Ms. Rivlin discusses how economists might be helpful in the current and upcoming macroeconomic policy process Remarks by the Vice Chairman of the Board of Governors of the US Federal Reserve System, Ms. Alice M. Rivlin, at the Annual Meeting of the Eastern Economic Association in Washington, D.C. on 4/4/97.

I am delighted to be here today with such a large group of my fellow economists. Economists are a very diverse group, but they share a basic kit of analytical tools that shape the way they approach problems. Economists share a useful shorthand vocabulary -- sometimes disparaged by others as jargon -- that makes it easier to communicate with each other. They share a sense of what kinds of things are known about how economies work and, far more important, an appreciation for how much is not known about the workings of any complex human system, including the economy in which we are all living and working right now. Most importantly, economists share a sense of excitement that others often find hard to fathom, about unraveling the many puzzles that abound in economic analysis.

At the moment, as a relatively new governor of the Federal Reserve, I am particularly glad to be in a group of economists, because I can be quite sure they don't share the popular stereotype of a Fed governor. This stereotype has several elements:

Any Fed governor or central banker is an inflation freak who thinks reducing inflation should be the only objective of monetary policy and a zero inflation economy would be heaven.

Any central banker has a firm view of exactly what growth rate the economy ought not to exceed and how high the unemployment rate ought to be to avoid inflation -- that something called the NAIRU is engraved on a stone tablet somewhere high on a mountain top and all we have to do is find it.

Moreover, this stereotypical central banker knows exactly what monetary policy ought to be in order to keep the economy on the desired track.

This stereotype leads otherwise quite intelligent members of the press to believe that if central bankers don't reveal this secret blueprint, it's because they are being deliberately obscure and inscrutable. The media's sacred calling is to interpret what central bankers really meant but out of sheer perversity did not choose to say.

So it's a pleasure to be in a room full of economists who know that:

while the Fed has access to all the latest statistics and an excellent staff to analyze them, it has not found the stone tablet;

those of us at the Fed are working our way through the same fascinating puzzles that confront all economists and make the profession such a lively place to be.

I would like to discuss today the primary puzzles that confront those of us in the monetary policymaking arena and then offer a few thoughts about how economists might focus their energies to be helpful in the current and upcoming macroeconomic policy process.

I'm afraid I don't fit the Fed Governor stereotype well at all. I'm not an inflation freak; I'm a growth freak. My answer to the question, "How fast should the economy grow?" is "As fast as it sustainably can." We don't benefit from rapid growth spurts that unleash inflation which later has to be reigned in at a high price, just as we don't benefit from growth that damages the environment and creates a need for costly repair. But we ought to try to be on the highest growth track that is sustainable and stay on it with as few ups and downs as possible, because the downs are so costly, especially in terms of lost opportunity to build human capital. Only trouble is we don't know exactly what that track is and we're sure it's not immutable.

By the same token, we ought to aim to keep unemployment as low as is sustainable. The benefits of tight labor markets are enormous, especially in a society whose future depends on continuous and persistent upgrading of the skills of the whole labor force. If we can keep labor markets at least as tight as they are now for a few years (which, judging from past history, would take an extraordinary combination of skillful policy and good luck), we can do a lot for the future standard of living of Americans.

The benefit would accrue not just to those who are employed and are acquiring job skills and experience that they would not have gotten if they were unemployed. The benefit of tight labor markets is also in the signals they send to individuals and businesses that people should be employed as productively as possible, and that investment in training pays off. These are the economic conditions we need in general, but especially if we are to make welfare reform a success and establish new patterns of school and work for many young people who now see little hope for the future. Welfare reform is going to be difficult to accomplish. The best hope for success is avoiding recession for a long time.

The benefits of the recent rapid job growth in the U.S. are especially evident by contrast with Europe. French and German unemployment rates have been incredibly high for a long time. French and German officials speak of their unemployment as "structural" and discuss the need to increase job training, improve the functioning of labor markets, and reduce the incentives not to work which are built into their generous benefit systems. These are all doubtless constructive things to do, but are unlikely to be very successful unless the economies are growing and jobs are being created. It is a lot easier to reduce structural unemployment when the demand for labor is brisk than when it is lagging.

So this central banker believes that the goal of monetary policy, like the goal of fiscal policy, ought to be the highest sustainable growth rate and the lowest sustainable unemployment. Low inflation should not be thought of as an end in itself, but as a means to an end. Accelerating inflation has proved a threat to the sustainability of growth, and the self-perpetuating nature of inflation makes it more costly to correct than to avoid.

The drafters of the Humphrey Hawkins Act gave the Fed multiple goals. They said: "The Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." That's a bit ambiguous, but it's about as good a set of instructions as any. It would be a mistake to reword the Act, as some have suggested, to give the Fed a single objective -- reducing inflation -- on which to focus monetary policy. It would be especially unfortunate to specify a zero inflation target.

First, because we don't measure inflation well enough to know when we have hit an exact target.

Second, because the benefits of getting all the way to zero may not be great and the costs could be substantial, especially if there is significant reluctance to reduce nominal wages.

But it is the second part of the central banker stereotype that economists see as most obviously absurd; namely, that the Fed actually controls interest rates and that it knows for sure where the monetary dials ought to be set to achieve a specific growth or unemployment target.

The reality is that the Fed controls -- and rather imperfectly at that -- one extremely short-term interest rate, the fed funds rate. The fed funds rate certainly has some influence on banks' ability to extend credit, but its relation to the longer term rates that really matter to investors and home buyers is uncertain at best. The most that one can say about the Fed's principal monetary policy tool is that we can safely guess the direction of the effect of moving it and that we know there is a considerable lag between the move and the effect; but we cannot specify with any degree of certainty how large the effect is or how long it takes. That's a pretty blunt instrument.

