

Federal Reserve Bank of Cleveland

Monetary Policy with Humility

by Sandra Pianalto

“On eight Tuesdays each year, Federal Reserve Chairman Greenspan convenes a small committee to set the short-term interest rate ... [T]he committee’s actions determine the economic well-being of every American. The availability of money for business or consumer loans, mortgages, job creation and overall national economic growth all flows from those decisions.”

—Bob Woodward, in his best-seller, *Maestro*

This is an intoxicating description of the Federal Reserve when the economy is making record economic gains, but it hangs like a yoke around our necks when the economic clouds darken. And indeed, the economic skies have clouded over since last October.

How should the central bank conduct monetary policy when faced with what potentially is a difficult year ahead? This *Economic Commentary* argues that we should resist the temptation to fine-tune economic performance and keep our focus on that which we know to be in the best interest of our longer-run prosperity.

In other words, smoothing out the business cycle, as it is conventionally conceived and measured, is not an appropriate goal of monetary policy. Monetary policy has been successful in recent years because the Federal Reserve has contained inflation and inflation expectations as it has responded to variations in real economic activity. Instead of trying to manage the business cycle, we have increasingly focused on managing

the inflationary psychology of households and businesses. With inflation expectations under control, we have created an environment in which this exceptional expansion in U.S. prosperity has taken root.

■ A Refresher on Activist Economic Policy

When monetary policy is used as a stabilization tool—sometimes called the “activist” approach to economic policy—the presumption is that the way markets allocate our national resources is fundamentally flawed. Adam Smith’s invisible hand is a bit arthritic. Prices don’t, in general, respond very quickly to changing market conditions, and entrepreneurs instead make their adjustments through the workforce—hiring new employees during periods of strong demand, laying off employees when demand is waning. And so what we see in the ups and downs of business activity is the market oscillating around its desired level, sometimes a little too strong, sometimes a little too weak, but rarely at a level that maximizes the economy’s long-run potential.

In the “activist” world view, the object of a sensible economic policy is one that helps the market along, propping up its sags during downturns and knocking the edges off the seemingly excessive good times. This is the macroeconomics of my youth, the economics of the Keynesian revolution. We were instructed that the focal point of economic policy was the management of the short-run swings in the “business cycle.” This idea is best summarized by John Maynard Keynes’ classic quote: “Economists set themselves too easy, too useless a task if in the tempestuous seasons they can only

When the economy slows, monetary policymakers face pressure to deviate from their longer-term goals to address short-term problems. This *Commentary* argues that the Fed must stay focused on the long term—maintaining the stable purchasing power of the dollar. The *Commentary* is adapted from a speech delivered by Sandra Pianalto, first vice president of the Federal Reserve Bank of Cleveland, to the Association for Corporate Growth in March 2001.

tell us that when the storm is long past the ocean will be flat.... In the long-run, we are all dead.”

Much of the policy advice offered by economists today takes this approach. They track the economic indicators that are supposed to help us decide when to push on the business cycle gas pedal, and when to brake. The activist philosophy would have economic policy strike a balance between growth on the one hand and inflation on the other. The 1960s and 1970s, when policymakers tried to exploit the presumed trade-off between growth and inflation, taught us that this approach can go terribly awry. Initially, economic policy undershot, then soon overshot the estimates of our economy’s potential, and all the while we watched our inflation rate ratchet higher until in the end, we were left with an economy that suffered from both high inflation *and* high unemployment. Dismal science indeed!

The ultimate cost of pursuing short-run economic gains, it turns out, was not merely a little bit more inflation, but a falloff in long-term national prosperity. It now appears that the initial decline in output that set the policymakers off on their corrective course represented the economy's natural response to changing economic events. The economy was doing what economies try to do, and that is allocate the nation's resources in a manner determined by the marketplace. Failing to appreciate the dynamic nature of markets created a confusing confluence of pricing signals—some real, some policy-generated—that led people to err more often when making economic decisions and then to divert some of their resources to measures that protected them from the ill effects of bad decisions. Poor resource reallocation ultimately caused the efficiency of the markets to diminish.

■ Can We Fix the Activist Model?

What did we learn from this national ordeal? Some say that what went wrong was purely a matter of inaccurate measurement. Identifying where our economy's potential is exactly is very difficult. The problem with the activist policy, some lament, is that we haven't done a better job of measuring that potential.

