LOW INFLATION AND THE ECONOMIC OUTLOOK

Comments by
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I have the pleasure today of speaking about the U.S. economy. As you know, the economy has just completed another stellar year, marked by strong growth and declining inflation. Indeed, the low inflation of recent years has been instrumental in reinvigorating the U.S. economy, helping unleash a new vibrancy and confidence across the country. I have every reason to believe that the economy will continue to perform at a high level this year. But a key ingredient will be the adequacy of monetary policy.

A Review of 1997

By almost any measure, the U.S. economy performed at an exceptional level last year. Although we won't have the final figures for a while, it appears that real GDP grew at about a 3½ percent rate for the year, the seventh consecutive year of expansion. Reflecting the strong growth, the unemployment rate fell to 4.7 percent by yearend, near a 24-year low. And inflation declined, with the Consumer Price Index, for example, up just 1.7 percent and the core CPI up just 2.2 percent.

You'll recall that the economy carried considerable momentum into 1997. Fueled by brisk consumer spending on durable goods and faster inventory investment, real economic activity surged at a 4.9 percent rate in the first quarter. Although inflation was low, there was a concern that the rapid pace of economic activity increased the risk of accelerating inflation that would eventually undermine the expansion. Accordingly, the Federal Open Market Committee raised the federal funds rate slightly in March, from 5¼ percent to 5½ percent.

Economic growth slowed in the second quarter, to a solid 3.3 percent. The deceleration in growth occurred as consumers reined in their expenditures. However, spending on business equipment—a source of strength throughout the expansion—surged in the quarter, led by rapid increases in expenditures for computers and peripheral equipment.

The economy continued to grow at a healthy pace in the second half of 1997. Bolstered by a sharp rebound in consumer expenditures for durable goods, economic activity advanced at a 3.1 percent rate in the third quarter. Spending on business equipment remained a significant source of strength, and residential investment rose solidly as well. And, as the year drew to a close, monthly data indicated that economic activity remained quite solid.

The strong economic growth last year was accompanied by a slowing of inflation. Led by a decline in food and energy prices, the consumer price index, for example, rose only 1.7 percent through December, after rising 3.3 percent in 1996. Meanwhile, core CPI inflation, which excludes food and energy prices, also improved, decelerating for a third consecutive year. The core CPI rose just 2.2 percent through December, after rising 2.6 percent in 1996 and 3.0 percent in 1995.

Because economic growth was solid and inflation was subdued, the FOMC kept monetary policy unchanged in the second half of the year.

The 1998 Outlook

Looking ahead, I believe economic performance in 1998 will again be good. While the recent problems in Asia cast more uncertainty than usual over the outlook, I believe the fundamentals are such that economic growth will remain solid, but will likely slow from its rapid pace in 1997. Inflation should remain subdued. A number of favorable factors underlie my view.

Strong domestic demand. The first factor is the momentum of strong domestic spending, which will propel the economy forward in 1998.

Consumer spending should remain solid this year because of continued gains in employment and income and a continued high level of consumer confidence. According to the Conference Board, consumer confidence hit a 28-year high in December. Moreover, increases in household wealth stemming from the impressive rise in the stock market over the past few years should also help keep consumer spending on a modest upward trajectory.

Business spending on plant and equipment should remain strong in 1998 as firms expand capacity to meet domestic demand and continue to modernize. Firms right now are highly profitable, so with low interest rates they can finance their investments on favorable terms. And with mortgage rates where they are (just under 7 percent), the housing sector also looks to stay in good shape.

While domestic spending will likely continue at a healthy pace, spending by foreigners on U.S. goods and services may rise more slowly than in the recent past. This slowdown in export growth, of course, is attributable to the recent financial crisis in Asia. As the Asian flu has spread from the emerging market economies of Southeast Asia to South Korea, estimates of its impact on the U.S. economy have gradually climbed. On balance, most economists, and I would include myself in this group, are currently guessing that reduced demand for our exports will trim perhaps a half percentage point off our overall growth rate this year. Of course, the degree of uncertainty surrounding this estimate is large. The actual slowdown will depend on how developments in Asia play out—including the policy response there and abroad. Nevertheless, when the moderating influence of slower growth in exports to Asia is combined with the projection for solid growth in domestic demand, the overall outlook for the U.S. economy remains, on balance, favorable.

Low inflation. A second favorable factor for the U.S. economy is the current low inflation environment and the likelihood that inflation will remain well-behaved.

It is my view that the current low inflation environment is one of the reasons investment demand has been so strong throughout the expansion. In fact, some of the strength in investment that we have seen may be evidence of a virtuous cycle in which low inflation begets greater investment, which, in turn, begets low inflation.

Let me briefly review the strength of investment demand during this expansion, which began in early 1991. Real business fixed investment has grown at an average annual rate of 7½ percent while real GDP has grown at an average rate of 2¾ percent. As a result, real gross investment as a share of GDP was 17¼ percent in the third quarter of 1997, the highest level since mid-1981 [1981:Q3]. In addition, industrial capacity grew 4.7 percent in the year ending in December. By comparison, industrial capacity grew on average 3.0 percent over the last 30 years.

