

## Remarks by Governor Laurence H. Meyer

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### The Global Economic Outlook and Challenges Facing Monetary Policy around the World

It is a special pleasure to be in London and have this opportunity to exchange views on the global outlook and challenges facing monetary policy around the world with members of the Society of Business Economists. I understand that the SBE in the U.K. is comparable to the National Association for Business Economics in the U.S. As a long-standing member and fellow of NABE, I bring you greetings from your American counterparts.

I want to emphasize at the outset that the views I present this evening, both about the economic outlook and monetary policy, are my own views and should not be interpreted as an expression of the views of the Board of Governors or the FOMC.

This is a particularly interesting and challenging time to be a central banker, virtually anywhere in the world. Interestingly, despite the common backdrop of weak world growth and turbulence in world foreign exchange and financial markets, there is an unusual diversity of domestic macroeconomic experiences across countries and therefore quite different challenges faced by monetary policymakers around the world. To illustrate this, I will briefly set out what I see as the challenges faced today by central banks in the U.K., Japan, the euro area, and emerging market economies. Then I will continue this theme as I turn my attention to the U.S. where, as you know, the macroeconomic record over the last three years has been exceptional. Precisely because of this exceptional performance, there are puzzles to resolve and important policy issues to be confronted in the U.S.

#### **I. Global Influences on Domestic Economies and Challenges to Monetary Policy Around the World**

Today, it seems more than ever, domestic macroeconomic performance and policy around the world are being dramatically affected by global developments. There are two features of the global environment to which I want to draw particular attention. First, there is a considerable diversity of cyclical conditions across industrial economies. Second, the serious crises in many emerging market economies, resulting in both sharp declines in their economic activity and turbulence in global foreign exchange and financial markets, have had repercussions throughout the global economy. Overall, this adds up to unusually weak global growth, continuing risks of renewed financial market turbulence, and, at least outside the U.S., more downside risks to demand than upside potential.

As you well know, the robust expansion in the United States has been juxtaposed with unprecedented recession in Japan, while Europe, the U.K., and Canada have experienced more moderate growth than the U.S. These differential growth rates among the industrial

economies and resulting changes in their real interest rate differentials, and hence exchange rates, have had an important impact on net exports across these countries. In the case of the U.S., these developments have interacted to result in a persistent drag from net exports on real output growth and a widening of the current account deficit, on the one hand, and restraint on inflation, on the other hand.

In light of concerns about wide swings in the exchange rates among major currencies, some have called for a system of target zones for exchange rates. But the variety of economic conditions across industrial countries itself highlights the inherent difficulties associated with such suggestions. Moving to such a system would require assigning monetary policy to the task of targeting exchange rates, and countries are free to do so if they wish. But, given the very different domestic conditions across industrial countries today, the cost of ignoring domestic considerations in order to stabilize exchange rates would, in my judgment, be considerable. My preference is to use monetary policy to stabilize the U.S. economy and I can imagine that central bankers in other major economies would share this sentiment with respect to their own economies.

The crises among emerging-market economies have resulted in a complex set of shocks to industrial economies. The most obvious spillover is the adverse external demand shock, via the decline in net exports, as a result of the combination of sharp declines in economic activity and dramatic devaluation of currencies in many emerging market economies. In the U.S., this has powerfully reinforced the effects on net exports of slower growth in the foreign G-10 economies and, until late in 1998, an appreciation of the dollar against the foreign G-10 currencies.

But the net effect on demand, both in the U.S. and in other industrial economies, has also been influenced by how each economy has been affected by other developments set in motion by these crises. First, there have been safe haven capital flows that, in the case of the U.S., lowered long-term interest rates and buoyed equity markets. Second, the slowing of aggregate demand globally has also depressed the prices of oil and other commodities. While the U.S. oil and agricultural sectors have been hurt by this downturn in the prices of their output, the economy as a whole has benefited on balance because the United States is a net consumer and importer of oil and many other commodities. The decline in energy and other commodity prices have helped to restrain inflationary pressures, and households and firms that depend on these items as inputs to their production have benefited accordingly. Until the Russian default and devaluation, the positive effects of lower interest rates and lower oil and non-oil commodity prices appeared to have contributed importantly to the strength of domestic demand in the U.S., offsetting, at least in part, the adverse effect on net exports.

