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MONETARY POLICY AND THE ECONOMIC OUTLOOK

BY

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GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

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MONETARY POLICY AND THE ECONOMIC OUTLOOK

Working Paper #89-170

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Introduction

Economic performances and policies were extraordinary in the 1980s. The economy suffered through the most wrenching recession since the 1930s. The time-honored anchor of fiscal balance was completely cast off. The tax code was re-written (and re-written again). Both the modus operandi and the basic thrust of monetary policy were reversed (and reversed again). The United States turned itself from the world's largest creditor to its largest debtor. But, finally, the decade that began in tumult ended in tranquility. The 1980s began with inflation, unemployment, and uncertainty each high and rising. They ended with inflation, unemployment, and uncertainty each low and steady.

The economy is now in very good condition. Output is high. Inflation is low. Most regions and industries are currently healthy and stable. Underlying strengths, not special or temporary factors, account for the current prosperity. The outlook for the next year is for continued prosperity.

Past Federal Reserve policy is responsible for having brought the underlying inflation rate down and for having re-stimulated the economy. Presently, the view is widely held that the Fed under the chairmanship of Alan Greenspan has the will and the ability to steer the economy without producing appreciable increases in unemployment over the short-term or in inflation over the long-term. That view is difficult to justify. Perhaps surprisingly, a

stronger case can be made that the Fed has forsaken reducing inflation and is now risking accelerating inflation. And in spite of today's public confidence in the Fed's abilities, there is little evidence that the Fed now has more ability to guide the economy than it has typically had in the past.

The Fed is conducting monetary policy in an active and fore-sighted manner. It does deserve credit for setting policy with an eye to the future, but its view seems to be near-sighted. There is now, as always, risk of recession, but the risk is not especially great for 1990. Even less likely for 1990 is low output or low inflation. The more likely eventuality is not falling output but rising inflation. Attempting to guide the economy into a "soft landing" at 1989's unemployment rates has contributed to the increase in the underlying rate of inflation, which has risen about 1 1/2% in the last two years. It also makes it likely that the underlying inflation rate will rise further in 1990.

Below we briefly assess the state of economic affairs as we leave the 1980s and head into the 1990s. Then we detail the public pronouncements by and perceptions of the Fed under Alan Greenspan, noting particular features of his short-run and longer-run policies. The next section points out how similar current conditions are to those of the mid-1960s, just before inflation accelerated. It also presents the case that the underlying inflation rate has risen steadily and noticeably under Fed Chairman Greenspan and that it is more likely to rise than fall from its current level. These recent and prospective future increases largely have their roots in Fed policy. Before turning to the 1990s, however, we reflect on what we have learned from the 1980s.

Lessons of the 1970s confirmed by the 1980s

By the end of the 1970s, what passed for conventional wisdom for some time

had been under attack. By the end of the 1980s, it was back. It was back in academic fashion, it was back in use by policymakers, and it was back in private-sector practice. Many of the empirical findings accumulated by mainstream economists that were expounded during the 1970s have been validated by the 1980s and now appear to be useful for the 1990s. The irrelevance of many of the supposed revelations of a new economics had been revealed.

The 1980s then did not so much teach us new lessons as confirm old ones. They confirmed what had in the 1970s been conventional wisdom across an impressively wide range of topics. Here is a sampler of some of the old lessons learned anew.

1. The money supply is an extremely erratic guide to the past, current, or future state of interest, unemployment, or inflation rates. It is not likely to be singularly useful to policymakers in Washington or forecasters any place else. It is a woefully insufficient statistic. Just as in the 1970s, in the 1980s the relation between the money supply and virtually anything else in the economy was unpredictable ahead of time, inconsistent over time, and inexplicable after that time. The relation between the money supply and the macroeconomy at this stage make it is easier to forecast where the Fed may try to take the economy than it is to predict how much money supply it will take to accomplish that objective.

2. Fiscal policy has potent effects on the economy. The consumer-led recovery of the mid-1980s resulted in good measure from the extra household cash flow resulting from income tax reductions. Arguments that private sector saving rates would rise as public sector saving rates fell ran afoul of the facts. Arguments that deficits do not affect interest rates shared a similar fate.

3. There is tremendous inertia in inflation; once embedded, it is expensive to exorcise, once rising it tends to rise further for a time. Inflation (total and underlying, price and wage) responds slowly to demand. Sales-pressure pass-through is low and slow. Inflation (total and underlying, price and wage) responds more quickly to supply. Cost pass-through is large and fast.

The slow response to demand means that large changes in unemployment and production lead to only small changes, initially, up or down, in the inflation rate. The short-run Phillips Curve is quite flat. Beating inflation out of hearts, minds, and wage and price agreements is slow and painful. The seven-year period of economic slack from 1980-1986 probably reduced the underlying inflation rate by six or seven percent. In lost profits and dividends, wages and salaries, that reduction cost about $200 billion per point. The total, direct economic cost was just about what conventional wisdom had always indicated it would be: $1 - $1 1/2 Trillion.

4. The dollar has powerful effects on exports and imports. The dollar decline of the latter 1970s was a boon for exporters and those who competed with imports. This seemed all but forgotten by the mid-1980s. One can only wonder why so many observers in the U.S. felt that a weaker dollar would do so little to move us toward trade balance, while so many outside the U.S. feared that it would do so much.

The huge rise and fall of the dollar over the decade of the 1980s produced a mirror image in our trade performance. Our share of international trade followed a V-shaped pattern, dropping precipitously in the first half of the 1980s and rising equally impressively in the second half. That recovery in the U.S. share of trade is largely the result of the dollar decline.

5. Whatever positive response of aggregate saving to the return on saving there may be is likely to be small. The high, expected, after-tax, real returns of the 1980s co-existed with low saving rates. Whatever positive response of aggregate labor supply to the return to labor there may be is likely to be small. Low, expected, after-tax, real wages in the 1980s produced little detectable reduction in labor supply.

6. The relationships embodied in "mainstream" models of the economy are often useful even in the face of large changes in governments, policies, and events. The forecasts that flow from them are likely to be equally useful. In this regard, the depreciation rate on human capital is much lower than is popularly thought (and feared). Fortunately for us, the frequent claims that "we are now living in a different world" are perhaps not much more credible or relevant than claims to have seen the residents of different worlds.

Where are we heading in the 1990s?

