

## Monetary Policy in the Post 9/11 Environment: Stability through Change

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The U.S. economy enjoyed a remarkable run in the 1990s. But it stumbled as we came into the new century, and has been struggling to find solid footing ever since. Now, as we enter the last quarter of 2003, the recovery seems to be on firmer ground. Employment gains will be slow in coming, and we still have some way to go before we reach our goal of maximum sustainable growth. Nonetheless, I expect the economy to continue moving ahead at a moderate pace through the remainder of this year and into 2004.

Today's conference provides a timely opportunity to reflect on the current business cycle and the tumultuous times surrounding it. The attacks of 9/11 figure prominently in the tumult --- partly because of the profound tragedy of the attacks themselves, partly because of the extraordinary sequence of events they set in motion, and partly because of how the attacks and their aftermath changed the way we think about the world in which we live.

Still, from an economic perspective, the events of 9/11 cannot be considered in isolation. They are part of a broader set of factors at work in the current business cycle. So we ask the broader questions: "Now, two years after 9/11, where are we and where is the economy likely to go from here?"

To be sure, there are many views of our post-9/11 world, and one's perspective on recent events depends on one's vantage point. Mine is as a monetary policymaker, and my intent today is to offer comments from that perspective. I will focus on how recent events, as well as ongoing trends, have affected both the economy and the conduct of monetary policy in this cycle. I will also address how they may influence the economy going forward.

### Examining the Framework

We all know that every business cycle is different. Each is the unique product of: (1) a relentlessly evolving economic structure, (2) some surprising new developments, and (3) a sequence of policy actions attempting to stabilize the situation.

If I were to point out the fundamental driver of the economy's evolution coming into this business cycle, it would be the revolution in information and communications technology. Cheap hardware, sophisticated software, and extensive networking capabilities --- both Internet and intranet --- began transforming business processes in earnest in the latter half of the 1990s.

History tells us that technological revolutions do not produce smooth economic evolutions, and this case is no exception. Nonetheless, the application of new information technologies brought real economic benefits. As these technologies were introduced into organizations and infused into business processes, productivity accelerated measurably. At the same time, however, they spawned unrealistic expectations that were manifested in a stock market bubble and overinvestment in new capital. When the bubble burst and the investment boom deflated, aggregate demand decelerated rapidly, ultimately driving the economy into recession.

The technology revolution has also been an important contributor to a second fundamental factor driving the evolution of our economic structure. A second megatrend, if you will. That megatrend is globalization.

By slashing communications costs, new technologies make the markets for financial assets, goods and services, and even labor, more globally integrated. Globalization is driven by other forces as well. Freer trade among nations and, even more fundamentally, the triumph of the market system over centralized

planning as the way to organize economic activity around the world are both movements that spur integration.

Like the introduction of new technologies, the globalization of the marketplace is a good thing. It fosters greater specialization and gains from trade, affording everyone higher living standards. These benefits are genuine and worthwhile, but they do not come without some cost. The adjustment costs are significant, and in an environment of rapid change, they are ongoing.

I will say more about technology and globalization in a few minutes. But first, let me turn to the second ingredient of any business cycle: surprising new developments and unexpected events.

## **Assessing the Impact of September 11**

Certainly, the most profound event affecting the course of the recent business cycle would have to be the attacks of September 11. It goes without saying that September 11 stands as one of the most shocking and tragic episodes in our nation's history. But I want to step back for a few moments and focus on its macroeconomic repercussions.

The supply side effects of September 11 were visible enough. We saw the great loss of life, and the horrific sights of the collapsing towers, the damaged Pentagon, and the smoldering wreckage of a jet in western Pennsylvania. But against the backdrop of our collective resources --- our nation's labor force and infrastructure --- the purely economic consequence of the loss of productive capacity must be assessed as relatively small.

However, there are also less visible costs that are more difficult to quantify, such as the loss in productivity created by enhanced security procedures in airports, office buildings, and mailrooms. These supply side losses are likely to be a one-time shift in productivity, rather than an ongoing drag on productivity growth. Indeed, most of these security systems seem to be in place now, and the productivity figures since September 11 suggest that the impact of these costs on the overall economy has been negligible.

On the demand side of the economy, September 11 and the events it triggered were generally contractionary.

Of course, the immediate effects of September 11 were predictably negative. At first, shock, fear, and uncertainty paralyzed everyone. We were absorbed by what happened, and we tried to figure out what it meant for our country and ourselves personally. Meanwhile, we cancelled air travel and hotel reservations, and put all but essential spending on hold.

