For Release:
January 14, 1991
10:30 a.m. EST

WHAT TO EXPECT FROM MONETARY POLICY

W. Lee Hoskins, President
Federal Reserve Bank of Cleveland

National Retail Federation
Annual Retail Industry Convention
New York Hilton Hotel
New York, New York
January 14, 1991

WHAT TO EXPECT FROM MONETARY POLICY

I am pleased to have this opportunity to address the annual meeting of the National Retail Federation. The past year has been one of surprises, some pleasant, some unpleasant. For monetary policy, last year was one of growing uncertainty. We are currently experiencing a significant decline in economic activity, largely, in my view, as a result of the uncertainties of the Persian Gulf situation, the economic adjustment to higher oil prices, and a sharp and sudden change in the mood and expectations of consumers.

Retailers have just closed the books on a difficult holiday season, which, unfortunately, came on top of some structural adjustments in your industry. You know more than I do about those issues, so I have decided it would be better for me to spend my time this morning discussing monetary policy and what we might expect from it in 1991 and thereafter. As you know, monetary policy will be one important factor determining the retail environment in 1991 and beyond.

The Current Economic Situation

The current decline in business activity is serious. While much of the recent softness has been centered in the coastal states, and predominantly in the construction, automotive, and retail industries, we cannot dismiss the possibility that weakness will become more pervasive. As is always the case, it is impossible to foretell with precision either when the decline will end or what the shape of the ensuing recovery will be. At the moment, the data we are seeing are consistent with the idea that the decline will be brief and, indeed, may be largely behind us. The run-up in business inventories to date has been slight compared with previous recessions, and capital goods and export markets may continue to provide the economy with a much-needed lift. But this is conjecture, as I will argue later.

The fears of inflation that arose last summer with the surge in oil prices seem to be diminishing. The sharp initial increases in consumer and producer prices have slowed. Moreover, there is little evidence that higher oil prices have spread in a substantial way elsewhere in the economy, and into an ongoing increase in inflation, as was the case in the 1970s. Of course, it is too soon to be very sure about this. The outcome will depend upon many factors, including how the situation in the Middle East is resolved. But, I believe that the monetary policies of the past several years, and the moderate growth of the money supply are powerful factors working toward a more promising inflation outlook for the next several years.

Monetary policy has been adjusted several times in the past year. The reduction in interest rates in the last several months, in my view, was an appropriate response to the slower money growth since October -- a slowdown which may be more than desirable for gradual disinflation. The year-end weakness in money supply growth is very difficult to interpret. It may be that the recent weakness in money growth is the result of restructuring in the financial industry -- the shift of deposits from the thrift industry to other financial institutions -- or a different attitude toward credit by borrowers and lenders. The recent easing actions should help boost money growth rates.

Monetary policymakers confront a number of problems and pressures. Public discussion centers on whether the Federal Reserve can reverse the current economic slowdown. I believe that monetary policymakers should proceed with caution. First, the recent softness in the economy was caused primarily by an increase in oil prices. Lowering interest rates further will not alter this situation. Second, experience shows that the Federal Reserve cannot fine-tune the economy. We do not have the knowledge or the foresight to operate policy on the basis of expected near-term fluctuations in business activity. Finally, it is my belief that the only economic objective that the

central bank can achieve is price stability. This is no small accomplishment. By achieving price stability, the Federal Reserve can reduce at least some of the uncertainties that businesses face, laying the foundation for a more efficient, and consequently, more prosperous economy.

Problems with Multiple Objectives

My concerns are not with current policy, but rather, with the lack of clarity in the Federal Reserve's goals, and the public's expectations of what those goals should be. Current law requires the Federal Reserve to pursue several goals, including maximum employment and production, stable prices, and moderate long-term interest rates. In effect, the Federal Reserve often seems to be in the position of the man who is attempting to serve all masters, and is ultimately able to serve none. Relying on monetary policy to achieve multiple goals, some of which are beyond the reach of monetary policy, may cause us to make mistakes, possibly serious ones like those of the 1970s.

As we consider monetary policy adjustments in 1991, we should recognize the limits of monetary policy in the current economic environment and the risks that inappropriate policies pose for 1992 and beyond. It is important to understand what monetary policy can and cannot do. Contrary to public expectations, the Federal Reserve cannot and does not control long-term interest rates. Nor can the Federal Reserve fine-tune economic growth. Efforts to do so in the past, while seemingly successful for awhile, have produced inflationary side-effects that have been very difficult and costly to deal with.

