

## **New Challenges for Monetary Policy**

C. Alan Garner  
Oklahoma Economic Forums  
October 14-16, 2003

Recent evidence suggests that economic activity is accelerating, but it does not feel that way to many Americans. Although the recession was relatively mild, many of us are still somewhat dazed after watching large declines in our retirement portfolios and suffering through the attacks of September 11 and the battles in Afghanistan and Iraq. Currently, the biggest concern is the soft job market. We are experiencing the second jobless recovery in U.S. economic history, but the joblessness is worse than in the early 1990s. Payroll employment has declined by more than a million jobs since the recovery began in November, 2001. Most of us can probably congratulate ourselves for navigating fairly well through tough economic times, although some found those times to be extremely painful. But we all remain keenly aware of the challenges that are lurking out there, and we wonder if any more big shocks are headed our way.

Monetary policymakers are in much the same boat. Overall, they steered the economy well through a series of unprecedented economic disturbances. Real output has been growing at a decent rate, and productivity growth has been exceptional. Even though the labor market is soft, the unemployment rate is well below peak levels reached in the 1970s and early 1980s. Yet policymakers are keenly aware that they face unique challenges and uncertainties. The risks of terrorism and war are inherently difficult to assess, and policy decisions are more challenging when the structure of the economy is shifting rapidly due to technological change and globalization.

In tonight's presentation, I will begin by reviewing recent economic conditions and the national outlook. I am happy to say that growth really *does* appear to be picking up, while inflation should remain low. But the geopolitical risks and the rapid structural changes in the U.S. and world economies create challenges for American businesses and consumers, and also for monetary policymakers. So in the final part of tonight's presentation, I will focus on some of those challenges and describe the Federal Reserve's approach to managing economic risks.

### **Recent Economic Conditions**

First, let's briefly review what's been happening in the economy. In the last few months, the economic growth rate appears to have picked up significantly. After rising sluggishly for two quarters, real GDP expanded at a 3.3 percent pace in the second quarter of this year. This growth rate approximately equals the trend growth rate for the U.S. economy, which many economists put at around 3 to 3.5 percent. However, real GDP will need to grow faster than this trend rate for a while to work off some of the excess economic capacity.

A look at the composition of second-quarter growth is also encouraging. Consumer spending grew at nearly a 4 percent pace, while residential investment expanded at about a 6.5 percent rate. Perhaps most encouraging, business fixed investment climbed at a 7 percent rate in the second quarter. Many economists have been saying that business spending must pick up to have a strong, sustainable recovery. We now have some tangible evidence that business spending on plant and equipment is strengthening.

Two key factors weakened real GDP growth in the second quarter. Net exports of goods and services fell by about \$36 billion as import growth picked up while U.S. exports declined slightly. In addition, business inventories fell by about \$18 billion in the second quarter. However, lean business inventories are a positive factor for the economic outlook. If domestic spending continues to firm, many businesses should start building their inventories, leading to increased orders and production in the manufacturing sector.

But the strengthening in private domestic demand is only beginning to produce more hiring by businesses. Payroll employment rose by 57,000 jobs in September, the first gain in 8 months. I certainly found September's gain to be encouraging, but job growth is still too sluggish to reduce the slack in the labor market. The civilian unemployment rate held steady at 6.1 percent in September. Many observers will not feel confident that the recovery is self-sustaining until stronger and steadier employment growth is established.

Despite the higher level of energy prices, the underlying inflation rate remains low and fairly stable. Consumer prices increased 2.3 percent over the last 12 months. But if you strip out volatile food and energy prices, the core CPI increased by a modest 1.2 percent over the last year. We continue to observe prices declining in some parts of the market—for example, many goods prices have been decreasing. However, the prices of consumer services are increasing at a moderate rate, keeping broad measures of the price level on an upward path.

### **Near-Term Outlook**

All in all, then, recent business statistics suggest that economic activity improved in the late spring and summer after the uncertainties related to the war in Iraq began to subside. But what evidence do we have about the outlook for the U.S. economy in the second half of 2003 and in 2004? Both economic fundamentals and forward-looking indicators point to stronger growth in the second half of this year, with this stronger growth likely to carry over into 2004.

