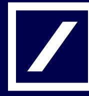
Deutsche Morgan Grenfell

US Equities Research

Portfolio Strategy Service

#32 The Undefeated Forces Of Deflation

#33 Productivity Must Be Booming

#34 Populist Capitalism And Other Wildly Bullish Themes

#35 The Economic Consequences Of The Peace

Topical Study #36

Conference Call With ALAN BLINDER

June 2, 1997

Dr. Edward Yardeni
Chief Economist

E-Mail: yardeni@ix.netcom.com
Web Site: http://www.yardeni.com/yardeni/

Yardeni: About a week ago, Professor Alan Blinder and I attended the quarterly meeting of TIME magazine's Board of Economists. I asked him to join me in a telephone conference call. He kindly accepted my invitation. I'm sure that you all know that Professor Blinder was a member of the Council of Economic Advisers in 1993 and 1994. He is the former vice-chairman of the Federal Reserve Board, having served from July 1994 to January 1996. Currently, he is the director of the Princeton Center for Economic Policy Studies. Professor Blinder, thank you very much for joining us.

Blinder: My pleasure. Glad to be here.

Yardeni: I think many of us have been a bit confused by the Fed. They raised rates in March; they did not do it again in May. Do you think they'll raise rates in July?

Blinder: Well, the one thing that I can say definitely is that Fed Chairman Alan Greenspan hasn't made up his mind. It's June 2nd, and the next meeting (of the Federal Open Market Committee [FOMC]) is on July 2nd. It depends, I believe, very much on the incoming data. The Fed, apparently, at the May meeting, in contrast to the March meeting, decided to run an experiment to test the scenario that says the economy is about to slow down dramatically and to test the scenario that the so-called natural rate or NAIRU may be lower than many people think. You can be sure that they'll be testing it warily and watchfully.

Yardeni: Might they consider the experiment of letting prosperity run its course, as long as inflation stays down? Or do you think that if the economy remains strong that they will definitely tighten at the July meeting?

Blinder: I think that if they perceive a pick-up, they'll probably tighten.

Yardeni: You mentioned Mr. Greenspan hasn't made up his mind yet. Is he the Wizard of Oz? Does he basically run the show?

Blinder: I would say he's vastly first among equals. By dint of his higher office, but especially by dint of his very good track record at the helm, he really commands the FOMC, and if you, in fact, look at the Greenspan record for 10 years, it's not only quite good, but relatively free of dissent.

Yardeni: Is Mr. Greenspan a New Era or Old Era economist? In other words, does he believe that strong economic growth might not be inflationary as it often was in the past?

Blinder: I wish I knew the answer to that. We discussed that more than once when I was at the Fed. I'm personally quite skeptical about this new era. Of course, it depends on what you mean; if a new era economist means that we can communicate and compute vastly faster than we could before, of course I am one. We can do that vastly more efficiently, more rapidly, and more widespread, but whether that actually has an appreciable effect on productivity and living standards is something I'm quite skeptical about. Mr. Greenspan has, on more than one occasion, talked fairly sympathetically in that kind of new era direction. Even if you're not constitutionally cautious, the fact that you sit at the head of the Fed should make you institutionally cautious. But in Greenspan's case, there's no conflict; it's his natural way. He's not going to bet the ranch on a new era view of the world, even if he thinks it might be true. What the Fed is doing, clearly, is sort of testing the limits, pushing the envelope a little, to see how far we can go before we encounter inflationary difficulties, and so far, it's been an amazingly successful strategy.

Yardeni: How much weight do the folks at the Fed put on different models of inflation such as NAIRU and the output gap between actual and potential GDP? Is it a moving target? We never know exactly what model is key. If Mr. Greenspan believes in the output gap model of inflation, what does he think is the maximum noninflationary potential growth of the economy?

