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Price Stability and Regional Diversity

by W. Lee Hoskins

In a recession, it may seem advantageous for the Federal Reserve System to stimulate output by expanding the money supply. This response cannot remedy the structural shocks that affect regional economies, however. In a recent speech, Federal Reserve Bank of Cleveland President W. Lee Hoskins presented this analysis of how regional economic structure supports the goal of price stability as the Fed's sole monetary policy focus.

Those who recognize and appreciate the regional diversity of our national economy can readily understand why I believe that price stability is the only policy objective that the Federal Reserve System can achieve. My reason for espousing this view is quite simple and is vested in the nature of national business cycles.

The national economy is an amalgam of diverse regional economies. The national business cycle, likewise, is an average of regional business cycles, which differ according to the timing of peaks and troughs and the magnitudes of expansions and contractions. Consequently, just as it is impossible for the Federal Reserve to pursue multiple national objectives, it becomes clear that aiming a single monetary instrument at a national target, which is made up of separate and perhaps independent regional cycles, would be a futile exercise that could yield only unpredictable and mostly undesirable results.

Weak national economic conditions have once again raised the issue of whether the Federal Reserve should take steps to stimulate the economy and of how large those steps should be. The System repeatedly reduced the discount rate and the federal funds rate late last year and early in 1991 in response to the economic slowdown. I have sometimes disagreed with the underlying motive, but I have not been troubled by these policy actions, because I do not think that they are inconsistent with progress toward lower inflation.

Nevertheless, I am troubled by the inference made by many analysts and policymakers that the Federal Reserve, by simply turning on the money spigots, can restore the economy to an acceptable and sustainable long-run growth path.

Therefore, in this *Economic Commentary* I wish to express why I believe that price stability is the only objective the Federal Reserve can achieve, and why I believe that a monetary policy that pursues price stability is optimal in a country whose regional diversity is as broad as ours.

I have often publicly discussed my reasons for not tying monetary policy objectives to the business cycle. My position stems from what policymakers can reasonably be expected to know about the economy and how policy affects the economy. I furthermore contend that regional economic diversity strengthens these arguments.

Should the Federal Reserve Respond to Business Cycles?

It is generally accepted that monetary policy affects the general price level in the long run, and aggregate output and employment in the short run. Therefore, why not simply pursue different monetary policies at different stages of the business cycle? Why not pursue a policy of stimulating output during a recession and promoting price stability when the economy has recovered and begins expanding again? Actually, that was pretty much what the Federal Reserve did in the 1970s, and the results were not good. We achieved neither price stability nor full employment.

First, we simply don't have the forecasting accuracy to fine-tune the economy with the precision necessary to implement a stop-and-go policy of expanding the money supply more rapidly when the risk of recession is higher, and restricting the monetary expansion when the threat subsides but is replaced by a greater likelihood of inflation. Even in the dullest of times, the world abounds with enough random events of significant economic consequence to make accurate forecasts virtually impossible. And dramatic events like the Persian Gulf conflict can only play complete havoc with our best, but still imperfect, forecasts. Who would have thought last May that Iraq would invade Kuwait and that by October oil prices would more than double, to over $40 a barrel? Obviously, shocks by definition are unpredictable, and their effects on the economy are not known with precision.

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Furthermore, since monetary policy influences business conditions with a considerable lag of six to 12 months, accurate forecasts of at least six months into the future are required for today's policy actions to have the desired effect six months from now. That is, in order to respond to economic conditions today, we should have foreseen perfectly as far back as last October the current state of the economy. With that information, we would have had to make the appropriate policy decisions.

The second reason that the Federal Reserve cannot fine-tune the economy is that the only variable the Fed can control over long periods of time is the price level. It is clear from both economic theory and practice that attempting to stimulate the economy through an easy monetary policy results only in higher inflation. An unstable price level leads to greater uncertainty for households and businesses, which reduces productivity and economic well-being. By anchoring the price level, the Federal Reserve maintains the value of our currency and promotes long-term economic efficiency.

Third, switching back and forth from a recession policy to an inflationary policy creates its own uncertainty in the economy about the Federal Reserve's willingness to control inflation. Moreover, high and variable rates of inflation generally cause mistakes in investment decisions because market signals become distorted.

■ Regional Business Cycles

I have made these first three arguments for a stable-price policy on numerous occasions, and I believe that they alone are sufficient grounds for the Fed to pursue such a policy exclusively. Yet, there is another dimension to the national economy that I believe makes my arguments even more convincing—its regional diversity.

When addressing the issue of whether the Fed should respond to business cycles, one must ask *which* business cycle. Policymakers typically think of the U.S. economy as monolithic and make policy decisions accordingly. When monitoring the pulse of the United States, they examine gross national product, the national unemployment rate, and the national Consumer Price Index. But, as the past few economic downturns have dramatically demonstrated, regional economies behave differently. Instead of each region marching in step with the national economy, it appears that some states enter and leave national recessions at different times and that some states can even remain untouched by national downturns. So far in this episode, for example, no more than 16 states have experienced year-over-year employment loss.

