HOLD FOR RELEASE AT 11:45 A.M. PST THURSDAY, DECEMBER 1, 1994

Intermountain Banking Seminar
Logan, Utah
For delivery on December 1, 1994(Luncheon).

Robert T. Parry, President
Federal Reserve Bank of San Francisco

RECENT MONETARY POLICY: A FEW QUESTIONS AND ANSWERS

I. Good afternoon.

  A. I'd like to start with a quick look at the economy in the intermountain states, and then I'll turn to the national picture and monetary policy.

II. Utah, Nevada, and Idaho have been among the nation's top performers since mid-1993,

  A. and the growth has been broad-based:

    1. Construction and real estate activity have been especially strong, accompanied by substantial increases in home values,

    2. and manufacturing activity has grown much more rapidly in this region than it has nationally.

  B. Two sectors deserve individual attention.

    1. One is technology-related industries

      a. Software has been a prominent growth industry in Utah, and computer hardware production has grown very strongly in Idaho.

    2. The second is the visitor industry.

      a. Obviously, it's important in Nevada, with the proliferation of huge new entertainment complexes,

      b. but it's also become increasingly prominent in Idaho and Utah.

  C. With generally strong economic conditions like these, it's no surprise that the banking sector is sharing in this strength.

    1. The region's bank loan growth, return on assets, and asset quality all are at or better than the national average.

  D. So, overall, the economic news from the intermountain region has been very good during the past couple of years.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A. When the Fed began shifting gears back in February, the overall economy was growing at a robust pace, without clear signs of rising inflation. So, what was the problem?

B. The problem was.and *is* that it takes a long time for a monetary policy action to produce results on inflation.probably from 1½ to 2 years.

1. 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.

2. Instead, we have to *anticipate* problems.

V. And this year, we've had good reasons to think that inflation would be a problem in

III. Now let me turn to the national picture. I want to focus mainly on the course of monetary policy over the past year.

A. As you know, monetary policy shifted gears this year, and it made the headlines.

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. Altogether there have been six rate increases,

b. taking the federal funds rate from 3 percent to 5½ percent.

c. The most recent action came in mid-November, when we raised both the federal funds and discount rates by 3/4 of a percentage point.

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

C. We've gotten some criticism over these moves. So today, I'm going to take a look at three of the main points our critics make.

1. First, some 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?"

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

2. Although not everybody agrees on exactly what that rate is in today's economy,

   a. most economists *do* agree that the current unemployment rate is at or below the natural rate,

   b. which means that capacity has been used up.

3. If the past is any guide to the future, then inflation will be on the rise unless things slow down a bit.

VI. The second criticism *starts* with the idea that the past *isn't* a good guide to the future in this case.

A. These critics question our moves because of the rise in global competition.

1. They ask, "Isn't it the amount of worldwide capacity--not just U.S. capacity--that determines our inflation rate?"

B. The answer largely is "no", for a couple of reasons.

1. First, a large proportion of what we consume in the U.S. isn't affected by foreign trade at all.

   a. For example, health care isn't traded internationally, and it amounts to about 14 percent of GDP.

   b. There are plenty of other examples, as well, like most services, construction, and so on.

2. 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.*

3. Let me explain this in a very simplified way.

4. Suppose the price of steel, or some other good, is lower in Japan than in the U.S.

5. When U.S. manufacturers buy Japanese steel, they have to pay for it in yen,

   a. which they buy on the foreign exchange market.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

6. Since that will mean additional bidders for yen, its value will climb relative to the dollar.

7. 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!

C. Of course, in the real world, a few of our trading partners *do* fix their exchange rates to the dollar, and some others don't let their currencies float with complete freedom. In addition, it may take time for exchange rates to adjust.

1. However, that doesn't change the basic point that we can't depend on foreign capacity to keep U.S. inflation in check.

D. 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.

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

A. Well, what's wrong is that a little more inflation may get us more employment, but only *temporarily.*

1. The Fed simply doesn't have the power to push the economy beyond its capacity to produce goods and services for very long.

a. As I said before, output and employment depend on things that are well beyond the Fed's control.

b. .things like the current technology, labor market size and composition, and so forth.

2. If the Fed *tried* to push the economy beyond its capacity, we *might* get a short-term rise in output and employment.

3. But in the long run, output and employment would return to their natural rates, and we'd be left with accelerating inflation and financial instability.

VIII. 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A. Since there's little or no slack in labor and product markets, it's clear that 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. And putting on the "economic brakes" to fight that inflation flare-up led to a major recession.

B. Although the recent situation wasn't nearly 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.

wc 1486

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis