Los Angeles Bond Club
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Shifting to Another Gear: Monetary Policy in 1994

I. Good afternoon.

A. This year monetary policy began shifting into another gear.

1. After four years of gradually lowering short-term interest rates to stimulate the economy's recovery from recession, the Fed began raising rates in February.

a. All told, this year, there have been five rate increases,

b. taking the federal funds rate from 3 percent to 4¾ percent.

B. The Fed took these actions to contain the buildup of inflationary pressures, which is key to fostering *sustainable* economic growth

C. Our moves have been met with controversy in some quarters.

1. For example, here in California, the economy is still pretty weak.

a. This has led some critics to ask, "Why not help the weak parts of the country before worrying about inflationary pressures?"

2. Others argue that we moved too soon, before there was much evidence of increases in the inflation statistics.

a. They ask, "Why not wait until we clearly see the problem before trying to solve it?"

3. Finally, some think a little more inflation might not be so bad anyway.

a. In other words, they ask, "If the benefit from a little more inflation is higher employment, then what's wrong it?"

D. Today, I'll tackle these questions and explain the rationale for Fed policy this year.

II. Okay, question number one. Shouldn't the Fed help the weak areas of the economy before worrying about inflationary pressures?

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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. First, as you know, U.S. credit markets are very efficient, so they quickly channel funds to the most productive uses.

    1. Therefore, the Fed has no way to direct stimulus to any particular part of the country that needs help.

    2. That's 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.

D. Does this focus on the well-being of the national economy mean that the Fed ignores regional economic conditions?

    1. Not by a long shot.

        a. The Fed places *great* importance on understanding regional economies.

    2. 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.

    3. This information is the subject of a good portion of each FOMC meeting,

        a. and we use it to fit together a picture of how the whole economy is doing.

E. Let me take a minute to talk about how the Twelfth Federal Reserve District fits into this picture.

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1. The District covers a lot of territory—literally and figuratively—and economic performance varies quite a lot.

   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.

F. We in California have suffered through an unusually prolonged period of economic weakness.

   1. For example, the unemployment rate has been stuck at around 9 percent for most of 1993 and 1994—

      a. —quite a bit higher than the national rate.

G. There are some signs that conditions started to improve by the middle of 1993—

   1. —but the improvement has been slow, sporadic, and uneven across both sectors and regions.

      a. For example, retail sales grew modestly in California during the first quarter, but that growth was partially offset by a drop during the second quarter.

      b. Furthermore, while business services are seeing healthy growth, the aerospace industry continues to lose jobs.

      c. And regionally, while the Bay Area's unemployment rate isn't much different from the national average, southern California's continues to hover around 9 percent.

H. The sheer size of California's economy and the severity of its difficulties are a significant drag on the nation's economy.

   1. When California is excluded from the calculations, the unemployment rate in the remainder of the nation country is 5.8 percent instead of the 6.1 percent national figure.

III. Now to the second question about the Fed's rate increases in 1994:

   A. Back in February, the overall economy was growing at a robust pace, without clear signs of rising inflation. So, what was the problem?

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B. The problem was—and *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's 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. Let me say that we actually *have* seen higher numbers for the CPI and PPI in the last couple of months—

1. —and while that doesn't make a trend, these data are troubling.

IV. Now we come to the third question. "What's wrong with a little more inflation if the benefit we get is more employment?"

A. Well, what's wrong is that a little more inflation may get us more employment, but it would only be temporary.

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.

V. Let me make my point by taking a look at the recent past.

A. After the 1990 recession, the national economy needed some stimulus, and the Fed delivered it by cutting short-term interest rates *substantially.*

1. The federal funds rate fell from just under 10 percent in 1989 to 3 percent at the end of 1993.

2. In fact, the *real* rate—that is, adjusted for inflation—was around zero throughout 1993.

B. These low interest rates stimulated robust growth in the economy.

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1. Over the past two and a half years, the growth rate for GDP has averaged about 3½ percent.

2. As a result, much of the unused capacity that had built up in the 1990 recession was employed.

   a. In the last two years, the unemployment rate has fallen by 1½ percentage points.

   b. Furthermore, industrial capacity utilization rates have risen from under 79 percent to over 84 percent.

C. Now, the Fed likes to see strong growth just as much as anybody else does.

D. But what gets the Fed concerned is a strain on capacity.

1. And that's what we started seeing early this year.

   a. It became apparent that the economy was moving rapidly into the range of "full utilization" of labor and capital markets.

2. Now, I don't want to suggest that the Fed has some magic number labeled "full utilization."

3. On the contrary, *precise* estimates simply aren't available.

   a. For example, just about everybody accepts the *concept* of a so-called "natural rate of unemployment"—

      (1) —that is, the rate that's consistent with current technology, labor market size and composition, and so forth, in today's economy.

   b. But not everybody agrees on precisely what that rate is in the U.S. economy today.

4. Even though economists *don't* agree on precisely what that rate is, most *do* agree that the current figure is in the ballpark.

5. I should point out that these estimates are *not* the Fed's idea of what the rate *ought* to be, or what any of us would *like* it to be.

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VI. To sum up, our 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.

A. 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.

1. The last time these rates stayed at low levels for a long period was in the 1970s.

2. It made the economy "go" for a while, but eventually it led to the run-up in inflation in the late 70s and early 80s.

3. As you know, putting on the "economic brakes" to fight that inflation flare-up led to a major recession.

B. 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.

C. As a consequence, I think the steps we've taken this year to raise rates are appropriate:

1. They should help to 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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