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A COMMITTEE MEMBER LOOKS AT THE OUTLOOK

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

to the

National Association of Business Economists'
Seminar on Money Markets

St. Louis, Missouri

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I appreciate the invitation that has been extended to me to address the National Association of Business Economists' 1978-1979 Outlook session on the subject "A Committee Member Looks at the Outlook." It provides an opportunity to make a personal assessment of the economic outlook and to suggest the policies that follow from that assessment. Mainly, however, this is a chance to zero in on the particular problems that members of the Federal Open Market Committee (FOMC) encounter in looking at the outlook.

The Outlook

At this juncture, I believe the economy is close to the full employment zone. Although inflation threatens to accelerate as we come close to the 5-6 per cent range of unemployment, I would not regard that fact as indicating that this rate of unemployment is above the "constant inflation" rate of unemployment. The acceleration that we observe is the result of special although very troublesome circumstances including government actions on minimum wage and farm price legislation, strikes and dollar devaluation. A determined anti-inflationary policy should be able to overcome the effects of circumstances of this sort. The fact that inflation seems to be accelerating, nevertheless, may be a warning that the constant inflation rate of unemployment is higher than many of us would have liked to think.

While the unemployment data may be exposed to crosscurrents, there can be little doubt that we have done very well on unemployment. The Administration's year-end objective of 6.2 per cent was passed in January of 1978. The recent experience suggests that because employment is more uniquely related to the rate of growth, it is a more meaningful variable than unemployment. Unemployment is a function, principally, of both growth and labor force developments. One must question the feasibility, therefore, of setting simultaneous targets for growth and for unemployment. In any event, over-all unemployment is no longer the top priority although sectoral unemployment, especially that of teenagers, continues to be a major social problem.

In restraining inflation, on the other hand, we have done poorly. There is a clear threat that inflation is accelerating, and a great deal of evidence that expectations of future inflation are accelerating.

A simple policy rule should follow from this combination of facts. The rule is that at any time the least attained policy goal should have priority. Today that goal is the restraint of inflation. The validity of the proposed rule is supported by the growing concern over inflation and the increasingly expressed view that inflation is indeed our number one problem.

Still another policy proposition follows from the circumstances described. It is that we must now get ready for a soft landing. We have had a long and fairly vigorous expansion. We have a good chance of extending this expansion provided we are prepared to allow it to taper off gradually from now on. This would still be consistent with further reductions in unemployment. But as time goes on, these reductions should be increasingly the result of structural measures and less that of expanding aggregate demand. That would be the way to phase gradually into the long-term rate of growth of perhaps 3.5 per cent. Since the economy has not yet accumulated irremediable imbalances that could block stable growth, we have a chance now of attaining that admittedly rare condition. An essential proviso is that the redressable imbalances that exist, especially the large Federal deficit and the current account deficit, and above all, of course, inflation, are brought under better control.

Federal Reserve Forecasting

After these general remarks on the outlook, I would like to examine in detail how the Federal Reserve goes about formulating its view of the outlook and its policy targets. This subject is of particular relevance because, under the Federal Reserve Reform Act of 1977, the Federal Reserve in its quarterly presentations to Congress is now required to take account of "past and prospective developments in production, employment, and prices." The Board already is under Congressional pressure to make explicit numerical projections in this regard although the legislative history of the Act indicates this is not required. Under the House-passed version of the Humphrey-Hawkins Bill, moreover, the Federal Reserve would be required once a year to present its intended policies for the year ahead and their relationship to (i) the short-term goals set forth in the Economic Report of the President and (ii) medium-term trends in employment, production and prices for the three calendar years beyond the period considered in the Economic Report. I have doubts the Federal Reserve can do this in any meaningful way. This is partly because of the inherent uncertainties of economics which make projections and targeting, as we have just observed in the case of unemployment, a high risk occupation, and all the more so when undertaken for five-year periods. More particularly, however, it is the structure of the Federal Reserve System and the Federal Open Market Committee that militates against a meaningful exercise of forecasting and target setting. The Committee print which is now before the Senate Human Resources Committee wisely does not require five-year projections.

The Federal Reserve System has a staff of economists, at the Board and in the Reserve Banks, that is probably second to none in the world. This staff engages in careful and detailed forecasting exercises every month. The results, of course, are fully available to the FOMC. However, a staff forecast is not that of the FOMC. Moreover, it would be very unwise to present the staff forecast to the Congress, even as a staff exercise. That would tend to politicize the process, would militate against firm analytic positions being taken, and would make it psychologically difficult for the staff to modify its forecast quickly in the light of changing circumstances.

