

Issues in Macroeconomic Policy

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Good morning. I am pleased to be back with the Financial Planning Association again this year, and to have the opportunity to discuss several issues of significance in macroeconomic policy. These are challenging times and therefore represent an appropriate opportunity to take stock of where we are and the issues we confront. Given that time is limited, I will launch into substance momentarily, but let me first remind you that I am speaking only for myself and not for others on the FOMC or in the Federal Reserve.

We central bankers face a key challenge in constructing an effective response to short-run shocks, which remains consonant with our long-run goals. We take our responsibility for financial stability seriously, and we attempt to ensure that the consequences for the economy of periods of instability are contained. History has a role to play in sorting through these demands; after all, while history does not repeat itself exactly, that doesn't imply that we should ignore it. An experience potentially relevant to current circumstances is the "headwinds" episode of the early 1990s. In particular, it is possible that an appreciable tightening of credit conditions will, as then, restrain the economy for a time. This is the immediate problem but in the historical context we should bear in mind that, after a slow start and with appropriate policy, the 1990s became a decade of growth, of sustained gains in employment, and of diminishing inflation.

Before reviewing this history in greater depth, I will provide, as is typical on these occasions, a review of the recent performance of the economy in order to establish a foundation for consideration of our economic prospects. 2007 marked the sixth consecutive year of the current economic expansion. Given the duration of the two previous periods of growth – that is, the expansions of 1982-90 and 1991-2000 – this is not an especially remarkable performance, but one that is

welcome nevertheless.

To be sure, since late summer economic events have been largely overshadowed by developments in financial and credit markets. I will not recite the litany of what has transpired, assuming that it is generally familiar to many of you, except where it is pertinent to describing the outlook and assessing the issues before us. Suffice it to say that for a time many financial markets were seriously impaired and, although conditions in some have shown signs of improvement more recently, other markets remain dysfunctional. Moreover, many large banks, both here and abroad, have found it desirable to protect balance sheet capacity in the wake of unanticipated asset expansion and material financial losses in some cases as well.

These are important events in my judgment, with potentially significant implications for the economy for the next year or two, but they are not completely unfamiliar. A brief review of history can help frame our short-term and longer-term objectives and implementation approaches in the current period. The situation we confront today is reminiscent, in several salient ways, of the headwinds environment that prevailed in the aftermath of the 1990-91 recession. In this regard, the 1994 “Economic Report of the President” devoted part of a chapter to those headwinds and provides a convenient jumping-off point to examine similarities. According to the 1994 Report, the headwinds that restrained the economy in the early 1990s consisted of: reductions in spending on national defense, weak foreign economies, a debt overhang, excesses in commercial construction, corporate downsizing, and a credit crunch. Several of these conditions are not pertinent today, and so I would dismiss parallels in defense spending, foreign economies, and downsizing.

However, while excesses in commercial construction have been avoided for the most part during the current expansion, the same cannot be said, of course, of residential construction, where the unsold, unoccupied inventory of houses and condominiums is large and where a major adjustment is still in train. Further, trends in commercial real estate finance and loan performance might suggest softness in the underlying income-producing capability of some properties. And while I think the term “debt overhang” is overly broad, a significant number of homeowners are experiencing considerable strain. Finally, in view of my earlier comments about impaired markets and institutions, the possibility of a credit crunch, and its attendant effects on economic performance, cannot be ruled out.

To my knowledge, there is not a precise definition of a credit crunch, but I would describe it as an environment in which quality borrowers find credit either unavailable or available only on very expensive terms. To the extent that such a situation develops, its economic impact is that some investment projects and planned spending will be deferred or delayed for a time because of the difficulty of obtaining financing, resulting in more modest economic growth than would otherwise occur.

These issues are clearly weighing on policy. While such an environment will not be permanent, it could well persist for an extended period because, if credit is in fact restricted by some institutions and in some markets, it will likely take time for potential borrowers to find alternatives and substitutes.

