

**Remarks by Cathy E. Minehan,
President, Federal Reserve Bank of Boston**

**to the
Government Bond Club of New England**

**Thursday, September 7, 1995
Le Meridien Hotel**

Remarks by Cathy E. Minehan
to the
Government Bond Club of New England
Thursday, September 7, 1995
Le Meridien Hotel

The holy grail that practitioners of monetary policy sometimes seek is a single economic or financial indicator that would serve as a North Star to guide monetary policy. We have tried M1, M1a, M2, and various and sundry other combinations of letters and numbers, but no indicator has proven stable, reliable, and consistent. While I certainly have not found that elusive holy grail since I have been at the Boston Fed, I do know one stable, reliable, and consistent feature of that Bank, and that is Eddie McCarthy.

Eddie has served more years at the Boston Fed, since his retirement, than most employees can hope to have at retirement. Eddie has also served as a bridge between this club and the Boston Fed for some time, and I would like to begin by thanking Eddie for his many years of helping the Boston Fed keep in touch

with financial market participants such as yourselves. Eddie is also a constant for me; every morning, almost without fail, he calls me on my way to work to let me know the latest market news, gossip, and speculation about the day ahead. While my predecessors, Dick Syron and Frank Morris, and I differ greatly in our backgrounds, our constant is Eddie, his news, advice, and help. He is a real treasure.

Turning to the search for the Holy Grail, some observers of the Federal Reserve have been disappointed that monetary policy does not have that simple, reliable guidepost. In a world in which financial institutions, financial markets, and financial regulation are changing dramatically and diverting from previous patterns, the very existence of such a guidepost is in question. Despite this, by most assessments our current progress towards obtaining a stable noninflationary economy has been remarkable. Tonight I'd like to discuss broadly how I think this has been accomplished, and how we at the Fed operate in this world of uncertainty.

Recent economic data suggest that we could achieve the economic equivalent of nirvana: a "soft landing." The Bank's expectations concur with those of most analysts; we expect the economy in the second half of this year to grow about at potential, with close to full employment and with an inflation rate that is essentially stable and at a level unlikely to distort business decisions. Thus, I expect that the slightly better than one percent growth in real GDP last quarter was a pause rather than a trend, and that growth will pick up in the second half of the year, fueled by a stronger housing sector, little or no further weakening in inventory investment, and continued restrained growth in consumption. I also expect good news on the inflation front to continue in the second half of this year, as the slow growth in benefits results in restrained growth in employee compensation; with low labor costs, reduced pressure on input costs, and strong competitive pressures in most industries, firms may have little incentive to raise prices, though that situation requires close and rigorous vigilance.

Should these expectations be realized, monetary policy makers will face tough choices. In fact, setting monetary policy is particularly challenging at just this point in a business cycle. Setting policy is easier when the economy is far from any definition of optimal. If unexpected supply shocks, foreign shocks, or aspects of previous economic policies cause the economy to experience high unemployment and falling rates of inflation, the policy path is clear: We need to be more accommodating. Similarly, if labor markets are very tight and higher rates of inflation are expected or, worse, being realized, again the policy path is clear: We need to tighten. However, absent such clear choices, our task becomes particularly difficult. Setting monetary policy at this juncture requires an assessment of the best economic outcome over time, an evaluation of the risks in achieving that outcome, and a determination of what insurance premiums it may be necessary to pay to address those risks.

If one's economic assessment involves the distinct risk of a rising rate of inflation, then one would be very careful about

upside risks to the "soft landing" forecast and would be willing to purchase insurance in the form of slightly tighter policy, all other things being equal. On the other hand, if the assessment views the risks that inflation rates will rise as very low, one may want to ensure against inadequate economic growth with easier policy.

And this process becomes even more subtle when we realize that these two policy stances--the hawk and the dove as often characterized by the media--are not aimed at different ends.

Rather, the goals of healthy growth and low inflation, which can at a moment in time seem incompatible, are intertwined if not co-dependent.

