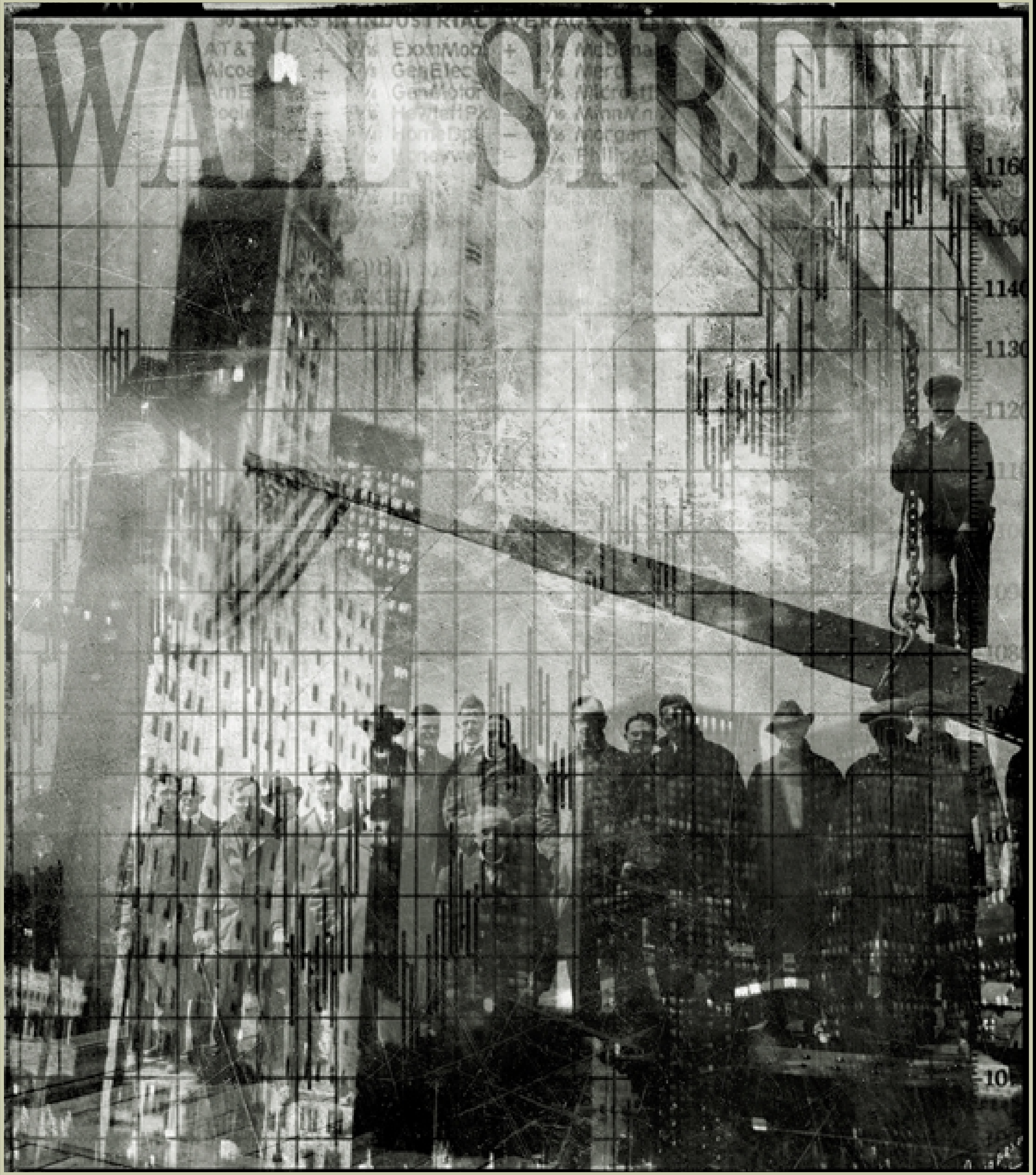
Monetary Policy



New challenges for monetary policy

As the final year of the century closed, the nation's economic expansion was poised to enter its ninth consecutive record-setting year. Midway through the year, the Federal Reserve embarked on a series of gradual, deliberate steps aimed at keeping inflation tame and the economy strong.

During the past three decades, the Federal Reserve Bank of Kansas City has enhanced the understanding of new policy issues by bringing together a distinguished group of the world's central bankers, policy analysts, and financial market experts at our annual Jackson Hole Symposium. The 1999 program, "New Challenges for Monetary Policy," was especially timely in today's global environment.

The 1999 economy

The nation's economy was strong again in 1999 — some might even say it boomed. Growth was solid, unemployment and inflation stayed at their lowest levels in decades, and, not surprisingly, consumer confidence continued to soar.

This remarkable mix of rapid growth, high employment, and low inflation was the outcome of two divergent trends — one domestic and the other foreign. Strong demand at home was tempered by weak demand abroad.

Real gross domestic product grew 4.6 percent in 1999, a momentum that should help launch our economy into the new millennium. Personal consumption grew rapidly, business investment expanded at double-digit rates, and sales of new and existing homes were solid. The performance of the U.S. stock market, meanwhile, continued to make great strides.

