

PRESIDENT'S MESSAGE

Policy Trumps Luck



In economic circles, the 1970s are known for the period's runaway inflation. As the story goes, Federal Reserve policymakers made all the wrong moves in attempting to rein in prices. It took the decisive actions of Fed Chairman Paul Volcker, who was willing to raise interest rates sharply in order to finally arrest inflation's rise in the early 1980s, ushering in the period known

as the Great Moderation.

It's a good story, but it is not unchallenged. As Vanessa Sumo's article in this issue of *Region Focus*, "Bad Luck or Bad Policy?" describes, some economists have argued that both the Great Inflation of the 1970s and the Great Moderation of the 1980s and onward resulted not so much from unwise and then shrewd monetary policy, but rather from luck — first bad and then good. According to this argument, in the 1970s, the United States suffered two energy shocks, in 1973 and 1979, which sent the price of many goods skyrocketing; the Fed may not have made all the right moves, but it was essentially powerless to prevent inflation from rising. Then, in the 1980s, oil prices stabilized and subsequently fell. And in the 1990s, labor productivity increased, thanks largely to advances in technology such as computer power. This provided an environment in which the economy could grow relatively rapidly and inflation could fall steadily until it reached a level more in line with historical norms. In that light, some claim that the low inflation and the two relatively short and mild recessions we've experienced since then have had little to do with actions of the Federal Open Market Committee (FOMC). All this happened almost by accident, incidental to monetary policy.

Our article concludes that there is likely a role for both luck and policy in this story. There can be no question that the U.S. economy encountered problems as a result of the energy shocks of the 1970s, and that this complicated the mission facing the Federal Reserve. Likewise, subsequent productivity improvements have been a great boon to the economy and arguably made the Fed's job easier. But in both cases, the Fed was far from powerless. Fundamentally, it retained the power to achieve low and stable inflation. But before discussing the core issue of monetary policy more fully, let me turn to another significant development that has affected the U.S. economy recently: the productivity improvements that have resulted from financial innovation.

Something of a revolution in unsecured credit began in the 1980s and picked up steam in the 1990s. The same

period saw advances in mortgage and home equity lending. Thanks to falling costs of computing and telecommunications, creditors became able to evaluate borrowers more efficiently and effectively. Thus, credit became more widely available, and on better terms, to more borrowers. Financial innovations also encompassed the world of high finance, with a host of new products coming to the wider market — derivative contracts, swaps, and securities backed by all sorts of assets.

What did all these innovations accomplish? They helped households smooth consumption and, by extension, contributed to economic growth by reducing the volatility of consumption relative to income and expense shocks. Moreover, financial innovation seems to have played a role in launching and sustaining the Great Moderation.

But as with our previous lessons, we must be careful not to draw overly broad conclusions. Yes, the fruits of financial innovation can be seen at the macroeconomic level in the form of reduced real volatility. Certainly, such "lucky" economic shocks make a difference in output. But the full story still must include a prominent place for monetary policy. Through its policy actions, only the FOMC can fundamentally control inflation — and in so doing, it can also foster an environment in which growth can occur.

During the 1970s, the economy and prices seemed to be at the mercy of energy shocks. But in my view, the damage need not have been nearly so great. Monetary policy during the 1970s was excessively loose. The resulting surge in overall inflation raised expectations of yet further inflation. The Fed accommodated energy price increases and let them pass through to the prices of other goods and services. Had we seen a more aggressive approach to confronting inflation, it is reasonable to believe that we would have achieved both lower inflation and faster economic growth.

In the debate over "luck vs. policy," place me firmly in the "policy" camp. Financial innovations and productivity improvements are important to economic growth. But these gains can easily be compromised by poor monetary policy. By keeping inflation low and stable, good monetary policy avoids the need for sharp movements in interest rates that can add to volatility in real economic activity. The improved economic performance of the last two and a half decades demonstrate the importance of the Fed's pursuit of price stability.

A handwritten signature in black ink, appearing to read "J M Lacker". The signature is fluid and cursive.

JEFFREY M. LACKER
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