

## *The Economy in Perspective*

*Keep on truckin'...* If the Dow Jones index accurately forecasts future economic conditions, its surge past 9700 in early March signals a continuation of the U.S. boom. And why not be optimistic? The pace of aggregate activity continues to exceed the nation's long-term average—and estimates of the threshold beyond which inflation should accelerate. No wonder forecasters of all stripes are confused.

U.S. production of goods and services expanded more than 4% in real terms last year for the second year in a row, once more outstripping private forecasters' average projections by a wide margin. Indeed, as late as January 1999, analysts' average prediction of last year's fourth-quarter growth tallied 3%; now, as the Commerce Department's official estimates become available, it appears that last year's real growth rate ended at a 6% annual rate. It turns out that U.S. exports, which declined in each of the first three quarters of 1998, rebounded so strongly in the final quarter that exports actually increased for the year as a whole. This welcome turn of events for U.S. producers had not generally been anticipated. Partly because of the improved trade picture, private forecasters have boosted their 1999 growth predictions from an average of 2% to 2.5% (even so, these figures remain far below the pace of the last two years).

Nor did forecasters anticipate the strength of consumer demand. Household purchases of goods and services expanded more vigorously than did real GDP last year, by nearly a full percentage point. Although the first quarter of 1999 seems to have made a slow start, the Conference Board's Present Situation Index rose sharply in February and now stands at the highest level recorded since the survey began 32 years ago.

The continued brisk pace of business fixed investment has also caught forecasters by surprise. Investment spending has been a driving force throughout the expansion, registering real gains in the 10–15% range for many years. Last year's pace was no different, and 1998 ended with a solid 16% annual rate gain in the fourth quarter. Businesses continue to see opportunities for improving productivity through capital investments. Last year, productivity in the nonfarm business sector increased nearly 2.5%, while manufacturing productivity expanded about 4%.

Elevated productivity growth means that the economy can translate a given amount of labor-force growth into more output (and income) than it otherwise could. When sustained for several

decades, seemingly small increments in productivity growth can amount to significant increases in living standards. For example, the difference between 2% and 3% productivity growth rates over a 20-year period cumulates into a 30% difference in real income levels.

Perhaps the most startling aspect of U.S. economic performance has been the price level: The Consumer Price Index rose a mere 1.6% in 1998. With the unemployment rate holding at levels not seen for nearly 30 years and the share of the working-age population actually employed hitting record highs, one might have expected that labor-market tightness would propel inflation forward. Although many analysts think that strong productivity growth accounts for inflation's present quiescence, the longer-term relationship is not obvious. Improved labor productivity makes each labor hour more valuable, which means that productivity gains should eventually translate into rising real wages and profits, not necessarily into lower-than-otherwise output prices. Prevailing inflation rates result from short-term productivity dynamics, falling import prices, and worldwide weakness in commodity and manufactured goods prices. It's likely that these conditions are already in the process of unwinding, but not so far as to push the U.S. inflation rate into the danger zone this year.

To be sure, there are risks to both the expansion's pace and the expansion itself. It is still possible that poor economic conditions in other parts of the world will damage the U.S. economy substantially. Already, certain industries such as steel, petrochemicals, and agriculture are suffering badly. In the past year, for example, soybean prices fell 25% and steel prices 40%. As for other risks, the phrase "equity markets" speaks volumes. Yet, despite widespread belief that these industry- and market-specific gales would tatter the economy's mainsails, the ship has held its course and maintained its speed.

Forecasting is an uncertain business for both private practitioners and central bankers. During such exceptionally good times as these, the downside potential appears so much greater than further upside gains. Monetary policymakers can take satisfaction from knowing that price stability can indeed be sought without compromising improvements in living standards. Indeed, the next time they are called upon to defend actions aimed at achieving price stability, central bankers can draw strength from that knowledge.