

Community Leaders Breakfast  
Portland, Oregon  
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### Shifting to Another Gear: Monetary Policy in 1994

- I. Good morning.
  - A. In 1994, monetary policy began shifting into another gear--by taking a series of steps that increased short-term interest rates.
    - 1. The most recent action came three weeks ago, when we raised the discount rate, along with the federal funds rate, by half a percent.
  - B. The Fed took these actions to foster *sustainable* economic growth by containing the buildup of inflationary pressures.
  - C. Not surprisingly, these moves have been met with some controversy.
    - 1. Our critics point out that there's no clear evidence of increases in the inflation statistics.
      - a. They ask, "Why not wait until we actually see the problem before trying to solve it?"
    - 2. Moreover, a couple of areas in the District—California and Hawaii—are still relatively weak.
      - a. Some critics have asked, "Why not help the weak parts of the country before worrying about inflation?"
  - D. Today, I'll tackle these questions and explain the rationale for Fed policy this year.
- II. Let me start with a little background.
  - A. After the 1990 recession, the national economy didn't boom as it so often has. Instead, the recovery was a little sluggish.
    - 1. The Fed did its part to keep things going by cutting short-term interest rates *substantially*.

- a. For example, the federal funds rate fell from just under 10 percent in 1989 to 3 percent by late 1992.
  - b. In fact, when adjusted for inflation, short-term rates were around zero levels throughout 1993.
- B. These low interest rates stimulated robust growth in the economy.
  - 1. Between 1992 and the first half of this year, GDP growth averaged between 3 and 3¾ percent.
  - 2. As a result, much of the unused capacity that had built up in the 1990 recession was employed:
    - a. The unemployment rate fell by 1½ percentage points in the past two years.
    - b. Furthermore, industrial capacity utilization rates rose from 79 percent to 83 percent.
- C. With labor and capital markets approaching full utilization, it was no longer desirable for policy to continue in a stimulative mode.
  - 1. The Fed simply doesn't have the power to push the economy beyond its capacity to produce goods and services for very long.
  - 2. And if it tried, the inevitable result would be accelerating inflation and financial instability--without either more production of goods and services or a lower unemployment rate.
- D. These were among the major considerations that led us to pull back from a stimulative mode and raise interest rates five times this year--for a total increase of 1¾ percentage points.
- III. Now, as I said at the beginning, not everyone agrees with our decision to reduce the monetary stimulus.
- IV. After all, some states remain quite weak. Shouldn't we help them before worrying about inflation?
  - A. The answer is that the Fed's emphasis *has* to be on the nation as a whole, and not on any particular state or region. And there are two reasons for this.
  - B. The first one is practical.

1. Monetary policy works through *national* credit markets.
  2. Therefore, we have no way to direct stimulus to any particular part of the country that needs help.
  3. This is why the effects of monetary policy are often referred to as "blunt."
- C. Second, beyond this practical difficulty, there's a real danger in focusing too much on any one region of the economy that's having a hard time.
1. Often enough, *some* state or region is going through a recession of its own while the national economy is humming along.
  2. If the Fed stimulated whenever *any* state had economic hard times, we'd be stimulating most of the time.
  3. And the upshot of that would be a very pro-inflationary environment,
    - a. and ultimately a deteriorating economy as well.
- D. 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.
1. In this Federal Reserve District--the largest both in terms of geography and population--we have five offices:
    - a. our headquarters in San Francisco, and four branches, including, of course, one here in Portland--
    - b. --each with its own set of directors.
  2. We rely on the directors to give us a good *regional* perspective on economic conditions, which is often quite different from what we hear from Wall Street or Washington, D.C.
  3. In addition to providing assessments of the region's performance, the Directors also vote on the discount rate, and their decisions are forwarded to the Board of Governors in Washington.
- E. Finally, the Research staff at each Bank uses the Directors' input--as well as survey responses from local people and regional data--to prepare a report on

regional conditions for the meetings of the FOMC, the Fed's monetary policy making body.

- V. Here in the Twelfth District, these reports cover a lot of territory--literally and figuratively--and a wide variety of economic performance.
  - A. Right now, we have the nation's three fastest growing states--Utah, Nevada, and Idaho---as well as two of its weaker performers--Hawaii and California.
  - B. The sheer size of California's economy and the severity of its recession have been a concern--and not just from a national perspective.
    - 1. From a *regional* point of view, California's important because of what are known as "spillover" effects.
      - a. Typically, weakness in California would be bad news for Oregon and some of California's other neighbors
      - b. because of the drop in California's demand for goods and services from other states.
    - 2. In recent years, however, the negative impact has been mitigated in some states, largely because a number of California's problems are structural rather than just cyclical.
      - a. In addition to California's losses due to defense cuts, the high real estate costs and other factors in the state have led people and jobs to move to other states, including Oregon.
    - 3. But as California works through its structural problems, the more traditional net positive spillover effects from California on its neighbors may become apparent once again.
  - C. In contrast to California, Oregon has been performing slightly better than the nation recently.
    - 1. Over the past year, payroll employment grew faster in the state than in the nation.
    - 2. Some of Oregon's sectors doing noticeably better than the nation include construction, financial services, and manufacturing--especially computers and electronics.

- D. The reports we get from our Directors and other regional contacts suggest that Oregon is similar to the U.S. overall in terms of a tightening in capacity constraints.
  - 1. For example, the reports indicate that firms are having a harder time finding skilled construction workers and office workers with advanced technical skills.
  
- E. So you can see how important the role of regional information is in determining the course of monetary policy.
  - 1. We use it to fit together a picture of how the whole economy is doing.
  - 2. In fact, it's the subject of a good portion of each FOMC meeting.
  - 3. But the bottom line is that decisions must be predicated on the overall average across regional disparities.
  
- VI. Now let me turn to the second reason some people think the Fed shouldn't have reduced the amount of accommodation in monetary policy.
  - A. They see the overall economy growing at a robust pace, without any clear signs of rising inflation. So, what's the problem?
  - B. The problem is that monetary policy effects aren't just "blunt"--they also involve "delayed reactions":
    - 1. It takes a long time for a policy action to produce results on inflation--probably from 1½ to 2 years.
    - 2. This kind of time lag means that it is dangerous to wait until the problems show up in the inflation data--
      - a. --by then we'd be too late.
    - 3. Instead, we have to *anticipate* problems.
  - C. The current situation is a good example. It's true that we haven't seen a significant acceleration recently in the important inflation statistics, like the consumer price index.
  - D. But as I've indicated, our actions this year were warranted to guard against an increase in *future* inflation in order to maintain a firm foundation for sustainable economic growth.

1. Since there's 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.
  - a. The last time these rates stayed at low levels for a long period was in the 1970s.
  - b. It made the economy "go" for a while, but ultimately it led to the run-up in inflation in the late 70s and early 80s.
  - c. As you know, putting on the "economic brakes" to fight that inflation flare-up and the resulting financial instability led to the biggest recession in the post-World War II period.
  - d. Although the recent situation wasn't as dire as that one was, we didn't want to risk even a small part of that kind of problem again.
  
- E. As a consequence, I think the steps we've taken this year to raise rates are appropriate:
  1. They foster stable, sustainable economic growth with low inflation.
  2. Such forward-looking monetary policy helps avoid the "go-stop" economic environment of the late 70s and early 80s, and it's much more likely to produce a lasting economic expansion.

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