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The following text represents the notes on which Mr. Parry based his remarks.

1998: Issues in Monetary Policymaking

I. Good afternoon. It's a pleasure to be here in Phoenix.

  A. As you know, over the last year, the Federal Open Market Committee has held monetary policy on a steady course.

  B. The basic reason is that, even though we've had strong growth and low unemployment,

    1. we haven't seen signs of rising inflation.

    2. Indeed, over the last three years, inflation's been *falling* gradually.

  C. Seeing inflation move toward price stability is something the Fed is obviously very glad about–

    1. –price stability is a fundamental goal of the Fed,

      a. since it promotes maximum sustainable output and employment in the long run.

  D. But the path to price stability isn't always so easy.

    1. More often, in the short run, it involves some "pain"–

    2. –that is, some slack in labor and product markets.

  E. In my remarks today, I'd like to explain

    1. a little about the source of our good fortune in getting inflation lower without the "pain."

    2. And I'd also like to point out some issues this raises for monetary policy in 1998.

II. Let me begin by reviewing national conditions in a bit more detail.

A. We're now in the eighth year of an expansion that's still going strong in virtually all sectors and regions of the economy.

1. This strength has helped bring the federal deficit very close to balance,

2. and create jobs for American workers.

a. In fact, the unemployment rate in March was 4.7 percent, close to the lowest levels in 25 years.

B. Normally, when product and labor markets are so tight, we'd expect to see rising inflation. But as I said, we've actually had good news on that front too.

1. The March data on the CPI show only a 1.4 percent increase over the prior twelve months.

2. And inflation has been on a downward trend.

a. If we look at the core CPI, which excludes the volatile food and energy items,

(1) it was 2.3 percent over the last twelve months,

(2) compared to 2.4 percent over the preceding twelve months,

(3) and 2.9 percent over the twelve months before that.

3. As a very rough rule of thumb, this kind of a decline in inflation usually would be accompanied by an extra three-quarters to one percent in the unemployment rate.

III. How have we been able to make progress on our goal of price stability, when real GDP growth has been so strong and unemployment has been so low?

A. First, a couple of temporary factors

1. One is the 32 percent drop in oil import prices over the past year.

2. Another is the strengthening dollar over the past year, which has led to lower prices for imported goods.

a. Of course, a good deal of the dollar's more *recent* rise has been due to the currency crisis in East Asia.

B. Beyond these is a factor that may be more fundamental and long-lasting--productivity.

1. Over the last couple of years, the numbers showed productivity growing at a faster rate,

a. and that's holding down business costs.

b. This may be the payoff we've been waiting for from the rapid investment in technology in the 1990s.

(1) For the last five years, investment in the sector has been growing at double-digit rates--

(a) --in fact, it hit 21 percent last year.

C. A final factor that's held down inflation recently is that people seem to have changed their expectations about inflation.

1. For example,

a. surveys show that people's expectations about inflation ten years out have fallen from around 3 percent to just over 2-1/2 percent.

2. Lower expectations affect inflation because

a. they lead businesses to keep a lid on the prices of their products,

b. and they lead workers to bargain for smaller wage increases.

3. Now, one thing that helps keep inflation expectations low is public confidence that the Fed means what it says about pledging to keep inflationary pressures in check.

a. I'd say it's possible that this change in expectations is due at least partly to the Fed's credibility on this point.

D. To sum up, these factors–oil prices, the dollar, productivity, and expectations–will probably continue to offset upward pressure on inflation from tight labor markets this year.

1. So, I expect inflation to come in at about 1997 levels.

IV. But it's important for policy to look beyond just this year, because monetary policy actions can take as much as *two* years to affect inflation.

A. And when we look beyond the next year, the picture for inflation is less clear.

1. For one thing, the favorable effects of oil prices and the dollar are temporary.

a. The price of oil has to *keep* falling and the dollar has to *keep* appreciating in order to hold down inflation in the longer run,

(1) and neither is likely to be a permanent feature of the economy.

2. For another, enhanced productivity isn't a completely sure bet--

a. --it may be mainly a *temporary* cyclical increase, not entirely a trend.

b. And even if there is a new trend, this acceleration in productivity growth would have to be very large by historical standards to account for economic growth rates like the ones we've seen in the last year or so.

B. So it's doubtful that productivity is growing fast enough to support the growth rates we've had in recent years without eventually leading to higher inflation.

V. One factor that could help *ensure* that inflation doesn't become a problem in the future is some slowing in the growth of aggregate demand to a more sustainable rate.

A. As it turns out, several factors suggest that it might just happen this year.

1. These include

a. a relatively restrictive fiscal policy,

b. and the higher dollar, which would restrain exports and stimulate imports.

2. Finally, we expect the fallout from the East Asian currency crisis to dampen U.S. growth this year.

a. With those economies facing difficult times, we can expect some slowing through our trade with East Asia.

b. But since our exposure in this area isn't all that great,

(1) most estimates suggest the Asia turmoil is likely to reduce real GDP growth this year by between ½ and 1 percentage point.

B. So far, the economy’s growth appears to have remained robust in the first quarter as a whole,

1. although activity seems to have slowed toward the end of the quarter.

a. For example, we may be seeing the first signs of a modest impact from Asia in the form of

(1) a higher trade deficit

(2) and slower growth in industrial production and manufacturing employment.

b. Furthermore, total employment and retail sales suggested some weakness in March.

2. But it’s just too soon to tell

a. if this was just a pause—

(1) —perhaps caused by tricky El Nino-related seasonal factors—

b. —or if the economy really *is* beginning to slow to a more sustainable pace.

VI. Now let me turn briefly to economic conditions in the Twelfth District and Arizona.

A. The western economy has expanded rapidly during the past year, due in large part to California's growing strength.

1. As the state's expansion gained momentum, it has attracted some jobs and workers from nearby states, which has slowed their economies.

B. But Arizona is an exception.

1. After slowing somewhat between 1995 and 1997,

2. employment growth in Arizona picked up again during the last six months.

3. And the unemployment rate here has fallen steadily, by nearly a point-and-a-half since the end of 1996.

VII. How will the East Asia problems play out in the West?

A. This area appears to be more at risk than the U.S. as a whole, since our trade exposure is about twice as great as the nation's.

B. But so far, East Asia has had about the same effect on the District as it's had on the nation.

1. This is due in part to the mix of our export products.

2. For example, compared to other parts of the U.S., District exports to East Asia are more concentrated in high-tech products and aircraft production.

a. This is especially true for Arizona: about 70 percent of the state's East Asian exports are electrical equipment and components.

3. And for the District as a whole, neither sector has experienced a large decline in total export demand during recent months.

C. The most noticeable export slowdown has been for agricultural and food products.

1. But these products don't account for a large share of employment in the District.

D. Overall, given these trade patterns, the impact of East Asia's problems on the District have been modest–so far, at least.

VIII. Let me conclude by returning to monetary policy.

A. We've had the good fortune in recent years to have inflation move toward price stability without the usual costs in terms of lost output and employment.

1. But this won't last forever.

2. At some point, economic activity will have to slow to a more sustainable pace, or we'll risk losing the gains we've made against inflation.

3. And that's a risk I'd hate to see us take.

a. Just because we had the good fortune to see inflation fall without "pain" doesn't mean we'll necessarily have the same good fortune again.

B. That’s why it's so important not to be lulled into a false sense of security by all the recent good news on the inflation front.

1. Given the lags in policy, the Fed must be concerned with the risks of possible problems with inflation in the future.