What do these lessons portend for 1990 and beyond? First, let's look at the condition of the economy as we enter the 1990s. Economic activity continues at a rapid pace. Compared to the levels of six or even three years ago, the capacity utilization rate is much higher and the unemployment rate is much lower. (see Figures 1A and 1B.) Those rates have moved to levels so strong that even relatively weak economic performance over the next year or so would leave them at relatively strong levels.

Most forecasts for the next year and beyond see few clouds visible on the horizon. Output is predicted to remain strong. Though there is a consensus that real growth is likely to be slower in 1990 than it has been in recent years, there are very few forecasts of recession in 1990 for the U.S. Forecasts for

FIGURE 1A

CAPACITY UTILIZATION IS HIGH

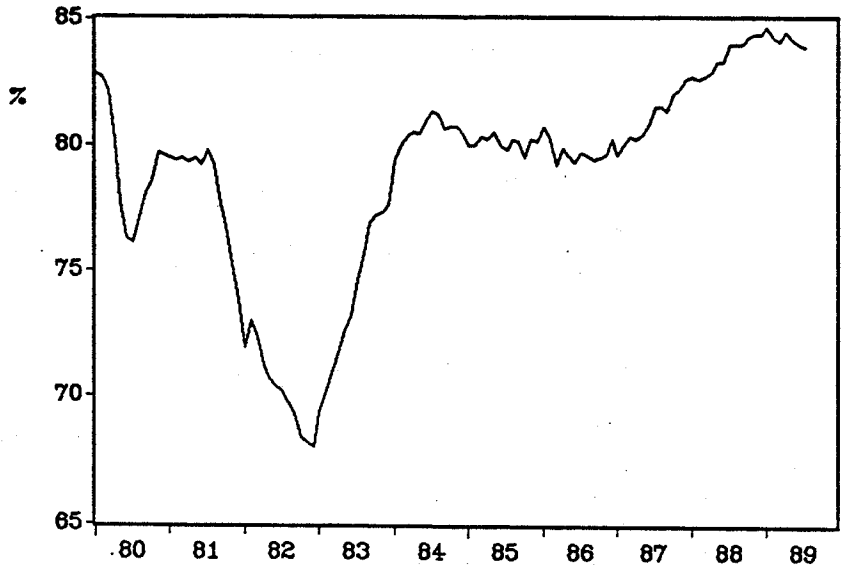
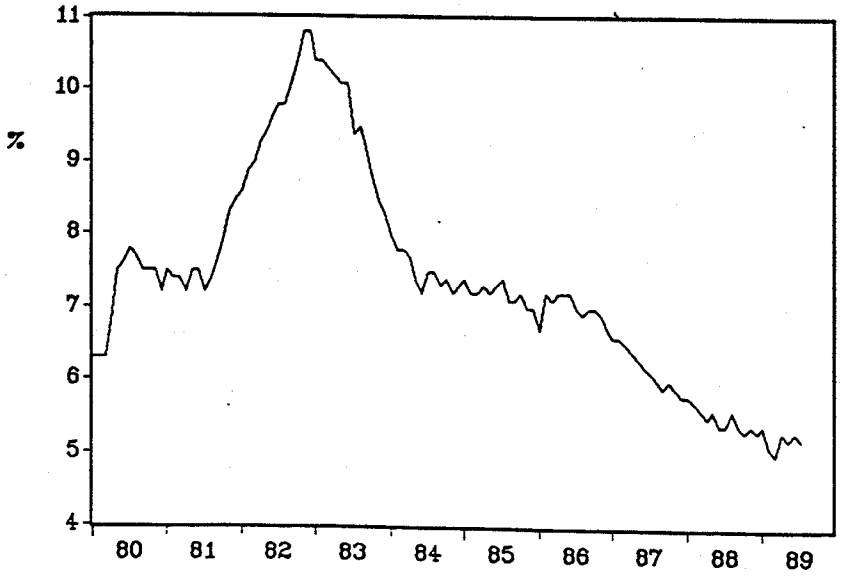


FIGURE 1B

UNEMPLOYMENT IS LOW



economic growth in the OECD as a whole and the majority of its individual members are similar, as are forecasts for many of the newly-industrializing countries.

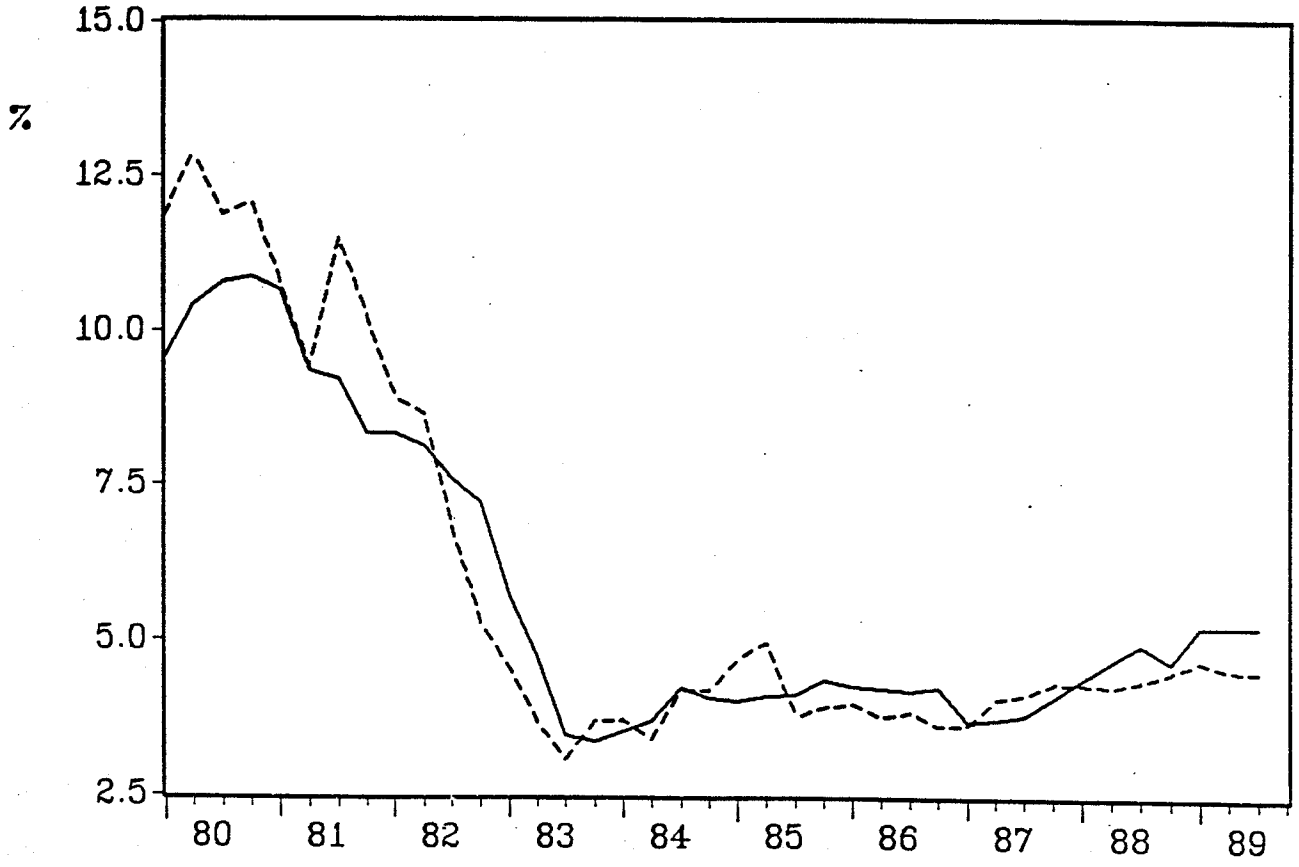
The economic slack that enveloped the world throughout the 1980s cut the global inflation rate substantially. Figure 2 shows that the U.S. was no exception. The four-quarter, seasonally adjusted, growth rate of consumer price (less food and energy) and labor compensation ("wages", for the sake of familiarity) inflation for the 1980s is plotted. There we see that inflation of both wages and prices retreated markedly in the early 1980s and has remained fairly low and steady since.