Others, I among them, say that the concept of economic potential cannot be made into a useful policy tool. The reason this is so lies in the fact that when we presumed that business cycles occur because markets fail, we were wrong. Can we fix the activist model? I don't think so.

Activist economic policies generally failed to appreciate the dynamic environment of the marketplace, and more specifically, the dynamic way in which the market forms its expectations. We now understand that as inflation rose, people altered their behavior to accommodate it, altering what had previously appeared to be a stable relationship in the data. The harder economic policy tried to push the unemployment rate lower, the greater and more disruptive the inflation price tag became. By continually working against the operations of the market, we were disrupting the beneficial, and ultimately necessary, adjustments that the economy was working through.

■ The Real Business Cycle View: A Brief Primer

What do we call two consecutive periods when national output falls by 60 percent or more? Answer: The weekend. Why don't we ask economic policymakers to do something about this extreme decline in output? Because the weekend drop-off is a natural response to a decline in effort as the nation consumes leisure—we take time off. On Monday, the economy picks up on its own, and economic policymakers have no role to play. Yes, we could easily, as some nations do, put in place national workweek rules such that we can “create jobs” by limiting the number of hours individuals are allowed to work per week, or alternatively, we can raise unemployment by making work on Saturdays mandatory. But we don't. We presume that what we see in the data is an efficient economy's response to the impulses of the economic agents, and therefore, the economic policymaker need not intervene.

Likewise, you might be surprised to know that national output typically falls about 7 percent between the fourth and first quarters. That puts these fluctuations on a par with the most extreme recessions the economy faces. And yet again, economic policymakers do nothing. In fact, this bit of information may surprise you because virtually all of the data reported on national economic performance is “seasonally adjusted,” which means that it only reports those fluctuations that are not part of the typical within-year gyrations in business activity. You are not alarmed by this omission in the data because, quite simply, it doesn't matter to you. Because the economy is responding naturally to seasonal forces that you understand, and moreover, you can do nothing useful about it, you care not to examine the data at this frequency.

These seemingly ridiculous examples underscore that we expect economic policymakers to identify aspects of economic performance where inefficiencies exist and then put policies and programs into place that reduce, if not eliminate those inefficiencies. This insight leads us to consider more carefully what we do and do not understand about the phenomenon known as the industrial “business cycle.” To what extent do output fluctuations at these frequencies reflect the failure of the marketplace, and how are our economic policies expected to

reduce the inefficiencies? Economists who continue to proscribe economic policies from the activist perspective fail to provide a satisfactory answer to either of these questions.

What if economic fluctuations that we call the business cycle can be characterized as the economy's optimal response to external forces—some fortunate, some not so fortunate—and are therefore not the appropriate objects of a policy response? What if, by interfering with that response, we lay the groundwork for greater, more disruptive economic problems somewhere a little farther down the road?

■ A Long-Run Perspective for Economic Policy

Despite the rhetoric of activist economic theory, which still pervades the policy debate inside and outside of government, I think economic policymakers, monetary and otherwise, are replacing their business cycle focus with a longer-term perspective. And this perspective has made all the difference.

In the case of fiscal policy, we have moved away from the idea that budgetary surpluses and deficits can be used to manage the course of the business cycle. Instead, we think more seriously about the incentives and investment properties of alternative government tax and spending proposals. We think not just in terms of this year's fiscal surplus or deficit, but also consider the generational inequities that various policies imply. In trade policy, we think less in terms of the number of jobs we create, but more about how trade redirects our existing jobs in the most effective way.

So, too, this perspective appears to have permeated the conduct of monetary policy. By striking a balance between money supply and its demand, that is, by providing a relatively stable purchasing power for the dollar, the central bank has done a remarkable job in building its credibility and keeping the inflationary psychology subdued. By abandoning the impulse to control fluctuations in national output and movements in the rate of national unemployment, policy has provided the environment that allows the marketplace the greatest clarity to do what the marketplace is best positioned to do.

The Federal Reserve is not alone among central banks in this realization. A large and growing number of nations now require as a matter of law that their central bank commit to multiyear targets for their retail price indexes. While the Federal Reserve does not have such a clearly proscribed Congressional mandate, the central bank has nevertheless produced an inflation path that is observationally equivalent to one.

■ Monetary Policy in the Current Economic Environment

Today we are faced with a set of economic indicators that have soured since the fall. National production, which set records for both duration and magnitude in the 1990s, slowed by more than half in the final quarter of 2000, and economic growth has been somewhat sluggish during the first half of 2001. Economic performance in our own backyard has seen a more precipitous drop. Heavy manufacturing, like steel, automobiles and heavy trucks, chemicals, and rubber and plastics, has seen its economic fortunes collapse over the past five months, and these industries make up a disproportionate share of our jobs and incomes.