While low inflation is obviously not the only reason for such investment strength, I think it is a contributing factor. Economists, particularly those of us in the Federal Reserve System, have long touted the benefits of a low inflation environment. It has often been argued that inflation interferes with the effective allocation of resources by confusing price signals. By that I mean that inflation makes it difficult for firms to determine whether an increase in their price reflects a general increase in the overall price level—shared by all goods—or an increase in their price relative to all other prices. This confusion is harmful because it increases uncertainty and reduces economic welfare.

Thus, low inflation may stimulate investment by reducing risk premia. As a result, low inflation makes it easier for firms to finance entrepreneurial projects. For example, low inflation is correlated with a narrow spread between high-risk securities and U.S. Treasury bonds. Consequently, the cost of finance to entrepreneurs is lower—and investment greater—in a low inflation environment.

The low inflation that we have seen in this expansion, for example, has been associated with less inflation volatility than in earlier, higher inflation periods. The associated reduction in inflation uncertainty has surely been a positive factor for investment in plant and equipment. Increased investment spending, in turn, has increased the economy's capacity to produce goods and services. As noted earlier, investment as a share of GDP is currently a high 17¼ percent, and capacity has been growing at very rapid rates.

Low inflation also reduces the distortion that arises from the way inflation interacts with the tax code. Inflation increases the effective tax rate to firms and individuals in many ways. For example, inflation reduces the value of depreciation allowances, thereby increasing the effective tax rate. For individuals, taxes levied on nominal capital gains and nominal interest income cause the effective tax rate to increase with the rate of inflation. Since inflation increases the effective tax rate on capital income, it discourages capital formation and long-term economic growth.

For all these reasons, the low inflation environment we have enjoyed has helped boost investment spending and increased productive capacity, thereby allowing firms to meet increased demand without raising prices. This greater capacity, moreover, should help ensure that the current low inflation environment continues.

At another level consider that, although labor markets are quite tight by historical standards, workers have remained restrained in demanding higher wages. As both short-term and long-term inflation expectations have fallen, workers so far have accepted—and may continue to accept—modest wage increases. And, to the extent wages have increased, there is some evidence to suggest that these increases have been matched by productivity gains. As a result, unit labor costs have remained subdued. If productivity is now rising faster than in the past, any given increase in wages will have less of an adverse implication for price inflation.

Finally, the recent appreciation of the foreign exchange value of the dollar will contribute to keeping U.S. inflation in check. The rise in the dollar has led to actual declines in the prices consumers pay for imported goods and services. Given lags in the transmission of exchange rate changes to import prices, the appreciation of the dollar last year should continue to have a restraining influence on consumer price inflation this year. This effect could be magnified by aggressive pricing of goods by Asian producers as they seek to liquidate inventories while maintaining production.

Strong financial markets. A third favorable factor for the U.S. economy is the high level of confidence that investors have in U.S. financial markets. This confidence is a reflection of the country’s macroeconomic and financial stability. This stability, in turn, is partly attributable to credible monetary policy and better fiscal policy. By continuing the move toward low inflation, the credibility of U.S. monetary policy has been enhanced. As important, Congress has made progress in moving the federal budget toward balance, thus removing a potential source of instability from the market. With the U.S. government reducing its appetite for more credit, U.S. Treasury securities are seen as an increasingly attractive asset, and interest rates on U.S. government debt have declined. More generally, given the liquidity of our markets and recent success of our macroeconomic policies, the United States remains a very attractive place in which to invest. Not only has our economy proved profitable for U.S. investors, it is also considered a safe haven for investors in other, more turbulent, areas of the world.

Conclusion: A Time for Vigilance

Given the many benefits of price stability, some of which I have alluded to, it is crucial that the Federal Reserve maintain a vigilant policy stance. One element of this effort is that monetary policy must remain forward-looking. The reason we must be forward-looking, as you well know, is that monetary policy actions affect the economy with long and variable lags.

Federal Reserve monetary policy was forward-looking in 1994. Policy was tightened then, although there was some slack in the economy. The Federal Reserve took actions based on its forecast that rapid growth was eliminating the slack and would ultimately produce inflationary pressures. Since then, growth has been stronger, core inflation has been lower, and the Dow-Jones Industrial Average has moved higher. Monetary policy was also forward-looking in 1995 when we reversed course and began to ease policy. In looking back, it strikes me that these actions were the prudent ones to take. They helped sustain the confidence of investors in the Federal Reserve's commitment to keeping inflation contained and keeping a balanced policy stance.

So, the Federal Reserve’s actions to some extent have to be based on forecasts of the economy in general and of inflation in particular. And unfortunately, the economy is always subject to unanticipated shocks. In particular, over the last couple of years, everyone, including us, has been somewhat surprised by just how tame inflation has been in the expansion. The fact that we have been pleasantly surprised, however, does not mean we in the Federal Reserve can afford to become complacent.

In closing, let me repeat that I believe the economy currently is in excellent shape. We expect to see some moderation in the economy's growth rate this year relative to last year, but with continued high employment and low inflation. The Federal Reserve can best contribute to this outlook by ensuring prices remain stable. If there is any lesson from our experience so far in the 1990s, it is that a stable, low inflation environment is a key ingredient in promoting maximum sustainable growth.