Speeches by Bob McTeer

Economic Policy in the United States

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It's an honor for me to participate in a conference sponsored by the Institute of Economic Affairs.

My assignment is U.S. economic policy. I take that to mean monetary policy, although I've provided a brief appendix on U.S. fiscal policy. As a Fed policymaker, I can only speak for myself, and not for my colleagues. In particular, I'm not Alan Greenspan. He asked me to make that perfectly clear.

Monetary Policy During the 1990s

For context, let me pick up the story with our last national recession. It began in August 1990, when Iraq invaded Kuwait and reminded people of the oil shocks of the 1970s. Oil prices spiked, consumer confidence plunged, and a weak economy tipped into recession. The recession officially bottomed out in March 1991, and recovery began that April, seven and one-half years ago. The current expansion has just surpassed the expansion of the 1980s as our second longest. We have 15 months to go to beat the record, set in the 1960s. We will make it if the Asian flu doesn't get us first.

Recovery from our last recession was sluggish at first, and unemployment continued to be a problem for a while longer, giving rise to the term "jobless recovery." Monetary easing, which had begun well before the recession hit, accelerated and continued until late 1992. By that time we had pushed our federal funds target rate (our interbank rate) to a low of 3 percent, or zero percent in real terms, where it remained until February 1994. The reason I remember the rate stuck at 3 percent throughout 1993 is because that was my first voting year on the FOMC and nothing exciting happened.

Monetary easing was aggressive and prolonged because we were pushing against what Chairman Greenspan called "50 mph head winds." The main head wind was the credit crunch left over from the S&L and banking crisis of the late 1980s. Borrowers were reluctant to borrow and lenders reluctant to lend. Other head winds included military base closings and continuing corporate downsizing.

During this period, money growth decelerated substantially and many critics accused the Fed of a tight policy despite the aggressive reduction in short-term interest rates. Congressional hearings were held, during which I tried to explain that, paradoxically, money growth was slowing because money was easy rather than tight. The very low interest rates had led bank customers to reduce their deposits at banks in favor of money market instruments outside the banking system, where they were not counted as part of the money supply. I tried to convince the Senate Banking Committee, but ultimately it was probably the strengthening economy that settled the argument over whether policy was easy or tight.

The economy picked up significantly, and we took the pedal off the metal, so to speak, during 1994. From February 1994 to February 1995 the fed funds rate and other short-term interest rates were allowed to rise in steps from 3 percent to 6 percent. Despite this withdrawal of monetary ease, 1994 was a very strong year. Employment grew rapidly and the unemployment rate declined further, with little adverse effect on inflation.

The question of money supply versus interest rate targeting continued to cause concern during this period. Many of us had been trained as monetarists and were still monetarists at heart, but we had to conclude that financial deregulation and innovation had rendered the old money-growth rules obsolete. Money still mattered, but the demand for money and its velocity became too unpredictable to bet the ranch on.

The withdrawal of monetary ease during 1994 took some wind out of the economy's sails in 1995, but a rare "soft landing" was achieved. Growth slowed in 1995 but didn't tank, thanks in part to three quarter-point easings, ending in January 1996, that cut the fed funds rate from 6 percent to 5.25 percent. Growth accelerated in 1996 and 1997, and this year started out very strong, with real GDP rising at a 5.5 percent annual rate in the first quarter. We raised the target funds rate back up to 5.5 percent in March 1997, its recent peak.

The financial press and market participants expected further tightening moves after March 1997. After all, rapid employment growth had tightened labor markets and pushed the unemployment rate under 5 percent, well below most economists' estimate of the NAIRU, or nonaccelerating inflation rate of unemployment. I don't particularly believe in a stable NAIRU, or Phillips curve, but rapid employment growth was exceeding both labor force growth and population growth, and unpleasant arithmetic suggested that something had to give, probably inflation. But it didn't. And it hasn't. Not yet, anyway.

Over the past couple of years, U.S. economic performance has exceeded recent historical norms. Real GDP growth has averaged over 3 percent; it was 3.8 percent in 1997 and started out this year even stronger. Employment growth has been rapid, bringing unemployment down to 4.5 percent. CPI inflation over the past year has declined to 1.5 percent. The combination of low inflation and low unemployment has been something of a mystery, suggesting more rapid but unmeasured productivity growth.

