ALAN R. HOLMES LECTURE SERIES
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Monetary Policy in a Global Economy

I. Introduction

A. Thank you for inviting me here today to give the annual Alan R. Holmes memorial lecture.

1. Alan Holmes was an economist for 31 years at the Federal Reserve Bank of New York, serving for a number of years as Executive Vice President. But it was as Manager of the System Open Market Account that Alan Holmes literally made monetary policy happen.

2. Mr. Holmes was in charge of the day-to-day implementation of the policies of the Federal Open Market Committee, the body which, as you know, shapes U.S. monetary policy.

B. As such, I believe that it is appropriate that in memory of Alan Holmes, we address the motivations behind FOMC decision-making.

1. In my lecture today I will discuss the goals of monetary policy at the U.S. Federal Reserve and in the global economy, and I will reflect on changes in the focus of monetary policy in the past 3 decades.

2. Before I begin discussing my main topic, I'd like to take a few minutes to discuss an issue that's very much in the news—Y2K .

3. Preparing for Y2K is the top priority for the Fed, and it's the topic of the year for the public at large. Between now and January 1st, we all have important roles to play.

II. Y2K

A. The public's role is to maintain perspective, use common sense, and not overreact. As a country, we've worked together to meet important challenges in the past. I'm confident that the public will keep the Year 2000 in perspective, realizing it's one more challenge we will meet.

   1. To meet this challenge, however, it's important that the Fed and others involved in Y2K efforts provide the public with reliable, accurate information. Lately we've seen that consumers are getting conflicting messages about steps they should take to prepare themselves for Year 2000.

   2. It's important that we aggressively combat misinformation that confuses the public. That's why the Fed is taking an active role in Y2K communications.

B. No one can say there won't be any glitches, but we're confident that the financial system will be prepared. The Federal Reserve is committed to doing all we can to safeguard the stability of the U.S. financial system. The Fed and financial institutions are making extensive preparations and things are going well.

C. The Fed has set some very ambitious goals for certifying our internal systems and we've met all of them so far.

   1. Our internal systems were fully compliant as of the end of March. We're also developing detailed contingency plans to handle any glitches that occur in the early days of 2000.

   2. We expect that any Y2K problems will be of limited duration. The Federal Reserve has vast experience in handling disruptions such as national disasters. We've learned how to keep banks open and critical systems going.

D. We've also made significant progress in working with banks that use our financial services. We began testing with banks and thrifts last June.

E. More than 6,000 of the Fed's customers across the nation have already conducted tests with the 12 Federal Reserve Banks.

F. Regarding the readiness of banks, we're working closely with the other regulators to review the preparedness of the financial institutions we supervise.

   1. Ultimately, it's up to the banks to ensure that they are ready, but the results of our Y2K exams so far indicate that the vast majority of institutions are making satisfactory progress.

   2. We don't have any institutions that are seriously behind. In fact, only a very small number of the banks we supervise are not in full compliance with our guidelines.

G. As you may know, the Fed has acted to ensure that more than sufficient cash will be available throughout 1999 and 2000. As a precaution, the Fed will increase the currency in circulation and in our vaults to about $700 billion in late 1999—that provides a cushion of about $200 billion to meet any increase in demand.

H. To sum up, we've all devoted a lot of time and effort to preparing for Y2K. I'm confident that our work is going to pay off and that our nation's banking system will be prepared for the century rollover.

III. Monetary Policy

A. Let me now turn to my main topic today: monetary policy in a global economy. The focus of monetary policy has shifted a great deal over the last 3 decades.

   1. As I will show in the first half of my talk today, the trend has been toward Fed policy being increasingly focused on seeking to achieve maximum sustainable growth by pursuing low inflation. In this first section I will also spell out some of the limitations of monetary policy beyond ensuring price stability.

   2. In my speech I will address two examples of how governments abroad are dealing with the issue of insuring that the formulation of monetary policy is insulated from political pressures. Both cases are currently at the top of the news: the European Monetary Union and the possibility of dollarization in Argentina.

B. To understand the goals of monetary policy it is useful to think about the goals of public policy more broadly. Public policy as developed by elected officials can have many objectives.

   1. Some policies may be designed to defend people's rights to work and obtain education; others may allow freedom of expression and the pursuit of ideas. Still others may protect people's right to accumulate wealth.

   2. Other objectives are redistributive and aim to ensure that all people have equal opportunities. These may include social insurance programs, and urban development subsidies to stimulate growth in underdeveloped regions.