Figure 3 provides a closer look at the same inflation data. There it is more apparent that wage and price inflation have been on the upswing for the past few years. Having fallen from their peaks around 1980, both troughed in the mid-1980s and have accelerated since. Just as output and inflation cooled together early in the decade, they have warmed together late in the decade. In fact, both output and inflation have been undergoing "global warming." To date, wage and price inflation have been neither high nor accelerating quickly. In 1989, labor costs will probably average about 5 1/2% higher than they did in 1988 and consumer prices are likely to be about 4 1/2% higher.

Figure 4 serves to remind us that sluggish adjustment of wages and prices to high utilization rates of labor and capital is a long-running phenomenon. Even the unemployment rate decline from 7% toward 4% produced but little detectable increase in the growth rate of labor costs by the middle of the 1960s, even though job markets, initially loose, had been tightening for some time. A similar pattern is evident for the latter 1980s in Figure 5. The two percentage point unemployment rate decline since the middle of the decade has not been associated with an alarming increase in labor cost inflation. The

FIGURE 2

PRICES AND LABOR COSTS ARE GROWING SLOWLY

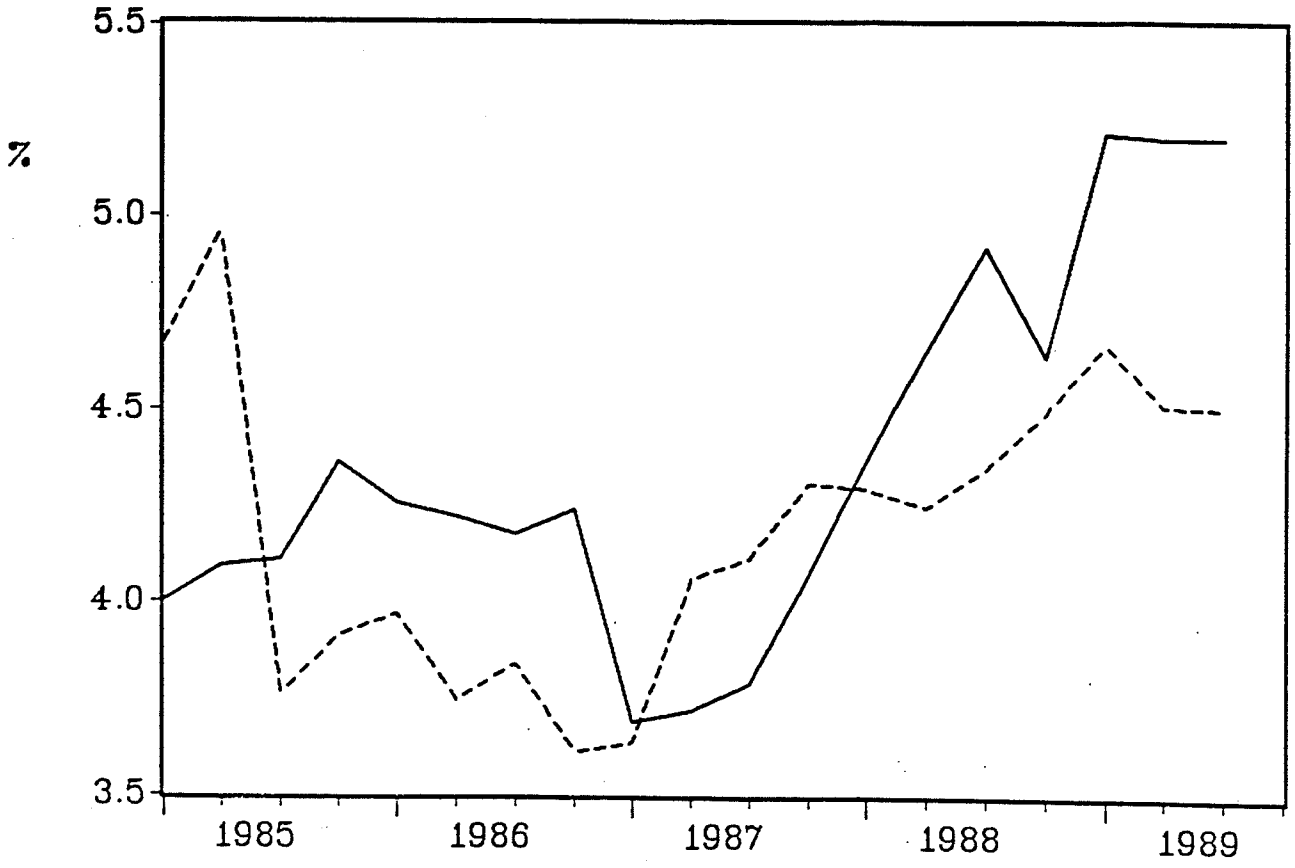


---------- PRICE INFLATION

———— WAGE INFLATION

FIGURE 3

RECENT PRICE AND LABOR COST INFLATION ARE HIGHER



