Speeches by Bob McTeer

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The last time I spoke to a national NABE meeting was in 1991. I thought you weren't going to invite me back.

I was active in NABE's Baltimore chapter in the 1980s—the Baltimore Economic Society. I even ran for a position on your board of directors in 1990. I remember the date because I was also interviewing for my present job at the same time.

I got the job, but lost the election. I don't want to speculate on what that says about the relative standards of the Dallas Fed and NABE members.

My platform was economic education. (We had to send in a couple of paragraphs.) I thought that NABE members—indeed, all economists—should do more to educate the electorate in the economic way of thinking. To make the world safe for sound policy. And unsafe for demagoguery.

The problem with economic education is that economists don't talk much in public about what they agree on, which is most of the important stuff.

Instead, we emphasize our disagreements at the margin. We sweat the small stuff and air our differences publicly.

Understandably, the public—and Congress—conclude that since the professionals can't agree, their own instincts are as good as any. So they generalize from personal experience, which often leads them to the fallacy of composition. What's true for the individual or the single business is rarely true for the whole economy. More money makes them richer, therefore more money increases the wealth of nations. Lower interest rates are always better for individual borrowers, therefore . . . .

Good economics is often counterintuitive, which is another way of saying, "If economics made sense, you wouldn't need economists."

I don't mean you should lecture your local audiences about demand elasticities or the H-O theorem. But you could do the country and the world a lot of good by explaining how a market economy works. How it can thrive with no one in charge and no one planning it.

Tell them about the invisible hand and the spontaneous order. About comparative advantage and creative destruction. Explain why protecting jobs might be less desirable than letting the churn work. Why freezing the price of medicine might not be good for our health.

With Seattle in mind, you might discuss why large corporations aren't necessarily the enemies of their customers and employees.
And ask: We're supposed to improve the environment and living standards of poor countries by refusing to trade with them?

Make it interesting. Don't be boring.

Tell them about Frédéric Bastiat and his plea to shut out the sun to protect the candlemakers from unfair competition. And about his negative railroad with all the stops to create jobs.

We do that all the time.

Relate Henry Hazlitt's broken window fallacy, and explain the distinction between the seen and the unseen, the whole truth and half truths, intended and unintended consequences.

For economic education purposes, you might even define economics as the study of unintended consequences.

These are the kinds of topics I hope you will address in your local communities every chance you get.

The chances of most of us making major theoretical contributions on the frontiers of economics are slim—and, in my case, none. But we can all make a difference by bringing popular understanding closer to that frontier, to make economic snake oil harder to sell.

We try to do some of that at the Dallas Fed, but it's a big country and we need help. (No, strike that. It's a big world.)

Unfortunately for the image of economists in the public mind, and perhaps in Congress, economists are regarded primarily as economic forecasters. That can be hard on reputations.

Fortunately, in my job, I'm discouraged from making public forecasts—especially about the future.

When Buddy Holly was 4 years old, he tried to play his toy fiddle in the family band. To mute the awful sound he made, his uncles waxed his bow. When it comes to forecasting and FOMC deliberations, my bow has been waxed. (Uncle Alan did it.)

You'll have to take my word for it, but I've had pretty good luck forecasting in recent years—not because of any skill, but because of my optimism. I've been called a "new-paradigm optimist," not always by those who meant it as a compliment. I've been called worse. I plead guilty.

In 1998, for example, I gave two college commencement addresses titled, "Graduating into the New-Paradigm Economy." Even as late as then, talk of "new paradigms" or "new economies" was considered naive and caused eyes to roll.

More sophisticated economists—usually those from elite universities that don't have good football teams—were still talking about good luck, or "positive supply shocks" soon to be reversed. They put quotation marks around the "so-called" New Economy.

Or they asked, dismissively, whether there was anything new in the New Economy. And suggested with great gravity that the law of supply and demand has not been repealed. To say "something is different this time" was considered naive. But to say "nothing has changed" was the voice of wisdom. Go figure.

But, as we all know, this economy has not been kind to pessimists. Even the optimists haven't been optimistic enough.

Late last December, *Business Week* ran its list of 50 forecasters with their real GDP forecasts for 2000 arrayed from top to bottom—from most optimistic to most pessimistic. At the top of the list, with the most optimistic forecast, was my friend and former colleague Wayne Angell. That didn't surprise me none, as we say in Texas.

What did surprise me was that Wayne won the top spot by forecasting a measly 4 percent growth for 2000. The 49 others were all lower. (The lower 49.)

Fear of the Fed, I guess. Or, fear of the Fed's fear of flying.

Growth had averaged more than 4 percent for the past four years, and 4 percent was the most optimistic forecast for 2000. As I recall, the first quarter came in at a 4.8 percent rate and the second at 5.3. I'm betting on Wayne.

Four percent growth is still regarded as unsustainable, even though we've been sustaining it for almost five years now. That's why my favorite economists are Richard Pryor and Yogi Berra. Yogi said you can observe a lot just by watching. Richard said, "Who are you going to believe? Me or your own lying eyes?"

(I wonder how Mae West would have put it.)

I know you must be wondering about my own forecasting methodology. Until recently, I'd take the results of the models (and the consensus view, which is about the same thing) and subtract at least a half point from the inflation projection and add it to the growth projection. Then I'd fine-tune it based on parking conditions at D/FW Airport, the taxi line at Reagan National, and the bulge in Alan Greenspan's briefcase. (What does he have in that thing, anyway?)

I know what many of you are thinking—especially those who are taking me too seriously. You're thinking, "You can't subtract from inflation while adding to growth." Growth and inflation go together. At least they don't go in opposite directions. Well, I'm not so sure. Remember, we're talking new paradigm here. (Since I'm from Dallas, I brought a chart.)

You are familiar with the equation of exchange: $MV = PQ$. Think of MV as the demand side and PQ as the supply side. Solving for P, we have $P = MV/Q$.

The big revelation here—and you may want to take notes on this—is that Q is the denominator, not the numerator. Other things equal, growth in Q will depress P, not inflate it.

I know what you're thinking. You're thinking: But Q will only be rising if MV, or aggregate demand, is rising. Granted. But the question is: Is Q (the supply side) passive, being dragged along against its will by surging demand, possibly stimulated by excessive money creation? Or is Q already at its "speed limit"? Or might Q (the supply side) have some life of its own?

I submit that the answer we learned to that question in the '70s was not the right answer for the second half of the '90s. And probably still isn't. (By the way, new-paradigm skeptics never talk about the second half of the '90s. The numbers look too good. They prefer to treat the whole decade as the relevant time frame. Watch for that.)

Anyway, a lot happened in the '90s. A lot that affected the supply side of the economy.

Even before the '90s—in the late '70s and '80s—much happened to revive the supply side and set the stage for further progress: marginal tax rate reductions, deregulation, PATCO.

As the '90s began,

> We won the Cold War. (As Ed Yardeni says, War is inflationary. Peace is not.)
> Communism and hard-core socialism collapsed—both as working models and as ideologies.
> The workers and consumers of the former Soviet Union and Soviet bloc countries moved from behind the Iron Curtain into the competitive world marketplace.
> The curtain of trade protection was also lifted in Mexico, Latin America and elsewhere.
> Privatization and deregulation began in the new market economies and accelerated in others.
> Euroland was created.
> Inflation was reduced, in the United States and elsewhere.
> Fiscal deficits turned into surplus.

Surely there's some supply-side impetus in here somewhere.

What else happened in the '90s?

> Technology happened. Information technology.
> High tech, both electronic and bio.
> The Internet, for most of us.
> The World Wide Web, search engines.
> Falling chip prices, rising processing and storage power.
> Moore's law. Wireless. Venture capital.
> CNBC—the nerd's ESPN.
> Viagra.

The return on invested capital increased. Profits increased.
Investment boomed, especially investment in equipment.
The boom drove the chronic budget deficit into surplus.

Both the production of high-tech equipment and its use throughout the economy are inherently disinflationary. Combined with the more competitive global economy, pricing power was reduced.

Two decades of improving monetary policy brought inflation and inflation expectations to low levels, so that they weren't a major factor in business decisions. (Close to the Chairman's definition of price stability.) The argument that stable prices are the best environment for rapid growth was borne out.

In the inflationary '70s, squeezed profits led to price increases. Competitors would go along. In the disinflationary '90s, with global competition—with cheap labor seeking capital and with cheap capital seeking labor—price increases were not so easy. Somebody, somewhere in the world would eat your lunch.

Rapid employment growth made labor markets tight, and tight labor markets created the incentive to invest in labor-saving, productivity-enhancing technology.

In other words, tight labor markets lead to rising productivity. I believe Alice Rivlin—your honoree today—was the first person I heard point that out.

Surely these factors also put a little kick in *Q*.

Like my new-paradigm frog, who sat in the pan and didn't jump while his water reached the boiling point because he didn't realize his paradigm was shifting, many policymakers—and even some normal people—apparently didn't notice the paradigm shift either.

Or many had learned earlier lessons too well.

One lesson from the early '70s to the early '90s was that productivity grows only a bit over 1 percent. The labor supply, or hours worked, also increased only a bit over 1 percent. Add them together, and real output could grow only two bits over 2 percent without an acceleration of inflation. Thus, the unposted speed limit became 2 to 2.5 percent.

