Balancing Inflation and Growth

Remarks before the Society of Business Economists

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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It is an honor to speak here in London to the Society of Business Economists at the suggestion of my much-admired friend, Charlie Bean at the Bank of England. Charlie is on the advisory board of the Dallas Fed's Globalization and Monetary Policy Institute, and we are most grateful for his insight and, not unimportantly, his wit.

I am on my way to a conference in Paris, where I have been invited by the Banque de France to comment on a paper by another of our institute's esteemed advisors, Harvard professor Ken Rogoff. I hope my French hosts will forgive me for bringing up my favorite of all of Shakespeare's histories this evening, *Henry V*, as I recall one of the more pleasant moments during my tenure on the Federal Open Market Committee. During our last meeting with Alan Greenspan as chairman, some of us took advantage of the moment to ham it up and work a farewell salute into our otherwise somber interventions. I chose to adapt Henry's speech to the troops at Agincourt. Affecting my best Kenneth Branagh imitation, I mangled the words of the Bard: "We few, we happy few, we band of bankers," and so on, concluding with the observation that "…other economists now abed"—it was morning when we met—"shall think themselves accursed they were not here, and hold their policy prescriptions cheap while any speaks that served in Alan Greenspan's days." When I finished, Alan looked down the table and said, "President Fisher, was that *Henry V*?" "Yes, Mr. Chairman," I replied. "I know I've reached retirement age," said the ancient chairman. "I went to high school with that guy."

Would that we could today enjoy such levity from the days when SIVs, CDOs, ARS and SLARS and VRDOs—or the "R" or the "S" words, as in "recession" and "stagflation"—were not yet part of the polite lexicon of monetary circles. These are not the happiest of times. These are, to put it euphemistically, challenging times for central bankers. We are confronted with the twin evils of slower growth and higher inflation, while also having to fight a banging hangover that resulted from allowing financial intermediaries to party on too hard for too long.

The monetary policy and regulatory frameworks that appeared to serve us so well in past decades are being stress-tested in ways that few dared imagine during that bucolic period when many were lulled into assuming things would be forever NICE, as Mervyn King so memorably put it.[1] We know now that a *N*on-*I*nflationary *C*onsistent *E*xpansion is not the steady state of nature. Neither is the Great Moderation of both the economy and financial market volatility.

Indeed, as I speak, central bankers here and across both the pond and the channel feel besieged by a seemingly insurmountable foe delivering retribution for our having been complacent, if not smug, during those happier days. Like Henry's troops at Agincourt, it may appear that we face overwhelming odds. Yet I am not overwhelmed.

Why not, you ask? Allow me to invoke another of your English ancestors in reply. Winston Churchill once asked: "Why is it that the ship beats the waves, when they are so many and the

[1] Mervyn King, Speech to East Midlands Development Agency/Bank of England Dinner in Leicester, Oct. 14, 2003.

ship is one? The reason is that the ship has a purpose." Tonight, I wish to give my view of the purpose of the Federal Reserve.

Needless to say—but I will say so anyway—the views I express this evening will be my own and not those of any other member of the Federal Open Market Committee or any official of the Federal Reserve System. This is but one man's soliloquy.

The Federal Reserve, unlike the Bank of England, has a dual mandate. We are charged with creating the monetary conditions to support sustainable noninflationary employment growth. We must keep our eyes on two things: economic growth and price pressures. Of course, this is easier said than done. It poses a conundrum of priority and balance. How should we weigh the risks of slow growth over the need to manage inflation? Reasonable men and women can agree that inflation is a sinister beast that, if untethered, will devour savings, erode the purchasing power of consumers, decimate returns on capital, undermine the reliability of financial accounting, distract the attention of corporate management and undercut employment growth and real wages. Thoughtful men and women can also agree that at certain junctures, sluggish employment growth and financial instability present greater risks than inflation to the economic welfare of the nation. Both feverish price pressures and economic anemia matter, and both present great risk to our welfare. Both deserve our attention. But the question of the day is which deserves more of our attention right now.

Some argue it is the slowing economy. Even if you foresee the most likely U.S. scenario as a period of flat growth for a few quarters, followed later in the year by a return to potential growth of about 3 percent, one cannot help but worry about whether the so-called tail risk—the odds of the worst-case scenario on the growth distribution curve unfolding—is getting fatter as the inventory of unsold homes continues to swell, consumers' sense of wealth and businesses' confidence erodes, and the solicitous bankers that used to court them become more coy.