After the default and devaluation in Russia, increased perception of and reduced tolerance for risk resulted in turbulence in domestic financial markets in industrial economies, as demonstrated by increased risk spreads and reduced liquidity, especially in the U.S. While risk spreads may have been unduly narrow to begin with, the degree to which they increased in reaction to that event surprised most observers, myself included. One reason these market developments appeared to be so serious for the U.S. was that they threatened to reverse the improvement in domestic financial conditions that had been so important in blunting the adverse demand shock from abroad.

*The Challenges Facing Monetary Policy Around the World*

Despite the common backdrop of weak world demand and turbulence in global financial markets, the diversity of domestic economic conditions around the world translates into a variety of challenges facing central banks. In the U.K., for example, what had looked like a traditional late-cycle challenge of resisting any tendency for inflation to increase, relative to the official target, while avoiding a premature halt in the expansion, has been complicated by the adverse shock from abroad. I will pose some questions, for your consideration, about the relative experiences in the U.S. and the U.K., once I have set out some of the puzzles in the U.S. experience.

The current conditions and challenges in Japan are very different. Japanese policymakers are confronted with the challenge of escaping from recession, amidst gathering deflation and serious banking and financial sector problems. Monetary policy, with short-term interest rates almost at zero, appears to have now all but exhausted the potential for stimulus associated with conventional measures. The Bank of Japan is operating in fairly uncharted waters and, frankly, the questions they face are easier to pose than to answer.

Is it possible, for example, once short rates have been pushed to zero, to use open market operations in long-term markets to lower long rates relative to short rates? Is it possible to push long-term rates below 2%, even when short-term rates are driven to zero? The U.S. experience in the Great Depression appears to confirm Keynes' worry that, despite the ability of monetary policymakers to push short-term rates to zero, there are limits on how low long-term rates can be driven. This raises the question as to whether the decline in Japanese 10-year rates to below  $\frac{3}{4}\%$  in 1998 was a temporary aberration, and the return to 2% might therefore not be easy to reverse. Even if monetary policy cannot affect short or long-term rates, is it possible nevertheless to stimulate demand by forcing liquidity into the system and raising monetary growth, and, if so, through what channels would that operate? Finally, if the major channel for such stimulus is depreciation of the yen, are the emerging market economies in Asia strong enough to withstand this development without a relapse?

The euro area is facing its own unique challenges. The initial policy setting was skillfully managed despite tension between the new central bank and finance ministries of the member countries. But growth appears to be slowing to below trend, in the context of already very high unemployment rates, not all of which is structural, and low inflation. At the same time, the need for the ECB to establish credibility, to demonstrate its independence relative to finance ministries, and to establish a euro-wide perspective in a structure that gives considerable power on the ECB's Governing Council to national central banks adds to these challenges.

Nowhere, however, is the challenge to monetary policymakers greater than in emerging economies around the world. Here the issues have centered on how aggressively to raise interest rates to defend pegged exchange rate regimes and, in the event of a change to floating rates, how aggressively to tighten to avoid overshooting of exchange rates and how to establish a monetary policy framework to control inflation. The challenge of setting monetary policy following a move from fixed to floating rates has proved to be especially difficult, as events in Brazil have illustrated. Monetary policymakers have had to balance the role of higher interest rates in avoiding overshooting of the currency and controlling inflation, against their effects on the real economy, on financial instability in light of potential banking and corporate debt problems, and on fiscal deficits via higher debt-service burdens.

## **II. The U.S. Outlook: Puzzles, Initial Conditions and Prospects**

That brings me to the U.S. Many would ask what challenges could monetary policymakers possibly face in the U.S., given the remarkable combination of consistent above-trend growth and declining inflation? The first inclination, to be sure, is to celebrate. The next is to line up to take some of the credit, although I have urged some caution here. Recent performance is both better than expected and better than most of us thought the structure of the economy would allow. Humility seems very much in order. Indeed, the uncertainties about the structure of the economy, in light of the unexpected nature of recent performance, and about the outlook going forward, in light of the recent poor record of forecasting, highlight the challenges facing U.S. policymakers.

The U.S. economy has been blessed with consistent above-trend growth, declining unemployment rates, soaring equity prices, and declining inflation. Mixing these elements together yields the following story. The unexpected strength in equity prices has combined with other positive demand surprises across a wide range of spending components to produce faster-than-expected growth and a progressive tightening of labor markets. At the same time, some combination of favorable supply shocks and supply-enhancing structural changes have prevented the pick-up in inflation that otherwise would have been expected from persistently robust demand and progressively higher labor utilization rates.

