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"MONETARY POLICY PRIORITIES"

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A great deal of attention has been given to various indicators that might help us to understand the state of our economic health and how to conduct appropriate monetary policy. By way of background to this continuing dialogue, it might be useful to briefly focus on our national long-term economic goals and how monetary policy might best contribute toward reaching them in the face of a host of important new complexities, many of which are totally exogenous to the central banking process.

The basic goals of monetary policy are established by the Full Employment and Balanced Growth Act of 1978, which specifies macroeconomic policy objectives for all of the Federal government, including the Federal Reserve System. It specifies a variety of desirable conditions that center around the concept of sustained economic growth which is very clearly and appropriately the overarching goal of economic policy. Much of our institutional and legal framework is accordingly designed toward that end. One of the conditions, which constitutes a primary responsibility and objective for the Federal Reserve through its authority to set monetary policy, is reasonable price stability.

Reasonable price stability, defined here as a non-inflationary price environment, is an essential prerequisite for sustainable long-term growth. History is crystal clear on that point. Inflation spawns economic inefficiencies which, in turn, create uncertainties and risks in the decision-making process. This inhibits investment, encourages a bias toward short-term decisions, diverts resources away from productive investment and toward over-consumption and other pursuits designed to protect against the erosion of real purchasing power. These conditions preclude satisfactory economic performance over time.

In the short run, of course, there are often tensions between near-term economic performance and progress toward price stability. For example, an overly restrictive monetary policy might well drive down inflation to low levels very quickly. But in the process such a policy would run the risk of inducing a deep recession. In today's environment this could seriously inhibit progress toward solving a variety of critical financial and other economic problems. On the other side of the coin, an overly expansionary monetary policy might, for a time, raise the level of output but if that occurred when (such as now) resource utilization rates were already at high levels such a posture could easily release inflationary pressures. Then the economy could be off on a boom-and-bust roller coaster which would ultimately be self defeating and which, as we saw in the early part of this decade, might require rather draconian measures to set right.

Obviously neither of these two scenarios represents an acceptable alternative and the principal challenge facing monetary policymakers over time is to develop strategies that work toward long-term objectives while avoiding the pitfalls on both sides of the road.

Before speculating on how policy making might best be approached, it is useful to keep in mind some of the complexities found in today's environment which complicate the process. There are at least three groups of considerations.

First, many uncertainties about the domestic nonfinancial economy make confident analysis difficult. Our understanding of the current state of affairs at any given moment in time is limited by the quality and inevitable tardiness of available statistics. Given our imperfect understanding of the structural dynamics of our evolving economy, the net impact of the enumerable factors that importantly affect the economy is difficult, if not impossible, to predict. These include, for example, such concerns as weather effects on food production, OPEC energy pricing, and fiscal and foreign policy decisions. Second, a host of recent financial innovations, while hopefully beneficial in terms of enhancing long-run economic efficiency, add to the problem. Deregulation has changed much of the legal and financial landscape in ways that continue to evolve and are still unclear. New financial concepts and products such as junk bonds, leveraged buy-outs, collateralized mortgage obligations and other derivative securities, are so new that their macroeconomic impact is as yet unable to be assessed. A third area is the recent globalization of capital markets and the much greater impact on our economy of international trade of goods and services. As a result, U.S. markets are now more sensitive to developments emanating from abroad. Due to these tighter linkages, disruptions in one country can quickly spill over into others. While these developments offer great hope for a better world tomorrow, they substantially complicate the consideration of appropriate policy today.

How then is monetary policy to be formulated in this dynamic environment where long-range, interdependent goals are in short-term tension, if not outright conflict, one with another? First of all, it is necessary to be clear about ends and means. As stated above, sustainable long-term growth is the primary social objective of economic policy. Price stability is a critically important precondition to achieving that end, and experience has taught us to be ever vigilant not to lose control of prices in the short-run as this inevitably leads to unacceptable long-term setbacks. However, as a means toward an end, policy that seeks price stability must be structured within a context of the overall social good. To repeat, price stability cannot ever be ignored, but its pursuit must consistently consider the larger stage upon which it plays its role. A good example of this is the modification made to monetary policy immediately following the stock market break of October, 1987.

Let me suggest two tactical concepts as to how best to proceed. First, seek to keep the trends moving in the correct direction. In light of the complexities I have just outlined, this is more consistently reliable than overemphasis on achieving any particular condition at any particular time. We should attempt to keep the trend of economic growth slanted upward as much of the time as possible while recognizing that the speed of advance will vary. Similarly, with inflation, we should work to keep the long-term trend pointed toward zero, realizing that in some economic conditions it may be more productive over time to accept somewhat slower short-term progress. The second tactic is to work toward shrinking the magnitude of economic fluctuations around the trends. The newspaper might call this "staying off the roller coaster" while statisticians might refer to it as "reducing the size of the standard deviation." For the policymaker considering sustainable growth, it means avoiding boom-and-bust episodes. In considering inflation, it means ensuring that there will be no breakout on the up side while maintaining conditions for steady long-term reduction.

In pursuing the above, three mind sets are in order. First, we must exercise caution in light of the many inevitable uncertainties and incomplete understanding of events and their interactions. Second, policy must remain flexible in light of the myriad forces acting in varying ways on the economy, which necessitates a changing mix of appropriate policy factors. And third, growing out of the above, a focus on judging which factors should receive how much weight in the short-term, in order to best move toward the long-term goal.

It is interesting to track the Federal Open Market Committee's evolving perceptions of appropriate policy emphasis. This can be done by examining the FOMC's domestic policy directives which always recite the Committee's concerns in priority order. Such variables in recent years have included inflation, strength of the expansion, monetary aggregates, exchange rates, and financial market conditions. In 1985 and 1986 concern for inflation was well down the list during a period which saw rapid reductions in inflationary pressures. From late 1985 through the spring of 1987 against the backdrop of a sharp depreciation of the dollar, exchange rates took center stage, going from lowest to highest priority. Inflation reemerged as the main concern from May 1987 throughout 1988, as resource utilization continued to increase. The one exception through this period provides an excellent example of how shocks can intrude and flexible responses may be quickly required. Following the stock market break of October 1987, financial market considerations went from totally off the list to the top consideration through the spring of 1988. This has more recently receded as confidence has returned. It is interesting that for the past eighteen months, the strength of the economy has remained in a prominent second place position as the Committee recognized the importance of a maintainable rate of economic growth as key to the solution of many national problems, while each one of the other considerations has moved up and down in emphasis.

To summarize, our nation's primary long-term goal for economic policy is to achieve a high level of sustainable long-term growth and many forces are acting to influence and work toward this end. A necessary precondition is the existence of price stability, and here not so many helpful institutional elements are in place. It is here that the Federal Reserve has assumed a primary role and it is here that the Federal Reserve must make its primary contribution to our nation's economic success. To do this, it must seek to integrate a shifting kaleidoscope of complex and often contradictory short-term factors into a coherent and effective long-term strategy. The key skill is the exercise of judgment as to the proper order and weighting of priorities as circumstances evolve.