   3. With all these different and potentially conflicting goals, various measures are used to evaluate the effectiveness of public policy. Some clear measures of success would be maximum employment, even growth across regions and cities, and equitable income distributions.

C. Of course, monetary policy cannot address these many and disparate goals. For example, the Fed can't address the distribution of employment across geographic regions and income levels.

   1. In the United States, Congress has mandated the goals of the Federal Reserve through its initial charter in 1913 and subsequent legislation, such as the Humphrey-Hawkins Act of 1978.

   2. The goals of monetary policy as now identified in the Federal Reserve Act are "maximum employment, stable prices and moderate long-term interest rates."

   3. In other words, far from being able to address the distribution of employment across the regions and income levels, monetary policy must be focused on national aggregate goals.

D. However, the fundamentals of the economy place limits on the Fed's effectiveness in obtaining these goals. Monetary policy cannot in any substantial manner permanently lower unemployment or raise economic growth. Attempts to engineer higher growth through expansionary policy can lead to the type of inflation we experienced in the 1970s.

E. Let me take a minute to review what would happen if the Fed tried to boost the economy above trend growth or potential growth by lowering interest rates.

1. As interest rates were lowered, liquidity would be created and more credit would be provided to borrowers at lower costs. Consumers would finance a higher level of expenditures on interest sensitive goods than previously expected, under the belief that real incomes would rise to meet the higher debt servicing.

2. Firms would face lower costs of funds, and hence lower hurdle rates for approving new investments. Consequently, they would approve more investment projects than were previously considered unprofitable, and undertake more risk for lower expected returns.

3. But as the monetary stimulus would cause aggregate demand to outstrip the economy's productive capabilities, prices would rise faster. Real wage growth would fail to materialize as hoped, and, as a result, the debt servicing would be more burdensome.

4. The lower rates of return on investment would no longer be perceived as acceptable. Projects would be cancelled if possible, and larger debts would serve as an overhang on firms' prospective plans. A pattern of boom would give way to bust, and excessively expansionary monetary policy would lead only to higher inflation and not permanently higher levels of economic activity.

5. This sort of short cut to prosperity has always been a temptation to government.

F. The good news is that the Fed hasn't attempted this sort of maneuver since the 1970s. Let's go back to that era … 1969, my first year in government.

1. I was a Senior Staff Economist at the Council on Economic Advisors in the Nixon administration at that time. The Bretton Woods era of fixed exchange rates was headed toward an unexpected end. We were still in the longest recorded economic expansion in U.S. experience.

2. By the end of that expansion, inflation had begun to accelerate to rates that were unusual for those times. We were starting to see the effect of the "guns and butter" economy. The cost of new social programs combined with the Vietnam War triggered inflation.

3. At the end of 1968 core CPI inflation, which excludes food and energy, was running at 5.1 percent. Just three years earlier core CPI was 1.5 percent.

G. By 1971, there was a feeling that monetary policy was ill-equipped to combat inflation of this kind. The times seemed so desperate, in fact, that the U.S. was even experimenting with unorthodox policies such as wage and price controls.

1. At first these efforts managed to temporarily bring down inflation — to 2.8% in 1972. But by 1975, prices were rising sharply, and the economy was slowing.

2. In other words, we were experiencing stagflation. Thanks in part to the unsuccessful price control efforts, and in part to the oil crisis, the mid-1970s were characterized by a frustrating combination of sluggish growth and high inflation.

3. As director of the Council on Wage and Price Stability, I saw first-hand the futility of any attempts to battle inflation through centrally administered controls. What happens when you try to regulate away inflation is that entrepreneurs, workers and consumers focus on overcoming costly and misguided regulations instead of channeling their creativity and energy toward creating value and prosperity.

H. Yes, some of the fundamental truths of the dismal science can be very dismal indeed.

1. One of the hardest-to-swallow truths in economics is that monetary policy only works indirectly in fostering economic growth. In the long run, the Fed can not create employment; it can only indirectly address unemployment problems by creating a healthy environment for growth through price stability.

2. The success of monetary policy makers in recent years has come in large part from this humbling understanding. Just as we can't mandate away inflation by outlawing it with price controls, monetary policy can't target unemployment.

I. What can monetary policy accomplish? Let's compare the current expansion with the expansion of the 1960s I just described.

1. The U.S. is experiencing the longest peacetime expansion ever. In ten months it will become the longest expansion of the postwar era period.