Fundamental economic factors have been encouraging the faster pace of growth. At its current level of 1 percent, the federal funds rate is at its lowest level in decades, and broad measures of the money supply are growing briskly. The effects of accommodative monetary policy are most evident in the housing market, where low interest rates stimulate home sales and mortgage refinancings. But accommodative monetary policy promotes activity outside the housing market as well. For example, low interest rates help corporations strengthen their balance sheets, and they boost household wealth, sustaining consumer spending.

Fiscal policy is also highly stimulative at the federal level. Defense spending grew rapidly in the second quarter because of the war. In the first half of 2003, about 0.8 percentage point of real GDP growth came from higher federal spending. Of course, tight state and local budgets are offsetting some of the stimulus at the federal level, but on net, government spending is still increasing real GDP. Moreover, budget analysts forecast that recently enacted federal tax cuts will boost household spendable income by about \$120 billion annually.

Past depreciation of the dollar is another fundamental factor that is improving the economic outlook. A weaker dollar makes U.S. goods more competitive in foreign markets and makes foreign-produced goods less competitive here at home, tending to narrow the trade deficit. The weaker dollar is also improving the profits of U.S. companies as their foreign-currency earnings are translated back into dollars.

Forward-looking economic indicators also imply a more favorable outlook for the months ahead. For example, higher stock prices suggest that geopolitical uncertainties may be less of a drag on business spending and hiring going forward. Stock prices bottomed out before the hostilities in Iraq actually began. The Standard and Poor's 500 stock price index is about 30 percent higher than its 2003 low on March 11, and the NASDAQ index has gained around 50 percent. In addition, measures of business confidence have risen sharply since last spring.

Based on the favorable fundamental factors and recent strength in forward-looking indicators, I expect economic growth should be fairly brisk over the rest of this year, and this strength should carry over into 2004. Real GDP should grow at about a 4.5 percent rate over the second half of this year and around 4 percent next year. Such growth should be strong enough to keep the unemployment rate on a gradual downward path next year.

But there will still be a lot of slack in the U.S. economy over this period. Operating rates are low in the industrial sector, and rapid productivity growth continues to expand our nation's sustainable output. Thus, stronger growth in domestic spending should not reignite inflationary pressures. I expect that core CPI inflation should remain low, around 1 1/4 percent annually, over the next year and a half.

## **New Policy Challenges**

From an historical standpoint, this forecast seems quite good: strong real GDP growth accompanied by low inflation, with an unemployment rate that is higher than desired but at least drifting downward. However, as I stressed earlier, these are challenging times when we cannot count on history to always be a reliable guide. For example, past relationships between job creation and real GDP growth may not hold at the moment because of geopolitical tensions, the rapid pace of technological change and increased globalization of economic activity.

At a recent symposium in Jackson Hole, Wyoming sponsored by the Kansas City Fed, Federal Reserve Chairman Alan Greenspan noted:

Uncertainty is not just an important feature of the monetary policy landscape; it is the defining characteristic of that landscape. As a consequence, the conduct of monetary policy in the United States at its core involves crucial elements of risk management . . .

I think that one of the key points in Chairman Greenspan's presentation was this. To achieve the goal of price stability and maximum sustainable growth, policymakers must consider not only the most likely path for the economy but also the distribution of possible outcomes around that path. In some cases, policymakers may even need to take out insurance against an unlikely outcome with very bad consequences. This approach is similar to a homeowner acquiring fire insurance even though the probability of one's home burning down is small.

The Russian debt default in the late 1990s is an example of this approach to monetary policy. There was a small chance that Russia's default would cascade through international and domestic financial markets with adverse effects on U.S. economic

growth. As a result, the Federal Reserve eased monetary policy as insurance against this low-probability but potentially painful outcome.

In the current situation, a decline in the inflation rate to undesirably low levels is a similar risk. The worst-case scenario here would be deflation, an actual decline in broad measures of the price level. But even an unexpected decline in the inflation rate from the current level to a very small but still positive rate might have some adverse effects, such as unplanned redistributions from debtors to creditors.

Very low inflation rates also could restrict monetary policy options by making it difficult for the Federal Reserve to stimulate the economy because of the zero lower bound on nominal interest rates. Although the probability of undesirably low inflation is small, the costs to the economy might be large, and thus a risk-management approach to monetary policy implies paying some extra attention to this scenario.

In discussing this risk, I want to emphasize that such a decline in the inflation rate *is* unlikely. Broad measures of the price level are still rising, and conventional economic models suggest inflation will probably remain near current low levels. Surveys of inflation expectations also do not imply a developing deflationary psychology.

