

One View

OF THE ECONOMY



September 12, 2000

The Challenge of Affluence

By Diane Swonk, Chief Economist, 1999-2000 NABE President

Over the last year, I was honored to serve as the President of the National Association for Business Economics (NABE). On September 12, I will deliver my final Presidential Address at NABE's 42nd Annual Meeting. This special edition of One View provides the text from that speech.

A Moment of Reflection

Over the years, there have been two types of NABE Presidential Addresses (I have read them all): the first laments on the profession (which I found depressing); the second lays out a view of the economy (Alan Greenspan focused on the economy in his address). I decided to do the latter, because it is what I do best. It is also what we as a group do best. When business leaders and policymakers want to know what's happening in the economy, they turn to us—the members of this association.

Extraordinary Times

We are living in truly extraordinary times:

- The expansion has crossed into record territory;
- The stock market has surged;
- Housing prices are rising in every state;
- Jobs are plentiful, giving opportunities to many who never thought they would get a chance again (something I am reminded of every time I wait in line at a cash register);
- Productivity growth is soaring; and,
- Real wages, our living standards, are rising robustly again.

One would be hard-pressed to find a corner of this country not touched in some way by the prosperity of this expansion.

Can it continue? Or, are the days of this expansion numbered? Our own NABE surveys show that the pricing power that was once absent has returned, and labor shortages continue to intensify. Perhaps the pendulum has swung too far.

An Outline

I am going to talk about the outlook as I see it, paying special attention to the themes that guide the forecast. I fear that the greatest mistake we make as forecasters is merely extrapolating the past rather than understanding how the past sets the stage for the future. I will talk at length about the Fed. I will comment less on fiscal policy, as I feel that much of economic policy (at least sound economic policy) is conducted at the Fed. I will wrap up my views on what it all means for financial markets.

I believe that the U.S. has hit a subtle, but important, turning point. We have moved from the first phase of the expansion to its second. The defining difference between the two phases is inflation: in "Phase-I," inflation tends to abate, while in "Phase-II," inflation tends to accelerate. Phase-I also tends to be a period where Wall Street prospers relative to Main Street. Phase-II tends to be a period where wage-earners regain the upper hand over wealth-holders.

The transition between phases does not signal the end of the expansion, because with it, the riches of the expansion have finally reached the masses. The characteristics of Phase-II, however, will be dramatically different than those of Phase-I.

Two Themes

Let's start with the outlook. I think that the outlook for the U.S. economy is currently

being shaped by two somewhat competing themes. The first is that the global financial market crisis, which wreaked havoc on exports, has finally passed. In fact, one could argue that we are moving into the first period of synchronous world growth in this expansion. The emerging markets of Asia and Latin America are coming back faster than anyone had imagined, Europe is in a cyclical upswing, and Japan, although still not doing great, is perhaps on the firmest footing it has seen in years.

One obvious consequence is that exports will accelerate, which is welcome news given the magnitude of the U.S. trade deficit. A less obvious consequence is that competition for capital both at home and abroad will intensify, which could put upward pressure on real interest rates.

Separately, and perhaps most importantly, the boost to purchasing power inadvertently created by the crisis has also passed:

- The "flight to safety," which pushed U.S. interest rates to extraordinary lows is over;
- Oil prices have returned to and surpassed pre-crisis highs; and,
- Import prices are no longer plummeting.

The result is that the two-thirds of the economy that belongs to the U.S. consumer will clearly slow. The mortgage refinancing boom (which brought billions to the table) has come to an end, and the housing market has peaked. The key question is, "By how much, and for how long, will the consumer slow?"

That brings me to the second theme. We are slowing into what may well be one of the strongest economies for the U.S. consumer that we have seen. Unemployment has fi-

nally dipped low enough to make a difference in people's lives. In July, only four states in the country—Alaska, Mississippi, New Mexico, and West Virginia—had unemployment rates above 5%.

I think that this is perhaps one of the most important and least understood aspects of the U.S. economy today. Somewhere around 5% unemployment (nobody knows the exact number) a threshold was crossed. Labor markets moved from “loose,” hard to find jobs and easy to find workers, to “tight,” easy to find jobs and hard to find workers.