All things considered, consumer spending came back relatively quickly. But for businesses, it was a much different story. Already left with an overhang of equipment from the investment boom of the late 1990s, businesses confronted these new uncertainties about the future and saw new reasons to defer and delay investment spending.

The events that followed in the aftermath of September 11 --- the anthrax attacks, and then the wars in Afghanistan and Iraq --- only served to heighten these uncertainties. In the case of Iraq, the uncertainties were extended and indeed still remain. First, there was uncertainty about whether war with Iraq would come, then about how the war would go, and now about whether we can secure the ultimate objective there --- a politically stable and economically successful nation. Thus, "geopolitical risks," as they are now known, and their business implications, continue to loom in the background.

On the other hand, the impact of September 11 on overall aggregate demand has been mitigated somewhat by the increase in government spending aimed at bolstering homeland security and fighting the wars in Afghanistan and Iraq. Moreover, it now appears that nation-building efforts in Iraq will require additional government spending.

Yet, as all of this was transpiring, aggregate demand was dampened by another set of unrelated but surprising developments. Just after September 11, revelations of irregularities in corporate accounting and lapses in corporate governance surfaced at some major companies. These revelations heightened investor

uncertainty and depressed stock prices, weakening households' and businesses' willingness to spend. For businesses, they also increased risk spreads in credit markets, raising the cost of capital.

Beyond the financial markets' reaction, these revelations also triggered reforms legislated under the Sarbanes-Oxley Act. Compliance with Sarbanes-Oxley focused companies' attention and resources on their audit, accounting, and governance processes. While this was appropriate and necessary, it also diverted companies' attention from new investment projects and future expansion.

Thus far, I have talked about the structural changes and surprising developments affecting the shape of the current business cycle. But, how has the third factor, namely, policymakers' actions, impacted economic dynamics?

Here, I would contend that remarkably aggressive policy action was a defining characteristic of this business cycle. Indeed, monetary and fiscal policy worked together to provide ample and rapid stimulus during the economic downturn.

The National Bureau of Economic Research has determined that we fell into recession in March 2001. On the monetary policy side, the Fed began reducing the fed funds rate in January of 2001, and had dropped it 300 basis points by August. On the fiscal policy side, the Bush administration's first round of tax cuts was enacted in the spring of 2001, and the first tax rebate checks were in the mail by July.

I think a case can be made that, had it not been for September 11, this double dose of strong stimulus might have averted a recession by countering the existing weakness and giving the economy the push it needed to turn around. In any event, the recession occurred and the recovery was attenuated in its aftermath. In response, both monetary and fiscal policymakers reacted by providing additional rounds of stimulus.

These policy actions may not have succeeded in turning investment spending around very quickly, but they certainly helped buoy consumer spending. This has kept the economy growing while the business sector positioned itself to re-engage.

To summarize this review of history, we have had an economy that experienced a period of unsustainable growth followed by a sharp slowdown in the information and computer technology revolution. Then it was pushed into recession and a tenuous recovery by the September 11 attacks and their aftermath, as well as a slew of corporate scandals. The nation was spared an even longer and more severe recession by extraordinary monetary and fiscal policy actions. With this behind us, and as the recovery seems to be gaining some traction, how will these forces play out in the future, and what are the implications for the expansion?

## **Technology and Trade as Drivers**

To begin with, I believe it is reasonable to assert that the macroeconomic impact of the surprising events of our recent past has been diminishing over time. Of course, the war against terrorism is not yet over. Another significant terrorist attack on America or on Americans could quickly resurface the anxieties and uncertainties we have recently experienced. But barring such an episode, the impact of September 11 is likely to recede.

Meanwhile, the fundamental factors I discussed at the outset --- the process of technological revolution driving the economy's structural evolution and the ongoing march of globalization --- are again taking center stage.

The tech boom and bust has passed. The economy has gone from rapid growth to recession to slow recovery. People and businesses have been subject to some extraordinary events. But new information and communications technologies continue to yield strong productivity growth in all types of businesses, as processes for producing and delivering goods and services continue to evolve and improve.

During the recent period of subpar growth, businesses have been squeezing productivity gains out of their existing technology. Now, much of that equipment has been fully depreciated. Businesses are beginning to replace it with new equipment that is still more powerful, setting the stage for additional productivity gains.

