

Current Challenges for Monetary Policy

C. Alan Garner
Colorado Economic Forums
May 7-10, 2001

When I first came up with the title for tonight's presentation back in February, I deliberately tried to pick something that would not pin me down. At that time, consumer confidence was falling, the housing market was solid, the unemployment rate was rising slightly but remained low by historical standards, and the stock market was volatile. We did not know, back then, whether the economy was headed into recession, or whether it was merely slowing to a more sustainable growth rate. So you can't blame me for picking a title like "Current Challenges for Monetary Policy," which I admit is a little bland, but it will always work since there are always challenges of some kind.

Well, it turns out that I should have just gone ahead and written my speech back in February. If you look at the recent economic releases, consumer confidence is falling, the housing market is solid, the unemployment rate is rising but still low by historical standards, and the stock market is volatile. Moreover, the economic outlook remains murky, although I do think the chances of an outright recession have diminished, and I am cautiously optimistic that growth will pick up in the second half of the year.

Tonight, I will begin by briefly summarizing recent economic developments. Then, I will discuss three major challenges facing Federal Reserve policymakers. These are, first, pursuing the right policy objectives; second, assessing the economic outlook; and third, taking the right policy actions. In a sense, monetary policymakers always face these three challenges, but they take on greater importance in this time of sluggish growth and heightened uncertainty. Adding to the uncertainty are dramatic changes in our

economy over the last decade, such as more widespread ownership of stocks and mutual funds, greater openness to international trade and capital flows, and rapid advances in information technology. I will mention as I go along how some of these changes in economic structure affect the three main challenges facing monetary policymakers.

Recent Conditions

First, though, let's briefly review what has been happening in the U.S. economy. Economic growth has slowed sharply since the middle of last year. Real GDP grew at over a 5 percent rate in the first half of last year, but growth slowed to about a 1 ½ percent pace in the second half of the year and a 2 percent rate in the first quarter of this year.

Consumer spending slowed over the same period, with consumer confidence dropping sharply at the end of last year and so far this year. Yet consumer spending remains fairly solid, advancing at a 3 percent rate over the last two quarters. And although consumer confidence has dropped, the level of confidence remains well above the lows reached in past recessions.

The housing market also remains surprisingly strong, given the sharp drop in consumer confidence. Past declines in mortgage rates and a low unemployment rate have kept buying conditions for single-family homes favorable. In fact, new homes sold at a record pace in March, and existing homes sold at the second highest rate ever.

Nevertheless, business and consumer spending slowed enough that many firms found themselves with excess inventories near the end of last year. Manufacturers cut back sharply in an effort to get inventories under control, causing manufacturing output and employment to weaken. However, the business sector has been making progress in

getting its inventory problems under control, and manufacturing output actually rose in March, reflecting gains in automobile and light truck output. Large parts of the manufacturing sector, however, remain in the doldrums, and manufacturing employment fell again in April.

The slowdown in economic growth and sharp declines in stock prices have also hurt business confidence and profits, prompting many firms to scale back their investment spending. This reduction in capital spending has hit many high-tech firms particularly hard, and concerns have grown that some industries may have substantial overcapacity.

Slower economic growth is also creating much weaker labor market conditions. Payroll employment fell by a much larger than expected 223 thousand jobs in April, and the unemployment rate drifted upward to 4.5 percent from a low of 3.9 percent last year.

Inflationary pressures remain fairly subdued. Higher energy prices boosted consumer price inflation over the last year, though energy prices have fallen back from recent highs. However, if you look at the core inflation rate, which excludes food and energy prices, consumer price inflation was a moderate 2.7 percent over the last year.

Pursuing the Right Objectives

Although growth has slowed substantially, real economic activity has not exactly fallen off the edge of a cliff. What may be more worrisome is a pervasive sense of uncertainty about future economic activity. Stock prices are down sharply from their recent peaks, as are business and consumer confidence, and fears of a recession remain widespread. In these times of uncertainty, the main challenges facing monetary policymakers are the bread-and-butter issues. What are the right objectives for monetary

policy? How can we best assess the economic outlook? What are the appropriate policy actions to keep the economy moving toward the objectives?

