

The Economy in Perspective

Are we there yet? ... The constant dollar value of goods and services produced in the United States increased for the fifth consecutive year in 1995. By the reckoning of most professional forecasters, the nation's economy will expand further this year and next. If this prediction proves correct, only 2 of the 60 quarters in the 1983–97 period will have recorded outright declines in total output. In real terms, the economy will have produced \$7.1 trillion in 1997, a 53% increase over its 1982 level.

Moreover, by most conventional measures, the economy is operating at high levels of resource utilization. Capacity utilization in the goods-producing sector registers close to its average for postwar economic expansions, having recently eased back from even higher rates. Considering the rapid pace of business fixed investment during the past few years, the continued activity of the enlarged capital stock testifies to the strength of demand. Labor markets have also been tight. Although payroll reductions in some large firms have attracted attention, labor demand has been growing. Since the labor force has been expanding only slowly, even moderate increases in labor demand have served to keep pushing the national average unemployment rate down toward 5.5 percent (the 1996:1Q average was 5.6 percent). The ratio of employment to working-age population is near its all-time peak of 63.2 percent.

One remarkable aspect of this expansion has been inflation's extraordinary performance. The inflation trend was negatively sloped during the 1983–95 period, although its actual path was marked by episodic ups and downs. According to the cost-push model that seems to dominate the popular press, economic expansions create a scarcity of resources, which in turn raises material and labor costs. Before long, inflation intensifies. Adherents of this view often prescribe monetary or fiscal restraint, thinking that inflation will slow when the demand for goods and services slackens.

If conventional measures of resource utilization are reasonably accurate, why aren't price pressures in the economy more visible? Does more capacity exist than is readily apparent? Maybe. The concept of physical capacity, though appealing, doesn't easily lend itself to practical measurement. Even relative to 30 years ago, our economy produces a greater proportion of its output in the form of services than goods. Self employment and part-time employment have become more commonplace, increasing labor force flexibility. Innovations in transportation, communication, and information management have changed not only the mix of goods and services, but also the means of their production. Resources can now be obtained more quickly, and from more locations, than at

any time in the past. It is by no means clear that we can confidently measure economic capacity. To the extent that increases in demand put upward pressure on prices, individual firms and markets may be more capable of deflecting those forces than ever before.

The dynamics of price-level movements may also differ from those implied by the cost-push model. Inflation—sustained increases in the price level—stems from excessive money creation. Over a few years, the price level may be buffeted by a variety of transitory or even cyclical factors. Over longer periods, however, monetary policy determines the price-level trend. When the money supply grows faster than the rate necessary to complete transactions at current prices, the prices of all goods and services rise to absorb the excess money stock. If the stock of money and its rate of turnover remain fixed, the price level can actually decline as real output expands. In other words, economic growth can proceed, even with a declining aggregate price level, in the presence of a stable monetary policy. (Such an episode occurred in the late 1800s.) Fears that economic growth will necessarily cause inflation are based on an unwarranted extrapolation of the cost-push model, a lack of confidence in monetary policy, or both.

The pace of economic activity ebbs and flows over time within industries, regions, and nations in response to a variety of factors. Greater coordination among households and firms yields less volatile fluctuations. Market economies excel at coordinating plans, and they contain self-equilibrating mechanisms to resolve errors. Serious disruptions to economic expansions are usually the result of unusual events such as oil price shocks, wars, or gross economic policy errors. Economic policies can actually strengthen the coordination process if their fundamental design supports efficient resource allocations and if their objectives are well understood.

In the aftermath of an inflation upheaval during the 1970s, monetary policy has been geared toward restoring a climate of price-level stability. Since 1983, while overall economic growth has generally been quite favorable, inflation has trended gradually downward. The Consumer Price Index (CPI) increased less than 3% in each of the last three years, as economic activity continued to be strong. Goods prices have actually been increasing far more slowly than have services prices (roughly 2 percent versus 3.5 percent annually during the last five years). Using a ballpark estimate of 1 percent as the size of total measurement bias in the CPI, and noting the already low rate of change in goods prices, it is easy to see why people increasingly indicate that inflation is no longer a factor in their economic decisions.