Several years ago in speeches I said that 2.5 percent growth was not enough. Three percent is not enough either. One night in a speech about three years ago, I got carried away and said even trees grow faster than 3 percent. The next morning Kathleen Hays quoted that on CNBC. Naturally, I was watching.

Truthfully, I don't know how fast trees grow, but there must be some constant in nature to use as a benchmark. I think pi might be a good candidate. That's a little over 3 percent.

Kathleen should check that out with her pi guy on CNBC.

Anyway, during the '70s and '80s the supply side of the economy came to be taken as a given—increasing 2 to 2.5 percent per year under full employment—while policy attention was focused almost exclusively on demand. The key was to hold demand growth down to the supply growth potential to keep inflation in check.

But during the 1990s, 1 plus 1 equals 2 became 2 plus 2 equals 4. That is, 2 percent productivity growth plus 2 percent growth in hours worked equals 4 percent output growth.

The doubling of productivity growth might or might not be sustained, according to conventional wisdom at the time. Probably not, since it resulted from temporary supply shocks and most of it was probably cyclical anyway—never mind that no cycle was visible and that the acceleration came several years into the longest expansion on record.

Sustaining the higher employment growth was considered even more problematical. Since rapid employment growth was drawing down the available supply of unemployed workers, it was just a matter of time and unpleasant arithmetic.

But, never mind, productivity growth continued to accelerate to 3 percent and more. 3 plus 1 also equals four.

Not long ago, when the idea of a doubling of productivity growth to more than 2 percent was still new and still in doubt, I went out on a limb by saying that I thought 3 percent productivity growth was possible. The numbers later showed that it already had reached 3 percent.

The new-paradigm optimist wasn't optimistic enough.

Of course, as we all know, nonfarm productivity growth in the second quarter of this year came in at a 5.7 percent rate. Over the past four quarters, it has averaged 5.2 percent. That's not one quarter's number annualized. That's the increase over the past year. Let's see now: 5 plus 1 . . . .

By the way, we need to work on that second number, the labor supply growth. Congress recently did an important, good thing when it removed the prohibitive extra tax on Social Security recipients over 65 who want to work. My guess is that will help more over time than people now expect.

The logical, next, overdue step is immigration reform—especially for skilled foreign workers needed in our high-tech industries. The first step should be to remove the cap on H1-B visas. Yes, send us "your tired, your poor, your huddled masses." They've served us well over the years. They are us. We are them.

But send us your techies as well. Many of those techies are already studying electrical engineering and computer science in U.S. universities—mostly those without good football teams (which is probably a good thing). Let them stay if they want to. Remember, the world's brain drain is our brain gain.

Why are we resisting it? This calls for satire. Where is Bastiat when you need him?

Last year I wrote an op-ed piece on this and got a letter from a graduate student at the University of Texas. She had married a German graduate student there, and both were about to finish their graduate programs. He wanted to stay and work in the United States; she wanted to stay, too. She said staying was okay with the German government. But we were sending him back, and she was going with him.

Again, where is Bastiat when you need him?

The big story in the economy right now is the unprecedented growth in productivity. As I indicated earlier, nonfarm labor productivity increased 5.2 percent over the past year, while real GDP was increasing 6 percent and unit labor costs were falling 0.4 percent. That 6 percent GDP number, by the way, is the combination of a 7 percent annual rate in the second half of last year and 5 percent in the first half of this year.

The change in the composition of GDP from the first to the second quarter this year suggests some further slowing, with consumption growth off and inventories building. Slowing employment growth also suggests some slowing as well, although it's hard to tell how much is demand-related and how much is due to supply constraints.

As Chairman Greenspan has pointed out, it's accelerating productivity rather than merely a high level of productivity growth that makes for policy nirvana (my word, not his). Accelerating productivity allows wages to rise without comparable increases in unit labor costs and keeps cost-push inflation—if you believe in such a thing—at bay.

I'm confident that productivity growth will remain high for the foreseeable future, especially if labor markets remain relatively tight. Productivity growth has even continued to accelerate—as the Chairman apparently pointed out recently in Jackson Hole— but acceleration can't be counted on forever.

Anyway, with the limits to productivity acceleration uncertain, I think the most important thing to avoid in conducting monetary policy is to avoid basing policy on real growth. We simply don't know what the speed limit is going to be.

More specifically, you shouldn't tighten monetary policy because growth is too fast or because the unemployment rate is too low. You don't fight prosperity with monetary policy.

As I've said many times before, the best place to look for inflation is in the inflation statistics. Or, to be preemptive, you look for inflation in leading market indicators and in leading financial indicators of inflation.