

RICHMOND ECONOMIC FORUM

Richmond, Indiana
July 15, 1999



Is the New Economic Paradigm Old News?

I. Introduction

- A. Good afternoon. It’s a pleasure to be here today. I appreciate the opportunity to be here in East Central Indiana and to have the opportunity to hear your views, ideas and questions regarding the regional economy, as well as the national economy. [comments on day in Springfield]
 - 1. At the Chicago Fed, we schedule forums such as this regularly throughout the district, so that we can solicit and respond to feedback from our customers and stakeholders.
 - 2. We’re here in Richmond in particular because we knew the residents of Wayne County could be counted on for insightful perspectives. After all, only folks with good sense would think of naming a town “Economy”.
 - 3. Although the bulk of my speech will pertain to the economy, I’d like to start off today by telling you a little bit about the Federal Reserve, including a few comments about Y2K.
- B. As most of you probably know, the Federal Reserve’s mission is to foster a safe and sound financial system and a healthy, growing economy.
 - 1. To ensure that the central bank is in touch with all corners of the economy, the Fed was created with a system of 12 regional banks back in 1913.

2. The Chicago Fed serves a five-state area consisting of most of Indiana, Illinois, Michigan, Wisconsin, and all of Iowa. In addition to our head office, we have offices in Indianapolis, Detroit, Des Moines, Milwaukee, and Peoria.

II. Y2K

- A. Obviously, given our role as the nation's central bank, we are focussing considerable attention on Y2K.
 1. 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. In fact, we're confident that the century date change will come and go with a minimum of disruption.
 2. As a nation, we have worked together to meet important challenges in the past.
 3. We believe that the public will keep the year 2000 rollover in perspective, realizing it is one more challenge we will meet.
- B. At the Fed we are addressing Y2K at all levels. We have three main areas of responsibility.
 1. First, we are a service provider: we provide financial services such as check processing and electronic payments to depository institutions and the U.S. government.
 2. Second, we are a bank regulator: we supervise and regulate state member banks and bank holding companies.
 3. Finally, but certainly not of least importance, we formulate national monetary policy. 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.
- C. We've already made significant progress in preparing for the rollover; all of our most important systems are prepared for Y2K and are already in production.
 1. As a financial service provider, we're confident there will be no disruption in our ability to meet the needs of our customers — be they banks or the U.S. government.
 2. As a regulator, we're working closely with other regulators to review the preparedness of the financial institutions we supervise.
 3. Ultimately, it's up to the banks themselves to ensure that they are ready, yet the results of our Y2K exams so far indicate that the vast majority of institutions are making satisfactory progress.
- D. There is an old saying that a person surprised is already 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 is only part of the battle. We must also encourage the public not to over-react.
 1. There has been concern that popular misconceptions about Y2K could lead some people to with-

draw unusually large sums of money from their bank accounts. For this reason the Federal Reserve is making available to depository institutions more than enough cash to cover any unusually large demands by the public.

2. However, I would like to remind everyone that there is no safer place for your money than where it is, Y2K or not.
3. Although you may want to have enough cash on hand for the long holiday weekend, remember that credit and debit cards, as well as checks, are expected to work over the New Year's holiday as they would at any other time of the year.
4. In short, we are confident the Federal Reserve and the financial system will be fully prepared for the century rollover.

III. Economy

- A. I'd now like to turn your attention to this vibrant economy we are currently experiencing.
- B. Over the past few years of the current economic expansion we've seen a rare combination of robust growth, and both low inflation and low unemployment. This was certainly true last year and in the first quarter of 1999.
 1. Real GDP grew more than 4 percent last year and we continued that rapid growth during the first quarter. Growth has been driven by unusually strong consumer spending.
 2. Although it still looks as though real GDP growth will moderate over the course of the year, our expectations for growth for the year as a whole are even more positive than earlier this year.
 3. It was only last fall that many were concerned that the prospects for sustained growth were threatened by a significant seizing-up of U.S. financial markets.
 4. The FOMC responded to those developments by decreasing its target for the federal funds rate from 5? percent to 4? percent. Since then, we've seen a significant easing of financial strains in the U.S., and the outlook for foreign economies has improved.
 5. With the U.S. economy growing at a healthy pace, the FOMC decided that at least part of last fall's easings was no longer necessary. Therefore, the committee voted on June 30 to increase its federal funds rate target by a quarter of a percentage point, to 5 percent.
 6. In announcing this action, the Committee noted that it would remain vigilant for any actual or potential signs of inflationary pressures in order to ensure that economic growth continues.
- C. The strength of the U.S. economy over recent years is evident by looking at the Midwest. Of course agriculture is one exception. Other sectors of the Midwest are faring much better, which provides a buffer for agriculture in the 1980s. Most of our manufacturing industries, which in earlier days earned us the "Rustbelt" moniker, are running near capacity.