As the expansion continues and the outlook improves, businesses will gradually be motivated to increase capacity. The pressures of a competitive marketplace will induce them to invest in the most efficient new technologies available. And, therein, we have the foundation for strong productivity growth on a sustained basis. So I expect this expansion to be marked by healthy growth in both business investment spending and in output per capita, beginning modestly at first but gaining steam as the recovery gains momentum.

The second megatrend of globalization also shows no sign of abating. Declining communications costs and new technologies are making the markets ever more globally integrated. Likewise, the trend toward greater specialization in production is likely to accelerate if unimpeded by protectionist policies.

As an economist, I recognize that the gains from trade afford everyone higher living standards. Nonetheless, transitions can be very difficult. Specialization in line with international comparative advantage entails reallocations, and some dislocations, in the domestic economy. Consequently, I expect the current expansion to be characterized by persistent concerns about structural unemployment, not only in manufacturing, but across a variety of industries and occupations.

Nonetheless, these megatrends of technological change and globalization will supplant the events surrounding September 11 and corporate scandals as shapers of economic performance going forward --- at least within the private sector. But September 11 and its aftermath may leave fiscal policy with a challenge that will take some time to resolve.

## **Fiscal Policy**

Prior to September 11, the Bush administration proposed, and Congress enacted, a tax reduction package intended to stimulate long run growth, front-end loaded to provide powerful countercyclical stimulus. But September 11 and its aftermath have since pushed the federal budget into a deep and prolonged projected deficit.

First, it was the additional expenditures to help with rescue and recovery, then homeland security, the wars in Afghanistan and Iraq, and now rebuilding Iraq. In addition, the tentative recovery motivated a second round of tax cuts this year. It is true that all of these measures provided additional stimulus in a time of significant economic slack, but the challenge now is how to return to a cyclically balanced budget.

## **Monetary Policy in the Current Environment**

At the same time, developments in the current business cycle, including the attacks of September 11, have induced the Fed to provide an extraordinary degree of monetary stimulus to the economy. Today, the fed funds rate is at a 45-year low of just one percent. As noted earlier, this aggressive action most likely reduced the severity of the current recession.

Let me close my discussion this afternoon with my own thoughts about monetary policy challenges going forward. In a sense, the Fed faces the predictable challenges of policymaking during an economic recovery. That is, how quickly to move from a stimulative policy stance, intended to ignite an acceleration of growth, to a somewhat more neutral policy stance, intended to support sustained growth.

In this particular cycle, I believe the challenge is somewhat more difficult because technological change and globalization are affecting the economy's long-run capacity for growth and near-term capacity to employ people in ways that are difficult to quantify. But this is a difference in degree, not in kind, from previous situations. I think we, as policymakers, just need to keep a close eye on the incoming data, keep an ear to the ground in our Districts, and use our best judgment.

In another sense, however, the Fed faces a less familiar challenge: the challenge of maintaining and managing countercyclical policy in a stable price environment. Indeed, the last time the Fed faced this challenge was back in the 1950s when, not coincidentally, short-term interest rates were last at one percent.

An important component of our stable price environment is low and stable expectations about future inflation. In 1995, the median forecast for long-term CPI inflation among economists responding to our [Survey of Professional Forecasters](#) fell to 2.5 percent. It has remained at 2.5 percent ever since.

Remarkably, it did not go up when the Fed began its easing in 2001; it did not go down as core inflation slipped below 2 percent in recent quarters.

I believe it was this achievement of essential price stability --- both in actual inflation and in inflation expectations --- that allowed the Fed the latitude to respond so decisively and effectively to the cumulating indications of economic weakness since 2001. Consequently, maintaining a stable price environment is, in my view, as important for short-run economic stabilization as it is for long-run economic performance.

As a consequence, in a recent talk I advocated that the Fed consider moving toward adopting an explicit inflation target. I think committing to a target would help institutionalize the Fed's commitment to maintaining essential price stability against both inflationary and deflationary pressures that could emerge over the course of this and any future cycle. By making a credible commitment to price stability, the Fed would make it that much easier to achieve.

## **Conclusion**

Stepping back, as I said at the outset, every business cycle is unique. This has certainly been a difficult one. It has been marked not only by economic setbacks, but also by profound human tragedy. The hopeful message it sends is that the United States is an extraordinarily robust and resilient nation. Unfortunate events may divert or delay, but they do not deter our economy from moving forward and improving living standards for us all.