Mr Ferguson expresses his views on monetary policy and the outlook for the US economy

Remarks by Mr Roger W. Ferguson, Jr., a member of the Board of Governors of the US Federal Reserve System, delivered at the East Hanover Area Chamber of Commerce, East Hanover, New Jersey on 15/1/99.

The Making of Monetary Policy

Thank you for inviting me to share lunch and a few thoughts with you today. I believe that it is important for the actions of this country's central bank to be as transparent as possible, and therefore I am happy to address this audience on the topic of what the Federal Reserve actually does and how it does it. I will also try to give an assessment of the national and international issues affecting Federal Reserve policy.

I hope that you will conclude from this discussion that, though the process of setting monetary policy is complex, it is nonetheless in many important ways accessible to the average citizen. I also hope that you will agree that there are really very few secrets; we attempt to be as open as is responsible, which is appropriate in a democracy.

History of the Federal Reserve System and the FOMC

The Federal Reserve was created by an Act of Congress on December 23, 1913. The Federal Reserve System consists of a seven-member Board of Governors (an independent agency of the federal government with headquarters in Washington, DC), plus a nationwide network of 12 Federal Reserve Banks and 25 branches. Congress established the Federal Reserve Banks as the operating arms of the nation's central banking system, and they have both public and private elements.

Neither the Board nor the Reserve Banks receive appropriations from Congress. Therefore, they do not operate with tax revenues, but rather pay expenses out of earnings. Earnings of the Federal Reserve Banks are derived primarily from interest received on their holdings of U.S. government securities and the fees they charge to depository institutions for providing services. All of the net earnings of the Banks, after expenses, contributions to surplus and payment of other assessments, are aggregated and paid over to the U.S. Treasury. In 1998, for example, the Federal Reserve paid approximately $26.5 billion to the U.S. Treasury.

The Federal Open Market Committee, or FOMC, is the most important monetary policy-making body of the Federal Reserve System. The FOMC makes the key decisions regarding the conduct of open market operations (purchases and sales of U.S. government securities) which affect the cost and availability of money and credit in the U.S. economy. The voting members of the Committee are the members of the Board of Governors and five Reserve Bank presidents. The president of the Federal Reserve Bank of New York serves on a continuous basis; the presidents of the other Reserve Banks serve one-year terms on a rotating basis, beginning on January 1 of each year. All the Reserve Bank presidents participate fully in the various discussions, regardless of whether they currently have a vote in the policy decision. By law, the FOMC must meet at least four times each year in Washington, DC. Since 1980, eight regularly scheduled meetings have been held each year. If circumstances require consultation or consideration of an action between regularly scheduled meetings, members may be called upon to participate in a special meeting or a telephone conference.

So what happens at these meetings? The order and structure of these meetings may change over time, but has been pretty much fixed during my term on the Board. Before each regularly scheduled meeting of the FOMC, System staff members prepare written reports on past and prospective economic and financial developments, which are sent to Committee participants. At the meeting itself, staff members present oral reports on the current and prospective business situation, conditions in financial markets and international economic and financial developments. After these reports, each Committee participant, voting and nonvoting, expresses his or her views on the current state of the economy and prospects for the future. After a short coffee break, we have a staff presentation on the alternatives we face in setting monetary policy. At that point, the Chairman gives his view of the economy and makes a suggestion for the appropriate direction of policy. Each Committee member then responds to the Chairman's suggestion, in the process setting out a preferred choice for policy. After this second "go-around," we take a formal vote on the target federal funds rate for the period until the next meeting. At this point, the focus is on the voting members, who, as I noted, include all of the Governors and five of the 12 Presidents. Generally, an announcement of a change in interest rates, if any, is made at about 2:15 in the afternoon. A full set of meeting minutes is made available after the subsequent meeting.

Let me turn now to a discussion of monetary policy and the outlook for the U.S. economy. Of course, the views I shall be expressing are my own and are not necessarily shared by the FOMC or the Board of Governors.

The Goals of Monetary Policy

Federal law establishes the goals of monetary policy. The Federal Reserve and the FOMC are "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". Many analysts believe that achieving price stability should be the primary goal of a central bank because a stable level of prices appears to be the condition most conducive to maximum sustained output and employment, and to moderate long-term interest rates. This presumably is because in times of price stability the prices of goods, materials and services are undistorted by inflation and thus can serve as clearer signals and guides for the efficient allocation of resources. Also, a background of stable prices is thought to encourage capital formation because it reduces the distortion created by a tax system that is only partly indexed for inflation. Some would argue that the remarkable period of growth that we are experiencing is due in no small measure to the low rate of inflation that has prevailed for some time.

