

THE NATIONAL ECONOMIC OUTLOOK

Comments by

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I am pleased to be here today to talk about the nation's economic outlook. The economy has entered its seventh year of expansion, enjoying robust economic growth and moderate inflation. As part of my comments, I would like to review these good results and share my perspective on the Federal Reserve's role in maintaining and prolonging this expansion. To put it succinctly, I believe that low levels of inflation have contributed importantly to our healthy economic performance by creating a financial and economic environment conducive to long-run planning. By preventing an acceleration of inflation, and ultimately moving to price stability, the Federal Reserve can "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The economy today

The current expansion has been characterized by robust growth and moderate inflation. Since the beginning of the expansion in 1991, growth has averaged 2.6 percent. More recently, real GDP grew 3.2 percent in 1996 and 3.8 percent in the fourth quarter of 1996. Moreover, indications are that the strong growth has carried over into the first part of this year.

Virtually all sectors of the economy are growing solidly. Consumer spending has increased at an impressive pace due to continued gains in employment and disposable income and a high level of consumer confidence. Business investment also has shown solid gains, aided by strong business profits. Investment in computers and business equipment is especially healthy. Firms have added to inventories at a moderate pace, keeping stocks relatively lean. With the inventory/sales ratio at 1.36, it is likely that inventory investment will continue to support growth in the period ahead. Meanwhile, the manufacturing sector continues to grow. The purchasing management index rose to 55.0 percent in March, above the 50 percent neutral level. And, residential investment has remained resilient despite the uptick in mortgage interest rates. The only sector that appears sluggish at present is the export sector, where a strong dollar and sluggish growth abroad have softened the demand for our products overseas. Taken together, all of these factors add up to a very good economy.

Inflation today and in the near term

In addition to enjoying a strong economy, we have been fortunate that inflation has remained moderate. Consumer price inflation is slightly higher than it was in 1995. For the 12 months ending in March, the CPI was up 2.8 percent, compared with 2.5 percent in the 12 months ending in December, 1995. The rise was due substantially to food and energy prices. When these prices are excluded, core inflation declined from 3.0 percent in 1995 to 2.5 percent in the 12 months ending in March. Similar patterns emerge when we look at other measures of inflation. Thus, it is difficult to conclude there is an upward or downward trend in inflation. I would note that core inflation has been essentially trendless over the last four years.

Some of the moderation in consumer price inflation we have seen is a statistical artifact. The government has changed the way it measures inflation. The Bureau of Labor Statistics, the government agency responsible for the CPI, implemented several methodological changes beginning in 1995, which address some of the problems that cause the index to overstate true consumer price inflation. Without these methodological changes, for example, core inflation in 1996 would have been reported 0.2 percentage points higher at 2.8 percent, still a moderate number.

Given these encouraging inflation trends, why are people raising questions about an increase in inflation now? There are actually two parts to this question. First, why do people raise the possibility that inflation may increase? Second, why are people concerned about an increase in inflation?

Let's first discuss why people are now raising the possibility of an increase in inflation. A critical issue is whether the strong growth in demand will be matched by an increase in supply, or whether the strong growth in demand will exceed the economy's long-run potential, thereby leading to a period of excess demand. Put succinctly, is the growth in demand we've seen over the last six months sustainable over the next year and a half without some increase in inflation? To be sure, the evidence is mixed. But, there are signs that inflation risks are on the upside.

The first sign is that resource utilization rates remain higher than normal. The unemployment rate in March was 5.2 percent, below most estimates of full employment. Historically, unemployment rates considered to be associated with full employment have been in the neighborhood of 5« to 6 percent. In addition, capacity utilization rates in the manufacturing sector stood at 83.3 percent in March, above its longer term average of 81.2 percent. Many analysts are concerned these tight labor and product markets may eventually lead to higher wages and prices, spurring inflation.

The second sign is that aggregate demand may be growing faster than aggregate supply. For example, retail sales grew at an average annual rate of 13.1 percent in the first quarter. This is unusually strong growth. If such demand grows faster than the productive potential of the economy, suppliers will be unable to meet demand, thereby putting upward pressure on prices.

A third matter deserving attention is that the factors contributing to the favorable inflation trends in 1996 may have reflected temporary factors of unknown duration. If these factors expire, upward pressure on prices may result. One such factor in 1996 was the modest pressure on wages. Over the last few years, wage inflation has risen slightly. Wages and salaries rose 2.9 percent in 1995 and 3.3 percent in 1996. Labor compensation--a broader measure which includes wages, salaries, and benefits--has shown a smaller increase, rising 2.7 percent in 1995 and 2.9 percent in 1996. Fortunately, increases in labor compensation have not translated into higher inflation, partly reflecting productivity increases, especially in manufacturing.

More broadly speaking, labor compensation has been held down for at least two reasons. First, since 1992, benefit cost inflation has dropped sharply. Benefit costs climbed 5.3 percent in 1992, but rose just 2.3 percent in 1995 and 2.0 percent in 1996. This deceleration in benefit cost inflation could end, however, especially if the considerable savings in health care have already been realized. Second, modest labor compensation is partly attributed to job insecurity; that is, workers have been more interested in keeping their jobs than in getting larger pay increases. It strikes me that sooner or later, the tradeoff between subdued wage growth and job security will end.

Indeed, anecdotal reports here in the Tenth District and elsewhere suggest labor markets are tightening. If these pressures persist, then higher labor costs should eventually lead to upward pressures on prices, unless there are significant productivity gains.

