

Current Challenges for U.S. Monetary Policy

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It is a pleasure and an honor to be invited to participate in this conference. I last visited Vienna in 1962, when I was a Fulbright scholar at the University of Strasbourg in France. Needless to say, Vienna has maintained its appearance much more successfully in the intervening years than I have, but I am very happy to have this opportunity to return nonetheless.

Let me offer a few of my views regarding the challenges facing U.S. monetary policymakers currently. Notice that I said challenges we're confronting "currently" rather than "in the new economy" or "in the new economic paradigm." In this regard, some of you may have seen the comments about paradigms by my friend and colleague Bob McTeer, president of the Dallas Fed, in his Bank's current *Annual Report*. Bob points out that if you want to cook a frog, which I gather some people do, you don't just throw it into a pot of boiling water because it will jump out. Instead, you put it into a pot of cold water and slowly increase the heat, since it won't realize its paradigm is shifting.

I don't know whether Bob had me specifically in mind when he told that story, but I suspect he had in mind people who think about this issue the way I do. I confess to being very skeptical about the view that the macroeconomy functions—if that's the right word—in a systematically different way now from the past, requiring a markedly different approach to conducting policy.

I do, however, recognize that some of the U.S. economy's key parameters, like the sustainable longer-term GDP growth rate, may have changed, and that the Fed and other central banks facing similar changes need to take this into

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account in their efforts to optimize the contribution of policy to economic performance. Where I might differ from some new paradigm advocates is that I believe we can do this effectively using analytical models that have evolved from the rational expectations revolution of the 1970s. Specifically, my own approach to policy analysis currently draws heavily on new neoclassical synthesis models, which integrate real world phenomena like price stickiness that many would think of as Keynesian with modern real business cycle theory. My colleague Marvin Goodfriend and several other members of our Bank's staff have made important contributions to the development of these models and to our appreciation of how they can be used to help guide monetary policymakers in making policy decisions in a changing environment.

This is not the place for a detailed discussion of these models, and I am certainly not the one to deliver it in any case. But let me briefly describe one of their key features, which will be useful when I turn in a minute to the U.S. economy and the immediate monetary policy challenges we face. In these models, the real interest rate (presented in the models as a single, representative rate) plays a central stabilizing role. Basically, the real rate serves as an intertemporal rate of substitution. In simple language, the real rate establishes how much households and business firms have to give up in terms of future consumption if they choose to consume and invest today. An unsurprising corollary is that the level of the rate directly affects the strength of the aggregate *current* demand for goods and services—the lower the rate, the stronger demand, and vice versa. In what follows I hope to show how this quite straightforward framework can be useful in analyzing current policy options in the U.S. and elsewhere.

Before doing this, let me briefly review a few of the main features of recent U.S. economic developments. As you may know, the U.S. economy recently entered its tenth consecutive year of economic expansion; indeed, we are enjoying the longest continuous expansion in our history. GDP growth during the early years of the expansion was somewhat below average compared to the corresponding phases of earlier post-World War II expansions. Growth equaled or exceeded 4 percent in each of the last four calendar years, however, and was about 5.5 percent at an annual rate in the first quarter of this year. These are exceptionally high growth rates at such an advanced stage of an expansion. Moreover, domestic demand grew at a 5.1 percent annual rate over this same time period. Most economists believe growth at this rate exceeds the sustainable growth in aggregate domestic supply, a supposition supported by the steady recent increase in the U.S. current account deficit. Beyond this, labor markets are exceptionally tight, and the national unemployment rate—at 4.1 percent—is close to its lowest level in a generation. Despite these signs of domestic macroeconomic imbalance, U.S. inflation has remained reasonably well contained up to now. The core consumer price index rose 1.9 percent in 1999, and the core personal consumption expenditures price index rose 2.1 percent. Most recently, however, core inflation has shown signs of accelerating.

The core CPI, for example, rose 2.2 percent in the 12 months ended in April compared to only 1.9 percent in the 12 months ended last December.

There are some signs in the most recent monthly economic data that the growth of demand may be moderating. These signs are hopeful but at this point must still be considered tentative.

In this situation, as you know, the Federal Open Market Committee has increased its federal funds rate operating instrument on six occasions recently, from 4.75 percent last summer to 6.5 percent currently. In a world where central bank transparency is increasingly valued, it is essential that the American public understand clearly the rationale for Fed actions, particularly tightening actions such as these. In this instance, while the increases have been reasonably well received by many Americans, they have not been accepted by all, at least in part because the increases seem counterintuitive to some in the context of the new economy-new paradigm idea. Specifically, many “new economy” adherents apparently believe that rising labor productivity growth has restrained increases in labor costs and hence reduced the risk of a renewal of inflation and reduced the need for preemptive monetary restraint by the Fed.

It is true that accelerated productivity growth temporarily limits labor cost increases in the interval before increased demand for workers forces wages up, and the initial increase in the output of goods and services can temporarily restrain price increases. I don't believe, however, that new economy advocates have thought this matter through fully. The analytical framework I mentioned earlier suggests exactly the opposite policy conclusion. It indicates that higher interest rates are required to restore macroeconomic balance and ensure *sustained* higher growth over the longer term.

