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Economy `in the Zone'...

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Financial market participants are hoping that today's congressional testimony by Alan Greenspan will help them to interpret recent market moves, to anticipate the economy's prospects, and to understand the Fed's policy intentions. The prospective stakes are high. After all, the recent combination of solid growth but minimal inflation -- together with the Fed's measured but relentless rate hikes since mid-2004 -- have produced far lower than expected long-term interest rates and rising stock prices.

Investors are beginning to suspect that the favorable financial environment may be sustained, despite consensus forecasts suggesting that recent market gains have been too good to last. More than anything else, the key to the outlook is whether low inflation can be maintained through a combination of fundamental forces and Fed resolve. Viewed this way, economic and market prospects are better than the analysts' consensus.

Pessimistic pundits emphasize the dangers lurking in unsustainable trade and payment imbalances, excessive liquidity, savings shortfalls, dollar overhangs and global deflation. Money also talks, however, and its message has failed to echo the pundits' pessimism. After all, the yield on 10-year U.S. Treasury securities -- the world's most actively traded security -- is not far from 4%, near 40-year lows.

Worrisome explanations are offered for the bond market's stubborn equanimity. Asian central banks, hedge funds, carry trades and mortgage-market shenanigans all have been proffered as evidence that low bond yields camouflage future travails. Inevitably, skeptics conjure up the specter of asset "bubbles." Can bond markets be aping 1999-2000, when the Nasdaq was stepping up to a spectacular swan dive?

Perhaps current low bond yields don't require such complicated and conspiratorial explanations. After all, Treasury bond yields, more than anything else, reflect the outlook for inflation. Strikingly, Federal Reserve officials by 2003 began describing the U.S. economy as operating within a "zone of price stability." And subsequent Fed policy moves have been consistent with keeping the **economy "in the zone."**

In fact, year on year increases in core inflation -- as measured by the Fed's preferred Personal Consumption Expenditure (PCE) price index -- have remained mainly within a 1% to 2% range since 1996. In late 2003, deflation worries dominated, as the core PCE flirted briefly with sub-1% increases. Amazingly, the indirect impact of last year's oil price surge only pushed this inflation measure back to the current 1.5%, just in the middle of its post-1996 range. Since mid-2004, core inflation's annualized pace has slowed back to the low end of the range.

According to consensus expectations -- as reflected in standard surveys -- core inflation inevitably will accelerate. The conventional claim is that the U.S. economy's comfort zone is an inflation rate of 2% to 3%, and that the Federal Reserve shares this expectation. This claim is far from self-evident, however. The Fed -- for its part -- has long maintained that establishing price stability represents its principal policy goal. The last time that core inflation was in a 2% to 3% annual range -- in the mid-1990s -- neither Fed officials nor investors labeled it price stability.

Contrary to the analysts' consensus, it isn't hard to justify optimism about sustained low inflation. Global GDP growth rebounded to about 3.3% last year -- marginally exceeding the 1990s average -- while output remains below potential. Although global demand growth recovered from its 2000-2001 swoon, industrial economies are far from fully employed, while capacity is growing rapidly in key emerging markets. In these circumstances, even the dollar's decline from its 2002 peak isn't creating inflationary pressures, as exporters have maintained their dollar prices in order to defend market share.

The modest 2004 acceleration in the core PCE index mainly reflected the indirect impact of the 2003-2004 oil price surge. Oil producers aren't trying to push prices still higher, however, as current production likely

exceeds current demand by a narrow margin. Thus, oil prices are widely expected to retreat modestly this year. Commodity prices also have stabilized, while last year's expiration of the Multi-Fiber Agreement -- eliminating trade quotas -- will reduce apparel prices this year.

Critically, broad measures of U.S. labor compensation have increased at a stable pace for the past few years, and there is little reason to expect any significant near-term acceleration. Although the unemployment rate has fallen over the past year, payroll employment only recently regained its pre-recession peak. Since that time, the U.S. working age population has risen by about nine million. Thus, full employment remains a distant goal, leaving ample margins for non-inflationary job gains.

Recently, concerns have been expressed that a slowdown in U.S. productivity growth could boost inflationary pressures. The risk is that slowing productivity gains could raise unit labor costs unexpectedly. Businesses' current intense focus on cost discipline calls this worry into question. Weakening productivity growth today would be more likely to produce a slowdown in wage gains than faster price increases.

In any case, a rise in inflation risks would elicit more aggressive Fed tightening, not faster inflation. Having spent the past 25 years returning the U.S. economy to price stability, Fed officials are not likely to acquiesce in inflation once again rising above the "zone."

To the contrary, the Fed has a historic opportunity to help lower long-term inflation expectations to a rate consistent with sustained price stability. With core inflation anchored below 2%, with economic growth solid, and with the Fed-funds rate headed toward neutrality, investors' optimistic suspicions about favorable financial market trends are more likely to prove correct than are the downbeat warnings of the consensus.

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