Blinder: You can call it an output gap, an unemployment gap—it's all the same. Mr. Greenspan has never quite adopted the prose, but he talks around it. I mean that he uses words that are vaguely synonymous with those concepts all the time—"tightness of the markets," and "growing faster than potential," for instance. Now, how fast is the potential? Well, there's a controversy about this, as you well know. My view, and I think it's probably the predominant view on the Fed, is fairly stodgy on this question. As we measure it—though fully admitting there are errors in measuring—2.5% is the maximum potential growth of real GDP. I always thought the low end of the well-celebrated 2.0%-2.5% range is more plausible than the high end. I repeat again—as we measure it, because it's not to dispute the argument that we're overstating prices, therefore understating productivity, and thus growing faster than the official measure shows.

Yardeni: You were in the thick of the Fed's 1994 preemptive attack on inflation. What are the similarities and differences between the preemptive attack in 1994 and what may be the beginning of a preemptive attack in 1997?

Blinder: I think there are a number, but the key difference is clearly the level of the fed funds rate from which this attack was launched. As everybody remembers, the Fed was taking off in February 1994 from a zero real

federal funds rate, an extraordinarily easy monetary policy rarely seen before that, and probably not to be frequently seen after that. That was clearly an untenable position if you believe, as I do, in the concept of a neutral real federal funds rate in the long run. It was very clear that the fed funds rate had to go up and go up appreciably. It wasn't clear in February 1994 whether appreciably was going to mean 200 basis points or 300 basis points or even 400 basis, but I think it should have been clear to almost everybody when the first 25 basis points was done, that there was a lot more coming, because the Fed was far below neutral. Now, the Fed is taking off from a real fed funds rate of 2.75%, assuming inflation is 2.5%. That is slightly on the north side of neutral. It tells me that the total amount of tightening has to be a lot less than it was in 1994, unless we get some huge surprise about the strength of the economy, I mean even bigger than we have.

Yardeni: Well, I have lots of other questions, but we have a huge audience out there and we certainly would like to get some of your questions. Operator, can we get some of the questions from the audience, please?

Question: I'm wondering whether you'd point out any other differences between now and 1994's preemptive attack, besides the real federal funds rate difference?

Blinder: I would point to two. One is that because of the recent—and by recent, I mean a couple of years—extraordinarily good news on the inflation front, I think there is a lower level of inflation jitters in the market, in the government, at the Fed, everywhere, and I think that is germane to the current stance of monetary policy and, in particular, to passing the opportunity to raise rates again in May.

Second, the latest tightening starts from a higher level of resource utilization. A fair number of observers do believe that the U.S. is at full resource utilization, or possibly beyond, and that's certainly different than the situation in early 1994.

Yardeni: What about Mr. Greenspan's concern about the "irrational exuberance" of the stock market?

Blinder: The stock market is kind of a new variable in the equation. It was almost irrelevant to monetary policy decision-making during the 1994 cycle. It can never be completely irrelevant; it is, after all, a transmission mechanism of monetary policy, but I think was irrelevant. Although I'm not at the Fed anymore, I know it was the case when I was there, and I can't believe it's not the case now, that views across the committee on how much attention should be paid to the stock market vary greatly. It is

clear that the most important member on the committee, by far, is paying quite a bit of attention to it and, as we all know, Alan Greenspan is a cautious man who realizes that his words reverberate and chooses them carefully. So it was not a slip of the tongue when he started speaking about "irrational exuberance." He knew exactly what he was suggesting. I believe somebody went back through the archives and found that it was the first time a Fed chairman had talked about the level of the stock market in 30 years, or something like that. It's not something you hear from the Fed a lot.

Question: I have two questions, please. First, at the May FOMC, how much discussion, if any, was there concerning the political situation of the balanced budget agreement being reached? And second, what is your outlook on inflation at this point in time, looking out 12 and 24 months?

Blinder: On your first question, I imagine there was substantial discussion of both the content of the agreement and what it actually meant in terms of aggregate demand. For example it looks like this is a mildly expansionary package in the short-term, and then contractionary some years down road. Considerable discussion of that and probably a small amount of discussion of the implicit message that might be sent by raising interest rates on the heels of an agreement like that.