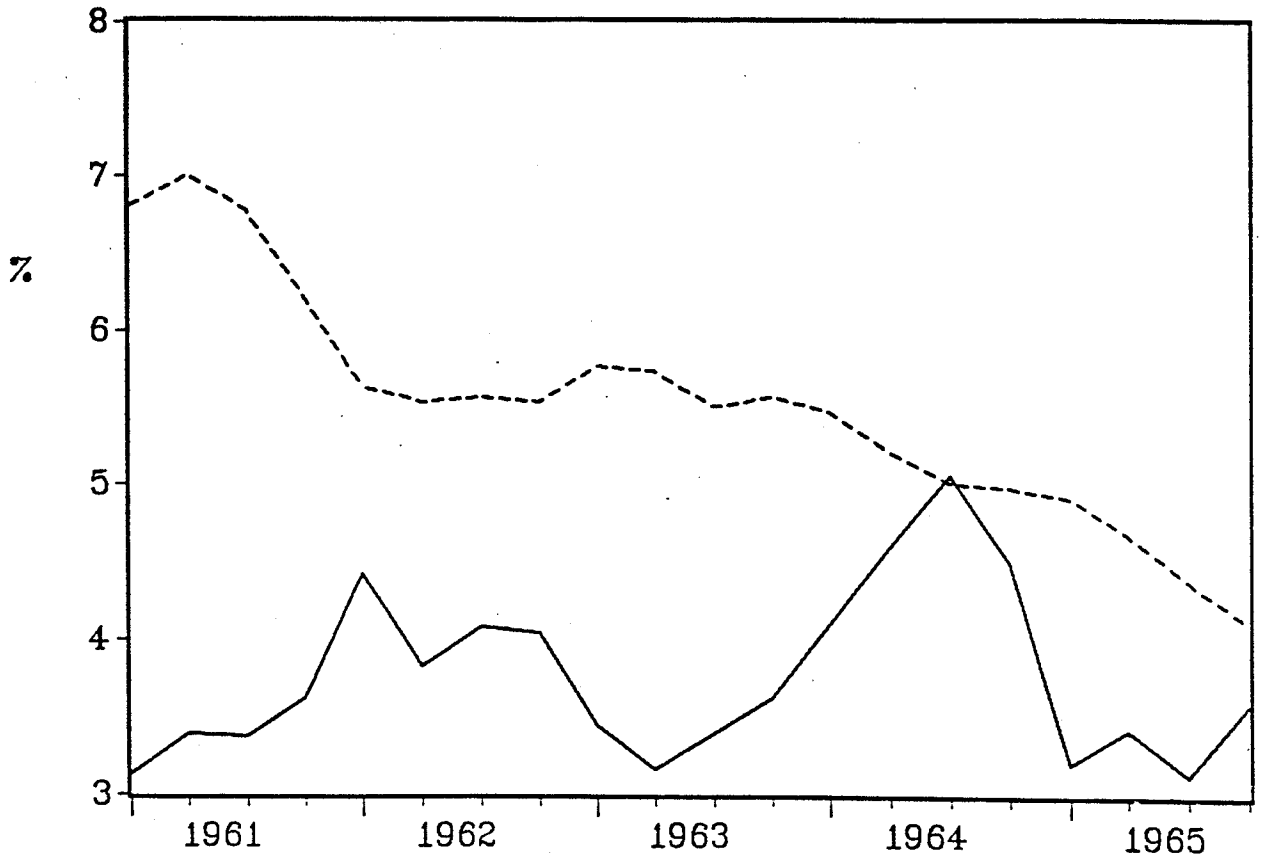
---------- PRICE INFLATION

_____ WAGE INFLATION

FIGURE 4

LABOR COSTS MAY HAVE RESPONDED SLOWLY TO UNEMPLOYMENT

1961 - 1965



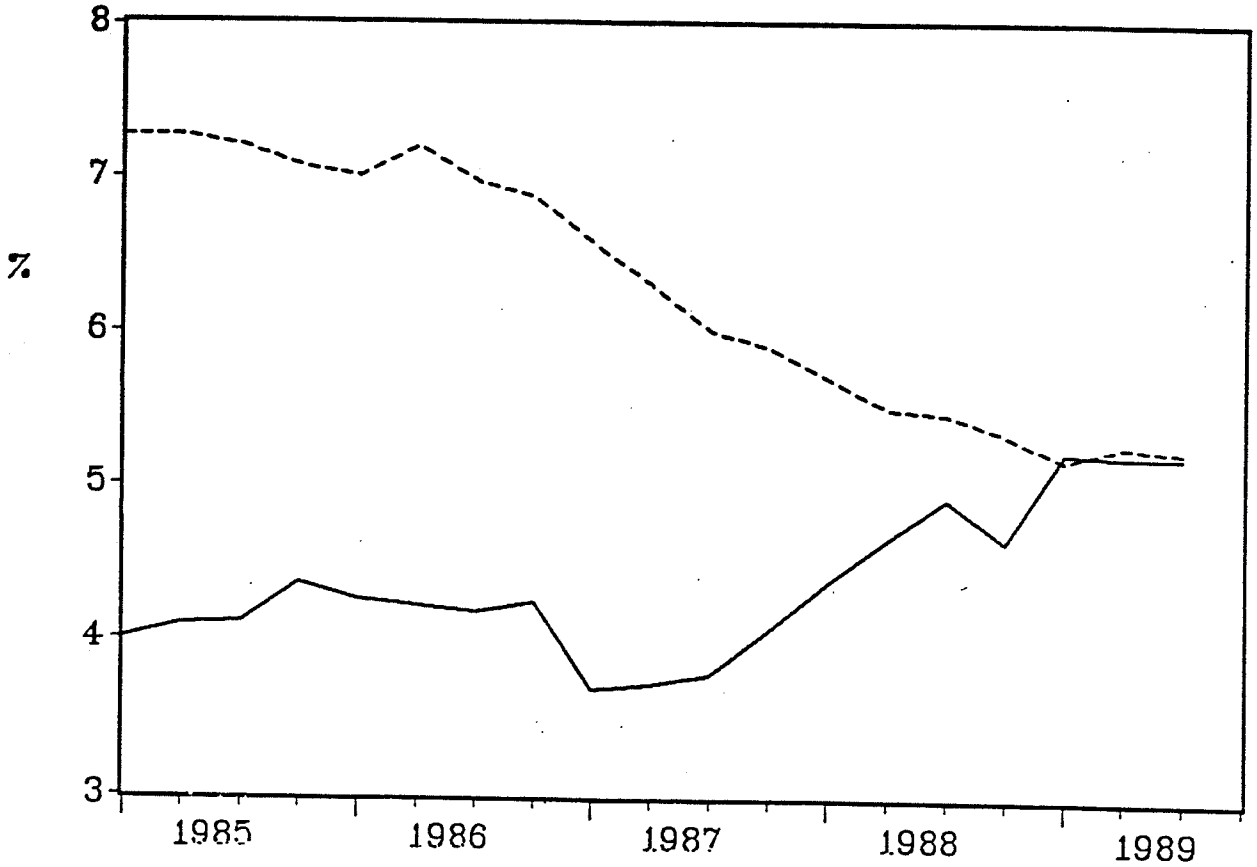
---------- UNEMPLOYMENT RATE

_____ WAGE INFLATION

FIGURE 5

LABOR COSTS MAY STILL RESPOND SLOWLY TO UNEMPLOYMENT

1985 - 1989



---------- UNEMPLOYMENT RATE

———— WAGE INFLATION

reasons for this performance in the 1980s are much the same as those for the 1960s: the economy started with a great deal of excess capacity which precluded upward pressure on wages and prices; after the pressure began to build, they adjusted slowly.

The reason for concern then is not what inflation is, but where it is headed. An appreciable amount of momentum may be being built into wage bargaining. Whether that momentum will be reversed depends on the perceptions and policies of the Fed.

The Greenspan-led Fed

The relative importance a Federal Reserve Chairman places on reducing unemployment relative to reducing inflation has decisive influence on how much of each the economy will experience. Ascertaining his relative weightings is always difficult. Determining how current Fed Chairman Alan Greenspan will act is especially problematic at this juncture: He has held office for barely over two years and during that time there have been few, large, identifiable macroeconomic shocks to put his policies in bold relief. Nonetheless, the choices a Chairman makes are so crucial that we must try to assess what they might be, in spite of the necessary imprecision of doing so.

