

Economic Priorities in 1989 and Beyond

W. Lee Hoskins, President
Federal Reserve Bank of Cleveland

FEDERAL RESERVE BANK
OF KANSAS CITY
DEC 12 1988
RESEARCH LIBRARY

Economic Outlook Conference
Greater Cincinnati Chamber of Commerce
Cincinnati, Ohio
December 7, 1988

Economic Priorities in 1989 and Beyond

In thinking about next year's economy, I would like to focus on two issues: the economic outlook for 1989 and long-term objectives for monetary policy.

As the events of the past year clearly demonstrate, life is full of surprises. Not much more than a year ago we were sorting through the debris of the stock market decline, and attempting to gauge the impact of the shock on investors, businessmen and consumers. Generally, it seemed reasonable to expect at least a cooling in the economic expansion, and perhaps even more.

Well, in retrospect, it didn't quite work that way, and we would be well advised to bear that in mind as we think about 1989. Clearly, a year ago, we underestimated the underlying strength and vigor of the expansion. Led by capital investment and export demands, and supported by solid increases in consumption, the economy shook off the chilling effects of the stock market decline and moved ahead more rapidly than all but a few would have guessed.

Today, as one evaluates the economy in the closing weeks of 1988, it is a pretty positive picture. There are few of the imbalances which normally precede a slowdown or recession. Inventories, for example, do not appear to be high. Capacity strains and favorable profit margins would suggest continued strength in business investment. Strong growth abroad seems likely to continue to support export demands.

The conventional or consensus view of the coming year, after incorporating these factors, projects continued economic expansion, though at a more moderate pace than the past year, and in an environment of still moderate

inflation. Those forecasters who see trouble on the horizon are betting that economic policy will have to forcefully deal with capacity strains and rising prices, with the result being recession. Well, as you would imagine, I do not plan to address that issue today.

I would simply note that many elements of the consensus view of next year appear pretty soundly based to me. The economy is closing this year on a very strong note. Those who expected a pause or a slowdown in the rapid pace of the expansion in the second half of the year, have instead seen continued strength in new orders, and rapid growth in employment and income. Our economy has moved closer to full capacity, although we should recognize that we really don't know precisely where that is.

Foreign economies, both in Western Europe and Asia, have accelerated in the past year, again contrary to the forecasts of a year ago, and there is little yet to suggest widespread or significant slowing.

Inflation last year, while not as bad as the pessimists feared, was a good deal worse than the optimists hoped. Regardless of which index one uses, the rate of inflation moved upward this past year, by one to one and a half percentage points into the 5 percent area. Not surprisingly, wages and costs have responded and are also rising along the same 5 percent track. So, for the first time since 1981 the thrust of prices and wages is upward.

One key overriding issue for 1989 is whether a slowing economy will hold inflation in the 5 percent area, or whether another step-up is already baked into the cake, so to speak, and how economic policymakers will react if inflation does indeed accelerate again.

This leads me to the second issue which I believe we need to bear in mind. Simply put, how do the possible outcomes in the year ahead relate to monetary policy and to the effort to achieve longer-term objectives? What are these objectives or what should they be? Unfortunately, neither economists nor policymakers agree fully on objectives. In recent years, however, we have come closer to agreement. I will argue today that there should be one overriding objective for monetary policy -- the provision of a stable price environment. I will also offer some suggestions about how I think this objective can be achieved.

The Objective: Price Stability

Our monetary system is a complex network of rules, procedures and institutions. Ideally, it promotes the efficient allocation of resources by reducing transaction and information costs. Any monetary system should promote an environment in which money provides a unit of account, an efficient medium of exchange, and a stable store of value. How well the monetary system operates depends on the nation's central bank. Specifically, it depends on what objectives the Federal Reserve seeks to achieve and its success in achieving them. The Federal Reserve Act of 1913, the Full Employment and Balanced Growth Act of 1946, and subsequent amendments to those Acts -- have given the Federal Reserve responsibility for multiple objectives, including stability in the purchasing power of the dollar, stability and growth of the economy, and high levels of employment.