I wasn't there, of course, but one thing I can say from my experience is it is amazing and to me very gratifying how little political discussion goes on at an FOMC meeting. I always heard this lore about how apolitical the Federal Reserve is, but you don't actually know until you get in the room and listen. It would be an exaggeration to say it never comes up, but it is certainly not high on the discussion list. I imagine that the nitty gritty, "what does it mean for the time path of aggregate demand?" probably got a lot of discussion as being quite relevant to monetary policy. The atmospherics of how it would look to raise interest rates just after the Congress finally agreed to do this probably got some, but secondary, attention.

The second question was on my outlook on inflation. Now, I might have said I'm an inflation optimist, but there are so many super inflation optimists, including one sitting on my left here, these days, that I don't think I'm an optimist any more. My outlook for inflation over the next 12 to 24 months would be a very small up-creep from where it is now. I don't know how much; possibly a quarter of a percentage point, predicated on the old-fashioned, sometimes maligned, output gap view of the world, and the suggestion that we probably have had an overshoot of potential GDP. I think it will probably not be large, and that that overshoot will not grow much larger or persist for a lengthy period of time. It's the kind of thing

that will probably be viewed, in hindsight, as a small error in a very successful fine-tuning episode by the Fed.

Yardeni: Let's say that the natural rate of unemployment is really 5% and we drop to 4.5% and we stay at half a percentage point below the natural rate for a year. How much do we pay for that in higher inflation?

Blinder: There is a kind of academic consensus: If we were to stay at half a percentage point below the natural rate per year, that would lead to about a quarter of a percentage point acceleration of inflation.

Yardeni: The Fed folks must be aware of that. So why don't they think it's a worthwhile experiment to test the outer limits of prosperity?

Blinder: The Fed folks are very much aware of that rule of thumb, and I think they are testing the outer limits, absolutely. If you'd like to urge the Fed to push the limits, I think that's what they're doing. They listened to you.

Question: How important is the dollar, the price of gold, and the shape of the yield curve in setting monetary policy?

Blinder: A rise in the value of the U.S. dollar is a contractionary financial policy, so to speak, not monetary policy, and a fall is expansionary, and it's foolish to think you can make monetary policy in a vacuum without letting the exchange rate in. I've always looked at it, but I know it varied greatly around the FOMC table how many people were paying how much attention to the exchange rate. There is no sense at all in which the exchange rate is an actual target of monetary policy. The way I use it and the way others use it was as an indicator of how the effects of financial policies not emanating inside the Federal Reserve building were affecting the U.S. economy. Gold, I would say, has about as close to a zero weight as is humanly possible to give it.

The yield curve, of course, is extremely germane because the Fed realizes, as do people in the market and academics, that it only has control over the very short end of the yield curve, but it's the middle and far end of the yield curve that are really turning spending around. A crucial question at every FOMC meeting—and you can see it in the minutes, and you certainly can see it in the details when the transcripts come out—is always trying to estimate how intermediate and long rates would react to various monetary policy decisions. What if we do nothing, what would happen to intermediate and long rates? What if we tighten, what would happen to intermediate and long rates?

Question: You used those words, Dr. Blinder, "as we measure it," and I'm wondering whether you know of economists who are making progress on measuring productivity in the service sector, which seems to me a huge missing piece for the Fed?

Blinder: It's not so much as a missing piece as under-researched piece, especially in the government. Our statistical system is still showing the vestiges of our agricultural past, and I almost was tempted to say our "manufacturing past", of course, we're not past manufacturing but the relative share of our economy that's in manufacturing is much less than it used to be. So we have enormous amounts of statistics on the agricultural sector, much more than anybody, except somebody who's focused on agriculture, would ever want. We have a huge volume of statistics on the manufacturing sector, and are woefully under-provided with statistics on the service sector. The Bureau of Economic Analysis is working on this; it's a very major project for the BEA. It will take years and it will also take a little bit more money, but the Congress keeps cutting their budget. Some extremely interesting recent research on medical services suggests we're making real measurement errors in productivity in health care, and varied other things about computers, and a variety of things like that. But you see, these little pieces don't get put together except in the government. It is not the nature of academics to try to put all the pieces together and say, "Here's how we can revise the national statistics system." It's an enormous effort, and it includes doing lots of little things that are totally boring and will never be published in scholarly journals. However, these are the kinds of things that go on in the bowels of the Commerce Department, and if they had a little bit more money, they'd be doing more of this. They are well aware of this problem and haven't yet been able to cope with it very well.

