

## *The Economy in Perspective*

*Potential problems ...* Has the economy been expanding beyond its potential, threatening to boost inflation? Or has the level of economic activity only now reached its potential? Can it grow at rates of 3% or more in real terms before inflation begins to drift up?

The Commerce Department recently announced that real GDP rose 2.25% during the last four quarters, a pace consistent with most analysts' estimates of the growth rate for potential GDP. The Labor Department followed with a report that the nation's unemployment rate held steady at 5.2% in October, a figure at or below conventional estimates for full employment. No wonder speculation about inflation's future course remains intense.

The concept of potential output (or full employment in the labor market) has a long, checkered history in macroeconomics. Early Keynesians advanced the idea, arguing that since inflation would result from resource utilization above potential, and deflation would arise from underutilization, governments should use monetary and fiscal policies to keep the level of actual economic activity equal to its potential.

Keynesian economists in the 1960s thought that potential output changed very slowly, and that its value could be closely pinpointed. Kennedy-Johnson era policymakers also believed that inflation and unemployment, which they regarded as inversely related, could be traded off against one another in a predictable way through the use of demand-management strategies. Against the backdrop of the Great Depression, an event that created public fear of widespread unemployment, the Keynesians' faith in full employment is understandable; however, in view of the accelerating inflation of the late 1960s and the poor economic performance of the 1970s, their confidence seems misplaced.

By the early 1970s, many economists embraced a more sophisticated version of potential output, called the natural rate concept. Milton Friedman, among others, theorized that actual unemployment would always gravitate toward a "natural rate" of unemployment. The actual and natural rates would equalize only when inflation matched the rate that people had already incorporated into their wage- and price-setting plans (that is, expected inflation). Natural-rate advocates emphasized that demand-management policies should not be used to hold unemployment permanently below the natural rate, since this strategy would result in escalating inflation. Policymakers could, however, attempt to keep unemployment at the natural rate and accept the prevailing pace of inflation.

Advocates also reasoned that the natural rate of unemployment could fluctuate both slowly—

through changes in the composition of the labor force, for example—and quickly—through changes in tax policy, unemployment compensation benefits, minimum wage laws, and other factors affecting labor supply. Proponents of this logic urged policymakers to be more cautious in estimating economic potential and less ambitious in their objectives. Nevertheless, the practice of using demand-management policies to guide the economy along a path of full resource utilization persisted throughout the 1970s. And, although the intellectual basis for taking greater care in policy design and implementation had been established, macroeconomic performance was dismal.

Have we learned from our experiences? Many economists have abandoned potential output as a conceptual guide for policymakers. Some think the idea itself is bankrupt, depending as it does on being able to quantify the supply and productivity of land, labor, and capital in some idealized state of economic activity. Others accept the concept, but worry about not being able to adequately estimate potential output or current and future economic conditions. These factors combine to make an "output gap" framework problematic for policymakers who try to keep real economic activity on any predetermined path, including that of full employment.

Despite these shortcomings, many economists still cherish the ambition of closing the output gap. This is partly because politicians and the public have been conditioned for decades to think that economic policy tools—principally those of monetary policy—should be continually geared toward keeping aggregate demand high. Ironically, although economists realize that monetary policy can be used to stimulate aggregate demand, most of the evidence suggests that these effects are short lived. Contemporary macroeconomic theorists teach that monetary policy does not affect the economy's level of potential output and cannot be relied on to keep output moving along a predetermined path. Monetary policy can be used systematically for only one purpose—to determine the price level. Indeed, a low inflation environment is monetary policy's best contribution to better economic conditions.

Closing the output gap remains a popular aspiration because people want to believe it can be done. Even though history has shown repeatedly that estimates of potential output are unreliable, when the next generation of economists and policymakers arrive on the scene they inevitably push—or get pushed—to create inflation. Unfortunately, our nation's ability to learn that full employment is no guide for macroeconomic policy has fallen far short of its potential.