

The Critical Role of Economic Education in the Conduct of Monetary Policy

Hawaii Council on Economic Education Annual Meeting
Honolulu, Hawaii
April 25, 2000

I am delighted to be here today to speak before the Hawaii Council on Economic Education. I have spent most of my life in higher education and now, as a policy official in the Federal Reserve System, I am still intimately involved in education issues. My audiences may be different, but the issues are the same. I must say, however, that it is considerably easier to speak to you today than to freshmen at nine in the morning.

I will proceed by discussing, first, why everyone needs to understand the basics of monetary policy. Lots of people, especially young people, seem to believe that those pesky supply and demand diagrams are too difficult and uninteresting to be worth spending much time on. Most people, though, eventually find that they cannot escape knowing something about mortgage interest rates and other mundane matters that turn out to be so terribly important for their economic welfare.

Speaking in the abstract about the importance of understanding monetary policy takes us only so far, however. To get to the real meat of the argument requires that we entangle ourselves in a live issue or two, and spend enough time on the issue to understand why everyone ought to know something about it. For this reason, I'll tackle three issues that strike me as particularly relevant in today's economy. The first issue is that the Federal Reserve really has only one policy instrument, or policy lever. If there is only one instrument, then there can be, or should be, only one policy goal. I'll explain why both of these statements—that the Fed has only one policy instrument and that one instrument requires only one goal—are

true. My second subject will be that we must keep our focus on the long run. John Maynard Keynes is often quoted to the effect that in the long run we are all dead, but that is a terribly misleading thing to say. If we do not look at the long-run consequences of policy actions, we are bound to get ourselves into a lot of trouble.

Thirdly, I'll emphasize that price stability, or low and stable inflation, is a far more important goal than many may think. When the price level is stable for an extended period, people tend to take price stability for granted and fail to understand that many other good features of the economy depend critically on its continued maintenance. By the same token, when the economy suffers from price instability, many things go wrong that should be, but often are not appreciated to be, linked to the loss of price stability.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, but I retain full credit for errors.

SOME BACKGROUND ON FED POLICY PROCEDURES

Before digging into the substance of policy, I need to be sure we're on the same wave length in our understanding of Fed policy procedures. The key interest rate for Fed policy is the federal funds rate. The funds rate, to use market lingo, is simply the interest rate banks charge each other on loans of the funds they hold in reserve accounts

at Federal Reserve Banks. Commercial banks and other depository institutions maintain these reserves on deposit at the Fed in order to meet their required reserves and to make payments as checks clear the banking system. Depository institutions—or “banks” as I will call them from now on—sometimes have surplus funds that they lend out to other banks that have a deficiency of funds. These loans are typically for one day at a time, or “overnight” in market parlance. The Federal Open Market Committee (FOMC) conducts monetary policy by determining an intended, or target, interest rate for federal funds. At the end of each of its meetings, the FOMC directs the Fed’s Operating Desk at the Federal Reserve Bank of New York to maintain the federal funds rate near its intended level. The Desk achieves this objective by placing additional funds in the market when the funds rate threatens to exceed the intended rate, or withdrawing funds from the market when the rate is falling short of the intended level.

Market participants spend a lot of time forming expectations about the likely course of the federal funds rate in the future. The rate on a 1-week Treasury bill, for example, reflects the market’s best guess as to the average for the federal funds rate over the next seven days. The interest rate on a 1-month obligation reflects expectations about the 1-week rate for the next 4 weeks, and the 1-year rate reflects expectations over the next 52 weeks. Continuing this line of argument, the 30-year bond rate reflects expectations about the next 30 one-year rates.

This picture, of course, is complicated by interest differentials of various kinds, but for our purposes the big picture is what we need. Let’s focus on two key elements: First, the FOMC sets the overnight rate, which quite naturally has a significant influence over short-term rates. Second, longer-term rates depend on the markets’ understanding the direction of monetary policy and all of the economic forces that interact to yield that long-run direction. Thus, a very important responsibility for the FOMC is to communicate as clearly as possible the longer-run direction of monetary policy and the considerations that underlie policy decisions.

WHY EVERYONE NEEDS TO UNDERSTAND MONETARY POLICY BASICS

Business enterprises often borrow large amounts of funds, and so the probable direction of interest rates and the monetary policy considerations behind future interest rates are of direct and immediate interest to every corporation. Every firm must also be concerned about future wage and price developments, which means that an understanding of the Fed’s objective of price stability and its success in achieving that objective is important for business managers.