To reiterate some economic verities, over time, the long-run growth rate of the economy can for all practical purposes only be increased through higher rates of productivity. In turn, higher rates of productivity growth can only be achieved through higher rates of domestic savings and investment. And, finally, higher rates of saving and investment will occur most readily in an environment in which the threat or reality of inflation does not

distort the decisions of savers or investors. I think we have only to look at the progress this country has made since 1982, when the back of the high rates of 1970s inflation was essentially broken, to realize the benefits to be realized from a restrained inflationary environment in terms of increased international competitiveness and a renewed emphasis on productive investment.

Thus, I start from the maxim that whether at any moment in time the primary concern is inflation or economic growth, the best policy over the longer run is to remain vigilant against inflation. This is a variant of the old maxim--an ounce of prevention is worth far more than a pound of cure. Moreover, from the point of view of the central bank, the credibility that accrues from a recognized pursuit of inflation stability is invaluable when it comes to addressing the Bank's other preeminent task of maintaining the country's financial stability. Throughout the 80s when crises of many types hit the financial markets, I cannot help but believe that the Fed's demonstrated willingness to take firm steps to pursue

the right economic ends was integral to its success in solving those crises. But however straightforward this policy prescription seems, it doesn't turn out to be easy to follow.

Setting monetary policy in these uncertain times is bedeviled by the answers to at least three questions: First, what is the maximum rate of noninflationary economic growth that can occur and does that change over time? Second, how forward-looking should monetary policy be in making very short-term judgements as to the possible tradeoffs between growth and inflation? And finally, what is the play between monetary and fiscal policy in affecting the real rates of interest that, among other things, act to encourage or discourage savings and investment? While the answers to these questions are far from clear, let me discuss them more fully as they relate to the inevitable uncertainties in the policy-making process.

The first question is tied to the issue of how low the rate of unemployment can be before labor markets tighten to the degree that wages and prices begin to accelerate. In economist jargon,

where is the non-accelerating-inflation rate of unemployment, or the NAIRU? Many economists have pegged this rate at 6 percent, with reasonable estimates falling between 5.5 and 6.5 percent. If these estimates are accurate, our current unemployment rate of 5.6 percent is at the lower edge of the range that would be consistent with no further acceleration in the inflation rate. Some have argued, however, that historical estimates of the NAIRU may be too high, as external competition has increased, as capital investment has ^{added to} ~~surged~~ productive capacity, and as business downsizing has made workers more risk averse and less prone to demand higher wages at given levels of market tightness. If that were true, we could at this point feel reasonably comfortable in the short run that wage pressures would not push inflation trends. In short, it could be that now we have more room to grow without risk.

Unfortunately, current data do little to provide that comfort. No significant inflation pressures in labor markets are apparent, but the inflation rate as measured by the CPI did rise somewhat in the

first half of this year. It is not clear whether the higher inflation rate for the first half of the year is an anomaly, and lower unit labor costs will prevent an acceleration of inflation or, alternatively, whether the low compensation numbers in the first half of this year are the anomaly, reflecting only temporary reductions in the rate of growth in compensation. Adding to the confusion is the clear recognition that reductions in benefit costs, which have affected labor costs positively, at some point will stop; then growth in benefits costs, even though moderate, will resume. When will that be and what effect will it have? In other words, neither the state or the art of contemporary economics, nor the crystal ball through which we look at economic statistics, are such as to provide clear signals as to the risks of reaching or shooting through the so-called natural rate of unemployment, with all that implies for the rate of growth in inflation.

The second question turns on the issue of whether the Federal Reserve in setting monetary policy in the short-run should give equal weight to the risks of recession and the risks of rising

inflation. Recessions are, of course, very costly in terms of foregone economic growth. Living here in New England in the early 90s was strong proof of the devastation recessions can cause--one job in ten lost--over 600,000--and the region still remains only about 50 percent of the way back to pre-recession employment levels. However, the vigilance needed to restrain inflation, even in the short run, is not at all incompatible with sustained economic expansion and avoidance of recession. The experience of the last dozen or so years is testimony to this fact. In each of the successive business cycles during this period, the peak rates of both inflation and unemployment were lower than the previous cycle.