### *The Role of Excess Demand, Supply Shocks, and Productivity*

It appears that both supply shocks and structural change have played a part in explaining the recent exceptional U.S. economic performance. Therefore, let me turn to the role of these developments in U.S. inflation dynamics. In the long run, inflation is, as Milton Friedman has taught us, always and everywhere a monetary phenomenon. But that still leaves us to identify the proximate sources of changes of inflation, the role of transitory shocks, and the effect of possible changes in NAIRU and/or the productivity trend.

The two key proximate sources of inflation pressure are excess demand and supply shocks. Traditionally, excess demand pressures are viewed as operating initially through wage pressures in labor markets and being passed through via higher unit labor costs to prices. Labor market pressures are often judged by the relationship between the prevailing unemployment rate and NAIRU, the "non-accelerating inflation rate of unemployment."

Supply shocks refer to the effect on inflation of changes in the prices of specific commodities that are unrelated to the balance between supply and demand in the domestic economy. Historically, the important supply shocks have been sharp movements in food or energy prices, often related to weather and political developments. In the current episode in the U.S., important sources of restraint in inflation have come from a decline in energy prices over the past two years; a three-year period, through mid 1998, of appreciation of the dollar and declining import prices; sharper-than-previous declines in computer prices over the past three years; and a slower rate of increase in health care prices, including the cost of health care insurance.

The direct impact of supply shocks depends on the weight of the affected goods and services in broader price measures. Indirect effects arise both from the role of those goods and services as inputs in production and through the effect on the wage-price process. A decline in overall inflation via favorable supply shocks lowers the pressure for nominal wage increases, which, in turn, reduces price pressures for a broader range of goods and services.

An increase in trend productivity growth will result in higher real wage growth, but the transition to higher real wages may include a near-term decline in inflation. For example, an unexpected acceleration in productivity might initially leave nominal wage change unaffected, but reduce price pressures by lowering costs--thus contributing to both higher real wage growth and, for a while, lower inflation.

One additional feature of recent experience that might also be important is the divergence between measures of labor market and product market demand balance. While the unemployment rate has declined to a 28-year low and to well below prevailing estimates of NAIRU, the capacity utilization rate is below its long-term average and estimates of its natural rate. It appears that a portion of the higher productivity growth has come through capital deepening and more generally has been associated with very rapid growth in the capital stock--especially high-tech equipment. The relevance of this development is that the absence of demand pressures in product markets likely contributes to the perceived absence of pricing leverage by good-producing firms. In addition, the resulting difficulty in passing on cost increases may have made firms more reluctant to bid up the price of workers in tight labor markets, resulting in restraint on nominal wage demands and contributing to the apparent decline in NAIRU.

Collectively, these factors--favorable supply shocks, a lower NAIRU and higher trend growth, and the gap between the unemployment and capacity utilization rates--can explain the combination of higher-than-expected growth, a decline in the unemployment rate well below previous estimates of NAIRU, and lower-than-expected inflation. Nevertheless, the relative importance of the various factors and uncertainty about their relative importance have important implications for monetary policy.

#### *Lessons from Experience in Other Industrial Economies?*

I wonder whether developments in other industrial economies, and specifically in the U.K., might shed some light on the relative importance of the various sources of exceptional U.S. performance. Here again I have more questions than answers, but shall rely on you for assistance.

If increased worker insecurity, as a result of rapid technological change and globalization, has been important in lowering NAIRU and improving the inflation-unemployment trade-off in the U.S., why isn't this force having a similar effect in the U.K.? Or is it? If more rapid technological change is raising productivity growth in the U.S., why does the discussion here seem to be focused on whether or not there has been a decline in trend productivity growth? Are there barriers in the U.K., for example labor resistance, to adopting new technologies and reorganizing production? Is there any indication in the U.K. of a divergence between unemployment and capacity utilization rates, as experienced in the U.S? Finally, if supply shocks and currency appreciation lower inflation in the U.S., allowing the economy to move temporarily beyond the point of sustainable capacity without inflationary consequences, why isn't the same true of the U.K, which itself has experienced falling commodity prices and a rising currency?