Each of us as a member of a consuming household also needs to understand the basics of monetary policy. From time to time, almost every household is faced with a decision about purchasing a house and must understand the basics of mortgage finance. These basics today require some knowledge of the relative advantages and disadvantages of fixed-rate and adjustable-rate mortgages. To understand the consequences of choosing one of these alternatives over the other, households need to know something about the basics of monetary policy and the likely success of the Federal Reserve in keeping inflation low on a sustained basis. In addition, households need to understand why the Fed is doing what it is doing so that family financial decisions will not be made on the basis of misinformation about monetary policy. Finally, just as businesses need to know something about prices, because businesses buy and sell goods, and about wages, because businesses hire labor, so also households must know something about these same issues. Households, after all, are on the opposite side of these economic transactions from businesses. Households pay the prices that businesses charge and receive the wages that businesses pay.

THREE ILLUSTRATIVE ISSUES THAT REALLY MATTER

The importance of understanding monetary policy basics really comes alive when we con-

sider some examples. I've selected three specific examples that are simple and easy to explain and yet extremely important.

One Policy Instrument Means One Policy Goal

I'll start this topic by making a statement that sounds technical and complicated, but really isn't: In engineering control theory, we know that to achieve N goals requires at least N instruments. For example, if we have three goals like controlling an airplane's speed, altitude and direction, the plane must have at least three control instruments. The throttle instrument controls speed, the rudder in combination with some other surfaces controls direction, and the elevators on the horizontal stabilizer control the plane's altitude by directing it up or down.

Consider another simple example. With two objectives, such as controlling a car's speed and direction, the driver needs two control instruments—a steering wheel and an accelerator.

What is the relevance of all this for monetary policy? The Federal Reserve has only one main policy instrument at its disposal. That instrument is the rate of creation of money, or more generally, liquidity. The Fed exercises control over money creation on a day-by-day basis by adjusting the intended federal funds rate. With only one policy instrument, the Fed can pursue successfully only one policy goal. That goal is low and stable inflation, or price stability, depending on the exact phrase used.

This simple fact that the Fed has one policy instrument and must, therefore, decide which single goal it will pursue is of tremendous consequence. People often insist that the Fed ought to pursue other objectives, such as reducing the unemployment rate, stabilizing the foreign exchange rate, or nudging the stock market up or down. The Federal Reserve cannot in fact pursue multiple objectives and hope to achieve them all. Given that the main consequence of excessive or deficient liquidity creation is inflation or deflation, either of which creates a whole host of other problems, the Federal Reserve must not allow its

primary mission of achieving price stability to be deflected by attempting to pursue other goals.

The issue I want to emphasize is not that other goals are unimportant. All of us want the unemployment rate to settle at as low a level as possible, and we want the stock market to be priced correctly, and we want the foreign exchange rate to settle at an appropriate level. But the Fed simply does not have policy instruments to achieve all of these goals and must instead concentrate on the goal that is its direct responsibility. To repeat, that goal is maintaining low and stable inflation.

Now this basic view can and should be modified just a bit. It is possible for the Fed from time to time to adjust monetary policy to counter problems in achieving other goals, but only to the extent that such policy adjustments do not damage the long-run cause of low and stable inflation. For example, in the fall of 1998, the FOMC reduced the intended federal funds rate to respond to financial disturbances that arose following the Russian bond default. Easing monetary policy temporarily did assist the economy in working through these financial disturbances, without a long-run consequence for the goal of low and stable inflation. By responding to the disturbance, the Fed was able to keep those problems from having an impact on employment and economic activity. The principle involved here is well understood in control theory. The application of a particular instrument may have simultaneous effects on several goals. For example, applying more power to an airplane will increase its rate of climb. But the point is that to fully achieve goals for both altitude and speed, the aircraft must have more than a throttle.

I invite you to keep your eyes and ears open for examples of people urging the Fed to pursue multiple objectives. I suspect that you will find many such examples and that a little thought will indicate just how uninformed these policy proposals are. It is important for the Fed to maintain its focus on what it can reasonably accomplish, and not to permit other issues to deflect it from its principal responsibility.