The recent oil price shock illustrates the difficulty that the Federal Reserve faces in attempting to achieve the goals of economic growth and low inflation. Iraq's invasion of Kuwait was accompanied by soaring oil prices, declines in stock and bond prices, and speculation about economic recession. Such concerns would seem to be well-founded. Since World War II, large oil price increases have been a harbinger of higher inflation and recession. Yet, without an overriding objective for monetary policy, it is unclear how the Federal Reserve will respond in the face of real disturbances.

The rise in oil prices reduces national output and may potentially trigger a period of adjustment during which the economy may recede. Such would seem to be the case today. Furthermore, the decline in national output creates a surplus of money relative to output that puts upward pressure on the price level. Under the current policy setting, the Federal Reserve is torn between its desire to keep the economy growing and its desire to keep the economy's inflationary pressures in check.

No amount of money will compensate for the fact that an important raw material, oil, is more scarce. But the common view is that monetary policy can fine-tune the economy; that is, offset temporary weakness by easing credit conditions, later instituting a period of tightening before the inflationary pressures become too serious.

Fine-Tuning the Economy with Monetary Policy

Using monetary policy to fine-tune the economy is fraught with peril. The record suggests that near-term real GNP projections are too inaccurate to be of much value in determining the appropriate course of monetary policy from quarter to quarter.

Admittedly, forecasts can reduce some of the uncertainty concerning the direction of the economy. A recent study at the Federal Reserve Bank of Cleveland found that quarterly forecasts up to one year ahead reduced uncertainty by roughly 14 percent for the growth rate of real GNP and by 52 percent for inflation. But are these forecasts accurate enough to be clear guides for monetary policy?

I think not. Near-term real GNP forecasts are unlikely to show us whether the economy will be strong or weak, even over the immediate future. Indeed, on average, the most accurate forecasters cannot predict at the beginning of a quarter, with any reasonable degree of certainty, whether the economy will be receding or booming that quarter.

One way to measure confidence in the near-term real GNP forecast is to examine the size of the typical forecast error relative to the average forecast. For example, the mean quarterly growth rate of the economy between 1968 and 1985 was 2.6 percent (at an annual rate), and the average one-quarter-ahead forecast error was about 4.2 percent. That is, the typical range around the average one-quarter-ahead real GNP forecast fell between -1.6 percent and 6.8 percent, roughly 68 percent of the time. How should monetary policy respond to forecasts if the range of precision is so wide that it includes both economic decline and rapid expansion?

While the errors in quarterly real GNP forecasts do not necessarily preclude some countercyclical policy, they do suggest that policy actions based on near-term forecasts should be conservative. Simply, the greater the uncertainty associated with the forecast, the smaller the policy response the forecast should induce.

Inflation is Costly

Even if we could predict recessions and wanted to use monetary policy to alleviate them, we still face another almost insurmountable problem -- monetary policy operates with a lag. The length of the lag varies over time, depending on conditions in the economy and on public perception of the policy process. The effect of today's monetary policy actions will probably not be felt for at least six to nine months, with the main influence -- higher inflation -- occurring perhaps two to three years from now. The act of trying to prevent a recession may not only fail, but may also create a future recession, via inflation, where otherwise there would not have been one.

If the central bank has a record of expanding the money supply in attempts to prevent recession, people will come to anticipate the policy, setting off an acceleration of inflation and reallocation of resources that will ultimately lead to a recession.

Moreover, inflation comes in waves and the uncertainty about future inflation adds risk to future investments. While uncertainty is a source of embarrassment to forecasters, it has very real costs to U.S. businesses and households by creating unnecessary inefficiencies and lowering our productivity growth.

Prices are the mechanism by which markets allocate an economy's resources. They show us what to produce, and in what quantities. Such price signals are the primary channel through which market information is transmitted and are, therefore, vitally

important to their efficient operation. Inflation, if it is mistakenly interpreted as a relative price signal, distorts market information and leads to errors in decisionmaking. Workers are unable to judge the real value of their wages, and firms the real value of their prices. We see these inefficiencies exhibited across the economy. In the labor market, inefficiency is manifest as reduced labor market mobility; for business, such as the retail industry, it appears as increased financial leverage (debt becomes a more viable source of capital than equity), and rising inventory costs.

Inflation reduces potential output by reducing productivity growth and the economy's accumulation of resources -- our wealth. And while these costs may appear small from quarter to quarter, or even year to year, ultimately our ability to maintain a rising standard of living and our ability to compete in global markets is threatened.

Improving the Policy Process

An ideal monetary policy is one that has a credible, predictable commitment to stabilize the price level. Inflation wastes resources, and uncertainty about the future rate of inflation wastes even more resources. Uncertainty about future inflation will raise real interest rates, drive investors away from long-term markets, and delay the very adjustments needed to end the recession. It is by avoiding such waste that monetary policy strengthens real growth and adds stability to the economy.

