

MANUFACTURERS ALLIANCE/
MAPI BOARD OF DIRECTORS MEETING

Arlington, Virginia
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Is the New Economic Paradigm Old News?

I. Thank you

A. Talk today about wonderfully vibrant economy.

1. Rare combination of strong growth and low inflation and unemployment.

B. There's been considerable talk about this bullish economy being a newer and faster breed, and maybe even a different beast altogether.

1. Some say advances in information technology have made such a difference that we can throw out all the old rules of economics.

2. Others say prosperous times are little more than a run of good luck, due to a happy coincidence of temporary factors.

3. Today, I'd like to discuss our remarkable economic performance and why we've done so well in recent years.

II. Y2K

A. First of all, I'd like to reassure you that there is no truth to the rumor that the Fed is stockpiling slide rules, sundials, and adding machines.

B. We're confident

1. Expecting minimum disruptions.
2. U.S. has worked together to meet important challenges in the past.
3. Public will keep the year 2000 rollover in perspective, realizing it is one more challenge we will all meet.

C. Y2K is one of the Fed's top priorities this year.

D. Our mission: foster a safe and sound financial system and a healthy, growing economy.

E. Three main Fed responsibilities.

1. service provider
2. bank regulator
3. formulate national monetary policy.

F. We are committed to doing all we can to safeguard the operations of the U.S. financial system; and that's the reason Y2K is so important to the Federal Reserve System.

G. Made significant progress.

1. As financial service provider: needs of customers will be met
2. As regulator: reviewing the preparedness of the financial institutions.
3. Ultimately, it's up to the banks themselves to ensure that they are ready.
4. But exams say vast majority making satisfactory progress.

H. There is an old saying that a person surprised is half-beaten. We have certainly taken this to heart and we have no intention of being surprised by anything Y2K has to offer. But sound preparation for Y2K is only half the battle. We must also encourage the public not to over-react.

1. Reminding everyone that no safer place for money than bank, Y2K or not.
2. Reminding everyone credit and debit cards, as well as checks, all will be okay.
3. Additional cash to cover any unusually large demands by the public, just in case.

III. Now getting back to the economy.

A. Life is not business as usual at the Federal Reserve... although, is it ever?

- B. Economic policymaking is always a difficult job, but, as Alan Greenspan said recently at a Chicago Fed conference, “we policymakers have been engaged in a lot of on-the-job training in recent years.”
- C. Even in the quietest times, economics is not a hard science.
 - 1. Economists don’t expect to *perfectly model the real world*. Our expectations are more modest. We build approximations of how markets might behave under specific conditions.
 - 2. In the hard sciences there are many simple, straightforward laws: like $E=MC$ squared, what goes up must come down.
 - 3. The few absolute “laws” in economics are always accompanied by a stream of qualifiers.
 - 4. For example, as we all know, according to the law of supply and demand, prices will rise if demand increases and supply remains constant ... that is, assuming the sellers are rational, the government doesn’t interfere, there is perfect information, there are no monopolies, everybody’s out to make a profit, etc., etc., etc.

IV. Despite all the room for debate, some consensus over past few decades

- A. In monetary policy:
 - 1. Inflation is first and foremost a monetary phenomenon, as Milton Friedman put it.
 - 2. If you look at countries that experienced high inflation, you’ll find a common cause—high growth rates of money.
 - 3. Economists disagreed on this point as recently as twenty years ago.
 - 4. This is important for the Fed and how it achieves its ultimate goal—maximum sustainable growth and a higher standard of living.
- B. Growth is good
 - 1. Growth is why our lives are more comfortable than our grandparents’ and why our grandchildren’s lives will be more comfortable than ours.
 - 2. Could have said children, but Fed takes the long view.
- C. Really do aim for growth over the long term—sustainable growth
 - 1. Short bursts of growth that quickly burn themselves out don’t accomplish our long-term objectives.

