San Marino City Club
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RECENT MONETARY POLICY: SOME QUESTIONS AND ANSWERS

I. Good evening.

II. As you know, monetary policy shifted gears about a year ago, and ever since, it's made the headlines.

A. 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 of 1994.

1. Altogether there have been six rate increases,

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

3. 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. One of the strongest complaints comes from areas like California, where the recovery has been slow in coming.

a. These critics 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, others think that, even if we got a little more inflation, that might not be so bad.

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

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

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, U.S. credit markets are *national* in scope. And they're 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.

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

   a. Right now, we have three of the nation's ten fastest growing states—Utah, Nevada, and Arizona—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 was stuck at around 9 percent for most of 1993 and 1994—

   a. —that's much higher than the 5 to 5½ percent rates we saw during the late 1980s.

2. And the problems have been much more severe here in the L.A. area than they have been in other parts of the state.

   a. Between mid-1990 and mid-1993, Southern California accounted for around 95 percent of the net job loss statewide, and Los Angeles County alone accounted for more than 80 percent!

G. It looks like conditions started to improve by the middle of 1993.

1. But the improvement has fallen far short of the rebound we would like to see

2. and California's economy remains much weaker than the national economy.

3. For example, California's unemployment rate, which typically tracks the U.S. rate fairly closely, is still 2 percentage points higher than the national rate.

4. And during the past year the pace of growth in California has lagged the national growth rate by a substantial margin.

IV. Now to the second question about the Fed's interest rate increases.

A. For some time now, we've had the overall economy growing at a robust pace, without clear signs of rising inflation. So, what's the problem?

B. The problem is, it takes a long time for a monetary policy action to produce results on inflation—probably from 1½ to 3 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 so far, we've had good reasons to think that inflation would *become* a problem unless we tightened policy. Let me explain by taking a look at the recent past.

A. The economy has grown at a 3½ percent average annual rate since the beginning of 1992.

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

a. The unemployment rate has fallen from a peak of about 7½ percent to just under 5½ percent.

b. Furthermore, manufacturing capacity utilization rates have risen from under 79 percent to over 85 percent.

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

C. But what gets the Fed concerned is a strain on the economy's capacity to produce goods and services.

1. In the past, when we've been at or near so-called "full utilization," higher inflation hasn't been far behind.

D. One widely accepted concept of full capacity in labor markets is the 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.

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 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. 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.

VII. To sum up, our actions to raise rates 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 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 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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