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economic commentary

Monetary Policy in the 1980s

by Karen N. Horn

Twenty years ago policymakers were optimistic that monetary and fiscal policies were capable of maintaining both full employment and price stability. With longer lags involved in deciding on and implementing tax and budget policies, fiscal policy became a more complicated process, less able to respond quickly to adverse shifts in employment and output. Consequently, the responsibility for stabilizing the economy fell more and more to the nation's central bank, and monetary policy objectives alternated between fighting inflation and fighting unemployment. At the peak of the business cycle, monetary policy was aimed primarily at subduing inflation; at the trough of the business cycle, monetary policy was directed at spurring business activity. By switching objectives between inflation and unemployment, both battles were lost. Experience shows that the Federal Reserve cannot, for very long, trade off a little more inflation for a little less unemployment. Indeed, our experience in the past 20 years has been the opposite, as inflation rose to higher levels in each expansion period and unemployment rose to new heights in each recession (see chart 1). To the extent that any trade-off exists, it is only temporary.

Focusing on Inflation

The experience of the past 20 years prompts two observations. First, the Federal Reserve does not have the tools or the knowledge to manipulate the economy in the short run to achieve full employment. Second, full employment cannot be achieved on an enduring basis in an inflationary environment. The difficulty, if not the impossibility, of achieving short-term goals, coupled with the growing awareness of the overriding importance of an inflation-free environment, has led to a consensus that price stability over the long run should be the central bank's primary goal. What do we mean by price stability? In theory, it can be argued that it does not matter whether the inflation rate is 0 or 5 percent, as long as it is predictable. In practice, we have found that *some* inflation soon becomes *more*, and that inflation becomes even less predictable at higher levels.

Adjusting to high levels of inflation in the real world is not costless, even when those levels are predictable. Repeated failure to deal with inflation on a long-term basis all but forced consumers, businessmen, savers, and borrowers to expect future inflation to be worse than current inflation. Eventually, the expectation of future inflation became entrenched in financial markets, and investors built a substantial inflation premium into

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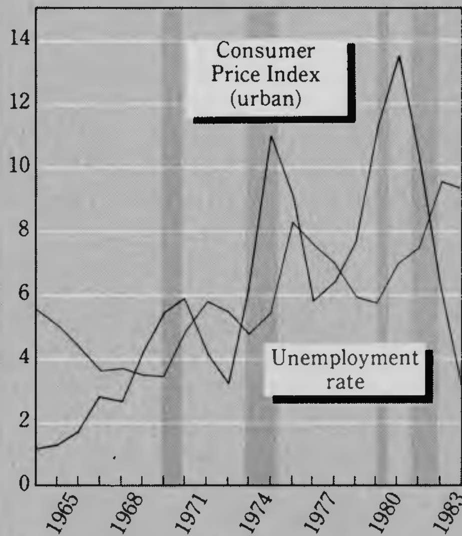


Chart 1 Inflation and the Unemployment Rate
Annual percent change

SOURCE: Bureau of Labor Statistics.

interest rates. Accelerating inflation led to more uncertainties and risks in financial markets as well as to distortions in savings and investment. These distortions eroded the stock of productive capital, lowered worker productivity, and contributed to even higher unemployment rates. Although there are certainly many who would disagree, economists increasingly have come to realize that the central bank can do little to promote full employment except provide an economic environment that includes a sound financial system and a stable price level.

Suppose we were to accept the objective of price stability as the principal goal of the central bank. What would this mean for monetary policy? We are now in the midst of, or perhaps half way through, a program to end inflation by gradually slowing the growth of money and credit. When this program began, it was informally defined as a policy to reduce the annual growth targets for the money supply gradually each year until inflation was eliminated. Because there are times when our daily open market operations do not conform to our inflation objective, the Federal Reserve needs intermediate targets that allow it to react correctly to unfolding events and incoming information. Perhaps at this time, when so many are calling for an end to monetary targeting, it might be worthwhile to review the reasons why the Federal Reserve has chosen to pursue intermediate targets on an annual basis.

Choosing a Target

At first, it may seem more appropriate for the central bank to react to incoming information about prices—if, after all, our objective is stable prices. But the objective is to achieve stable prices, or zero inflation, over several years. The central bank has neither the ability nor the desire to prevent short-run fluctuations in the price indexes—fluctuations that result from myriad adjustments in supply and demand in many different sectors of the economy. If there were no inflationary bias in monetary growth, then all the shocks to aggregate demand and aggregate supply would cancel out. On the other hand, the inflationary impulse from excessive monetary growth shows up in reported price indexes only after many quarters—perhaps years.

The central bank probably would contribute to instability in the economy if it tried to react on a daily or weekly basis to incoming information about specific price indexes. We might go even further and suggest why policymakers should not react to price movements on a quarterly basis. There is cyclical movement of prices around the secular trend. Prices tend to rise least in the early years of a recovery. It is during this period, when the momentum of the economy is upward but before inflationary expectations begin to rise, that a disinflation policy designed to prevent future inflation would be least disruptive. Prices tend to rise fastest around the peak of the business cycle. At that point, inflation is already entrenched in the economy, becoming increasingly difficult for the central bank to control.

Today, if the Federal Reserve were to react only to incoming information about price indexes, it would have little reason to contain monetary growth. Rather, the Fed would wait to tighten monetary policy until the current recovery was well documented and prices began to rise. By then, however, inflationary expectations might become embedded in labor contracts and investment decisions. Tightening monetary policy at that point would tend to cause hardships as firms and individuals would be forced to revise their expectations and their contracts.