State business cycles exhibited disparate patterns even during the twin recessions between 1980 and 1982—the most severe since the Great Depression. Although the national economy entered a recessionary period in 1980, Louisiana, Oklahoma, and Texas—all energy-producing states—exhibited no significant slowdown. Their economies also held up during the much deeper recession that began in late 1981. However, as the rest of the country began to climb out of the second recession, the oil states began their own downturn. After these three states recovered briefly within a year of the national trough, they again slid into a period of employment decline, lasting well into 1987.

The distinction among regional business cycles has been accentuated in recent years to the extent that some analysts have even coined the term "rolling recessions." During the 1980s, farm states, energy states, and then Midwest manufacturing states experienced downturns while the nation as a whole was expanding. Currently, several New England states are having severe problems. For example, after a period of unprecedented growth during the late 1970s and early 1980s, the Massachusetts economy plummeted in June 1986. Rhode Island and New Hampshire immediately followed suit, and Vermont and Maine were pulled into the regional downturn soon thereafter. These states have yet to recover.

■ Why the Differences in Regional Economic Performance?

What, then, explains the variation in regional business cycles? James Tobin, the Nobel Laureate macroeconomist, and William Nordhaus once stated that the veil of macroeconomic aggregates conceals "... all the drama of the events —the rise and fall of products, technologies, and industries, and the accompanying transformation of the spatial and occupational distribution of the population."[1] Each regional economy plays out its own drama against the backdrop of its natural resources, industrial structure, human capital, and physical and cultural infrastructure.

Fluctuations in the national economy are caused by a combination of structural shifts and cyclical patterns within each regional economy. These structural shifts affect industries and regions differently, depending on the industry's productivity and the region's comparative advantage. For example, because of factors such as relatively high wages, entrenched special-interest groups, aging private and public capital stock, and foreign competition, manufacturing employment and population in many midwestern states have declined relative to states in the South and Southwest, as well as to other countries.

Whether these regional shocks are sufficiently large to spill over into other regions and eventually generate a downturn large enough to affect the national aggregates or averages depends on the extent of the regional adjustments and the linkages among regional economies. For instance, of the nine recessions recorded since World War II, the Great Lakes states have ushered in three. This current downturn marks the first time that the New England region has led the way.

Regional business cycles are also caused by broader but more temporary factors. These broader shocks often hit regions simultaneously, such as when oil prices rise suddenly. As a result of differences in industrial composition and relative industrial productivity, regions may be affected differently by an oil price shock, but the simultaneous impact may be enough to affect the aggregate

economy. This may explain why there is strong evidence that all but one of the previous eight national recessions have been preceded by an oil price shock.

Monetary surprises are another example of shocks that hit regions simultaneously and have widespread but differing effects. In the early 1980s, we had two recessions caused by the monetary policy mistakes of excessive money growth during the 1970s. The shock produced by a disinflationary policy that was necessary to get our economy back on an acceptable real growth trend left 46 of the 48 contiguous states with year-over-year employment losses at some point during the twin recessions.

Federal Reserve Policy within a Regional Context

It is clear, then, that the national economy is an amalgam of regional economies, each coping with different structural shifts. Should the Federal Reserve use a short-term money-based solution to try to correct long-term structural shocks facing perhaps only a handful of regions? The answer is clearly no for three reasons. First, the Fed does not have policy instruments that can target one region differently from another region. Second, the regional economies within this country already have market mechanisms that can accommodate adjustments to regional shocks, and money and capital markets are national. Third, monetary policy mistakes can distort the price signals necessary for these regional market-adjustment mechanisms to work efficiently.

The Federal Reserve System is unusual among central banks in that it has the institutional structure to take a regional view of the national economy. Each of the 12 District Bank presidents participates in the eight Federal Open Market Committee meetings held every year. The meeting agenda includes an opportunity for each president to share with the entire Committee current economic conditions within his District. The Federal Reserve System also compiles and releases a synopsis of District conditions, prepared by each of the 12 regional Banks, in what is popularly called the "Beige Book." However, after these regional presentations are made, the FOMC forms a consensus view of the national economy and conducts monetary policy according to this view.

In its early days, when the discount window was the Fed's principal policy instrument, each Federal Reserve Bank could (and to some extent did) pursue its own separate monetary policy by charging member banks different discount rates, depending on the state of their regional commerce.[2] Today, however, regional, national, and international integration of money and capital markets precludes this possibility. Although regional economies maintain distinct identities, the money that flows through and circulates within them does not. Consequently, monetary policy has no way of responding to the economic conditions of one region without affecting all regions.

Even if monetary policy could be targeted to individual regions, this would not necessarily be the most efficient way to combat structural shocks. The economy already has mechanisms—*market* mechanisms—that can accommodate adjustments to these regional shocks. Although the country is a patchwork of different regional economies, these economies are linked by a market system through which people, capital, ideas, and technology move back and forth. The ease with which resources respond to regional market incentives enhances the capability of the U.S. economy to absorb regional shocks.