1. The automobile industry, which, as you know, is heavily concentrated in this region, reported sales results for the past three months that were the strongest since 1986.
 2. Sales of both new and existing homes in the Midwest have exceeded practically everyone's expectations, which in turn has kept items such as appliances, electronics, and lawn furniture, selling rapidly.
 3. At the same time, strong employment growth earlier in the 1990s pushed unemployment rates in the region much lower than the nation as a whole, where they remain today. The seasonally adjusted unemployment rate for Indiana, for example, is at 3.0% in May, more than a percentage point below the current national average of 4.3%.
- D. Why is the economy doing so well? One key reason is the low inflation environment. Low inflation is essential, because growth can only be created by investment in human and physical capital, and because the Fed can't make that investment directly, it falls on the Fed to facilitate that investment ... by creating an economic environment of low and stable inflation.
1. The Fed can't create long-term growth directly. The Fed can't train the workforce, and it doesn't build factories.
 2. In fact, Fed economists did try to build a widget factory once, but the employees didn't like it because they only had jobs in theory.
- E. As the 1970s showed, high inflation, especially when it's volatile, disrupts economic efficiency. Inflation distorts prices, jamming the signals which consumers and investors depend on to make appropriate economic decisions.
- F. Since those dark days of stagflation 20 years ago when inflation was 13 percent, the Fed has made significant strides toward price stability.
1. The challenge is to avoid holding back the economy, but not to push aggregate demand beyond its limits either.
 2. As we now know, over-stimulating the economy using monetary policy would simply impede growth in the long term by inducing inflation.
 3. Understanding this is important to how the Fed achieves its ultimate goal—maximum sustainable growth and a higher standard of living, over the long term. The key word here is “sustainable.” Short bursts of growth that quickly burn themselves out don't accomplish our long-term objective.
- G. The lower inflation we've achieved has provided the foundation for the strong real growth and low unemployment that are a hallmark of the current expansion.
1. Things have been going so well lately that some pundits have claimed we've entered a new economic era.
 2. It is rare to see such low inflation during a period of such strong economic growth.

- H. Next February, this expansion will become the longest in U.S. history. And this is an extraordinary expansion in many ways. So it's understandable that there is a lot of talk about this economy being a newer and faster breed, and maybe even a different beast altogether.
 - 1. Some say that American workers are just much more productive than they used to be, possibly due to advances in information technology, and therefore, we can throw out all the old rules of economics.
 - 2. Others argue that these prosperous times are little more than a run of good luck, due to a happy coincidence of temporary factors.
- I. Let us first look at the role of temporary factors.
 - 1. Cheap oil, declining import prices, and less dramatic growth in medical costs have all helped hold down the inflation rate.
 - 2. However, the longer the economy continues on its current trajectory, the more difficult it is to attribute our good fortune to temporary factors alone.
- J. Some temporary factors are still working in our favor, but others have started to swing the other way.
 - 1. For example, medical costs have risen as have oil prices. So far, these changes have not triggered a major increase in general inflation, but the full effects of such developments often aren't felt for many months.
 - 2. In addition to such temporary factors, more permanent changes may be occurring in the economy.
 - 3. For instance, much research at the Fed and elsewhere has been directed toward understanding whether structural changes in the labor market may have lowered the unemployment rate consistent with stable inflation.
- K. A snapshot of the economy would always show some level of unemployment — the result of inevitable frictions in the labor market.
 - 1. In a dynamic economy, some firms will always have vacancies, and some workers will always be changing jobs or moving in and out of the labor force. In other words, a certain percentage of the work force will always be unemployed. This is part of the ongoing process of matching people with jobs.
 - 2. The existence of this pool of job seekers is one reason there is a threshold of how low unemployment can go without inducing inflation.
 - 3. Just a few years ago, an unemployment rate below 6 percent would have been seen by many as an indicator that the economy was operating beyond its potential and that a pickup in inflation was just around the corner. But we have been below 6 percent since 1994, which has caused economists to reexamine the labor market to see if the threshold may have changed.

- L. It's important to recognize that the labor market is more flexible and efficient than in the past.
 - 1. The growth of labor market intermediaries, especially temporary services firms, has made it possible to match firms and workers more easily and more quickly. And the Internet has probably made job searching more efficient.
 - 2. In fact, studies have shown that much of the decrease in unemployment is among the short-term unemployed; in other words, the low unemployment rate may be due in large part to the fact that more people avoid long periods of unemployment when changing jobs.

- M. The more flexible labor market is a reflection of the creative problem solving that is intrinsic to the American economy. But some of the credit for the low unemployment rate may go simply to a shift in demographics.
 - 1. The baby boomer cohort — the largest portion of the population — is now in its forties and fifties.
 - 2. When unemployment was at the much higher levels we saw in the late 1970s and early 1980s, the baby boomers were in their teens and early twenties, an age at which they were much more likely to be unemployed. Now that they are older they are much less likely to experience unemployment.
 - 3. Since the baby boomer cohort is such a large portion of the population, they have an important impact on employment in the economy as a whole.