The problem with the rather neat formulation that I have just given is that it does not include an element of time. In the long run, I have no doubt that price stability underpins efforts to achieve maximum output and employment. But, in the short run, some tensions can arise between efforts to reduce inflation and efforts to maximize employment and output. For example, the economy may at times be faced with adverse developments affecting supply, such as a bad agricultural harvest or a disruption in the supply of oil, which put upward pressure on prices and downward pressure on output and employment. In these circumstances, makers of monetary policy must decide the extent to which we should focus on defusing price pressures or on cushioning the loss of output and employment in the short run, in the context of our long-term objectives. At other times, policy-makers may be concerned that expectations of inflation will get built into decisions about wages and prices, become a self-fulfilling prophecy, and result in temporary losses of output and employment. Countering this threat of inflation with a more restrictive monetary policy could risk small losses of output and employment in the short run but might make it possible to avoid larger losses later should expectations of higher inflation become embedded in the economy.

The press tries to categorize FOMC members as “hawks” and “doves.” These labels are an effort to simplify, in fact oversimplify, the complex choices that each member of the FOMC must make in deciding how to trade off the risk that action, or inaction, on our part will lead to inflation heating up to unacceptable levels, as opposed to having an inadequate creation of jobs. But I believe that all members of the Committee recognize that the major contribution the Federal Reserve can make to higher standards of living over time is to promote price stability.

It is generally thought that monetary policy takes many months to have most of its effect on growth and employment, while of course it has an immediate impact on financial markets. Because of the long time frame for effect on the real economy, I believe that it is important for policy to look ahead one to two years as it aims at promoting stable prices and a sustainable GDP growth path, along which the economy is at full potential. Given that we need to be forward-looking, or “preemptive,” as it is often put, one potentially important element in making monetary policy is the forecast or likely outlook for economic growth, unemployment and the price level for the next year or two. Fortunately, as we make monetary policy we have the advantage of several forecasts. The staff of the Board of Governors, private sector economists and the staffs of the Federal Reserve Banks all make forecasts. Some individual Governors and Reserve Bank Presidents also have considerable experience and expertise in forecasting.

To be useful for monetary policy, forecasts of the future health of the economy need to be reasonably reliable. Good forecasts rest on the identification of empirical regularities that can be confidently relied upon to provide guidance. Regrettably, some previously reliable empirical relations have not proven so of late. As one example, the failure of price inflation to pick up as labor markets have become tighter is not consistent with older empirical observations. Moreover, factors outside of economists’ models have provided some surprises, such as the Asian economic and financial turmoil and the collapse of oil prices.

If forecast relationships are less certain, it becomes more challenging to be “preemptive.” In these circumstances, I believe, it is appropriate to put greater weight on incoming data to determine whether the stance of monetary policy should be changed. Some of the variables relevant in this regard are: 1) the level of unemployment and the rate of job creation; 2) the rate of change in wages or prices or early signs of emerging inflation; 3) the rate and composition of GDP growth (inventory, trade flows, consumption, investment, residential and commercial construction, etc.); and 4) international developments. Economists refer to these variables as being from the “real” side of the economy. Another set of variables to be considered in making monetary policy are financial variables, such as money supply, interest rates, exchange rates, credit flows and conditions in bank lending or in the debt and equity markets.

The last two years, 1997 and 1998, gave an interesting case study of the interplay between these different variables and the degree of forward-looking behavior in the making of monetary policy. From March of 1997 through much of 1998, pleasant surprises in the performance of inflation and the general absence of early signs of inflation, and uncertainty about the relationship of inflation to changes in the level of production, kept the FOMC from tightening. We did not tighten despite the economy being beyond most estimates of its potential and despite many forecasts of rising inflation. Put another way, the FOMC could have “preemptively” tightened monetary policy, based on forecasts, but, recognizing the uncertainties about empirical relationships, chose not to do so.

But in the fall of 1998, you may recall, there was concern regarding the performance of the debt markets, especially the bond market and market for commercial paper. These concerns were centered around the fact that corporate borrowers could no longer raise funds in the bond or commercial paper markets at reasonable prices or, at some times and for some borrowers, at all. In this case, we were reasonably confident that constraints on the ability of corporations to borrow would eventually have a negative effect on their willingness to invest in productive capacity and therefore on their ability to provide goods and services and to create jobs. A related concern was that weakened foreign economies might have adverse consequences for future domestic activity. Under those circumstances, the FOMC thought it appropriate to ease to offset a likely significant impact on future domestic spending and growth.

Finally, no discussion of monetary policy and financial markets would be complete without reference to the equity markets. I believe that the Fed cannot target specific levels in equity markets. However, equity markets have spillover effects into the real economy and hence send important signals to policy-makers. As you know, economists often speak of the “wealth effect,” and econometric modeling indicates that consumers tend to raise the level of their spending about 2 –to 4 percent of incremental wealth, after two or three years. Through the so-called wealth effect, equity valuations can and do have an effect on consumption and on macroeconomic performance. Additionally, equity markets are a source of investment capital, and valuations in the stock market are one determinant of the cost of capital for businesses. Therefore, equity prices have an influence on business fixed investment, along with consumption, the major drivers of our economy. Finally, equity markets are of interest to policy-makers because we have a responsibility for macro-stability. We have seen in other economies that bubbles and busts in financial markets can create unsettled conditions that impair real economic activity. Therefore, while it would be incorrect to say that policy-makers target the equity markets or that market concerns “tie the hands” of the Fed, the markets are an important consideration in macroeconomic analysis.

