Occasional Essays on Current Policy Issues No. 16

The Limits to Monetary Stabilization Policy

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22 August 2001

We had it all figured out, or so we were told. Monetary policy could be counted on to stabilize the economy, and so recessions were a thing of the past. The evidence was clear. In a broad cross-section of industrialized countries, both growth and inflation were more stable in the 1990s than they were a decade earlier. The move toward independent central banks, with a focus on inflation objectives, was reaping significant benefits worldwide.

The American economy was the poster child for the view that central bankers had conquered the business cycle, leaving us all to sleep more soundly. The U.S. had not experienced any sort of output decline in 10 years. The last official "recession," from July 1990 to March 1991, was so mild as to be barely visible in current (substantially revised) data. The last real recession ended in July 1981! But the story doesn't stop there. During this period of phenomenal growth, inflation was falling steadily from over 10% in the early 1980s to less than 2% by the end of the 1990s. Comparing the last fifteen years with the fifteen before them, the volatility of U.S. growth and inflation both were cut more than in half.

The U.S. was not the eye of a hurricane, as the stability of the 1990s extended throughout the developed world. Inflation volatility fell nearly everywhere, while output variability declined in over half of the countries for which data are available.

Knowing the source of the stability of the 1990s is crucial for understanding what is coming next. It could be that the all-powerful monetary policymakers finally figured out how to do their job. If so, then our sound sleep should not be disturbed. But there are other possibilities. We may have been lucky, and the 1990s could simply have been a calmer time. Alternatively, it may be that the economy has become more nimble in responding to external shocks. How likely is each of these?

Did good fortune bring us the stability of the 1990s? This is a difficult case to argue, as it seems so unlikely on its face. Surely the last decade was not calm for financial markets, with crises in Latin America, Asia, and Eastern Europe, as well as the failure of Long Term Capital Management. Prices of raw materials fluctuated wildly as well. Oil prices spiked at over $35 per barrel in late 1990 and plunged below $12 per barrel at the end of 1998. It is just too easy to find examples of external disturbances that should have destabilized the economy but somehow did not.

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If the size and frequency of external shocks has not materially fallen, then it must be that we are somehow doing a better job of cushioning the blows. A number of people have argued that advances in information technology have increased the flexibility of manufacturing to respond to changes in demand. The result has been a dramatic decline in the level of inventories at every stage of the production. In durable manufacturing the ratio of inventories to sales fell from around 2½ in the early 1990s to 1½ by the beginning of 2000. The introduction of just-in-time inventory control seems the most likely explanation for this phenomenon.

But just as we thought that aggregate fluctuations would not be beholden to inventory adjustments, all of the descriptions of the U.S. slowdown focus on the impact of an inventory adjustment. Ironically, the most persistent problems have emerged in the high-technology sector – semiconductors, computers and communications equipment. Extrapolation of the nearly 50% growth rates of the past few years turned out, not surprisingly, to be overly optimistic leaving producers with inventories far in excess of their targets. It is surely ironic that the producers of the equipment that was to have eliminated the inventory cycle are themselves having one!

As Chairman Greenspan in his testimony on the semiannual Monetary Policy Report to Congress, "Innovations, such as more advanced supply-chain management and flexible manufacturing technologies, have enable firms to adjust production levels more rapidly to changes in sales. But these improvements apparently have not solved the thornier problem of correctly anticipating demand." In other words, the structure of the economy has changed, but not enough to completely inoculate us from inventory cycles.

This brings us back to monetary policy. Central banking is surely not what it used to be. We now have a much greater understanding of how to implement effective monetary policy than we did as recently as twenty years ago. To be successful in producing low and stable inflation, and high and stable real growth, central banks must be independent of shortsighted political influence and have clear objectives. Importantly the secret temples of the past have also been breached, as we now believe that transparency of actions and accountability to the public is a crucial ingredient for any successful monetary policy. The fact is that central bankers now have the tools and the wherewithal they need to do the job we all want them to do.

My view, supported by my own research, is that roughly one half of the reduction in the volatility of growth and inflation has been a result of improved central bank policy.[1] This suggests the limits to what monetary policy can do to stabilize the economy today. Innovations in information technology have allowed for faster, more flexible adjustment of production to changes in demand and reducing the cyclicality brought on by retail inventory accumulation. But this looks increasingly like it has pushed the problem back one step, as businesses still have the ability to over-invest in productive capacity, resulting in aggregate instability.

The problem of business investment has been clearly exacerbated by the fluctuations in stock markets. We seem to have gone from being irrationally exuberant and overly optimistic about the economy to being irrationally depressed and excessively pessimistic. The economy has moved

[1] Cecchetti, Stephen G., Alfonso Flores-Lagunes and Stefan Krause, "Has Monetary Policy Become More Efficient?" unpublished manuscript, Department of Economics, The Ohio State University, May 2001. Available at http://economics.sbs.ohio-state.edu/cecchetti/pdf/cf-lk52001.pdf.

from inventory cycles to a case of manic-depression. It doesn't make much sense, but given the influence of equity valuation on the ability of corporate manager to raising funding, investor sentiment cannot be ignored when making their business investment decisions.

Monetary policymakers are clearly doing a better job than they ever have before. But their early incompetence was only half of the problem. There are limits to what central bankers can do to stabilize the economy. Until we can invent something an antidote to investor mood swings – some sort of lithium for financial markets – cycle fluctuations, albeit more modest ones will remain with us.