



Sustainable economic growth

By ALAN GREENSPAN

CHAIRMAN OF THE FEDERAL RESERVE BOARD

What are the key trends in the US and global economy?



ALAN GREENSPAN

took office in June 1996 as chairman of the Board of Governors of the Federal Reserve System for a third four-year term ending in June 2000. He also serves as chairman of the Federal Open Market Committee, the System's monetary policy-making body.

A number of important forces have been shaping recent developments in the US economy. One has been a recovery of financial markets from the disruptions of last fall. By the end of 1998, the extreme withdrawal from the risk-taking and consequent seizing-up of markets had largely dissipated. This year, risk spreads have narrowed further - though generally not to the unrealistically low levels of a year ago - and a heavy volume of issuance in credit markets has signalled a return to their more normal functioning. Equity prices have risen to new highs and, in the process, have elevated price-earnings ratios to historic levels.

Abroad, many financial markets and economies have also improved. Brazil weathered a depreciation of its currency with limited fallout on its neighbours. In Asia, a number of the emerging market economies seemed to be reviving after the trying adjustments of the previous year or so. Progress has not been universal, and in many economies prospects remain clouded, depending importantly on the persistence of efforts to make fundamental reforms whose necessity had been made so painfully obvious in the crises those economies endured. Nonetheless, the risks of further major disruptions to financial and trade flows that had concerned the FOMC when it eased policy last fall have clearly diminished. Improving global prospects also mean that the US economy will no longer be experiencing declines in basic commodity and import prices that held down inflation in recent years.

In the domestic US economy, data becoming available this year have tended to confirm that productivity growth has stepped up. It is this acceleration of productivity over recent years that has explained much of the surprising combination of a slowing in inflation and sustained rapid real growth. Increased labour productivity has directly limited the rise of unit labour costs and accordingly damped pressures on prices. This good inflation performance, reinforced also by falling import prices, in turn has fostered further declines in inflation expectations over recent years that bode well for pressures on costs and prices going forward.

Several years ago, I raised the possibility that we were entering a period of technological innovation that occurs perhaps once every fifty or one-hundred years. The evidence then was only marginal and inconclusive. Of course, tremendous advances in computing and telecommunications were apparent, but their translations into improved overall economic efficiency and rising national productivity were conjectural at best.

While the growth of output per hour had shown some signs of quickening, the normal variations exhibited by such data in the past were quite large. More intriguing was the remarkable surge in capital investment after 1993, especially in high-tech goods, a full two years after a general recovery was under way. This suggested a marked increase in the perceived prospective rates of return on the newer technologies.

To gauge the potential for similar, if not larger, gains in productivity going forward, we need to attempt to arrive at some understanding of what has occurred to date. A good deal of the acceleration in output per hour has reflected the sizeable increase in the stock of labour-saving equipment. But that is not the whole story. Output has grown beyond what normally would have been expected from increased inputs of labour and capital alone. Business restructuring and the synergies of the new technologies have enhanced productive efficiencies. American industry quite generally has shared an improved level of efficiency and cost containment through high-tech capital investment, not solely the newer industries at the cutting edge of innovation. Our century-old motor vehicle industry, for example, has raised output per hour by a dramatic 41/2 per cent annually on average in the past two years, compared with a lacklustre 11/4 per cent on average earlier this decade. Much the same is true of many other mature industries, such as steel, textiles, and other stalwarts of an earlier age. This has confirmed the earlier indications of an underlying improvement in rates of return on the newer technologies and their profitable synergies with the existing capital stock.

These developments have created a broad range of potential innovations that have granted firms greater ability to profitably displace costly factors of production whenever profit margins have been threatened. Moreover, the accelerating use of newer technologies has markedly enhanced the flexibility of our productive facilities. It has dramatically reduced the lead times on the acquisition of new equipment and enabled firms to adjust quickly to changing market demands. This has indirectly increased productive capacity and effectively, at least for now, eliminated production bottlenecks and the shortages and price pressures they inevitably breed.

This greater ability to pare costs, increase production flexibility, and expand capacity are arguably the major reasons why inflationary pressures have been held in check in recent years. Others have included the one-time fall in the prices of oil, other commodities, and imports more generally. In addition, a breaking down of barriers to cross-border trade, owing both to the new technologies and to the reduction of government restrictions on trade, has intensified the pressures of competition, helping to contain prices. Coupled with the decline in military spending worldwide, this has freed up resources for more productive endeavours, especially in a number of previously non-market economies.

More generally, the consequent erosion of pricing power has imparted an important imperative to hold down costs. The availability of new technology to each company and its rivals affords both the opportunity and the competitive necessity of taking steps to reduce costs, which translates on a consolidated basis into increased national productivity.

Despite the remarkable progress witnessed to date, history counsels us to be quite modest about our ability to project the future path and pace of technology and its implications for productivity and economic growth. We must remember that the pick up in productivity is relatively recent, and a key question is whether that growth will per-

sist at a high rate, drop back toward the slower standard of much of the last twenty-five years, or climb even more. By the last I do not just mean that productivity will continue to grow, but that it will grow at an increasingly faster pace through a continuation of the process that has so successfully contained inflation and supported economic growth in recent years.

