The Economy and Inflation

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As we begin 1998, the risks facing the economy are less one-sided than they were a year ago. Last year the primary focus was on the possibility of too rapid growth that could lead to overheating of the economy. Today, there is less concern that overheating will occur. In fact, downside risks loom much larger now than they have for the past two years. And as testimony to the growing globalization of our economy, the concern about downside risks to our nation's economy stems not so much from domestic developments, but from international ones.

I want to focus my remarks tonight on both the outlook for the economy and the view that the Asian crisis may push the US into a period of deflation. First, the outlook.

The Outlook

Last year was an extraordinary year in terms of economic performance. The nation's economy grew rapidly, keeping this economic expansion going for a seventh straight year. With strong growth, the unemployment rate fell to 4.7 percent, its lowest level in 24 years, as businesses created more than 3 million new jobs. And all of this was accomplished without a resurgence in inflation. In fact, consumer price inflation slowed to a little less than 2 percent last year, after rising more than 3 percent in 1996.

This year growth will almost certainly be less rapid, in part because of developments in Asia. The Asian situation will affect the US economy in several ways. About 20 percent of our nation's merchandise exports are to Asian countries other than Japan and China, so the expected slump in many east Asian economies is going to translate into fewer shipments of our goods to that region of the world. On the other side of the trade coin, the decline in the value of many Asian currencies against the dollar means that Asian goods will look quite cheap to US consumers, which will tend to increase our imports of those goods. Indeed, we have already begun to see declines in the prices of some internationally traded goods and a pickup in imports from Asia. Lower import prices will put downward pressure on the prices of similar goods produced by US firms. The result will be both lower net exports, which will translate into slower growth in the US, and less consumer price inflation.

A potential risk of the Asian situation is that financial problems in Asia might spread to other developing nations, such as those in Latin America or eastern and central Europe. So far the impact of Asia's problems on other developing countries

has been quite limited. If that continues to be the case, the total impact on the US economy will also be modest. But if the Asian currency crisis and resulting economic slowdown spread to other developing countries that are major markets for US exports, the adverse effect on our trade sector will be larger, and the dampening effect on US growth in 1998 could become more significant. Fortunately, such a scenario seems unlikely at this point. In fact, several Asian currencies and stock markets have shown more stability in recent weeks.

On the basis of what we know now, our nation's economy, while continuing to operate at a high level, is likely to grow moderately in 1998. More specifically, I believe the nation's economy entered 1998 with enough momentum to keep this year's pace of economic growth around 2.5 percent, with the unemployment rate remaining between 4.5 and 5 percent.

Reductions in import prices, along with the decline in world oil prices we have already seen, are likely to help keep consumer price inflation at around 2 percent or a little less in 1998--about the same as in 1997. These are the lowest annual rates of inflation we have seen since 1986, when a sharp decline in oil prices kept consumer price inflation between 1 and 1-1/2 percent.

With the unemployment rate at 4.7 percent, many firms are having difficulty finding and keeping skilled workers. Despite the tightness of labor markets and increases in average hourly earnings, businesses continue to find ways to improve productivity and keep their unit labor costs down. Businesses also have been rapidly expanding their effective capacity, so that capacity utilization rates in industry are now generally lower than they were three years ago. Both of these trends contribute to keeping inflation down.

The deceleration of consumer price inflation during the past year has kept the longer-run average inflation rate during this business cycle expansion at about 2.7 percent--the lowest cyclical level of inflation since the long business expansion of the 1960s.

As I have said many times, monetary policy's primary long-run objective is to pursue price stability as a means of fostering maximum sustainable economic and job growth. Doing so helps ensure that living standards improve over time. Maintaining an environment of stable prices means that there is so little inflation that expectations about inflation do not have a significant influence on the decisions of households or businesses. On the basis of our experience last year and the outlook for inflation this year, I suspect we are close to achieving this primary objective of monetary policy. But we aren't there yet. Expected inflation has not yet fallen to near zero, or even to 1 percent, at least not based on the Survey of Professional Forecasters that our Reserve Bank just released this week. Respondents to that survey said that they expected the consumer price index to rise at an average annual rate of 2.6 percent during the next 10 years, and they expect consumer price inflation this year to be about 2 percent. Other surveys of people's expectations of future inflation give similar, or higher, numbers. So we still have a way to go in bringing down expectations of future inflation.

Some analysts, however, are now saying that the Asian situation is likely to lead not just to lower inflation and eventual price stability, but rather to deflation. Let me turn to this second issue.

Inflation, Disinflation, and Deflation

Let's first define "deflation"--it is widespread and continuing declines in the prices of goods and services, that is, a widespread and continuing decline in the general price level. Deflation is at times confused with disinflation, which occurs when inflation declines but remains positive -- for instance when consumer price inflation falls from 3 percent to 2 percent, as it did last year. Prices were still rising, but not as fast as before. On the other hand, deflation means that the inflation rate is negative--for example, the CPI would be declining at an annual rate of 2 percent.

The price measure that has declined is the producer price index. This past year producer prices for finished goods, intermediate goods, and crude goods all declined. Of course, last year's decline followed increases in the producer price measures, especially for finished goods, during the previous year. We have not yet seen continuing declines. In addition, the decline in the producer price index for finished goods this past year was entirely due to a drop in food and energy prices. The so-called core producer price index was about flat last year.

