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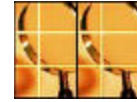
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IS THE NEW ECONOMY RESPONSIBLE FOR THE CLINTON EXPANSION

BY
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Everyone is aware that US economic growth in the last few years has been robust. Since 1995, real GDP has been growing at close to 5% per year. By contrast, from 1972 to 1995, it grew at only 2.75% per year. Just a few years ago, almost no one would have believed that we could return to pre-1972 growth rates; indeed, many believed that the “speed limit” for the U.S. economy was probably something like 2.5% per year, with any higher growth fueling inflation. However, looking back from the perspective of the first year of the new millennium, the “doomsayers” appear to have completely missed the birth of the “New Economy”. Not only did economic growth accelerate, but growth of labor productivity boomed. Many argue that this productivity increase is more than the “normal” improvement that can be attributed to a business cycle expansion. Rather, it is believed that a fundamental change has taken place that will keep productivity growth high. If true, this means that the slow growth post-1973 period, as well as the NAIRU inflation-unemployment trade-off may have been banished.

Chairman Greenspan was an early convert to the view that the rapid pace of technological innovation since the mid 1990s was fueling productivity growth that allowed for rapid economic growth without inflation. Indeed, this recognition is credited for convincing the Fed to postpone monetary tightening-allowing the economy to continue to grow more robustly than many had thought possible. Where some had shown pessimism, enthusiasts for the New Economy view display nearly unbounded optimism. Nowhere is this more in evidence than in President Clinton’s budget surplus projections-that rely heavily on a sustained expansion, and that seem to grow by the trillions upon every revision. By nearly all accounts, the cornucopia is here to stay.

I hate to throw cold water on such Pollyanna thinking. In reality, the Goldilocks economy is not all that unusual. Rather, we seem to have simply returned to a more normal growth rate after a quarter century of below normal growth. The constraints that kept growth low during most of the final quarter of the 20th century were the same constraints that have periodically limited growth in the US, and that have limited growth in other OECD countries-namely, demand constraints. That is, during the Clinton expansion US

aggregate demand has been remarkably high, allowing firms to utilize their labor forces and equipment at a high rate, raising measured productivity. In contrast, demand was generally so low between 1975 and 1995 that resources could not be fully utilized; hence, measured productivity growth was low. On this view, the features of the New Economy, as well as other supply-side factors, have next to nothing to do with rapid productivity growth in the past five years.

Let me offer two different kinds of evidence in support of this hypothesis. The first is supplied by economist Robert Gordon, who uses a typical production function approach to estimate multi-factor productivity growth for the period 1995-99. (See “Does the ‘New Economy’ measure up to the great inventions of the past?”, Robert Gordon, NBER Working Paper 7833.) He finds that there has been an acceleration of productivity growth in the durable manufacturing sector, however, this is limited to the production of computer hardware and other closely related durables. Surprisingly, there has been no increase in multi-factor productivity in the 88 percent of the rest of the private economy. That is, all the productivity growth he measures is attributed only to *production* of computers and none to the *computer-using* part of the economy. This finding should be quite disconcerting to those who believe that the tremendous diffusion of the computer throughout our economy has generated “New Economy” productivity-enhancing effects that are largely responsible for the Clinton expansion.

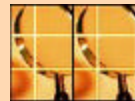
There is another, less direct, method of looking at this issue. One can apportion per capita GDP growth between growth of the employment rate (number employed divided by population) and growth of output per worker. In a sense, a nation can “choose” between employing a greater percent of its population (a “high employment” path), or getting more output per worker (a “high labor productivity” path). If we compare US experience with that of Western Europe or Japan, one finds a quite remarkable difference: while other nations took a high productivity path, the US chose a “middle road”. Since 1970, the US has increased its per capita GDP by about 50%; Western Europe has increased its per capita output by about 55%, and Japan has increased its by over 100%. However, while the *source* of US growth of per capita output is just about evenly apportioned between increases to its employment rate (which grew by about 25%) and improvements to labor productivity (which grew by a bit more than 25%), virtually all the per capita growth in Western Europe and Japan has been due to growth of labor productivity (Japan’s employment rate grew by about 5%, while Western Europe’s was essentially flat).

Economists have long argued that the US has much “freer” labor markets, which encourage employment and allow us to enjoy lower unemployment rates. This appears to be true. But these freer labor markets do not give us any advantages with respect to economic growth! Rather, there appears to be a trade-off, and maybe a choice: we can *choose* higher employment rates *or* greater productivity growth. This choice is taken within a context of growth of aggregate demand. Given our “freer” labor markets and high growth of employment rates, the US must grow much faster than Western Europe or Japan does in order to

raise our labor productivity. The Clinton expansion has merely allowed aggregate demand to grow sufficiently fast to lower unemployment and increase labor productivity. Thus, this expansion is unusual only when compared with the 1973-95 period, when demand constraints were tighter (so that our output growth barely kept pace with employment growth-resulting in low measured productivity growth). When compared with the “Keynesian” 1960s, the years surrounding WWII, or the “frontier” years after the Civil War-all periods during which aggregate demand remained high-there is nothing so unusual about the current expansion. In the past few years, our growth was finally high enough to raise productivity growth. Thus, we can reject the supply-side arguments that really underlie the New Economy view, as well as other arguments that focus on supposed US advantages deriving from greater reliance on free markets. Neither slow growth between 1973-93, nor rapid growth post-1995 should be attributed to slow or fast productivity growth. Indeed, productivity growth should be seen as an uninteresting residual that results from the interplay between employment growth and growth of per capita output (when output grows faster than employment rates, measured productivity increases)-both of which are primarily demand-driven. The real constraints in the coming years in the US will be demand constraints -as they usually are. Thus, while I would argue that the US Goldilocks expansion is not sustainable, this has nothing to do with the tenuous nature of the New Economy, but rather with the inevitable downturn of spending that will come when households slow their record pace of borrowing.

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