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THE ECONOMY AND POLICY AS 1993 BEGINS

Prepared for the Joint Economic Committee
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The economy continues to expand as we enter 1993. In contrast to the many gloomy forecasts and interpretations of statistical data, that captured the headlines, last year, this growth cannot be explained as mainly the result of special, non-repeating factors. "Special factors" did not work one way; they include the cutback in defense spending which has worked to slow the recovery.

Your letter describes the recovery as "anemic". I would not use that term to describe recent performance. Preliminary data for the second half of last year show a growth rate of 3-3/4%, well above average growth for the U.S. economy. For 1992 as a whole, growth was slightly above the historical average of 2.8% with only one quarter below the average rate. This performance hardly justifies the mountains of paper that have been used to describe the economy as stagnating or anemic or to forecast second and third "dips" into recession that, we now know, did not occur.

Of course, the economy must grow at above average rates during recoveries to compensate for falling output during recessions, so we should not be complacent about the recent record. But we should also avoid additional short-term stimulus based on faulty interpretations. Policy in 1993 should concentrate on encouraging sustained growth and productivity to continue the very promising improvement in productivity achieved during this recovery.

There are at least four reasons why the recovery has been slower than the postwar average. First, many of the earlier, more rapid cyclical expansions laid the seeds of future inflation followed by disinflation and recession. The main reason: excessive money growth in the early quarters of recovery later spilled over into
despite recessions in many overseas markets. Lower inflation reduces the tax on durable capital that results from the failure to index depreciation allowances. If low inflation is sustained, it will be a lasting benefit for capital-intensive industries. It is beyond logic to suggest that the government should offer firms an investment tax credit while raising the hidden tax on capital by increasing future inflation.

The best available evidence suggests that long-term growth is not changed by the slow pace of recovery. The difference between the recent 2-3/4% or 3-3/4% and a more rapid 4% or 5% recovery will be made up in future years. A durable recovery and prolonged expansion is important for making up the difference. Future income is not equivalent to current income, of course, so there is a cost to slow recovery. But the cost is only a small fraction of the difference between 2-3/4% and 4% growth for a year or two. And if inflation continues to decline, the loss will be compensated in whole or part by the benefits of lower inflation. And low inflation will extend the years of expansion.

The Role of Monetary Policy

Some critics of the Fed, and some members of this committee, have been critical of the slow growth of a particular broad measure of money known as M2. In the past, M2 growth has been a reliable indicator of long-term growth of nominal GDP. There is no reason to believe this long-term relationship has changed.

However, the short-term relation between the growth of M2 and the growth of nominal GDP has always been subject to relatively large departures from the long-term relation. Forecasts of near-term spending based on M2 have often been subject to relatively large errors. The same is true of the more complex interactions in large-scale computer models containing hundreds of equations. Indeed, all short-term economic relations are subject to large errors. Few forecasters predicted the jump in GDP growth in the second half of last year. Until November, some were still revising downward their forecasts and predicting a return to recession in the 4th quarter. It would be a mistake to give credence to the cacophony from these croaking Cassandras. We should choose policies that promote sustained growth with low
GROWTH RATE OF SPENDING AND DOMESTIC MONETARY BASE (GDP)

GROWTH RATE

□ Spending □ Domestic Base six quarters earlier
growth is the necessary condition for sustained growth of real incomes and living standards. During the postwar expansion, the service sector has been by far the largest source of new jobs. This will continue to be true. Consider this: the Federal Reserve's index of manufacturing production increased from 18 in 1946 to 110 in 1992, but the number of production jobs in manufacturing are no different now than in 1946. Most of the 67 million jobs created since 1946 are in the service sector.

Productivity growth not only raises standards of living, but the historical record suggested to Simon Kuznets earlier, as it has to me recently, that over long periods economic growth narrows the spread of the income distribution. Everyone gains from growth but lower income-earners gain relatively more so that income differences narrow slowly but steadily. In the 1980s, this long-term relation between growth and income distribution was disrupted, mainly by changes in returns to education that worked to widen the income distribution. I believe the long-term relation will continue to hold. To raise real incomes and spread the benefits widely, we should choose policies that have long-term benefits. I make some suggestions below.

The opposite side of increased productivity growth is the slower growth of employment during the recovery to date. When combined with the loss of jobs in the defense and defense-related industries, we get below average growth in employment and the highest unemployment rates concentrated in the states with larger defense related activities. For 1992, the average unemployment rate in the ten states with heaviest concentration of defense spending was considerably higher than unemployment in the other 40 states.

POLICIES FOR GROWTH AND PRICE STABILITY

Much current discussion suggests that the most urgent necessity is to reduce the deficit while increasing spending to provide short-term stimulus. I do not share that view. The recovery will continue without additional short-run stimulus. The reported deficit is poorly measured and overstated. The budget deficit is not as much of a problem as is widely repeated.
larger amounts than in any previous period. The most favored nation principle that started here in the U.S. Congress, and multilateral tariff reduction led by the U.S., were major forces producing this achievement.

Now, many in this same Congress want to turn back toward protectionist policies that are costly to us and destructive of the rules of open trade. They urge policies that are inimical to growth and that lower living standards here and elsewhere.

Much of the U.S. economy is in a strong, competitive position. Unit labor costs in many industries have fallen far below comparable costs abroad. This is the time to benefit our own economy and the world economy by adopting rules for freer and more open trade and by strengthening enforcement through GATT.

Lower payroll taxes would encourage employment. A higher minimum wage and more mandated benefits raise the cost of employing labor and reduce employment.

Avoid, the temptation to develop an industrial policy. The private sector is not always right, and the public sector is not always wrong. What matters is the batting average over years or decades. Be happy that you did not subsidize investment in the Supersonic Transport, HDTV, the fifth generation computer and many other well-advertised projects that were at one time or another claimed to be critical for our prosperity. Productivity growth occurs in both old and new industries. Steelmaking, tire making, bread baking, and other industries are as capable of increasing standards of living as the more talked about new industries. Beware of the Marxist fallacy, pushed by proponents of protectionist policies, that progress is limited to the so-called “leading sectors”.

The policies I urge on you are policies for growth and higher living standards, not short-term stimulus. If you remove barriers to trade, avoid costly and burdensome regulation of commerce and industry, encourage improvements in the quality of education for all, reduce taxes on saving and investing, and insist that the Federal Reserve maintain the near price stability, that is now ours, growth and living standards will continue to rise as they have throughout our history. And jobs will increase and opportunities expand, as they always have.