2. The labor force currently totals over 138 million people, the unemployment rate is 4.2%, and over the last three years the real GDP has grown at a annualized rate of 4.0%.

3. And yet, core CPI inflation has been drifting down throughout the decade, and has averaged below two and a half percent over the last three years.

J. Everywhere I go, when I talk with business people, I hear the same comments about prices.

1. Firms no longer expect that they can raise prices routinely in order to improve revenues and profits. Instead, cost-cutting and productivity enhancements are the focus of their profit development plans.

2. Is it a coincidence that we've had low inflation during this expansion, and strong productivity growth? I don't think so.

K. What role has monetary policy played in these economic developments?

1. Well, from February 1994 through February 1995, the Federal Open Market Committee responded aggressively to signs that bottlenecks were emerging and aggregate demand was growing strongly above its sustainable path. Sensing that inflation was about to be re-ignited, the FOMC increased the federal funds rate from 3 percent to 6 percent in a series of steps over a twelve-month period. Since then inflation continued on its downward trajectory.

2. Although some might disagree, I would argue that this tightening clipped the top of an unsustainable boom. Although many factors have contributed to our current expansion, the Fed's actions have been an important factor in extending the current expansion.

L. I have argued today that a central bank must focus on long-term sustainable growth and price stability.

1. Periodically, however, events arise where a central bank must place greater weight on the short-term economic landscape.

2. The response last fall of U.S. monetary policy to the global financial crisis highlights an essential role a central bank must play in the short-term as well. Fortunately, this is completely compatible with the goals of sustainable growth and low inflation.

3. The circumstances that led to the Fed's monetary policy decisions highlight the important role of the financial sector.

M. A classic risk for financial institutions, such as banks, is the mismatching of the maturity of their assets and liabilities.

1. As the simple example goes, banks raise funds by creating demand deposits for their retail customers. These funds are loaned out for a period of time. The bank's liabilities have zero maturity, since the deposits can be redeemed on demand. The bank's assets have a longer maturity.

2. For decades, this problem has been recounted every holiday season by Jimmy Stewart in "It's a Wonderful Life." If too many of the bank's depositors show up to redeem their funds, the bank will be unable to quickly liquidate its long-maturity assets at non-fire-sale prices.

3. A liquidity crisis can ensue even though the bank is initially solvent: if the bank had temporary access to funds, it could rearrange its debt-maturity structure and remain liquid. If the bank borrowed from the Federal Reserve at the discount window, the Fed would be serving as a lender of last resort.

N. Now when Russia defaulted on its sovereign debt obligations in the summer of 1998, several highly leveraged institutions experienced a liquidity crisis of immense proportions.

1. As these firms scrambled to adjust their debt-maturity to make margin calls, investors worldwide lost their appetite for risk and a massive flight-to-quality ensued.

2. Interest rate spreads between private and Treasury securities rose dramatically, with some at historically high levels.

3. The Federal Open Market Committee monitored this situation closely, and became concerned that credit-worthy borrowers in the U.S. might not be able to obtain capital for clearly productive investments. In that event, a credit crunch might have reduced economic activity dramatically.

4. Consequently, in the fall of 1998, the FOMC reduced the federal funds rate on three separate occasions from 5.5% to 4.75%.

O. When it eased monetary policy last fall, the Fed was maintaining its focus on price stability and sustainable growth.

1. As I mentioned, if a severe credit crunch had ensued, economic activity would have declined, perhaps severely. In that case, aggregate demand would have fallen well below the economy's ability to produce goods and services. Inflation would have slowed dramatically. Providing additional liquidity at such times is consistent with the Fed's general goals.

2. In a severe situation, deflation may have occurred, although in the case of the U.S. last fall that is probably overstating the risk.

3. Recall that the Fed is committed to maintaining price stability as a means of keeping the economy on track for maximum sustainable growth. Erratic changes in the inflation rate may hamper growth. For this reason, it's important for the Fed to respond to instability in financial markets by providing additional liquidity through lower interest rates.

P. A subtle but important issue remains unresolved. It is often difficult to define when an illiquid institution passes from being simply illiquid to being also insolvent.

1. If liquidity is supplied to an insolvent institution, then inflationary pressures could emerge if the bankrupt firm's debt became government debt that was subsequently monetized. I won't dwell on this specific issue any longer.

2. However, the ability of governments to pay their debts through taxation rather than inflationary financing is an important ingredient for keeping long-run inflation low.

3. This is recognized in the Maastricht treaty and the Growth and Stability pact for the Euro countries, and in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 in the United States.