- N. As I mentioned earlier, another explanation for our remarkable economy that has been discussed a great deal in the media is the increase in productivity growth over the past three years.
 - 1. Some have suggested that increased productivity growth is allowing the economy to grow at a faster pace without triggering inflation.
 - 2. In fact, productivity has increased dramatically during the past three years. Output per hour worked in the nonfarm business sector has been rising at around 2 percent per year, compared to an average annual increase of around 1 percent during the previous two decades.

- O. When I came to the Fed in late 1994, potential long-term GDP growth was thought to be around 2 percent annually — 1 percent due to growth in productivity and 1 percent due to growth in the labor force.
 - 1. Certainly, if productivity growth has shifted into a higher gear of 2 percent, that 1994 assessment might now be a point too low.
 - 2. The human impact of such a change would be enormous: a productivity growth rate of 2 percent would allow the average family's standard of living to double in half the time that it would take at a productivity growth rate of 1 percent. That's 35 years instead of 70.
 - 3. With the stakes this high, no wonder there's no shortage of theorists trying to understand whether the U.S. is experiencing a long-term productivity surge.

- P. Unfortunately, if we look at the data for productivity growth over the entire expansion, the evidence for a longer-term productivity surge isn't particularly strong.
1. Since the expansion began in 1991, productivity growth has averaged only 1.1 percent per year. That's about the same as in the other expansions of the 70s and 80s, and not nearly as high as the expansions in the 50s and 60s.
 2. So although the burst of productivity over the past three years is large, it is far from being unprecedented.
- Q. What is encouraging, however, is that the recent speed-up in productivity comes so late in an expansion.
1. Productivity commonly increases rapidly as the economy comes out of a recession and firms try to employ idle resources.
 2. The challenge is to keep up the pace further into the expansion once factories and workers are essentially fully employed.
 3. At that point, increasing output would utilize less productive resources. We've met that challenge so far.
- R. If we are experiencing a long-running productivity surge, there are several possible explanations.
1. Many economists have credited advances in information technology. Of course if that's the case, you may then wonder why productivity didn't improve years ago when computers first came on the scene.
 2. There is a very popular theory being bantered about in the media that information technology is only now boosting productivity because we're only now becoming skilled at utilizing software efficiently. Such a theory is in keeping with historical precedent regarding the relationship between productivity and other technological advances such as electric motors.
 3. And I must say, with the numerous versions my office software has gone through over the years, I for one wouldn't be surprised if there were a more efficient way to go about all this.
- S. But if a new wave of technology is pushing the economy into more prosperous waters, why is it only happening in the U.S.?
1. Japan is in a long-running slump and European growth has been tepid in recent years. Is our economy that much more flexible than theirs? Perhaps.
 2. But international experience should make us a little more skeptical of attributing the recent large acceleration in productivity growth solely to advances in technology.
- T. I'm personally intrigued by the idea that managerial improvements, independent of computer technology, could also be part of the explanation for the recent pickup in productivity.

1. Global competitive pressures provided a wake-up call in the 1980s and we are clearly running our businesses smarter. Manufacturing firms have revolutionized how workers do their jobs since the mid-1980s.
2. By talking to business leaders at forums such as this one, and visiting factories here in the Midwest, I've seen many examples of this phenomenon.

III. Conclusion

- A. In conclusion, it's still too early to determine how long productivity will continue to increase at a higher rate. However, the longer such growth continues, the more evidence we have.
- B. Everyone at the Fed is of course keeping this possibility in mind as we assess the myriad of economic data.
 1. But, at the same time, we can't change how we conduct monetary policy based on an unproven hypothesis. In other words, the possibility of higher productivity growth doesn't mean the end of the need for a vigilant Fed.
 2. In this age of faster modems and constantly increasing computer memory, we shouldn't confuse significant progress with limitless possibilities.
- C. Economic history does have a tendency to repeat itself — what appears new is often just recycled.
 1. As I mentioned, we experienced similar strong productivity growth during the 1960s. But we now know that the “go go 60s” quickly gave way to the “stagflation 70s.”
 2. The mistake policymakers made then was to overestimate the trend in productivity growth and underestimate inflation. That new era wasn't the last, and this one won't be either.
 3. Much as we may like to, we can't throw out the old rules—the parameters may have changed, but the rules still apply.
- D. If you asked me to describe the current economic expansion as if it were a car, I would have to say that it's a nice conservative family sedan, definitely domestic.
 1. It served us well for years, with plenty of room for everyone. Then, just when we thought it had seen its best days, a neighborhood teenage car enthusiast got a hold of it. Now it's still a nice conservative family sedan, but with great acceleration.
 2. I'm delighted that the old car is running so well, but I'd love to know what that teenager did to the engine and how long I can expect the car to keep running.