After that, real wages, which had been nearly stagnant for thirty years, began rising robustly. The money in people's pockets—the single largest determinant of spending decisions—started growing again.

Moreover, and this is the important part, the upward pressure on wages is likely to persist. Let me repeat that, the upward pressure on wages is likely to persist...even if unemployment rises slightly. (It is a long way back to a 5% rate.)

As a result, it is very likely that real wages, at least in the initial stages of Phase II, will be accelerating. Our own analysis suggests that real wages could soon be growing in the neighborhood of 3% to 4%.

Why is that important? Because it means that, adding in labor force growth, consumers will be able to spend at a rate that is close to (or in excess of) the economy's potential just by spending in line with the gains in their paychecks.

Let me say that another way. A good portion of this economy will be able to grow at a rate that could put further downward pressure on unemployment and upward pressure on inflation, without any additional gains in the stock market and without any additional access to consumer credit.

Add to that, the confidence that accompanies an economy that makes jobs abundant and workers scarce, and it is hard to imagine an almost perfect soft-landing.

The ability to obtain jobs really matters. It is no surprise that consumer expectations of the economy five years out hit a record high this summer. It is also no surprise that almost all of the improvement in those expectations occurred in households earning less than \$50,000 a year. The expansion that once seemed to live mainly on Wall Street has finally moved to Main Street.

One result is a willingness to borrow. Consumer attitudes about using debt have hardly

changed over the last year, despite a tightening in monetary policy.

The willingness for households to cash-in on the equity in their homes is especially high. This is not all that shocking given the expansion in home equity lending and the recent rise in home ownership—almost 70% of all households now own their own homes.

What is surprising is the rate at which homeowners are cashing in their gains. The share of equity held in housing in the U.S. *declined* last year, despite one of the best and most regionally-balanced housing booms in history. This means that people were actually cashing-in on their gains faster than they were earning them.

The free lunch that Wall Street has enjoyed for so long has passed...

At the same time, we are experiencing an investment boom, with presumably no end in sight. Our own NABE surveys tell us that we are investing in a new technological infrastructure, and will continue to do so until that infrastructure is in place.

Finally, we appear to be on the brink of one of the largest shifts to fiscal stimulus since the Vietnam War. Most politicians appear to be scrambling for ways to “spend” the surplus this election year. The net result is an economy that slows, but probably not enough to prevent a continued acceleration in inflation. It will continue to surprise many with its resilience.

The Fed

Now, I would like to turn my comments to the Fed. Up until the early part of this year, I would argue that much of what the Fed was doing was retracing the steps it had made during the height of a crisis. The first 75 basis points of tightening in 1999 merely brought us back to ground zero—where we were prior to the financial market crisis of 1998.

By early 2000, however, the Fed turned its efforts more directly toward inflation:

- The deflation associated with the global financial market crisis was beginning to dissipate, unmasking inflation elsewhere in the economy;
- Labor market conditions were continuing to tighten; and,

- Our own NABE surveys were showing that firms who once complained of a lack of pricing power were suddenly able to institute price increases.

The bright spot is productivity growth, which has been accelerating. The problem, of course, is that if unemployment is already too low, even those gains will eventually be overwhelmed by wage gains.

This is where Fed policy gets complicated. Determining whether the economy is running above or below full employment is at best a difficult task. Some even doubt its relevance in today's economy. I am not in that camp. No economist should be. Productivity growth has shifted, but not eliminated, the threshold on inflationary pressures in the labor market.

Productivity growth is a physical phenomenon. It is, by its very nature, bounded. It would be almost impossible to see a rapid doubling of productivity growth from its already lofty levels. Wages, on the other hand, are not bounded. They can literally double overnight. (I have heard that wages for a good Nanny in New York can double in a matter of hours in a bidding war.) At some point in time, which none of us can completely pinpoint, wage gains will dominate, and exceed productivity growth.

This is what Greenspan is alluding to when he underscores that the “laws of supply and demand in the labor market have not been repealed.” Wage gains will eventually win the race against productivity growth.

To further complicate matters, the Fed knows that inflation is *inertial*. The exceedingly low levels of inflation reached over the last several years, helped by the Asian crisis, are actually dampening the rise in inflation today. The urgency to tighten in such an environment is diminished.