Some background information on recent U.S. productivity growth trends is required to appreciate this result. U.S. hourly labor productivity grew at about a 2.25 percent average annual rate over the 80-year period between 1890 and 1970. This persistent and healthy growth had an enormously positive impact on income and living standards. At this rate, output per worker doubled approximately every 30 years and increased nearly eight-fold over the period as a whole.

Around the mid-'70s, however, trend productivity growth decelerated noticeably to about a 1.5 percent annual rate, at which rate per worker output doubled only about every 45 years, and the reduced growth persisted until the mid-'90s. We still don't fully understand the cause of the slowdown, although it is reasonable to suspect that it was related in part to the oil shocks of the mid- and late '70s and the high inflation of that period. It may also have reflected changes in the composition of the workforce, particularly the entry of a large number of young workers with less than average work experience and therefore lower productivity.

Whatever its causes, the key point is that most Americans perceived the slowdown, although they did not think of it analytically in terms of a reduced

trend productivity growth rate. Rather, they thought of it in personal terms as reduced economic opportunities both currently and prospectively. It was during this period that, for the first time in recent U.S. history, many workers concluded that their living standards would be no higher than those of their parents.

As you undoubtedly know, there is now considerable evidence that trend productivity growth in the U.S. has revived since the mid-'90s. It is of course much too early to verify this statistically, but the persistently higher-than-expected real growth in the U.S. economy over the last four years or so without a reacceleration of inflation would be consistent with higher trend productivity growth. Many U.S. economists now estimate that this trend growth has increased 1 to 1.5 percentage points from the reduced mid-'70s-to-mid-'90s rate to the vicinity of 2.5 to 3 percent currently. With trend labor force growth at approximately 1 percent, trend productivity growth at this higher rate would imply that the economy's "speed limit"—its maximum sustainable, noninflationary growth rate—is now in the neighborhood of 3.5 to 4 percent, an appreciable increase from the commonly perceived 2 to 2.5 percent limit in the early '90s.

Just as the earlier slowdown in trend productivity growth was perceived, at least intuitively, by the public, so, too, the apparent recent acceleration in trend growth is perceived. Evidence of this perception is widespread. The long bull market in U.S. stocks reflects higher expected future business earnings growth. And I can assure you that my two grown sons and their friends and associates expect lifetime incomes and living standards well above those of their parents. Again, neither my sons, other households, nor business firms typically think explicitly of their expected higher future income as the result of an increase in trend productivity growth. But their expectations and—as I will indicate momentarily—the actions they take based on these expectations make it clear that they perceive the increase implicitly.

What do all these developments in the "real" economy have to do with monetary policy? The answer is that U.S. households are now borrowing quite liberally against their higher expected future incomes to consume today. They are buying new homes, adding on to existing homes, and buying consumer durables such as new cars, furniture, and electronic equipment. Similarly, firms are borrowing against their higher expected future earnings to invest in new plant and equipment.

The problem posed for monetary policy by all this is that the higher expected *future* income driving the increased current demand for goods and services is not yet available in the form of increased *current* output of goods and services. This mismatch between expected future resources and currently available resources, in my view, is the principal factor creating the present aggregate demand-supply imbalance in the U.S. economy I discussed earlier. The excess demand has been satisfied to date by imports and progressively tighter labor markets. But demand is now rising more rapidly here in Europe and elsewhere around the world, which may soon put upward pressure on the

dollar prices of imports. And labor shortages are now widely reported in a number of sectors and industries. On their present course, U.S. labor markets will eventually tighten to the point where competition for workers will cause wages to rise more rapidly than productivity, which sooner or later would induce businesses to pass the higher costs on in higher prices. As I suggested earlier, there is evidence in some of the latest U.S. price and labor cost data that an inflationary process of this sort may now be beginning.

The implication of this analysis, as I indicated at the outset, is that the apparently higher trend productivity growth in the U.S. economy—whether one labels it a “new paradigm” or not—requires higher real interest rates to maintain macroeconomic balance. In order to prevent a reemergence of inflationary pressures and, in doing so, to sustain the expansion, U.S. monetary policy must allow short-term real interest rates to rise to induce households and business firms to be patient and defer spending until the higher expected future income is actually available, in the aggregate, in the form of higher domestic output.

This necessity presents the Fed with several challenges. First, while the need for rate increases seems clear, how do we decide on the magnitude and timing of the increases? In principle, of course, we want to allow rates to rise to the level where the growth in aggregate current demand equals the sustainable growth in productive capacity. In the technical language I noted earlier, ideally we would like to establish an equilibrium intertemporal rate of substitution consistent with aggregate demand-supply balance. Identifying this equilibrium level is difficult, because it is continuously responding not only to the apparent trend productivity growth increase but also to any number of other shocks hitting the economy. Taylor-type rules may offer some operational help in setting the appropriate federal funds rate level, but in the absence of a stronger professional consensus regarding how to use these rules, policymakers in practice will have to apply judgment based on their interpretation of current economic data and forecasts.

As you know, we have in fact been allowing real rates to rise. (I am deliberately avoiding the misleading terminology that the Fed is “raising rates.”) In the spirit of the increased emphasis on transparency in monetary policy, perhaps the principal challenge for the Fed currently is making it clear to the public that these actions have not been the misguided result of “old economy” thinking, but steps that are essential for maintaining balance and maximizing long-term growth in the economy, whether one regards it as new, old, or simply evolving.

REFERENCE

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