

The Economy and Financial Markets in the New Competitive Era

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I am pleased to have the opportunity this morning to talk about current conditions in the economy and financial markets and their implications for the future. My premise is that today's prosperity reflects the drive that began twenty years ago toward greater competition in the open market. The implication is that the economy and financial markets will continue to perform well as long as the forces responsible for this new competitive era remain in place.

By "New Era," I do not mean to suggest that the world is operating differently or that the game has changed. The game is the same, and so are the rules. But because of the steady emergence of competitive forces, the game is now being played mainly on the offensive end of the field. An excellent example is the economy of Michigan, which has gone from "poster child for the 'Rust Belt'" to economic juggernaut on the winds of free-market reforms.

I want to emphasize how competition is responsible for today's prosperity and bright prospects and then discuss the specific outlook.

Competition is the Key

First, the economy is in the best shape ever. The unemployment rate is about as low as it gets in peacetime. As a result, incomes have grown substantially, and consumer attitudes are as positive as they have been in thirty years. Corporate profits have doubled in just the last five years and corporate balance sheets are a financial fortress. Consumer price inflation has been about 3 percent or less in each of the last seven years. Interest rates are near very long-time lows, and stock prices have been rising rapidly as a consequence. Looked at another way, the economy does not suffer imbalances, such as high levels of debt or inventories, that make it vulnerable to disturbances, such major shifts in economic policy or a disruption in the supply of oil.

I attribute these favorable circumstances largely to the interplay among five factors that, over the last twenty years or so, have forged the new competitive era: (1) deregulation, (2) globalization, (3) innovation, (4) disinflation, and (5) good luck. The large reduction in marginal tax rates has also contributed to the economic boom, but probably not by fostering competition.

The thought of competition brings to mind something a little bit different for each of us. But a common thread among all visions of competition is "doing your best." And it is the same with the overall economy. The competitive environment breeds economic success because it spurs countless individuals and businesses to do their best.

The first competitive factor, deregulation, dates back to trucking and airlines in the 1970s and includes energy, financial services, and more recently, telecommunications. The electric power generating industry is up next. How has deregulation been beneficial? By removing legal or regulatory barriers to competition among firms within the targeted industries

and between those firms and firms from other industries. Deregulation spawned a drive for greater efficiency that has resulted in better quality goods and services for consumers, stronger corporate balance sheets, and some of the healthiest and most vibrant industries in the world.

Globalization has occurred through technological innovation, and trade-opening agreements. I would include here the extended period of peace, which created an environment conducive to free enterprise, and the collapse of Communism, which brought hundreds of millions of people several steps closer to the market. Technology has made it possible to operate far-flung multi-national operations that draw on the comparative advantages of the different regions of the world. The North American Free Trade Agreement and the latest General Agreement on Tariffs and Trade have removed some statutory obstacles to cross-border activity. This process of globalization has added an international layer to the new competitive era.

The most obvious form of innovation, the third factor, is the technological progress I just mentioned. The widespread adoption of computer-based just-in-time inventory control, for example, saves companies billions each year in overhead costs, reduces their exposure to shifts in demand, and appears to have reduced swings in overall economic activity. Fax machines and, now, the World Wide Web feed competition by quickly and inexpensively disseminating information about products, services, and prices.

The fourth trend is disinflation, or the downward trend inflation, that broke the inflation psychology of the late 1970s and early 1980s. Back then, consumers tried to buy ahead of the next price increase, thereby perpetuating the inflation spiral. Businesses passively accepted cost increases and were less vigilant about mistakes and missed opportunities, because they could be passed on in the form of higher prices to customers – all to the detriment of efficiency and economic growth.

Since then, the mentality has reversed. Consumers sniff at 30 percent off sales, waiting for the 50 percent markdown or heading to the outlet mall or to discount stores. Because people are no longer willing to pay higher prices without receiving greater value, businesses are forced to deliver quality to maintain market share and wring efficiencies out of operations to sustain profits. As businesses compete for workers, capital, and the best ideas, the fabric of the economy grows stronger.

The last element behind the sound economy is good luck. Individuals and businesses have fully adjusted to the bad luck and major policy shifts of the past. And we have experienced no new oil embargoes or poisonous economic policies. I hesitate to put too much emphasis on good luck, however. Coleman Cox said, "I am a great believer in luck. The harder I work the more of it I seem to have." I think to a significant extent, we have made our own good luck by pursuing economic policies and facilitating behaviors that have fostered competition and made the economy more resilient.

