

The Challenge of Affluence

HOW DO WE ADAPT TO CHANGING TIMES?

By Diane C. Swonk



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If economic policymakers behave prudently, the good times in the U.S. can roll on for several more years. The future, however, is likely to be very different from the past, as the expansion's momentum shifts from Wall Street to Main Street.

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We are living in extraordinary times in the U.S.:

- 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.
- Productivity growth is soaring.
- 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 its days numbered? 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.

In this paper, I present my outlook for the U.S. economy, paying special attention to its guiding themes. I fear that forecasters' greatest mistake is to merely extrapolate the past rather than understand 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 conclude 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 that Shape the Outlook for the U.S.

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. Most of the emerging markets of Asia and Latin America are coming back quickly. Europe is in a cyclical upswing; and Japan, although still struggling, is perhaps on the firmest footing it has experienced 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 that was 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.
- 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 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 finally 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 five percent.

I think that this is perhaps one of the most important and least understood aspects of the U.S. economy today. Somewhere around five percent 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).

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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. . . even if unemployment rises slightly. (It is a long way back to a five-percent 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 three percent to four percent.

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. Thus, 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 in which jobs are 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 seventy percent 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.

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.

Interpreting the Fed

Now, I would like to turn my comments to the Federal Reserve Board. Up until the early part of 2000, 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 seventy-five 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.
- 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.

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This is what Chairman 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 three percent. I do not think that is likely to happen until late in 2001. 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 five percent to six percent when the Fed *accidentally* tipped the economy into recession in 1990.)

Avoiding Fiscal Policy Mistakes

This brings me to my concerns regarding fiscal policy. I agree with the vast majority of those 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 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." The prospect of tax cuts 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 these 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 forecast 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 ten-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 helped financial markets.

Rising interest rates, however, will eventually erode price-earnings ratios. The timing is tricky, but if wages behave as I think they will, the wage-share of the economy will be gaining ground in 2001, while the share going to profits will fall. The result is much more precarious for financial markets than the outsized gains they have enjoyed for so long.

What should we expect? If my forecast of relatively robust growth of output 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 the technological revolution promised by

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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), money comes in faster than it can be spent. In the case of Asia, it showed up in showy (but not necessarily efficient) infrastructure investments. (For example, Malaysia now has the tallest buildings in the world.) In the case of e-commerce, it showed up in the \$2 million spent for each of a number of thirty-second ads for the Super 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.

Avoiding Complacency is the Main Challenge of Affluence

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 disinflationary phase, is typically the shortest of an expansion; and we just had the longest Phase I in history. Hence, I am optimistic 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 free lunch that Wall Street has enjoyed for so long in Phase I has passed, and we now have growth with a price that must be paid in Phase II—gradually rising inflation and gradually rising interest rates.

What is the challenge of this affluence to the next administration? It is to avoid the complacency bred by good times. Expansionary fiscal policy could make our extraordinary prosperity unwind much faster than any of us expect. Now is the time to be prudent and to 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. Accurate, timely data are a prerequisite for the adept business and policymaking decisions that will help prolong America's prosperity. ■