Safeguarding Good Policy Practice

"Reflections on Monetary Policy 25 Years After October 1979"
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I can't help recognizing an emotional note in my reaction to this conference. Yesterday, we enjoyed three superb scholarly papers. Allan Meltzer's paper left me depressed, and the Lindsey, Orphanides, Rasche paper left me elated. Marvin Goodfriend's paper left me with hope for the future.

But now I'll try to be a dispassionate social scientist. This panel inevitably overlaps somewhat the previous one on what we have learned since October 1979. In no small part, what we have learned *since* October 1979 starts with what we learned *from* the Great Inflation and how it was brought to an end. Going forward, we need to incorporate in policy practice both sound theory and lessons from history.

I will make five major points, none of which is new but all of which deserve attention in the context of this conference. First, good science is extraordinarily important. Second, market confidence in the central bank is essential for good monetary policy. Third, stability of the real economy requires price stability. Fourth, central bankers have an obligation to communicate clearly with the general public. Fifth, we should not underestimate the role of leadership.

GOOD SCIENCE

The problems of the 1960s and 1970s were partly—not totally, but partly—the consequence of bad economics. Allan Meltzer has discussed those issues, and I do not need to repeat his argument here.

I note especially that Chairman Martin's dismissal of economics and economists does not make for happy reading today. I hope that we never again see Federal Open Market Committee (FOMC) members with that attitude. Policymakers need not be professional economists, but they must be able to understand what economists bring to the table.

How do we safeguard a high level of expertise in the FOMC of the future? There is no way to ensure that the appointment process will always put the right people on the FOMC. But I think we can help to guard against appointment errors by working with Reserve Bank directors, who choose Reserve Bank presidents, with Congress, and with opinion leaders in general. Those of us in leadership positions today, and everyone else with monetary policy expertise, need to spend time in helping to instill in the general public a deeper understanding of monetary policy responsibilities. We need to discuss what characteristics are necessary for policymakers to be successful. I hope that we never again have appointments yielding the results of the 1930s, 1960s, and 1970s.

The largest gap in macroeconomics is the weak understanding of the relationship between real and nominal variables. In our models, we employ a Phillips-curve type of relationship to model inflation, or changes in the rate of inflation. In our models, a departure of the actual rate of inflation from the expected rate depends on a current and expected future real gap measure of some sort. I simply distrust this model, on both theoretical and empirical grounds. Empirically, I don't think it works very well, and theoretically it ought not to work very well.

I'd love to hear Chairman Greenspan offer a systematic exposition of his enormous success

in forecasting inflation pressures. My sense of what I do, which I think is not dissimilar to what most FOMC members do, is attempt to intuit future inflation pressures from current observed pressures as they show up in both price changes and resource pressures, or real gaps, in individual markets. The approach is not totally without theory; for example, wage changes are evaluated in light of expected productivity trends. I attempt to sort out temporary from more lasting wage and price changes and attempt informally to construct an appropriately weighted average of disparate experience in various sectors. I look closely at data on inflation expectations, but treat such data carefully because longer-run expectations are really a vote of confidence on the Fed and not an independent reading on inflation.

I am extremely uncomfortable with this approach and believe that it is an invitation to future mistakes. I don't know what better to do.

PUBLIC CONFIDENCE

A standard feature of monetary analysis in recent years is that market confidence in the central bank is tremendously important. Retaining confidence requires, above all, successful outcomes. There is no adequate substitute for good results. The market does not require perfection—people do understand in broad outline what the central bank can and cannot do. People understand that some small mistakes are inevitable. Still, the market will surely lose confidence from mistakes occurring year after year after year.

Once confidence is gone, restoring it is incredibly costly. That is one of the prime lessons of U.S. experience in the late 1970s and early 1980s and experience around the world. To restore confidence, it is necessary to achieve, or at least make progress on, policy objectives of price stability and full employment.

Making progress on policy objectives is far more important than hitting an intermediate target such as a steady, moderate rate of money growth. To the noneconomist, intermediate targets are highly technical in character. I am not an engineer, for example, and really don't care what engineers say about the strength of steel when bridges fall down. Similarly, the noneconomist really doesn't care about the rate of money growth. If it works, fine, but stable money growth is not a substitute for price stability. Of course, an intermediate target may be of transitional importance in restoring confidence, as the 1979-82 experience shows.

Restoring confidence may require—indeed, I suspect in most cases *does* require—bearing a lot of pain to demonstrate that a central bank is serious about meeting its responsibilities. The recession of 1981-82 is such an event. The market wants to see the central bank is able to bear pain, and the reasoning is simple. If you cannot withstand a lot of pain, why should anyone believe you are serious given all the pressures to change course? Technical explanations can always be offered to explain a change in policy direction, but if it appears that technical mumbo jumbo is an excuse for not completing the job, then confidence will not be restored. Thus, a change in policy direction will require a fairly understandable explanation once a fair amount of pain has been endured.

The logic of pain seems inescapable. Inflation cannot fall permanently unless inflation expectations come down. Expectations will not come down in the absence of confidence that the central bank will keep inflation down in the future. Confidence in the central bank will not be obtained unless the market becomes convinced that the central bank, and the political system more generally, has the institutional strength to maintain low inflation. The real test of institutional strength is capacity to bear pain.

