PRICE STABILITY AND REGIONAL DIVERSITY

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Price Stability and Regional Diversity

I am pleased to have the opportunity to speak before this gathering of the Twenty-fifth Annual Pacific Northwest Regional Economic Conference. I have stood before many groups to discuss why I believe that price stability is the only policy objective that the Federal Reserve System can achieve. I can think of few other groups that should be more sympathetic to this view than one like yours, which recognizes and appreciates the regional diversity of our national economy. My reason for saying this is quite simple, and is vested in the nature of national business cycles.

Given your interest in regional issues, you well understand that the national economy is an amalgam of diverse regional economies. The national business cycle is an average of regional business cycles, which differ according to the timing of peaks and troughs and the magnitudes of expansions and contractions. Consequently, just as it is impossible for the Federal Reserve to pursue multiple national objectives, it becomes clear that aiming a single monetary instrument at the national business cycle, which is made up of separate and perhaps independent regional cycles, would be a futile exercise that could yield only unpredictable and mostly undesirable results.

Weak national economic conditions have once again raised the issue of whether the Federal Reserve should take steps to stimulate the economy and of how large those steps should be. As you know, the System repeatedly reduced the discount rate and the federal funds rate late last year and early in 1991 in response to the economic slowdown. I sometimes have disagreed with the underlying motive, but I have not been troubled by these policy actions, because I do not think that they are inconsistent with progress toward lower inflation. Nevertheless, I am troubled by the inference made by many analysts and policymakers that the Federal Reserve, by simply turning on the money spigots, can restore the economy to an acceptable and sustainable long-run growth path.
Therefore, I want to spend my time this evening discussing with you why I believe that price stability is the only objective the Federal Reserve can achieve, and why I believe that a monetary policy that pursues price stability is optimal in a country whose regional diversity is as broad as ours.

I have publicly discussed my reasons for not tying monetary policy objectives to the business cycle many times. My position stems from what policymakers can reasonably be expected to know about the economy and how policy affects the economy. As I explain my position tonight, I hope to convince you that regional economic diversity strengthens my arguments.

Should the Federal Reserve Respond to Business Cycles?

It is generally accepted that monetary policy affects the general price level in the long run, and aggregate output and employment in the short run. Therefore, why not simply pursue different monetary policies at different stages of the business cycle? Why not pursue a policy of stimulating output during a recession and promoting price stability when the economy has recovered and begins expanding again? Actually, that was essentially what the Federal Reserve did in the 1970s, and the results were not good. We achieved neither price stability nor full employment.

We simply don't have the forecasting accuracy to fine-tune the economy with the precision necessary to expand the money supply more rapidly when the risk of recession is higher, and restrict the monetary expansion when the threat subsides but is replaced by a greater likelihood of inflation. Given the imprecision in forecasts and the inability to predict shocks, such a policy would be like riding in a car with someone who drives with one foot on the accelerator and the other on the brake. It makes for a very jerky ride. This policy alone would exacerbate business cycles, not smooth them.
A smooth policy ride would require the ability to identify, at every point in time, the exact state of the economy. Furthermore, since monetary policy influences business conditions with a considerable lag of six to twelve months, accurate forecasts of at least six months into the future are required for today's policy actions to have the desired effect six months from now. That is, in order to respond to economic conditions today, we should have foreseen perfectly as far back as last October the current state of the economy. With that information, we would have had to make the appropriate policy decisions.

A retrospective view of typical forecasting accuracy drives home my point. Over the past twenty years, the average real quarterly growth rate of the economy (on an annual basis) was around $2^{3/4}$ percent. The median range of forecast errors one quarter ahead is about 4 percent. That means that if the forecast for real GNP one quarter ahead was 2 percent, the realized growth rate would have ranged between a recession (-2 percent) and a boom (6 percent) roughly two-thirds of the time.

