

ECONOMIC CHALLENGES OF THE 1990s

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A Rule for Handling Economic Challenges

The United States has just been through a very extraordinary period in its economic history, in the number of economic challenges that it has had to face and digest in a relatively short period of time. I think if there is no sound rule about how to handle those challenges, we should make one. The rule ought to be that there is a limit to the capacity of any economy to handle economic dislocations. Moreover, when those economic dislocations and challenges occur at a rapid pace, it is only natural to expect that the efficiency of the economy will diminish.

Three Economic Challenges

Several economic challenges need to be emphasized, and all are of an international character: (1) the challenge of coordinating international banking regulations; (2) the challenge of lowering inflation in the G-7 countries; and (3) the challenge of adjusting to the post-Soviet international order. There are other challenges, but I think these three give a flavor of just how dramatic the changes in the past few years have been.

Coordinating International Banking Regulation

In the mid-to-late 1980s, it became increasingly apparent that the nation-state based method of banking regulation, which had been in place from time immemorial, was no longer sufficient to handle what was becoming an increasingly global banking market. In an age in which billions of dollars could travel overseas in a nanosecond, it became increasingly important for national regulators of banks to be

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able to at least sing from the same song sheet. The demand to try to have some sort of international coordination in the way in which banking regulation was conducted was the impetus behind the meetings in Basle.

Without going into the details of the Basle agreements, one can conclude that whenever there is a change in the rules of the game, the adjustment costs are going to be high. Adjustment costs in the banking industry have been high not only in this country but around the world. The banking industry has had to change the method by which it does business and has had to take on a whole new paperwork burden, all in the name of meeting the new rules of the game. Moreover, because banking is the lifeblood, financially, of any economy, changes in the rules of the game that affect the banking industry will affect the entire economy, especially those sectors that depend on banks for financial support. Consequently, the adjustment to the new rules have reduced economic growth, both here and abroad.

The United States has largely completed the adjustment process. At the end of 1993, more than 98.5 percent of U.S. bank assets were in institutions that, under the new rules, were either adequately or well-capitalized, with the majority of assets in well-capitalized institutions. The transition, however, is still going on in some of our major trading partners, most notably Japan. Like the United States, those countries will face difficult economic decisions as they adjust to the new rules of the game.

Lowering the Rate of Inflation

The second challenge the United States faced was an international decision to lower the underlying rate of inflation. When I went to school, I was taught that there was a permanent tradeoff between inflation and unemployment. It was assumed that economic policymakers could pick the optimal policy mix and, if they were wise, they would pick a mix that involved moderately high rates of inflation in order to buy moderately low rates of unemployment. It was assumed that only unemployment, not inflation, was costly to the economy.

I think it is fair to say that the wisdom of 20 years ago is no longer the consensus view in the economics profession. It is certainly not the consensus view in central banks and finance ministries around the world. What we have come to appreciate in the last 20 years is that those countries that did not accommodate the oil shocks of the 1970s, with increased monetary ease, ended up doing better than those economies that did accommodate those shocks. We have also come to appreciate that there may be higher costs to inflation than what we previously thought was the case.

One of those costs—the capacity to do long-term planning—is fairly hard to quantify. Yet, it should be clear that inflation affects such planning by making the future price level less predictable. Even an inflation rate of four percent means that the price level will double in 18 years, quadruple in 36 years, go up by a factor of 16 in a lifetime, and a factor of 50 in a century. How can we expect a 30-year old to plan for retirement when the price level at the time of retirement may be 10 or 15 times what it is today? Or how can we expect an electric utility or other major investor to plan to build a factory with a 50-year life when the price level at the time the plant becomes obsolete may be 30 times what it is today?

More demonstrably, because of the interaction of inflation with our tax system, inflation produces a higher effective tax rate on saving and investment than would otherwise be the case. On the saving side of the ledger, if there is a 4 percent real rate that is taxed and a 4 percent inflation rate, which is also taxed, the effective tax rate on returns to saving will double.

The effect of inflation on the investment side of the ledger is equally clear. Because the U.S. tax code requires firms to carry assets at historical cost, high rates of inflation will erode the nation's capital stock. True replacement costs will exceed the legally allowable limits, and firms will be unable to maintain their capital assets. At the Federal Reserve, we have estimated that knocking four percentage points off the inflation rate is equivalent to a 3.5 percent investment tax credit—not a temporary investment tax credit, not an incremental investment tax credit, but a 3.5 percent *permanent* investment tax credit on all plant and equipment. Such a change would be a substantial stimulus to investment.

In sum, because of the need for long-term planning and to encourage saving and investment, it is clearer today than it was when I went to school that (a) there is probably no long-term tradeoff between inflation and unemployment, and (b) inflation is a lot more costly than we thought it was. As a result, in the United States and around the world, the decision has been made to try to reduce inflation. To say there is no long-run tradeoff, however, does not mean there is no short-run tradeoff. It is well-known that the United States and other countries have experienced slower economic growth in the short-run because of the process of disinflation. The challenge is to lower inflation and accept the short-run costs while adjusting to the new rules governing financial regulation.

Adapting to the Post-Soviet Economic Order

The third international challenge that the United States has faced, unlike the first two, which were intentional, was a surprise: the collapse

of the Soviet Empire. While clearly beneficial in the long-run—and I point out that the other two challenges will also produce clearly beneficial long-term results—the short-term effect has been to raise real interest rates. I think that this effect is most clearly seen if one examines what happened to Germany. Germany used to be a net capital exporter to the rest of the world. Today, all of that once exported capital is consumed in East Germany, and unified Germany is a net capital importer. On a somewhat smaller scale, the entire former Soviet empire has been turned into a net capital importer from roughly a neutral position. The effect has been to change supply and demand relationships and increase real interest rates here and abroad.

Other Challenges

In addition to the major challenges just discussed, there have been other challenges, such as the Persian Gulf war. If prior to 1990, economic forecasters were asked what a Middle East war with 400,000 U.S. ground troops would do to the U.S. economy, I think they would have said that there would either be a crash landing or no landing at all. In fact, we made it through.

The United States has also been faced with the challenge of ongoing industrial reorganization and the challenge of dealing with the 1990 budget deal. We have juggled all these challenges and have gotten through with, at worst, an average recession.

Some Lessons

We have learned some lessons from the international challenges we have faced: first, the importance of resiliency; and second, the limits of monetary policy.

The Importance of Resiliency

Today the U.S. economy is more resilient, more efficient, than it was in the 1970s. Financial market changes, regulatory changes, a conscious policy of disinflation, and a contractionary fiscal policy have produced a less severe recession than we experienced in the 1970s. The lesson, I believe, is that the proper goal of government policy should be to make markets as resilient and efficient as possible. Government policymakers should get rid of the traditional bottlenecks of overregulation, overtaxation, and overprotection, and let markets work. If we do that, then we can absorb far more severe policy shocks than we otherwise would be able to.

The Limits of Monetary Policy

There is a second lesson, and I think it can best be summed up as the limits of monetary policy. What is increasingly obvious is that much of the economic dislocation we have is not of a macroeconomic nature but of a microeconomic nature. It is industry specific and regionally specific. For example, as defense spending is reduced, resources need to move to alternative uses, and states such as California will be hit harder than others.

It is obviously impossible for the monetary authorities to run separate monetary policies for California and for the rest of the country. It is also obviously impossible to run separate monetary policies for the defense sector and for the rest of the economy. Given the kind of gross, blunt instrument that monetary policy is, it is therefore often inappropriate.

When we look at statistics that imply a large degree of slack in an economy, we must be conscious of whether those statistics of high unemployment are due to microeconomic bottleneck problems, or whether they are due to macroeconomic aggregate-demand problems. When that distinction is made, I think it should be clear that today our economy is closer to full employment than we might otherwise expect.

Monetary policy is not a solution to microeconomic problems. And one of the greatest challenges we have in the years ahead, in addition to making sure that bottlenecks do not reoccur, is that we do not inadvertently use monetary policy as a tool to cure problems that monetary policy is not designed to cure.

RETHINKING THE FRAMEWORK FOR MONETARY POLICY

W. Lee Hoskins

Once again, the Federal Reserve is under attack from lawmakers who propose measures designed to increase the accountability of monetary policymakers while preserving the independence of the institution. Legislation that is currently the subject of debate on Capitol Hill would either remove the voting power of District Reserve Bank presidents (Hamilton 1993; Sarbanes 1993) or require that they be appointed by the President of the United States and confirmed by the Senate (Gonzalez 1993). I will argue in this paper that these efforts (well-intentioned or not) to alter the monetary policymaking process cannot possibly improve the substance of policy, because they do not address the central shortcoming of the present framework: the absence of a single, clear, measurable, and attainable objective for monetary policy. Instead, the political leadership focuses on a mix of objectives that no central bank can provide.

Congress should direct the central bank to promote the maximum attainable level of employment and output by achieving and sustaining a stable price level. The ideal framework for monetary policy includes independence for policymakers in pursuing the objective of price stability and accountability for performance relative to that objective. The Federal Reserve should have complete freedom to design and adopt procedures and set and seek intermediate targets, without political interference. At the same time, it must constantly be held accountable for the results of its actions—for producing a stable price level over time. The appropriate committees of Congress or the Executive Branch must have the authority to, and be specifically directed to,

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