V. Fed doesn’t create growth directly

- A. Growth depends on investment in human and physical capital

1. Fed doesn't train workers
2. It doesn't build any factories
- B. Fed creates the environment
 1. An environment of low and stable inflation enables workers and entrepreneurs to create wealth.
 2. Economy depends on the price system to signal where resources should be directed.
 3. Inflation, especially volatile inflation, jams the signals prices need to send.
 4. Those who create wealth count on the Fed to provide a stable financial environment — allows long-term planning
- F. Fed has a tough job
 1. Need to strike a balance: can't unduly hold back a strong economy
 2. And can't unduly push an economy beyond its limits — that can't succeed and attempting to do it any way would lead to inflation and financial instability that would impede long-term growth
 3. Achieving this balance is not an easy job — but it's interesting work

VI. Recently, good performance

- A. Fed has made a lot of progress over the last 20 years
 1. Inflation has come down
 2. Not quite price stability, but much closer than many envisioned 20 years ago
- B. In the process the Fed has achieved quite a bit of credibility; people believe that we are committed to keeping inflation in check and have the ability to do so.
- C. We believe that this progress is a significant contributing factor to the very good economic performance we've seen in recent years
- D. Good times:
 1. Strong real growth
 2. Rapid employment gains
 3. Low unemployment
- E. Moreover, inflation has not accelerated as it often has when we have grown very quickly or allowed labor markets to become tight.

F. Inverse of Murphy's Law: What could go right, did go right?

VII. Things have been going so well lately, some claim we've entered a new economic era.

- A. Clearly, economy hasn't followed usual patterns. If this bullish economy isn't a new breed, then at the very least it's bucking the trend.
- B. The explanations range from the most extreme versions of the so-called "New Economic Paradigm" to those that focus on temporary factors.
- C. One factor to keep in mind—there's a tendency to overestimate how much inflation has dropped.
 - 1. BLS has made some methodological improvements to the CPI that brings this measure of inflation closer to the truth.
 - 2. But BLS doesn't revise old data, so the official figures exaggerate the deceleration in inflation.
 - 3. The current methodology lowers measured CPI inflation in 1999 by 0.6 percentage point relative to 1994.
 - 3. PCE deflator has seen a more significant slowing.
- D. Still, measurement issues only provide a partial explanation for low (measured) inflation.

VIII. Clearly, temporary factors have played a role.

- A. Cheap oil, a decline in import prices, and less dramatic growth in medical benefit costs, all helped.
- B. However, the longer the economy continues on its current trajectory without signs of a pickup in inflation, the more difficult it is to attribute our good fortune to temporary factors alone.
- C. So measurement issues and temporary factors help explain some of our surprisingly low inflation.
- D. But our surprisingly low unemployment rates may be due to important changes in the labor market.

IX. Is labor market functioning better?

- A. Lots of attention given to the low unemployment rate
- B. A snap shot of the economy at any given point in time would always show some level of unemployment — the result of inevitable frictions in the labor market
 - 1. Some workers will always be unemployed and some firms will always have vacancies

- 2. Matching them up is an incredibly complex job
 - C. The Fed can't permanently hold the unemployment rate below its natural level.
 - D. Natural rate can change over time.
 - E. In fact, many analysts at the Fed and elsewhere often look to unemployment as indicator of whether the economy is beyond its productive capacity.
 - F. A few years ago most would have said an unemployment rate of around 4.0% was clear indication that we were beyond potential.
 - G. But several developments may have lowered the natural rate of unemployment.
 - H. One rather mundane reason is the aging of the work force
 - 1. Baby boomer cohort—the largest portion of the population—is at most employable age—forties and fifties.
 - I. A more intriguing development is the growth of labor market intermediaries, especially temporary services firms
 - 1. Make matching firms and workers easier
 - 2. Help avoid bottlenecks
 - J. Internet, etc., also make job searches more efficient.
 - K. Evidence this is leading to a better functioning labor market:
 - 1. Vacancies (help-wanted) not up as much as might be expected.
 - 2. Fewer short-term unemployed workers
 - L. Impossible to say how much lower natural rate might be
 - M. Fed has not over-reacted to low unemployment—But it remains watchful for the kinds of imbalances that would lead to inflationary pressures.
- X. Another explanation for our remarkable economy is the increase in productivity growth during the past two years.**
- A. Some say structural shift could allow us to grow faster without triggering inflation.

- B. Productivity has increased dramatically during the past three years.
- C. Real output per hour in the non-farm business sector grew at around 2 percent per year, compared to around 1 percent average annual increase during the previous two decades.
- D. When I came to the Fed in late 1994:
 - 1. Potential long-term GDP growth thought to be around 2 percent annual rate—1 percent growth in available hours of work and 1 percent growth in productivity.
 - 1. If productivity growth has shifted into a higher gear we may be able to sustain a higher real GDP growth rate.
- E. That's why lasting increases in productivity have a tremendous impact on the standard of living.
 - 1. The average family's standard of living would take 70 years to double at a productivity growth rate of 1%.
 - 2. At a rate of 2% per year, the same family's standard of living would double in only 35 years.
- F. As you can imagine, there's no shortage of theorists trying to unravel the secrets behind the recent change in productivity.