While these signs suggest upward price pressures, there are other encouraging signs to also keep in mind. For example, if the computer revolution is causing higher rates of productivity, then gains in labor Compensation that match gains in productivity are not inflationary. In addition, some financial market developments suggest there are moderating inflationary pressures. While I am not going to forecast the dollar exchange rate, I will note that the appreciation of the dollar we have seen should help restrain inflation. Moreover, since the exchange rate is the price of the dollar, a rising dollar suggests that the demand for U.S. dollars and U.S. assets is rising. The rise reflects, in part, greater confidence in U.S. macro policy. Finally, although the Commodity Research Bureau's futures index has risen about 4 percent since January 1995, the Journal of Commerce index has fallen about 8 percent.

Thus, while the risks of inflation appear to be on the upside, the evidence is not all in one direction.

The benefits of price stability

Let's now turn to the second question: Why are people concerned about an increase in inflation? I believe people better realize today that low levels of inflation and inflation expectations contribute to our healthy economic performance. In the United States, these two factors have helped create a financial and economic environment conducive to strong capital spending and longer range planning generally, and therefore to sustained economic expansion. I believe that by pursuing price stability, the Federal Reserve contributes to maximum sustainable output and employment and to moderate long-term interest rates. Simply put, price stability contributes to long-run economic performance.

People sometimes wonder whether a little inflation is really all bad. Why not risk a little more inflation if in doing so we have a little more growth? Asking this question presupposes a tradeoff between inflation and growth. But our experience from the 1970s taught us that over any reasonable period we cannot achieve a little more growth by accepting a little more inflation. Most of us here lived

through the 1970s and early 1980s. By remembering when inflation reached 13 percent, we know why it's important not to repeat the mistakes of the past. Moreover, since 1991, core inflation has averaged a moderate 3.2 percent while real GDP has grown 2.6 percent on average. So the historical evidence has shown that high and rising inflation is not a prerequisite for economic growth.

I also would suggest that as the nation's central bank, the Federal Reserve has an obligation to preserve the value of the currency. Some people may argue 3 percent inflation is "low enough." It is true that 3 percent is low relative to the double-digit rates of the late 1970s. But, in a very real sense, inflation--even 3 percent inflation--leads to a depreciation in the internal value of the currency. With an inflation rate of 3 percent, the value of the dollar is cut in half every 25 years.

Consider the 21-year-old who puts aside \$2,000 each year in a retirement fund. At 7 percent interest, she will have approximately \$575,000 when she retires at age 65. But of course, with 3 percent inflation, the real value of her fund is only slightly above \$150,000. Investors of all kinds also are concerned that inflation might pick up in the future. Does anyone really know what the inflation rate will be over the next 44 years? Suppose inflation turns out to be slightly higher--3.1 percent rather than 3.0 percent. The real value of that retirement fund falls about 4 percent, just because inflation was slightly higher.

Experience at home and abroad teaches us that inflation also leads to a depreciation of the foreign exchange--or external--value of the currency. Ask yourself this: Which countries have historically had strong currencies and which have historically had weak currencies? The evidence is clear: countries with low inflation have the strong currencies. Thus, I believe if we are to meet our obligation of preserving the internal and external value of our currency, it is essential that we have an environment of price stability.

Inflation also interferes with the efficient allocation of resources by confusing price signals. There is a whole world of difference between living with low inflation and living with moderate or high inflation. As a business person in an inflationary world, one can pass mistakes on and raise prices because everyone else is raising their prices and we consumers tend to accept the increase. Such is less the case in a low-inflation world. Competitors will not let prices increase so easily. Businesses have to minimize mistakes, be more productive, create real wealth, and ensure that nominal increases in wages reflect increases in productivity.

Research done at the Kansas City Fed shows that low inflation provides significant benefits to the economy. Inflation, even moderate inflation, leads to inflation uncertainty, real growth variability, and relative price volatility. All of these are harmful because they reduce economic efficiency--and therefore the level of economic output--and ultimately consumer welfare. Thus, by reducing inflation and eventually moving toward price stability, the economy benefits.

In summary, I believe that continued low levels of inflation and inflation expectations have been a key support for healthy economic

performance. They have helped create a financial and economic environment conducive to long-range planning and to sustained economic expansion. This, then, is why it is important that we promote price stability over time.

Conclusion: A time for vigilance

Finally, the most difficult aspect of the pursuit of a strong economy with low inflation is that monetary policy must be forward-looking. The Federal Reserve must anticipate an acceleration of inflation, not simply respond to higher inflation that is already upon us. If we simply responded, we would always be behind the curve, because monetary policy acts with long and variable lags.

Federal Reserve monetary policy, for example, 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. 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 prudent.

What this suggests is that today's economic environment requires vigilance.

The expansion has entered in its seventh year. I, and most analysts, believe the economy will continue to grow between 2 and 3 percent this year. Employment growth should continue its positive tone. Indeed, unemployment rates compare quite favorably with rates in other countries. Unemployment is currently 5.2 percent in the United States. In Germany, unemployment was 11.3 percent in February and in Canada it was 9.7 percent.

But while inflation remains moderate, there are, as I have suggested above, upside risks. In order to prolong the current expansion, and let the economy achieve its maximum sustainable output and employment, we must encourage an environment with stable prices. And, it is in this context that we must remain alert, watch the economic trends, assess the outlook for inflation, and when appropriate act.