Is the New Economy for Real?

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It is a pleasure to be your guest speaker at this fine event.

The exceptional nature of this time is underscored by the turmoil that we have experienced in recent years. The Congress impeached the president. We fought a war in Europe. Financial crisis circled the globe. European nations introduced a new currency. The Federal Reserve embarked on an all-out race against inflation. Massive mergers are reshaping the oil, auto, telecom, financial services and other industries. The price of oil posted the largest 2-year decline in history in 1997-98, and has almost tripled since.

These are the sort of disturbances that have interrupted economic growth in the past. Yet the economy and financial markets have never performed better. The business expansion that officially began in March 1991 became the longest in history this month. As of March, the economy will have expanded in 200 of the last 208 months. It has been larger at the end of each of the last 17 years than at the beginning. Growth has exceeded 4% for 4 years running and in 5 of the last 6 -- well above the 2.5-3.0% the experts used to say is possible over time. At 4%, the unemployment rate is the lowest in 30 years, due mainly to a decline in the number of people who lost their last job. The federal budget deficit has swung into surplus, and stock prices have staged a nearly unprecedented 5-year ascent. It is safe to say that we have never witnessed a time quite like this before.

For awhile, people called this the Goldilocks economy -- not too hot, not too cold. I never liked that analogy, in part because at the end of the original version, Goldilocks was eaten by the three bears. I prefer to think of it as the Miller Lite economy -- great growth, less inflation.

Today's pleasant circumstances have become more widely known as the New Economy. This New Economy is very much for real, and that it will continue on its record-breaking course. But what exactly is the New Economy?

My definition of the New Economy is simply rapid economic growth with low inflation, made possible by increased competition and higher investment. Heightened competition has come from deregulation, which lowered barriers to competition between industries, and international trade agreements, which invited competition across national borders.

At the same time, massive investment in equipment has raised the productivity of the workforce and smoothed and lengthened the business cycle. In the last 20 years, annual investment in computer and related equipment has doubled … more than 8 times! Last year, U.S. businesses bought roughly 280 times as much computer and related equipment as they did in 1979.

This hi-tech infrastructure has made possible much more than email and on-line shopping. It has changed the way Americans do business. Historically, the swings in business fortune have been plagued by production bottlenecks in good times and amplified by inventory overhangs in bad times. The computer systems of the New Economy, however, have neutralized these distortions.

Today, businesses closely track demand and adjust production before imbalances occur. The Limited apparel retailer, for example, knows in real time which items are selling in which sizes and colors in which locations. It can adjust production half a world away accordingly, and either avoid what would be unsold goods or ramp up production of hot sellers and ship them to the U.S. within hours.

Across millions of American businesses, more careful process management has substantially lowered inventory carrying costs and eliminated the accelerator effect from inventory shortfalls or excesses.

The point is that our good fortune is not the result of good luck. It is the child of greater competition and innovation, mixed together with some pretty good economic policy. In other words, the New Economy is the sustainable result of our actions. As long as we continue to push the right buttons, the inevitable future downturns in the economy will be as infrequent and as mild as we have experienced in the past 17 years.

So where are we headed? I should start out by telling you that I try to follow the Cardinal Rule of forecasting, which is: if you give a number, don't give a date, and if you give a date, then don't give a number. There are those who say you can tell that economists have a sense of humor because they forecast interest rates to 2 decimal places more than a year into the future. I too find that rather amusing, and circulate my share of good jokes every month.

In fact, there is an old story about Albert Einstein. He dies and goes to heaven and comes across three people with varying IQs. The first has an IQ of 250. Einstein says, "That's wonderful. Let me tell you about my new theory of relativity." The second has an IQ of 150, and Einstein says, "Good. Lets talk about how to create world peace." The third has an IQ of 50. Einstein pauses and then says, "Tell me, where do you think interest rates will be a year from now."

With that in mind my forecast is that this is going to be another great year for the economy. But Alan Greenspan has declared war on growth -- a war he always wins -- and that means things will wind down considerably next year. Inflation will peak in the first half of this year at about 3% on the CPI. The Fed will raise rates perhaps three more times this year. Long-term interest rates have peaked for this cycle. And the great bull market in stocks has just about run its course. Let me address these in turn.