The policy debate over the past couple of years has focused on the tight labor markets and the "impending" acceleration in inflation. The argument that inflation is just around the next corner because of tight labor markets is a wage-push, or cost-push, argument, although no one uses those terms these days. I was taught that cost-push causes sustained inflation only if ratified by monetary expansion. But it's become hard to know how much monetary expansion is too much. Money growth numbers have accelerated over the past year or so and are above our "target cones," but market-based measures of monetary policy have given different signals. For example, the dollar has generally been strong, commodity prices—including gold—have continued to decline, and the yield curve has been flattening. The Asia crisis only reinforced these trends.

Some commentators, recalling that the Fed's policy tightening in 1994 was a "preemptive" move rather than a reaction to an actual acceleration of inflation, asked why we weren't preempting inflation this time. My answer is that, in 1994, while final consumer prices had not yet accelerated, commodity prices worldwide were going straight up and real short-term interest rates were zero. In the recent period, commodity prices have been falling and real short-term rates were already relatively high, the result of falling inflation in the face of unchanged nominal rates. So, during the recent period, while everyone was on high-inflation alert, inflation decelerated further. Cost-push forces were apparently not being ratified by monetary ease.

Let me reveal a supply-side streak here and say that while most analysts saw inflation as being under control *despite* our strong economy, I tend to believe it was under control *because* of our strong economy. If inflation is caused by too much money chasing too few goods, then more goods are as helpful as less money growth. This assumes, of course, that the supply-side impetus to growth is not totally demand driven, which I believe to be the case. The main drivers have been the revolution in technology, freer trade, deregulation, the collapse of communism and hard-core socialism, and the globalization of capitalism—what many call the "new paradigm" economy.

While some of us believe in a new paradigm, many just chalk up the improved economy—especially the coincidence of low inflation and low unemployment—to good luck, or, in economists' terms, positive supply shocks. They point to computer price deflation, health care disinflation, and lower import prices coming from a strong dollar as helpful factors likely to be reversed. I continue to believe, however, that something more fundamental is going on.

Recent Policy and the Asia Crisis

Which brings me to the Asia crisis. Initially, policymakers underestimated its impact on our economy on grounds of low trade weights. We just didn't trade that much with those economies other than Japan and China. Thinking hadn't fully adjusted to the reality that modern strains of economic flu are transmitted more through the capital accounts than through the trade accounts, and dominos apparently don't have to be close to fall on you. Indeed, until the middle of this past summer, the Asia crisis probably helped the U.S. economy more than hurt it because of the impact of the worldwide capital flight to quality on U.S. interest rates. But that is beginning to be old news. More recently, our trade accounts have "worsened" significantly and the contagion has hit our financial markets pretty hard.

Our stock market peaked in mid-July, but it didn't tank until the Russian default in August. Then it, too, became a victim of the flight to quality, as investors sold stocks to buy Treasury bonds. We hear a lot of talk about avoiding the moral hazard of bailouts and rescues, but the world's financial markets seemed not to appreciate the virtues of the

Russian default.

While U.S. monetary policy had not changed since the quarter-point fed funds increase in March 1997—unless you consider no change in the face of declining inflation a tightening in real terms—it's in the public record that at least some policymakers were leaning toward tightening. Since March 1997, there have been eight publicly announced dissents toward tightening from the majority vote on the FOMC to hold steady. The Committee itself had adopted an asymmetric directive, or "tilt" toward tightening, on seven occasions since then. None of these numbers reflects this week's meeting. The public record also shows that the last recorded tilt toward tightening was at the July meeting and that a neutral stance was adopted at the next meeting in August. The record of the September 29 meeting won't be announced for a few hours yet.

Chairman Greenspan had given a speech on September 4, which the markets interpreted as signaling a shift in the Fed's thinking. His key sentence was that "it is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress." One economist, Ed Yardini, later quipped that it was "midnight at the oasis."

We eased slightly at our regular meeting on September 29, reducing the funds target by a quarter point. We did another quarter point on October 15, bringing the target rate down to 5 percent. In the second move, the discount rate was also reduced from 5 percent to 4.75 percent.

Financial markets seemed to react negatively to the first move on September 29, but our stock market took off with the second and began a rise that restored most of the summer's lost ground. This movement back into equities also involved a reversal of some of the flight to quality in Treasury bonds, and long-term interest rates moved back up from their lows.