The rational expectations argument of costless disinflation through restoration of credibility never appealed to me. In 1979, given what the Fed had said and done over the preceding 15 years, it would have been irrational to have granted the Fed instant credibility.

PRICE STABILITY AND REAL ECONOMIC STABILITY

My third point is that maintaining price stability is extraordinarily important for stability of the real economy. The idea that we can trade off

employment stability against inflation stability is flawed. I do not want to deny that there may be some trade-off around the edges, but the key regularity is that instability of inflation and real growth are positively correlated. Tolerance of higher inflation is not a recipe for creating higher employment or improved employment stability, but just the reverse. The reason is that inflation instability creates more instability in inflation expectations and wider dispersion in the expected rate of inflation.

Greater variability and dispersion of inflation expectations increases the magnitude of expectational errors and therefore increases misallocations in the real economy. Moreover, an increase in inflation tends to reduce the market's confidence in the central bank, which, in turn, makes it more difficult for the central bank to adjust its policy to help stabilize the real economy. This point was demonstrated dramatically in the 1980-82 period. Given weak market confidence in the Federal Reserve's willingness to control inflation, the Fed was not able to switch gears toward a less restrictive policy as employment weakened in the 1981 recession. The central bank could not switch gears because doing so ran the risk of undoing tentative progress in restoring the market's confidence in the central bank.

The arguments I have just offered flow from sound economics—the observed positive correlation between inflation instability and employment instability is what we ought to expect.

COMMUNICATION

Allan Meltzer discussed the intellectual environment that made the Great Inflation possible. By the 1960s, traditional central bank concern over inflation had come to be regarded as old fashioned and the new economics promise of an optimal trade-off of modest inflation to buy lower unemployment had won many converts. Although the Federal Reserve, especially the Board of Governors, included converts, the Fed also included leaders who shared traditional concerns about inflation. My memory of this period, which I have not tried to research for accuracy, is that traditional concerns were not stated forcefully by articulate defenders of price stability within the Fed.

Central bankers can influence public debates, if they try. One of the lessons I draw from the Great Inflation is that those of us in leadership positions in the Federal Reserve have an obligation to communicate actively. If we do not, by default we leave the debate to others. I think that academics are important to public debates primarily through the longer-run force of their scholarly contributions. These are all that really matter in the long run; in the short run, some academics command public attention, but not very many and not much attention in the scheme of things. Press attention is concentrated on politicians, office-holders in general, and business leaders who control large resources. Federal Reserve office-holders immediately attract press attention, by nature of their positions. As a Reserve Bank president, I have an opportunity to reach an audience far larger than I ever had as a professor at Brown University.

The communications environment is quite different today from the early 1980s, when the Fed released relatively little information. In the interest of full disclosure, I was one of the skeptics when the Fed abandoned reserve targeting in the late summer of 1982. My fear was that the Fed would embark once again on a policy that would permit inflation to rise. As a monetary economist, perhaps I knew too much; I found the Fed's explanation for switching from nonborrowed-reserves to borrowed-reserves control in 1982 an example of the technical mumbo jumbo I referred to earlier. But the market bought the argument, and the fact that monetarists such as I were suspicious was irrelevant. I was wrong, and I am certainly happy that I was wrong.

Still, the current environment of much greater Fed openness has probably raised the standard of what will be required in debates in the future. If the Fed makes major mistakes and must again embark on a campaign to restore credibility, I suspect that it will have to pursue a more open dialog with the public.

In any event, safeguarding good policy practice from political pressures will require ongoing communication with Congress, market professionals, leading citizens, and the general public. Good monetary policy will be easier, and more effective, with widespread understanding of what constitutes good policy. That to me is one of the clear lessons of the Great Inflation.

LEADERSHIP

My last point concerns the role of leadership. This conference is a celebration of Paul Volcker's leadership.

Central bank leadership requires at times a willingness to push hard enough to get the job done—and recognition of how hard is too hard. The central bank does not want to get itself fired through changes in law or appointments that undermine the bank's authority. Pushing hard enough but not too hard is obviously a dicey act at times, requiring political judgment and acumen, but it is nevertheless one that central bank leadership must be able to pull off successfully.

I appreciate, at a much deeper level today than I did at the time, the extent of Paul Volcker's achievements in the 1979-82 period. Saying that is not meant to imply a negative comment about his achievements in later years. But certainly 1979-82 was a critical period in U.S. monetary history. I know that Paul Volcker did not do the job alone—support from President Reagan was critical. That said, there was no guarantee that President Carter would appoint Paul Volcker. Volcker was a logical, but not inevitable, appointment. President Carter could instead have appointed a Chairman who would have continued the policy of drift. The inflation rate would have continued to rise, and the pain of unwinding the inflation would have been greater.

The Great Inflation is understandable, but was not unavoidable. Stronger leadership by Chairman Martin would have cut short the early development of inflation. Chairman Burns could have stopped it. The intellectual and political environment of the 1960s and 1970s certainly had a lot to do with making the Great Inflation possible. Still, the Great Inflation was not inevitable.

Leadership really does matter.