

ISSUES IN THE INFLATION OUTLOOK

I. Good afternoon. I'm delighted to be here today at the Annual Outlook Conference.

A. The outlook I want to talk about concerns inflation in the U.S.

B. As I'm sure you know, inflation was the key in the Fed's decision last month to lower the federal funds rate by a quarter percentage point.

1. Let me quote from Chairman Greenspan:

a. "Since ... July, inflation has been somewhat more favorable than anticipated, and this result, along with an associated moderation in inflation expectations, warrants a modest easing in monetary conditions."

C. Now, I know that sometimes people have complained that the Chairman's quotes aren't so easy to understand.

1. In fact, Herb Caen in the San Francisco Chronicle said that the next edition of Bartlett's Familiar Quotations is going to contain the following quote from Chairman Greenspan:

a. "If I seem unusually clear to you, you must have misunderstood what I said."

D. But the statement he made about the inflation outlook is both clear and free of misunderstandings_and there are a couple of good reasons for that.

1. One reason is the recent performance of the CPI.

a. Since May of 1995, there's been a string of low numbers for the CPI_so that inflation has risen at just over a 1½ percent rate.

b. That's much better than the 3½ percent rate we had in the first part of the year,

c. and it also beats the average rate for 1994, which was 2.6 percent.

2. Another reason is the recent lowering of expectations about inflation.

a. For example, the latest Philadelphia Fed Survey of Professional Forecasters indicated a significant drop_

(1) _inflation expectations ten-years-ahead fell from 3½ percent at the end of 1994 to 3 percent at the end of 1995.

b. A half percentage point drop over a year is significant because, for some time now, expectations have tended to move down at a "glacial" pace.

3. These favorable developments on the inflation front certainly are welcome news,

a. and they support the recent modest drop in the funds rate on two counts:

b. First, the decline in long-term inflation expectations should directly relieve inflationary pressures.

c. Second, the recent drop in inflation essentially meant that the "real" funds rate had risen_

(1) _in effect, making policy "tighter" than before.

d. Our recent action undid some of that.

II. Although I'm pleased with recent inflation developments, my main message today is that I wouldn't want to go overboard_that is, I wouldn't want to say that our modest reduction in the funds rate means that we agree with those who say we've won the battle on inflation.

A. For example, not too long ago, a Wall Street Journal article quoted a strategist from Salomon Brothers who said,

1. "This time, the Federal Reserve has slain inflation."

B. And U.S. World and News Report devoted a full article to the subject:

1. Their headline was, "Conquering Inflation_The Monster that Menaced the Economy Has Met Its Master."

C. Frankly, I just don't think such unbounded optimism about inflationary pressures is justified.

1. In fact, I think there's room for uncertainty about potential pitfalls the Fed could face in pursuing its goal of price stability.

D. So in my remarks today, I'd like to go over a few of the concerns that are on my mind as we look ahead to possible inflation developments in the years ahead.

III. Let me begin by disposing of one of the least compelling arguments about a rosy inflation outlook.

A. Some people think there's no reason to worry about inflation anymore because of the so-called "globalization" of markets.

1. According to this view, world capacity, rather than U.S. capacity, is what determines U.S. inflation.

B. There are at least a couple of things wrong with this line of thinking.

1. And, if you were at the Annual Meeting of NABE in September, you may remember my long harangue on the subject.

C. I pointed out that the U.S. economy is actually less integrated into the world economy than most people think.

1. According to one rough estimate, 70-80 percent of U.S. output is not traded internationally.

2. That means that a very sizable part of our economy isn't directly sensitive to foreign price factors.

D. I also emphasized that, even considering the prices of goods traded internationally, the effect on U.S. prices is offset to a large extent by our policy of flexible foreign exchange rates.

1. For example, suppose the price of steel is lower in Japan than in the U.S.

2. When U.S. manufacturers buy Japanese steel, they have to pay for it in yen,

a. and in the process, they bid up the yen relative to the dollar.

3. As the yen appreciates, the cost of Japanese steel to U.S. firms goes up_even though the Japanese haven't changed the yen price they charge!

4. Or course, in the real world, exchange rates don't offset international developments perfectly.

5. But that doesn't change the basic point that we can't depend on foreign capacity to keep U.S. inflation in check.

IV. The next issue I'd like to touch on is the recent slowdown in the growth of labor compensation costs.

A. The employment cost index rose at a 2½ percent rate in the first three quarters of 1995,

1. compared to 3 percent in 1994.

2. And according to some observers, this downward trend will continue, keeping price inflation down as well.

B. But I'm not completely convinced on this point, because all of the decline in labor cost inflation has been due to moderating benefits costs.

1. They decelerated to only a 1.3 percent rate in the first three quarters of 1995, compared to around a 4½ percent rate in 1994.

2. A good part of the reason for this, of course, is that firms are holding down medical costs by switching to managed care and other medical cost-containing programs.

a. We've certainly done it at the Fed, and I'm sure many of your companies have as well.

3. Now, this switch may very well have permanently lowered the level of benefit costs.

4. But it can't permanently reduce the rate of change in benefit costs.

a. After all, eventually this route to cost-savings will come to an end.

5. Moreover, even if benefit cost inflation does stay down a while longer, total compensation may not.

a. Workers and firms care about total compensation, including wages, salaries and benefits.

b. As a result, persistently low benefits costs may eventually show up in higher wages.

6. So, at some point, we may see a reversal in the recent downward trend in labor cost inflation.

V. Finally, measures of capacity in the U.S. economy present some uncertainty as to whether there currently is much downward pressure on inflation.

A. First, capacity utilization in manufacturing stands at just over 82 percent, which is slightly above the common range of estimates of full utilization.

1. Taken literally, this measure suggests that there may be some excess demand in goods markets right now.

B. Second, the unemployment rate is now at 5.6 percent, which leads me to a discussion of the natural rate.

1. Until very recently, mainstream estimates of the natural rate were around 6 percent, which would suggest that the economy has overshot capacity.

2. Now, I realize that there's a lot of talk these days suggesting that the natural rate has fallen below this estimate_in part because of changes in the structure of the labor market.

3. An example of this that's often cited is the growing role of temporary workers, who have less strong ties to the labor market.

C. But,

1. even if the structure is changing,

2. and even if the natural rate has fallen a bit,

3. the current 5.6 percent unemployment rate still provides a reason to be cautious about the inflation outlook.

a. For example, even if you assume a drop in the natural rate_say, to 5[®] percent_then our model simulations say that putting inflation on a downward trend would not be a painless process.

VI. Now, I started out by saying that, while the inflation picture has improved, it's important not to exaggerate what that improvement means.

A. As I've tried to argue, it doesn't mean that the battle on inflation has been won.

1. On the contrary: the Fed's goal is to move gradually towards price stability.

2. And we're not there yet.

B. In my remarks today, I've mentioned a few of the areas of uncertainty we face as we make progress toward our goal_

1. _such as whether there is any excess capacity in the economy,

2. and how much longer benefit costs will continue to moderate.

C. To make our way in the face of these uncertainties, we'll need to maintain our vigilance and be prepared to respond to new information on issues such as those I've discussed today.

D. But one thing about which there's no uncertainty is the reason for our goal of price stability_

1. _that is, through a policy of delivering low and stable inflation, the Fed makes its best contribution toward maximum sustainable growth for our nation's economy.