It's the Long Run That Matters

One of my favorite formats for a student term paper was to ask the student to review a particular economic episode by going back to news magazines and newspapers. Asking a student to read the newspapers for a few weeks on either side of the stock market crashes of 1929 and 1987, or over a few months during the recession of 1982, or a few months as inflation rose sharply starting in the fall of 1973, is an excellent way to get the student to develop a sense of these events.

Economic historians writing about such episodes distill the detailed record into the key events and policy decisions. The job of the historian, of course, is to put events into a longer-run perspective by examining the key milestones, policy decisions, and causal mechanisms. But at any given time, people get caught up in the events of the day and find it difficult to put these events into the appropriate perspective.

As I reflect on how events unfold, I am always struck by the enormous amount of attention paid to information that will, to the historian, be at most random noise. Perhaps you have had the strange sensation, as I have had more times than I like to admit, of picking up a newspaper and after reading for a few minutes developing a strange sense that you must have read this paper before. I look at the date, and discover that I've picked up a newspaper several weeks old. I've already read the paper and have discarded from memory almost every single bit of information in it. Yet, all too many policy positions are driven by the trivial information that happens to hit the headlines.

The long run is, of course, the sum of a series of short runs. One year is the sum of 12 months, and one decade the sum of 10 years. Our economic well-being depends mostly on averages over a decade, and only to a relatively small extent on fluctuations around those averages. Policymakers usually prefer to minimize fluctuations around the long-run trends, but the government's power to do so is often very limited. Thus, a key objective for policy is to prevent short-run fluctuations from affecting policy in such a way as to drive the economy off the desired long-run track.

Policymakers often find themselves confronted by a public clamor to do something in response to a short-run problem. On occasion, a short-run policy response can be constructive, as was the case in the Russian bond default in 1998. But more often the appropriate advice is, "Don't just do something, stand there!"

One argument for keeping policy on a steady, even course is that policy actions in response to short-run disturbances are seldom successful. But the argument is really deeper than that. Productivity growth and job creation in a market economy are driven by thousands upon thousands of decisions in the private sector. An important responsibility of government, including the Federal Reserve's responsibility for monetary policy, is to set a stable and predictable course within which private decisions can be made efficiently. On the whole, households and firms, interacting through markets, do make efficient decisions about prices and quantities of goods and services. Excessive government activism can interfere with the efficiency of those decisions.

If you have any doubts about the overriding importance of the long run, try to think back to the detailed events of a year or two ago. If you start reading newspapers several years old, you will find your memory refreshed but you will be impressed by how trivial in the light of subsequent developments most of those day-to-day events were.

Price Stability Is More Important Than You May Think

The ultimate goal of Federal Reserve policy is to promote maximum sustainable economic growth. We emphasize the importance of price stability because that is the single most important contribution that monetary policy can make toward achieving the deeper objective of maximum sustainable economic growth. The Federal Reserve also contributes to society's growth goals by supervising and regulating banks to maintain a sound banking system and by providing efficient payment services such as check processing and electronic payment mechanisms.

With regard to monetary policy, too few people seem to understand how greatly price stability contributes to the economy's general welfare. Price stability will not by itself guarantee success, for there are many other cooperating conditions necessary. But price instability without question can guarantee significant problems in any economy. The public often attributes these problems to non-monetary conditions when they in fact stem from monetary instability.

The U.S. economy today, and for the past several years, has been enjoying extraordinarily low unemployment and rapid job growth. I believe that stable monetary conditions yielding a low and stable rate of inflation and solid expectations of continuing stability have played a substantial role in the economy's success in the labor markets. U.S. inflation in the 1970s certainly contributed substantially to the employment volatility of that period. The recessions of 1973-75 and 1981-82 were the most serious downturns since the Great Depression, and these downturns arose on the backs of accelerating inflation and expectational errors caused by unanticipated changes in monetary policy. Today, despite an economic expansion of record length, we see no signs that the expansion is closing in on old age. If inflation gets away from the Fed to any significant degree in the years ahead—and I am pushing with every bone in my body to do what I can to make sure that circumstance does not face us—then the dangers of recession will surely rise.

Monetary instability and inflation damage stability not only in the labor market but also on a host of other fronts. Some of you may recall the difficulty people had in buying homes when mortgage rates averaged more than 15 percent in 1982. During much of the decade of the 1970s, falling stock and bond prices damaged income security for older Americans. Public concern over inflation led to the unwise political response of wage and price controls in 1971, and those controls created a vast array of other problems.