Policy Makers' Forecasts

For the individual member of the FOMC, it is quite impossible to take the staff forecast literally. Precise numerical forecasts are the product of computers and, in the U.S. Government context, of the need to have hard GNP forecasts for budget making and revenue estimating. Experienced users of such data will tend to think in terms of ranges, of probability distributions, perhaps skewed, and quite likely even of altogether different alternative scenarios.

As policymakers, the members of the FOMC will tend to factor into their own assessment of the future the chance that they have, if the economy develops differently from what they expect or desire, to take action that might help bring the economy back on track. This may lead to rather different evaluations of risks and probabilities than those a passive observer might arrive at.

Given this wide range of possible outcomes, it is most unlikely that all the members of the FOMC would arrive at a uniform forecast. It would not be meaningful for the FOMC, moreover, to vote on the outlook as such. "Truth," or even probability, cannot be determined by majority decision. In the nature of things, there can be no fully agreed FOMC forecast, although means, medians, broad consensuses and the like could be developed. Any such over-all consensus would undoubtedly conceal a large number of differences on specifics.

Policy Makers' Targets

Where the setting of targets is concerned, such as for growth, unemployment, and inflation, the case is different. Targets calling for action can be established by majority decision. Very likely, however, the sets of such targets chosen by individual FOMC members would vary greatly. They would reflect different value judgments, different trade-offs, different degrees of time preference, and differences of views concerning the effectiveness and the lags of the instruments to be employed in pursuit of these targets. Conceivably no single set of three objectives might command a majority. Only broad ranges, or even qualitative descriptions of targets, might attract a consensus.

Furthermore, one must question the very meaning of any setting of targets for the real sector of the economy by policymakers that have only quite limited powers. An FOMC member may believe that certain levels of growth, unemployment, and inflation are achievable if all the powers at the disposal of government were brought to bear. But the Federal Reserve wields only a fraction, in my opinion a very modest one, of these powers. If the much larger powers outside the grasp of the FOMC are not brought to bear, or are brought to bear in ways not conducive to the attainment of these targets, what is the meaning of the FOMC saying that it has such and such targets? This very practical consideration is buttressed, at a more theoretical level, by the familiar proposition that the number of instruments must be at least equal to the number of targets. The Federal Reserve in effect has only one instrument -- monetary policy. Discount rate, open market operations, and reserve requirement changes are only variants of the same tool, permitting only insignificant goal differentiation. It is not possible to achieve independent levels of growth, unemployment, inflation with this single instrument. These factors -- the difficulty of reaching a highly specific consensus and the limitations of control -- are the underlying reasons, I believe, why the FOMC has been wise not to try to set highly specific targets.

Targets and Proxies

What the FOMC typically has done is to specify some financial variable or variables, as a proxy for real sector targets. In recent years, the monetary aggregates have served this function. Naturally one takes for granted that FOMC members' ultimate concern is with real sector variables and not with some financial magnitudes.

But agreement on a proxy is often feasible where agreement on a set of real sector targets would be difficult.

This presupposes, of course, that there is a reasonably close link between the financial proxy, say the money supply, and the real sector. Most people believe, rightly in my opinion, that this is true only to an approximation. In addition, focusing on a proxy variable such as the money supply also can be justified by a belief that the real sector responds to monetary policy action only after a long lag.

The use of a proxy variable greatly facilitates the decision process. There are several reasons for this. First, only one variable needs to be determined, instead of a whole set. Each FOMC member chooses the value of the proxy variable he believes most likely to achieve his real sector preferences, possibly including variables other than the familiar targets of growth, unemployment, and inflation, and including also diverse trade-offs among all of these. Second, the proxy variable, if it is well chosen, will be subject to the control of the FOMC. This is clearly the case of the money supply, although only to a much lesser degree than that of interest rates. Finally, a proxy variable that is within the purview of the FOMC encourages arrival at a consensus or at least at some immediate decision, precisely because action on it is needed and can be made effective immediately. Futile debate over matters that the Federal Reserve cannot control thus is replaced by purposeful discussion of something it can control.

In the FOMC's discussion of the desirable setting of the proxy variable or variables, the expected real sector effects, possibly quite different in the anticipations of different members of the Committee, will play a large role. The Committee is unlikely to mistake an instrumental variable for an ultimate one. But the decision process is greatly aided by focusing on the instrument. At a time when the need to bring down inflation imparts a clear preference for moving a money supply target in a downward direction, this advantage is particularly pronounced.

