

Speeches by Bob McTeer

Economic Policy in the United States

Remarks before the Institute of Economic Affairs conference—"The World Economy: 'New Paradigm' or Old Enemies Lurking?"

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It's an honor to be invited back by the IEA—to its conference on "The World Economy: 'New Paradigm' or Old Enemies Lurking?" The topic is right on target for the U.S. economy and economic policy, especially monetary policy. I may not be the most articulate "new paradigm optimist" in the United States, but I am persistent. An op-ed piece I recently submitted to the *Wall Street Journal* on that topic has the working title "Out on a New Paradigm Limb."

Both last year and this year I came directly here from an FOMC meeting in Washington. At that meeting last year, the FOMC had just made its third quarter-point easing move to insulate the U.S. economy from Asian contagion—or, more precisely, from the aftermath of the Russian default. In some respects, the U.S. economy had benefited from flight of capital seeking safe haven during the Asian crisis. Only after the Russian default were U.S. capital markets adversely affected. Liquidity and risk premiums rose significantly, and signs of market disruption were increasing. Prior to the Asian crisis, some FOMC members had dissented from the majority favoring tightening policy.

After the Asian crisis abated earlier this year, the FOMC raised the target federal funds rate on June 30 and August 24, thus reversing two of the three easing moves. No change was made at our October 5 meeting, but the committee announced a "bias" toward further tightening in the future. At our meeting this Tuesday, the committee followed through and reversed the third, with the fed funds target back up to 5.5 percent. The Board of Governors raised the discount rate to 5 percent.

The announcement of our bias—or leanings—is a new practice for the FOMC. In May and again in October, no policy change was made but a bias toward tightening was announced. In both cases, the markets remained nervous waiting for the next shoe to drop. It hasn't worked out very well in that regard. In October, the committee announced that the practice would be reviewed again for possible change.

As you know, I dissented from our tightening moves in June and August. It's not that I thought they were a huge mistake. It's more that I thought they were unnecessary to achieve our inflation objective and that they risked bringing a premature end to what I regarded as an "experiment" testing the limits of the new economy—or, if you prefer, the new limits of the old economy. I'll elaborate on that in a moment.

Following the IEA conference last November, I visited officials at the Bank of England, the Bundesbank, the European Central Bank and the Hong Kong monetary authority. I have found that plane fare is cheaper if you keep going in the same direction. Everyone was polite, but I got the sense that most of the central bankers I talked to thought the Fed was taking the contagion risk of the Asian crisis a bit too seriously. They were skeptical about our three easing moves, especially the third one. And, for good measure, they thought the U.S. stock market was in a bubble.

As it turned out, the Bank of England and the ECB later made easing moves of their own, although in the latter case, from a lower level of nominal interest rates. More recently, of course, everyone's been moving back up.

Let me pause here for a moment and give you some perspective on the U.S. economy. Our last national recession began in August 1990, with Iraq's invasion of Kuwait. It bottomed out in March 1991 and recovery began that April—8.5 years ago. Early this year, the current expansion—in its ninth year—became our longest peacetime expansion when it exceeded the expansion of the 1980s. Early next year—in February, I believe—it will become our longest expansion, period, when it exceeds the expansion of the 1960s. I see nothing to prevent us from reaching that milestone, although nobody expected the Gulf War recession either.

After a sluggish start in terms of job growth, the current expansion picked up steam in mid-1992. Job growth rose, the unemployment rate declined nicely, and inflation fell to around 3 percent. But starting in the second half of 1995, the economy seemed to move into a higher gear. Growth accelerated to average over 4 percent per year, unemployment declined further to just over 4 percent, and inflation decelerated further—to below 2 percent. By the standards of the past two decades, these numbers were very good. Much was made of the simultaneous decline of inflation and

unemployment and whether the old "rules," like the Phillips curve and the NAIRU, were no longer valid.

The higher real growth rate in the late 1990s has been about evenly divided between higher productivity growth—that is, growth in output per hour worked—and higher employment growth—growth in the number of hours worked. (Actually, the split was about 60 percent productivity and 40 percent employment.) Let me elaborate on productivity first. It is productivity growth that produces a higher standard of living and higher per capita incomes.

Beginning around 1973, growth in U.S. productivity slowed dramatically—by more than half—to just over 1 percent per year, where it stayed until the mid-1990s. Labor force growth was about the same 1 percent plus, so the range for potential noninflationary output growth was considered to be 2 to 2.5 percent. Many economists and policymakers came to regard that supply-side potential as a given, and the policy emphasis shifted to the demand side. Critics of policy saw it as a speed limit enforced by holding growth in aggregate demand down to that level to avoid inflation.

Parenthetically, one might say that Keynes' law—demand creates its own supply—was the dominant way of looking at the economy, rather than Say's law—supply creates its own demand. While both laws are doubtlessly true, they lead to different policy biases. For example, if you regard rapid growth as being demand-driven, you worry about excess demand and its inflationary implications. If you regard the same rapid growth as supply-driven, it's consistent with falling inflation.

Beginning around 1996, however, the 1 percent productivity growth plus 1 percent labor supply growth yielding just over 2 percent output growth changed from $1+1=2$ to $2+2=4$. Both productivity growth and labor growth roughly doubled. The question became, was it temporary or permanent? Was it just good luck, positive supply shocks, or was it something changing more fundamentally?

New paradigm, or new economy, skeptics emphasize the good luck explanation. Certainly, we had some good luck. Falling energy prices, a strong dollar, and the Asian crisis all helped hold inflation down, at least temporarily. But new paradigm optimists point to what they regard as a once-in-a-century revolution in technology as the primary force raising productivity growth and to globalization as helping to contain inflation despite strong growth. I say "despite" strong growth, but as I indicated earlier, if you believe the impetus for growth is coming from supply-side forces like deregulation, lower taxes, freer trade, and cost-cutting opportunities, the growth itself might be considered disinflationary. Some of the new technologies, most notably the Internet, certainly promote disinflationary growth. These factors could be considered good luck, but they are not temporary.