I do not plan to say much about policy objectives tonight. The Federal Reserve has pursued a consistent set of objectives over time. Usually, we describe them as sustainable economic growth and long-run price stability, and I think these are still the right objectives.

I do want to say a little bit, however, about what would *not* be the right objective for monetary policy. You occasionally hear people say the Federal Reserve should ease monetary policy to get stock prices back up. This view is not surprising given that many investors have suffered large declines in their stock market wealth. Moreover, these losses are being felt more widely than in the past because stock ownership is spread over a larger fraction of the population. In addition, some people argue that the Federal Reserve should react to recent drops in stock prices because high stock prices have helped to spur technological innovations and productivity growth. However, it seems to me that stock prices would not be a good target for monetary policy.

Stock prices are not a good policy target because the Federal Reserve cannot be sure what the “right” level of stock prices is. Financial markets are fairly efficient in pricing stocks, and there is no reason to believe that monetary policymakers can produce a better estimate of stock values than the market. Tech stock prices *may* have fallen over the last year for perfectly rational reasons—for example, investors may have learned that many Internet companies would not be able to achieve the rapid growth of sales and earnings projected previously.

Moreover, targeting an incorrect value for stock prices could do great harm to the economy. For example, trying to prop stock prices up at a level that could not be justified by earnings prospects might lead to an overly easy policy, one that might ultimately worsen inflationary pressures or lead to excessive investment.

Stock prices do have value in making monetary policy. Stock market fluctuations may contain useful information about the outlook for economic growth and business profits. Moreover, stock market fluctuations have wealth effects on household spending and cost-of-capital effects on business investment. Fluctuations in stock prices should, thus, be taken into account in making economic projections, but this does not mean that policymakers should adopt the goal of getting stock prices back to some previous level.

Sustainable economic growth and price stability are better goals for monetary policy. These goals are more closely related to the welfare of the American people than stock prices are. Also, sustainable growth and price stability are mutually reinforcing over the long run. For example, low inflation actually encourages saving and investment, activities that raise the sustainable growth rate.

Assessing the Economic Outlook

A second challenge for policymakers is to correctly assess the economic outlook in this time of fragile confidence and heightened financial market volatility. Structural changes in our economy make this exercise even more uncertain than usual. The dramatic changes in the 1990s, such as greater globalization of our economy and the spread of new information technologies, may affect how fast the economy adjusts to imbalances and who bears the brunt of these adjustments.

Globalization, for example, means that foreign producers have increasingly supplied goods and services to U.S. consumers and businesses. As a result, recent slower growth of domestic demand and the adjustment of excess inventories fall partly on foreign factories and workers, easing the impact domestically. People sometimes refer to this as “exporting the slowdown.” We saw this effect, perhaps, in the latest monthly trade deficit, which improved more sharply than expected because of reduced imports.

New information technology also might change patterns of economic adjustment. New technologies allow firms to keep much closer track of sales and inventories than ever before, meaning that imbalances may be detected and eliminated more quickly. But the inventory adjustment may still be jarring because companies, using the same computer systems and reacting to similar information, may all adjust their output at about the same time.

More could be said about how technological and structural changes may alter the timing and severity of business fluctuations. But the main point is that we really do not know for sure what the effects are, having never faced exactly this set of conditions and this economic structure before. The challenge for economic forecasters and policymakers is, therefore, magnified.

Nevertheless, duly recognizing that challenge, I will say that I am cautiously optimistic about the economic outlook over the rest of this year. With 2 percentage points of monetary easing in place and growing evidence that businesses are getting their inventories under control, the chances of a recession appear somewhat diminished, and economic growth seems likely to strengthen later this year.

Economic activity will likely remain sluggish in the current quarter as manufacturers continue to hold down production to eliminate inventory imbalances. Increasingly, these imbalances are centered in business equipment industries rather than consumer goods industries. I expect second-quarter real GDP growth rate will be in the 1 to 2 percent range. With slow employment growth, we may also see some additional upward movement in the unemployment rate over the next few months.