These are just some of the factors that might go into making monetary policy. The interesting part of the job is that the relative importance of these factors – forecasts, current macroeconomic conditions, financial market conditions and others – is often in flux. For those who seek to monitor our actions, the good news is that through a reading of FOMC announcements and minutes, speeches by Governors and Presidents, and interviews, an observer can get a pretty good handle on which variables are uppermost in each policy-maker’s mind at any given time. Often, however, many factors are relevant, and we cannot indicate precisely the relative weights the FOMC may be applying to them in making policy. After all, the economy is influenced by all of the factors I have outlined, and the FOMC’s emphasis on specific factors varies over time as economic conditions change.

Outlook for 1999

With this general statement of the factors that go into setting monetary policy, let me turn to the outlook for 1999. Recent economic data have been stronger than many had expected. It now appears to many forecasters that real GDP growth for 1998 was 3.5 percent or more on a fourth-quarter-to-fourth-quarter basis. The consensus, as represented by the most recent Blue Chip Economic Indicators, is that real growth in 1999 will moderate, perhaps to slightly over 2 percent, again on a fourth-quarter-to-fourth-quarter basis (nearly 2.5 percent on a year-over-year basis). This consensus outlook, if accurate, would eventually produce a “soft landing”, with growth near the economy’s potential and inflation remaining low. The range of forecasts that compose this so-called consensus is large, perhaps indicating that forecasters are cognizant of the fact that it’s not hard to imagine risks to both sides of this scenario. I should also note that this is a repeat of earlier forecasts that growth will moderate, and the economy has surprised many forecasters with its resilience. I can see that 1999 will require a continued high level of vigilance for policy-makers.

Not surprisingly, many of the forces and uncertainties that seemed to shape so much of last year’s discussion are present in the outlook. Tight labor markets are putting pressures on wages, but competitive markets are limiting pricing leverage and causing profits to be squeezed. Under these circumstances, will businesses become more cautious in their spending and hiring plans? Rising stock prices continue to point to strong consumer demand, but valuations are high by historical standards and one wonders whether this stimulus will remain so strong. The downturns in some of the troubled economies of Asia seem to be bottoming out, at least outside of Japan, but the risk of spreading distress in Latin America creates another element of international uncertainty.

Recent events in Brazil have made this concern more evident. It is now even more important that Brazil move as quickly as possible to implement a clearly sustainable fiscal position and regain the confidence of international markets and investors. The Federal Reserve will continue to monitor closely international developments and their potential effect on domestic activity.

At the same time, U.S. inflation has been contained, at least until recently, by a number of factors, such as a rising exchange rate for the U.S. dollar through much of last year, well-contained health care costs, and declining prices for oil and other commodities, which may prove to be short-lived. The ability of businesses to pass on price increases has been constrained, in part, by international competition. Will the restraint on pricing power remain as strong or weaken? If the latter, at what pace? Will the special factors I mentioned above continue to mitigate inflationary pressures arising from labor markets? Are there other, longer-term forces at work damping price pressures that we have not yet identified?

A new factor that I find most interesting as we start this year is the likely impact of the upcoming century date change. As you may know, I am Chairman of the Joint Year 2000 Council, which is a group of financial regulators that has spent the last nine months focusing on the Year 2000 computer problem. In an international context, the Year 2000 is likely to have differing impacts across different regions. Here in the United States, my colleague Governor Mike Kelley has stated that we are likely to see some disruptions to economic activity because of Year 2000 problems but the effects are likely to be temporary and quickly reversed. This outcome also seems likely to me. Overseas, the early signs are that Europe has successfully converted its computer systems to the euro, but there were some periods early in the transition when the settlement of some cross-border transactions in Europe did experience end-of-day glitches. It is now important for senior management of major European institutions to turn their attention to preparations for the Year 2000. Asian financial and other business firms, too, should focus energy on preparing for the Year 2000 even as they are restoring fundamental financial soundness. Indeed, the events of the last 18 months have probably distracted their attention from this problem. It is in everyone’s interest that we not become complacent as we enter these last 12 months before the start of the new millennium.

Conclusion

The Federal Reserve has an important role to play in our economy. However, our role in the economy should be kept in perspective. We control just a few of the levers that drive the economy. We observe consumption, investment and labor market decisions and try to adjust monetary policy to the signals that we receive so that our nation’s economic welfare is not threatened by inflation or by growth that is below the economy’s potential. However, it is the decisions and actions that you take as consumers and business managers that ultimately determine the health of the United States economy. Despite difficult periods, 1998 turned out to be a very good year because of a mix of private action and economic policy. I hope that 1999 will be as good to us all.

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