The New Economy? A reply

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I was interested to read Prof. Knetter's comments about the so-called New Economy in an article in the Fall '99 issue of Paradigm. I have a few of my own theories for the current boom which I would be interested in bouncing off Professor Knetter.

First, the current low inflationary state is I believe significantly helped by the openness of the US economy. One of the reasons why producers cannot raise prices significantly in the face of strong, sustained demand is that competition is so much stronger. US companies find themselves competing at a global level, where competitors from all over the world are scrambling to gain at their expense.

I strongly believe that one of the reasons why business cycles persist in Europe and elsewhere is the existence of high trade barriers that reduce market transparency and lead to price fluctuations (inflation/deflation) as supply constantly over-reacts to even small changes in demand. A simple truism that any Wall Street trader can tell you is that a more liquid market reduces price volatility. A more open market improves liquidity in goods and services. I would be interested to hear of any empirical research that has been done that explores the relationship between the degree of openness in an economy and its resistance to business cycles.

Secondly, I'm not sure that the Philips curve is quite dead. The inverse relationship between unemployment and wage inflation is still strong - just ask Steve Lubrano about wage inflation in the graduating classes at Tuck over the past five years, and the evidence is clear. The difference today is that the premium for skills has increased. The skills shortage in the US is chronic. Ask any dot-com company what their biggest concern is today and almost invariably, they will say the shortage of skilled talent. The ages long shift towards a skills based economy has continued, at an increasing rate as services have come to dominate the US economy, but the underlying infrastructure to supply that trend has not kept up. This, I believe, is the biggest threat to the current economic boom than any other single factor. Even as Capitol Hill debates the number of H-1 visas to be issued to skilled temporary workers, they hold the balance of the economy in their hands. Do you think they know this?

Finally, I am curious to see how the current economy measures when asset price inflation is taken into account. If such investments (real estate, stocks, bonds, etc.) are considered as deferred consumption, and included as part of the measure of overall consumption, then doesn't the current economy perform less admirably?

The great asset price inflation over the past decade or so has largely been the result of the baby-boomer generation's admirable propensity to save, which has provided the fuel for the long economic boom. However, what happens when this stops? There are signs that this is happening already as net receipts by mutual funds have slowed significantly over the past couple of years. As the boomer generation transitions, I believe there will be significant implications for the real economy as consumption patterns shift once more.

Regards

Yong

Michael Knetter's reply

Great letter Yong. I agree that openness to trade, especially increasing openness to trade as opposed to the current state, puts a brake on inflation. A strengthening currency does the same. Both of these factors have helped keep inflation in check. But I still believe that the primary factor is sound monetary policy. That is part of what keeps the dollar strong.

Transparency and liquidity certainly help keep a market economy on an even keel. I have not seen much empirical work on this because it is difficult if not impossible to develop good measures of transparency and liquidity for goods and services markets. Especially measures that could be compared across countries. That doesn't mean they are less important. In fact, because we cannot measure them, they may not get the attention they deserve.

I think the fact you cite in support of the Philips Curve (that MBA wages have risen sharply) falls into the selection trap. You are only considering a small sector of employment. Overall, there is no mistaking that wage growth has been unusually restrained during the current expansion. That doesn't mean we won't at some point see inflation rising due to the tight labor market. But it has been remarkably quiet. The gains in wages of highly skilled workers have been largely offset by the stagnation in the compensation of those with less education. I agree that immigration policy might help alleviate certain labor shortages, but I do not think that a national immigration policy should be driven by a desire to tame the business cycle. Other considerations are far more important in my opinion.

The inclusion of asset price inflation in an assessment of monetary policy or a broader measure of price pressure is intriguing. *The Economist* keeps writing about this, but I am not sure I am buying it. Surely high asset prices can mean higher future demand for goods and services and if the supply is not there, then prices of future consumption goods will be bid up. But the asset prices are presumably high because of the belief that future productivity of firms is high relative to current productivity. If this is true, then the supply will be there to meet future demand. That leaves me thinking that the real potential problem is simply that asset prices are overvalued, i.e., that we are overestimating the future supply and profit potential of today's firms. Your guess is as good as mine whether that is true.

Regards

Mike