The economy should strengthen in the second half of the year, however, with growth at a 2 ½ to 3 percent rate by year-end. Three factors are likely to contribute to stronger second-half growth. First, as the current inventory adjustment subsides, businesses should return to more normal production schedules, which will boost output and employment. Second, over time the effects of lower interest rates should spread through the interest-sensitive sectors of the economy, and the lower cost of funds should encourage higher consumer and business spending. Third, fiscal policy is likely to become more stimulative. The expected passage of a tax cut should encourage consumer spending by raising after-tax incomes and improving consumer confidence. In addition, federal government spending will likely increase as Congress and the Administration spend part of the growing budget surplus.

Inflationary pressures will probably moderate somewhat as a result of the slower economic growth. Energy prices remain something of a “wild card.” As you well know, gasoline prices have been rising, and electricity prices may remain under pressure in some parts of the country as we enter the summer cooling season. Health care costs also continue to rise at a faster pace than most other goods and services. However, ample productive capacity exists in the industrial sector, which should help to hold down prices

for many consumer goods. Moreover, labor market pressures are easing as the unemployment rate drifts higher, helping contain inflation in the services industries. I expect core CPI inflation to be around 2.5 percent this year, slightly below what we experienced over the last year.

Taking the Right Actions

A third challenge facing policymakers is taking the right policy actions, in terms of both the amount and the timing of monetary ease. Policy actions must be based on the outlook for growth and inflation rather than just the current situation because monetary policy operates with long lags. Although the FOMC's policy actions sometimes immediately move the financial markets, most economists believe it takes six months or so, on average, before monetary easing has a noticeable effect on real spending and production decisions. The lag with which monetary policy affects inflation is typically even longer.

Policymakers must be careful to provide enough stimulus to get us through the current sluggishness without providing so much liquidity that the economy will overheat in the future. After 2 percentage points of easing, policymakers must weigh this issue carefully. In addition, FOMC members cannot forget that fiscal policy is becoming more expansionary.

The rapid growth of high-tech industries also creates uncertainty about how quickly the economy will respond to recent monetary easings. History gives some guidance about how fast car sales and construction respond to policy actions, but we know much less about what happens when there is excess capacity in high-tech capital, such as computers and fiberoptic cable. In fact, recent studies do not agree on how big

the excess of high-tech capital goods is, although there seems to be fairly widespread agreement that there has been some overinvestment.

We also do not know how quickly an excess of high-tech capital goods can be eliminated. Much of this high-tech equipment has become obsolescent rather quickly and must be replaced in just a few years. If that continues to be true, the overhang of high-tech equipment may be eliminated quickly. But if the pace of technological change slows or if businesses simply do not find compelling new features on the next generation of machines, then the slowdown in business investment on computers and other high-tech equipment might be more protracted.

The strength of foreign economic growth is also a key risk factor that makes it difficult to judge the right amount of monetary easing. Most foreign economies have been slowing, due partly to reduced exports to the United States, partly to higher energy prices, and partly their own policy tightenings. With the Japanese economy still stalled, Europe remains the primary area driving world growth, but European growth rates have also been slowing. Thus, foreign growth is a risk factor that must be followed carefully.

All of these risk factors introduce considerable uncertainty into the current policy situation. At the time of the last FOMC press release in mid-April, Committee members felt that the “risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.” Federal Reserve policymakers will be monitoring developments closely and adjusting policy as the economic situation changes.

Conclusion

Obviously, this is a challenging time for the economy and for the Federal Reserve. The three main challenges for monetary policymakers are pursuing the right

objectives, assessing the economic outlook, and taking proper policy actions. The proper policy objectives really do not change—the Federal Reserve continues to pursue its longstanding objectives of sustainable growth and price stability. Assessing the economic outlook is a more difficult challenge, but I am cautiously optimistic about the outlook. Recent policy easings, continued solid spending by consumers, progress in reducing excess inventories, and prospects for fiscal stimulus all suggest that economic momentum should build later this year. But significant downside risks remain, and large changes in the economic structure make it hard to judge how much monetary easing is required. As a result, policymakers are monitoring the incoming statistics carefully and remain ready to take additional policy actions if needed.