

# SECURING THE FUTURE: ECONOMIC ACTIVITY, LOW INFLATION, AND MONETARY POLICY

—Craig S. Hakkio

U.S. economic performance has been very strong recently. But the economies of nations throughout the world are undergoing such rapid change that policymakers everywhere, particularly within the Federal Reserve, must understand the forces of globalization, financial innovation, and advancing technology. And they must appreciate how these forces are reshaping our world. An essential element in developing this understanding is the research and policy advice provided by the staffs at Federal Reserve Banks.

## U.S. ECONOMIC PERFORMANCE AND MONETARY POLICY

To date, the U.S. economy has coped quite well with these changes. By almost any measure, the U.S. economy performed at an exceptional level last year. Current estimates show that real GDP grew 3.7 percent in 1997. Reflecting this strong growth, the unemployment rate fell to 4.7 percent by yearend. At the same time, inflation declined over the year, with the consumer price index rising just 1.9 percent and core CPI up just 2.2 percent.

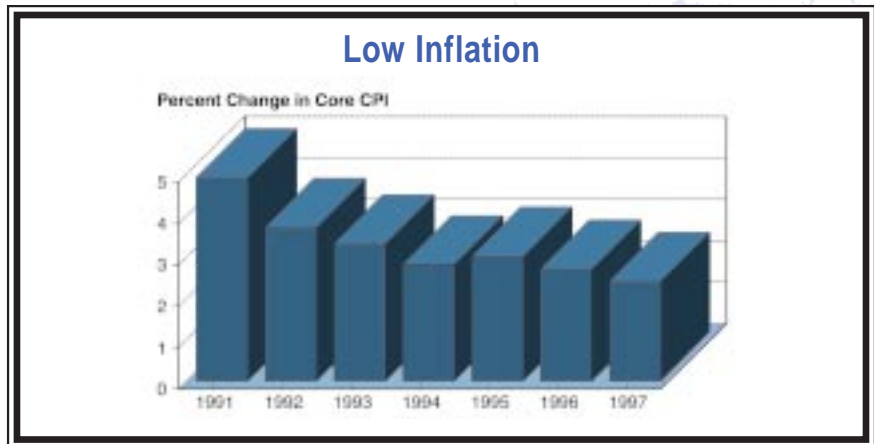
Virtually all sectors of the economy performed well last year. Brisk consumer spending, faster inventory accumulation, and a surge in investment spending helped sustain the

nation's economic expansion in 1997. Net exports represent the only sector that did not contribute to the nation's strong performance.

While it is tempting to focus on the strengths of 1997, it is illuminating to consider the current expansion as a whole. The expansion began seven years ago in 1991 and has been remarkable in that as the economy has grown, both inflation and unemployment have fallen. After averaging 5.8 percent in the 1980s, core CPI inflation fell from 4.4 percent in 1991 to 2.2 percent last year, the lowest level in almost 35 years. And after averaging 7.3 percent in the 1980s, unemployment fell from 6.8 percent in 1991 to 4.6 percent in November of last year, before inching back up to 4.7 percent in December. The last time the unemployment rate reached such low levels was in October 1973.



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*The trend in core CPI, which excludes the volatile food and energy sectors, is unmistakable. While prices continue to rise, they are rising at a slower, far more steady rate.*

## ECONOMIC RESEARCH AT THE KANSAS CITY FED

The Bank's Economic Research staff plays an important role in helping President Tom Hoenig prepare for his participation in Federal Open Market Committee (FOMC) meetings. Made up of the seven governors of the Federal Reserve Board and five of the 12 Reserve Bank presidents, the FOMC meets eight times a year to determine the appropriate monetary policy stance. By law, the FOMC is charged to oversee open market operations, the principal tool of national monetary policy. The FOMC also directs opera-

An important contributor to economic activity during this expansion has been strong investment. During the expansion real business fixed investment has grown at an average rate of 6.9 percent annually, while real GDP has grown 2.8 percent. As a result, in the second half of 1997 real business fixed investment as a share of GDP was 12.1 percent, the highest level in the post-World War II period.

While many factors have contributed to the strength in investment spending, the current low inflation environment is one of the reasons investment demand has been so strong throughout the expansion. Economists have long warned of the harmful effects of rising prices. Inflation interferes with the efficient allocation of resources by confusing price signals. This confusion is harmful because it increases uncertainty and reduces economic welfare.

***For these reasons, the low inflation environment of the 1990s has undoubtedly helped boost investment spending, increased productive capacity, and enabled firms to meet increased demand without raising prices.***

History has shown that there is less volatility in low inflation times than in higher inflation times. The associated reduction in inflation uncertainty has surely been a positive factor for investment in plant and equipment during the current expansion. Increased investment

spending, in turn, has enhanced the economy's capacity to produce goods and services, hire more workers, and raise standards of living.

Low inflation also reduces the distortionary effects on the tax code. Inflation increases the effective tax rate to firms and households in many ways. For example, inflation reduces the value of depreciation allowances, thereby increasing the effective tax rate on businesses. For individuals, inflation causes the taxes levied on the nominal capital gains and nominal interest income to rise. But low inflation decreases the effective tax rate on capital income and thus encourages capital formation and long-term economic growth.

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tions undertaken by the Federal Reserve in foreign exchange markets.

The Kansas City Fed's economic research area includes professionals specializing in a number of relevant fields, including monetary policy and macroeconomics, international economics, financial markets and institutions, and regional economics. The economists also advise the Bank's management and directors on economic developments and monetary policy issues. The key to providing effective advice is to ensure the Bank's research staff is a leading source of innovative research on issues relevant to the Tenth District and the Federal Reserve as a whole.

investment spending, increased productive capacity, and enabled firms to meet increased demand without raising prices. These conditions should help prolong the current low inflation environment.

Investor confidence in U.S. financial markets is another factor contributing to the long economic expansion. This confidence is a reflection of the country's macroeconomic and financial stability, which, in turn, is partly attributable to effectiveness of Federal Reserve monetary policy.

By continuing the move toward low inflation, the credibility of U.S. monetary policy has been enhanced. Given the many benefits of price stability, it is crucial that the Federal Reserve maintain a vigilant policy stance.

One element of this effort is that monetary policy must remain forward-looking because policy actions affect the economy with long and variable lags. For example, in 1994 monetary policy was tightened despite some evidence of slack in the economy. The Federal Reserve acted based on its forecast that rapid growth would be eliminating the slack and ultimately produce inflationary pressures. Monetary policy was also forward-looking in 1995 when the Federal Reserve reversed course and began to ease policy.

Monetary policy actions such as these have contributed to the strong performance of the economy. In addition, they have helped sustain the confidence of investors in the Federal Reserve's commitment to keep inflation low while maintaining a balanced policy stance.

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