

## *The Economy in Perspective*

*Paradigm Lost?* ... What should we make of the unexpectedly good macroeconomic performance of the U.S. economy in the last several years? Does the combination of under-3% inflation and under-5% unemployment mean that structural changes have permanently transformed the economy's business cycle characteristics? Have we entered a Golden Age that eternalizes not only low inflation and unemployment but also higher rates of saving, capital investment, and productivity? Is it time to replace an old paradigm with a brave new one?

Economists typically divide macroeconomic activity into two "predictable" components—trend and cycle. Trends represent the economy's performance in the absence of cyclical disturbances, and cycles describe the economy's movement around trends in response to transient forces. The economy's real growth trend is determined by the growth rates of labor and capital and by their productivity. Its underlying inflation rate is determined by the excess of money supply over money demand.

The traditional framework for describing cyclical dynamics requires an estimate of the economy's maximum, noninflationary, real output level and growth trend. Once the level and trend growth of "potential" output are established, it is straightforward to estimate gaps between potential and actual output. Knowing the historical relationships between labor utilization rates and output, we can express these gaps in terms of differences between the actual unemployment rate and the NAIRU, a theoretical "nonaccelerating inflation rate of unemployment" that corresponds to potential output. Advocates of this approach expect that when the economy's resources are stretched beyond the NAIRU threshold, the prevailing inflation rate will accelerate as goods and services markets are strained by excess demand.

Analysts who predict inflation exclusively on the basis of current and projected resource utilization gaps think that available money supply and demand estimates are not sufficiently reliable for their purposes. They consider wages especially vulnerable to excess demand pressures because they believe labor supply is relatively fixed in the short run. But the location of NAIRU depends crucially on estimates of "potential output," which in turn are heavily reliant on productivity assumptions.

Basic economic growth theory suggests that a society raises its living standard (output per

capita) over time either by increasing the amount of capital per worker or by making technology changes that enable people to use capital stocks more effectively. Generally, the living standard increases slowly over time along with the steady diffusion of education and of the capital equipment that accompanies technological advance. Once in a great while, however, technological innovation and diffusion become highly condensed in time, causing productivity growth to accelerate.

As an economy shifts from one productivity level to another, investment outstrips labor force growth. Domestic consumption need not contract during the investment boom, however, if society can import savings from abroad. When additions to the capital stock expand productive capacity, the output gap may not widen, because actual output is also growing. Moreover, if employees at many skill levels can use the new technology, overall labor demand will increase as the economic expansion continues. Finally, money demand may strengthen along with the expanded volume of economic activity, rendering current money growth rates noninflationary (or even disinflationary!).

Traditional economic growth theory can, in other words, account for the simultaneous appearance of an investment-led expansion, healthy domestic consumption, trade deficits (and corresponding capital inflows), greater-than-expected labor force participation and utilization, and declining inflation in the face of stable money supply growth. It could also account for a pickup in real wages, as a corollary to capital deepening. Thus, no new paradigm is needed.

All of this makes perfect sense except for one essential fact: Official data for the U.S. economy do not support the proposition that productivity growth is accelerating. These data could be misleading, especially if a greater proportion of current-dollar output consists of goods and services that embody enhanced features and quality. If so, we are underestimating real output growth and overestimating inflation. But if the reported data are essentially correct, temporary factors may be suppressing an otherwise yeasty inflation process. So we see that the difference of opinion about productivity growth is not so much a clash of old versus new paradigms as a commentary on the quality of current economic statistics. And on that subject, at least, all economists can agree.