The business and financial community does not as yet appear to sense a pending flattening in this process of increasing productivity growth. This is certainly the widespread impression imparted by corporate executives. And it is further evidenced by the earnings forecasts of more than a thousand securities analysts who regularly follow S&P 500 companies on a firm-by-firm basis, which presumably embody what corporate executives are telling them. While the level of these estimates is no doubt upwardly biased, unless these biases have significantly changed over time, the revisions of these estimates should be suggestive of changes in underlying economic forces. Except for a short hiatus in the latter part of 1998, analysts' expectations of five-year earnings growth have been revised up continually since early 1995. If anything, the pace of those upward revisions has quickened of late. True, some of that may reflect a pickup in expected earnings of foreign affiliates, especially in Europe, Japan, and the rest of Asia. But most of this year's increase almost surely owes to domestic influences.

There are only a limited number of ways that the expected long-term growth of domestic profits can increase, and some we can reasonably rule out. There is little evidence that company executives or security analysts have significantly changed their views in recent months of the longer-term outlook for continued price containment, the share of profits relative to wages, or anticipated growth of hours worked. Rather, analysts and the company executives they talk to appear to be expecting that unit costs will be held in check, or even lowered, as sales expand. Hence, implicit in upward revisions of their forecasts, when consolidated, is higher than expected national productivity growth.

Independent data on costs and prices in recent years tend to confirm what aggregate data on output and hours worked indicate: that productivity growth has risen. With price inflation stable and domestic operating profit margins rising, the rate of increase in total consolidated unit costs must have been falling.

Even taking into account the evidence of declining unit interest costs of non-financial corporations, unit labour cost increases (which constitute three quarters of total unit costs) must also be slowing. Because until very recently growth of compensation per hour has been rising, albeit modestly, it follows that productivity growth must have been rising these past five years, as well. Accelerating productivity is thus evident in underlying consolidated income statements of non-financial corporations, as well as in our more direct, though doubtless partly flawed, measures of output and input.

That said, we must also understand the limits to this process of productivity-driven growth. To be sure, the recent acceleration in productivity has provided an offset to our taut labour markets by holding unit costs in check and by adding to the competitive pressures that have contained prices. But once out-put-per-hour growth stabilises, even if at a higher rate, any pickup in the growth of nominal compensation per hour will translate directly onto a more-rapid rate of increase in unit labour costs, heightening the pressure on firms to raise the prices of the goods and services they sell. Thus, should the increments of gains in technology that have fostered productivity slow, any extant pressures in the labour market should ultimately show through to product prices.

Meanwhile, though, the impressive productivity growth of recent years also has had important implications for the growth of aggregate demand. If productivity is driving up real incomes and profits - and, hence, gross domestic income - then gross domestic product must mirror this rise with some combination of higher sales of motor vehicles, other consumer goods, new homes, capital equipment, and net exports. By themselves, surges in economic growth are not necessarily unsustainable - provided they do not exceed the sum of the rate of growth in the labour force and productivity for a protracted period. However, when productivity is accelerating, it is very difficult to gauge when an economy is in the process of overheating.

In such circumstances, assessing conditions in the labour market can be helpful in forming those judgements. Employment growth has exceeded the growth in working-age population this past year by almost 1/2 percentage point. While somewhat less than the spread between these growth rates over much of the past few years, this excess is still large enough to continue the further tightening of labour markets. It implies that real GDP is growing faster than its potential. To an important extent, this excess of the growth of demand over supply owes to the wealth effect as consumers increasingly perceive their capital gains in the stock and housing markets as permanent and, evidently as a consequence, spend part of them.

There can be little doubt that, if the pool of job seekers shrinks sufficiently, upward pressures on wage costs are inevitable, short - as I have put it previously - of a repeal of the law of supply and demand. Such cost increases have invariably presaged rising inflation in the past, and presumably would in the future, which would threaten the economic expansion.

With productivity growth boosting both aggregate demand and aggregate supply, the implications for the real market interest rates that are consistent with sustainable economic growth are not obvious. In fact, current real rates, although somewhat high by historical standards, have been consistent with continuing rapid growth in an environment where, as a consequence of greater productivity growth, capital gains and high returns on investment give both households and businesses enhanced incentives to spend.

Even if the labour supply and demand were in balance, however, other aspects of the economic environment may exhibit imbalances that could have important implications for future developments.

As a result of the US's ongoing favourable economic performance, not only have the broad majority of Americans moved to a higher standard of living, but a strong economy also has managed to bring into the productive workforce many who had for too long been at its periphery. The unemployment rate for those with less than a high-school education has declined from 103/4 per cent to 63/4 per cent today, twice the percentage point decline in the overall unemployment rate. These gains have enabled large segments of US society to obtain skills on the job and the self-esteem associated with work.

No doubt, a monetary policy focused on promoting price stability over the long run and a fiscal policy focused on enhancing national saving by accumulating budget surpluses have been key elements in creating an environment fostering the capital investment that has driven the gains to productivity and living standards. ■