Alan Greenspan is regarded as an astute and experienced observed of the economy. He has long been widely reputed to be a formidable foe of inflation. Much of his support among economists, financial market participants, the business sector, and the general public is based on that perception. His public statements have engendered and reinforced that perception.

In August of 1988, Greenspan testified that the risks of inflation were sufficiently great that monetary policy should err on the side of being

restrictive. (The unemployment rate had averaged about 5 1/2% for previous half year.)

In January of 1989, he told The New York Times that it was really important to make certain that the Fed not allow inflation pressures to emerge. He said that the Fed should lean over backward to preclude that from happening. Greenspan went on to identify the central focus of what the Fed was doing: keeping inflation from accelerating--and preferably decelerating. He even claimed to have tightened monetary policy at one point to avoid being thought of as soft on inflation.

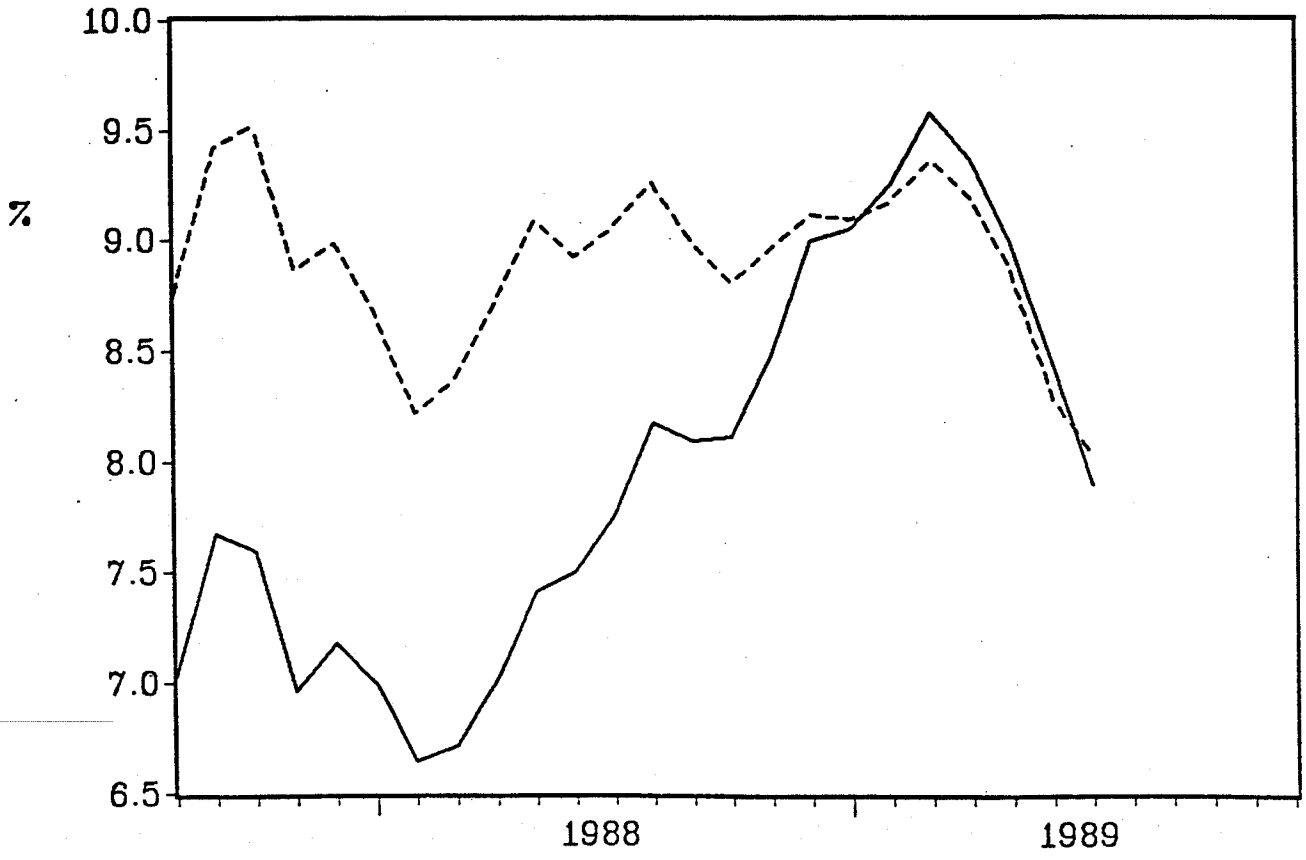
In November of 1989, Business Week magazine described Greenspan as having corralled the Fed into pursuing the single long-term goal of reducing inflation to a negligible level by the mid-1990s. And, currently, Greenspan does support the Neal Resolution, which directs the Fed to follow policies that would eradicate inflation within five years.

