

The Economy in Perspective

Thinking productively about monetary policy... Some of the talk about the “new economy” and the “old economy” has been highly productive, spotlighting the dramatic transformation of the U.S. capital stock and the way its growth drives domestic economic activity. Not surprisingly, capital markets reward “new economy” companies, which offer the prospect of explosive growth as they propagate their products and services in the larger, older economy. One need not think that “new economy” firms are valued correctly to understand why spending on their products has risen so dramatically and why investors expect them to generate significant future earnings.

Another positive aspect of the discussion is its focus on the role of legal systems and business practices in channeling capital to its highest uses around the world. Just as economic development specialists came to understand that nations rich in natural resources did not inevitably unlock their wealth, the current experts realize that wealth creation depends on an ability to organize the means of production into value-creating enterprises. Legal systems, contract enforcement, accounting standards, financial infrastructures, labor laws, and trade policies are all factors in determining the value of resources in a particular location. Nations compete not so much with what they have, but what they can do with what they can get.

It has been fashionable to assert that the United States is benefiting from a virtuous cycle of events, initially set in motion by new technologies. As the new capital stock is built, economic output accelerates and wages expand along with faster productivity growth. Everyone has the potential for becoming wealthier, although those closest to technology’s epicenter are likely to benefit most. Since people’s lifetime wealth has increased, it is natural for them to spend more on themselves. As a nation, we need not choose between new fiber-optic cable communications backbones and sport-utility vehicles because U.S. firms have been able to borrow readily from foreign savers, even as this nation’s household saving dwindles.

In this virtuous cycle, accelerating productivity growth naturally puts downward pressure on the inflation rate, and the U.S. dollar—bolstered by capital inflows—lowers import prices. The net result has been a record-setting U.S. economic expansion with no adverse inflation impacts.

With conditions so good, is it any wonder so many pundits are already lamenting the unwinding of this virtuous cycle? It is true that unsustainable forces have a habit of ending, and the U.S. investment boom will eventually fade. What are some of the plausible consequences when it does? One is that the U.S. economy could emerge with a faster rate of trend productivity growth than before the boom, accompanied by a stronger

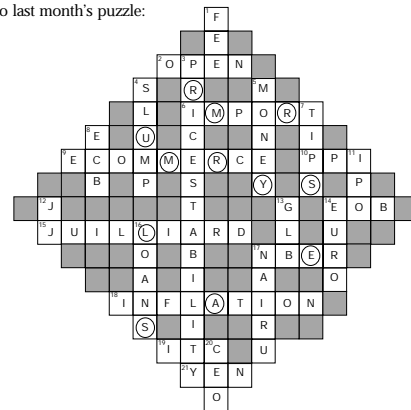
trend rate of real GDP growth. Per capita real earnings could be higher and faster growing than before, reflecting the better productivity picture. But as the transition to this improved situation nears completion, investment activity could slow dramatically for a time, just as real GDP growth will recede from its boom-induced pace. At the same time, we should expect to see some increase in the household saving rate, attenuating the need for foreign capital. Import growth would slow, and the current account surplus would move toward balance.

The challenge for monetary policy in this transition is often misunderstood. During the boom phase, the monetary authority should expect the demand for money to increase, along with the equilibrium real interest rate. If the central bank desires to hold the inflation rate steady, it most likely will need to allow money growth to accelerate and its interbank interest rate to increase. Keeping the interbank rate steady could result in accelerating inflation. If the central bank wants to glide on the disinflationary air currents of the productivity boom, it will not permit money growth to expand commensurately with output.

As the boom fades, the monetary authority must anticipate that money growth will necessarily slow and the equilibrium real interest rate will decline. If the economy emerges from the boom at its target inflation rate, the central bank will need to reduce its interbank rate in pace with the decline in money demand. If the economy shows undesirably high inflation, the central bank could reduce its interbank interest rate more slowly, so as to exert disinflationary pressure.

It should be clear that productivity, investment, trade, and labor markets all shape the terrain on which monetary policy decisions are made. The productivity boom—and its eventual demise—have implications for inflation, but only insofar as they complicate policymakers’ ability to understand the dynamic evolution of the economy. As the “new economy” becomes old, let us hope that it ages gracefully.

Solution to last month’s puzzle:



SOLUTION: L A R R Y S U M M E R S