential obstacles ahead of us. If you take a speed bump at 15 miles an hour, after all, you're still moving forward. But the same bump at 70 will surely destroy your vehicle.

So what should we watch out for? Well, when it comes to economic expansion killers, there are three usual suspects: imbalances, shocks and policy mistakes. We can usually spot the first, economic imbalances, as they develop: corporate or personal borrowing that gets out of line, for example, or excessive commercial real estate speculation. I don't yet see any of those kinds of systemic imbalances. But I am concerned that our savings gap and the trade deficit *could* become an imbalance if we don't keep inflation in check and continue to make the United States the leading investment destination for foreigners.

The second expansion killer, shocks, you almost never see coming. (That's why we call them shocks.) They can be negative, as with the 1970s oil crisis, or positive, as with the oil glut of a few years ago. However shocks manifest themselves, though, we know they can be managed or mitigated if we have our policies right: as, for

example, when the FOMC cut rates three times in 1998 to inoculate the U.S. economy from the Asian flu.

And that brings me to the third expansion killer, policy mistakes. You've heard me argue that low inflation is the one *essential* element for economic growth. It's not *sufficient*—businesses and consumers have got to make good choices too—but without it our economy would have slowed some time ago. That means that for the economy to continue to grow, inflation must remain low. And that means my colleagues and I have got to continue to get our policies right. Inflation, remember, only enters the economy when monetary policymakers allow it to. And it almost always happens by mistake: when we let down our guard, when we get complacent, when inflation expectations begin to creep from one sector of the economy to another. The six rate increases we've implemented since last summer should be understood as a measure of our determination not to let those things happen.

The policy environment

Now let's consider how the economy has changed over the last few years and those factors that put us on our tightening path. The most obvious difference is that Asia is no longer in an economic crisis. As I mentioned, the FOMC engineered three rate cuts in late 1998 in order to ameliorate the pain of—and provide additional liquidity for—those sectors of the U.S. economy most adversely affected by the Asian crisis. Remember, though, that those easing moves came at a time when our economy was already growing over 4 percent on the year. They provided an additional stimulus that we were not able to take back immediately.

The policy environment changed in other ways too last year: most significantly, the balance of risks to the economy shifted away from an absence of liquidity and strains in the financial markets and toward growing inflationary pressures. Those risks have remained.

In the first place, while it's true that the Asian crisis was a serious threat to certain sectors of the economy, it was also—in other ways—very beneficial to the Fed's price-stability agenda. But when the crisis ended, so did the low inflation assist. Now, with much of the world in recovery, imported consumer goods are no longer falling in price. Likewise with commodities; as demand has increased around the world, so have commodity prices.

Think also about what has happened with energy prices. Two years ago, \$11 per barrel oil prices exerted downward pressure on prices across the board, allowing manufacturers to either cut prices or pad their margins. Now, even with a decline in April, energy prices have more than doubled, and manufacturers face the opposite dilemma: increase prices or cut margins.

After an extended period of dormancy, we're beginning to see wages creep up, and benefits costs are moving up significantly, as well. Of course, some of these increases simply reflect higher compensation for a more productive workforce. And they're also an important source of the very strong consumer confidence and consumer spending we're witnessing. The downside, though, is that in an environment like this, it's much easier for manufacturers to pass on price increases—and for consumers to expect them.

I want to reiterate that robust demand does not cause inflation. Inflation results only when demand exceeds productive capacity. And in the current expansion, capacity has remained ahead of demand because of productivity growth and an expanding labor pool. With last Friday's unemployment report and other recent data releases, I'm encouraged that that balance is being maintained and that we may be beginning to see the economy approach a more sustainable level of growth.

Much, perhaps even most, of our economy *is* new and improved. But it remains vulnerable to that oldest enemy of all: inflation. And while inflation has not yet taken root in the economy, the price increases we're witnessing in some sectors are an indication that inflationary pressures are emerging.

I firmly expect the economy to continue to grow beyond its 10th year and to continue to create jobs in the process. But that can only happen in a low-inflation environment. In the long term, then, the health of the economy demands that we begin to bring demand back into line with productive capacity. And in the short term, that requires some difficult policy choices. I hope I've made the case today that those choices are the right ones and that they'll be worth the cost.

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