Defending the Goal*

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In practice, the Federal Open Market Committee (FOMC) believes that it has a broad mission to achieve three main goals. These are to:

- Maintain a low inflation environment.
- Stabilize the real economy.
- Underpin the soundness of the financial system.

There is little controversy over these laudable goals. There is plenty of controversy, however, as to what is the best way to achieve all three goals. Many economists, including those on the Shadow Open Market Committee, believe that the attainment of the second two goals – a stable real economy and a sound financial system – can best be achieved through the attainment of the first objective – a low inflation environment. That is, the goals are not competing, but complementary. The reason underlying this belief is that businesses and households can make sounder long-term economic decisions when the overall price level is relatively stable. In turn, these sounder decisions will make the real economy less volatile and financial markets less skittish to changes in the economic environment.

To arrive at the conclusion that a low inflation environment should be the FOMC's main priority, a policymaker would have to take an extremely long view of policy. And Washington just does not seem to be focused on long-term policy analysis right now. John Maynard Keynes once quipped that "in the long run we are all dead", so in that in this sense, policymakers are all

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Keynesians now. Besides, perhaps there may even be some good reasons to focus on the short term right now?

Recent Economic Activity

Current economic activity in the United States is being driven by two distinct dynamics. The first is the cyclical slowdown, which began sometime during mid- to late-2000, following on the heels of unprecedented prosperity. Looking back, it appears as though the "new economy" brought forth an unsustainable level of exuberance to business investment spending. To be sure, the U.S. economy gained from the rapid adoption and continuing improvement in technology. And while this circumstance may have led to a permanent improvement in the level of our production capacity in America, it does not appear to have led to a permanent rise in the growth of production capacity. Simply put, I think businesses extrapolated the temporary rise in growth into a permanent rise in growth that was illusory. The sectoral imbalance in the technology and communication industries, the rise in inventories, and the decline of many manufacturing firms' outlooks resulted, and firms have struggled to right themselves over the last year. While this adjustment is not entirely over, much of it has passed. Firms are more likely to be sobered, prudent and hesitant to invest and expand capacity, though in time they will.

The second dynamic affecting the U.S. economy stems from the truly horrible events of September 11th. Its impact on the airline and tourism industries will be hard felt. In addition, the lingering uncertainty will slow other aspects of consumer spending, notably durable goods. In the face of such a sudden shift in uncertainty, households are likely to temporarily hold back on major purchases, which is sure to soften aggregate spending in the third and fourth quarters of 2001.

In a soon to be finished study, co-authored with Eduard Pelz of the Federal Reserve Bank of Cleveland, we produce some empirical estimates of how conflict affects per-capita consumption growth. Using annual data across 150 countries, and examining both large and small internal and external conflicts (both at home and abroad), we find that on average, a conflict in a given year lowers consumption growth by 1 – 2% in that year.[1] Interestingly, our evidence suggests that the G7 economies have been affected less than this average amount for two main reasons. First, they have avoided internal conflicts (e.g. revolutions and non-constitutional regime changes) during this time period. Second, their external conflicts have been fought abroad rather than at home.

From this evidence, we can posit that the effect of terrorism on its own soil is likely to raise the impact of the recent conflict on the U.S. economy closer to the overall average of 1 – 2% on an annual basis. And while a reduction of consumption growth on the order of 1 – 2% is large and greatly increases our risk having a recession in the second half of 2001, the growth rate is only affected temporarily. By 2002, given a non-incendiary resolution of the attacks of September 11th, the economic impact on future growth from the events of September 11th will be likely to be zero.

Implementing Monetary Policy in a Crisis

As I argued above, the economy's current softness stems from two distinct dynamics: a response to the misallocation of resources that took place in the later 1990's and first half of the year 2000, and the events of September 11th. How has monetary policy reacted to each of these?

Let's first look at the FOMC's response to the cyclical slowdown. As I argued in my last Shadow Open Market Committee paper[2], I believed that the FOMC was over-aggressively responding to symptoms of the slowdown, rather than the causes of the slowdown. In summary, I

[1] This is similar to the effect that conflict has on per-capita real GDP growth – see Blomberg, Hess and Thacker (2001), "Is There Evidence of a Poverty-Conflict Trap?"

[2] Gregory D. Hess, "A Tale of Two Press Conferences," Shadow Open Market Committee Statement, April 2001, http://www.somc.rochester.edu/Apr01/HessApr01.pdf .

argued that the FOMC was interpreting the slowdown as a sharp reduction in aggregate demand, rather than as an end of the temporary aggregate supply boom. Granted, the evidence is hard to disentangle in favor of either hypothesis. However, while a reduction in aggregate demand would likely lead to a reduction in both consumption and investment, the evidence suggest that only spending by firms had slowed. Indeed, household consumption spending (including for durable goods) and new and existing housing purchases have remained bright spots in the economy. In contrast, if the economy were to be facing the end of a temporary aggregate supply boom, then investment spending by firms would fall (as economic activity becomes less productive) and consumers would smooth through the slowdown (by borrowing or running down their wealth). My point was that the FOMC, by over-responding to the temporary symptoms of the slowdown, was potentially jeopardizing its ability to maintain a low inflation environment, and that more "long-run" thinking was in order.

