

Speeches by Bob McTeer

Remarks before The Friday Group
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Thanks. You've been overly generous. You've raised the bar way too high. I thought all Texans were entitled to the benefit of the presumption of low expectations—even Texans by choice.

Long ago, I read that three things are hard to do are: kiss a pretty girl leaning away from you, climb a fence leaning toward you and respond appropriately to a flattering introduction. I think I've mastered the kiss thing—after a lot of practice. I've been working on the fence thing since I became a Fed policymaker. But I still don't have the intro thing down.

I really prefer: "I don't know this guy. Never heard him before. If he's any good, let's get on with it. If not, let's get it over with."

Recently, I've talked to bankers about banking, economists about economics and businesspeople about the economy. What do you talk to a "Friday Group" about? Fridays? TGIF? That's already been taken. Casual Friday? That makes Friday my favorite day of the workweek. But the Friday Group messed this one up.

I resisted Casual Friday at the Dallas Fed until it dawned on me that Casual Friday is a New Economy phenomenon—part of the new paradigm. Then I went whole hog. Every day is Casual Friday now.

We've all seen press reports lately that some businesses are turning the clock back and dressing up again, going back to the uniform of the Second Wave—the industrial era.

Pretty soon someone will opine on an editorial page somewhere—probably somewhere in the Northeast—that the reappearance of coats and ties is a sign the Third Wave Information Economy either was a mirage and never existed or that it is fading away.

That would be the third reason for doubting the New Economy. The first two I've seen are: 1) the bursting of the high-tech stock bubble and 2) the economic slowdown.

That's the first topic I'd like to address today: Is the New Economy dead?

I summarized my reasons for not thinking so in our recently released annual report.

Forgive me for quoting myself:

The slowdown has prompted some to question the New Economy's viability, but I remain a new-paradigm optimist. The New Economy has never been about infinite price-earnings ratios or an end to business cycles. It was and is about invention, innovation, risk-taking, animal spirits, and new ways of thinking and working. It's about new technology increasing productivity and growth potential, about technology, productivity and global competition tempering inflation. In policy terms, it's about a higher noninflationary speed limit and considering the supply side of the economy as well as the demand side.

I then point out that even with the slowdown that began in mid-2000, productivity growth last year was over 4 percent, the highest rate in many years.

(By the way, the main essay in our 2000 annual report is about improving working conditions. If you are interested in a reprint, give me or one of my colleagues your card.)

One reason I'm still a new-paradigm optimist is that we are well into an "information economy" or a "knowledge economy," and no information or knowledge has been lost. All the new recipes for the new technologies and the innovations have been saved. There will continue to be some churning among the cooks, but the cookbook has been

saved—including the new "Book of Life" resulting from the Human Genome Project.

We shouldn't forget that when we talk about the wonders of high tech, we should include high biotech, as well as high electronic (IT) tech.

Eubie Blake is alleged to have said that if he'd known he was going to live as long as he did, he would have taken better care of himself. If we can just hang on a few more years, we may be the first generation to live forever.

Just how far life-saving recipes have come in recent years was illustrated recently by a *New York Times* story comparing the treatment of President Eisenhower's heart problems with Vice President Cheney's. When President Eisenhower experienced chest pains, Mamie was told to cuddle up to him in bed to keep him warm. While the vice president would doubtlessly benefit from cuddling as well, it seemed more like he dropped his car into the garage for a tune-up.

The list of coronary-care recipes that were not available in Ike's time includes clot busters, angioplasties, stents, special coronary-care units, defibrillators, pacemakers, ultrasound devices and bypass surgery.

Next to this article in the *Times* was one on quantum computing—the prospect of using radio waves to manipulate atoms like so many quantum abacus beads and achieving a supercomputer in miniature. Of course, I didn't understand that article, and reading it made my head hurt.

Biotech reminds me of Dave Barry, who has wondered if the new gene therapies would make his genes fit better. And the Austin Lounge Lizards, who wonder about the consequences of being born in the shallow end of the gene pool.

Besides saving the recipes, another reason the New Economy will remain viable is that none of its laws have been repealed. I refer to laws like Moore's law regarding chip power, Metcalfe's law of networks and Gilder's law regarding bandwidth.

This does not mean I think last year's high productivity growth can hold up during the current slowdown. As slack increases in labor markets and the supply of high-tech equipment remains in excess of demand for a while, cyclical productivity is likely to suffer, even while underlying structural productivity continues to improve.

At the risk of embarrassing myself, let me make a comment or two on the stock market. Especially in retrospect, we obviously had a tech stock bubble, and it now has burst.

In 1999, some people argued—and many agreed with them—that the old valuation rules didn't apply to New Economy firms. The mania started with Netscape, which had its wildly successful IPO only about 18 months after its start-up and long before profitability. Others followed and rapid growth, high volume and early-bird advantage replaced profits—and even the prospect of profits—as the mantra.

Well, about a year ago something happened. Remember the old Road Runner cartoons? The Road Runner always managed to stop at the edge of the cliff, but Wile E. Coyote never could. He would overrun the cliff and keep running. He never fell until he looked down.

Well, someone looked down. And saw all foam and no beer.

That's not correct. There was beer there. A good bit of beer. But it did have too big a head on it.

With zero profits, you get infinite price-earnings ratios. When infinity became untenable, there was no guide for reasonableness other than the old historical norms. So excessive pessimism replaced excessive optimism.

But there ought to be some middle ground. Because there was a grain of truth beneath the New Economy hype. Much of the New Economy features high start-up or fixed costs but low variable or marginal costs. The first copy of software, or the first batch of new medicine, or the first reel of a new movie, or the first use of a new breakthrough medical procedure are all very expensive to develop. But the cost of reproduction is very low. That means the greater

the volume, the lower the average cost.

Compared with industrial operations, declining long-run cost curves and increasing returns to scale are much more prevalent in the New Economy. And by New Economy, I don't mean "New Economy firms." I mean firms—new and old—using the new technology. Volume and scale are your friends.

There is an early-bird advantage to getting there early and moving down your long-run cost curve before your competitors or potential competitors. Your early start means they can't compete with you on price. They have to compete with invention and innovation, by not doing your thing cheaper but by doing a new thing that makes your thing obsolete.

I don't think the stock market was wrong to place a value on rapid growth in that environment. It obviously just placed too high a value on it. But I don't think it's necessary for all the Old Economy valuations to be restored before the stock market becomes reasonably priced. Excessive optimism doesn't have to be cured with excessive pessimism.

What we are going through now with the market adjustment and the churn in the economy is to some extent the replacement of "The early bird gets the worm" with "The second mouse gets the cheese."

In passing, this is a reminder that the new technology—especially the Internet—transfers power from producers to consumers. Consumers get to participate in the New Economy. Producers have to participate—to survive. But their profits will be fleeting—as each new thing is replaced by a new new thing.