Even in the dullest of times, the world abounds with enough random events of significant economic consequence to make accurate forecasts virtually impossible. And dramatic events like the Persian Gulf conflict can only play complete havoc with our best, but still imperfect, forecasts. Who would have thought last May that Iraq would invade Kuwait and that by October oil prices would more than double, to over $40$ a barrel? Obviously, shocks by definition are unpredictable, and their effects on the economy are not known with precision.

A second reason that the Federal Reserve cannot fine-tune the economy is that the only variable the Fed can control over long periods of time is the price level. It is clear from both economic theory and practice that attempting to stimulate the economy through an easy monetary policy results only in higher inflation. An unstable price level leads to greater uncertainty for households and businesses, which reduces
productivity and economic well-being. By anchoring the price level, the Federal Reserve maintains the value of our currency and promotes long-term economic efficiency.

Third, switching back and forth from a recession policy to an inflation policy creates its own uncertainty in the economy about the Federal Reserve's willingness to control inflation. Moreover, high and variable rates of inflation generally cause mistakes in investment decisions. For example, the run-up in inflation during the late 1970s was a boost to the wood products industry in Oregon and throughout the Pacific Northwest, inducing many resources to flow into this industry. The boom in the timber industry can also be traced to the structure of deposit insurance. This subsidization of market risk allows financial institutions to seek out and pursue excessively risky investment opportunities, such as certain mortgage lending and real estate ventures. However, because the housing boom that initiated the timber boom was built largely on the desire to hedge against inflation, the subsequent steep rise in interest rates engineered by the Federal Reserve to curb inflation had ruinous consequences for the wood products industry and for the communities it supported.

If market signals had not been distorted by a general price rise, then some of the resources that went into the wood products industry would have been diverted to other industries. A boom would have been less likely, and a subsequent and immediate bust would not have followed.

Regional Business Cycles

I have made these first three arguments for a stable-price policy on numerous occasions, and I believe that they alone are sufficient grounds for the Fed to pursue such a policy exclusively. Yet, there is another dimension to the national economy -- its regional diversity -- that I believe makes my arguments even more convincing.
When addressing the issue of whether the Fed should respond to business cycles, one must ask which business cycle. Policymakers typically think of the U.S. economy as monolithic and make policy decisions accordingly. When monitoring the pulse of the United States, they look at gross national product (GNP), the national unemployment rate, and the national consumer price index (CPI). But, as the past few economic downturns have dramatically demonstrated, regional economies behave differently. Instead of each region marching in step with the national economy, it appears that some states enter and leave national recessions at different times, and that some states can even remain untouched by national downturns. So far in this episode, for example, no more than sixteen states have experienced year-over-year employment loss.

State business cycles exhibited disparate patterns even during the twin recessions between 1980 and 1982 -- the most severe since the Great Depression. As the U.S. economy fell into a recession in 1980, the energy-producing states of Texas, Louisiana, and Oklahoma showed no significant slowdown. The same held true during the subsequent and much deeper recession that began in late 1981. Yet, as the rest of the nation began to climb out of the second recession, the oil states slipped into their own downturn. After enjoying a brief recovery within a year after the national trough, these three states again descended into a period of employment decline, lasting well into 1987.

The distinction among regional business cycles has been accentuated in recent years to the extent that some analysts have even coined the term "rolling recessions." During the 1980s, farm states, energy states, and then Midwest manufacturing states experienced downturns while the nation as a whole was expanding. Now, several New England states, centered around Massachusetts, are having severe problems. After years of seemingly unprecedented growth during the late 1970s and early 1980s, the Massachusetts economy abruptly changed course in June 1986, when it entered a
protracted period of employment decline that still persists. Rhode Island and New Hampshire immediately joined Massachusetts, and Vermont and Maine were pulled into the regional recession soon thereafter. These states have yet to recover.

Why the Differences in Regional Economic Performance?

What, then, explains the variation in regional business cycles? James Tobin, the Nobel Laureate economist, and William Nordhaus once stated that the veil of macroeconomic aggregates conceals "... all the drama of the events -- the rise and fall of products, technologies, and industries, and the accompanying transformation of the spatial and occupational distribution of the population." 1 Each regional economy plays out its own drama against the backdrop of its natural resources, industrial structure, human capital, and physical and cultural infrastructure.