Traditionally, those who advocate tight monetary policy to reduce inflation also recommend that policy be passive, that it not react to actual or prospective events. A well-known policy of this kind is the statement of and adherence to pre-determined growth rates for the money supply over a multi-year horizon. A Fed Chairman could reduce the inflation rate as a matter of longer-run policy while altering the short-run settings of monetary policy, but such "fine-tuning" is often thought to have led and to lead, in practice, to effectively sacrificing the long-run goal. Engaging in fine-tuning need not, however, imply that one is soft on inflation.

Over the past two years, the Fed has engaged in fairly extensive fine-tuning. In its attempt to bring the economy to a "soft landing", it has changed policy repeatedly. Figure 6 shows the course of short and long nominal Treasury

FIGURE 6

UNDER GREENSPAN, THE FED TIGHTENED AND EASED, TIGHTENED AND EASED



——— 1-YEAR INTEREST RATE

---------- 10-YEAR INTEREST RATE

issue interest rates over the past two years. Initially monetary policy was tightened when Greenspan took over as Fed Chairman and rates rose accordingly. (The unemployment rate at the time was 6%) The October 19, 1987 stock market crash led to an instant, and entirely appropriate, reversal. Policy eased until spring of the following year, by which time it seemed clear that recession was not imminent. (The unemployment rate at that time was about 5.5%) Interest rates then rose substantially for the next year as monetary policy tightened. Beginning in the spring of 1989, policy again eased and rates again fell. (The unemployment rate at the time was below 5.5% and had fallen to 5% in March.) By November of 1989, the federal funds rate was again falling amid widespread speculation that the Fed would ease policy further. (The unemployment rate stood at 5.3%) The short-run policy may be attempting to steady the economy, but it is not a steady policy.

Apart from the degree of fine-tuning, two aspects of the Greenspan policies are noteworthy. First, the Fed has done little to dispel the notion that it controls the thrust of monetary policy, and thereby the trajectory of the economy, rather precisely. This flies in the face of lesson 1 above. The Fed probably has no more control over such matters than it has in the past. The Fed has adroitly offset some substantial financial shocks. For example, the Fed deserves unstinting praise for its reaction to the stock market crash(es). Offsetting movements in aggregate demand and supply, however, is less easily and quickly accomplished. Some of those variations are unpredictable. Some shocks involve inevitable hardship. The Fed may come to wish it did not have the (undeserved) reputation for such precise control over economic outcomes when it is unable to foresee the unforeseeable or to avoid the unavoidable.

That brings us to a second aspect of the Fed's policies: inflation. It is possible the Fed is following, as advertised, a longer-run policy of reducing the underlying inflation rate. But the fact is that wage inflation, price inflation, and expectations of inflation have each been steadily rising since Greenspan took office. What do the Fed's policies portend for inflation in the 1990s?

Risking return to the 1960s

In response to sufficiently high production and low unemployment, output and input price inflation gradually rise. There will not usually be an "earth-shaking event" that will alert us that inflation is rising or will be rising. Instead, inflation spurred by excess aggregate demand is more likely to emerge and be perceived gradually, just as an object is seen steadily more distinctly when fog burns off.

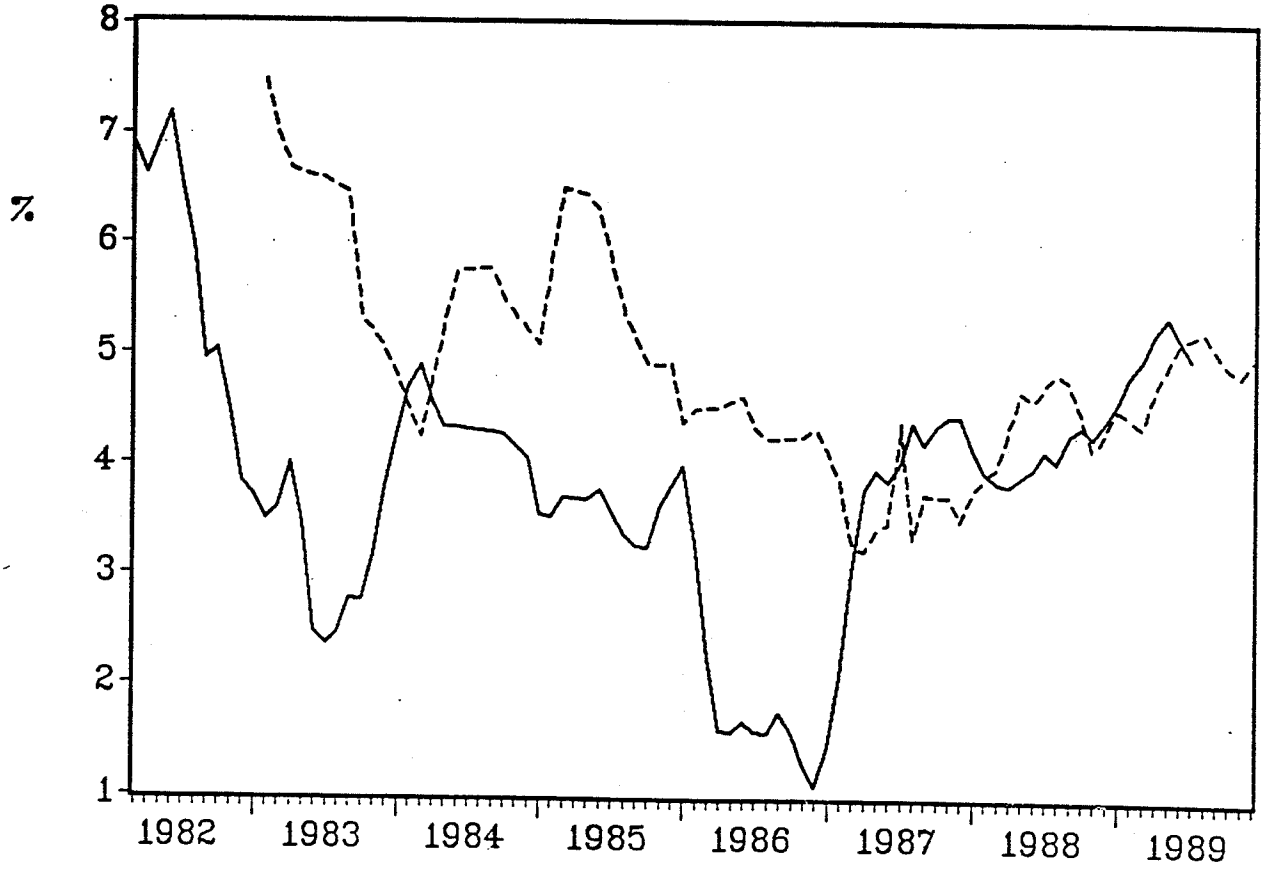
That is what seems to have happened in the 1980s. Figure 7 shows the actual inflation rate over the previous year and the rate that had been forecasted for that period one year earlier. These forecasts trailed the lower, downward trajectory of inflation through 1986. When inflation began to rise in 1987, the forecasts reversed course as well, but still generally lagged.