To top it all off, the factors behind the new competitive era feed on each other to make their combined impact greater than the sum of their individual contributions. For example, deregulation feeds disinflation, by forcing companies to hold the line on pricing, which in turn spurs innovation, as businesses strive to maintain profit margins by improving efficiency. Globalization begets more innovation by increasing the number of competitors, which also puts added downward pressure on prices. As long as this virtuous competitive circle remains in motion, we can expect our good fortune to continue.

The Forecast

Unfortunately, no one knows for sure where the economy and financial markets are headed. John Kenneth Galbraith, the Nobel Prize winning economist, put it bluntly when he said "Economists forecast because they are asked, not because they know." I don't pretend to know the exact course of the economy, but I do think we can draw some broader conclusions about the future from the current situation that are useful in investment and business planning.

In general, my forecast is that the current good fortune will last indefinitely. Now, I do not mean to suggest that everything will forever be right with the world, or even with the economy. Unknowable disasters doubtless lie ahead. My point is that the new competitive era both reduces the chances of unfortunate events and partly protects the economy from those that will inevitably occur.

For example, an oil embargo would be less likely today, even if OPEC still had the market power it had twenty-five years ago. The 1974 oil shock was brought on in part by unsound U.S. monetary policy. By permitting inflation to rise in the late 1960s and then severing the dollar's link to gold in the early 1970s, U.S. policy substantially eroded the real value of the dollars received by oil exporting nations in exchange for oil. The sound monetary policy of recent years guards against a repeat. But in the event that OPEC for some reason struck again, the dismantling of petroleum price controls in the early 1980s and the increased flexibility of the U.S. capital stock and labor markets developed since then, would greatly soften the blow. A recession might even be avoided.

My specific forecast is for uninterrupted economic growth at the recent pace of approximately 3 percent – maybe a little slower, maybe a little faster – through at least next year. I expect inflation to remain in the recent 2-3 percent range, with a greater possibility of a lower than a higher rate. And as a result, I expect that interest rates will remain in the long-term slide that began about sixteen years ago. In the near-term, I expect short rates to wobble around current levels and the government's 30-year bond yield to fluctuate in the 6-7 percent range. This will continue to be a favorable environment for the stock market. Let me address each one of these forecasts separately.

Economic Growth

The hallmark of the current period of economic expansion is the tremendous surge in investment in new equipment by businesses. Purchases of equipment amounted to just one-sixteenth of annual economic activity six years ago, but has generated nearly one-third of all economic growth since then. Business are responding to the wide availability and affordability of capital and the competitive necessity of continually improving efficiency. There is no sign of an end.

The main sustaining force behind growth has been consumer spending. Consumers have contributed only slightly more than their share during the expansion, and less than that in recent years. But the consumer sector comprises two-thirds of all economic activity, so that even average growth in consumer spending pulls the rest of the economy along. With the unemployment rate at a long-time low and income growth up, with consumer confidence at long-time highs and credit widely available, the recent contribution from consumer spending to overall growth is sustainable. Together, investment in new equipment by businesses and

spending by consumers comprise three-quarters of the economy, but have accounted for almost all growth during the last six years.

Another way of looking at the growth picture is that the trend in economic growth has been a stable 2.7 percent for six years. In the past year, the economy has expanded by 3.5 percent, and in the past nine months by 4.3 percent. The various wiggles around the trend are largely the result of a series of random shocks, such as the changes to the tax structure in 1990 and 1993, the shifts in monetary policy in 1994 and 1995, the government shut downs in 1995 and 1996, unusually severe winter weather in a couple of years, and a few major strikes. Growth near 3 percent appears sustainable. But these are just numbers. In the broadest sense, they equate to "business as usual."

It is true that the expansion is getting old. The current period of economic growth officially began in the spring of 1991, and has now lasted for 78 months. It is the fourth longest period of continuous economic growth on record, and exceeds the post-war average by almost two and a half years. In December, it will move into the number three spot. If growth continues through December of 1998, the expansion will become the second longest, and in February 2000 it would be the longest ever.

To put this in perspective, in human terms, the expansion is about 118 years old. It will have to reach 162 to set a new record. The months of expansion are translated into human years by dividing by the post-war average for expansions and multiplying by the average life expectancy of humans at birth in 1991 – the year the expansion started. Fortunately, researchers have decided that the probability that an expansion is about to end does not increase as the expansion goes on. In other words, expansions do not die of old age; they get murdered by some calamity. And the economy is rather insulated – though not immune – from such a disturbance, and none have occurred recently or are on the horizon.

One slight cause for concern – and I emphasize slight – is the warning from a long-range recession indicator with an amazing record. For the twenty expansions this century, there is a very strong correlation between the lengths of the expansions and the lengths of time during which short-term interest rates decreased at the outset.

The prime rate reached its low point 35 months into the current period of growth. If the average historical relationship had held exactly this time, a recession would have begun in June 1996. That is shown by the solid circle toward the middle. The asterisk shows where we are now, which is still within the normal variation around average, but headed for the upper limit. If there is anything at all to this analysis, it suggests that time is running short for economic growth.

A more precise way of measuring the risk of an upcoming recession, which takes into account the historical variation in this relationship, says that there is a 95 percent chance that growth will end by next June. Before we jump to conclusions, though, it is worth considering a statistics lesson that I have learned through experience. Even if the odds are 95 to 5 against you, there is still about a 50-50 chance of being in the 5 percent.

What should we make of this analysis? It is a little short on both data and theory. But it is based on the work of two prominent researchers – one of whom pioneered the measurement and analysis of the business cycle. And, it seems to work! My conclusion is that – for the first time in years – the economy is beginning to face some distant, but very real, business cycle risk.

Where might the threat lie? A leading candidate is the rapid deterioration in consumer finances. Growth in installment credit outstanding – mainly for cars and credit cards – topped

15 percent at an annual rate in 1994 and 1995, as consumers leveraged the improved economic outlook. As a result, monthly payments of principal and interest on consumer debt, including auto leases, have increased to a record share of after-tax income. The higher debt repayment burden has been offset in part by a decrease in liabilities of households, compared to financial assets, back down to the lowest level in a decade. But consumers are clearly experiencing financial stress. Late payments on credit cards increased to an all-time high last year. Although still short of the record, overall consumer loan delinquency has increased sharply since 1994. Personal bankruptcies set a record last year, and they continue to increase.

I expect that the deterioration in consumer finances will continue, that it will exacerbate the next recession, and perhaps hobble the subsequent expansion. But I do not expect consumer debt to precipitate a downturn by itself or to materially reduce the rate of economic growth in the meantime. Despite the signs of stress, the run-up in indebtedness is a normal feature of the economy. The willingness of consumers to accumulate debt reflects an optimism borne of strong labor markets and appreciating financial assets that raise expectations of future incomes that will be sufficiently to pay back the debt.

What might defeat such expectations? A perennial wildcard is a conflict somewhere in the world that (1) entangles the United States, (2) obstructs access to markets abroad, or (3) interferes with the supply of a key raw material. There are, as always, many potential trouble spots, but none appear more threatening than usual right now. Another source of potential instability is a major shift in economic policy at home. But these days Washington is tinkering, not transforming. Monetary policy is on target. Tax policy changes consist of a few new holes in the existing code. Spending policy changes amount to higher Medicare premiums and more price controls on doctors and hospitals. People are talking about reforming the tax code and the Medicare and Social Security programs, but fundamental changes are not imminent. While policy tinkering leaves much potential good undone, it also avoids far-reaching changes that – while positive in the long haul – could destabilize the economy in the near term. No one would prescribe paralysis in policy making as means of promoting economic stability, but it does have at least this one positive side-effect.

Inflation

The most underrated factor responsible for the solid economy is the low and stable rate of inflation in recent years. Inflation increases real interest rates and distorts the signals that coordinate economic activity. Inflation weakens the foreign exchange value of the dollar and interacts with the tax code to transfer resources to the public sector and away from the more productive private sector. People waste time, effort, and money protecting themselves against the effects of inflation. Inflation makes planning and decision-making more difficult. And inflation can lead to recession by forcing the central bank to tighten monetary conditions. My forecast is that inflation will stay near 3 percent or less for the eighth consecutive year next year.

Why has inflation stayed so low while the economy has been so strong and the unemployment rate so low? Old-fashioned economic theory says that rapid economic growth in an economy that is already running close to its potential creates inflation. There exists some level of unemployment, the thinking goes, beneath which firms are forced to raise wages to keep or attract workers. To cover the higher costs, firms then raise prices.

The world may have appeared to work this way at one time, but it does not. If it did, why would firms wait until labor costs increased to raise prices? Is there anyone here this morning who can raise prices whenever they want? Profit margins are so wide and competition

is so intense that those who try would have their competitors thank them for the additional market share.

How can it be that low inflation is coexisting with a strong economy and low unemployment? Actually, it is the same reason that both inflation and the unemployment rate were high in the 1970s. High inflation undermines economic growth and raises the unemployment rate. Low inflation promotes economic efficiency and growth and lowers the unemployment rate. Rather than being a harbinger of rising inflation in the future, the low unemployment rate is the prize from squeezing inflation out of the economy. Unless the Federal Reserve implements an inflationary monetary policy, inflation will stay low, regardless of the level of unemployment.

