

MAINTAINING FAVORABLE ECONOMIC PERFORMANCE

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Economic performance remains outstanding. Real GDP continues to grow faster than commonly accepted estimates of its sustainable trendline, and the domestic economy is largely absent potentially disruptive imbalances. The Asian crisis will subtract moderately from growth in 1998, but will not sidetrack the expansion. Inflation remains low and inflationary expectations have receded. Low bond yields and high stock valuations reflect these sound fundamentals. The Federal Reserve's successful disinflationary monetary policy has been the primary source of the outstanding economic and financial market performance. The vastly improved federal budget conditions have contributed positively, particularly to robust investment. The Fed must continue to pursue its long-run objective of zero inflation, and avoid committing monetary policy mistakes by responding inappropriately to the temporary impacts of the Asian crisis, overmanaging the economy, or misleading the posture of monetary thrust. A monetary tightening should not be ruled out.

Foundations for Strong Economic Performance

As the economic expansion completes its seventh consecutive year, several of its characteristics stand out relative to recent expansions, particularly its strengthening in recent years. A continuation of sound macroeconomic policies is a necessary foundation for sustaining the expansion.

The most outstanding characteristic of this expansion has been its durability and the sustained decline in unemployment accompanied by decelerating inflation. These favorable trends have not resulted from luck or temporary factors, nor do they represent a "brave new world." Rather, they derive largely from the Federal Reserve's even-keeled, credible disinflationary monetary policy that has constrained nominal spending growth and dampened its volatility. In contrast to every recent expansion, nominal GDP growth

has not accelerated, and its fluctuations have been mild (see Chart 1). This has lowered inflation, created a sound basis for sustained expansion and enhanced economic efficiency.

The Fed's restrictive monetary policy has generated moderate growth in aggregate demand that has constrained business flexibility to raise prices; in response, firms have restrained operating costs and raised productivity. Production efficiencies, technological innovations and robust capital spending have lifted productive capacity and sustainable trendline growth. The squeeze on excess demand as a result of the narrowing gap between growth of nominal spending and productive capacity has raised the share of nominal spending growth that is real output and lowered inflation.

This supply-driven economic growth contrasts sharply with recent expansions in which accommodative monetary policy generated rising excess demand relative to productive capacity, and higher inflation. The durability of the expansion stems from the low, stable inflation and the narrower swings in aggregate demand that have enhanced economic efficiency and limited potentially disruptive imbalances in the goods, labor and capital markets.

A few facts confirm this assessment. Nominal GDP growth has averaged 5.3 percent since 1991; this is materially slower than the 7.7 percent average during the initial disinflationary expansion period 1983-1990 or the 10.2 percent average during the inflationary 1970s (nominal GDP growth averaged 11.8 percent during the 1975-1980 expansion). The average growth of nominal GDP this expansion is lower than in any single nonrecession year since the early 1960s. Noteworthy, the Fed has tightened monetary policy both times in the 1990s when year-over-year nominal GDP growth exceeded 6 percent (1994 and 1997 Q1); in earlier expansions, the Fed was much slower to respond. Consequently, real growth now is over half of nominal GDP growth, higher than in past expansions.

This has been the only expansion in recent history in which inflation has declined. The end-expansion rate of inflation ratcheted up in each succeeding cyclical peak from 1960 to 1980; since then, each succeeding expansion-end inflation rate has been lower. Not coincidentally, the expansion-end unemployment rate has followed a similar pattern. Certainly, the negative supply shocks in the 1970s and the positive productivity

enhancements in the 1990s have contributed to this pattern, but the primary factor underlying this trend is the Fed's shift from monetary accommodation in the 1970s to disinflation in the 1990s.

The decelerating inflation and declining unemployment rates underlines the crucial role of monetary policy and reveals the fatal flaws of the NAIRU framework. The NAIRU framework does not explicitly consider the role of monetary policy, and thereby does not distinguish between supply and demand-driven changes in the unemployment rate; accordingly, it fails to anticipate changes in the natural rate of unemployment. In the 1990s, the sustained healthy economic expansion has generated tight labor markets, but the resulting wage increases have reflected productivity gains, while the Fed's appropriately restrictive monetary policy has squeezed excess demand and broken the link between unemployment and inflation. This contrasts with the wage-price spiral of the late 1970s that resulted from monetary accommodation and excess demand. The Fed has grudgingly acknowledged the weaknesses of the NAIRU framework and has signaled its rising comfort with low unemployment: since 1996, the Fed has significantly lowered its central tendency forecasts for both the unemployment rate and inflation, and it has not tightened monetary policy in response to declining unemployment.

The sustained strong growth of capital spending in the 1990s also stands out, contributing significantly to this expansion's pace of growth and productive capacity. Business fixed investment has grown 6.8 percent annualized since 1991 Q2, while investment in producer durable goods equipment has grown 9.7 percent. This strength has been fueled primarily by investment in information processing equipment, with healthy increases in current dollar spending and a rapidly declining deflator, reflecting dramatic technological innovation.