Fluctuations in the national economy are a combination of structural shifts and cyclical patterns within each regional economy. These structural shifts affect industries and regions differently, depending on the industry's productivity and the region's comparative advantage. For example, because of factors such as relatively high wages, entrenched special-interest groups, aging private and public capital stock, and foreign competition, manufacturing employment and population in many Midwestern states have declined relative to states in the South and Southwest, as well as to other countries.

Within the Pacific Northwest itself, we see diverse industrial and regional differences. The timber industry during the last decade has come under intense competition from Canada and the southeastern United States, in part as a result of technological changes in process and in end-use products. The result has been a significant decline in the share of total jobs in related industries. At the same time, the aircraft and ancillary industries, riding the crest of unprecedented worldwide demand
for commercial aircraft, have brought a tremendous number of new job opportunities to the region. Considerable differences emerge even within relatively small geographical areas. The diversified and bustling economy of the Portland area stands in stark contrast to the struggling timber-based economies of southwestern Oregon.

Whether these regional shocks are sufficiently large to spill over into other regions and eventually generate a downturn large enough to affect the national aggregates or averages depends on the severity of the regional shock and the linkages among regional economies. For instance, of the nine recessions recorded since World War II, the Great Lakes states have ushered in three. This current recession marks the first time that the New England region has led the way.

Regional business cycles are also caused by broader but more temporary factors. These broader shocks often hit regions simultaneously, such as when oil prices rise suddenly. As a result of differences in industrial composition and relative industrial productivity, regions may be affected differently by an oil price shock, but the simultaneous impact may be enough to affect the aggregate economy. This may explain why there is strong evidence that all but one of the previous eight national recessions have been preceded by an oil price shock.

Monetary surprises are another example of shocks that hit regions simultaneously and have widespread but differing effects. In the early 1980s, we had two recessions caused by the monetary policy mistakes of excessive money growth during the 1970s. The shock produced by a disinflationary policy that was necessary to get our economy back on an acceptable real growth trend left 46 of the 48 contiguous states with year-over-year employment losses at some point during the twin recessions.
Federal Reserve Policy within a Regional Context

It is clear, then, that the national economy is an amalgam of regional economies, each coping with different structural shocks. Should the Federal Reserve use a short-term money-based solution to try to correct long-term structural shocks facing perhaps only a handful of regions? The answer is clearly no for three reasons. First, the Fed does not have policy instruments that can target one region differently from another region. Second, the regional economies within this country already have market mechanisms that can accommodate adjustments to regional shocks. Third, monetary policy mistakes can distort the price signals necessary for these regional market adjustment mechanisms to work efficiently.

The Federal Reserve System is unusual among central banks in that it has the institutional structure to take a regional view of the national economy. Each of the twelve District Bank presidents participates in the eight Federal Open Market Committee meetings held every year. The meeting agenda includes an opportunity for each president to share with the entire Committee current economic conditions within his District. The Federal Reserve System also compiles and releases a synopsis of District conditions, prepared by each of the twelve regional Banks, in what is popularly called the "Beige Book." However, after these regional presentations are made, the FOMC forms a consensus view of the national economy and conducts monetary policy according to this view.

In its early days, when the discount window was the Fed’s principal policy instrument, each Federal Reserve Bank could (and to some extent did) pursue its own separate monetary policy by charging member banks different discount rates, depending on the state of their regional commerce. Today, however, regional, national, and international integration of money and capital markets precludes this possibility. Although regional economies maintain distinct identities, the money that flows
through and circulates within them does not. Consequently, monetary policy has no way of responding to the economic conditions of one region without affecting all regions.

