

SEVENTH DISTRICT OUTLOOK

Chicago, Illinois  
March 4, 1998



**Sustainable Growth and Price Stability: The Role of Monetary Policy**

**I. Introduction**

- A. Great pleasure, etc. Economist joke, if desired.
- B. Today, I'd like to take a step back from the steady stream of economic data that we all see in the media and discuss the role of monetary policy from a longer-term perspective.
- C. More specifically, I'd like to discuss the capabilities and limitations of monetary policy—what monetary policy can and cannot do.
- D. A quick look back helps to illustrate monetary policy's capabilities and limitations.
  - 1. It was only about twenty years ago that the U.S. economy was at a low ebb.
  - 2. Our economy's dismal performance even led some to question the viability of our capitalistic system.
  - 3. Among the doubters was Time magazine, with a cover story in 1980 that asked, "Is capitalism working?"
  - 4. The answer from Time was a qualified yes. Capitalism was working, but not very well.
  - 5. Time noted that "Price spurts once associated with profligate banana republics are now common...and threaten the foundations of democratic society."

- E. Eighteen years later we've seen a dramatic change—an amazing reversal of economic fortunes. We've just finished a remarkable year.
  - 1. Real GDP rose 3.8 percent last year—the largest increase since 1987.
  - 2. The unemployment rate averaged  $4\frac{3}{4}$  percent in the fourth quarter of 1997—its lowest sustained level since the late 1960s.
  - 3. And the CPI increased only  $1\frac{3}{4}$  percent over the 12 months of 1997. That's the smallest increase since 1986.
  - 4. From a central banker's point of view, we hit the trifecta—we had strong growth, high employment, and low inflation.
- F. I can't give the Federal Reserve full credit for these events. But I do believe that monetary policy has contributed significantly to our good economic fortune.
- G. To explain why, let me first address the question: What is the goal of monetary policy?

## II. Goal of Monetary Policy

- A. Stated simply, the goal of monetary policy is to help the nation achieve maximum sustained growth and improved living standards. In other words, the Fed is all about growth—but that growth has to be sustainable.
- B. The growth can't be at such a high level that it will quickly burn itself out. As I'll discuss in just a minute, the only way to achieve sustainable growth is to have a low inflation environment.
- C. The economy's ability to grow in the long-run is limited by a number of factors, such as the rate of productivity, the size of the labor force, and the scarcity of other resources.
- D. The Fed must take these factors into account when it evaluates whether the economy is achieving maximum sustainable growth.
  - 1. We're like a downhill skier at the winter Olympics:
  - 2. all the skiers go as fast as they can,
  - 3. given factors such as the weather and the condition of the slope.
  - 4. Go too slow and you end up out of the running; go too fast and you crash.
  - 5. Finding the right balance separates the winners from the losers.
  - 6. Another important concept that reinforces the appropriate balance is the key role of the price system in allocating resources efficiently.

- E. Businesses and households use prices to make decisions—decisions that ultimately determine how resources are allocated.
  - 1. For example, if the price of a product increases due to higher demand, then we should see suppliers respond by shifting more resources to that good's production.
  - 2. We saw this during the 1990s when consumers increased their demand for minivans, and sport utility vehicles
  - 3. Another recent example of price movements causing a shift in resource allocation comes from the computer industry where we've had substantial price declines as well as extraordinary quality improvements.
  - 4. In response, both businesses and consumers have dramatically increased their purchases of PCs and related products.
  
- F. This constant ebb and flow in a free market economy occurs in response to changes in *relative* prices—the price of an apple versus a banana or a Dell PC versus a Mac.
  - 1. A *general* rise in the level of *all* prices—inflation—shouldn't affect resource allocation in this way. So why is inflation a concern?
  
- G. It's difficult for households and businesses to distinguish between an increase in all prices as opposed to a change in relative prices.
  - 1. Inflation that's high and erratic makes it even more difficult to make that distinction.
  - 2. So a central bank's primary objective should be to ensure that inflation is not high and erratic—it should focus on achieving low and stable inflation or price stability.
  
- H. Pursuing this goal doesn't mean that the central bank shouldn't intervene in the economy in the short run.
  - 1. The crux of the monetary policy decision is deciding when inflationary—or deflationary—pressures threaten the efficiency of the price system.
  - 2. Sometimes people tend to get disinflation mixed up with deflation.
  - 3. Deflation is when the general level of prices is actually decreasing. Disinflation is when inflation is slowing down.
  - 4. So as a central banker, I'm happy to see disinflation, but not necessarily deflation.
  
- I. Deciding when to act in response to inflation isn't an easy job, especially given the uncertainty about the economic outlook and many of the factors determining the economy's growth potential.
  - 1. In addition, there's a great deal of uncertainty about the length and variability of the lags between a monetary policy action and its impact on the economy.