When price cuts reflect lower costs or technological innovation, we should welcome them. As we have seen in recent years, cost-cutting and productivity gains generate rising profits and strong growth, along with lower prices. And we need to bear in mind that price adjustments, downward as well as upward, are a critical part of the market mechanism that makes our economy so productive.

For consumers, although there has been disinflation in the consumer price index, there has NOT been deflation. Certainly prices of some consumer items have fallen. Whenever consumer price inflation is low or close to zero, there will be some sectors of the economy in which prices are falling and other sectors in which prices are rising. In addition to the typical example of personal computers, last year prices declined for girls clothing, jewelry, refrigerators and home freezers, used cars, televisions, and other video products. But the overall consumer price index still rose last year, as those price declines were more than offset by increases in the prices of other goods and services. Even allowing for mismeasurement of the CPI--which the Boskin Commission placed at about 1 percentage point--the CPI is not yet showing deflation, although we are getting close to zero inflation. Broader measures of inflation, such as the chain-weighted GDP price index, also rose last year, by somewhat less than 2 percent. The producer price index fell this past year, as prices of internationally-traded commodities dropped, but that followed a rise in producer prices the previous year. Such declines in producer prices should help restrain consumer price inflation this year, although so far it has not led to major reductions in survey measures of expected inflation. On balance, then, we are NOT seeing deflationary trends in the CPI or in other broad measures of the price level.

We must also distinguish between deflation in the prices of goods and services and deflation in asset prices. Economists usually are referring to prices of goods and services when they talk about inflation and deflation. In contrast, asset price deflation refers to widespread and continuing declines in the prices of real and financial assets. People often focus on stock prices when talking about deflation. But a general deflation in asset prices would also involve declining prices of real assets such as houses and office buildings. Asset price deflation is certainly important for people who hold assets whose prices decline and for lenders who hold those assets as collateral. It is less clear whether monetary policy should react to changes in asset prices. One wonders, for instance, whether those who think the Fed should intervene in some way when the stock market falls sharply would also advocate that the Fed should intervene when the stock market rises sharply.

Asset prices fluctuate a great deal, and even large changes in asset prices may not call for a change in monetary policy. That doesn't mean central banks are totally indifferent to asset price deflations, since sharp declines in asset prices can, at times, have significant implications for economic activity. In my view, central bankers should be most concerned about asset price deflations that pose a threat to the health and liquidity of the financial system, because a stable financial system is critical to the healthy functioning of the overall economy.

We did see some drop in the prices of financial assets last fall, especially in stock prices, when problems in Asia became widespread. So far this year, however, most stock price indexes have recovered from their big drops of last fall and have been reaching new highs on some days. What's more, prices of real assets such as houses and office buildings have continued to rise, not fall, in the US. So, again, we have no evidence of a widespread deflationary trend in the US, even in asset prices.

The notion that Asian developments will lead to a deflationary trend in the general price level of goods and services in the US, or in prices of real assets, is not one I share. Although I expect the fall in the value of Asian currencies and the slump in Asian economies to slow US growth and reduce import prices, I don't expect this to lead to a general decline in consumer prices in the US. Nevertheless, we are now reaching such low levels of inflation that we certainly must be on guard against movements away from price stability on both the upside and the downside.

As I said earlier, monetary policy's primary long-run objective is to pursue price stability as a means of fostering maximum sustainable economic and job growth. Pursuing price stability means avoiding deflation of the general level of prices of goods and services as well as avoiding inflation of those prices. Just as we don't want expectations of inflation to have a significant influence on the decisions of households or businesses, we also don't want expectations of deflation to have a significant influence on their decisions. Both inflation and deflation are undesirable, and we must guard against both.

In recent years we have seen how well our economy can operate when it is close to price

stability--an environment we have not had the opportunity to deal with since the 1950s or early 1960s, about 40 years ago. But that ought not make us complacent about the risks of a resurgence of inflation. Certainly there are downside risks to the economy this year. But significant upside risks remain as well. Whenever the economy is operating as close to full capacity of its labor and industrial resources as it has been recently, any sharp rise in aggregate demand is likely to lead to a resurgence of inflationary pressures. So we must remain on guard against inflation, as well as be watchful for signs that problems in Asia are leading to a more marked slowing of the US economy.

Good economic policies have helped us achieve the strong economic results we have been enjoying, and we must continue making good economic policy to keep the economy strong. By that I don't mean just good monetary policy. Widespread deregulation of various industries has spurred competition and helped reduce prices to consumers and costs to businesses. And much improved fiscal policy has restrained federal spending and reduced the budget deficit.

Last year the country began to address longer-term budget issues by passing the Balanced Budget Act, which was intended to balance the budget in 2002. In fact, federal tax receipts have continued to exceed expectations, so now slight federal budget surpluses are in sight even before the year 2002. But just as monetary policy ought not reflect complacency about our success in restraining inflation, fiscal policy ought not reflect complacency about fiscal discipline. We still have several major, long-term budget issues to address with regard to Social Security and Medicare.

Conclusion

In sum, I expect 1998 to be a year of more moderate growth than 1997--one that will see this economic expansion continue through an eighth straight year with continued low inflation. The challenge this year will be to continue the good economic policies that have helped produce this low-inflation, low-unemployment, strong-growth economy.