

## *The Economy in Perspective*

*Growing pains...* Policymakers and analysts will be closely scanning fourth-quarter data for signs of a meaningful slowing in U.S. economic activity. Meaningful, in this context, refers to the duration of the adjustment as well as its magnitude. Analysts who think the economy is growing at an unsustainable pace look forward to a lengthy period of more moderate expansion. Unless the economy slows for longer than a quarter or so, they fear that its heady condition could easily generate larger trade deficits, labor shortages, and accelerating inflation. A much better outcome, they say, would be a growth downshift sufficient to keep the expansion intact, but without the hazards that could accompany its present course.

The prospect of this “soft landing” already seems tantalizing. In recent months, housing market activity has been off the pace it showed in the first half of the year. Heavy truck sales to industry have similarly stalled. So far, sizeable energy price increases and a languishing stock market have neither reduced consumer confidence nor raised inflation expectations, but they apparently have combined to affect household purchases: Consumer spending has softened somewhat lately, especially for automobiles. Net employment growth has moderated considerably from its pace earlier this year.

Discerning shifts in growth trends can be a difficult task, especially when the economy’s trajectory is subject to several powerful and complex forces. The United States continues to be the beneficiary of a capital investment boom, driven by new scientific discoveries as well as a legal and market infrastructure that enables spending on the new technologies to exert its maximum effect. At the same time, investment opportunities in some other parts of the world are not keeping pace, favoring U.S.-based corporations and dollar-denominated assets by a widening margin. Confidence in the U.S. dollar’s price stability reinforces these effects.

Many observers are watching for evidence that the force of this economic tailwind is waning, but they may have to wait. Capital spending booms usually do not last as long as the present one but, unlike most, this boom is not being driven principally by firms’ desires to expand capacity. Rather, firms are achieving dramatic cost reductions and developing highly valued products rapidly by applying new technologies. A few historical episodes suggest that the diffusion of breakthrough technologies can continue for decades.

How, then, should we regard some signs of slower growth in the current data? Even if the fourth quarter’s growth rate dips, how can we be sure that it portends a slower trend rate of growth, and for how long? During this expansion, quarterly growth rates have averaged 3.8% (at an annualized rate), with a standard deviation of 1.9%. In several instances, the expansion’s course has seemed to shift, only to be followed by episodes with different characteristics.

More important, should we really wish for the pace of growth to slow if its driving force is vigorous capital investment and strong productivity growth? Why should we believe that this kind of growth causes problems? The simplistic response is that producing beyond the economy’s supply capacity causes inflation. On the surface, this answer appears sensible because of the imbalance implied when actual demand exceeds supply. On reflection, however, it seems doubtful that output could surpass the ability to produce, especially for a protracted time. After all, if capacity defines the limit, how can output exceed it? Adding imports to the equation makes the calculation of supply even more problematic.

Inflation is not an endogenous response to economic growth, especially growth driven by productivity-enhancing investment in new technologies. Inflation is a monetary phenomenon. Too much output cannot be a bad thing, but too much money can. In the United States, the Federal Reserve is responsible for regulating the supply of money, gearing its availability to the needs of commerce. Without a foolproof method for predicting how the business cycle will ebb and flow, it is easy to see how money growth can get off kilter when the Federal Reserve sets targets for the federal funds rate.

If the economy’s growth trend moderates, the Federal Reserve will need to take care that its target rate is not set too high, lest it induce undesired disinflation. If the growth trend proves stronger than anticipated, the Fed will want to ensure that its target rate is not too low, lest it induce undesired inflation. In neither hypothetical case does sound monetary policy require putting economic growth on any particular track, and economic growth in itself does not cause price-level fluctuations. Let’s not assign guilt by association.