Q. By way of comparison, let's move on to how monetary policy is being implemented in other industrialized countries. It's interesting that a number of new monetary institutions internationally are being designed to focus exclusively on price stability.

1. The new European System of Central Banks, for example, now establishes monetary policy for the eleven Euro zone countries. The only goal of monetary policy is to keep inflation between zero and two percent within the Euro zone. No explicit references are made in the central bank's mandate regarding economic activity or unemployment, except as they relate to inflationary pressures.

2. In the United Kingdom, which hasn't joined the new European Central Bank, Prime Minister Tony Blair's Labour government immediately granted independence to the Bank of England upon coming to power in 1997. The Bank of England's single mandate is to keep inflation within one percentage point of 2.5%.

3. And the list of other countries which have strict inflation targets for their central banks includes Canada, New Zealand and Sweden.

R. The theoretical foundation for the narrow goals of these central banks is that monetary policy cannot keep economic activity above its sustainable level, but monetary policy can keep inflation permanently low. Therefore, the best way for a central bank to foster sustainable growth is to ensure an environment of price stability.

S. But again, focusing on price stability does not mean that central banks should ignore real economic activity.

   1. The rationale is simple enough: the state of aggregate demand relative to the economy's ability to supply these goods and services is important for assessing inflationary pressures. It is as important for a central bank to take into consideration economic indicators as it is for a central bank to react to inflation.

   2. Thus, for example, in 1997 and early 1998, the Bank of England concluded that aggregate demand was running ahead of supply, even though inflation was reasonably contained within its band around 2.5%. Monetary policy was tightened largely on the basis of these real economic measures.

   3. Similarly, the new European Central Bank will undoubtedly give substantial weight to monetary aggregates, similar to the Bundesbank in Germany. Nevertheless, in keeping with its focus on price stability, President Duisenburg's press conferences to date have discussed a wide range of real economic data.

T. The monetary policy process in the United States focuses a large amount of attention to factors such as real GDP growth, employment conditions and consumer attitudes.

   1. The Federal Reserve is charged under Humphrey Hawkins with a number of goals, but even if our mandate were to simply maintain price stability, the FOMC would still routinely monitor aggregate demand conditions.

   2. As long as inflation tends to be driven by aggregate demand conditions relative to the economy's ability to produce goods and services, monetary-policy making under the US system will be quite similar to the European system.

   3. Under these circumstances, it makes little difference if low unemployment as well as price stabilization are both specified as monetary policy goals. In other words, although the European Central Bank and the Fed have different mandates, in many situations the policy responses will be similar.

U. Why do different central banks with different monetary policy goals undertake similar policies? This is due to essentially two important factors.

   1. First, as we've already discussed, central banks understand that monetary policy cannot keep unemployment permanently lower, but can lower inflation permanently. This leads monetary authorities in question to pursue policies that keep economic activity as close to sustainable growth paths as possible while keeping inflation low and contained. But there is more to this.

2. The second factor is that all participants in the economy must view the central bank's pursuit of these goals as credible. This is one factor in the formation of the European Central Bank: the member countries anticipated that they would all benefit from the low-inflation credibility of the Bundesbank.

3. Although credibility is important at all times, it is critical in countries with large fiscal deficits and government debt. In these situations, there is a tremendous temptation to inflate the debt away by printing money if the tax system is dysfunctional.

V. Countries that succumb to this temptation often find their currency under attack. Extreme cases of this can result in chronic high inflation, such as that experienced by Argentina and Brazil in the 1980s.

1. Governments in these countries attempted to halt price increases by changing monetary policies and introducing exchange rate pegs, price and wage controls and new currencies — but without implementing the fiscal austerity necessary to curb money growth.

2. As a result, their stabilization programs failed to curb inflation. In contrast, later programs in Brazil, Argentina and Israel have included fiscal restraint and were more successful.

W. One instrument many countries have used is to fix the exchange rate to a stable currency, like the U.S. dollar, and then promise to maintain the exchange rate peg by pursuing appropriate monetary and fiscal policies.

1. An important question then becomes, how credible is the exchange rate commitment? One way to demonstrate more credibility is to back the currency one-for-one through a currency board.

2. Argentina's Convertibility Plan of 1991 is an example of this. News reports indicate that Argentina is considering going one step further by abandoning its own currency, the peso, and using the U.S. dollar instead, a process called dollarization.

X. It doesn't appear that such a move is close to becoming a reality in Argentina. But it does provide an interesting case study on the difficulty of building credibility on exchange rate commitments.