The potential for headwinds is integral to thinking about economic prospects over the next year or two. To the extent that these headwinds gain momentum, they suggest relatively modest growth for a time and the likelihood of increases in

the unemployment rate. Their implications for inflation are not so clear, although I would note that the pace of inflation diminished in the early 1990s relative to its performance over the preceding several years.

As you know, Federal Reserve monetary policy has moved decisively in recent months, and the target for the Federal funds rate is now 3 percent, down from 5 ¼ percent as recently as September. Against the background of the financial shocks that have beset the economy and their implications for the outlook, the reduction in the funds rate target appears wholly appropriate. The Federal Reserve has a responsibility, insofar as possible, to restore financial stability and protect the real economy from collateral damage, and policy is now better positioned to attain these objectives than formerly. On numerous previous occasions, I have extolled the underlying resilience of the economy, but I have also pointed out that resilience is in some sense “endogenous;” that is, it has resulted in part as a consequence of well-functioning financial markets and appropriate policy responses to emerging problems.

But our responses to short-run disturbances need not lead to compromise of long-run objectives. Let me shift now to longer-term considerations and prospects for the economy. I have already suggested that headwinds will not last forever. As they diminish, the economy’s performance will essentially be determined by the factors that shape the long term, namely, gains in productivity and growth of the labor force or, to be a bit more precise, of hours worked. On the productivity score, there is reason for continued optimism in view of the reacceleration last year and sustained healthy increases overall since the mid 1990s. For the labor force and hours, a number of matters come into play. The labor force is projected to grow modestly in the years ahead, reflecting relatively slow expansion of the

working-age population as members of the baby boom generation begin to retire and as female labor force participation rates level off. This, by the way, will translate into the monthly employment statistics, so we might expect to see relatively small increments in employment in these data.

But the story is more complicated. The decision to participate in the labor force and at what level presumably depends on things like compensation broadly defined, tax rates, public policies toward child care and education, and so on. In short, the labor force, or hours worked for that matter, is not determined exclusively by demographics, to say nothing about the possible effects of changes in immigration. Still, without putting too fine a point on it, I would expect economic growth in the long run to average somewhere around 2 ½ percent per year, given my expectations for productivity and for hours. Such a performance is likely to exceed the pace of population increase, implying a further rise in standards of living over time.

There is another element critical to this long-run projection, namely, that we in the Federal Reserve remain committed to achieving of our dual mandate of low inflation and maximum employment. Given the consensus that in the long run price stability represents the most significant contribution monetary policy can make to attaining high employment, it is essential that we conduct policy with this objective in mind, and I have no doubt that we will.

Well before I began preparation for this meeting, I was asked by a member of the Financial Planning Association to discuss another form of the “debt overhang,” namely, estimates of the “shortfalls” in Social Security and Medicare – that is, the extent to which the social insurance programs are out of balance under

current financing arrangements relative to scheduled benefit obligations. The estimates I have are reported in the 2007 Financial Report of the United States Government and therefore should be in the ballpark; they are for the next 75 years and reveal a Social Security shortfall of about \$15-16 trillion and a Medicare gap of approximately \$29 trillion. I think it fair to say that shortfalls of these magnitudes are considered both unsustainable and difficult to address.

Of the topics I have covered this morning, this fiscal imbalance is likely to matter most for the long-run performance of the economy. If debt financed, such deficits are likely to restrain growth over time through their effects on interest rates and, in turn, the consequences for investment, capacity, and productivity. If tax financed, there could be disincentives to work and/or to invest depending on the form of the increases, and the implications for growth would likely be negative. Finally, if program benefits are to be scaled back, it is far preferable to take this step sooner rather than later so that potential beneficiaries can plan appropriately and adjust.

In conclusion, I think the Federal Reserve has taken appropriate policy steps to respond to a financial shock, a shock that may well produce parallels to the headwinds episode of the early 1990s. In this environment, we need to remain sensitive to evolving financial conditions and to incoming information on business activity in order to further determine the relevance of that earlier experience. And the aftermath of that episode may also prove relevant, in that it illustrates the underlying resilience of the American economy and the value of policy adherence to the dual mandate.

Thank you for your attention.