But we live in uncertain times where conditions seem too changeable to dismiss such risks altogether. Geopolitical events are one source of uncertainty that is extremely difficult to assess with the models and statistics available to economists. Terrorist attacks are still possible, either on U.S. soil or directed against U.S. interests abroad, and tensions persist with North Korea and in the Middle East. Large geopolitical shocks could, conceivably, damage the confidence of consumers and businesses, reducing domestic spending on goods and services and worsening downward pressures on the inflation rate.

Another source of uncertainty is the rapid pace of structural change in the U.S. economy. New technologies, such as personal computers and the Internet, have been contributing to exceptional productivity growth for the last few years. And during the recent recession and sluggish recovery, productivity has surprised us again by growing even faster at a time when productivity growth would historically have slowed. Over the last year, output per hour in the nonfarm business sector rose over 4 percent, well above the 2.5 percent average pace in the late 1990s. Rapid productivity growth is an important part of the story why we have experienced soft labor markets and continued low inflation even as real GDP has expanded.

Globalization is another part of that story. Lower transportation costs and better communications have fostered growing international trade. For example, silicon chips are light-weight and high in value, making it cost-effective to produce such chips in Taiwan or Malaysia and then ship them by air to the United States. The growing trade deficit has increased the supply of goods and services to U.S. households and kept pricing highly competitive. Many domestic manufacturers have restructured under this intense competitive pressure, sometimes choosing to close their U.S. facilities and move their production abroad.

Dramatic advances in computers and technology are also making it easier to trade services internationally. Software engineers in India are already working on many projects for U.S. and European companies, “shipping” their products around the world at light speed through fiber-optic cables. Ernst & Young now has over 200 accountants in India who process U.S. tax returns, and Indian radiologists analyze CT scans and chest X-rays for American patients.



I want to stress that rapid productivity growth and increased globalization are not necessarily bad things. Over the long run, both of these factors should raise the average living standard of U.S. citizens. The challenges come primarily in the short to intermediate run as our economy adjusts to these structural changes and as resources are reallocated from declining sectors to those with better growth prospects.

For example, a recent study from the Federal Reserve Bank of New York suggests that the rapid pace structural change is contributing to the joblessness of the current economic recovery. Reflecting such factors as globalization and technical progress, industries have restructured to a larger degree than in past economic slowdowns. As a result, a higher percentage of job losses have been permanent, as opposed to temporary layoffs from which workers are recalled. Such job losers take longer, on average, to find a new job because they are often shifting industries or professions, perhaps even returning to school for further training. The end result is a softer job market and a higher unemployment rate even after growth has turned up.

These structural changes have aggravated concerns about a decline in the inflation rate to undesirably low levels. Even with demand growth apparently picking up, the supply of goods and services is expanding because of productivity growth and increased imports. In these circumstances, it is hard for policymakers to assess how much excess capacity remains in the economy and how quickly this capacity will be put back to work as growth picks up. If the excess capacity is not eliminated quickly, the inflation rate might remain under some downward pressure.

Thus, there is a small possibility of inflation declining to undesirably low levels. And by the same logic, there seems to be very little chance of a sudden upward surge in

the inflation rate in the current environment. The risk-management approach to monetary policy has led policymakers on the Federal Open Market Committee, therefore, to adopt an accommodative policy stance, and the FOMC believes this stance can be maintained for a considerable period.

### **Conclusion**

To summarize, the risk-management approach to monetary policy suggests that policymakers should pay close attention to low-probability events that might have large adverse consequences. This philosophy explains why members of the Federal Open Market Committee have been discussing the possibility of an undesirably low inflation rate. The risk-management approach to policy is especially useful in a challenging economic environment, such as we currently face. Geopolitical risks remain heightened, and rapid productivity growth and increased globalization are changing the economic structure. Nowhere is this more evident than in the continued sluggishness of the labor market at a time when real GDP is rising.

But recent signs point to a solid recovery in economic growth that will carry over into next year, while inflation is likely to remain near its current low level. Fundamental forces are in place that should sustain the recovery and start producing job gains. Moreover, the Federal Reserve stands ready to provide sufficient liquidity to insure sustainable growth and price stability. Although the economic environment is challenging, I feel confident that policymakers and our nation's economy can meet the challenge.