Finally, inflation itself, although higher than it was a year ago, remains exceedingly low. One could even argue that it remains relatively benign, and certainly not high enough for the Fed to run the risk of accidentally inducing a recession...even if some FOMC members feel that an increase in the unemployment rate may be ultimately necessary.

So, what are we left with? A Fed whose initial attempts at a slowdown will be gradual. The hope is to get the economy to its potential, stabilize the unemployment rate at its politically preferred low level, and deal with gradually rising price inflation when a problem is more widely recognized.

At some point in time, I believe that Fed moves will become more aggressive. When? The timing is tricky, but I think that the Fed will step-up its efforts once core inflation crosses 3%. I do not think that is likely to happen until late next year.

It will take substantially higher inflation, however, for the Fed to actively run the risk of recession with its efforts to tighten. (Remember, inflation was moving from 5% to 6% when the Fed *accidentally* tipped the economy into recession in 1990.)

Fiscal Policy

This brings me to my concerns regarding fiscal policy. I hope you never discern my political affiliations from my comments (I have been offended by both sides of the aisle when it comes to economic policy). I agree with the vast number of you who responded in the NABE Policy Survey that debt repayment or some sort of shoring up of the social security trust fund should be the top priority for the budget surplus. The only offset to rising real rates that I can see is some sort of a reduction in the government's holding of debt, which would free funds for the private sector.

Tax cuts are attractive for my own portfolio, but economically perplexing. Working for a large consumer bank, I have always had the motto that "give a consumer a dime and he'll spend a dollar." It all seems a bit reminiscent of the 1960s, when the fiscal stimulus of the Vietnam War blew the lid off inflation in an already full employment economy. I thought we learned something from those years.

Finally, there is the issue of spending, and on this I will only comment on one thing. Of all the spending that is planned, why can't we adequately fund the statistical agencies? Amidst all the proposals for spending increases, NABE has been lobbying aggressively to prevent further cuts in funding for the statistical agencies. To ignore the monitoring of the very economy that delivered this prosperity seems utterly ridiculous. It compromises everything from business planning to policymaking. NABE has drawn a line in the sand. There will be no more compromising of this data without a fight.

Financial Market Impact

Last, but not least, I will turn my attention to financial markets. About a year and a half ago, I surprised the Chicago Executives' Club by forecasting a Dow of 11,000 year-end 1999—out-bulling Abby Cohen's fore-

cast of a little more than 9,000 on the same panel. Now, I am decidedly less optimistic about the outlook for financial markets.

Treasury bonds will probably still benefit from buy-backs, especially in the 10-Year arena. But a world moving in synchronous growth, with more competition for capital, higher productivity growth, and potentially higher inflation, is a world that is ultimately bad for bonds. Real, as well as nominal, rates are expected to creep up.

Equities are a little more complicated. Robust growth and a catch-up in activity related to the earlier crises abroad are currently providing a lift to profits. Persistently strong productivity growth and the hopes of an end to Fed tightening have also, undoubtedly, helped financial markets.

Rising interest rates, however, will eventually erode P/E ratios. The timing is tricky, but if wages behave as I think they will, the wage-share of the economy will be gaining ground next year, while the share going to profits will fall. The result is much more precarious for financial markets than the outsized gains financial markets have enjoyed for so long.

What should we expect? If our forecast for relatively robust growth and modest Fed tightening is realized, then it would be difficult to justify much of a gain in the broader market indices. Indeed, it would not take much additional Fed tightening to tip those indices into negative territory.

Finally, no comment on financial markets would be complete without some discussion of the NASDAQ.

My own sense is that the NASDAQ shares some similarities with the Asia Tigers. Humans, by our very nature, are more comfortable buying a stock that is rising rather than one that is falling or has bottomed. The old adage "buy low/sell high" is rarely put into action by the masses. Instead, investors seek out high-return investments, and when a story comes along as promising as that of the Asian Tigers, or more recently, the technological revolution promised by the Internet, they flock to that investment in droves. Returns are bid up, and the process itself becomes a self-fulfilling prophecy.