The fundamental factors underlying the investment boom include the sustained disinflationary expansion and increases in real earnings, declining costs of capital (lower bond yields and higher stock multiples) and high expected rates of return, the efficient capital markets and, not to be overlooked, the marked reduction of government purchases as a share of national output and temporary elimination of budget deficits. The reduction in government purchases has reduced the direct absorption of national resources for public sector uses and freed them for private uses. Resource allocation toward more

productive private uses has enhanced productivity and productive capacity; the superior allocation of investment dollars by private investors relative to government investments comes as no surprise.

Although this expansion's average rate of real GDP growth has been modest compared to most recent expansions, its late-blooming strength is unique. This trend reflects the sound underlying fundamentals, the expansion's slow start through 1993, and the successful soft-landing engineered by the Fed in 1994-1995. The 3.5 percent growth pace in 1996-1997 has involved a pickup in both employment growth and productivity gains.

In 1996-1997, nonfarm payrolls rose about 2.5 percent annualized, while the labor force nearly kept pace, growing about 1.7 percent annualized. These sharp increases, particularly the elastic supply of labor, reflect in part the positive impact of welfare reform.

The recent robust productivity gains—an average of about 2 percent annually in 1996-1997 in the nonfarm business sector, and 4.6 percent in manufacturing—reflect heightened production efficiencies, technological innovations and capital spending as businesses strive to maintain margins in an environment of constrained aggregate demand.

As is typical of most economic expansions, corporate profits and cash flows have outpaced economic growth, but in real terms, their increases shine. Since 1991 Q2, real after-tax earnings have risen 9.3 percent annualized. This reflected several factors: rapid productivity gains, low unit labor cost increases and wide profit margins on domestic operations; the rising share of profits generated from overseas operations whose activities are not counted in GDP; and heightened efficiencies and returns on capital, particularly in the service-producing sectors, that are not reflected in either the productivity or GDP statistics.

Robust financial markets have reflected these sound fundamentals and unique economic patterns. High real interest rates have been maintained by strong economic performance and high expected real rates of return on investment, while declining inflation expectations have generated low bond yields and a flat yield curve. The U.S. dollar has strengthened as the strong economic performance and declining inflation have

increased expected rates of return on dollar-
valuations reflect the sustained economic growth and record-
earnings, low inflation, lower perceived riskiness of stocks, and asset allocation into
-denominated assets. While price/earnings multiples are close to record highs, and
they remain only modestly above P/Es in major European exchanges, and are

1996- in which growth in real GDP averaged 3.5 percent annualized, growth is
projected to moderate to an approximate 2.5 percent rate in the first half of 1998 and 2.8

monetary policy is not restrictive; rather, following a lengthy period of above trendline

Asian crisis and a moderation of business investment from its recent rapid pace.

Domestic dem

underperformance is not anticipated.

Consumer spending and housing activity continue to be fueled by solid increases
in employment and real disposable incomes, low interest rates and appreciatio
financial assets. In recent years, consumption of services in particular has increased
rapidly, perhaps in response to sharp increases in household wealth. Lower interest rates
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significant shifts are expected in these trends.

The Asian crisis is expected to have a moderate and contained impact on the U.S.
economy, primarily by widening the trade deficit. Most likely, it will subtract less than 1
in 1998, denting its rapid growth rate but not derailing the expansion.
While slower exports and an acceleration of imports will reduce domestic production

demand. Through February, retail sales and housing activity have picked up. Real

quarter of this year, even faster than its 3.7 percent pace in all of 1997. The impact of Asia on business investment and production is uncertain; cautious businesses may decide to delay investment plans or slow production and reduce inventory building. So far, only hints of such a response are evident, with weaker investment in late 1997 and a slowing of manufacturing orders for export. A material, sustained cutback in business fixed investment, although not expected may slow the recent pickup in the growth of productive capacity.

U.S. exports may not be suppressed as much as recent estimates or popular headlines suggest. Exports to all affected Asian nations, including China but excluding Japan, total less than \$110 billion, or about 1.3 percent of U.S. GDP; with Japan, the total is approximately \$170 billion, or 2.1 percent of GDP. Even a whopping 20 percent decline in exports to Asia would reduce GDP by only 0.4-0.5 percent. Most likely, exports will fall by less, as Japan's economic decline from already moribund performance in the 1990s will be substantial but not severe. The magnitude and duration of the acceleration of imports is uncertain, depending in part on the price adjustments to the exchange rate shifts and how they are calculated in the GDP import deflator. Many analysts fails to recognize that lower-priced production inputs, in the wake of the crisis, are available in many cases to domestic as well as Asian producers, mitigating any Asian advantage.