Are the policies of the Greenspan-led Fed leading to higher or lower inflation? One way to forecast whether inflation is likely to rise from this point onward is to assess whether the unemployment rate has been or is likely to be below what has been termed the "non-accelerating inflation rate of unemployment" (NAIRU). Unemployment rates below NAIRU prevent deceleration and bring on acceleration of (actual and expected) inflation. What rate of unemployment NAIRU is cannot be known with certainty.

FIGURE 7

INFLATION EXPECTATIONS REFLECT

THE UPSWING IN THE ECONOMY



———— ACTUAL INFLATION

---------- EXPECTED INFLATION

By virtually all accounts, the unemployment rate fell below NAIRU in the second half of the 1960s, which led to the acceleration of inflation at that time. That is shown in Figure 8, which is the same as Figure 4, except that it continues until just before wage and price controls were imposed in 1971. Figure 8 can be interpreted as showing that labor costs respond very slowly but that they respond fairly substantially once unemployment reaches NAIRU. It is these long lags make it so difficult to recognize and resist inflation promptly.

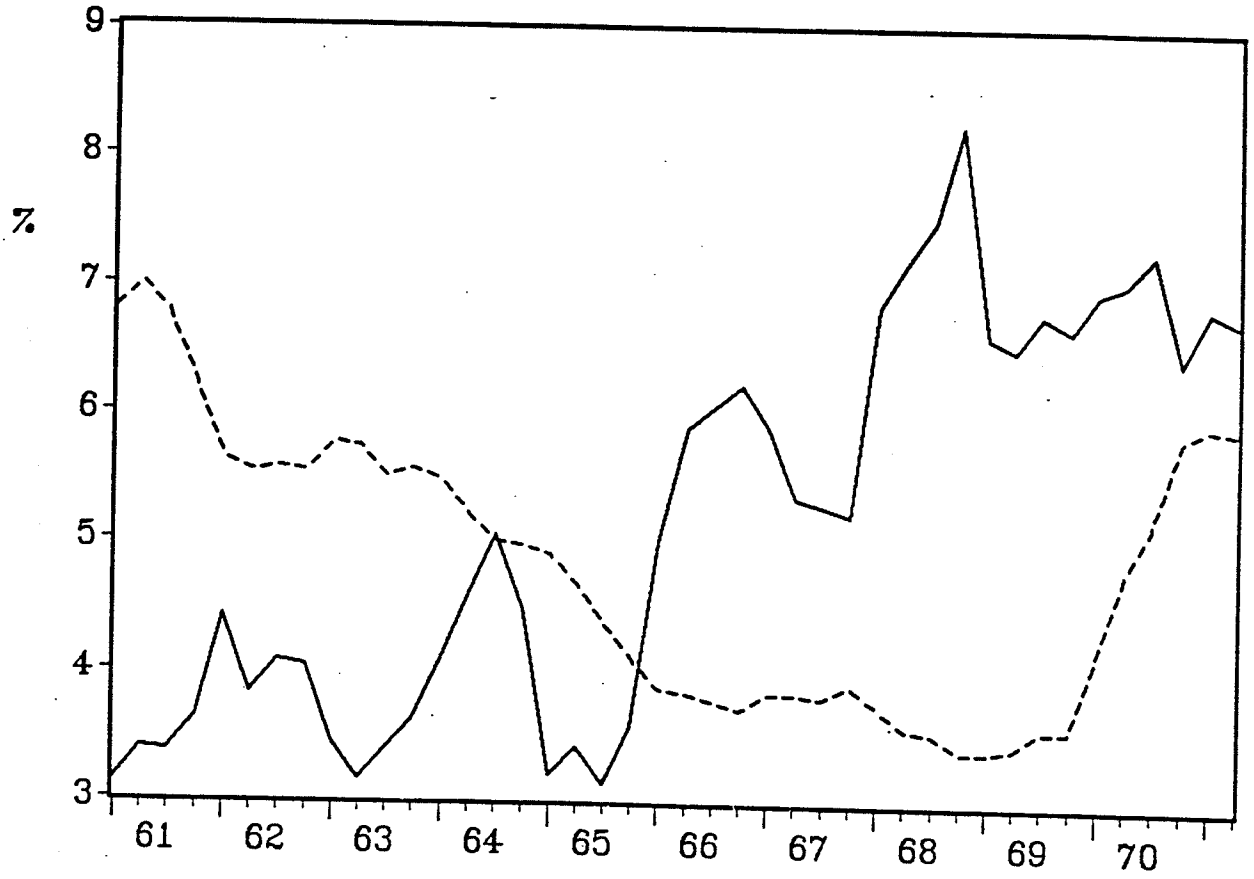
The question now is whether the unemployment rate is going to be below today's NAIRU. We have mounting, but not incontrovertible, evidence that the unemployment rate has reached levels low enough to lead to higher inflation. First, as Figure 7 shows, both actual and expected price inflation have been rising since 1987. Second, as Figure 3 shows, labor costs have been accelerating steadily since 1987 when the unemployment rate dipped below 6%. (For the year ending in the third quarter of 1989, labor compensation in the private business sector grew about 5 1/2%.) The sluggish adjustment of labor costs makes it likely that the acceleration will continue for a time. Third, some more recent labor agreements deliver even greater labor cost increases. For example, The Kaiser Foundation HMO just agreed to a three-year contract with 11,000 of its workers that raises wages 6% each year on top of an initial 9%-14% "adjustment". Boeing workers, who are in unusually high demand, agreed to a contract that appears to deliver hourly labor cost increases of about 10% per year.