The role of accelerating labor force growth may not prove to be as lasting as productivity growth through new technology. The increase from roughly 1 percent to 2 percent growth in hours worked was made possible largely by drawing down the pool of unemployed and underemployed workers and potential workers not in the labor force, including those freed up by welfare reform. So $2+2=4$ could become $2+1=3$ if labor supply growth reverts to normal. Actually, recent changes in methodology have produced benchmark revisions in our national accounts that raised U.S. productivity growth closer to 2.5 percent and above, depending on the measure. Productivity may be able to sustain close to a 4 percent growth rate even if employment growth slows somewhat. I would prefer a liberalization of our immigration laws to keep the labor force growing faster, however.

I should note that for purposes of monetary policy, there is a subtle but important distinction between higher productivity growth and a higher increase in productivity growth—the second derivative. If productivity growth flattens, even at a high level, a further easing of policy is not warranted, as it may be during a period of acceleration. Some of Chairman Greenspan's remarks on this topic have been misinterpreted. He has said that productivity growth cannot accelerate forever and has been misunderstood to be saying that productivity growth will decline.

Productivity, of course, is a difficult concept to measure in a service economy. For some time, it was a mysterious X factor, not showing up in the statistics but making its presence felt. Then it started to show up in the statistics. Then on October 28, benchmark revisions in our GDP numbers, reflecting better methodology, produced significant improvements in both output and productivity numbers for the past decade. As I indicated earlier, productivity growth increased from 1 percent for about two decades to about 2.5 percent in the past few years.

"Things are different this time" are famous last words, and cautious central bankers are naturally reluctant to use them. Basing monetary policy on an acceleration in productivity that you aren't quite sure of is risky business. In particular, it conflicts with preemptive tightening so as not to get behind the curve in the fight against inflation. One can reasonably interpret the Fed's tolerance of higher real growth rates and lower unemployment than the models

said were compatible with price stability as a courageous experiment that paid off in more growth and lower unemployment without an inflation penalty. I thought the experiment could go on a while longer without significant risk, but my colleagues didn't wish to push their luck. The high inflation numbers in September did not help my cause. Prior to September, most of the uptick in the numbers reflected higher energy prices, but even the core was high in September.

I'm sure you've noticed by now a curious absence of references to the money supply in my story—made more curious by the fact that U.S. money growth rates have exceeded those that led the ECB to tighten policy in the face of a less vigorous economy. I still believe that money matters, and probably matters more than anything else in determining the rate of inflation. The problem is that, due to financial innovations and changes in U.S. financial markets and institutions, it is difficult to tell how much money growth is too much. We know it's high relative to historical experience, but we don't know if it's high relative to the growth in the demand for money in a growing economy.

Market-based indicators of the stance of monetary policy—such as sensitive commodity prices, the strength of the currency, the slope of the yield curve—have been generally reassuring on that score. Presumably, the money supply as the primary indicator of policy has held up better in Europe, or at least European policymakers believe it has.

I also haven't mentioned U.S. fiscal policy, although the shift from a large and prolonged deficit to a surplus has doubtlessly contributed to our Goldilocks economy. The big debate now—as you probably know—is whether to cut taxes to return the money to taxpayers or to increase government spending. Chairman Greenspan's preference—and mine—is to do neither any time soon. Let the debt run down for a while, then cut taxes. More spending is the last choice.

While it's nice to have a surplus for a change, we wouldn't have one if we weren't including the current Social Security surplus as part of it, even though we know Social Security will turn into a deficit when our baby boomers start collecting. Also, the budget is balanced at fairly high levels of federal taxing and spending. I'm sure there are many in this room who believe the size of government is more important than how it's financed. That includes me, although I must admit the recent tax rate increases didn't do the damage I anticipated.

Perhaps I should mention the dollar as well. Until recently, the strong dollar was credited with helping hold down U.S. inflation in the face of rapid growth. It's hard to know what "strong" means, but if the dollar has been strong, it still is. Most of the hand-wringing over a weakening dollar has focused on the dollar-yen rate. Relative to the yen, all currencies have been weak lately. In my opinion, it's a yen thing rather than a dollar thing. The mystery to me is why the yen is so strong. I assume it is the belief that Japan may finally have turned the corner.

Related to the dollar is the U.S. balance of payments. Thanks to the grace of God and double-entry bookkeeping, our balance of payments is in balance. It does seem like an odd balance for a large, mature economy, with a large and growing trade deficit financed by a large and growing capital inflow. I don't believe the negative version, which focuses on our trade deficit and declares us uncompetitive. I favor the more positive view that has the capital inflow as the independent variable, based on good investment opportunities, with the trade deficit financing the capital inflow. A third way of looking at it is that we are overconsuming and relying on foreign saving to finance our domestic investment. Our apparent role as consumer of last resort for the world certainly expanded during the Asian crisis. Consuming is a dirty business, but somebody has to do it.

I don't have anything intelligent to say about the new euro, but since it was just about to be born this time last year, I feel like I should mention it. One thing that comes to mind is how much has changed since then. Notable last year was the irony of the single currency being conceived by Christian Democrats and being delivered by Social Democrats. This time last year Mr. LaFontaine, the German finance minister, was trying to change the rules of the game. His early exit may speak to the power of the bond vigilantes (or currency vigilantes) and to the "Twilight of Sovereignty" (see Walter Wriston's book of that title) brought about by new technology and globalization.