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A Look Back at Monetary Policy in 1994

The following is adapted from a series of recent speeches given by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, in the Twelfth Federal Reserve District.

In February of 1994, monetary policy began shifting into another gear. After four years of gradually lowering short-term interest rates to stimulate the economy's recovery from recession, the Fed began raising rates. All told, since February, the federal funds rate has been raised from 3 percent to 5½ percent. The Fed took these actions to contain the buildup of inflationary pressures, which is key to fostering *sustainable* economic growth.

These moves have been met with controversy in some quarters. For example, in early 1994, the California economy was pretty weak. This has led some critics to ask, "Why not help the parts of the country that are *not* yet strong before worrying about inflationary pressures?"

Others have argued that the Fed moved too soon, before there was much evidence of increases in the inflation statistics. They ask, "Why not wait until we clearly see the problem before trying to solve it?"

From a third point of view, some have argued that the Fed was ignoring the fact that the U.S. operates in an increasingly global environment. Their question is, "Why worry about constraints on U.S. capacity when what matters is world capacity?"

Finally, some think a little more inflation might not be so bad anyway. In other words, they ask, "If the benefit from a little more inflation is higher employment, then what's wrong with it?"

This *Weekly Letter* addresses these questions in order to explain the rationale for Fed policy in 1994.

Question 1.
Shouldn't the Fed help the weak areas of the economy before worrying about inflationary pressures?

There are two main reasons why the Fed's emphasis *has* to be on the nation as a whole, and not on any particular state or region. First, U.S. credit markets are very efficient, so they quickly channel funds to the most productive uses. Therefore, the Fed has no way to direct stimulus to any particular part of the country that needs help. That is why the effects of monetary policy are often referred to as "blunt."

Second, beyond this practical difficulty, there is a real danger in focusing too much on any one region of the economy that is having a hard time. Often enough, *some* state or region is going through a recession of its own while the national economy is humming along. For example, the Twelfth Federal Reserve District, which covers nine western states, currently includes the nation's three fastest growing states—Utah, Nevada, and Idaho—as well as two of its weaker performers—Hawaii and California. If the Fed stimulated whenever *any* state had economic hard times, it would be stimulating most of the time. And the upshot would be a very pro-inflationary environment. (See Cogley and Schaan 1994.)

Does this focus on the well-being of the national economy mean that the Fed ignores regional economic conditions? Not by a long shot. The Fed places *great* importance on understanding regional economies. We do this by analyzing regional data and by talking with people who have insights on current economic developments in their areas of the country. This information is the subject of a good portion of each Federal Open Market Committee meeting, and it is used to fit together a picture of how the whole economy is doing.

Question 2.
Since the overall economy was growing at a robust pace in February 1994, without clear signs of rising inflation, what was the problem?

The problem was—and *is*—that monetary policy effects are not just "blunt"—they also involve "delayed reactions." It takes a long time for a policy action to produce results on inflation—probably from 1½ to 2 years. This kind of lag times means that it is dangerous to wait until the problems show up in the inflation data—by then it would be too late. Instead, the Fed has to *anticipate* problems.

In 1994, there were good reasons to think that inflation would be a problem in the future unless the Fed raised rates. The economy has grown at a 3½ percent rate on average since the beginning of 1992. As a result, much of the unused capacity that had built up in the 1990 recession was employed. The unemployment rate has fallen from a peak of about 7½ percent to just over 5½ percent. Furthermore, manufacturing capacity utilization rates have risen from under 77 percent to over 84 percent.

Now, the Fed likes to see strong growth just as much as anybody else does. But what gets the Fed concerned is a strain on the economy's capacity to produce goods and services. In the past, when we've been at or near so-called "full utilization," higher inflation hasn't been far behind.

This is not to suggest that the Fed has some magic number labeled "full utilization." On the contrary, *precise* estimates simply are not available. For example, just about everybody accepts the *concept* of a so-called "natural rate of unemployment"—that is, the rate that is sustainable in the long run, given current technology, labor market size and composition, and so forth. But not everybody agrees on precisely what that rate is in the U.S. economy today.

Even though economists *don't* agree on precisely what that rate is, most *do* agree that the current figure is in the ballpark. If the past is any guide to the future, then inflation will be on the rise unless things slow down a bit. I should point out that these estimates are *not* the Fed's idea of what the rate *ought* to be, or what anyone at the Fed or anywhere else would *like* it to be.

Question 3.
"Isn't it the amount of worldwide capacity—not just U.S. capacity—that determines our inflation rate?"

The answer largely is "no"—for a couple of reasons. First, a large proportion of what we consume in the U.S. is not affected by foreign trade at all. For example, health care is not traded internationally, and it amounts to about 14 percent of GDP. There are plenty of other examples, as well, like most services, construction, and so on. Second, even when we consider goods that are traded internationally, the effect on U.S. prices is offset to a large extent by *flexible exchange rates*. This offset can be illustrated with a very simplified example. Suppose the price of steel, or some other good, is lower in Japan than in the U.S. When U.S. manufacturers buy Japanese steel, they have to pay for it in yen, which they buy on the foreign exchange market. Since that will mean additional bidders for yen, its value will climb relative to the dollar. As the yen appreciates, the cost of Japanese steel to U.S. firms goes up—even though the Japanese have not changed the (yen) price they charge!

Of course, in the real world, a few of our trading partners *do* fix their exchange rates to the dollar, and some others do not let their currencies float with complete freedom. In addition, it may take time for exchange rates to adjust. However, that does not change the basic point that we cannot depend on foreign capacity to keep U.S. inflation in check. This helps explain why the historical relationship between *domestic* capacity in labor and product markets and inflation has held up throughout the 1980s and so far in the 1990s.

Question 4.
"What's wrong with a little more inflation if the benefit we get is more employment?"

The answer to what's wrong with a little more inflation ties back to the issue of the natural rate of unemployment. A little more inflation *may* get us more employment, but it would only be temporary. The Fed simply does not have the power to push the economy beyond its capacity to produce goods and services for very long, because the things that influence capacity—such as current technology, labor market size and composition—are well beyond the Fed's control. If the Fed *tried* to push the economy beyond its capacity, we *might* get a short-term rise in output and employment. But in the long run, unemployment and capacity utilization would return to their natural rates, and we'd be left with accelerating inflation and financial instability.

Conclusion
To sum up, the Fed's actions this year have been warranted to guard against an increase in *future* inflation. Maintaining low inflation is important in providing a firm foundation for sustainable economic growth. Since there is much less slack in labor and product markets, it would have been a mistake to keep real short-term interest rates at the stimulative levels of late 1992 through

1993. The last time these rates stayed at low levels for a long period was in the 1970s. It made the economy "go" for a while, but eventually it led to the run-up in inflation in the late 1970s and early 1980s. Putting on the "economic brakes" to fight that inflation flare-up led to a major recession. Although the recent situation was not as dire as that one was, we did not want to risk even a small part of that kind of problem again.

As a consequence, I think the steps the Fed has taken this year to raise rates are appropriate: They should help to foster stable, sustainable economic growth with low inflation. Such forward-looking monetary policy helps avoid the "go-stop" economic environment of the late 1970s and early 1980s, and it is much more likely to produce a lasting economic expansion.

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Reference

Cogley, Timothy, and Desiree Schaan. 1994. "Should the Central Bank Be Responsible for Regional Stabilization?" *FRBSF Weekly Letter* 94-25 (July 15).

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