Don’t Set Growth Limits for the New Economy

Robert D. McTeer, Jr.

I used to attend Cato’s monetary conferences in the 1980s when I ran the Richmond Fed’s Baltimore Branch, just up the road. The persistent criticism was hard to take, especially when it came from one of my former professors, Dick Timberlake, also an adjunct scholar of Cato. I still get Christmas cards from Dick every year. He writes good stuff about family activities. Sometimes he adds that the Fed is doing a pretty good job these days, but, of course, it still should be abolished.

Our original sin, according to Dick, apparently was the circumstances of our conception. We were created by government—by an act of Congress—rather than by nature and the market, like the gold standard. In short, his message was, “You’ve been doing a pretty good job, you bastards.”

I thought of that recently while reading the book *How to Think like Leonardo da Vinci*. Because his prosperous father was not wed to his peasant mother, Leonardo was excluded from the Guild of Notaries and was unable to follow the profession of his father and grandfather. The world was thus denied what probably would have been the greatest accountant and notary of all time. Like da Vinci, we’ll just have to do the best we can with the cards we’re dealt.

Gauging Monetary Policy

I am proud to be here, but I feel somewhat awkward because my invitation was probably based on my reputation as a maverick who dissented from the Fed’s first two tightening moves in 1999. So for

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the record, let me say that I have the highest respect and regard for all my Federal Open Market Committee (FOMC) colleagues—especially Chairman Greenspan. My differences involved degree, timing, and tactics, not goals.

To avoid beating around the bush, let me just repeat my dissent statement from the published minutes of our meeting on June 29–30, 1999:

> Mr. McTeer dissented because he believed that tightening was unnecessary to contain inflation. He noted that most measures of current inflation remain low, and he saw few signs of inflation in the pipeline. Conditions that called for a preemptive tightening in 1994—rapidly rising commodity prices and real short-term interest rates near zero—are not present today. While money growth has been rapid by historical standards, market-based indicators of monetary policy suggest sufficient restraint. Except for oil, most sensitive commodity prices have risen only slightly after years of decline, the dollar remains strong, real short-term interest rates are near historical norms and productivity growth has accelerated in recent quarters. Mr. McTeer does not believe that rapid growth based on new technology, rising productivity, and other supply-side factors is inflationary, especially in the current global environment. He would have preferred to continue to test the growth limits of the New Economy.

Regarding my dissent at the next meeting, the August 24, 1999, minutes said:

> Mr. McTeer dissented for essentially the same reasons he did at the June 30 meeting: low inflation and, except for energy, minimal inflation in the pipeline. He believes that positive supply-side forces will continue to damp the impact of strong demand on output prices and that productivity gains will continue to damp the effect of higher wages on unit labor costs.

Regarding that last point, I can't resist noting that productivity gains over the following four quarters exceeded 5 percent and drove unit labor costs down a half percent despite good wage increases. The CPI for May and June of 1999 came in with zero increases. But inflation did begin to creep up, primarily in the energy sector. Of the next three FOMC meetings, the only further tightening last year came in November, and that was unanimous.

A point that is often overlooked is that a decision not to change policy—not to change the federal funds rate—is as significant a decision as a decision to change it. It is not a compromise between

easing and tightening, nor is it usually the middle ground in a three-way choice. The decision is almost never about whether to zig or to zag. The question is usually whether to zig or not zig or whether to zag or not zag. I mention this because I think the chairman's and the FOMC's finest hours in recent years were their decisions not to tighten during the period when growth exceeded previous speed limits and when unemployment fell below previous estimates of the nonaccelerating inflation rate of unemployment (NAIRU). The committee, in effect, was testing the growth limits of the New Economy. I just wanted to continue the testing a little longer.

People normally think of central banker courage as the courage to tighten, since tightening is never popular. But it may take more courage not to tighten when elite academic and Wall Street opinion believes you are making the same old mistake of too little too late and getting behind the inflation curve. In this world, the bond vigilantes might string you up. In the next world, as everyone knows, doves don't get into central banker heaven. Only hawks need apply.

By elite opinion, I mean the opinion of traditional establishment types who attended universities that don't have good football teams and who have a large investment, either literally or intellectually, in the Old Economy. Fortunately, I had no such investment and wasn't too proud to look at the economy as well as models of the economy. My favorite economists are Yogi Berra, who said, "You can observe a lot just by watching," and Richard Pryor, who asked, "Who are you going to believe? Me or your own lying eyes?" When the gauges are broken, it pays to look out the window.

The New Economy

Many economists still roll their eyes at the mention of a new economy or a new paradigm. You can tell who they are. They put quotation marks around the term or preface it with the pejorative "so-called." Some are beginning to come around, however. They admit that it is working in practice; they just wonder if it will work in theory.

Policy dissents are not all that uncommon. Mine probably got more attention because it was in the so-called "dovish" direction. But I'm not a dove. I'm just a kinder, gentler hawk. Most dissents favor tightening. The minutes show three such dissents in 1996 and three in 1997. They probably validated the press view that the FOMC is

composed of one wise owl and at least 12 crazed hawks. I didn't fit the mold.

Picking up on the Richard Pryor quote, the *Wall Street Journal* put the title "Believe Your Eyes, the New Economy Is Real" on an op-ed piece I wrote expanding on my views. My own working title was a more nervous-sounding "Out on a New-Paradigm Limb.‘

Let me just touch on some of my views mentioned there and elsewhere. I believe that during the recent disinflationary period, inflation declined not despite strong growth but largely because of it. If inflation results from too much money chasing too few goods, why can't it fall when more goods chase the money? Why can't more goods be as disinflationary as less money?

In the equation of exchange, MV = PQ, note that solving for prices puts Q in the denominator, not the numerator: P = MV/Q. Other things equal, more Q means a lower P. Most policymakers ignore that because they're used to taking Q as a given and focusing on effective demand, or MV. Many who might flinch at being called Keynesians seem to believe more in Keynes' law—that demand creates its own supply—than Say's law—that supply creates its own demand. It seems to me that both are valid.

Those who ignore Q's denominator status probably assume that it has no life of its own. Output responds passively to demand. I'm not so sure about that. It seems to me that the 1990s were chock-full of supply-side, Q-altering events: the collapse of communism and hard-core socialism; privatization and deregulation all over the world; freer trade and capital flows; more efficient financial markets; an explosion of high-tech invention, innovation, and deployment; venture capital to finance high tech; better monetary policies; budget deficits turning into surpluses; the proliferation of tiny computer chip brains in everything, everywhere.

If I am right about rapid growth being disinflationary in the New Economy, does that mean that slow growth is inflationary? It's something to think about. Can you slow demand without slowing supply? I hope so. Although when I try to lose weight, my metabolism slows down.

Another unintended consequence might be slower productivity growth. Some say we have been lucky to have strong productivity growth to offset the negative effects of our tight labor market. But necessity being the mother of invention, what if tight labor markets contributed to productivity growth by forcing employers to seek labor-saving technology? If so, will slack in the labor market slow productivity growth?

Recent productivity growth has been impressive: from mid-1999 to mid-2000, productivity growth exceeded 5 percent. During that pe-

riod, real GDP grew by over 6 percent and unit labor costs fell by half a percent—despite rapid wage and benefit increases.

The Phillips curve and its kissing cousin, the NAIRU, figure prominently in the zigzag question. If you polled most economists, they would probably tell you there is no long-run Phillips curve tradeoff between unemployment and inflation. But short-term Phillips curve thinking is hard to resist. Why else would you hesitate to tighten, or ease, when needed?

I'm no Phillips curver, but I know you can always fit a curve to the dots depicting unemployment and inflation combinations over the years. But if you have lots of dots for lots of years, the fit is bad. If you break the time into shorter segments, the curve keeps shifting around. Since unemployment and inflation declined together in the late 1990s, I guess we were sliding backwards on an upward-sloping Phillips curve.

The NAIRU is equally fickle. I suppose there is always some unemployment rate below which a jolt of demand will cause inflation to rise, but that is likely to be true at any rate. The idea of an irreducible minimum has not held up very well. In recent years, estimates of NAIRU have been about a half percentage point above the prevailing unemployment rate.

Lately, the NAIRU's been dropping like a stone. With U.S. unemployment at 3.9 percent, the latest estimate is probably around 4.5 percent. I do not find the NAIRU concept particularly useful, and using it gives the false impression that you prefer higher unemployment rates. My hunch is that the NAIRU survives in some places because large econometric models need such relationships embedded in them to work—not to work well, just to work.

The Economics of the New Economy

New Economy skeptics often say we have not repealed the law of supply and demand—as if someone had made that claim. To be politically correct, I'd call that a straw person. While the law of supply and demand has not been broken, supply and demand curves may have been bent a little. Former Fed Vice Chairman Alan Blinder and Ed Yardeni, not to mention Larry Kudlow, all have pointed out that the New Economy represents a move toward the textbook model of perfect competition. That model is becoming less hypothetical and more realistic as new technology permeates the economy. It is not just a matter of New Economy firms growing relative to Old Economy firms. That is a false distinction since Old Economy dogs are rapidly learning New Economy tricks.

The economics of the New Economy differ from the Old Economy in several respects. Barriers to entry are lower and less expensive on the Internet. In the New Economy, fixed costs are high, but marginal costs are low, often very low. The first automobile costs a lot to produce, but the second and third are not so cheap either. That is not the case with software, movies, music CDs, medicine, and drugs. First-copy costs are high, but reproduction costs are low—close to zero.

Another aspect of the New Economy is that its product—information—does not disappear when consumed. My consumption does not preclude your consumption of the same product. Networks are a big part of the New Economy. Telephones, cell phones, faxes, pagers, and Internet connections all become more valuable to each participant as others are added. In the New Economy, long-run average-cost curves slope downward longer, reflecting economies of scale. Supply curves derived from cost curves are flatter, more elastic, so that rising demand affects output more and price less. Increasing returns characterize the New Economy.

Economies of scale and scope in the New Economy make size your friend and offer advantages to early producers. The wired, global economy makes a larger scale possible and more profitable. The differences in the economics of the New Economy are summarized in our 1999 annual report. I also recommend a great book, *Information Rules*, by Carl Shapiro and Hal Varian. Of course the work of Paul Romer is leading the way.

Monetary Policy in the New Economy

In thinking about monetary policy in the New Economy, I do not have a new approach to offer. I grew up a monetarist, and I still find that framework the easiest way to think about the role of money in monetary theory and policy. However, I do think New Economy considerations strengthen the case for relying primarily on market prices and signals, as recommended by Manley Johnson. The demand for money, hence its velocity, has become too unreliable in recent years to base policy on. Still, I cannot help watching the money supply out of the corner of my eye and feeling better when its growth is moderate.

What I have been trying to do is avoid basing policy on real economic variables like output growth and the unemployment rate. More specifically, since we don't know how far the acceleration of productivity will take us, we don't know the growth limits of the New Economy. We know the speed limit has risen but not how much. My

guess is that the speed limit has risen from the old 2 to 2.5 percent to 4 percent plus.

The main point is that the Fed shouldn't try to enforce any speed limit, and I'm confident we won't. I think policy should be based on measures of inflation and market-based leading indicators of inflation. Policy should not be tightened because real growth rises above any particular level or because the unemployment rate falls below some level—if direct measures of inflation pressures are not sending off danger signals.