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A Perspective on Recent Monetary Policy

I. Good afternoon. It's a pleasure to be here.

A. Last year, the Fed was in the news quite a lot_

1. mostly because between February 1994 and February 1995, we doubled the federal funds rate_

a. _from 3 to 6 percent_

2. _in order to head off inflationary pressures.

B. Well, we're in the news again_

1. now that we cut the funds rate by one-quarter percentage point earlier this month.

C. And some observers have raised questions about what it means for the future.

1. For example, does it mean that the Fed thinks the economy's in for big trouble?

2. Does it mean that our earlier moves were a mistake?

3. Or, does it mean we're putting our low-inflation goal "on the back burner," so to speak?

D. The answer to all three of these questions is "no." But they arise because of some misconceptions about policy.

1. So today, I'd like to try to clear some of these misconceptions up and put the recent move into perspective.

II. Here's the basic story: The recent cut in rates is consistent with the principles of the policy regime the Fed has been following for more than a decade.

A. The chief principle of our policy regime is to deliver low and stable inflation.

1. And there's a good reason for that:
2. delivering low and stable inflation is the main way monetary policy can promote the maximum sustainable advance in the country's economic output and the people's standard of living.

B. Now the question is_how do we approach this goal? To answer this, I need to give you a mini-lecture from Economics 101.

1. First, monetary policy affects the economy with long and variable lags.

a. It can take anywhere from a year and a half to three years for policy to produce results on inflation.

b. This means that we can't gauge policy by looking only at current inflation.

2. Instead, we have to anticipate future changes in inflation by looking for signs of inflationary pressures.

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a. We find pressures for higher inflation when the economy is operating beyond its long-run capacity to produce goods and services.

b. And we find pressures for lower inflation when it's operating below its long-run capacity.

3. Two of the basic guidelines to judge long-run capacity are measures of

a. the economy's potential growth rate

b. and the so-called "natural rate of unemployment."

III. I'd like to talk about these two guidelines briefly, because they're at the heart of much of the Fed's deliberation_and yet they can't be pinned down to decimal point accuracy.

A. I'll start with a definition of the potential growth rate: It's the growth rate an economy is capable of sustaining in the long run.

1. For the U.S., it appears to be in the range of 2 to 3 percent per year,

a. and it's determined by a lot of factors,

(1) including population growth

(2) and improvements in technology and productivity,

(3) such as inventions and a more skilled labor force.

B. The second key factor underlying inflationary risks in the economy is the so-called "natural rate of unemployment."

1. This is the lowest rate the economy can sustain in the long run without causing inflationary pressures,

2. and it's determined by current technology, labor market size and composition, and so forth, in today's economy.

a. Currently, most economists put it in the range of 5½ to 6½ percent.

IV. Now let me apply this mini-lecture to recent history.

A. In 1992, '93, and '94, the economy grew rapidly_well above the long-run potential rate.

1. This long stretch of rapid growth ultimately pushed the economy to operate beyond its long-run capacity to produce goods and services.

a. For example, signs of strain showed up in things like manufacturing capacity utilization rates.

2. And the unemployment rate fell to just under 5½ percent, which appeared to be somewhat below the natural rate.

B. So, based on these indicators, the overall picture suggested that we overshot capacity.

C. As a result, inflation would have been on the rise in the future_

1. _unless the economy slowed down.

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2. As I said, that's why we raised short-term interest rates from February 1994 to February 1995.

D. Since the beginning of this year, the pace of economic activity has cooled, and the timing of the slowdown has followed the normal lags between policy and economic activity.

1. The first quarter numbers show that growth slowed substantially_

a. _from a 5 percent pace at the end of 1994 to 2® percent.

2. Although data on the second quarter aren't complete yet, it's clear that the slowdown has intensified.

a. In fact, I wouldn't be surprised to see a decline in real GDP for that quarter.

V. With this scenario in mind, let me return to the questions raised about the Fed's recent lowering of short-term rates.

A. The first question was, "Does this mean the Fed thinks the economy's headed for big trouble?"

1. Well, looking at some of the positives and negatives, it looks like we'll probably have a quick return to moderate growth.

2. On the negative side, growth in interest-sensitive sectors_like housing and consumer durables_has slowed.

3. But there are a number of positives.

a. Prospects for growth in the rest of the world appear reasonably good, so that foreign purchases of our exports should bolster growth in this country.

b. Second, I expect to see continuing strength in business investment.

(1) For example, spending on information processing equipment has been on a remarkable upward trend for years.

c. Finally, various financial factors_such as the strength in the stock market_should help boost the economy.

4. Even though the fundamentals look good for a return to moderate growth, we're well aware that any forecast is subject to uncertainty.

a. So part of the reason for a lower funds rate is to provide some insurance against the economy turning out to be weaker than we expect.

B. Now for the other two questions: "Does the rate cut mean that the Fed's earlier moves were mistaken?" and "Has the Fed put its low-inflation goal on the back burner?"

1. Well, the answer to both questions is "no"_ and for the same reasons.

2. The main factor behind the recent rate cut again has to do with the indicators_

a. _with the economy slowing, inflationary pressures have receded enough to warrant a modest adjustment in short-term interest rates.

3. Therefore, the rate cuts are consistent with our goal of a gradual reduction in inflation.

a. The gradual approach comes in because we'd like to lower inflation without

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causing major disruptions in the economy.

4. So, both the earlier interest rate increases, as well as the recent decrease, are in keeping with this basic goal.

VI. The slowing of the national economy certainly has implications for us here in California.

A. If the state were following its usual pattern, our growth rate would be expected to moderate by about the same amount as the nation's.

B. But in this business cycle, California has been "out of sync" with the national economy,

1. and that's affecting the dynamics of its recovery.

C. California had to absorb severe shocks to sectors like defense, aerospace, and construction.

1. and, as a result, the state went into a deep downturn that lasted more than three times as long as the national recession.

D. The recovery has been slow in building momentum.

1. According to the payroll employment numbers, California ranked 42nd among the states in the percent increase in payroll jobs over the past year.

2. And while California's unemployment rate is about 1 percentage point lower than a year ago,

a. it hasn't changed much on balance so far this year

b. and it's still well above the national rate.

E. The modest recovery reflects the continuing pressure of several negative factors.

1. The biggest continues to be the cutbacks in aerospace and defense-related jobs.

2. In addition, there are

a. problems with state and local budgets,

b. developments affecting trade with Mexico,

c. not to mention competition from our faster growing neighbors.

F. But there also are definitely some positive features for California.

1. For example, sectors such as high tech, business-related services, entertainment, and tourism, are experiencing impressive gains.

G. These positive features have the potential to mitigate the impact of slower, but more sustainable, growth nationally;

1. and they help explain why the consensus forecast is for California to maintain a moderate pace of recovery in 1995.

VII. I'd like to conclude by emphasizing my point about our recent action on short-term interest rates.

A. As I've explained, given the slowdown in the economy, a cut in rates is very much in keeping with the policy of gradually lowering inflation that the Fed has been

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following for a decade.

B. And although its execution calls for frequent reassessments and readjustments, as economic conditions develop,

1. the policy goal remains constant_

2. _providing the maximum sustainable economic growth through fostering low and stable inflation.

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