Weekly Perspectives

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A Weekly View of Global Economies

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In the past two columns we examined the impact of technological change and trends in labour market conditions on the potential growth of the US economy. Based on the evidence, we adopted the view that future prospects are likely to be less promising than the experience of the past decade. This has important implications for monetary policy, corporate profits and exchange rates.

Alan Greenspan, the former chairman of the Fed, was smart enough to recognise the changes taking place in the US economy during the nineties and their impact on enhancing productivity growth. Some of the hype by others about a "miracle" was exaggerated, but Greenspan's view was essentially correct and he drew the appropriate policy conclusions. There was no need to tighten-up monetary policy to head off non-existent inflationary pressures.

Adherence to orthodoxy would have necessitated tighter credit conditions to keep the unemployment rate from falling below the so-called natural rate, - - a decline below that level was supposed to trigger higher inflation. But, when there are changes taking place in the real world, it is best to analyse what's actually going on and forget about orthodox prescriptions based on backward-looking models.

Greenspan didn't get everything right, but on this issue he did the correct thing. His successor, Ben Bernanke, who has yet to complete a full year in office, may lack the flexible turn of mind demonstrated by his predecessor. There are reports that he is in favour of a more structured approach to policy making. This would be in keeping with his strong academic background but, so far, there has been little evidence of any change in the way policy is determined.

If Greenspan had implemented the wrong strategy in the nineties, by conducting a tighter monetary policy than was warranted by the real changes taking place in the economy, he would have lowered the growth rate below what was achievable. However, the underlying forces would have been strong enough to prevent a major decline in the growth rate.

In practice, the relatively loose policy that was actually implemented did not generate inflationary pressures either, because of the high productivity growth rate. The structural conditions were so favourable that policy errors in either direction would not have been severely punished

If the view is correct that the potential growth rate of the economy is now lower than was the case previously, then the Fed will be operating in a more challenging environment. In conducting a relatively loose monetary policy, there is a risk of over-stimulating the economy and generating inflationary pressures. On the other hand, if they tighten too much, the slowdown in growth will be more noticeable with the economy operating below an already low ceiling.

Essentially, the margin for error is narrower now than it was in the past. Judging from comments made by Bernanke, it appears that he is still optimistic about the technological input to productivity growth. The implication is that he is likely to run a relatively looser monetary policy to get the economy close to the potential growth rate, which he estimates to be quite high. If his estimate is wrong then we will experience over-stimulation of the economy and the rise of inflationary pressures.

There are nagging worries among some analysts that US monetary policy generally has a bias towards furnishing excess liquidity to the system. This was a factor in the recent sell-off that the dollar experienced, particularly against the euro and sterling. Naturally, Bernanke was quick to come out with soothing statements that the economy was showing strength, and by implication there was no need to cut interest rates.

However, leading indicators still point to a loss of momentum in the economy. As for the important housing sector, there are few signs that it has bottomed. Many Fed notables have come out with statements to the effect that they see a turnaround in housing, but it is hard to see any sign of this in the data. Housing statistics on permits, starts and a slew of other stats are still pretty gloomy.

The Fed does not determine exchange rate policy, the Treasury does that, but they are both keen to prevent further sharp falls in the value of the dollar, which will substantially complicate the task of managing a so-called soft landing. Taking a look at a longer time frame, the hot economy of the nineties, which was registering high productivity and profit growth was a magnet attracting substantial inflows from aboard that supported the dollar's value.

If our base-case forward looking scenario for the economy is broadly correct then one of the planks upholding the value of the dollar is less solid than before. Relative productivity and profit growth rates may not be high enough to induce large capital inflows. There are, of course, other factors that determine the exchange rate.

Looking at the profit picture, the high pace of technological change and capital spending have been main drivers of profitability. But business capital spending is increasing at a slower rate than in the era of major high-tech innovations.

Corporate America has been very adept at squeezing out higher earnings by improving efficiency and engaging in global outsourcing. However, the labour market is tighter, and this is showing up in low unemployment rates, even as the average monthly increase in payrolls is lower now than it was previously.

Non-farm unit labour costs have been rising sharply. At the same time, revenue growth is set to decline in conjunction with a slowing economy. Margins may come under pressure. Also, the profit share of GDP is the highest it has been since the sixties. It would be a challenge for it to rise to a higher level.

In addition, we should be on the lookout for creeping protectionism. It is possible that global outsourcing may come under greater threat in a slow-growing economy, with a less business-friendly Congress controlled by democrats. Popular pressure against "unfair" trade and business practices may increase.

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