Fed Focus: Spokane: Partners with Business
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The Role of the Federal Reserve in the Economy and the National Economic Outlook

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

   A. My topic today is in two parts—

      1. first, the role of the Fed in the economy,

      2. and, second, the national economic outlook.

   B. Now, from the discussions you heard earlier today, you've already gotten some idea about certain Fed responsibilities—

      1. such as banking supervision,

      2. and the Fed's efforts to track the regional economy.

   C. This afternoon, I want to focus on monetary policy, because that's the most important way in which the Fed affects the national economy.

II. To begin with, Congress has delegated to the Fed the responsibility for managing monetary policy.

   A. Our goals include

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1. stable prices and

2. the maximum sustainable employment and economic growth.

B. Of course, monetary policy is only one out of a *number* of factors that affect the U.S. economy.

1. For example, there's also fiscal policy, which involves taxation and government spending,

2. as well as developments in world markets,

3. and, of course, advances in technology and know-how that make our work force more productive.

C. The way the Fed tries to achieve its goals is to balance the demand for goods and services with the national economy's capacity to produce them.

1. If the economy's out of balance with too *much* demand, then we end up with inflation.

2. If the balance tips toward too *little* demand, then we end up with sluggish growth and rising unemployment..

D. Our tools for maintaining the balance are open market operations—

1. —that is, the purchase and sale of government securities on the open market, which serves to lower or raise short-term interest rates.

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E. The conditions for *doing* the job of conducting monetary policy are the subject of a lot of study—

1. —not only by the Federal Reserve and other central banks,

2. but also by researchers in economics, political science, game theory, and a number of other disciplines.

F. And much of this research confirms the wisdom of the founders of the Federal Reserve System:

1. They knew very well that it was important to keep the people who control the country's supply of money and credit *independent* of the people who frame the government's spending decisions.

2. That's why they structured the Fed to be "independent within government."

G. One of the hallmarks of Fed independence is that power isn't concentrated in Washington, D.C., but is shared with the District Banks.

1. As President of the Twelfth District, I attend all meetings of the Federal Open Market Committee, which sets monetary policy.

2. One of the key contributions the District Bank Presidents make to the Committee's deliberations is a regional perspective.

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a. And an important source of help on this is our Boards of Directors.

b. Our Boards comprise people who represent banking, business, labor, and consumers.

(1) And they often have a very different perspective from people on Wall Street or the Washington, D.C. Beltway.

c. In addition, they have their fingers on the pulse of regional economic events.

H. Regional economic conditions are very important in helping us put together a detailed picture of the *national* economy.

1. Indeed, monetary policy *must* focus on the national economic picture rather than on the regional picture for a couple of reasons.

2. The first reason is a practical one.

a. The Fed *can't* ease up or tighten up on short-term interest rates in just one region

b. because monetary policy works through *national* credit markets.

(1) These markets are very efficient,

(2) processing transactions from coast to coast in a split second.

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c. So, working through these markets, monetary policy affects the whole economy—

(1) —in fact, that's why it's sometimes called a "blunt" policy instrument.

3. Beyond the practical difficulties, there's also a real danger of focusing too much on any one region of the economy that's having a hard time.

a. Often enough, *some* state or region is going through a recession of its own while the national economy is humming along.

b. If the Fed stimulated whenever *any* state had economic hard times, we'd be stimulating almost *all* the time.

c. And the upshot of that would be a very pro-inflationary environment, and, ultimately, a deteriorating economy as well.

III. This brings me to the outlook for the national economy. Let me begin by looking at the recent course of events, and I'll try to sketch out the Fed's view on them.

A. Last year, the Fed became concerned about rising inflationary pressures.

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1. The concern was that for about three years—from '92 to '94—the economy grew rapidly.

   a. It averaged growth rates of between 3 and 4 percent—

   b. —well above the 2 to 3 percent long-run potential rate.

2. This long stretch of rapid growth ultimately pushed goods and labor markets to operate *beyond* their long-run capacities.

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

   b. And the unemployment rate fell to just under 5½ percent,

      (1) which appeared to be somewhat below the rate that can be sustained without rising inflation.

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

4. *That's* why we raised short-term interest rates from February 1994 to February 1995.

B. Since the beginning of this year, the pace of economic activity *has* cooled.

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1. The first quarter numbers showed substantially slower growth—

    a. —from a 5 percent pace at the end of 1994 to 2¾ percent.

2. In the second quarter, the numbers showed an even greater slowdown—

    a. —to a meager 1-1/4 percent.

C. As a result of this slowing in the economy, inflationary pressures receded a bit.

1. In fact, they receded enough that we felt a modest reduction in short-term interest rates was warranted.

2. That's what led to our ¼ percentage point cut in the funds rate in July.

IV. Looking ahead, I'm optimistic that we'll have a fairly quick return to the kind of moderate, sustainable growth that the economy needs.

A. For one thing, the second quarter GDP figures weren't as weak as they appeared on the surface.

1. Most of the weakness occurred in inventory investment, as firms made progress in working off excess stocks.

2. But it now appears that inventories are in better balance with sales,

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a. so a good deal of this depressing factor appears to be behind us.

3. In addition, the demand of households and firms for goods and services held up quite well in the second quarter,

a. growing at a modest and sustainable 2½ percent rate.

B. It looks as if demand probably will *continue* to hold up at about that pace in the future.

V. Now, so far,

A. I've described

1. the Fed's concerns,

2. its course of action,

3. and the effects on the economy.

B. What I'd like to do in closing is show you how these actions and outcomes are consistent with a set of goals and procedures the Fed has adhered to for quite some time now.

C. The primary goal, of course, is to deliver stable prices.

1. There's a good reason we focus on price stability:

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a. it's the main way monetary policy can promote the maximum *sustainable* advance in the country's economic output and the people's standard of living.

2. This isn't just a theoretical matter.

3. For one thing, we're not the only central bank with that focus.

   a. In the 1980s, a number of countries—both developed and developing—shifted their emphasis to reducing inflation.

      (1) Let me just rattle off a short list:

      (2) There's Australia, Canada, New Zealand, Sweden, the United Kingdom, France, and Argentina.

   b. Of course, Germany and Japan have had this emphasis for a lot longer.

4. For another, here in the U.S., we learned about the need for price stability from hard experience:

   a. In the 1970s, when inflation rose to double digits,

      (1) we had economic and financial instability,

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(2) and ultimately a big, double-dip recession in the early 1980s.

D. Since that episode some 15 years ago, the Fed has basically been following the same policy regime:

1. While being responsive to cyclical ups downs in the economy, we're also seeking to lower inflation *gradually*.

2. And the emphasis is on *gradual* change,

a. because we want monetary policy to have the smallest possible adverse effect on economic activity during the transition.

E. Both the interest rate increases from 1994 to early this year—as well as the recent cut in rates—were in keeping with this policy regime.

1. As I said, we *raised* rates when it became apparent

a. that the economy had overshot capacity

b. and that inflation would be on the rise unless the economy slowed.

2. Well, it did slow, and therefore inflationary pressures receded enough to warrant a modest *reduction* in rates.

F. Now, pursuing this policy isn't a straightforward, mechanical proposition.

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1. It calls for frequent reassessments and readjustments, as economic conditions develop.

2. But there is a constant in this policy regime that you can count on.

3. And that's the policy *goal*—

    a. —providing the maximum sustainable economic growth through fostering price stability.

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