Up until this year, the NASDAQ was perceived as a sure bet. Then, and this is the critical stage, the money comes in faster than it can be spent. In the case of Asia, it showed up in infrastructure investments. (Malaysia has the tallest buildings in the world.) In the case of e-commerce, it showed up in the \$2 million spent for 30-second ads for the Su-

per Bowl. There is little doubt that the Internet and e-commerce will eventually deliver some extraordinary winners. Those who build and control the infrastructure of this new technology should do well, as will those who employ the technology to reduce costs and effectively boost productivity—many of the old-line industries who have been punished by the rise in the NASDAQ.

The margins in the technology sector, however, are inherently small. Many Internet companies still can't come up with a way to actually make money. My own view is that the Internet will eventually deliver extraordinary gains, but not in many of the places people are currently placing their bets.

Wrap Up

I truly believe that we have hit a turning point in this economy. Wall Street is handing off the baton to Main Street, and with that shift, the economy is moving from its first phase to its second. The good news is that the first, or dis-inflationary phase, is typically the shortest of an expansion, and we just had the longest Phase-I in history. Hence, my optimism that this expansion still has many years to go. I think we can make it to 2004, and maybe beyond.

The bad news is that the characteristics of Phase-II are decidedly different than those of Phase-I. The free lunch that Wall Street has enjoyed for so long has passed, and we now have growth with a price...*gradually* rising inflation and *gradually* rising interest rates.

What is the challenge of this affluence to the next administration? Good times breed complacency, and overly aggressive fiscal policy could make the whole thing unwind much faster than any of us expect. Now is the time to be prudent, and enjoy the good times while they last, because they won't last forever. It is also the time to invest wisely in the statistical agencies. Adept business and policymaking decisions require good data, which could help prolong the prosperity.

Thank You. □

For those who would like to know more about NABE, you can visit the NABE web site at www.nabe.com, or call the main office in Washington at (202) 463-6223. □