Any monetary policy move is a judgment call to be made with a great deal of humility because the judgment involves making a guess about what is likely to be happening to economic activity six months to a year or more in advance and whether resources might be underutilized by then or inflationary pressure might be building.

The judgment call seems especially hard at the moment, although I suspect it almost always seems especially hard, because the economy is behaving in ways that are gratifyingly puzzling. The combination of macro-economic statistics is actually more favorable -- more growth, more employment, less budget deficit, less inflation -- than most people would have guessed possible a year or two ago. On one level, these are pleasant surprises; on another level, the behavior of the economy is revealing big challenges for the economics profession. These challenges are not likely to yield to more assiduous statistical manipulation of the same data that we already collect, but instead would require some new tools and new kinds of data.

It would be a lot easier to make those judgment calls -- to move the blunt instrument so as to increase the probability of keeping labor markets tight and the economy growing at the highest sustainable rate -- if we knew a lot more about three interrelated questions.

1. What's really going on in labor markets?

2. What's really going on with prices?

3. And especially, what's really going on with productivity?

The labor market puzzle is partly why low unemployment is not leading to more obvious bottlenecks, more serious skill shortages and more rapid increases in compensation than we are in fact experiencing? It's tempting to believe that the uniformity of unemployment rates around the country indicates that the information age is paying off in better functioning labor markets. Possibly, at the equilibrating margin, people now move more easily to jobs, and jobs more easily to people than they once did. Possibly the organizations that worked so hard under the pressure of competition and recession to become less rigid and more flexible have in fact done so. But those are all guesses -- or wishful thinking. We don't know for sure.

The price puzzle is why prices have been so well behaved in the face of labor costs that have been rising, albeit not especially fast. Has the economy, as so many business anecdotes allege, really become more fiercely competitive both nationally and internationally? Is the ability of firms to absorb labor cost increases without raising prices and without apparent reduction in profit margins confirming the hypothesis that productivity is rising faster than we thought, or faster than the admittedly inadequate data have been telling us?

Indeed, it is the productivity puzzle that may hold the key to the gratifyingly mysterious behavior of the economy. Economists have thought for some time that the increasing importance of services in the economy is confounding the ability to understand what is happening to both product and productivity. We observed an increase in manufacturing productivity, but not in service productivity. Indeed, measured productivity was generally negative in service industries even where anecdotal evidence indicated that processes had been streamlined, products had been substantially improved, as well as greatly proliferated, and the people in the industry believed they were doing a much more effective job serving their customers. Economists freely admitted they didn't quite know how to identify and measure the quality of the products that were being produced in service industries, sometimes even in manufacturing. Economists also wondered aloud why all the investment in computers and information technology that was so obviously changing the world was not having an impact on productivity. We opined that maybe people weren't using computers very well or that many things people were using computers for -- like editing everything to death or spelling things correctly -- were not actually contributing to productivity at least as we were measuring it. Now, we should turn all this speculation

into a full court press to figure out what kind of data we need and what kind of analytical methods we need to invent in order to understand better what is going on in this economy.

The need to improve the accuracy of the CPI has captured the attention of the press and the politicians because the indexing of benefits and tax brackets plays such a large part in the federal budget. But the problems of identifying what consumers are buying and how the quality of the items purchased has changed is very closely related to the problem of identifying what is being produced and what inputs are going into the production. The Clinton Administration, to its credit, has recognized the need for improving both the concepts and measurement of prices and products and has asked for a modest increase in resources for the statistical agencies in the President's budget, even in the context of general budget cuts. Strong support from the users of the data is surely in order -- not just from academic economists, but from the whole community of market analysts, Fed watchers and business and financial organizations who need to understand how the economy is working in order to operate better in it.

Indeed, I have been struck since I have been at the Fed by the magnitude of the resources our economy puts into analyzing, reporting and commenting upon the standard set of statistics generated by federal statistical agencies every week -- efforts by the press, the business community and the people in between, such as those who write the newsletters and poop sheets that circulate over faxes and computers. Wouldn't it be in everyone's interest to take a portion of those resources and devote them to improving the flow of statistics that are being analyzed to death?

Another thought that has struck me at the Fed is the enormous usefulness of reporting on examples of real world happenings -- anecdotes if you will -- and the absence of useful data that bridge the gap between the anecdote or real world case and an aggregate statistical series.

One of the unique features of the Federal Reserve is its strong regional structure. The twelve Reserve Banks are very closely tied to the economies of their regions. The Reserve Banks not only supervise and interact with the local commercial banks, but also keep in close touch with the business, farming, labor, and community leadership in their area. They have broadly representative boards and a whole network of advisory committees (as does the Board of Governors itself).

This network of contacts and information makes the Reserve Bank presidents very valuable participants in the FOMC discussion. Indeed, the most interesting part of an FOMC meeting is usually the regional round-up from the Bank presidents. This regional network and set of real world interactions has given me more sense of being in touch with the whole economy than I have had in previous economic policy jobs where I was largely dependent on aggregate statistics.

I am not proposing government by anecdote and I am aware of the potential dangers of non-random samples. Nevertheless, I have the sense that our understanding of the economy would be greatly advanced if economists could set themselves seriously to the task of systematizing feedback about real world dilemmas being faced and decisions being made in the economy in ways that give a more nuanced and lively picture of what is going on out there than can be gleaned from standard statistical series.

Anyway, it's an exciting time to be an economist and I'm glad to see so many fellow professionals puzzling together over how the economy works and ought to work.