Yardeni: Let me just wrap it up with what may be the question that we'd all like an answer to; I'm sure you have an opinion on this. I don't know that anybody has the definitive answer, but let's say the economy continues to grow just a little bit better than what is perceived as its potential. Let's say it grows 3% through the rest of the year, but let's say that, at the same time, the inflation news continues to be very moderate, running at around 2%. Will the Fed look at the latest inflation news and just say, "that's history, it's irrelevant," and just focus on the fact that the GDP seems to be growing faster than they believe it can grow, and therefore, we should expect a series of tightenings, or will they just give it a chance here and let the economy grow a little bit better than expected, as long as inflation stays low?

Blinder: I guess I'll give you a two-handed answer to that, but it's not the usual, awful, two-handed answer, 50-50. I'll give you a 75-25 answer. I think my 75% is that the Fed is betting on a slowdown to much below 3%. A

slowdown off the blistering pace of the first quarter only to 3% for the rest of the year will leave the Fed very afraid of incipient inflationary pressures. My 25% answer, which the decision to pass on raising interest rates in May tends to support, is that the Fed is willing to experiment and, instead of having a preemptive attitude based on an output gap model of the economy, will be willing to let the economy run until it actually sees the whites of inflation's eyes. That's your scenario, Ed, that we'll get through another year without seeing the whites of inflation's eyes.

Yardeni: Yes, it is Alan. I'm in your 25% contrary camp. I'm singing the John Lennon song, "all we are saying is give Prosperity a chance." Thank you, really, for your very clear and helpful opinions and views. We'd love to have you back. Thank you all for joining us.

TOPICAL STUDIES

Topical Studies #19 and higher are available on http://www.yardeni.com/yardeni/topical.html

#35 Dr. Edward Yardeni, *The Economic Consequences Of The Peace*, May 7, 1997

#34 Dr. Edward Yardeni, *Populist Capitalism And Other Wildly Bullish Themes*, February 25, 1997

#33 Dr. Edward Yardeni, *Productivity Must Be Booming*, January 20, 1997

#32 Dr. Edward Yardeni, *The Undefeated Forces Of Deflation*, October 28, 1996

#31 Dr. Edward Yardeni, *Economic Consequences Of The Internet*, October 22, 1996

#30 Dr. Edward Yardeni, *Backlash: Workers Vs. Bonds*, May 8, 1996

#29 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book 1996*, March 28, 1996

#28 Dr. Edward Yardeni, *Liquidity Story Is Wildly Bullish*, February 12, 1996

#27 Dr. Edward Yardeni, *10,000 In 2000*, November 6, 1995

#26 Dr. Edward Yardeni, *The US Economy's Mega-Trends*, July 10, 1995

#25 Dr. Edward Yardeni, *The High-Tech Revolution In The US of @*, March 20, 1995

#24 Dr. Edward Yardeni, *Hard Or Soft Landing?*, February 6, 1995

Copyright (C) Deutsche Morgan Grenfell Inc. 1997. All rights reserved. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. Deutsche Morgan Grenfell Inc. and its affiliated companies and/or individuals may, from time to time, own, have positions in, or options on the securities discussed herein and may also perform financial advisory services, and/or have lending or other credit relationships with those companies. This material has been approved for distribution in the United Kingdom, to professional investors who fall within the exemptions contained within the UK Financial Services Act 1986 - Investment Advertisement Exemptions Order 1988, by Deutsche Bank AG London, 6 Bishopsgate, London EC2P 2AT. Member of the LSE and regulated by SFA, Tel: (171) 545-4900, Fax: (171) 545-4988. Orders placed by UK persons directly with Deutsche Morgan Grenfell Inc. will not be governed by all investor protection provisions of the UK Financial Services Act 1986. **Additional Information Available on Request.**