In my view, the basic objective of monetary policy should be to stabilize the price level. Variables such as employment, output, and incomes, for example, cannot be controlled directly. The supply of goods and services

available to consumers depends on the quantity of productive resources and how they are used. Monetary policy can do little to directly affect the total quantity of land, labor, and physical capital that is available, or the efficiency with which these resources are used. The Federal Reserve can, however, control the price level and, by providing a stable price environment, can encourage investment and real economic growth. Through price stability, the Federal Reserve can provide an environment in which other economic objectives stand a better chance of being met.

Neither the Federal Reserve, nor other policymakers, have adopted this view completely, but they have moved closer to it. Alan Greenspan, for example, in his most recent Humphrey-Hawkins Testimony stated, "By price stability I mean a situation in which households and businesses in making their savings and investment decisions, can safely ignore the possibility of sustained generalized price increases or decreases. Essentially, the average of all prices would exhibit no trend over time. The strategy for monetary policy needs to be centered on making further progress toward and ultimately reaching stable prices. Price stability is a prerequisite for achieving the maximum economic expansion consistent with a sustainable external balance at full employment."

Neither the statement nor the context in which it was made suggest that the Federal Reserve is not concerned about other objectives. Nevertheless, the statement is a clear delineation of what I believe is the appropriate framework for discussing monetary policy issues for 1989 and beyond. I would go even further. To promote general economic welfare, the Federal Reserve should stabilize the price level, even if it means putting other objectives aside.

The Role of Money and Price Stability

The role of money, and therefore, the role of monetary policy, is to provide transaction and information services. If the Federal Reserve stabilizes the price level, then transaction and information costs in the economy will be reduced, and we will have an optimum climate for decision-making and resource allocation. If the Federal Reserve fails to achieve an inflation-free environment, it will obscure relative price signals, raise transaction costs and add to uncertainty. Increased uncertainty about future inflation and about monetary policy objectives diminishes efficiency of resource use and adds to the instability of the economy.

If monetary policy cannot control real economic variables directly, why do people believe it can influence the variables indirectly through stabilizing the price level? According to economic theory, people attain the highest possible level of welfare in a competitive economy with no transaction costs and perfect information. In this world, prices act as important signals, indicating the quantity of particular goods and services to be produced.

Transaction Costs. In the real world, money and monetary policy do have a role to play because there are transaction costs and people do not have perfect information. Let us first consider the inefficiencies that arise from transaction costs. Labor contracts give employers considerable discretion over employment at a fixed-dollar wage rate. Transaction costs are evident by the fact that the contracted wage rate is not fully and continuously adjusted for inflation. However, people take expected inflation into account when entering into these contracts. Once wages are fixed, firms then choose output and employment levels to maximize profits. If inflation is higher than

originally expected when the contracts were signed, the real wage rate will fall. Firms will increase output and employment to take advantage of higher profit margins.

The resulting expansion of activity is unsustainable and therefore inappropriate because it arises from decisions that have been distorted by inflation, rather than representing an appropriate response to economic fundamentals. Once this misallocation of resources is realized, a costly readjustment of resources must be undertaken. Eventually, labor supplies, wages and employment will adjust to the underlying fundamental conditions. Monetary policy should be designed to prevent unexpected changes in the price level, and thereby keep the problems associated with fixed wage and price contracts to a minimum. In short, inflation reduces economic performance, holding output, employment, and incomes below their longer-term sustainable levels.

Information Costs. Another important role for money and monetary policy is to provide information. For example, people face uncertainty when choosing whether to save or consume, because they do not know the real interest rate. The real interest rate, which represents the return to savings in terms of future consumption, is simply the nominal interest rate minus the expected rate of inflation. If people could predict inflation accurately, the problem would disappear. But because people are uncertain about future inflation and the real interest rate, they are unable to plan optimally for current and future consumption. The monetary authorities can reduce the problem by making the price level predictable.

Businesses also face this sort of uncertainty. Investment decisions depend on the cost of capital and on the expected return. Expected returns depend importantly on how accurately current interest rates reflect future inflation. Not having this information is costly. We know it is because we see firms paying for insurance by participating in financial futures and options markets. Many of the developments in the financial markets in the last 20 years represent attempts by the private economy to protect itself from uncertainty about inflation. Even if the price level cannot be predicted with certainty, the costs associated with inflation uncertainty can be reduced if the Federal Reserve focuses more sharply on a stable price level. These examples illustrate why I conclude that the only objective of monetary policy should be a stable price level.