Even if monetary policy could be targeted to individual regions, this would not necessarily be the most efficient way to combat structural shocks. The economy already has mechanisms -- market mechanisms -- that can accommodate adjustments to these regional shocks. Although the country is a patchwork of different regional economies, these economies are linked by a market system through which people, capital, ideas, and technology move back and forth. The ease with which resources respond to regional market incentives enhances the capability of the U.S. economy to absorb regional shocks.

The United States is unique among industrial countries in that its regional economies are unified under one common currency. Other economies of similar size, such as those encompassed by the European Community and the emerging Pacific Rim countries, are segmented into nations with separate monetary and fiscal institutions and typically disparate monetary policy goals. Furthermore, with these national boundaries delineating regional economies, goods and resources typically flow less freely across those economies than within ours. For these countries, adjustments to "regional" shocks occur to a large extent through exchange rates.

Labor and capital flows are the primary mechanisms by which regional economies in the United States adjust. A phrase once used by Chairman Greenspan -- "migration arbitrage" -- captures the essence of this regional adjustment process: resources flowing to the region in which they receive their greatest return. The regional flow of workers is one of several factors that allows for our economy's relatively quick adjustment to shocks. For example, because of the easy flow of labor among regions in this country compared to labor flows within Europe, one study shows that regional unemployment rates adjust to one another 20 percent faster in the United States than in the European Community. Even within a single country --
Germany, for instance— it has been estimated that labor migration plays a surprisingly minor role in labor-market adjustment compared to the United States. In a similar fashion, capital flows are also instrumental in the adjustment process. In fact, one of the principal objectives of the European Community’s single market policy is to promote economic growth through a greater reliance on market adjustment mechanisms.

In addition to market mechanisms, the United States has institutions that enhance the regional adjustment process. The government system of fiscal federalism essentially provides regional insurance, in that the combination of federal tax payments and transfers are countercyclical, attenuating the impact of regional shocks on interregional income differentials. The Federal Reserve System, through its function as lender of last resort, also acts as an interregional conduit of funds. The liquidity necessary to prevent widespread failure of solvent financial institutions in a specific region is transferred from other parts of the country by the Fed.

Finally, with well-greased market adjustment mechanisms and institutions already in place to promote the regional adjustment process, I believe that there is no place in this framework for a monetary policy that responds principally to business cycles. Why should one look to short-term monetary policy as a way to alleviate these typically longer-term regional shocks, many of which are structural? We cannot forecast with enough precision; the economy responds to policy with a lag; and a stimulative monetary policy cannot alleviate structural problems. By acting as if the implementation of monetary policy can overcome these problems, at best we risk making policy mistakes that would distort price signals that are essential for these regional markets to adjust to economic disturbances. In addition, since regional economies are typically at different phases of their own business cycles, a monetary response to any one regional shock, even if it is manifested in a national business cycle, may only intensify the business cycles of other regions.
Conclusion

A thoughtful consideration of the nation's regional economic structure strengthens my belief that the Federal Reserve should focus solely on long-term price stability. By viewing the national economy as a conglomerate of regional economies, it is easy to see the futility and potential harm that could result by acting as if fine-tuning the money supply could remedy the different structural shocks that impact regional economies. It is equally apparent that such monetary policy mistakes could send shocks through all regions, which could exacerbate regional business cycles and make it difficult for regions to absorb these disturbances.

The only policy that the Federal Reserve should pursue is price stability. Price stability maximizes the efficiency of money as a vehicle of trade across regions, nations, and time. This is especially important in a region such as the Pacific Northwest, which is becoming increasingly sensitive to international trade. Price stability also eliminates hedging against unanticipated inflation, thereby channeling resources to their most productive uses, which is vitally important for the prudent use of the region's valuable natural resources. Price stability encourages long-term investment, which is important for technological advancement, and enables people to allocate labor and capital across regions intelligently -- all factors that contribute to the real growth of a region.

Economic diversity has served our nation well, both as a source of growth and as a buffer against shocks. Monetary policy should respect this diversity by not encumbering the markets through which resources move. A monetary policy that promotes price stability is the best way to ensure long-term national and regional economic growth.
Footnotes