As other nations recovered slowly from the world financial crisis of the year before, our export performance was less than stellar. Our foreign trade deficit swelled to $343 billion, reaching its largest mark ever.

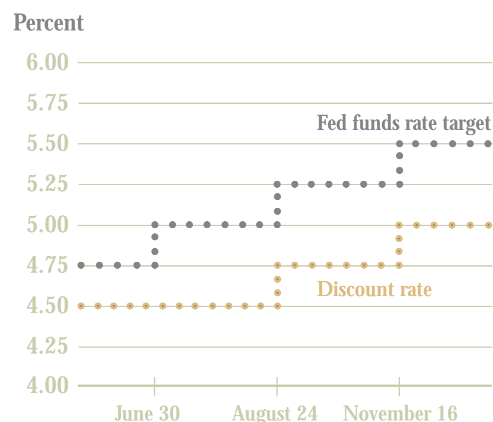
Without such a sharp drop in net exports, GDP growth in 1999 may well have exceeded 5 percent. So, in effect, our weakness in net exports helped provide a safety valve for what might otherwise have been an overheated U.S. economy.

The FOMC tightened three times

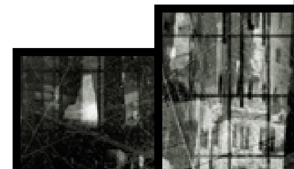
The Federal Open Market Committee (FOMC), the Federal Reserve's principal policymaking body, acted three times during the year to keep inflation at bay.

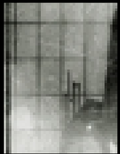
By raising its target for the federal funds rate a quarter point in June, August, and November, and by raising the discount rate a quarter point the latter two times, the FOMC reversed its 1998 actions to provide liquidity in the wake of the Asian financial crisis. With its June and August moves, the FOMC cited firming foreign economies, financial markets functioning more normally, tightening labor markets, and domestic demand holding strong.

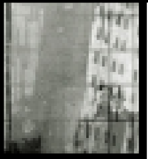
Signs of "slowing in some interest-sensitive sectors of the economy and of accelerating productivity" appeared late in the year, but "growth of demand continued to outpace that of supply," as evidenced by the shrinking pool of workers willing to take jobs. In November, the FOMC described this trend as one "that must eventually be contained if inflationary imbalances are to remain in check and economic expansion continue."



FEDERAL RESERVE POLICY MOVES - 1999







Symposium highlights

Many developments and events in today's dynamic global economy are transforming the environment for monetary policy. Prices at home and throughout much of the industrialized world have become relatively stable. The stock market in the United States keeps booming, despite fears that it may be overvalued. And economic gyrations in the farthest corners of the world can sway U.S. financial markets overnight, thanks to the speed and ease of trading in today's e-economy.

This year's Jackson Hole Symposium, "New Challenges for Monetary Policy," explored whether, in today's global environment, policymakers enjoy greater flexibility in meeting their goals, or whether they now face a whole new set of operational challenges.

Federal Reserve Chairman Alan Greenspan discussed how asset prices might influence the performance of the economy. He noted that central bankers need a better understanding of how asset prices are set and how changes in their value shape economic activity.

Ben Bernanke and Mark Gertler, professors at Princeton and New York University, respectively, explored why policymakers should care about the volatility of asset prices. They argued that central banks should adjust monetary policy to offset changes in expected inflation. One implication of this is that policy should respond to asset price changes only insofar as they signal changes in expected inflation.

Willem Duisenberg, president of the European Central Bank, identified the key challenges the ECB faces upon completion of its first year of operation. He stressed the need to maintain a strong commitment to price stability, to develop a better understanding of the structure of the euro area's economy, and to communicate effectively with the public.

Mervyn King, deputy governor of the Bank of England, described a number of challenges to policymakers in today's new environment. He also endorsed the idea that targeting the price level might be more effective in stabilizing prices than targeting the inflation rate.

Lars Svensson, professor at Stockholm University, examined a number of operational issues central bankers face in a low-inflation environment. He compared the relative merits of conducting monetary policy using simple rules, targeting an inflation forecast, and targeting a monetary aggregate, concluding that inflation forecast targeting is the best way for central banks to maintain price stability.

A debate arose on the choice of an exchange-rate regime for emerging open economies in Asia, Latin America, and Central Europe. Barry Eichengreen, professor at the University of California-Berkeley, Ricardo Hausmann, chief economist at the Inter-American Development Bank, and Rudiger Dornbusch, professor at MIT, argued many countries should seriously consider dollarizing or adopting a currency board.

Martin Feldstein, president of the National Bureau of Economic Research, took the opposite view, suggesting that most exchange rate crises have been caused by fundamental structural policy errors. He argued that adopting flexible exchange rates and increasing international liquidity would provide a more stable environment for small open economies.

For the full text of the papers and commentary presented at the symposium, as well as transcripts of the discussions, visit our web site (*www.kc.frb.org*) or contact our Public Affairs Department.