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BANK ONE Economic Forecast

	1998(A)	1999(A)	2000	2001	2000:1(A)	2000:2	2000:3	2000:4	2001:1	2001:2
National Outlook										
Chain-Weighted GDP	4.4	4.2	5.2	4.1	4.8	5.3	2.5	4.4	4.3	3.9
Personal Consumption	4.7	5.3	5.2	3.6	7.6	2.9	3.8	3.9	3.9	3.2
Business Fixed Investment	13.0	10.1	14.2	13.2	21.0	14.6	12.1	14.4	14.1	13.0
Residential Investment	8.2	6.5	-0.6	-4.7	3.2	-0.1	-8.9	-4.5	-5.0	-3.0
Inventory Investment (billions)	80.0	45.0	54.6	44.8	29.9	73.0	53.3	36.8	39.8	35.8
Net Exports (billions)	-238.2	-334.2	-408.0	-456.6	-376.9	-408.6	-423.4	-423.3	-446.6	-455.0
Exports	2.3	2.9	9.8	10.7	6.3	13.5	10.0	13.5	9.4	9.6
Imports	11.9	10.7	13.8	11.1	12.0	19.5	11.4	9.7	13.1	9.1
Government Expenditures	2.1	3.3	2.8	2.2	-1.1	4.9	-1.7	2.6	3.5	1.7
Federal	-0.5	2.5	1.6	1.4	-14.2	16.8	-6.6	2.1	3.8	-0.8
State and Local	3.6	3.8	3.4	2.6	6.6	-0.9	1.1	2.9	3.3	3.1
Final Sales	4.2	4.7	5.1	4.2	6.9	3.4	3.4	5.2	4.2	4.1
Inflation:										
GDP Deflator	1.3	1.5	2.2	2.1	3.3	2.6	2.1	2.0	2.1	2.0
CPI	1.6	2.2	3.3	2.7	4.0	3.6	3.7	2.2	2.4	2.6
Corporate Profits*	-7.5	10.4	15.3	11.2	9.9	15.2	14.6	13.3	13.9	12.2
Disposable Personal Income	4.8	3.2	3.4	4.4	2.0	3.3	6.7	1.9	4.8	4.6
Housing Starts (millions)	1.62	1.68	1.60	1.48	1.73	1.60	1.51	1.54	1.51	1.51
Civilian Unemployment Rate	4.5	4.2	4.0	3.9	4.1	4.0	4.1	3.9	3.9	3.9
Employment	2.4	2.2	1.9	1.4	2.6	2.9	0.2	1.9	1.5	1.3
Automobile Sales (millions)	8.1	8.7	9.0	8.7	9.4	8.9	8.8	8.8	8.8	8.7
Domestic	6.8	7.0	7.0	6.8	7.3	6.9	6.8	6.8	6.8	6.8
Imports	1.4	1.7	2.0	1.9	2.0	2.0	2.0	2.0	2.0	1.9
Lt. Trucks (millions)	7.3	8.1	8.4	7.9	8.8	8.3	8.2	8.1	8.0	8.0
Domestic	6.6	7.3	7.5	7.2	8.0	7.4	7.5	7.3	7.2	7.2
Imports	0.6	0.8	0.8	0.8	0.8	0.9	0.8	0.8	0.8	0.8
Combined Auto/Lt. Truck	15.4	16.8	17.3	16.6	18.2	17.2	17.1	16.9	16.8	16.7
Heavy Truck Sales	0.6	0.6	0.5	0.0	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (millions)	16.1	17.3	17.8	16.6	18.7	17.7	17.6	17.4	17.3	17.2
Interest Rates/Yields										
Federal Funds	5 ³ / ₈	5	6 ¹ / ₄	7 ¹ / ₈	5 ⁵ / ₈	6 ¹ / ₄	6 ¹ / ₂	6 ¹ / ₂	6 ³ / ₄	7 ¹ / ₈
90-Day Treasury Bill	4 ³ / ₄	4 ⁵ / ₈	5 ⁷ / ₈	6 ³ / ₄	5 ¹ / ₂	5 ³ / ₄	6	6 ¹ / ₈	6 ¹ / ₄	6 ³ / ₄
Prime Rate	8 ³ / ₈	8	9 ¹ / ₄	9 ³ / ₄	8 ⁵ / ₈	9 ¹ / ₄	9 ¹ / ₂	9 ¹ / ₂	9 ³ / ₄	10 ¹ / ₈
Corporate Bond AAA	6 ¹ / ₂	7	7 ⁵ / ₈	8 ⁵ / ₈	7 ³ / ₄	7 ³ / ₄	7 ¹ / ₂	7 ⁵ / ₈	8 ¹ / ₄	8 ¹ / ₂
Exchange Rates										
Yen/Dollar	131	114	107	113	107	106	108	108	110	112
Euro/Dollar	N/A	0.97	0.95	0.95	0.99	0.93	0.92	0.92	0.94	0.95
Regional Outlook										
Great Lakes (IL, IN, MI, OH, WI):										
Great Lakes Index (GLI)	3.3	3.3	2.5	2.4	1.8	3.0	1.8	2.6	2.4	2.2
Civilian Unemployment Rate	4.0	3.8	3.7	3.6	3.6	3.8	3.8	3.7	3.7	3.7
Employment	0.8	1.3	1.1	1.0	0.7	1.7	0.8	1.1	0.8	0.8
Southeast (KY, FL, WV):										
Southeast Index (SEI)	4.8	4.3	4.8	4.5	4.9	5.7	4.6	4.6	4.3	4.2
Civilian Unemployment Rate	3.1	4.2	3.9	3.7	3.9	4.0	3.8	3.8	3.7	3.7
Employment	4.4	3.2	3.8	3.2	3.8	4.2	3.6	3.2	3.1	3.1
Oil Patch (TX, LA, OK):										
Oil Patch Index (OPI)	5.1	3.2	3.8	4.1	3.9	4.3	3.8	4.4	4.4	3.9
Civilian Unemployment Rate	4.8	4.5	4.5	4.2	4.8	4.6	4.4	4.4	4.3	4.3
Employment	3.4	2.0	2.5	2.7	2.4	3.0	2.7	2.8	2.7	2.5
Mountain (AZ, CO, UT):										
Mountain Index (MTI)	6.1	5.3	5.0	4.2	5.2	4.7	4.2	4.6	4.4	4.0
Civilian Unemployment Rate	3.8	3.5	3.0	2.8	3.3	3.1	2.9	2.9	2.9	2.9
Employment	3.9	3.7	3.7	3.0	3.8	3.4	3.4	3.2	3.1	3.1

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation. *Corporate Profits, four-quarter percent change. Totals may not add up due to rounding. In 1997, GDP was \$8,165 billion in chain-weighted dollars. □