

188 9:06

INTEGRATED

Risks in the Economic Outlook: A Policymaker's Perspective

W. Lee Hoskins, President  
Federal Reserve Bank of Cleveland

ABA Funds Management Conference  
San Diego, California  
February 19, 1988

FEDERAL RESERVE BANK  
OF KANSAS CITY  
JUL 11 1988  
RESEARCH LIBRARY

Like everyone else here, I read the newspapers, and today's economic news is focusing on the risk of a recession in 1988. Certainly the stock market crash last October and the weakening in consumer spending have made most forecasters more cautious.

Recession is only one risk for the economy in 1988. I would like to remind you of a couple of other risks which we should not overlook. An acceleration in prices is, of course, another. But perhaps the most dangerous risk is that an acceleration in prices this year will become embodied in ongoing inflation.

While the focus on recession-inflation risks rarely extends more than six to twelve months ahead, the focus required for policymakers to deal with the long-term inflation risk is years, not months. This risk is always present, of course, but several characteristics of today's economy and the monetary policy process itself cause me to be more concerned than usual.

Today, I would like to sketch out my view of the outlook, talk about the need for more explicit inflation objectives, and explain my concern with current policy dilemmas.

### The Outlook and the Risks

Few of you need to be reminded that our current economic expansion, now in its sixth year, is longer than all but one other expansion since 1950. Personal consumption spending slowed in 1987, and we expect continued sluggishness in personal consumption growth in 1988. It seems reasonable to expect this weakness to be offset by strength in exports and investment.

Export growth this year should be on a par with last year's torrid pace, and I expect business spending to remain strong this year. Today a number of industries are still operating at very high levels of capacity. I do not see a very compelling argument for forecasting a recession in the near term. However, these are good reasons to worry about an acceleration in prices.

There was a substantial rise in prices of imported goods last year. As import prices continue to accelerate, domestic producers have more room to raise their own prices, especially in markets where capacity is scarce. Although I expect business spending to be strong this year, it is not yet clear how much of that spending will be directed to capacity expansion. Many business people are reluctant to adopt bold expansion plans, especially when such plans require a significant commitment to increase the number of employees. Another year of solid profits and economic growth, and clearer evidence that policymakers will not allow an acceleration of inflation may be needed before firms embark on major expansion plans.

Finally, federal government spending is always a question mark. Most economists expect a reduction in government purchases this year because of Gramm-Rudman constraints. However, this is an election year, and the Gramm-Rudman constraints have proven to be elusive even in non-election times.

Demands on our productive capacity from all sources--consumers, businesses, government, and foreigners--could strengthen again this year and next. Capacity strains and higher import prices could become embedded in ongoing inflation and inflationary expectations.

What safeguards do we have against inflation? How do we know whether monetary policy is, or will be, too easy or too tight?

### The Importance of Long-term Policy Objectives

Economic policymakers must have objectives and a framework which are longer than the business cycle six months out. Long-term objectives are a way to bring more discipline, and therefore more credibility and more certainty, to the policy process. In my view, an inflation-free environment should be our primary objective because it is the only way we have to achieve maximum sustainable growth and other important goals. We can make a material contribution to reducing market uncertainty by specifying a path for reducing inflation, starting at about four percent for 1988 and going to zero in some reasonable period--for example, three to five years.

At one time, not long ago, only a few economists recognized the need for a stable price level as the primary goal for policy. But we have learned that the central bank can control only nominal variables. We influence many real ones, but largely through the environment provided for private decisions. An inflation-prone environment is not conducive to optimal economic performance.

Of course, at any moment in time we don't really know whether monetary policy is too tight or too loose. We have never known with certainty in advance. From time to time we have been fortunate to have some guideposts that worked pretty well, such as the growth of the money supply defined in one way or another. During the past few years, the relationship between money and the public's total spending has been very unpredictable. Rigidly controlling money according to previously-announced plans most likely would have forced interest rates and asset prices to bear even more of the adjustment for the large shifts in the demand for money. The effects, if carried to an extreme, probably would have produced needless shocks and fluctuations in real variables and in financial markets.

