Remarks by Cathy E. Minehan
at
Merrimack College Fall Corporate Breakfast
October 17, 1995

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It's a pleasure to be with you this morning. I'm told that today's breakfast is the first of a new series, and I'm honored to have been asked by President Santagati and Jane Walsh to participate in the beginning of what I know will be a fine tradition.

Today I'd like to talk to you about monetary policy, particularly in terms of the challenges we now face and to give you some insight into the factors one considers in determining its direction. It's a rather good time to talk about monetary policy, I think, because by many people's standards, monetary policy has been successful, both recently and over a longer time period.

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 always requires close and rigorous vigilance.

Should these expectations be realized, monetary policy makers will face difficult 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. Hypothetically speaking, if unexpected supply shocks, foreign shocks, or aspects of previous economic policies cause the economy to experience high unemployment amidst 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 direction for the economy over time, an evaluation of the risks in achieving that outcome, and a determination of what insurance premiums in terms of policy actions it may be necessary to pay to address those risks.

And this process becomes even more subtle when we realize that insurance in the form of tighter or easier policy, while seemingly aimed at a goal of either high growth or lower inflation at a moment in time, really seeks to achieve both outcomes. They are not incompatible in any sense, and, in fact, work together.

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 evaluating the risks to either subpar growth or inflationary pressures? Third, 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? And beyond these macro concerns, there are also issues related to regional economic conditions, particularly in times like these when at least some regions of the country vary greatly in terms of economic health.

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.

If unemployment is above the NAIRU, growth can be rapid without creating inflationary pressures. At the NAIRU, however, growth faster than the growth in the economy's productive capacity risks putting upward pressure on inflation.

Some have argued that historical estimates of the NAIRU may be too high, as external competition has increased, as capital investment has 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 nor 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 how the Federal Reserve in setting monetary policy in the short-run should weight 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. 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 into the future, and how aggressive to be, remain an open question. Significant tightening at the first risks of rising inflation, if timed badly, could trigger a recession. On the other hand, inadequate responses may allow the inflation rate to increase much 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.

Turning to issues of regional economic health, I am often asked how the economic situation in New England enters into national policy setting. As you know, New England experienced an economic boom (one might even say a bubble) at the end of the 80s, only to have a bust in the early 90s. The up was higher and, as I noted earlier, the down further than the rest of the country, and while the rest of the country is expanding in terms of job growth, New England still plods along, growing but only about 50 percent back to its pre-recession employment levels. One could argue that the employment levels were too high at the end of the 80s (unemployment was 3 percent after all) and that we shouldn't be too hasty in getting back to that point, recognizing the effect that has on regional cost trends and competitiveness, but this is a hard argument to make to unemployed defense workers.

And it is the unemployed defense or computer industry worker we need to be concerned about. During this recovery, job gains have come in services - from software, to legal services, window washers, to engineers. The losses have been in manufacturing - and while manufacturing layoffs often occur during recessions, usually manufacturing leads the recovery. Not this time. Due to structural changes in the defense and computer industries, and to some degree the continuing high cost structure in Massachusetts, in particular, manufacturing jobs are going away without a tremendous likelihood they will return in the same number. Moreover, the jobs we are creating in manufacturing and in services require an increasing level of technical skill, creating a mismatch between the available workers and the available jobs.

Can monetary policy, however formulated, deal with these structural long-term regional issues? Not directly, though I do think federal and state fiscal policies directed at public education could be part of the answer. But we at the central bank can over time create an environment of stable national economic growth that is a tide that lifts all regional boats. And in the end, this will do as much as anything to bring New England slowly back through its recovery to an expansionary phase. Most forecasts see that occurring in late 1998 or 1999, and we pretty much agree with them.

I have raised several questions this morning, 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. Despite this, 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 always clear, and many issues remain to be addressed. 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. 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 - and that augurs well not only for the national economy, but for New England as well.