Some sort of an economic slowdown was not entirely unexpected. Our economic expansion had entered into Lake Wobegon territory—where all of our years were above average. But at some point during this unprecedented period of economic growth, we need to either rethink what an “average” economic growth rate is, or we need to be prepared for a sharp realignment between our economic performance and underlying economic realities. For economists who have consistently underpredicted the growth rate in national income for seven consecutive years—and that list is both long and prominent—the current set of economic data probably comes as a belated “I told you so.”

But before we lay this incredible period of economic expansion to rest, and heap all of that “New Economy” literature in the wastebasket, let’s consider what we know, or more accurately, don’t know about our current state of economic affairs.

As we currently conceive of national economic policy, it is the job of the policymaker to regulate the amount of

aggregate national spending by raising or lowering money market interest rates. The presumption is that economic slowdowns, such as that which we are seeing today, reflect a hesitancy on the part of consumers and businesses to adequately consume all of the nation’s product. This seems a dubious strategy for at least two reasons. First, it is unclear that reductions in money market interest rates translate directly into lower capital market interest rates and, if they do, how sensitive aggregate spending is to the interest rate. More importantly, we never know with any certainty whether the decline in aggregate economic performance originates from a lack of adequate national demand, or a change in national supply. And in retrospect, there is growing evidence that much of what policymakers believed to be demand-side weaknesses in economic performance are more likely to have been supply disturbances, many of which appear to have been initiated by an energy shortage.

This is an important distinction. It may be, as many have suggested, that a sudden drop in consumer and business confidence created an unexpected shortfall in spending, which in turn caused an undesired rise in inventories and a cut-back in industrial production. Certainly, recent readings showing an upturn in business inventory-to-sales ratios and the frightening drop in consumer optimism are consistent with this view. One elixir for this economic condition might be to help restore confidence by lowering money market interest rates.

But it may also be that the economy is working to digest some of the past year’s rather hard-to-swallow energy-cost increases, and our measures of business performance are merely reflecting this economic reality. Here, a tonic that encourages the public to spend more may actually be counterproductive. If we attempt to boost economic demands on an economy that is having difficulty maintaining its ability to supply, we risk turning a period of modest economic adjustment into a protracted period of economic chaos. One need only look to data on national energy costs, the recent sharp step-up in the Producer and Consumer Price Indexes, and the troubling high rate of domestic money growth to support this view of our economic condition.

■ A New Economic Revolution?

I am convinced that we are part of an economic revolution on an order of magnitude rarely seen in a lifetime, but this New Economy is not likely to always emerge smoothly. We will be continually challenged, by business cycle forces and from other quarters, to deviate from our longer-term goals to try to achieve some shorter-term economic gains.

I believe that the New Economy has yet to deliver its greatest gains. Consider that it has been about 25 years since the development of the microprocessor—halfway through the innovation process as suggested by historical experience—and almost on schedule, the U.S. capital stock has expanded explosively. In the past two and a half years, non-farm business productivity has grown at a pace of about 3 percent per year—its best showing in about thirty years. If past technological revolutions are a good indication, this may be only the beginning.

Moreover, the new technologies capable of rapidly propelling our economy forward over the next few decades may have the added benefit of helping us cope with the economic adjustments that we inevitably face from time to time—our business cycle fluctuations. If business fluctuations are propagated by large swings in business inventories, the time it takes for information to flow between consumers and business and from business to business may dramatically shorten from earlier episodes.

I wish I could tell you whether or not there is a recession in our path. I think not, and I believe that by year’s end, we will once again be impressed by the speed of our economic progress. But while I suspect that this will be the road our economy takes, I remain convinced that the only appropriate role for the monetary authority in addressing the business cycle is to endeavor to keep liquidity in the marketplace consistent with the economic demands of the marketplace. We need to resist the great temptation to alter the economy’s path by presuming too much knowledge and

too much power over the course of economic events. We must be humbled by the knowledge that growth, in the end, comes from entrepreneurial energy, not monetary policy. We facilitate, rather than manage. We nurture, rather than instigate. And in pursuing such a course, the monetary authority contributes to our economic prosperity in the most productive way it can, by laying the stable financial foundation on which economic prosperity can be built.

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