Growth

The pace of economic activity should start to slow later this year for three reasons.

First, much of growth late last year was borrowed from early this year. The increase in grocery store sales in December, for example, was the largest 1-month rise in modern times, as Americans apparently stocked up on bottled water, batteries, and what have you. The offsetting decrease in January was even larger. Other examples include the 14 percent increase in government spending and the massive build-up of business inventories in the fourth quarter.

Second, and more fundamental, the jump in the price of oil will cut into consumer spending power. Americans are relatively insensitive to changes in gasoline prices in the short-run. We fill up our gas tanks each week, regardless. So when the price goes up, we have less money to spend on other things.

This time, the negative effect of higher oil prices is tempered somewhat by the fact that the rise followed a large decline, that petroleum is much less important to our economy than even 10 years ago, and that the increase is still relatively recent, so that spending patterns have not been adjusted. My sense, however, is that the higher price of gasoline is just now starting to pinch.

The story with respect to interest rates is much the same. The increase in borrowing costs since 1998 has shut down mortgage refinancing activity, which had been turbo-charging consumer spending. But rates are only roughly back to where they were before the financial crisis struck, and credit remains readily available (just ask any of the Huntington officers in this room). The catch is that Alan Greenspan is determined to raise rates until he sees the economy give. More on that in a minute.

As this slowdown starts to unfold, a larger transition will be underway. The mix of activity will shift away from consumer spending, especially in interest sensitive areas like housing and autos, and toward production for export. This is already happening. As demand has revived in Asia and gained strength in Europe, industrial production in the U.S. has ramped up to meet the extra demand. I believe this will be a key area of growth in the year ahead.

As an aside, one of the pleasant byproducts of the New Economy is the appearance of the federal budget surplus. The flood of excess revenue has raised the prospect of saving Social Security and Medicare, paying off the national debt, and cutting taxes.

On the tax issue I like to quote Arthur Godfrey, who once said, "I'm proud to be a tax-paying American, but I could be just as proud for half the taxes." Unfortunately, we are unlikely to try this out any time soon for a couple of reasons, despite the various "risky tax schemes" being touted by presidential candidates.

For one, lawmakers of all stripes (now there's an image) agree on using the Social Security surplus to reduce federal debt dollar-for-dollar, at least until they come up with an alternative. If sustained, this strategy would eliminate federal debt held by the public within about 13 years. That would free up approximately one-quarter of a trillion dollars in annual interest payments. This stands a real chance of happening, but don't get too excited. Gross federal debt would continue to increase, due to mounting future liabilities in Social Security and other programs. Our left pocket would empty faster than our right pocket would fill up.

The non-Social Security budget is a different story, having barely made it into surplus last year. The nearly $2 trillion in cumulative surplus projected for the next 10 years is based on very realistic economic assumptions, but I'm not holding my breath. Alternative and more likely assumptions regarding federal spending reduce the projected 10-year non-Social Security surplus to zero.

And, although the revenue projections are based on realistic economic assumptions, they are very sensitive to actual conditions. A change in economic growth of one tenth of one percent, for example, would alter the 10-year surplus projection by as much as $200 billion.

The fiscal story is summed up by the kid in the cartoon, who says to his friend, "I just found out about Santa Claus and the tooth fairy. I'm afraid to ask about the budget surplus."

Inflation

A chief risk to this largely favorable economic outlook is inflation. Though, the risk is that an increase in inflation would be very damaging, not that it is very likely. Last year was the ninth straight year of low inflation, and 2000 will be the tenth. Inflation tends to stay high when it is high and tends to stay low when it is low. We are in a low inflation environment to stay, and if I am wrong, Alan Greenspan will see to it that I'm right.

Prices will rise faster this year than last, when they increased considerably faster than the year before. But oil is the lone culprit, and the faster pace of price increase has not spread broadly beyond petroleum. In fact, consumer prices excluding energy increased last year at the slowest pace in 35 years.

Oil futures prices forecast about a one-third reduction in the price of oil during the next two years. But even if the price stabilizes at recent levels, historical patterns suggest that inflation should settle down to about 2.5 percent by later this year.