I used the weasel words "seemed to" react negatively to the first move because the problems of Long Term Capital Management, the large, highly leveraged hedge fund came to light at about the same time and shook up the markets. Risk premiums, or yield spreads, widened dramatically in the United States, and the demand for investments with risk virtually dried up. Not only did risk premiums rise, liquidity premiums on riskless assets also rose to—dare I say it?—"irrational" levels during early October. The perfect became the enemy of the good to such an extent that credit to riskier borrowers was drying up and markets were disrupted.

Chairman Greenspan has pointed out that the rise of liquidity premiums on riskless assets and assets of the same risk, and I quote him here,

...implies that any commitment is perceived as so tentative that the ability to easily reverse the decision is accorded a high premium. Risk differentiation, despite its recent abruptness, is, of course, a straightforward feature of well-functioning capital markets. The enhanced demand for liquidity protection, however, reflected a markedly decreased willingness to deal with uncertainty—that is, a tendency to disengage from risk-taking to a highly unusual degree. [Greenspan's Nov. 5, 1998, speech]

It is noteworthy, I think, that the press release announcing the second easing, on October 15, stressed "growing caution by lenders and unsettled conditions in financial markets more generally" that "are likely to be restraining aggregate demand in the future."

Market conditions improved considerably after our October 15 easing but are not yet back to normal. While monetary policy most recently has been focused on Asian contagion and financial markets, the real economy is only beginning to signal slower growth ahead. Third-quarter real GDP increased at a surprisingly strong 3.3 percent rate, but employment growth and the manufacturing sectors have weakened during the past couple of months, and consumer confidence has declined. Some further slowing seems inevitable.

Money growth has been rapid recently, but an acceleration of inflation seems unlikely to me in the face of continuing worldwide deflationary pressures. Oil and other commodities, as well as gold and other metals, continue to decline at rapid rates.

Looking to the future, one aspect of our economy that we don't talk about much—perhaps because we don't think about it that much—is our external trade position. Our trade and current account deficits have grown persistently for a long time, a trend that has accelerated strongly during recent months of the Asia crisis. Since the fourth quarter of

1997, U.S. exports have declined $33.8 billion while imports have risen $79.7 billion. That's a 3.4 percent decline in exports and a 6.9 percent increase in imports.

Until recently, the dollar has appreciated passively in the face of steep and pervasive foreign devaluations. True, the East Asian countries and Russia don't trade that much with us, but Canada, Mexico and Japan do. The unwinding of hedge fund positions has reversed many of the flows associated with the Asia crisis and makes it difficult to sort it all out. For example, the Japanese yen went from 113 to the dollar in June 1997 to the mid-140s in June 1998, back down to 119 more recently. The flight to quality drove our 30-year bond rate to an all-time low of 4.7 in early October, but it's now back up to around 5.3 percent.

U.S. monetary policy in recent years has been focused primarily on the domestic economy, while our floating exchange rate has reconciled our domestic economy and policy with external influences. The role of the dollar as a reserve currency has insulated us further from external constraints. But even so, there may be limits to how much the United States can play the role of consumer of last resort for the world. I hope we can continue to be an engine of growth for the world during this perilous time. I hope Britain can, too.

Looking back over the 1990s, I think U.S. monetary policy has been either good or lucky, despite the dangers inherent in using discretion rather than a rule or rules. It's not that we wanted to do it that way, but we felt we had little choice. Of course, we kept the rules in the back of our mind.

In the early 1990s, coming out of the recession, rapid velocity increases were offsetting declining money growth rates, so our pragmatic focus on interest rates and the economy itself kept us from a too-easy policy that would have resulted from blindly following a money-growth rule.

More recently, during the past year or so, money growth has sped up but has been partially offset by velocity declines. For me personally, it was a focus on market-based indicators like commodity price trends, such as gold and oil, the strength of the dollar and the yield curve that signaled policy was appropriately tight, at first, and when those trends continued and accelerated, inappropriately tight.

The very recent and current periods are fraught with danger for policy. We still have very tight labor markets, with upward pressure on wages and other employment costs, and the money supply is growing well above historically safe rates. At the same time, worldwide deflationary pressures have intensified with the Asian and Russian crises. Our financial markets have improved since the middle of October, but risk and liquidity premiums are still unusually high and lenders remain increasingly selective. I've never seen such a disconnect between the financial markets and the contemporaneous real economy and the implications of each for monetary policy.

To add to the uncertainty, Asia is trying to recover from its financial and real debacle, and Latin America, after being hit hard financially, is trying to save its fixed exchange rates with high, economy-killing interest rates. Among our three largest trading partners, both Canadian and Mexican currencies have depreciated against the dollar, while Japan is not out of the woods yet. I don't know how to classify the giant, unprecedented experiment about to take place in Euroland. It's certainly historic, but I don't know whether in the near term it will be a stabilizing or destabilizing influence on world financial markets. I'm sure that's of more immediate concern here than across the Atlantic.

