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Federal Reserve Bank of Cleveland

Construction and Monetary Policy: A View from the Sidelines

by Sandra Pianalto

On January 27, Sandra Pianalto, First Vice President and Chief Operating Officer of the Federal Reserve Bank of Cleveland, spoke at the annual forecast dinner held by the Home Builders' Association of Greater Akron. This *Economic Commentary* is adapted from her remarks.

The Federal Reserve's popularity in the business community is as high as it has been in the 15 years I've been in the System, and perhaps as high as ever in our 86-year history. I often hear someone say, "The Fed sure is doing a good job."

As Chief Operating Officer of the Federal Reserve Bank of Cleveland, I'm tempted to interpret such a compliment as a statement about how efficient we have become at clearing checks. And indeed we have. But that isn't what you mean, is it?

Do you mean that the Fed is monitoring banks effectively, providing leadership in electronic payments development, and working hard to ensure that all financial institutions are Y2K compliant well before New Year's Eve? We are, you know, but these accomplishments don't usually get us noticed in the business community.

Perhaps "doing a good job" means that we are providing the world with one of its best known and most confidently used products, the dollar. And so we are. But I doubt this is what accounts for our recent popularity—at least not directly.

No, I am sure that satisfaction with the central bank reflects happiness over business conditions. You are prospering, and have been, for one of the longest uninterrupted periods in modern U.S. history. Here, in my hometown, we've seen the rate of joblessness fall to less than 4 percent of the labor force. A remarkable level when you consider that this is ½ of 1 percentage point under the very low U.S. average—and in a region that, just a decade ago, had an average rate of unemployment that was 1½ percentage points *higher* than the national average.

For some reason, the business community is quick to give us the credit. Or perhaps I've said that backwards. It is often supposed that the Federal Reserve has given borrowers, and your industry in particular, access to relatively cheap credit, which has allowed our economy to grow. If this is what "doing a good job" means regarding the performance of the Federal Reserve, then it's a backhanded compliment at best.

Judging the performance of monetary policy is like judging the quality of NFL officiating (an especially apt analogy tonight, just four days before Super Bowl XXXIII). Officiating is best when it is noticed least—when the game is what generates the thrills, not the *rules* of the game. If part of the crowd heaps praise on officials, it's generally in response to a decisive call that helps create a wished-for outcome. And that, of course, implies that there is another, unhappy group to whom the officials' call seems less clearheaded.

Indeed, for all the wonderful compliments we have received from the business community recently, the Fed has gotten less-than-glorious reviews from pensioners and others on fixed incomes who believe that low interest rates have created a hardship for them. Like a football referee, I might be inclined to say that we call 'em as we see 'em. In what I will refer to as the "conventional view" of monetary policy, the Federal Reserve is often presumed to be the judge of what the "right" amount of credit in the economy should be.

But here the analogy breaks down. We are not the arbiters of credit; the financial system is. A better analogy, I think, is that we are the makers of the monetary football. That thing you pass back and forth between you. It's a crucial part of the business game to be sure, but a passive part. I've been at many football games and not once have I heard someone say, "Wow, what a great ball." It goes unnoticed, and the players take for granted its constancy, its sameness, its predictable shape and size.

I wonder if football manufacturers are ever tempted to make the ball a bit smaller to give the offense a boost. Or maybe they'd like to let some air out of the ball and turn things in favor of the defense. Thankfully, rules prevent the ball from varying from contest to contest. The caretakers of the NFL want the game to be about the athletics on the field, not about the whims of those who provide the footballs. This is precisely why many of us in the Federal Reserve System would like to see Congress give the central bank a single objective—the attainment of price stability—so that you can take for granted the predictability and consistency of the dollar.

