

# Monetary Trends



## Monetary Policy and Productivity

Many people have called recently on the Federal Reserve to ease monetary policy as, in the words of Federal Reserve Chairman Alan Greenspan, economic growth slows "from unsustainable to more modest rates of growth." During the third quarter, real GDP grew at its slowest pace in four years and private-sector job creation slipped to less than 125,000 jobs per month. In its December release, the Blue Chip consensus forecast of fourth-quarter-to-fourth-quarter growth during 2001 is only 3 percent. Yet, at the same time, the risk of higher inflation remains. During the third quarter of 2000, the chain-type price index for gross domestic purchases increased at a 2.3 percent pace versus increases of 1.7 and 1.1 percent, respectively, in the third quarters of 1999 and 1998. Excluding food and energy, the index increased at a 1.8 percent rate during the third quarter, versus 1.1 and 1.4 percent, respectively, in 1999 and 1998. Some measures of inflation expectations also have increased.

Many economists believe that the FOMC should aggressively act to forestall higher inflation. Ingrained expectations of higher inflation cause firms and households to divert resources to less-productive uses and are costly to reverse. Participants in the federal funds and Eurodollar futures markets, however, seem to expect that economic weakness will induce the FOMC to ease monetary policy in the near future. It is possible that no inflation threat looms: The recent pickup in inflation might be only a temporary reaction to elevated energy prices. Some indexes, such as the personal consumption expenditure deflator excluding food and energy, display little acceleration. But, labor markets remain tight, and productivity-enhancing investment has slowed. As a result, the economy may be more vulnerable than usual to an increase in core inflation triggered by shocks such as increases in energy prices.

Reacting appropriately to a slowdown in economic growth is complicated by uncertainty about future productivity growth. Is the current slowing cyclical, or does it signal a leveling-off of productivity growth? Suppose, for example, that technological change has both permanently increased the productivity of relatively lower-skilled workers and reduced the market power of higher-skilled workers. In this case, the long-run rate of unemployment consistent with a stable inflation rate might perhaps be 4 percent. If so, one might use monetary policy to lean against cyclical increases in unemployment above this rate without causing a future acceleration of inflation.

But, despite recent productivity trends, some analysts assert that the long-run rate of unemployment consistent with steady inflation remains near 5-1/2 percent. In their analysis, recent lower-than-anticipated inflation and unemployment has been due to a transitory productivity shock with two parts. First, decreases in the prices of computing and telecommunications equipment have encouraged an increase in the amount of capital used per hour of labor. Second, technological advances have changed business practices, contributing further to productivity growth. When such gains have been exhausted, the analysts argue, the *level* of productivity will be permanently higher, but its growth rate will slow. They cite lower-than-anticipated earnings of technology companies as a signal of such a turning point. If productivity growth has slowed, a sharp acceleration of inflation could occur if monetary policy is used to forestall increases in the unemployment rate. An expansionary monetary policy might be somewhat effective in the short-run, but its long-run expansionary effect will be thwarted by accelerating inflation.

Monetary policy must remain focused on a low, stable inflation rate. To do so—while also seeking to moderate cyclical fluctuations—is a challenge that requires improving our understanding of the recent acceleration in U.S. productivity growth.

--Richard G. Anderson