2. Monetary policy works like a time-release capsule. A policy action to cure the economy doesn't have an effect for many months or even longer.
- J. Despite these difficulties, I believe that monetary policy during the '90s has made a significant contribution toward achieving maximum sustainable growth. The Fed can continue to make a significant contribution by building on its progress in achieving low inflation.

### III. What Monetary Policy Can Not Do

- A. So far I've discussed the relationship between monetary policy and average rates of inflation. Economists generally agree that this relationship exists, but it's not well understood by the general public.
1. I think this is due in part to the failure of economists to communicate this relationship in a simple and succinct manner.
  2. In particular, I think there's confusion among the general public about what monetary policy can and cannot do.
  3. I'd like to use the remainder of this talk to discuss the limitations and capabilities of a central bank.
  4. I believe this is important because it's paramount that the *objectives* of monetary policy are aligned with the *realities* of monetary policy.
- B. So what is it that monetary policy cannot do? The biggest limitation of monetary policy is that printing money does not directly create wealth for society.
1. Wealth consists of two things—financial assets and physical assets.
  2. Financial assets are simply claims on current and future physical assets.
  3. Physical assets, of course, are real things like computers, cars, houses, and factories.
  4. Another type of asset is human capital, which is a form of wealth. It's human capital such as organizational knowledge that makes it possible to use physical assets such as machinery to produce goods and services
- C. So, wealth is not created by printing money. New factories, houses, and cars aren't created by a stroke of the Fed's pen.
1. Money is a piece of paper whose value is in facilitating the purchase of goods and services.
  2. This value needs to be relatively constant and predictable.
  3. As we've seen recently in Asia, volatile and rapidly declining currency values can throw a nation's economy into turmoil.

- D. There's no doubt instability can lead to problems. The other side of the coin is that economic and financial stability leads to wealth creation.
1. A stable decision-making environment facilitates efficiency and the creation of real wealth that everyone can share in.
  2. In a stable environment there's less uncertainty and businesses can focus on formulating long-range plans.
  3. This leads to greater investments in plants and equipment and higher employment, income, and living standards.
- E. We've seen this scenario unfold in recent years. One noticeable benefit of our recent economic growth is that many more people, including some previously considered unemployable, have found jobs.
1. A large number of *underemployed* workers have been able to find jobs that are a better match for their skills. And many low or unskilled workers have found employment.
  2. This trend can be seen in the success of many states in moving individuals from welfare to work.
  3. Many of these individuals will permanently benefit from the training and experience they've received on the job.
- F. A stable environment also means that investors—both individuals and institutions—will have more confidence in the economy's productive ability. This increase in investor confidence undergirds the stability of the equity markets.
- G. Increased growth and prosperity helps to reduce budget deficits which benefits the government.
1. The nation as a whole benefits from reduced budget deficits as well. Reducing the deficit—or even better, running a budget *surplus*—helps promote a higher level of national savings.
  2. And a higher level of national savings tends to decrease long-term interest rates, which spurs additional business investment.
  3. And, as I just mentioned, such investment eventually leads to higher employment, income, and living standards.
- H. Of course, the goal for the economy is stability, not rigidity.
1. For example, technological breakthroughs can occur overnight and generate volatility. That's the nature of the free market system—and one of its great advantages.
  2. The kind of instability that is destructive is linked to more general economic or financial volatility.

3. For example, an unanticipated disruption to business cash flows can lead to the cancellation of productive investments.
  4. Sustained economic growth is only possible if such worthwhile projects are continued.
- I. What happens if the Fed tries to create economic growth by keeping interest rates inappropriately low?
1. To keep nominal rates low, the Fed must supply additional liquidity to the economy. This policy ultimately increases the flow of money and credit.
  2. The resulting lower interest rates and cost of funds tends to lead to increased spending. Consumers buy more expensive goods, such as houses and cars.
  3. At the same time, lower interest rates mean lower hurdle rates for investments. Lower quality investment projects are more likely to find financing.
- J. Ultimately, businesses' ability to provide goods and services can't keep up with the increase in spending.
1. Production bottlenecks appear and resources become more and more constrained. Eventually, upward pressure on wages and prices emerge.
  2. This leads to higher inflation. Financial markets begin to build in an inflation premium into interest rates. This inevitably results in a cooling in demand—the boom cycle unwinds into a bust cycle.
  3. Businesses find themselves with too many workers. Layoffs occur. Some businesses go bankrupt or cut back on investments. Valuable economic relationships are lost.
  4. In the end, real economic activity is no greater than when it started. And it may be lower because of the jarring changes such as job losses.
  5. This is the type of boom and bust cycles we endured during the '70s and early '80s—the cycles that led to the fundamental misgivings about our economy that I mentioned earlier.