Yet, the worst-case scenario remains very much a "tail" risk. As Chairman Bernanke noted in testimony before Congress last week, the nonfinancial sector has held up reasonably well and continues to expand. Employment growth is weakening and consumer confidence is sagging, but inventories and other indicators remain constructive. You can see evidence of this in the fourth quarter's corporate performance. Thomson Financial reported last week that earnings were on track to be down 22 percent for the 462 S&P 500 companies that have so far released their numbers for the quarter. But strip out the financial institutions, and earnings were up 12 percent, and 62 percent of those 462 companies reported earnings that topped analysts' expectations. In all, that is not bad when you consider the beating the financials have taken and how stocks of housing and housing-related companies have been pummeled.

The woes of financial operators should not be overlooked, of course. There is a palpable risk that their pathology will lead to credit constriction that will, in turn, trigger an economic contraction. But thus far, the Cassandras on Wall Street, in the press and on the political campaign trails have had less to be glum about than they expected—or perhaps they had hoped for.

This is not to say that we are not at risk of encountering turbulence. Personally, I think the cruising speed of the U.S. economy has slowed considerably, and it is likely to remain subpar for the current and following quarter. Without getting into specific numbers, I will tell you that my growth forecast is one of the more bearish among FOMC members. For someone like me, who has served on corporate boards and run a private company, it is not difficult to imagine managers being cautioned by their directors and consultants to batten down their hatches and run ever tighter ships at a time of gloomy news stories, dire predictions by respectable analysts and alarming rhetoric from public officials. While there is a risk the U.S. economy might sputter, I do not believe that mighty engine will stall. I have tremendous faith in the ability of the women and men who operate the private sector to overcome obstacles placed before them and keep the pistons of the economy pumping. You can lose a lot of money betting against the recuperative power of the American economy.

At the same time, I am fully aware that the FOMC must be careful to not undermine that recuperative process. Here, of course, I refer to the potential harm to the consumer and the business and financial sectors alike by unwittingly allowing the perception to take hold that, as the *New York Times* editorialized in its lead front page article last Thursday, "the Federal Reserve, signaled [its] readiness … to bolster the economy with cheaper money even though inflation is picking up speed."[2]

Talk of "cheap money" makes my skin crawl. The words imply a debased currency and inflation and the harsh medicine that inevitably must be administered to purge it. So you should not be surprised that I consider the perception that the Fed is pursuing a cheap-money strategy, should it take root, to be a paramount risk to the long-term welfare of the U.S. economy.

I believe the *Times* overstates its case. Chairman Bernanke made clear in his congressional testimony last week that we are monitoring inflationary pressures and expectations closely. And yet, I understand the source of the *Times*' sentiment. In a globalized capital market where money is free to move anywhere it pleases, there is scant tolerance for even the slightest whiff of inflation. Since the January FOMC meeting, longer-term rates, including those on fixed mortgages, have risen rather than followed the federal funds rate downward. Over the same period, the dollar has declined nearly 3 percent against the euro. We know that monetary policy acts with a lag, but even with my well-documented pessimism about the efficacy of lowering the fed funds rate to 3 percent, I had privately hoped, against the odds, that we might get a psychological pop out of the yield curve. Instead, we have heard more and more reports of inflationary concerns, and with them increases in longer-term rates and record low exchange rates for the dollar.

Mind you, all these signals could be aberrations—twitches in markets that have occasionally led me to wonder if they were afflicted with the financial equivalent of Tourette's syndrome. But they might also indicate that the markets are unnerved by the idea of further monetary accommodation in a world where commodity prices inch upward almost on a daily basis and labor costs escalate in Chinese factories, among Indian programmers and all along global supply chains.

I am going to dwell on inflation for a few minutes because I consider it a critical issue. I spoke earlier of Churchill's ship of purpose. As my FOMC colleague Governor Rick Mishkin argues so eloquently, it is essential that monetary policy firmly anchor inflation expectations. If the Federal Reserve has an overarching purpose, in my opinion, it is to make sure that anchor stays firmly in place.

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[2] "Bernanke Says Sagging Growth Is Chief Concern," *New York Times*, Feb. 28, 2008, Edmund L. Andrews, A1.