XI. What about in the official data?

- A. If we look at productivity growth over the entire expansion, there is not much support for a longer-term productivity surge.
 - 1. Since the expansion began, it has averaged 1.1%
 - 2. That's about the same as in the previous expansion and indeed other expansions since the early 1970s
 - 3. And not nearly as good as the expansions of the 1950s and 1960s.
 - 4. A big, largely unanswered question has been—what caused the productivity slowdown during the 1980s?
 - 5. The recent burst of faster productivity growth is quite new.
 - 6. Indeed when I came to the Fed, productivity growth had been especially poor then.
- B. The recent numbers are good, but far from unprecedented
 - 1. Cite better episodes
- C. What's probably most encouraging is that the recent speedup in productivity is coming so late in our expansion.

1. Productivity often increases rapidly as the economy comes out of a recession and firms try and get maximum output out of under-utilized resources
2. The challenge is to keep up the pace once factories and workers are essentially fully employed, and increasing productivity would drain less productive reserves.
3. We seem to be doing that.
4. We may also be in the midst of a cyclical rebound in the economy.
5. We had a pause in growth in 1995—perhaps we're in the midst of a cycle within the cycle.

XII. Many economists have credited advances in information technology for the productivity surge.

- A. But if computers are the cause, then why didn't productivity improve years ago?
 1. It's possible that information technology is only now boosting productivity because we're only now becoming skilled at utilizing software efficiently.
 2. Such a theory is in keeping with historical precedent.
 3. Economists such as Paul David have noted electric motors had little immediate impact on productivity when they were first introduced.
 - a. Electric motors didn't revolutionize production until the 1920s.
 - b. It took decades for factories to reorganize and rebuild to take advantage of the new technology.
 - c. Similarly, we may have taken many years to learn how to take advantage of computers.
 - d. And the education system may only now be preparing a work force that truly deserves the moniker, "the computer generation."
 - e. This comparison between delayed productivity surge following introduction of electric motors and a possible computer-related surge now has been repeated a fair bit in press and is fueling excitement over recent productivity data.
- B. If a new wave of technology is driving a better era, why is it only here?
 1. Japan is in a long running slump
 2. Growth in Europe is tepid.
 3. Japan and Germany's stock markets haven't grown as much as ours.
 4. It may be that our economy is much more flexible than theirs.
 5. Innovation doesn't mean much if it's stifled by regulation
 6. But international experience should make us more skeptical.

- C. Managerial improvements, independent of computer technology, have also been proposed as an explanation for the recent surge in productivity.
 - 1. Global competitive pressures provided a wake-up call in the 1980's and we are clearly running our businesses smarter.
 - 2. As all of you know, manufacturing industries have revolutionized how workers do their jobs over the past few years.
 - 3. MM—cite examples

XIII. In conclusion

- A. Too early to determine that productivity will grow at a strong pace for the longer term.
 - 1. However, the longer such growth continues, the more evidence we have. A plausible hypothesis — and it's only a hypotheses at this point — is that productivity may continue to grow at higher rate for some time.
 - 2. Because we're running our businesses smarter due to increased global competition.
 - 3. And because computer and technology investments are finally having an impact.
- B. Fed keeps this in mind as we assess myriad of data but we can't change how we conduct monetary policy based on this hypothesis.
 - 1. The possibility of higher productivity doesn't mean the end of the need for vigilant Fed.
 - 2. In this age of faster modems and constantly increasing computer memory, we shouldn't confuse room for improvement with limitless possibilities.
 - 3. Economic history does have a tendency to repeat itself — what appears new is often just recycled.
 - 4. As I said, we experienced similar strong productivity growth during the 1960s. But I wouldn't want to go back there, even if it was possible to see Ernie Banks at bat again (OR, even if it was possible to catch an inning of Bob Gibson vs. Carl Yazstremsky in the 1967 world series).
 - 5. That's because the “go go 60s” gave way to the “stagflation 70s”.
 - 6. Mistake policymakers made was to overestimate productivity and underestimate inflation.
- C. That new era wasn't the last, and this one won't be either.
- D. Can't throw out the old rules—the parameters may have changed, but the rules still apply.
- E. Fed will need to continue to strike appropriate balance.