

## Speeches

### Thoughts on the Economy and Monetary Policy

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Thank you for that kind introduction, and thank you, Dennis Carreker, for inviting me to join you.

Let me assure you that this is one monetary policymaker who's as vigilant about rhetorical inflation as he is about the economic variety. Having sat in your seat for many early-morning speeches (including more than a few on Monday mornings), I know that too many words chasing too few ideas can be just as lethal as too much money chasing too few goods.

In the next few minutes, I want to share some thoughts on a set of policies that have contributed to the national economic environment: monetary policies. At our third meeting of 1999 last month, the Federal Open Market Committee adopted what monetary policymakers call an "asymmetric directive." That's the Fed's somewhat obscure way of saying we've changed our assessment of the balance of risks to the economy—even if we're not yet ready to act on the change.

But the policy stance we adopted and announced—with a bias toward tightening—comes from a commitment that has *not* changed: a commitment to low inflation and the role it plays in sustaining economic growth. More than anything else, I would argue that commitment to low inflation has been the key factor in the remarkable economic performance we've enjoyed these last eight years.

#### **Where We Are**

Before I talk about what has and has not changed with regard to monetary policy and the economic outlook, let me summarize where we are with the U.S. economy and how we got here.

- The current expansion began around April 1991 and is the longest peacetime expansion in the post-World War II period. It will surpass the 106-month Vietnam-era expansion around March of next year.
- Real gross domestic product grew 3.9 percent in 1997 and again in 1998, and the pace of growth does not appear to have decelerated in the first four months of 1999.
- Inflation and unemployment, meanwhile, remain at generational lows.
- Inflation as measured by the consumer price index was 1.6 percent in 1998, the lowest it's been since 1965.
- And unemployment was 4.5 percent in 1998, lowest since 1969.

In short, the economy continues to amaze everyone who observes it.

#### **And How We Got Here**

But if it's one thing to recite those numbers it's quite another to know what produced them. Let's consider that question for a moment.

In the first place, **consumer and business spending** continue to grow at rates much more typical of an early recovery year, when bottled-up demand for durable goods is first satisfied. Without question, much of this has to do with continued strength in the **single-family housing market**, which continues to defy gravity and demographics. Rising incomes and lower interest rates have made housing affordable, and demand for housing brings with it demand for durable consumer goods.

But while every expansion is fueled by spending, many of them are ultimately undone by it, too, when excesses in one or more sectors don't get corrected in an orderly way. A second factor in the current expansion is that **spending remains fundamentally balanced**.

Previous expansions, including the 1982–90 expansion that preceded the current one, were made vulnerable by imbalances in the consumer and corporate debt sectors and an oversupply of commercial real estate. While an economy can continue to grow with some imbalances in place, those imbalances are easily exposed by economic shocks. The imbalances in the last expansion, of course, were ultimately exposed by the Persian Gulf War. Had any serious imbalances accumulated during the current expansion, the economic and financial shocks we experienced last year almost surely would have brought them to light.

A third factor in the economy's performance is **productivity growth**. Anecdotally and statistically, business investments in technology do appear to be allowing workers to produce more per hour. That is the definition of productivity growth, and it not only increases aggregate supply in the economy, but it also allows labor compensation to rise without adding to unit labor costs.

I'll elaborate on the issue of productivity growth when I talk about what's behind the latest FOMC directive, but let me preview that discussion by saying that this issue has profound implications for monetary policy. While it's pretty clear that productivity improvements are alive and well in the current expansion, I'm among those who would caution against throwing out the economic history book. More on that shortly.

A fourth contributor to the current expansion is simple dumb luck. Actually, we've had at least two significant lucky breaks. Until recently, the first had been the dramatic fall in **oil and energy prices**. As the cost of this major production input fell over the last two years, many manufacturers picked up a little breathing room on pricing. As for consumers, the lower costs of oil and energy gave them more money to spend on other things, and, at the margin, this was an additional source of economic stimulation.

**The Asian crisis** also conferred some luck on the U.S. economy. Lower global demand helped bring commodity prices down, and a strong dollar combined with weak foreign currencies meant that imported goods sold for less in the United States. This development also helped keep the lid on prices of import-competing goods produced by U.S. companies.

These four factors—consumer and business spending, balance, productivity improvements and old-fashioned luck—helped bring our economic expansion into its ninth year. But any one of them can change and in turn compel the FOMC to change its assessment of the risks to the economy. For us, then, there must be a baseline, a goal, an unchanging policy objective against which the economy's underlying factors can be evaluated.

#### **What Hasn't Changed**

That objective—the one condition that makes stable economic growth and low unemployment possible—is low inflation.

Inflation, remember, refers to an increase in the general level of prices, and it works its perverse brand of magic by distorting the allocation of resources. So consumers, when they know prices will rise tomorrow, spend today rather than save. Employees demand cost of living adjustments (COLAs). Businesses build inventories based on the assumption of rising prices, instead of managing the stock of goods at an optimal level. And investors demand an inflation premium on interest rates.

For monetary policymakers, then, inflation is the ultimate phantom menace—except that, unlike the movie version, it always lives up to its billing. The reason monetary policymakers must remain vigilant about inflation is that we write the script with our policy choices.

At every meeting, the FOMC has the same three options: add purchasing power, remove it or leave it the same. Inflation enters the economy when purchasing power exceeds output—when, as our high school economics teachers put it, “too much money chases too few goods.”