What seems to have Greenspan so worried, though, is the risk that tight labor markets will force up labor costs and then prices. To this, I respond with a question. Can you get your customers to pay higher prices just because you have to pay your workers more? I rest my case.

The cost-push inflation story reminds me of the old Marx Brothers movie. Groucho is trying to convince the hotel clerk, who is attempting to shut down the boisterous party he is having in his room, that there is no one else there. Finally, he says, "Who you gonna believe, me or your own eyes?" I believe my own eyes. Since 1992 -- for eight years -- inflation has declined hand in hand with the unemployment rate. Last year, total labor costs adjusted for productivity increased a measly 1.5 percent.

The low unemployment rate is actually the result of low inflation, which has enabled the economy to operate at a much higher level.

Short-Term Interest Rates

But I don't make monetary policy. Greenspan does. And he does it with help from a group that just became a lot more hawkish on inflation. The presidents of the 12 District Banks rotate annually among 5 voting seats. One, who just rotated out, objected strenuously last year to the interest rate increase. Three, who just rotated in, have in the past either wanted to raise rates when the committee didn't or didn't want to lower them when the committee did.

Greenspan has explained himself with uncharacteristic clarity recently. At the height of the 1998 financial crisis, his message was: "I'm concerned, and I'm going to just keep lowering rates until things look better." His message last week was "I'm concerned, and I'm just going to keep raising rates until things look better."

I don't share the chairman's urgency, but it is hard to disagree with his approach. If inflation is in the process of picking up and the Fed fails to head it off, then the costs to the economy will be high. If inflation is not really picking up, as I suspect, but the Fed gradually boosts rates as a precaution, there might be some small short-term costs in the form of foregone economic activity, but there will be no lasting negative effect on the economy.

Long-Term Interest Rates

The big swings in long-term interest rates have always and everywhere been associated with the big swings in inflation. That is one reason, along with the Treasury debt buyback, that long-term rates have fallen, even as the Fed has been raising short-term rates. It is a sign that the market believes Greenspan will be able to keep inflation in check.

My forecast is that we have seen the peak in long rates, and that they are headed, over the course of this decade, back to normal. Normal levels are those that prevailed in the 1950s and early to mid-60s, because at that time inflation was negligible. Perhaps by the middle of this decade, the levels experienced briefly during the financial crisis in the summer and early fall of 1998 will be the lower end of the normal trading range.

Stock Market

Finally, what does all of this mean for the stock market. Well, my favorite stock market analyst, Will Rogers, used to say, "It's easy to get rich in the stock market. Just buy a stock and wait for it to go up. If it doesn't go up, don't buy it."

I say the great bull market is ending for the two reasons it has existed: corporate profits and valuations of those profits.

During the last 5 years, corporate profits have grown at double the 50-year trend. Stein's Law says that anything that is unsustainable will end. Corporate profit growth at this pace is unsustainable unless either profits claim an ever-increasing share of national income or economic growth increases substantially.

Corporations' share of national income is already near its all-time high, and it cannot go higher without reducing workers' share. Given the situation in labor markets, it will probably give some ground to workers.

With profits claiming a constant or falling share of national income, they can continue growing at the recent pace only if the rate of economic growth doubles. Even if we have permanently arrived in the Promised Land of the New Economy, growth will be only 1 or 2 percentage points higher, not 6 or 7.

The other factor behind rising stock prices has been increased valuations, or rising P/E ratios. Declining inflation and interest rates have made a given future stream of profits more valuable in the present. As long as inflation and rates remain down, P/Es can stay high, but there is little room for further increases, and much potential for declines, should inflation and rates even temporarily move up.

This does not mean that the bull market must give way to a punishing bear market. It simply means that the broad market cannot rise any faster on average over time than the rate of economic growth, which is about 6 percent. This is significant because surveys indicate that investors expect annual returns of well into double digits for the next decade. Something tells me that a lot of people will be retiring later or on less favorable terms than they have been expecting.

Conclusion

Let me close with a couple of quotes from John Kenneth Galbraith that might soften the blow of this market outlook. He once said that economists forecast because they are asked, not because they know. And he also said there are two classes of forecasters: those who don't know, and those who don't know that they don't know. It is in this sense only that I claim to be a first-class forecaster.