#### *Prospects*

In thinking about the outlook for the U.S. economy, I start with questions about the interpretation of initial conditions. Following three years of exceptional performance, there are some areas where the economy looks stretched and where there might be some question about sustainability. For example, is the current state of labor market tightness sustainable,

without rising inflation, once the recent favorable supply shocks dissipate? Is the current level of equity prices sustainable, without further declines in real interest rates and under the assumption of some slowing in growth toward trend going forward? Is the prevailing and still widening current account deficit sustainable or does it carry important risks to U.S. interest rates and exchange rates going forward? Despite the recent exceptional performance, these questions are challenging ones.

The next question is whether, going forward, developments will resolve some of these possible tensions or exacerbate them. The consensus forecast, for example, continues to project a slowdown to below-trend growth, resulting in a gradual increase in unemployment. This would immediately unwind some of the prevailing tightness in labor markets and, as a result, holds open the possibility that the economy will make a successful transition to a more sustainable state, without policy intervention, before the effects of the recent favorable supply shocks fully dissipate.

The FOMC's central tendency forecast, released earlier this week in the semi-annual Humphrey-Hawkins report, projects growth in the 2 ½% - 3% range and a nearly unchanged unemployment rate--still a slowdown, but only to trend growth. A more modest slowdown would maintain the current level of labor market tightness and therefore make my first question about sustainability more critical.

Both the consensus and FOMC forecasts projects higher inflation. However, the increase in inflation is principally a result of the dissipation of the direct effects of recent favorable supply shocks. As a result, overall CPI inflation converges to recent core inflation. Because the effects of recent declines in inflation are still working through the wage-price process, nominal wage demands are likely to be restrained going forward, at least for a while. As a result, core measures of inflation are expected to remain well contained and nearly unchanged over 1999. The most recent inflation data continue to appear consistent with this expectation, showing no signs of any rebound in core inflation. The latest Blue Chip consensus forecast projects just a 2% increase in the CPI over 1999, while the central tendency for the FOMC consensus forecast is in the 2 ¼% - 2 ½% range.

### **III. The Challenges Facing U.S. Monetary Policy**

I now turn to the challenge of designing a strategy for monetary policy in light of uncertainties both about the sources of recent performance and about the outlook going forward.

#### *Implications of Supply Shocks and Structural Change for Monetary Policy*

The relative importance of supply shocks and structural change has important implications for monetary policy. For example, if the recent exceptional U.S. economic performance were entirely due to the temporary effects of favorable supply shocks, the economy's level of production might be interpreted as being beyond its sustainable capacity, with the inflationary consequences temporarily suppressed by the favorable supply shocks. The challenge for monetary policy would be to make the transition from the current exceptional but unsustainable state to a less exceptional but more sustainable one, prior to the supply shocks fully dissipating.

On the other hand, if the recent performance is accounted for entirely by supply-enhancing structural changes and, therefore, reflects the new, more favorable performance characteristics of the U.S. economy, the role of monetary policy is to accommodate this

more favorable performance rather than to constrain it.

But the key is that both explanations--favorable supply shocks and capacity-enhancing structural change--appear to be part of the story behind the exceptional performance, with some uncertainty about the relative weight that should be assigned to each explanation. The challenge is to set a strategy that respects this uncertainty, takes advantages of opportunities for better performance, while mitigating the risks of overtaxing the limits of sustainable production and growth.

### *Monetary Policy Strategy: Principles and Practice*

Let me now turn to how U.S. monetary policy has responded during this episode and to the challenges that it faces going forward. I will describe the evolution of monetary policy in relation to the strategy embodied in the Taylor Rule. I refer to the Taylor Rule not because the Federal Reserve follows such a specific rule, but because this rule highlights the systematic policy responses to changing economic conditions that one expects in disciplined discretionary policy.

The Taylor Rule prescribes movements in real interest rates in response to deviations of inflation from the policymakers' inflation target and to deviations of output from its long-run potential (or to deviations in the unemployment rate from its natural rate). These responses impose what I believe are the two key ingredients for a disciplined monetary policy strategy: a nominal anchor (via the inflation target) and a policy that leans against cyclical winds (via the response to changes in resource utilization rates).

During most of the recent episode, monetary policy broadly followed the Taylor Rule prescription, while holding the nominal federal funds rate about unchanged. Since 1995, the simultaneous declines in the unemployment rate (as a result of faster than expected growth) and lower-than-expected inflation had almost perfectly offsetting effects on the target nominal federal funds rate. That is, the prescriptions for the target funds rate from the two surprises just offset, leaving an unchanged nominal funds rate target consistent with the Taylor Rule. The drop in the unemployment rate outweighed the fall in inflation in terms of the prescription for real rates, but the higher real federal funds rate prescribed by the Taylor Rule was achieved passively via declines in inflation, without the need for an increase in nominal funds rate.