Sometimes policymakers choose inflation because they believe it's the least bad of several very unpleasant options. This situation occurred during the oil crises of the 1970s, when the FOMC eased monetary policy to provide some relief for businesses and consumers who had to spend more of their income on energy and less on other things. It's important to remember, though, that it was this policy choice—and not the rise in oil prices—that caused the inflation of that period. Countries that did not make this choice—including Japan and Germany, which import much more oil than the United States—did not experience (serious) inflation. What they endured instead were very serious recessions.

Most often, however, inflation enters the economy by mistake, when monetary policymakers let down their guard. The FOMC's asymmetric directive should be taken as an indication of our resolve not to let that happen.

#### **And What Has Changed**

Before I talk about the potential sources of risk to the economy, let me first try to clarify what the Fed means by “asymmetric bias.” The term asymmetric is economic shorthand for “tilt” or “leaning.” It simply means that of the two prevailing risks to monetary policy objectives—the risk that economic growth will slow to below its potential versus the risk that imbalances will lead to accelerating inflation—one is more likely to happen than the other. If we judge the risks to be evenly balanced, we'll adopt a symmetric directive that doesn't tilt in either direction.

As you may know, at our meeting last month we adopted an asymmetric bias with a tilt toward tightening. That was a change from the symmetric bias we'd had in place since our December meeting. From September to December, of course, we maintained a tilt toward loosening, during which time we actually cut the fed funds rate  $\frac{1}{4}$  of a percent and the discount rate  $\frac{1}{4}$  percent. But it's worth noting that for most of 1998, the policy bias was exactly where it is today: tilted toward tightening. All of which is to say that just because we've adopted a tilt in one direction doesn't necessarily mean we're going to cut or increase rates. In fact, we've had a bias toward tightening more than once since we last increased rates in March 1997.

Nevertheless, in my judgment the risks are currently weighted toward the possibility (though not the inevitability) of growing inflationary pressures.

For one thing, the lucky streak I mentioned earlier has finally run out. Energy prices are up substantially from their year-ago levels, and other commodity prices have risen, too. What's happened, of course, is that as the economies of Asia and elsewhere have turned the corner to recovery, global demand has picked up, and so have prices. As developing economies around the world continue to improve, I expect more of the same.

A second concern is what I'll call the residual stimulus from last fall's Fed rate cuts. I believe the policy lag (as monetary policymakers call it) is alive and well. This is the well-established idea that it takes some time for the economy to respond to monetary policy changes. And while the economy responded with unusual alacrity to last year's interest rate cuts, that doesn't mean the policy lag has disappeared. Unfortunately, the tools of monetary policy don't yet come with an instantaneous on-off switch, and I believe the rate cuts we implemented last fall are still working their way through the economy and will be for some time.

My third concern is inflation expectations. While at least part of the recent long-term interest rate increases are very likely attributable to growing confidence in the global economy and falling demand for the safety and liquidity of U.S. Treasuries (the opposite of the flight to quality we saw last fall), I'm concerned that the markets may be signaling concerns about increasing inflation.

A fourth concern is the rapid growth in monetary aggregates we've seen over the last several years and again in April. To be perfectly clear here: *in the short term* the money growth we're seeing is not necessarily inconsistent with low inflation. It may or may not be. And as those of you who follow the money supply debate know, the chief reason the FOMC stopped targeting monetary aggregates several years ago is that it is not useful for short-term, operational decisions. But in the long term, there is a well-established direct relationship between money supply growth and inflation. So the recent growth in the aggregate money supply over the last few years remains a real concern.

Finally, I remain concerned that tight labor market conditions are a signal that the economy is overstimulated. And it's here, most critically, where the debate over productivity growth matters.

As I said earlier, I believe that productivity growth—a firm's ability to produce more with less—has been an important part of the current expansion. By lowering unit costs through productivity improvements, firms have been able to hold the line on prices while also increasing wages.

The problem is that it's not at all clear that the extraordinary productivity gains we've seen in recent years will continue at this pace. For one thing, productivity growth is notoriously cyclical. For another, we measure it very poorly.

Still, it's hard to think of an issue that has more long-term implications for the economy. Monetary policy, remember, operates on the demand side of the economy. And our decisions there—whether to add purchasing power, remove it, or leave it the same—are premised on our understanding of the economy's productive capacity. If we're wrong on one side—if the economy is capable of producing more than we think it can—then it's unlikely that growth will ever reach its potential (except by accident). If we're wrong on the other side—if we overestimate productive capacity—we won't put the brakes on in time, and inflation will break out.

The truth is that we policymakers would be much better off if we were more like you: if we could measure productivity as accurately as you do at the company level and if we could aggregate it at the national level. Until we're able to do that, though, any bet that the extraordinary productivity gains we've seen in recent quarters are here to stay for the long term is just that: a bet.

Many of the areas of concern I just mentioned have been with us for some time, and yet so far we've avoided any negative inflation implications from the risks they represent. Other concerns represent more recent developments that will have to be monitored and evaluated on an ongoing basis.

The asymmetric policy directive we adopted last month represents a blinking caution light. It indicates that we're paying especially close attention to developments as they emerge and that we're prepared to adjust policy if and when that seems appropriate. And that, ultimately, signals our dedication to keeping the economy and this near-record expansion thriving well into the third millennium. Stay tuned.

## **CONTACTS**

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