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Shocks and More Shocks

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There is no way I can discuss the current economic situation without starting with the observation that the U.S. economy is dealing with shock after shock after shock: The 9/11 attacks; threats of additional terrorism on U.S. shores or against U.S. interests abroad; corporate governance scandals; bankruptcies of large firms; war in Iraq; SARS; oil price spikes. I've left out the large decline in the stock market, starting in early 2000, because that decline is probably more a consequence of downward revisions of earnings forecasts than a cause. Still, the rather sudden transition from an environment of unbridled optimism to one of caution and the associated stock market decline has certainly not been a positive influence on the economy.

There are several ways to react to this list of shocks, but before I do so I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, but I retain full responsibility for errors.

If I were back in the classroom teaching a course in macroeconomics, I could ask my students to analyze the effects on the economy of each of these shocks. A student who told me that any of these shocks would raise economic growth and expand employment would not be a good candidate for an "A" grade, unless he or she had an extraordinarily clever analytical story to tell.

As we live through this period day by day, we can express our disappointment over the economy's lack of job creation, and I have done so in a number of speeches. However, if we can create a little distance, perhaps by thinking about the likely assessment of this period several years hence, I suspect that we will marvel at the economy's resilience in the face of all these shocks.

How resilient has the economy been? The recession of 2001 was mild, measured by the total decline in real GDP and by the duration of the decline. GDP rose by 2.8 percent over the four quarters of 2002. Forecasters anticipate that GDP growth will remain positive this year and next, at a gradually rising rate.

Why has the economy been so resilient? The Federal Reserve Bank of St. Louis devoted its main essay in its *Annual Report for 2001* to exactly this question. The essay, written at the end of 2001 and early 2002, focused on the sources of the economy's resilience because that topic seemed highly appropriate in the immediate aftermath of 9/11.

Our conclusion was that the economy survived the shock of terrorist attacks so well because of four extremely important features of the current U.S. economy. First, the United States enjoys vigorously competitive markets, which promote rapid and efficient adjustment to new circumstances. Second, the country has a robust financial system; the banking system is well capitalized, and few banks have failed in recent years. Third, despite current strains, federal and state governments for the most part are in a sound fiscal position. True, many governments are experiencing significant budget deficits, but fiscal positions

are fundamentally sound in that the deficits are generally not huge relative to GDP and governments retain ample taxing power to raise additional revenues if they so choose. Fourth, the nation enjoys low inflation and monetary stability.

The Bank's Annual Report essay emphasized that these four elements of economic strength have not always been staples of the U.S. landscape. I'll not repeat the essay here, but anyone familiar with U.S. economic history can point to episodes where one or more of the four elements was compromised.

What impresses me about the current situation is how well the economy has handled multiple severe shocks. I cannot guarantee that the modest economic growth rate of last year will continue without interruption, but I do think that is the most likely outcome. The consensus of the Blue Chip panel of economic forecasters in its most recent release (April 10, 2003) is for real GDP, measured by the annual level of GDP for the year, to grow by 2.4 percent this year and 3.5 percent next year. Not one of the panel of 53 forecasters expects a decline in real GDP this year or next.

Many observers have pointed to the role played by the Federal Reserve's policy response as the economy weakened over the course of 2001. The Federal Open Market Committee (FOMC) reduced rates aggressively once the economic weakness became apparent. I hear some people say that monetary policy is not working, but find that position hard to fathom. Would the auto companies have introduced zero-interest financing incentives if interest rates had remained high? Would we have experienced a continuing housing boom if rates had remained high? Would we have seen the mortgage-refinancing boom that has helped to support households' discretionary expenditures if rates had remained high? The answer to all these questions is "most certainly not."

What is not generally appreciated is the central role played by an entrenched environment of low and stable inflation. Inflation has remained low and, at least as important, so have inflation expectations. Often in the past, as I have documented at some length elsewhere, the Fed's response to developing recession has been limited by concern that inflation and inflation expectations would be boosted by premature easing of monetary policy.[1] Over the last five years, inflation has been well contained, and inflation expectations remarkably low.