Looking forward, the lesson from history would seem to be that the Federal Reserve should be as responsive as possible to incipient inflation pressures. However, how far to look forward, and how responsive to be, remains an open question. Significant tightening at the first risks of growth in inflation, if timed badly, could trigger the very recession we seek to avoid. On the other

hand, inadequate responses may allow the inflation rate to increase so sufficiently that a more vigorous response becomes necessary later, with the certainty that recession will follow and that the worse the inflation, the deeper the recession.

The third issue revolves around whether or not current real rates of interest are too high. If one examines the macro economy, real interest rates--whatever their exact level--do not appear to be a major restraint on the economy. The unemployment rate is low, and most forecasters project that it will remain at this level through the year. Credit seems readily available, corporate profits are good, and financial markets are humming along to say the least. Nonetheless, by some historical analyses, real rates of interest seem high.

Real interest rates are a function of three major factors--concerns about the future rate of inflation, the supply and demand for savings in the future, and the real rate of return on investment. Integrally related to these factors are actions taken by fiscal policy makers to reduce or increase deficits. A smaller deficit could

reduce economic growth in the short run but will also free up the supply of long-term capital for private sector investment, bring down long-term interest rates, and add greatly to economic health over time. All other things being equal, these could be factors the Federal Reserve would consider in assessing the stance of monetary policy. However, if easing monetary policy adds to future fears of inflation, it could be self-defeating. While deficit reduction is central to our nation's long-term economic prosperity, great care is needed in seeking to draw linkages between that and monetary policy. For example, how much, if anything, do we really know about whether significant fiscal tightening will occur and how it will play out over the near term? Similarly, over the period in time suggested by any deficit reduction plan, many other factors will impact the country's economy requiring monetary policy action independent of deficit reduction efforts.

I have raised several questions tonight, and you have probably noted that I have not fully answered any of them. With rapid changes occurring in both the macro economy and the

financial markets, answers to these questions are unlikely to be clear or unchanging. That is probably good for economists in research departments, since new questions are likely to arise more quickly than new answers, providing ample employment to those who study the economy and financial markets. It is not, however, necessarily good news for us policy makers, who like to make correct decisions each six weeks, and who, as I noted earlier, view the credibility that comes with that as a great positive.

Rapidly changing conditions have made the role of the central bank increasingly complicated. Some indicators used in monetary policy formation, like the Ms, which were reasonably stable in the past, have proven to be unreliable and, understandably, are now given less weight. Most interesting is the fact that despite the lack of any easy monetary policy rule for the central bank and financial market participants to follow, our macroeconomic outcomes have been, by many assessments, quite good. This probably owes something to a healthy strain of pragmatism within the Federal Reserve System; to a willingness to incorporate the

best from many varied economic philosophies, to incorporate the "rules" of the moment flexibly into our analysis; to be willing to listen to the financial and foreign exchange markets without necessarily following their advice; and to a willingness to shoulder the responsibility for a decision process that involves an implicit weighting of a variety of factors.

The guideposts for policy are not clear, and many issues remain to be addressed. But that does not mean that policy is rudderless or should be incomprehensible to those of you who spend at least some of your time forecasting future policy actions. History indicates that the best policy is to remain vigilant against creeping inflation. By avoiding inflationary cycles, we are likely to dampen employment cycles and increase the probability of long expansionary periods such as we enjoyed through much of the 1980s. That is precisely why we are pleased that prices and wages remain well behaved, indicating that, however eclectic, monetary policy has been reasonably successful. The soft landing that I expect to see in the second half of this year should allow us

to consolidate our gains against inflation, providing a good environment for stable growth in the economy for the rest of the 1990s.