I'm also sure European monetary policy will be much more fun to watch in the coming months than U.S. monetary policy as the desire and need for central bank credibility under the new regime comes up against the renewed political commitment to reduce unemployment. I said earlier that I don't believe in a stable Phillips curve—certainly not in the long term—but the short-term trade-off between inflation and unemployment will continue to be much harder to deal with in Continental Europe than in the United States because of less labor market flexibility.

It seems to me that current worldwide deflationary pressures offer most of us an opportunity to be more balanced in our policies as the needs of the unemployed and the requirements of worldwide financial stability converge, at least for a time. Central bankers have learned the lesson well that fighting inflation is the highest priority and that it takes courage to do so. I've had to remind myself, personally, in recent months, that sometimes discretion is the better part of valor—even discretion in monetary policy.

Appendix: Recent Changes in U.S. Fiscal Policy

For the first time in 29 years, the federal budget posted a surplus in fiscal 1998, which ended on September 30. The unexpected move into surplus during the last two years reinforces a trend toward lower deficits that began four years earlier. The budget changes, which include both revenue increases and spending reductions, are attributable to a mixture of policy changes and feedback effects from economic events.

After peaking (in nominal terms) at $290 billion in fiscal 1992, the deficit declined to $107 billion in fiscal 1996. Part of this decline was due to deficit-reduction laws signed by President Bush in 1990 and by President Clinton in 1993, which restrained the growth of defense and other discretionary spending, slowed Medicare payments to health care providers, and increased income and excise taxes. The economic expansion and the winding down of the costly savings and loan bailout also played a major role in reducing the deficit.

In January 1997, the Congressional Budget Office (CBO) forecast deficits of $124 billion in fiscal 1997 and $120 billion in fiscal 1998, with gradual increases in the following years. During the spring of 1997, however, it became clear that the deficit would be much lower, due to higher individual income tax receipts and lower Medicare and Medicaid costs. The actual fiscal 1997 deficit was only $23 billion.

On August 5, 1997, Congress and President Clinton enacted laws that continued to restrain discretionary spending and further reduced Medicare outlays, while granting income tax cuts to parents, investors and students. At the time, CBO forecast a $51 billion deficit in fiscal 1998, with the new law leading to a small surplus in fiscal 2002.

But the budget continued to outperform expectations. In January 1998, CBO forecast a $5 billion deficit in fiscal 1998, with surpluses beginning in 2001 and growing to $138 billion in 2007. In July, CBO estimated a $63 billion surplus in fiscal 1998 and projected an $80 billion surplus in fiscal 1999, growing to $251 billion in 2008. On October 28, the government announced that the actual fiscal 1998 surplus was $70 billion.

Several factors have combined to produce this "budget surprise." Strong economic growth has increased tax receipts, low nominal interest rates have reduced the government's interest costs and boosted taxable corporate profits, and Medicare and Medicaid costs have been lower than expected. The biggest single item, however, is individual income tax payments, which are running almost $50 billion per year above previous projections, even after controlling for general economic growth. A major portion of the additional tax payments is due to higher capital gains realizations during the stock market boom. Realizations jumped 45 percent in 1996. Although data are not yet available, realizations probably remained high in 1997, particularly since the reduction of the top capital gains tax rate from 28 to 20 percent, effective May 7, 1997, probably spurred more investors to realize gains. Of course, 1998 realizations will probably be reduced, due to the stock market's weaker performance. Part of the higher tax payments is due to higher partnership income and more income in the top brackets, but part is still unexplained.

The unexpected surpluses have generated political pressure to increase spending and reduce taxes. The first step in this direction has already been taken. On October 21, Congress and President Clinton enacted legislation that increases defense and nondefense discretionary spending by $17 billion in fiscal 1999 (the current fiscal year), reducing this year's estimated surplus from $80 billion to $63 billion.

If there are no additional spending increases or tax reductions, CBO and other forecasters expect large surpluses for more than a decade. Under current policies, however, forecasters predict that the retirement of the baby boomers will then send the budget back into deficit after 2010, and the deficits will grow explosively during the subsequent decades. Of course, federal budget forecasting must be approached with caution—we now know better than ever how unpredictable the budget can be.