In that regard, the public has been well served in the past few years by the judgementally oriented policy of the Federal Reserve. A testimony to the success of the policy can be seen in the current long economic expansion without accelerating inflation. But the process contains some dangers and risks which leave me uncomfortable. Only a decade or so ago, the Federal Reserve did not act quickly or firmly enough to prevent inflation from getting out of control.

#### Resisting Pressures to Inflate

Achieving price stability requires public acceptance of the idea that price stability is the only lasting contribution toward economic growth that the Federal Reserve can make. We cannot solve business cycle problems just by throwing money at them. This concept has been demonstrated in other spheres of government policy time and time again.

Recent history suggests that monetary policy may help to sustain business cycle expansions by resisting inflationary growth in economic activity. Early in this expansion, during 1984, the Federal Reserve tightened monetary policy because the pace of economic activity was so rapid that it threatened to reignite inflation. Slowing the rate of money growth restricted the rate of price increases. By not giving the public all the money it wanted, we helped maintain discipline on wages and prices. The expansion continued, and inflation did not accelerate.

Last year we also tightened policy to forestall upward pressures on the price level. Money grew rapidly early in the year and the economy appeared to be strengthening. It was reasonable to expect that many market participants would be bidding prices up during the year, leading to an acceleration in

inflation. Today most analysts expect less inflation this year than they had been expecting six months ago. The pace of economic expansion seems to have slowed somewhat, and perhaps our resource demands are now more in line with our ability to supply at stable prices. Keeping the rate of inflation relatively low, as we have done for five years now, has been a valuable contribution to the longevity of this economic expansion. It seems to me that our actions have added to the credibility of the commitment of the Federal Reserve to keep the inflation rate as low as possible.

### The Current Dilemma

My concerns with the current situation come from an inability to specify, in advance, a method for conducting monetary policy that will guide policy decisions along a desired path toward longer-term objectives.

Today, markets see the Federal Reserve reacting to news about the economy, deciding from one FOMC meeting to the next where the greatest risks lie, and taking action accordingly. If the greatest risks seem to lie in recession, then markets expect the Fed to ease. If the greatest risks seem to lie in accelerating inflation, then markets expect the Fed to tighten.

This is, of course, not a new approach. It was used for over 30 years with good results in the 1950s and the early 1960s'--but the results began to deteriorate in the late 1960s and in the 1970s. Policymakers, in hedging against recession, or the perceived threat of recession, lost sight of long-term inflation goals and underwrote accelerating inflation.

By reacting to the economy in this way policy often seems driven by unpredictable events without clear links with longer-term objectives. Given the bad experience of the 1970s, the lack of a longer-term constraint on

policy is itself a source of uncertainty and volatile swings in interest rates and asset prices, as you know all too well. The Fed may reduce uncertainty about near-term interest rates--or the near-term economy, but at the expense of introducing more uncertainty about the long-term outcome. What the Fed does in the near term must be consistent with some known long-term objective if policy is to be successful in minimizing risk and uncertainty in our economy.

A credible zero inflation policy would achieve other goals as well. We encourage investment and real economic growth by providing a stable price environment with low interest rates. The way to get long-term interest rates down is to stabilize the price level. Let me ask you where the long bond rate would be today if we expected zero-inflation in five years? Whatever your answer is, I doubt that it would be 8 1/2 percent. The Federal Reserve can furnish that environment providing there is a public consensus. The German and Japanese central banks have done it, and there is no reason why we cannot.

### Conclusion

It is possible that world growth will slow or that U.S. producers have seriously overestimated the future demand for their products. I am not forecasting a recession in the year ahead, but I have made enough forecasting errors in my career to know that a recession is possible. It is also possible that inflation will accelerate into the five percent range by the end of the year, but I am not forecasting that either.

Beyond these risks, there is another, and I think it is more enduring. Some fear that the Fed may inadvertently make things worse by engineering an acceleration in inflation in an attempt to forestall a recession. This will only bring added difficulties down the road for you in the financial markets and for the economy as well. In doing so, we might lose the opportunity to achieve an inflation-free environment and maximum sustainable economic growth.

Unless we lift our eyes from the problems of the day, we have little assurance that conditions will improve in the long run. If we focus only on short-run concerns, underlying problems will never be resolved and will continue to reemerge. I am confident that you in the financial markets will not allow policymakers to forget those problems.