

Monetary Policy in the New Economy's First Slowdown

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Imagine that you are at the end of a tightrope that is just a few feet off the ground. You are committed to crossing to the other side. As you slowly step away from the platform, you become aware of the fact that the rope is slowly rising. Your balance is reasonably good, and you are somewhat skilled at tightrope walking, but as the ground disappears under your feet, you start to feel nervous about the prospects of surviving the trip. Then, just when your nerves begin to calm and you are ready to begin your trip, the wind starts to swirl.

This is how I envision the job of central bankers in today's world. It is easy to stand on the sidelines and criticize – policy changes should have bigger or small, faster or slower – but imagine facing the pressures yourself. Your economy is slowing, inflation is rising, and everyone is saying you should do something about it! What exactly is it that central bankers are supposed to do?

Attempts to balance the long-term goal of price stability against the immediate and more politically popular desire to stabilize the real economy can become almost impossible. On the one hand, there are almost daily downward revisions in the estimates of both current and near-term real growth. At the same time, gauges of inflation show alarming signs of increasing above the range that most people feel is acceptable. Should policy lean toward easing, with an eye toward averting a possible recession, or should interest rates be relatively higher, in an effort to contain the risk of higher inflation?

In the end, the decision depends on what the productivity growth trend will be once the economy settles down from its current gyrations. Will the next five years resemble the first half of the 1990s, when productivity growth averaged less than 1½% per year, or the second half, with its annual growth rate over of 2½%? Or, will it be somewhere in between?

Understanding whether changes in productivity growth rate changes are temporary or permanent is absolutely crucial for successful monetary policy. Faced with a temporary shift, policymakers should attempt to stabilize output about its permanent growth path, allowing inflation to deviate somewhat from its long-run target rate. By contrast, if productivity growth shifts permanently, then the appropriate policy response is to stabilize inflation about its target while allowing output to move to its new long-run growth path.

Mistaking permanent shifts in the growth rate for transitory ones can be catastrophic. In fact, one can make a good case that in the U.S. in the late 1970s when, under the chairmanship of

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Arthur Burns, the Federal Reserve attempted to stabilize growth at an unsustainably high level and ended up driving inflation to double-digit levels.

Returning to the current circumstance, most people now agree that a significant portion of the improvement in the productivity growth trend – as much as 2/3rds of the increase – can be ascribed to a combination of the production and use of IT equipment. Unless growth in investment in information technology equipment recovers quickly returns to recent levels, the productivity trend could easily fall from its recent dizzying heights.

A quick look at a few numbers shows how important IT investment growth has been for growth in the last five years. From 1995 to 2000 real investment in computer hardware grew at an astonishing average of 46% per year. This was more than twice the rate of the previous five years, and alone contributed one-half a percentage point of growth, accounting for one-third of the productivity acceleration. We will see higher productivity growth so long as IT investment continues at the recent rates.

Meanwhile, newspapers and magazines are filled with stories about the price cuts computer hardware manufacturers are announcing in an attempt to rid themselves of unwanted inventories. At the same time, computers that once belonged to now defunct Internet firms are piled high in warehouses. There are signs everywhere of over-investment in information technology equipment – the exact stuff that people claimed would streamline production and inventory control, stabilizing the economy without the help of unreliable policymakers.

If the corporate thirst for faster and fancier computer systems has been quenched, then we really could be in trouble. This is clearly what is on the minds of monetary policymakers as they have been easing this winter and spring. The signs of an investment collapse are everywhere, and its effect on long-term productivity growth should it continue is the biggest risk that we face today. The Federal Reserve's Federal Open Market Committee is clearly hoping that their swift and sizeable interest rate cuts will rejuvenate the now lifeless capital spending plans. If they are successful, then, in the words of the FOMC's 15 May 2001 statement, "the impressive underlying rate of increase [in productivity growth] that developed in recent years appears to be largely intact, supporting longer-term prospects."

In my view the risks in this policy path are very asymmetrical, as it really does presume that the next five years will look like the last five. If the late 1990s really were a time of over investment in IT equipment, then it could be quite some time before computer producers recover, and we may come to see the stratospheric growth rates in hardware investment of a few years ago as quaint vestiges of the past. This means that we could be in for a rough ride. Policy bases on the presumption that trend productivity growth is over 2½% could easily generate inflation well above acceptable long-run levels.

The American Consumer Price Index is now rising at a rate close to 3 percent per year, with core measures of inflation three-quarters of one percentage point from their level eighteen months ago. Inflation expectations seem to be rising and the yield curve is steepening. By the beginning of 2002, policy may once again have to reverse course.