How did the low inflation environment become so entrenched? The answer is that years of disciplined monetary policy have created a conviction almost everywhere that inflation will remain low because the Fed will do what is necessary to achieve that result. Indeed, in the last year or two the talk has been of the possibility of deflation, rather than the risk of Fed overreaction creating inflation. However, when we examine survey evidence on inflation expectations, and evidence from the yield spread between conventional and indexed Treasury bonds, talk of deflation is just that—talk. The evidence does not support the view that the talk has affected the way people behave.

Resisting inflation pressures has at times not been very popular, but doing so has been an investment that is now paying off in spades. The shocks hitting the economy have not created inflation fears, as past shocks have so often done. The Fed has not had to deal with the possibility that easing policy might create inflation fears. Inflation stability, therefore, has been an investment that has permitted a vigorous policy response to the spate of shocks hitting the economy in recent years. Nor have inflation fears affected the way market participants have responded to the shocks. Without inflation uncertainty, the economy has adjusted quickly and efficiently.

I've emphasized the importance of the economy's resilience in the face of multiple negative shocks, but should also emphasize that there is evidence of an extremely important positive shock in recent years—the sustained growth of labor productivity. The trend tilted up in 1995; what is truly remarkable is that productivity growth remained high as the economy slowed in

[1] "Inflation, Recession and Fed Policy," Midwest Economic Education Conference, St. Louis, Missouri, April 11, 2002.

2000, fell into recession in 2001 and then recovered slowly during 2002. Measured over four quarters of the year, productivity in the nonfarm business sector rose by 2.1 percent in 2000, 1.9 percent in 2001, and 4.1 percent in 2002. Given the pace of output growth, this productivity performance meant that employment growth was significantly negative during the recession and roughly flat last year. Stagnant employment growth is an important problem, but I think that the sustained high productivity growth bodes well for employment and output growth over the long run. Productivity data, rather than just a gut feeling, justify an optimistic long-term outlook.

As for coming quarters, I have no way of forecasting what additional negative shocks might be headed our way, or how rapidly the effects of recent adverse shocks will wear off. I do not believe that the Fed can do anything directly to deal with overcapacity in the telecom industry or reductions in travel due to security and SARS concerns. People delaying spending so they can follow the war on TV will not start shopping because of anything the Fed can do. What I do believe is that the Federal Reserve will respond to changing circumstances as required to maintain low inflation and a financial environment consistent with maximum sustainable growth in employment and output.

I often get questions, usually with a wry smile, asking me about the probable direction of Fed policy. I have a stock answer, and it is not a coy answer. Monetary policy is driven by new information. My position at each FOMC meeting is that the intended fed funds rate should be set at the level that provides the best chance of fostering healthy economic growth and sustained low inflation, taking into account everything we know.

If I knew for sure that available information would justify a different intended fed funds rate at the next FOMC meeting, then I would argue for moving to that rate right away. Between meetings, we receive a flow of new information, consisting of formal statistical releases, anecdotal reports from contacts across the country, new analytical insights generated by research staff and events of all sorts with possible implications for the course of the economy. Important information is inherently unpredictable. To the extent information is predictable, I have already factored into my thinking experts' best guesses about what will happen. Deviations from best guesses, obviously, are unforecastable.

It is this new information that drives changes in the FOMC's setting of the intended federal funds rate. For this reason, and not because I am being coy, I cannot predict what will be the appropriate policy setting at the next FOMC meeting.

Looking ahead, in time, financial stability and the inherent growth potential of the U.S. economy will come to dominate the situation. Arriving information will take a more favorable turn. Fed policy will respond as the new information makes the case. That more favorable economic conditions will come is my optimistic message, though I have no idea as to when more rapid growth will appear.