More recently, however, monetary policy has significantly departed from the Taylor Rule prescription. That is, the nominal funds rate today is lower than could be justified by typical Taylor Rules, given prevailing inflation and labor utilization rates. How did this happen and what does it mean? The FOMC, of course, is not committed to a Taylor Rule and only some of us pay significant attention to it. Still I believe there is a story here.

There are three developments, each of which, I believe, contributed to this decline in the funds rate relative to Taylor Rule prescription. The first event was the dramatic financial market turbulence, following the Russian default and devaluation. The decline in the federal funds rate was, in my view, appropriate to offset the sharp deterioration in financial market conditions, including wider private risk spreads, evidence of tighter underwriting and loan terms at banks, and sharply reduced liquidity in financial markets. In effect, a decline in the funds rate was required to maintain unchanged overall financial conditions following the disruption to private capital markets. This was intended to ensure that monetary policy and overall financial conditions remained consistent with a forecast of a benign slowdown in

U.S. growth.

But the events following the Russian default and devaluation seemed to call for easing rather than just maintaining the prevailing degree of financial market conditions. Specifically, even at prevailing financial conditions, weaker foreign growth threatened to transform what was otherwise expected to be a benign slowdown into one that might be excessive, particularly given what also appeared to be asymmetrical downside risks in the global economy. Because the incoming data continued to look resilient, a backward-looking Taylor Rule would not have dictated an easing. But a forward-looking version of the Taylor Rule did, in my view, justify the policy action, at least given the revision in my own expectations for growth going forward. This was a classic example of pre-emptive policy response, of policy responding to the forecast rather than to the data in hand.

The third development is the reduced confidence of some (not including yours truly) in the traditional model of inflation dynamics and the appreciation by nearly everyone of increased uncertainty about the estimate of NAIRU, in response to the persistence of faster-than-expected growth and lower-than-expected inflation.

### *The Challenges Ahead*

As events have unfolded, the economy retained more momentum than most expected and financial market conditions have improved, though, to be sure, had the Federal Reserve not responded so quickly and aggressively, there is some question as to whether financial markets would have recovered as much as they have. This brings us to the challenges policy faces going forward and to the questions that have to be addressed in meeting these challenges. Once again, I'll specialize in questions.

The first question is whether the degree of easing implemented in response to financial market turbulence and the abrupt downward revision in the forecast should be reassessed in light of the subsequent improvement in financial conditions and the continued robustness of domestic demand. Such a reassessment would, of course, also have to take into account both the incoming data on inflation and the downside risks to the U.S. economy, including those related to the continuing stresses in the global economy.

The second question is how to position policy, given uncertainty about the relative roles of supply shocks and structural change. One way to rationalize the current policy setting is that the movement away from the Taylor Rule prescription reflects a lack of confidence in the assumption about NAIRU that underpins the typical specification of that rule. After all, the precise specification of the Taylor Rule requires an estimate of the level of potential output or NAIRU. In effect, uncertainty about NAIRU can be interpreted as having made monetary policy reluctant to move on the basis of declines in the unemployment rate relative to some given estimate of NAIRU.

While this could be rationalized as an appropriate response to uncertainty about the level of NAIRU, such a strategy positions monetary policy to accommodate continued above-trend growth and further increases in labor market tightness with faster money growth, in order to preserve the prevailing level of nominal federal funds rate. This would result in a monetary policy that reinforced rather than leaned against the cyclical winds, at least until actual price data confirmed that NAIRU had been passed. Given that the unemployment rate is now so low relative to the range of estimates of NAIRU, and given the long lags between policy actions and the effect on inflation, continuing such an accommodative strategy would run a

substantial risk of unleashing inflation pressures that would be disruptive to reverse. This may not be an issue going forward, however, given that both the consensus and FOMC forecasts project a slowing to or below trend growth and therefore no further tightening in labor markets.

Let me conclude where I began. Despite the common and challenging global backdrop, central banks around the world face rather unique challenges. Hopefully, we will have the wisdom to make the right choices and contribute both to meeting our respective domestic objectives and to strengthening the global economy at a time of significant stress.

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