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Stable Growth without Inflation: The Challenge for Monetary Policy

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A combination of serendipitous tax cuts and aggressive interest rate reductions have kept the US economy on an impressively stable path. Alan Greenspan, the Federal Reserve chairman, is surely right that the recuperative powers of the American economy have been remarkable.

But policymakers can take some of the credit too. The Feds prescience and agility have been equally remarkable in assuring that calamity has been averted once again. After all, the decline in total US gross domestic product, from the peak in the first quarter of last year to the trough of the third quarter, has been less than one-quarter of 1 per cent. And the chances of a double dip recession look increasingly remote. This is conclusive evidence that better policymaking and an economy that is more nimble in responding to shocks have combined to create more stable growth.

But a policymaker's work is never done. Interest rates today are at their lowest in decades, and far below any level consistent with long-run price stability. The implication is obvious: interest rates will have to rise. The only question is how far and how fast.

My answer is that monetary tightening should start soon, and that interest rates will need to return to at least 4 ½ percent within 18 months.

The target of 4 ½ percent comes from adding together the interest rate estimated to be consistent with stable, non-inflationary growth and medium-term inflation. The former is now thought to be about 3 per cent, while the Feds estimate of the latter is 1 ½ per cent (it focuses on a measure derived from the GDP accounts rather than the more commonly quoted consumer price index). From this, we can conclude that any interest rate below 4 per cent is likely to be expansionary, and will eventually lead to inflation.

Most forecasters, however, seem to believe that a combination of idle productive capacity and labor market slack will drive inflation down by as much as 1 percentage point over the remainder of this year. Forecasts are for further declines into 2003 as economic growth rises well over 3 per cent. Low and falling inflation, especially at levels close to those consistent with price stability, would surely justify a relaxed attitude towards monetary tightening.

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But is inflation really going to fall over the remainder of this year? I think not. At first blush, the current situation looks like a repeat of 1997-1998, when the worldwide slowdown precipitated by the Asian financial crisis created a glut in production capacity. There was downward pressure on prices for some time, and inflation fell substantially.

It is true that capacity utilization, both domestic and international, is comparatively low today. But, significantly, the excess capacity is mainly in manufacturing. Services are another story: in the US, medical care prices and housing costs have both been rising more rapidly in recent years, and show no sign of decelerating.

While the prices of goods may be stable, the price of services is rising at a rate of 4 per cent or more a year. Since services are three times as important as goods in measures of core inflation – those that ignore energy and raw food – simple arithmetic leads to the troubling conclusion that overall inflation is on its way to 3 per cent.

Indeed, the likely depreciation of the dollar, combined with the possibility of a global recovery, presents a risk that inflation could go even higher. Policymakers need to be ready for a sharp fall in the currency's external value, and the attendant difficulties that will come with it.

In the New Economy, everything happens more quickly. Production and inventory adjustments are faster, companies move more quickly to shed unneeded workers, and financial markets are more flexible. As a result, output, employment and even productivity are less volatile than in they were in past downturns.

This enhanced ability to moderate the impact of economic shocks is only to be welcomed. But it also means that past cyclical patterns have become a poor guide to the future. We are used to seeing productivity decline dramatically in recessions, recovering swiftly during the first stages of a boom. When productivity accelerates, profits can grow while prices remain stable. But that pattern has disappeared, and with it, the room for monetary policy to raise rates at a leisurely pace during the nascent recovery.

The pace of policymakers' actions must now match the speed with which the private sector is able to adjust to changing economic circumstances. Last year the Federal Open Markets Committee was quick to reduce the federal funds rate by 4 ¾ percentage points in a series of 11 cuts. The real test comes now, as interest rates need to rise. With important Congressional elections due in November, tightening monetary policy will not be popular. But the fact remains that the next move in US interest rates needs to be upwards, and it needs to be soon.