1. For the past 8 years, Argentina's monetary system has been closely linked to the dollar. Every peso in circulation is backed one-for-one by foreign reserves in dollars, and the currency board stands ready at all times to convert pesos into dollars one-for-one.

2. The currency board operates like 100% reserve banking. Anyone who has doubts about the peso's value can get dollars instead from the board. A currency board has two main properties: the value of the currency is firmly pegged at a fixed rate, and the government does not have the ability to create money at will. There are arguments, pro and con, about the desirability of both properties.

3. One disadvantage is that the Argentine central bank would cede its control of monetary policy to the U.S. If the economic conditions in the U.S. are significantly different, the same monetary policy may not be appropriate for both countries.

4. One advantage of a control board is that it should protect Argentina from turmoil in foreign exchange markets.

5. However, this advantage is dependent on the market's belief that Argentina will maintain its currency board.

Y. Nevertheless, Argentina has encountered problems. Earlier this year Brazil experienced extreme pressure on its currency and abandoned the rate at which the real was pegged against the U.S. dollar.

1. Brazil's problems had a ripple effect on Argentina, which suffered bouts of speculation against its currency, capital flight and high interest rates. Argentina is close to Brazil geographically and has a tight trading relationship with Brazil. But a decrease in exports to Brazil would not have been absolutely devastating to Argentina.

2. Furthermore, the two countries have fundamentally different economies. However, investor perceptions caused a contagion effect. Argentina suffered from a similar speculative bout in the aftermath of the Mexican crisis in 1995 — the so-called "tequila effect". Even though Argentina was committed to its currency board, investors demanded higher interest yields to compensate for their fear of a peso devaluation.

Z. The implicit fear of the capital markets is that Argentina might change its monetary system although the currency board has been in place for 8 years. It could decide to print pesos and issue them in exchange for government bonds — thereby, monetizing a deficit. Given their recent experience, the Argentines are reexamining the value of having a printing press. Dollarization would mean a much more credible commitment than the present currency board because it would be more difficult to undo.

AA. How could Argentina implement such a program? Argentina could do it on its own, or it could negotiate an agreement with U.S. monetary authorities.

1. Doing it on its own is simple, in principle, because Argentina already has the dollars or their equivalent, in the form of the currency board's reserves.

2. It could simply buy a lot of dollar bills from the US with those reserves, exchange the outstanding pesos for the dollar bills and burn the pesos. Argentina would prefer not do that, because it means giving up those reserves forever.

3. As things currently stand, the reserves are earning interest for the currency board. The interest would be lost with unilateral dollarization. This cost may or may not be smaller than the benefit of dollarization.

4. If that cost was reduced while keeping the benefit of increased credibility, Argentina might be more likely to go ahead.

AB. If Argentina decided to pursue dollarization, one option for reducing the costs of the program would be to pursue an agreement with U.S. monetary authorities.

1. Under this arrangement, instead of selling its reserves to the Fed for dollar bills, Argentina would lease them. The reserves would remain Argentina's, but be held in, say, a Swiss bank. The Fed and Argentina would share the interest earned.

2. Of course, the Fed would be wary of printing a large number of bills, even if they are to be shipped to Argentina. What if they all came back to the U.S. and generated inflation?

3. One approach for Argentina would be to reach an agreement to treat the reserves as a kind of surety bond. If Argentina reneged and went back to the peso without warning, the Fed could seize the reserves.

4. The advantage to the U.S. would be its ability to print dollar bills on which it will earn some interest, without adding to its money supply.

AC. I should note that I offer this description only as an interesting case study, not as an endorsement. My understanding is that this idea is only at the discussion stage in Argentina. Obviously such a change would be highly involved and require a great deal of study on Argentina's part.

III. Conclusion

A. In conclusion, I would like to note that low inflation is currently a global phenomenon across industrialized countries, and global monetary policies have undoubtedly contributed to this.

1. Economies whose central banks focus on keeping inflation down and maintaining sustainable economic growth rates are likely to be rewarded with higher productivity growth and prudent access to financial capital.

2. Steering clear of persistent and unsustainable government budget deficits minimizes the likelihood of rampant inflation due to debt-monetization. In recognition of this, many countries have recently chosen to accept more restrictive monetary and fiscal policies.

B. This doesn't mean that unemployment must be high or economic growth must be low: other public policies should be considered for tackling those persistent problems. But for tackling inflation, the appropriate tool should be monetary policy.