Congressional Presentation

The nature of a group decision, as described, makes it difficult to formulate for presentation to the Congress, targets for the real sector, as has sometimes been proposed. Thc FOMC does not formulate such goals internally for its own purposes. It probably is wise not to engage in an overly formalistic exercise of that sort, so long as the consensus, to the extent that there is one, can be expressed through a proxy. Such an attempt could polarize, perhaps paralyze, a group otherwise capable of action.

There is a second reason why explicit formulation of detailed real sector targets would be undesirable. In all probability, the exercise would generate pressures on the Federal Reserve, emanating from the public, the Administration, and the Congress, for more credit creation and monetary expansion. But, as noted above, consistency among real sector targets, and consensus on them, is difficult to achieve even in a small and quite professional group such as the FOMC.

The chances that targets urged by outside groups should turn out to be consistent and feasible must be evaluated with even greater skepticism.

Adequate coordination between monetary policy, fiscal policy, and other government policies must, of course, be achieved. The present procedure for coordination is simple, albeit largely implicit. The Congress, the Administration, and the Federal Reserve all develop their forecasts of the economy and their views of appropriate policies in the light of information about the forecasts, targets, and operating plans of the others.

The most explicit and continuous communication concerning expectations and policy intentions probably is provided by the Federal Reserve. As I have already mentioned under the Federal Reserve Reform Act, the successor to House Concurrent Resolution 133, the Fed must report to the Congress quarterly on its one-year money supply targets, taking account of past and prospective developments in production, employment, and prices. Given the ability of the monetary authorities to implement their money supply targets, therefore, Congress and the Administration are enabled to form reasonably dependable expectations of future growth of the money supply. The ability of Congress and the Administration to generate reliable expectations in the fiscal and other areas may be subject to greater uncertainty, although the Budget Control Act of 1974 has helped in this regard. But an appropriate fiscal-monetary mix can be made to emerge from actions based on these sets of expectations.

This form of fiscal-monetary coordination, to be sure, is somewhat looser than those who believe in centralization of macro decision making might like to see. It should be noted, however, that coordination of expectations is the best that can be attempted, since full control of monetary and fiscal variables, in the nature of a market economy, is not possible. Moreover, there is no single focus of policy even for fiscal policy decisions and other government policies. In varying degree, these policies are determined by interaction between the Congress, the political forces in the Executive Branch, and the bureaucracy.

Congressional and Executive Branch Moves to Influence Federal Reserve Policy

The Federal Reserve communication with Congress and with the Administration should of course be forthcoming and meaningful. It should not, however, change the role of the Federal Reserve.

There are grounds for concern that there have been so many legislative proposals in recent years which have sought to reduce the degree of independence the Federal Reserve has historically enjoyed. In the case of the Federal Reserve Reform Act the legislation was substantially modified before passage and the modifications in the Humphrey-Hawkins bill have not yet been completed. Yet both these projects of law explicitly require that we set targets and provide for Congressional review of our performance. This could accord the Congress a growing influence over Federal Reserve policies in the years ahead. I believe that members of the Congressional Budget Committees would give ample testimony to the Congressional bias towards enacting programs -- the sum total of which are inflationary. It is my expectation that a similar bias may develop in Congressional recommendations concerning monetary policy.

This worrisome trend is reinforced since legislation subjecting the Federal Reserve to a GAO audit -- and the GAO is the investigatory arm of the U.S. Congress -- is well advanced in the Congress.

The Federal Reserve fought this legislation for many years because it feared that GAO audit would go beyond a financial audit and become a performance audit of our monetary policy. Fortunately, under the evolving Bill, monetary policy is still exempt from the GAO's sway, but no one can tell for how long. If our monetary policy decisons ever are audited, it will not be difficult, with the benefit of hindsight, to demonstrate that Federal Reserve policies have fallen far short of perfection. The more numerous and more specific the targets that we are required to announce because of legislation, the more glaring will be the inability to attain all or perhaps even any of them. Once such "failure" is documented by an official audit, what could be more reasonable than for Congress itself to take over direct control of monetary policy in order to remedy this "mismanagement," and what would be the predictable consequences?

There are many arguments for and against central bank independence. They turn on the degree to which monetary policy follows the democratic process, the degree of coordination with fiscal and other policies, the need for the Executive -- or the Congress -- to have adequate control of all policy instruments. But fundamentally there is only one issue. It is inflation. The founding fathers of the Federal Reserve System knew very well that for politicians the power to print money represents a temptation difficult to resist. It was clear to them that more Executive or Congressional control over the printing press would mean more inflation. Independence of the central bank would mean less inflation. That was the basis on which the legislators who designed the Federal Reserve Act made their choice. It remains to be seen whether their successors will abide by that choice.