I could extend this list to great length, but will not do so. My point is that many features of the 1970s were related to the inflationary environment, and many favorable features of today's

economy are related to the price stability the economy has enjoyed in recent years. Price stability is an abstract goal and is not much worth pursuing for its own sake. But so many aspects of our economic welfare are directly and indirectly connected to price stability that it is important not to underestimate the importance of achieving that goal.

I said a moment ago that I was not going to extend the list of ills from price instability, and the virtues of price stability, but I will break that promise just briefly to comment on the economics of the education sector. Our current prosperity has generated large amounts of tax revenue at all levels of government. These resources are available for a great variety of public responsibilities, including education. With university budgets growing, I know that the university demand for economists is high; that demand makes it difficult for us to hire the young economists we need for our staff at the St. Louis Fed. In contrast, during the 1970s, many state budgets were under substantial pressure because rising prices were out-running the available tax revenues. Some of you may recall the periods of stringency during those years.

Moreover, the relative stability of wages and prices has made the job of educational budget planning a lot easier. All of us may have to scramble to find the talent we need, but we do our scrambling within an environment in which we can reasonably plan our budget outlays. The end result is greater efficiency in matching talent and resources. Clearly, also, with the job market so strong, there are ample employment opportunities for our students as they finish their degrees.

CONCLUDING OBSERVATIONS

By now, I'm sure you have a good idea of the thrust of my thinking. I will, however, point out that I have discussed these and other monetary policy issues that really matter at greater length in a number of speeches over the last two years that I have been at the St. Louis Fed, and I'll put in a plug for our web site that contains those speeches.

ECONOMIC EDUCATION

Finally, then, let me circle back to my main theme about the importance of public understanding of these monetary policy issues for the job of the Federal Reserve System. Some people may take the view that the public should simply put good people in office and then allow these experts to do the job right without further public interference. If that view were correct, then there would be no need for the public to understand much about what we do.

I reject this view for two reasons. First, my observation of American politics tells me that, in a vigorous democracy, people will not sit back and let the experts do their own thing. In fact, I think the voters are right to pay attention to what we do, for experts in power do not always make the proper decisions. Wherever you come out on this issue, the fact is that voters do not ignore what we do, and therefore it is in the interest of the nation that voters understand what good policy is all about. Otherwise, they and their representatives may demand the Federal Reserve to move in directions that will not turn out to be constructive.

There is another reason for the Federal Reserve to be concerned about public understanding of monetary policy issues. In my brief description of monetary policy at the beginning of this speech, I pointed out that the Fed directly sets an intended rate for the overnight federal funds rate while the market sets longer-term interest rates on the basis of expectations about the future. How can the market set the 10-year bond rate or the 20-year mortgage rate without knowing something about monetary policy? The interaction of borrowers and lenders in the marketplace determines those longer-term rates. Mortgage borrowers, for example, need to make judgments about whether the current rate is likely to reflect a good buy or whether the mortgage rate might be lower in the coming months. Similarly, lenders need to decide when to lend and when to hang on to funds in the

expectation that the interest rate received will be higher in the future. To make these decisions intelligently, borrowers and lenders need to understand the basics of monetary policy. Otherwise, they will make mistaken decisions that will ultimately damage the economy's long-run growth. Thus, in pursuing the goal of maximum sustainable economic growth, the Fed must be concerned with much more than setting the intended federal funds rate at the next FOMC meeting. We need to do the best job we can in conveying to the market the reasoning and outlook for monetary policy and the economy more generally. We cannot, of course, forecast the unforecastable, but we can make clear our conviction that maintaining low and stable inflation is our primary responsibility. We can also provide a sense of how we go about responding to and analyzing the flow of incoming information.

Looking at this argument from a business perspective, we know that efficient business management requires firms to make correct decisions in hiring labor, building plant and equipment, designing and pricing goods and services, and so forth. These decisions include efficient financial decisions. And those decisions in turn require some knowledge of monetary policy issues.

I'm sure that most of you in this audience are convinced of the importance of economic education. We need to convince those who teach English, foreign languages, history, and other non-economics subjects that at least a taste of economics is good for every student. Everyone needs to understand the basics to make sound decisions in household financial management. Understanding the basics of monetary policy will pay dividends, both for individuals as citizens and for them as members of households and in their capacity as productive employees of businesses.