Milton Friedman put it best. "Whether higher growth leads to more or less inflation depends on what produces the higher growth." He went on: "If the higher growth comes from easy monetary policy, it will indeed tend to lead to more inflation. [I]f ... higher growth is produced by greater capital investment, technological improvements, deregulation, increased flexibility of prices, [or] increased competition, ... such growth will lead to lower inflation." The current situation fits the second set of conditions better than the first.

If economic growth and unemployment are not good gauges of the stance of monetary policy, what are reliable measures and what do they say about the prospects for inflation? One is the real, or inflation-adjusted, federal funds rate – which is the rate that banks pay to borrow from each other overnight and which is controlled by the Federal Reserve. At 3 percent or more, the rate is currently well above its long-run average of about 2 percent, so by this measure, policy has not been inflationary.

Credit growth is an excellent indicator of inflation pressures, not having missed a turn up or down in inflation in the last twenty-five years. Credit stabilized early this year, after decelerating by more than half from early 1995, suggesting additional downward pressure on inflation. Inflationary monetary policy tends to show up early in commodity prices, and here again, the trend remains down. In particular, the drop in the price of gold during the past year indicates a lack of inflation pressure. Finally, the foreign exchange value of the dollar is strengthening, rather than weakening, as it probably would be if inflation were on the way.

Inflation is not gone forever. It will return when the Federal Reserve holds short-term interest rates too low for too long. The change in the psychology and behavior of consumers and business people since the early 1980s and the credibility earned by the Fed in recent years make it more difficult, though not impossible, for high inflation to return. My guess is that inflation will stay low – perhaps surprisingly low – for the foreseeable future.

Interest Rates

Regarding the outlook for short-term interest rates, there is likely to be little action. The Fed has policy just about right. The possibility of another small upward adjustment to the federal funds rate later this year or early next exists, but the odds are not high enough to include that in a specific forecast. In fact, the funds rate might be a little on the high side right now. But the Fed will not lower short rates soon, unless and until the economy appears to weaken and the unemployment rate increases.

The big swings in long-term interest rates have always and everywhere resulted from big swings in inflation. Therefore, the 30-year government bond yield should remain in the recent 6-7 percent range through next year. The downward trend that took hold in 1981 remains in

place, and bond yields could eventually decrease by another full percentage point. The decline will occur gradually, however, because it requires further reductions in inflation expectations, which occur only slowly over time. The yield will bounce up to the top end of the range when inflation concerns surface, and fall down to the low end of the range when the economy appears to weaken. But these gyrations will prove temporary until investors expect inflation to stay down for good. Speculation about short-term twists in interest rates is just that – speculation. What I think we can say with some certainty is that interest rates will fluctuate around a lower average than in recent years for quite a while – and perhaps with a slight downward trend – because of low inflation.

The Stock market

Finally, what is in store for stocks? Mark Twain warned us when he wrote: "October. This is one of the peculiarly dangerous months to speculate in stocks in. The others are July, January, September, April, November, May, March, June, December, August, and February." Actually, the market has performed the worst on average in September, but random short-term fluctuations are not relevant for investing. Longer term, the greatest demon for stocks has been inflation. And as long as inflation stays down, the bull markets in stocks will be longer and larger than the inevitable, and dare I say unpredictable, bear markets that intrude. Unfortunately, while low inflation is good for the market, it is falling inflation that really gets stocks going, and most of the decline is behind us.

Warren Buffet explains that falling inflation is good for stocks, because they are essentially perpetual bonds with fairly constant coupons. The value today of a given stream of expected earnings increases as falling inflation reduces the discount factor. And, as I argued earlier, earnings will not be given when inflation is low; they will tend to rise, because of the positive effects of low inflation on the economy. So low and falling inflation is a double positive for stocks.

The historical record demonstrates the inverse relationship between inflation and stock returns very clearly. In the eighty-six years since 1870 in which inflation has been 3 percent or less, the total return on large cap stocks has averaged 13.0 percent. In the other forty years, during which inflation exceeded 3 percent, the total return averaged half as much – 6.4 percent. After adjusting for inflation, the difference is even more striking: 13.4 percent compared with a negative 0.8 percent.

The business cycle has not been repealed. Earnings will go down as well as up, and stock prices will move accordingly. My point is simply that, as long as the Federal Reserve keeps inflation low, stock prices will rise over the long-term.

Conclusion

It is tempting to think that we have stumbled upon a new, golden era. But I do not believe that. Today's prosperity is largely homemade – built over the years through the five factors that forged the new competitive era: deregulation, globalization, innovation, disinflation, and, yes, good luck. As a result, the current favorable conditions are sustainable, though not perpetual. No doubt, bad things will happen. But as long as we embrace these trends, the economy will tend to steer back to the right track.