But the events of September 11th left the FOMC with little opportunity to concern itself with the long run. Due to the financial turmoil caused by the terrorist activity and the resulting closure of Wall Street, the FOMC aggressively and correctly pulled out all the stops to ensure their third goal, namely to "Underpin the soundness of the financial system". The tools they used were:

a. Increased Liquidity Leading to Lower Interest Rates.

b. Regulatory Forbearance (i.e. looking the other way).

c. Moral Suasion (i.e. gentle arm-twisting).

d. Open Discount Window Policy.

On the day that the stock market re-opened on September 17th, the Federal Reserve injected liquidity directly into the reserves market enough to lower the Federal Funds Rate by 50 basis points. Together with the SEC, the FOMC temporarily allowed for firms to more easily repurchase their equity shares – regulatory forbearance. They also encouraged banks not to pull back on loans (or enforce all loan provisions) on clients adversely affected by the terrorism –

moral suasion. Moreover, the FOMC opened the discount window liberally even before the stock market re-opened. For example, Discount window borrowing on September 5th was $195 million. On the day after the attack, it was at a record $45.6 billion. By September 19th it had fallen to $2.7 billion, and by the 26th of September it was at $95 million.

Extraordinary times require an extraordinary monetary policy, and that is exactly what the FOMC successfully delivered. Taken together, these steps by the FOMC were timely, appropriate, and perhaps most importantly, they worked! The Federal Reserve System should be applauded for their effort and success in containing and limiting the spread of chaos to the private sector.

But by and large, the extent to which monetary policy can limit the direct impact of financial turmoil brought about by the events of September 11th is over. That's not to say that the disruption will not lead to weaker spending than we would have experienced otherwise. It does suggest, however, that the FOMC will not need to continue to resort to extraordinary measures to underpin confidence in financial market. Simply put, options (b), (c) and (d) are no longer needed.

What Now?

The question now before us is whether and/or by how much more does the FOMC need to ease monetary policy, by increasing liquidity and lowering short-term interest rates—option (a)? In their recent meeting of October 2nd, the FOMC eased again by 50 basis points. The Federal Funds rate now stands at 2.5%, the lowest it has been since 1962. In real terms, if we adjust the Federal Funds rate for the core rate of inflation, the Federal Funds rate stands at near or below zero. The year-over-year annual inflation rate from the CPI excluding food and energy grew at a rate of 2.7% through August of 2001. That means that the real federal funds rate is –0.2%. If we similarly measure inflation using the Median CPI as published by the Federal Reserve Bank of Cleveland, then year over year inflation is at 3.8%. This suggests that the real

Federal Funds rate would be –1.3%. Monetary policy, as measured by the short-term real interest rates, is clearly very aggressive.

At current negative short-term real interest rates, in a complete reversal of fortunes, lenders are subsidizing borrowers. While this has some historical precedent, it is simply not credible to argue that monetary policy has not been eased substantially.

The monetary aggregates paint a further picture of the increased supply of liquidity to the U.S. economy. There can be no doubt that money growth in the U.S. is high and recently accelerating. The Federal Reserve Board's October 4th release (shown below along with calculations from the St. Louis Federal Reserve Bank) suggests that seasonally adjusted, annualized money growth has been very high over the past quarter, half a year and year. Moreover, money growth for Base Money and M1 has accelerated, while for M2 it has remained constant and high. While not shown, money growth in September is likely to be even higher!

MONEY STOCK MEASURES
Percent change at seasonally adjusted annual rates

	Base Money	M1	M2
3 Months from May 2001 TO Aug. 2001	9.1	9.3	8.8
6 Months from Feb. 2001 TO Aug. 2001	6.5	7.8	9.7
12 Months from Aug. 2000 TO Aug. 2001	6.4	4.0	9.2

Source: Federal Reserve Board H.6 release, October 4th, 2001, and St. Louis Federal Reserve Bank Web page.

Should we be concerned by such high money growth? Historically, the answer is "Yes"! Economists agree that higher money growth rates lead to higher inflation in the long run. Should we be worried? Perhaps not immediately, but pretty soon thereafter. The fact is that if real spending does not pick up robustly in the near term, then persistently easier money will find its way into higher prices and rising rates of inflation. Moreover, even if the economy does pick up robustly, the FOMC may be put in the difficult position of having to drain this extra liquidity to head off rising inflation.

The fact of the matter is that monetary policy still works in the following sense. The Federal Reserve can give people the liquidity and incentive to spend and produce, but it can't make them spend and produce. And if the conditions are such that people are unwilling to spend and produce as much as the Federal Reserve desires, then an economic slowdown whose cause was not directly related to monetary policy, may simply not have a solution that is monetary policy based. An overly aggressive monetary policy would then find the FOMC in a poor position to defend the goal of maintaining a low inflation environment.