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The Fed, Interest Rates, and Purchasing Power Uncertainty

The invitation I received billed tonight's event as an "annual forecast meeting." And I clearly understand your expectations for my remarks: The health of the construction industry is sensitive to the level and direction of interest rates; you would like me, as a representative of the Federal Reserve, to tell you what those interest rates will be. On this score, I'm afraid I must disappoint you. Not because there's a deep secret that I can't disclose, but because of a popular misconception about what the Fed actually does and how it does it.

I do not doubt that credit availability may be the single most important factor in the near-term outlook for your industry. But how, exactly, do we control the amount of credit in financial markets? The conventional view of monetary policy explains the process something like this: If the Federal Reserve believes the economy is overheating (or, in economists' vernacular, "operating beyond its potential"), then it drains reserves from the banking system. This, in turn, drives up interest rates, and the higher rates cool the economy off. On the other hand, if we think the economy needs a little perking up, then the conventional view would have us do the opposite—add reserves to the banking system, push interest rates downward, and in so doing boost economic growth.

This conventional view of monetary policy has at least two major shortcomings. To begin with, its adherents would have you believe that the economy is inherently unstable and, if left alone, is doomed to unnecessarily long periods of unemployment and stagnation. It is the job of the Federal Reserve, they say, to ensure that the economy marches to a steady, more predictable beat.

I have a more optimistic view of the marketplace. I believe it marches to a beat of its own making, and the best judges of its tempo are the entrepreneurs and laborers whose efforts are the origin of its growth.

My second dispute with the conventional view of monetary policy concerns the notion that we can control interest rates in such a way as to determine the spending behavior of borrowers. I object to this for essentially the same reason—because I think that the interest rates that influence economic growth (what economists call "real" interest rates) are set in the marketplace through the negotiations of investors who supply capital to the credit market and the entrepreneurs who use that capital to fund business expansion.

The conventional view has popular appeal because people don't always make the necessary distinction between nominal and real values. By altering the amount of reserves, we alter the supply of *money*, which is distinct from credit. By changing the supply of money relative to its demand, we change the purchasing power of a dollar. That is, we change all measurements based on dollars. In other words, we create money, not wealth; a dollar is only a *measurement* of wealth.

Perhaps an example would be useful. Suppose you live in a 3,000-square-foot house, but you want more space. One thing you could do is to build a larger house. This takes resources: lumber, concrete, drywall, and the knowledge to put them together. If, after all this effort, you had added 1,300 more square feet of living space, you would be happier because you would have made a real gain in your standard of living.

Alternatively, suppose the government wanted to help you out a bit. While they might not take on any of the burden of building a new house, they could easily change the number of square feet in your present home by redefining the foot. The Bureau of Weights and Measures in Washington, D.C. could decide that from now on, the U.S. foot is to contain only 10 inches. They would then rightly note that your house, formerly 3,000 square feet, is now a little more than 4,300 square feet! It has grown by the same amount as before, but without any of the mortar, nails, or sweat!

Of course, as you walk through your home you are sure to notice that your new 4,300-square-foot house looks the same as the old 3,000-square-foot model. In fact, they are the same; all that has changed is the standard by which we measure space. Since the new foot contains just 10 inches, your house has changed in nominal value only. Everything real remains as it was.

No doubt this example seems absurd to you, but no more so than talk about increasing wealth through monetary policy seems to me. By altering the supply of dollars in the marketplace, we do not alter real values but only measured values. We create the illusion of growth and prosperity, not the real thing, and then come to regret it. Once we learn that our wealth has not grown in real terms, but rather that the dollar has shrunk, we must reverse all the bad decisions that were based on that erroneous measurement. Further, we must protect the dollar from further debasement.

Here the distinction between *nominal* and *real* interest rates becomes crucial. Credit markets want to be rewarded for providing entrepreneurs with credit. That is the real interest rate. But they also want to be paid back in dollars that have the same purchasing power as the ones they lent out. So the interest rate will also have an inflation premium in it, making nominal rates somewhat higher than real ones. Finally, because lenders know that the value of the dollar can change at the whim of monetary policy, an added bit of risk must be priced into the real interest rate, something financial analysts call the *inflation risk premium*.