The key is credibility and predictability in the policy process. The more credible the commitment to price stability, the more limited will be the market reaction to adverse events. The more predictable the policy reaction to unforeseen economic events, the fewer wrong decisions will be made. The policy process today, with its focus on the near-term economic outlook, does not provide as clear or credible policy objectives as is desirable.

Long-run real growth is determined by non-monetary forces such as population growth, labor force participation, capital accumulation, and changes in technology. If monetary policy influences these "real" factors at all, it is only through very subtle means that are very difficult to predict.

Yet, monetary policy determines the long-term inflation trend. In principle, the Federal Reserve can make the trend in the price level follow any path. Uncertainty about the trend in inflation can be reduced by committing to a long-run target for the price level. Such a policy may even reduce some near-term uncertainties about the economy as it reduces the frequency of monetary "surprises." Sharp increases, as well as sharp declines, in the money supply should be avoided. Money supply growth trends should be matched more closely with the trend in the economy's potential growth.

A New Agenda for Policymaking

Experience has shown that there are no quick fixes in the promotion of economic growth. There is no evidence that a faster trend rate of output growth can be bought with a higher rate of inflation. In fact, inflation reduces the welfare implied by growth by creating inefficient decisionmaking and thus lowering wealth-enhancing productivity. Viewed in this light, a monetary policy designed to eliminate inflation is also a policy that best encourages growth -- long-term growth -- and our policies since 1986 are a solid foundation for providing lower inflation in the future.

Have we eased enough? I honestly do not know. For the moment, I believe we have done enough and we should wait until we are able to judge the results of the adjustments we have already made. Lower short-term rates helped to boost the money growth rates in December and will probably do so again this month. The current target

growth range set by the Federal Reserve for M2 (one measure of money) has a midpoint of around 4 percent. I would like us to be near that midpoint. I would be quite comfortable if the growth rate of M2 recovers to around 4 percent. But if the inflation statistics begin to decline at an accelerated pace and if the monetary aggregates remain flat, further policy adjustments may be necessary.

In short, monetary policy has made progress over the past decade. Policymakers have had the discipline to align the growth rate of money more closely with the economy's long-term ability to expand. The result has been moderate inflation. Moderate inflation is better than rapid inflation. Moreover, the steady money supply growth of the past several years may even portend a further slight reduction in inflation in 1991 and thereafter, despite the serious price pressures caused by oil prices and more recently by adverse weather in the fruit and vegetable growing areas of the west coast.

But a slight further reduction in inflation is not good enough. Our goal should continue to be price stability, achieved over a reasonable time frame. This will require steady discipline when implementing monetary policy. If there is a danger to this process, it would be the possibility that the Federal Reserve, in reacting to short-term phenomena, like recession, oil prices, or similar events beyond its control, will be distracted from its primary responsibility -- price stability.

For Release: 10:30 a.m., EST, January 14, 1990

Contact: June Gates, 216/579-2048

Cleveland Fed President Urges Caution in Fed Policy Moves

With the recent decline in business activity and a slowing in the growth rate of consumer and producer prices, many observers are calling for further easing by the Federal Reserve. However, Federal Reserve Bank of Cleveland President W. Lee Hoskins believes that monetary policymakers should proceed with caution until they are able to judge the results of the adjustments they have already made.

In a speech to the National Retail Federation in New York City, Hoskins said that in considering monetary policy adjustments in 1991, it is important to recognize the limits of monetary policy and the risks that inappropriate policies pose for 1992 and beyond. "It is important to understand what monetary policy can and cannot do. Contrary to public expectations, the Federal Reserve cannot and does not control long-term interest rates. Nor can the Federal Reserve fine tune economic growth. Efforts to do so in the past, while seemingly successful for awhile, have produced inflationary side effects that have been very difficult and costly to deal with."

Hoskins went on to say that there are no quick fixes in the promotion of economic growth. "There is no evidence that a faster trend rate of output growth can be bought with a higher rate of inflation. In fact, inflation reduces the welfare implied by growth by creating inefficient decisionmaking and thus lowering wealth-enhancing productivity." Hoskins said that a policy that best encourages growth -- long-term growth -- is one that is designed to eliminate inflation.

--more--

In assessing the current economic environment, Hoskins noted that lower short-term interest rates helped boost the growth rate of M2, a measure of the money supply, in December. "The current target growth range set by the Federal Reserve for M2 has a midpoint of around 4 percent. I would like us to be near that midpoint. I would be quite comfortable if the growth rate of M2 recovers to around 4 percent" said Hoskins. "But if the inflation statistics begin to decline at an accelerated pace and the monetary aggregates remain flat, further policy adjustments may be necessary."

# # #