#### IV. What Monetary Policy Can Do

- A. So if all the world's a stage, then the Fed would not be the lead player as far as the economy is concerned.
1. In fact, it wouldn't even be an actor or the director.
  2. The Fed's role is more behind-the-scenes—a stage manager who provides the appropriate environment for a successful production...the person who builds the right set so the actors can operate at an optimal level.

3. How does the Fed do this? That brings me to my next point. I've discussed what monetary policy cannot do. So, what can monetary policy do?
- B. Control the rate of inflation.
1. The central bank ultimately influences the money supply. And there's almost uniform agreement among economists that inflation is first and foremost a monetary phenomenon.
  2. The empirical evidence also supports the clear connection between inflation and the money supply.
  3. History has shown us that countries with high inflation rates also have high growth rates of money.
  4. Macroeconomic textbook writers tended to disagree on this point as recently as the 1970s, but that's no longer the case.
- C. The Fed's ability in this arena is important because low and stable inflation is one of the keys to a stable decision-making environment and its accompanying benefits. The consequences of high and variable inflation are clear:
- D. First, it leads to inefficiency. Unanticipated inflation complicates decision making.
1. A firm that can efficiently set wages and prices provides important signals to workers and customers on how to allocate their scarce resources.
  2. For example, high wages for computer programmers attract the right workers to companies that need to solve their Year 2000 problems.
  3. Similarly prices and profits in an industry signal to potential competitors the possibility of financial rewards.
  4. This process naturally leads to more products, better quality, and perhaps lower prices.
- E. A second disadvantage of persistent inflation is its destructive effect on economic prosperity.
1. Unanticipated inflation eats away at savings and erodes wealth. Even if inflation is anticipated, it has unintended costs.
  2. People try to avoid inflation through additional financial transactions—transactions that are unnecessary in a more stable environment.
- F. Inflation is also costly because it's a tax that nobody votes for.
1. Printing money to pay for goods and services is a long-established method of government finance that has unavoidable negative consequences.

2. It inevitably leads to inflation. If it continues for too long it leads to hyperinflation.
  3. There are numerous examples—Germany during the 1920s and several Latin American countries during the late 1970s.
  4. Looking at inflation in this way reinforces the idea that low inflation rates will tend to increase economic growth and create wealth. After all, lower tax rates tend to stimulate growth.
- G. There's much evidence suggesting that economies perform better in low inflation environments than they do when inflation is persistently high.
1. In fact, the evidence has motivated several central banks and governments—including New Zealand, Canada, Sweden, and the United Kingdom—to establish official low inflation targets.
  2. And the central banks of continental Europe are focusing on decreasing inflation in order to meet the economic criteria for taking part in the European Monetary Union.
  3. So there's a worldwide dislike of unacceptably high inflation rates. Due in part to the efforts of central banks, low inflation is now a worldwide phenomenon.
- H. It's very important for society and financial markets to understand the limitations of monetary policy. But it's just as important that everyone know that the Federal Reserve understands these limits. Why? Central bank credibility.
1. People must understand that the Fed knows its limitations and will pursue a sound monetary policy based on price stability.
  2. The Fed must make it clear that it's committed to price stability. And even more important, the Fed must follow through on that commitment.
  3. In this case, actions definitely speak louder than words. When households and businesses understand the Fed is committed to price stability, the pricing system can operate at a more efficient level. We'll be in a much better position to realize the many benefits of a low-inflation environment.

## V. Conclusion

- A. In conclusion, it's essential to align the *objectives* of monetary policy with the *realities* of monetary policy.
1. Monetary policy cannot increase economic activity beyond its capabilities. Trying to do so will only lead to higher inflation and the loss of productive economic arrangements.
  2. Monetary policy can help achieve sustainable growth by maintaining low and stable inflation and fostering a stable environment.

3. This stability provides the critical infrastructure for maximum sustainable growth.
- B. A credible commitment on the part of central banks to keep inflation low and stable will minimize the cycles of boom and bust we saw in the U.S. during the '70s and early '80s
  - C. Let me close by stating that the Federal Reserve is committed to maintaining low inflation and providing an environment consistent with sustained economic growth.
    1. Inflation is low by recent historical standards, but it shouldn't be considered dead.
    2. The risk of an acceleration in inflation is not negligible. Over the past couple of years, monetary policy and economic events have allowed us to bring the inflation rate down from the levels of the early 1990s.
    3. As a result, resource allocation is undoubtedly closer to optimal efficiency with a resulting benefit in growth and living standards.
  - D. The Federal Reserve is committed to the challenge of building on this progress in the face of an ever changing domestic and global economy.
  - E. Thank You.