The Asian turmoil is having a significant but temporary impact on reported inflation. Core consumer price inflation is projected to remain relatively unchanged at approximately 2.2 percent in 1998. Declining oil prices, a stronger U.S. dollar and an acceleration of declines in prices of nonpetroleum imports suppressed reported inflation to 1.9 percent from 1996 Q4 to 1997 Q4, and 0.7 percent pace in the last three months. Consequently, the CPI will increase approximately 1.6 percent in 1998. The PPI, benefiting from strong productivity gains that have produced four consecutive years of declining unit labor costs in manufacturing industries, along with recent declines in nonwage costs, largely reflecting falling commodity prices, has been relatively stable at all stages of production in the past year and has fallen substantially in recent months.

Following a year in which real economic performance exceeded the Fed's expectations and inflation once again was below them, the Fed continues to forecast

slower economic growth and has significantly lowered its inflation forecast. For 1997 Q4 to 1998 Q4, the Fed's central tendency forecasts a -2.75 percent real growth and -2.25 percent (see Table 1). Its inflation forecast is largely an -driven decline in reported inflation, umably reflects its expectations of a negative Asian impact.

As the Asian impact dissipates and the U.S. trade deficit stabilizes or narrows in depend on monetary policy and the structural fundamentals underlying the economy.

disruptive imbalances, 2.5- rebound in nominal GDP from the temporary Asia related slowdown in an environment of tight labor markets and rising wages may exert upward pressure on inflation.

Maintaining Low Inflation

The length and durability of the current expansion, the strong sustained growth of , and a pickup in productivity and productive capacity are positive responses to the Fed's progress in achieving price stability. Maintaining stable low continue to squeeze excess demand. The recent growth rates of money and the trend of -over year growth of nominal GDP exceeded 5.5 percent throughout 1997. From 1996 Q4 to 1997 Q4, real growth resulted in 1.8 percent rise in the GDP deflator. Money growth has gradually accelerated, which should sustain domestic demand growth. In the those are temporary effects.

Based on the assumption of approximately 2.75 percent sustainable trendline flexibility to raise prices and generate modestly higher inflation. Unit labor costs rose a in 1997 Q4 (compensation increased 5.2 percent), and in the first half of 1998, they will

accelerate as productivity gains weaken while tight labor markets continue to exert upward pressure on compensation. In this environment, the Fed must constrain nominal spending and prevent any rise in consumer price inflation.

The wide array of monetary aggregates have accelerated modestly since mid-1997: sweep-adjusted, bank reserves have risen 7.8 percent in the past year and at a 6.2 percent rate in the last three months; the monetary base, 7.9 percent and 9.8 percent, respectively; and M2, 5.8 percent and 7.3 percent (see Chart 2). From 1996 Q4 to 1997 Q4, M2 rose faster (5.6 percent) than the Fed's 1-5 percent target, and has exceeded it so far this year. The high real Federal funds rate is not restrictive. Rather, the strong economic performance has raised the equilibrium real rate of interest and, as such, the high real funds rate has been associated with modestly accelerating money growth.

Money demand has increased in response to the strong economic growth and decline in interest rates, and the Fed has accommodated that demand. To the extent that the secular decline in interest rates has reflected lower inflation expectations, accommodating the monetary adjustment has been defensible. It is possible that as economic growth slows and portfolios adjust to the lower interest rates, money demand will subside without an increase in the federal funds rate. But that outcome is uncertain: the pickup in money growth has been marked and rather persistent, and domestic demand shows no sign of slowing. Although the Asian turmoil will suppress domestic production, ultimately the Fed's primary concern is aggregate demand management, and a successful low inflation monetary policy must distinguish between trends and temporary impacts, and between domestic demand and domestic production. In light of the Fed's objective of long-run stability, the benefits of a pre-emptive tightening should not be overlooked.

Financial Markets

Following several years in which the inflationary expectations priced into bond yields were too high relative to actual inflation and the Fed's low inflation monetary policy, inflationary expectations tumbled in the second half of 1997, as bond yields fell and the yield curve flattened. As inflationary expectations fell relative to actual inflation, the cash bond significantly outperformed the Treasury's inflation-indexed bond. The

nature of this curve flattening is distinctly different than flattenings during the mature stages of recent cycles, when monetary tightening pushed up short-term interest rates faster than bond yields.

In early 1998, the Asian-related asset reallocation into bonds pushed Treasury yields through 10-year maturities below the federal funds rate, an unsustainable term structure in light of the Fed's symmetric monetary posture. Recently, as the crisis stage of the Asian turmoil has dissipated and the flight to quality subsided, Treasury yields have corrected upward, but the curve remains relatively flat, reflecting continued low inflation expectations and high real rates and economic strength. Even though the market's inflationary expectations temporarily may be too low, the longer-term outlook for lower bond yields remains favorable, insofar as real interest rates have room to decline as economic growth moderates, and the Fed, although presently exhibiting perhaps too much patience, seemingly remains committed to long-run zero inflation.