

Rates and Inflationary Pressures, Real or Imagined: The Reality of Our Time Working Paper Sent to Chairman Greenspan in July 2000

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Between 1999 and June 2000, some of us watched the activities of the Fed with interest and commended the body for the brilliant job it had done over the years. However, the trend that we were witnessing in the economy as we came into 2000 and the measures that the Fed was using to tackle what it saw as potential economic problems caused a few economists to question whether the Fed was not overplaying its hands. One questioned whether or not there was a strong rationale for continuously raising interest rate at this time in order to “cool down the economy or stop it from overheating,” blaming it on surging inflationary pressures.

Business cycles in the economy were taught in macroeconomics classes and we had first-hand experience of these economic phenomena. Until now, it made economic sense to watch money market rates hawkishly and manipulate them continuously to reverse or avert the adverse effects of these cycles. I sincerely believe that we should be more prudent than ever before in tinkering with these rates, especially at this time in our economic growth. Let us look at some evidences that may support this premise.

In the 1970s and 1980s, the business cycle phenomenon was still a problem that economists contended with and tried to forecast. At that time, and years before, the economy of the United States was still pretty much isolated from the rest of the world. The economic indicators were made up of factors that occurred within the “family.” The borders of the country essentially marked the extent to which we were able to expand. It was as if we were in a box and when we moved to and hit the side of that box, we “recoiled” inward and started over again to walk. This example of inward and outward movements in the box came to represent our business cycles. The economy expanded until it hit the end of the box and contracted. Then the “walk” would be

repeated over and over again. We were then able to predict with a great deal of accuracy when these expansions and contractions were going to occur.

Economic activities in developed economies of the world have gone through revolutions. Some of these have been transferred to developing economies, where they are still in their crude forms. These include agrarian revolution, industrial revolution, service revolution, and now information (technology) revolution. Each event produced some upward bumps in the economy and economic activities. They brought hitherto unprecedented prosperity. But the economies of developed nations were still working in virtual isolation. Each was enclosed in its box. The lid was lifted only when it was beneficial to the boxed economy to do so.

In what seems to be, in our lifetime at least, the final revolutionary episode, information (technology) revolution has come to be the only one that has impacted the entire world simultaneously. For example, agrarian revolution began in England and gradually made its way to other parts of the world. It is still going the round today in many developing countries. The information age is impacting the world with unprecedented simultaneity, meaning that an individual can do business in the United States in a matter of seconds from anywhere in the world, such as Costa Rica, where I was two weeks ago.

In the 1990s, the Clinton Administration began pushing down the sides of the “box” that had protected the economy for so long, thereby exposing it to outside influences. This was achieved through the opening up of trade with other economies. Following our box example, the economy can now walk to what used to be the end of the box and keep on going. It is no longer confined. Apart from physically negotiating trade with other countries, the Internet is regularly used to buy and sell commodities within and outside the borders of this country. Outside investors are all the time buying U.S. stocks as a way to hedge their capital in a strong economy. Once the economy

begins to slide, these outside investors would look elsewhere and that may not bode well for this vibrant economy. What of the fear that shrinking labor supply in the area of information and/or technology would lead to a rise in labor cost, which would rein in inflation? Again, it appears that we are not calculating the pool of labor within the country that could be brought in to offset the apparent shortage. This would have been a recipe for disaster if a build up of inventory in the manufacturing sector had compounded this labor crunch. Information technology has improved productivity and opened the way for some workers to work for two or more employers at the same time from the confines of their homes. In the past, when we were in the box described above, the recent increase in fuel prices would have led to significant increases in prices and, in turn, in inflation. But, this has not been a serious problem. In fact, the on-going decrease in fuel prices would even lead to the lowering of commodity prices, which would further dampen inflationary expectations.

In early 1999, I told my banker that no matter what the Fed did with money market rates, it was not going to affect the stock market in a very significant fashion. It was then my view that the manipulation of money market rates should be done less regularly to allow the economy to grow to accommodate the age in which we live. There are many economists who share this view but are not among those who are regularly heard making predictions that are no longer relevant about the economy. On the other hand, there are others who had done excellent jobs predicting economic cycles in the past, but who are having problems accepting the fact that things have changed and they can no longer predict it with previous accuracy. If they can, even for once, see a stock market crash, leading to a reverse in the booming economy, they would feel a great vindication and pride. Fortunately, the Malthusian doomsday prediction has not materialized.

The world population is still growing but there is no sign that we are going to run out of food and land any time soon.

Just recently, Microsoft was added to Dow Jones Industrial. This move took into consideration the reality of our time. Could this be a lesson for economic and/or inflation predictors? Are we still using the old economic indicators to predict the economy? If that is the case, maybe the time has come to take into account the new factors that are presently impacting our economy in very significant ways. Even if we cannot incorporate these as inputs into the statistical framework, can we, at least, consider them in making our final future economic pronouncements? Some of the influences on our economy, which changed the way we should be looking at things include, external trade and other market forces (imports), capital inflow/outflow, Internet access and trade, and accessibility to and knowledge of computer technology. There may be other indicators, which do not give ready indicator points that could be added to this list.

Finally, I would ask that the Fed allow this great economy to expand because the times demand it and there is still room for expansion. Things are no longer what they used to be. We are in a new revolutionary age and cannot forcefully reverse a historical trend. What we need is to open up more markets to absorb our products, whether they are agricultural, manufactured, or information (technology). Such a measure would offset the much anticipated or imagined increases in labor costs and inflation. At the same time, developing economies should be encouraged to expand and become more economically viable, socially attractive, and environmentally friendly. The balance among the economic, social, and environmental factors, as well as an awareness of and access to information (technology) in these countries, would lead to further expansion of the US economy without inflation. There will be no need then to

continuously raise interest rates to stifle expansive economic activities. Unlike the 1980s, the national economy does not depend on much borrowing for expansion.