

The Economy in Perspective

What? Me Worry?...You don't need an opinion poll to tell you that people are worried about Kosovo, upset about violence, and concerned about the future of Social Security. Fortunately, poor economic conditions are not among the many problems facing the country.

The list of favorable developments has been recounted so often lately that it sounds like a late-night TV ad for capitalism. But it's true: the Big Picture just doesn't get much better than this. Our economy has been expanding for nearly a decade, and labor market conditions have been so buoyant that the fraction of working-age people employed stands at an all-time high.

Investment defines this expansion. While total real output increased 30% over eight years, business investment grew 80% over the same period, and spending on information processing equipment doubled. To be sure, personal consumption spending has also been vigorous, but more so later in the business cycle than earlier on. Spending on business equipment, which took off early in the expansion, has remained strong.

Investment activity over this decade appears to be geared toward embodying new technologies in the capital stock in order to lower production costs and improve product quality. Investment activity's duration, magnitude, and composition, coupled with an irrepressible stock market, testify to investors' and business managers' confidence in future corporate profits. Alternatively, they signal a sea change in how investors regard the risk of owning stocks. Unless investors really expect corporate profits to grow at an exceptional rate for the foreseeable future, today's price-earnings ratios reveal that investors consider the inherent risk of stock returns to be on a par with that of bond returns. Since bond-holders are paid before equity-holders, a convergence in risk premiums expresses powerful confidence in the upside potential of stocks.

Investors also seem to have great confidence in the Federal Reserve's ability to keep inflation low. Inflation has actually been lower during the past two years than at any other time this decade. Inflationary pressures have been considerably undercut by declining import prices, but chiefly by stable employment costs. These inflation-suppressing factors might prove merely temporary, however, as productivity growth stabilizes and labor compensation becomes more evenly matched to it.

An important anomaly of the economy's behavior thus far has been the utter lack of acceleration in inflation, despite prevailing labor market conditions. By several conventional measures, labor markets are tight, but upward pressure on labor compensation is notably absent from the list. Indeed, according to the Employment Cost Index, year-over-year wage increases moderated last quarter from the previous quarter's pace.

Some policymakers look to labor markets for information about future inflation, and although this relationship has always featured some noise, lately the static has been deafening. Had the Federal Open Market Committee (FOMC) subscribed to the once-popular view that inflation would accelerate after the unemployment rate fell below 6.0%, it might have taken restrictive actions just before the economy's sharp, noninflationary acceleration. And, even though labor markets are substantially tighter today (the unemployment rate has been below 4.5% for about a year), the continuing absence of overt wage acceleration prevents some policymakers from relying too heavily on this signal.

As indexed by the federal funds rate, monetary policy has been remarkably steady for the past several years; the FOMC reduced the funds rate markedly last fall in response to liquidity pressures in financial markets, not as a direct result of weakness in economic activity. Indeed, many financial market observers have been expecting the FOMC to unwind some of these rate reductions as the need for extra liquidity accommodation dissipates. The federal funds futures market expects the Fed to move in that direction this year, albeit very cautiously. Fed-watchers' lack of conviction is well founded: During the past few years, the funds market has anticipated both rate cuts and rate hikes that never materialized, while missing some that did.

Even if the traditional leading indicators do not signal an acceleration of inflation, it would be unwise to assume that monetary policy is set appropriately, or that inflation will remain dormant. Monetary policy aims to support maximum sustainable economic growth. Ordinarily, this means not allowing inflation to distort resource allocation decisions. In today's environment, however, there may be other factors that impinge on sustainable growth. It is in the nature of monetary authorities to worry. After all, if not us, who? If not now, when?