The only way the Federal Reserve can lower real interest rates predictably and sustainably is by eliminating the threat of inflation from the contract between borrowers and lenders. In short, an accurate, steady dollar may be the most indispensable tool used in the construction industry.

The Outlook

What about tonight's subject, the outlook for the economy? We all know that economic forecasting falls somewhere between rocket science and the occult, but I'd like to note an especially curious fact: In 1998, economists underpredicted the overall U.S. growth rate for the sixth consecutive year. Persistent, large misses like this should make us cautious about attaching too much significance to economic predictions.

But maybe we ask the wrong questions of an economic forecast. Let me go back to an example from football. When the season began, few gurus saw the Atlanta Falcons in the Super Bowl. Why? Because an enormous, indeed an uncountable, number of factors determine which teams win and which lose, and many of these factors are simply unpredictable.

I believe that the value added by an annual forecast meeting comes not only, and perhaps not even primarily, from the ultimate accuracy of the forecast. The forecast provides a framework for evaluating our risks, and this dinner is an opportunity to weigh the risks before us and debate alternative strategies for confronting them.

Consider what economists are telling us about 1999. Next month, the economy will have completed its eighth consecutive year of growth. Still, economists are holding to the view that our expansion in business activity will moderate somewhat sharply this year. But there is scant data to indicate that such a slowing has begun or soon will. Indeed, on Friday [January 29], we are likely to get a GDP report indicating that, at year's end, the economy was growing at an annualized pace exceeding 4 percent—well above what most would consider a typical growth rate.

The key to whether the economy can continue its string of unusually large growth rates, it seems to me, is the ultimate strength of U.S. capital expansion—our enormous and virtually unprecedented growth in construction and the production of machinery. Your industry, residential construction, has been an important variable in the national growth equation in recent years. Last year, residential construction almost certainly topped 4 percent of GDP, its largest contribution to the economy in a decade. But according to the consensus view, U.S. housing starts are expected to be about 1.54 million units in 1999, a 4 percent drop-off from last's year record. And economists on average see U.S. housing construction falling another 4 percent next year.

What factors have gone into this rather lackluster projection? It's hard to see in the industry's economic fundamentals. The December surveys of homebuilders and homebuyers revealed unusually positive assessments of homebuying conditions, and favorable housing "affordability" indicators are generally expected to persist well into the year 2000. In fact, economic forecasters expect long-term interest rates to fall modestly from their current levels, at least over the next two years. Furthermore, joblessness is low and productivity growth continues to make solid gains; the combined influence of the two is expected to keep income growth in the U.S. economy reasonably strong over the forecast horizon.

I suspect that the soft residential construction numbers in the consensus forecast have more to do with basic arithmetic than economic fundamentals. Despite their outward sophistication, forecasts rely heavily on averages. If the economy goes through a period of better-than-average growth, such as we have seen in this industry over the past few years, economic forecasts almost invariably project a less-than-average performance until the economy returns to its historical trend. After all, the average must be maintained.

Returning to our football analogy: The Atlanta Falcons surprised the football world by winning five of their first six games. Quite an accomplishment for a team that traditionally wins about half its contests and that won only three games two years ago. Did this year's strong start cause analysts to predict that Atlanta would lose five of their next six games? No. Analysts reacted, as would any student of statistics, by predicting that they would play according to their history and win half of their remaining games.

But even this proved an overly pessimistic outlook, and Atlanta closed the season by winning nine of their last 10 games. Come playoff time, some predicted that Atlanta's "luck" would run out—a rational response if one weighs the Falcons' long history too heavily.