While the ultimate goal of the Federal Reserve is to maintain stable domestic economic growth and full employment, I believe the only way to achieve these goals is to stabilize the price level. By price stability, I mean a condition in which people expect and therefore act as though prices will be stable. People can adapt best to zero inflation. I don't mean that all the different components of price indexes will be unchanging. Each price index has its own peculiar characteristics. Non-monetary factors and measurement problems will always affect price indexes, but the short-term variation in the indexes should be just that--short-term variations around a zero trend.

The Strategy: An Explicit Price Stability Goal

This brings me to my main point, the need for a strategy for achieving price stability. Having chosen a stable price level as the appropriate

objective for monetary policy, what is a sensible strategy for achieving it? Indeed we have made much progress in recent years. There are some lessons in that progress for us to consider.

The first, and most important, element of a successful strategy is to enlist the support of market expectations, by announcing clear, explicit goals and acting in a credible manner to achieve them. When inflation was at double-digit rates at the end of the 1970s, people did not believe that inflation would stop rising, because the often-promised end to inflation was not delivered. In that environment, stating general policy goals simply was not credible. The Federal Reserve gained credibility in the 1980s by reducing inflation and preventing it from rising above a 3 to 5 percent zone.

I think we can improve the performance of our economy by announcing a goal of zero inflation to be achieved over some reasonably short time period -- 3 to 5 years. If, as I believe, 5 percent is the rate of inflation today, then I suggest the acceptable upper limit should be 4 percent a year from now. If zero inflation is the goal, such a path, if steadfastly pursued, would produce a stable price level by 1993. I think an explicit goal with a clear timetable is the first part of an effective strategy.

The second part of an effective strategy is demonstrating a determination to achieve it. While it may seem that there is never a good time to begin, price stability must be the focal point of our policy discussion. If price stability is the overriding goal, other objectives must not interfere with efforts to achieve it. I believe that prompt and full explanations of policy and of policy changes, perhaps immediately following the actual decision, would help reduce uncertainty and allow markets to operate more efficiently.

Market expectations would be better based and presumably more accurate with explicit statements of policy intentions and changes therein. More efficient market expectations would, in turn, serve to discipline policy decisions.

Achieving Price Stability

The lack of a reliable short-term linkage between the monetary aggregates and the price level adds to the difficulty of knowing what is the appropriate monetary policy to achieve a zero inflation goal. Externally, markets must be able to judge whether the Federal Reserve's actions are consistent with the desired outcome. Because policy works with a long and variable lag, it becomes more difficult than ever to know whether the Federal Reserve is using a good recipe or a bad one.

The framework we use for making decisions must allow for uncertainty and minimize the costs associated with mistakes. In achieving price stability, some risks are more acceptable than others, because some mistakes are either less costly or more easily reversed. Inflation, once embedded in expectations, contracts and resource allocation decisions, is very costly to deal with. This fact argues strongly for a decision framework which tilts short-run implementation decisions away from the risks of inflation acceleration.

The M2 Target As a Long-run Inflation Indicator. In the last few years the intention to reduce inflation has been manifested in the gradual reduction in the upper limit of the M2 target growth ranges. The M2 aggregate is composed of those assets that are used primarily for transactions and less liquid savings and small time deposits. The usefulness of M2 stems from the relative stability over long periods of time of its relationship to total

spending. In principle, an aggregate with a stable turnover rate, such as M2, can be used as a convenient indicator that policy is consistent with desired long-run trends in the price level.

The upper limit on M2 growth can be thought of as an upper limit on total spending growth. Continued growth in M2, in excess of our long-term 3 percent or so growth in productivity, will result in inflation. Continued reduction in M2 growth will eventually mean reduced inflation. In the last four years, the Federal Reserve has gradually reduced the upper limit of the M2 growth range from 9 percent to the 7 percent proposed last July for next year -- a rate which by our calculations, if maintained for a long period of time, would be consistent with the present ⁵ percent inflation. The FOMC will review the target range for 1989 at its December meeting.