Recent readings on inflation have not been encouraging. The rate of increase in the core personal consumption expenditures price index, or core PCE—that is, what people buy, except food and energy—was 2.2 percent over the 12 months ending in January. Yet, its headline counterpart, which includes food and energy, increased an alarming 3.7 percent over the same time frame. Both core and headline PCE figures have been following an accelerating trajectory over the past several months. If you annualize the change in the PCE over the most recent three-month period, for example, you'll notice that the core rose 3 percent, while headline rose 5.4 percent.

Clearly, food and energy prices matter, as these differences make clear. The price index for food rose 4.7 percent over the past 12 months, a rate not seen since 1990. Through January, the PCE energy component was up roughly 23 percent over 12 months.

While some of the movement in core consumer price inflation represents pass-through of high energy prices—to transportation services, for example—we have also seen pickups in other components, such as recreation, education and personal care services, and upticks in components, such as apparel, that have historically exerted downward pressure on the price of the consumer's basket of goods.

There was a time, back when I was an outside observer of the Federal Reserve, when the Fed practiced what some have dubbed "opportunistic disinflation." Beginning in the mid-1980s, the FOMC recognized that while recessions sometimes occur, they could not be anticipated with any precision and that by the time the data revealed a recession, it was too late to do much about it, given the impact lags of monetary policy. The FOMC also recognized that the trend rate of inflation generally fell by about a percentage point or more following a recession. Put it all together and you get opportunistic disinflation, or the idea that if recession comes, make the best of it by bringing down the inflation rate.

This was a period of persistent disinflation—and, I might add, a period during which the U.S. economy experienced only two short and mild recessions, a total of 16 months over almost 25 years. Over this same period, the inflation rate declined inexorably, reaching a point where the FOMC had to deal with the threat of deflation in 2003–04. It was also the period when the Fed made the largest gains in its policy credibility.

One would like to think that as the economy slows, inflationary pressures will do likewise. But we cannot always be sure they will, given the globalized nature of the U.S. economy. Demand-pull pressures abroad have an increasingly potent influence on our domestic economy. Traditionally, a central bank would expect slack to develop as the economy under its jurisdiction weakened, leading to less demand for most inputs and an easing of price pressures. We no longer operate in a traditional economy. Domestic inflation developments have become increasingly less sensitive to domestic measures of slack. In an open, globalized economy, capacity utilization and inflation pressures need to be measured, or at a minimum, understood in their global context.

You cannot think in a purely domestic context about the pricing of oil or steel or soybeans or pulp or shoes or clothing or even what I consider to be one of life's essentials, beer, because innovations in transportation and communications technology have all but eliminated national borders for almost any product for which trade barriers were negotiated away during the 1980s and '90s. More vexing for economists and econometric modelers, the information technology revolution and the spread of the Internet have blurred the once-clear distinction between easy-to-trade goods and difficult-to-trade services. As a result, trade in services is one of the most rapidly growing components of global trade. Thus, even the available supply of architects or petroleum engineers or software designers or medical technicians or lawyers must increasingly be considered in the context of global rather than domestic demand.

The point is that, at present, we simply do not have the ability to adequately account for the impact globalization has on the gearing of our domestic economy. Absent that capacity, we cannot, in my opinion, confidently assume that slower U.S. economic growth will quell U.S. inflation and, more important, keep inflationary expectations anchored. Containing inflation is the purpose of the ship I crew for, and if a temporary economic slowdown is what we must endure while we achieve that purpose, then it is, in my opinion, a burden we must bear, however politically inconvenient.

To some, this may appear a Hobson's choice. I don't see it that way. Our obligation is to prevent inflation in order to sustain long-term employment growth. I believe that the best way to cut through the treacherous economic waves that are upon us and keep our ship steaming forward is to stick to our purpose.

That about says it all for tonight. Let me bring this back to London. Recently, the *New York Times* ran a delightful article on your search for a motto that captures the essence of Britain. My favorite was *Nemo me impune lacessit*, which loosely translated—according to my Texas Latin—means "Never sit on a thistle." Tonight I may have taken the risk of sitting on the thistle of opprobrium of those of you who wished to hear a more felicitous speech. But Charlie Bean's advice was to "just tell 'em what you think." That is what I have done, and I thank you for allowing me to do so.

In the time that remains this evening, I would be happy to take questions and, in true central banking fashion, do my level best to avoid answering them.