The United States is unique among industrial countries in that its regional economies are unified under one common currency. Other economies of similar size, such as those encompassed by the European Community and the emerging Pacific Rim countries, are segmented into nations with separate monetary and fiscal institutions and typically disparate monetary policy goals. Furthermore, with these national boundaries delineating regional economies, goods and resources generally flow less freely across those economies than within ours. For these countries, adjustments to "regional" shocks occur to a large extent through exchange rates.

Labor and capital flows are the primary mechanisms by which regional economies in the United States adjust. A phrase once used by Chairman Greenspan—"migration arbitrage"—captures the essence of this regional adjustment process: resources flowing to the region in which they receive their greatest return. The regional flow of workers is one of several factors that allows for our economy's relatively quick adjustment to shocks. For example, because of the easy flow of labor among regions in this country compared to labor flows within Europe, one study shows that regional unemployment rates adjust to one another 20 percent faster in the United States than in the European Community.[3] Even within a single country—Germany, for instance—it has been estimated that labor migration plays a surprisingly minor role in labor-market adjustment compared to the United States.[4] In a similar fashion, capital flows are also instrumental in the adjustment process. In fact, one of the principal objectives of the European Community's single market policy is to promote economic growth through a greater reliance on market adjustment mechanisms.

In addition to market mechanisms, the United States has institutions that enhance the regional adjustment process. The government system of fiscal federalism essentially provides regional insurance, in that the combination of federal tax payments and transfers is countercyclical, attenuating the impact of regional shocks on interregional income differentials. The Federal Reserve System, through its function as lender of last resort, also acts as an interregional conduit of funds. The liquidity needed to prevent widespread failure of solvent financial institutions in a specific region is transferred from other parts of the country by the Fed.

Finally, with well-greased market adjustment mechanisms and institutions already in place to promote the regional adjustment process, I believe that there is no place in this framework for a

monetary policy that responds principally to business cycles. Why should we look to short-term policy as a way to alleviate these typically longer-term regional shocks, many of which are structural? We cannot forecast with enough precision; the economy responds to policy with a lag; and a stimulative monetary policy cannot alleviate structural problems. By acting as if the implementation of monetary policy can overcome these problems, at best we risk making policy mistakes that would distort price signals that are essential for these regional markets to adjust to economic disturbances. In addition, since regional economies are typically at different phases of their own business cycles, a monetary response to any one regional shock, even if it is manifested in a national business cycle, may only intensify the business cycles of other regions.

Conclusion

A thoughtful consideration of the nation's regional economic structure strengthens my belief that the Federal Reserve should focus solely on long-term price stability. By viewing the national economy as a conglomerate of regional economies, it is easy to see the futility and potential harm that could result by acting as if fine-tuning the money supply could remedy the different structural shocks that afflict regional economies. It is equally apparent that such monetary policy mistakes could send shocks through all regions, which could exacerbate regional business cycles and make it difficult for regions to absorb these disturbances.

The only policy that the Federal Reserve should pursue is price stability. Price stability maximizes the efficiency of money as a vehicle of trade across regions, nations, and time. It also eliminates the necessity to hedge against unanticipated inflation, thereby channeling resources to their most productive uses, which is vitally important for the prudent use of valuable resources. Price stability encourages long-term investment, which seems most important for technological advancement, and enables people to allocate labor and capital across regions intelligently—all factors that contribute to the real growth of a region.

Economic diversity has served our nation well, both as a source of growth and as a buffer against shocks. Monetary policy should respect this diversity by not encumbering the markets through which resources move. A monetary policy that promotes price stability is the best way to ensure long-term national and regional economic growth.

Footnotes

1. See William D. Nordhaus and James Tobin, "Is Growth Obsolete?" in F. Thomas Juster, ed., *Economic Research: Retrospect and Prospect—Economic Growth.* New York: National Bureau of Economic Research, 1972, pp. 1–80.

2. See Lester V. Chandler, *Benjamin Strong, Central Banker.* Washington, D.C.: The Brookings Institution, 1958, p. 134.

3. See Barry Eichengreen, "One Money for Europe? Lessons from the U.S. Currency Union," *Economic Policy*, vol. 10 (1990), pp. 117–87.

4. See Susan N. Houseman and Katharine G. Abraham, "Regional Labor Market Responses to Demand Shocks: A Comparison of the United States and West Germany," paper presented at the annual meeting of the Association for Public Policy Analysis and Management, San Francisco, October 18, 1990.

W. Lee Hoskins is president of the Federal Reserve Bank of Cleveland. The material in this Economic Commentary *is based on a speech Mr. Hoskins presented to the Twenty-fifth Annual Meeting of the Pacific Northwest Regional Economic Conference in Portland, Oregon, on May 3, 1991.*

A complete text of this speech is available upon request from the Public Affairs and Bank Relations Department of the Federal Reserve Bank of Cleveland. 216/579-2157.

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