The Need For A Short-Term Policy Guide. Unfortunately, M2 is not a useful short-term guide to policy actions because the connection between M2 and inflation is quite loose. Despite the reduction in the M2 target range and in M2 growth, inflation is slightly higher than four years ago. Inflation expectations, as measured by the University of Michigan's Survey of Consumers, have begun to increase again. Other surveys and economists forecasts, as well as the inflation forecasts embedded in asset prices, have begun to show a similar rebound of expectations.

Money is special because it is used in transactions, reducing marketing and information costs, and because as the unit of account it is the basis for contractual obligations. Only about one-third of M2 is composed of those assets that provide a medium of exchange such as currency and deposits in checkable accounts. The balance of M2 consists of household savings which are

extremely sensitive to interest-rate spreads. When market interest rates fall, banks may be slow to reduce interest rates on deposits and M2 tends to grow very rapidly, as in 1985 and 1986. When market rates rise, banks may be slow to raise deposit rates and M2 tends to grow slowly, as it did in 1987 and as it has in 1988. The sensitivity of M2 to changes in interest rate spreads greatly diminishes its usefulness as a short-term guide to policy.

Furthermore, the Federal Reserve does not have direct control over M2 as it does over the monetary base. The base contains currency and member-bank reserves which are Federal Reserve balance sheet liabilities. In principle, the base and the federal funds rate could be used as continuous monitoring devices to indicate whether daily, weekly and monthly policy actions are consistent with announced long-term goals. But the relationship between the monetary base and the various measures of the money supply, on the one hand, and the reported price indexes, on the other, is not close over short periods of time.

In general, both the economy and the financial markets are buffeted by all sorts of disturbances. The problem is knowing which of these should be accommodated, and which should be resisted to keep inflation in check. Because the source of the disturbances is seldom clear, at least at the time, the Federal Reserve under the current operating procedures usually fully accommodates shocks, at least initially. The FOMC could target paths for the base from one meeting to the next and react to deviations from the target with automatic, but limited, changes in reserve restraint. Interest rates would respond partially, but automatically to resist incipient inflationary pressures.

Using the base as a short-run operating vehicle would still require just as much judgment at FOMC meetings as at present. Given time to evaluate shocks to the economy, the FOMC would adjust the base target. Because the base is controllable, it would provide the Federal Reserve with a better way to explain how it was exercising judgment and how the short-term operating decisions fit within the strategy of moving toward price stability.

Using the Forecast of the Price Level as the Intermediate Target. While I see merit to using the monetary base as the operating target, let me make it clear that the objective is to stabilize the price level and thereby eliminate expectations of long-run inflation. On an annual basis I would prefer to target a controllable instrument, such as the monetary base. But there have been important shifts in money demand over the past decade, and I see no reason to ignore the possibility of future shifts. Consequently, it seems probable that a preset target for any aggregate would have to be adjusted to achieve and maintain a stable price level.

Since our goal is to control the price level, it seems reasonable to use the forecast of the price level as the intermediate target or as the frame of reference for adjusting the operating targets. The forecast of the price level over a one-to-three year horizon would be more sensitive to policy actions than would the price level itself.

When we observe rising price expectations, and raise our own conditional forecast of the price level -- that is, the forecast conditioned on the current policy stance -- policy would be changed to bring our forecasts in line with the desired outcome.

Conclusion

I believe the Federal Reserve has the responsibility for providing an environment of stable prices. The Federal Reserve can achieve stable prices by formally announcing a goal of zero inflation to be attained over a reasonable period and a specific plan to achieve it. Undoubtedly, there will be short-term costs because many people will have written contracts, developed investment plans, and established institutions in anticipation of continued inflation. But I believe that the adjustment costs can be minimized by reducing inflation gradually. Disinflation, typically, is associated with temporarily higher real interest rates. If we try to reduce inflation too fast, current financial problems in the Southwest and in the developing countries may be aggravated unnecessarily.

On the other hand, credibility problems may result from going too slow. If people cannot perceive a reduction in inflation, or if they perceive a central bank that is either unwilling to commit to the objective or unwilling to begin the journey, they are unlikely to believe we will eliminate inflation.

I propose that we reduce inflation by 1 percent per year from its current rate. A year ago, I proposed that we go from 4 percent inflation to zero in about 4 years. Today, the inflation rate has risen to 5 percent and a reasonable policy will now take a year longer and may entail higher costs.