There is a forecasting lesson here. Averages are of little use when fundamental changes are introduced into the economic system. Consider the year just past. If you had asked economists in 1997 what they were expecting for 1998—and we did—they would have said 1.42 million units, a small drop from the strong 1996 rate of 1.48 million units. You see, that 4 percent decline I told you they are projecting for this year was the general view for 1998 as well. But last year's starts came in at a phenomenal 7½ percent *increase* over the 1997 level! And in 1996, economists projected a 1.39 million unit pace—again a retreat from the good growth of the year before—only to be surprised by a 1.48-million-start result. The fact is that economists have seriously underestimated housing construction activity for each of the past three years.

Persistent misses like this indicate that something fundamental is changing the U.S. economic landscape and it's having a dramatic impact on the construction trades. We euphemistically refer to these changes as "the technological revolution," which is generally thought to be about the power of computers. And that may be its origin. But the key word in the phrase is really *revolution*. We are rapidly transforming how we go about doing what we do, where we do it, and with whom. The revolution has radically altered the relationships that bind manufacturers to retailers, retailers to consumers, workers to jobs, and yes, families to houses.

These breaks from our observed history introduce a great deal of uncertainty or risk into the outlook, and there seems to be even more uncertainty in the current housing market outlook than is typical in this very volatile industry. When we examine the range of publicly available forecasts, we find that the 10 most pessimistic ones see housing starts falling by nearly 9 percent from 1998—a decline of almost recessionary magnitude. But the economic optimists are projecting that the industry will grow by more than 5 percent in real terms during the next year, another new record high for the industry.

Some of the risk we face tonight comes from circumstances outside the U.S. economy. While this country continues to move strongly and steadily ahead, many of our major foreign trading partners have seen economic growth amounting to less than half of ours. The economies of Japan, Korea, and much of South America are at best flat and, in most cases, still shrinking. These weaknesses have begun to affect certain segments of the U.S. manufacturing sector. Not only have our exports to these nations dried up, but now these nations are fierce competitors. America's steel, chemicals, and textiles industries have all seen production levels drop sharply since August in the face of a brutal foreign economic environment.

I don't deny that these international issues cause significant problems in companies and communities. Certainly those of us who have lived in this city for any length of time remember the plant closings and unemployment associated with the changes in the worldwide rubber and tire industry. But our economic system has tremendous resiliency, which manifests itself in several ways.

For example, the economic weakness that has characterized Japan and other nations has caused the prices of basic construction commodities, like lumber and steel, to remain low, despite the U.S. building boom. Perhaps even more importantly, our weakening trade balance implies that investment dollars—which had been flowing abroad—are now flowing back to the United States. More savers, quite simply, make for lower interest rates, and this too has had a positive, unpredicted influence on the construction industry.

■ Conclusion

In the past, the great unknowns facing your industry rarely came from the international environment. They came from government policy or, more to the point, from changes in that policy. Alternating tax treatments of structures have been both the boon and the bane of the construction market—more bane than boon, I would guess.

And fiscal policy is certainly not alone in this criticism. Using the monetary authority to "manage" the level of construction activity is fraught with peril. At best, policy's effectiveness is unpredictable and temporary. In the end, "easy" money policy causes interest rates to rise, not fall—and construction to languish, not flourish.

When we conceive of monetary policy in this light, we focus on the appropriate role of the central bank in creating wealth. If the Federal Reserve has contributed to the revolution driving our economy, and this industry in particular, it has done so only by providing the nation with a steadier measure of value. In this way, the unnecessary risk premium in capital market interest rates caused by inflation uncertainty has been reduced. This—not easy money—has made credit cheaper.

Creating an environment of steady prices has helped to liberate the investment potential of the nation, opening up previously unobtainable trade opportunities abroad and encouraging more research and development. In other words, reducing the risks associated with an uncertain purchasing power of money has made more room for other risks, those associated with entrepreneurial inspiration.

One day monetary policy may achieve the status of the football and become a passive rather than an active participant in the economy. I will know when that day arrives, because the business headlines will not be about the Federal Reserve or monetary policy but about you—the builders and other investors who are now, and always have been, the real source of economic prosperity.

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