The Economy in Perspective

Extreme economics ... Like a skier barreling down a triple-black-diamond run, the U.S. economy is racing into the new year. The Commerce Department reported that real growth reached 4.3 percent last quarter, substantially exceeding analysts' expectations. The fourth-quarter pace brought the 1997 growth rate to nearly 4 percent, itself a considerably higher figure than the economy's 20-year average of 2.6 percent. On the heels of the Commerce Department's announcement came word from the Bureau of Labor Statistics that nonfarm establishments added 358,000 net new jobs to the economy in January, a number that overshot analysts' earlier projections by roughly 25 percent. The nation's unemployment rate remained steady at 4.7 percent, and the employment-to-population ratio hit a record peak of 64.2 percent. The January labor market data depict an economy performing with the same vigor it displayed last quarter.

Despite the perils of breakneck speed, a collision with inflation is not in sight. The Consumer Price Index (CPI) increased only 1.7 percent last year, about half its 1996 pace. Core inflation measures also suggest deceleration. The CPI less food and energy dropped from 2.6 percent in 1996 to 2.2 percent last year. Favorable inflation trends have clearly affected inflation expectations and interest rates. The University of Michigan's latest consumer survey shows that the median household foresees the CPI rising only 2.3 percent over the next 12 months, a notable decline in expectations. Partly in response to this revision in thinking, interest rates stand about 100 basis points below year-ago levels at most maturity points along the yield curve.

At seven years, the current expansion has far outdistanced the post–World War II average of four years. Moreover, resource utilization rates surpass conditions traditionally associated with accelerating inflation and rising interest rates. Many mainstream economic forecasters still cling to the belief that inflation cannot remain in check with an unemployment rate below 5.25 percent. Indeed, after the Federal Open Market Committee raised the federal funds rate by 25 basis points last March, Fedwatchers thought that additional actions would be taken to avoid an inflationary wage–price spiral. But not only has the March action turned out to be the last thus far; many Fedwatchers now consider a funds rate decrease slightly more likely than an increase—despite continued reports of vigorous economic activity.

There is, of course, a rational explanation for this recent reversal in market sentiment. Many analysts expect recent developments in Southeast Asia to act as a break on the surging U.S. economy, slowing its growth and quelling incipient price pressures. Mainstream economic forecasters generally expect that U.S. net exports will decline sharply this year, with the Asian crisis subtracting anywhere from one-half to one whole point from real GDP growth. An unfortunate turn of events, to be sure, but propitiously timed if one is concerned about rapid growth.

Without this development, what could slow the economy's pace? One unpleasant scenario involves a weakening of the forces that have boosted economic productivity. Business fixed investment began to strengthen about 15 years ago; this trend, encouraged by low inflation, deregulation, new technologies, global markets, and changes in management practices, suggests that recently improved productivity figures could be more than temporary. Higher productivity translates into faster increases in labor compensation that do not adversely affect profit margins. Consequently, strong productivity performance increases the chances that the general level of output prices will stabilize throughout an economic expansion, and supports a monetary policy aimed at that objective.

In these circumstances, monetary policymakers will want to be careful about holding on to preconceived notions about the limits to economic growth and the reliability of the unemployment rate as an indicator of labor market tightness. But they also need to be wary of other conventional expectations, including the effects of the Asian crisis on the U.S. economy. The expansion might simply continue apace, with little interruption, raising the usual questions about inflation.

Schussing down unmarked trails is exhilarating, but as policymakers know, today's fresh powder can cover a very icy base.