Finally, many econometric estimates of the current NAIRU are in the 5.5% to 6% range. One of those comes from Adrian W. Throop's Federal Reserve Bank of San Francisco Working Paper (#88-06, revised 1989) entitled, "A Macroeconometric Model of the U.S. Economy". From that model, we have taken the estimate of the underlying rate of price inflation. Figure 9 plots that rate

FIGURE 8

BUT LABOR COSTS EVENTUALLY RESPOND TO UNEMPLOYMENT

1961 - 1971



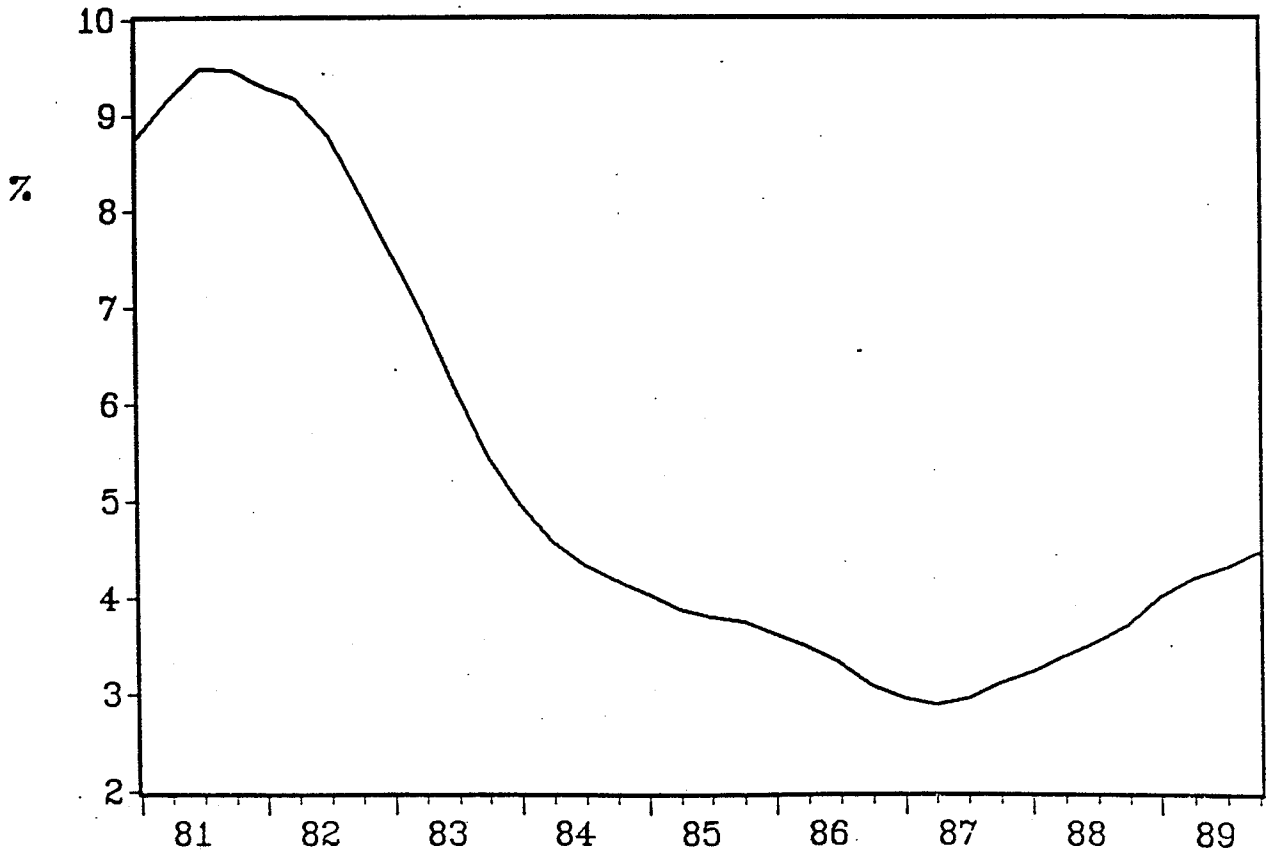
---------- UNEMPLOYMENT RATE

———— WAGE INFLATION

FIGURE 9

THE LONG FALL AND RECENT RISE OF

THE UNDERLYING INFLATION RATE



for the 1980s. There, we again see an upturn starting in 1987, suggesting that the unemployment rate has fallen below NAIRU. In that likely event, the unemployment rates that we have seen this year, and that are forecast for next year, imply that the underlying inflation rate has risen and is likely to rise further as we begin the 1990s.

In addition to the rise in the underlying component, the more stimulative monetary policy begun in the spring of 1989 may push up the total inflation rate as we move in the 1990s by pushing down the dollar. The part of dis-inflation that was borrowed in the early 1980s from the future through dollar appreciation will be paid back when the dollar depreciates. Econometric models and financial markets both predict a decline in the exchange rate, largely due to relatively weaker U.S. interest rates and stronger foreign economies. As the dollar declines, dollar prices of imports and their domestically-produced competition will rise. There is little reason to hope that foreign competition will hold down the U.S. inflation rate in the near term since there is currently "global warming" of inflation. (The other scheduled shocks to the overall inflation rate, the increases in the minimum wage and in social security taxes, are likely to have effects that are fairly small, and are outside the Fed's control in any event.)

The easing of monetary policy that started in the Spring of 1989 then will have the direct effect of stimulating an economy that may already be poised to move to higher inflation rates. It may also have the effect of signalling that Fed is not willing to endure sufficiently weak growth in order to reduce the inflation rate.

Conclusion

The Fed's policies under Chairman Alan Greenspan have been responsive to impending crises, have largely and appropriately ignored exchange rate considerations, and have produced hundreds of billions of dollars of production and income that would otherwise have been lost. In risking a return to the 1960s, Fed policy has taken the unemployment rate to levels not seen in over 15 years. Largely due to these policies, 1990 is likely to be another prosperous year.

The policies may not have been what inflation foes had in mind, however. For the other result of these policies is that the underlying inflation rate has risen steadily and substantially. It is now about 1 1/2% higher than when Greenspan took office two years ago. The combination of forces already set in motion and continuation of these policies make it likely that the underlying inflation rate will rise further.

A complete policy about-face would be required to follow the Neal Resolution and drag the inflation rate down to zero. It would require monetary policy tight enough to keep the unemployment rate at about 7 1/2% for five years. Rather than become a prisoner of the Neal Resolution, the Greenspan of the 1990s should retain the freedom to act like the Greenspan of the 1980s.