Another policy approach currently getting much attention is for the Federal Reserve to target nominal GNP. This choice has an advantage over a price target in that the lags from monetary policy to GNP are shorter than those to prices. However, the time horizon over which the Federal Reserve may expect to control nominal GNP is highly variable and still measured in years—not quarters. Under the Full Employment and Balanced Growth Act of 1978, the Federal Reserve is required to operate on an annual reporting cycle. It is not clear that the potential benefit derived from switching to a multi-year planning cycle would

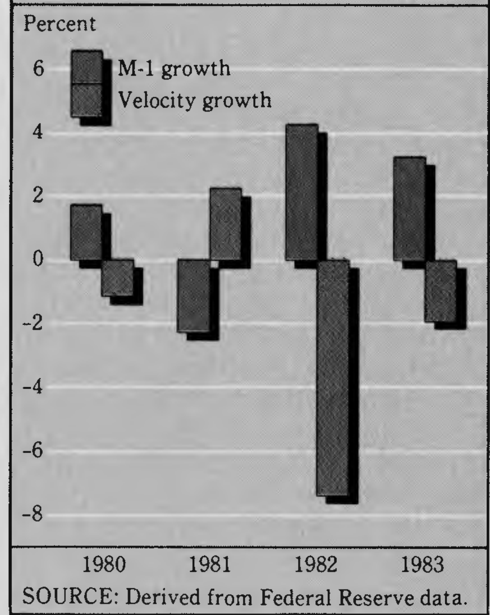
satisfy Congress' and the public's desire to discuss policy on an annual basis. Looseness in the linkage between money and GNP, together with the existence of the business cycle, suggests that the Federal Reserve would have almost no chance of ever achieving an annual target for GNP. Again, as with the case of price indexes, there are many short-run fluctuations in nominal GNP that are transitory and need not induce a change in monetary policy. This does not mean that the Federal Reserve should ignore current information about GNP or prices. Incoming information that leads us to change our estimate of the trends in these variables should be and has been an important factor in setting annual monetary targets and in deciding either to change those targets or permit deviation from them.

Targeting the Money Supply

In 1982, our effort to lower the money targets gradually each year was set aside. A series of well-documented events led to a sharp shift in the linkages between the money supply and total spending in the economy. Massive shifts of funds among the various measures of the money supply—the monetary aggregates—distorted the growth of those aggregates, particularly of M-1. Other factors, such as the sudden decline in inflation and improved expectations about the future cost of holding money relative to other financial assets, also played a role. The Federal Open Market Committee agreed to de-emphasize the M-1 policy target and to place more emphasis on the broader monetary aggregates. As events since have proven, that decision did not mean that the battle against inflation was over. It was merely an acknowledgment that events had occurred that made the preannounced targets inappropriate—indeed inconsistent—with our policy to end inflation gradually.

In retrospect, we believe that the surge of M-1 in the first half of 1983 and the subsequent slowdown resulted from the effects of the ongoing deregulation of the financial markets and lower inflation itself. These transition effects appear to be ending. Barring further substantial changes in depository regulations, we expect the linkage between money and spending to be restored. This does not mean that the money supply would become perfectly predictable, or even that the relationship between the monetary aggregates and nominal GNP would become any more stable and predictable than it was in earlier times. Nevertheless, the current dissatisfaction with the M-1 target probably stems from M-1's unusually rapid growth throughout the last recession. Although we cannot yet be totally sure, this anomaly most likely resulted from deregulation and the decline of inflation expectations. While we have no guarantee of how M-1 will behave in the future, the last three years have shown that the Federal Reserve can achieve its disinflation goal using annual monetary targets, even in the presence of enormous distortions to the aggregates. This success is predicated on the Federal Reserve's freedom to deviate from its targets when appropriate. An analysis of the last four years shows that the Federal Reserve did not achieve its original monetary targets; yet, in each of those four years, the deviations from target can be most accurately interpreted as reflecting offsetting deviations in the velocity of money from trend (see chart 2).

Chart 2 Deviations of Money from Target and Velocity from Trend



SOURCE: Derived from Federal Reserve data.

The progress that we have made in reducing inflation in the past three years has increased the credibility of the Federal Reserve System. With increased credibility, we can afford to be more flexible in implementing our monetary policy. If we were to abandon the monetary targets or choose targets that are inconsistent with disinflation, however, we could quickly erode that credibility. We need targets, but we also need wide ranges for those targets. We need to move M-1 within the target ranges to offset unexpected developments in pursuit of the ultimate goal of zero inflation.

Toward Zero Inflation

The question then arises as to which plan for monetary targets is consistent with gradual but steady progress toward zero inflation. One plan, which is consistent with the policy of the last four years, is to

continue to reduce the annual targets a little more each year. We realize that either nominal GNP or prices would not precisely follow the steadily declining trend implied by such a policy. Indeed, even the monetary aggregates would not decelerate so smoothly. We would continue to have cyclical troughs and peaks, but we expect each cyclical level of inflation to be well below the one reached before.

The Federal Reserve has clearly established and acknowledged that its primary responsibility is to end inflation, and we have made much progress. The trend rate of inflation has been halved in less than four years, and some believe that this is progress enough. However, our goal has not been achieved. We cannot contain inflation in the 4 percent to 5 percent range. The late economist Arthur M. Okun wrote

> I would emphasize that such a state [of steady inflation] has never existed and can never be attained. The adoption of a public policy designed to yield steady, fully anticipated inflation would commit the government to an impossible goal. Economic policy making is a highly imperfect art and it cannot produce steady inflation any more than it can produce steady unemployment or a steady price level. Moreover, the very acceptance by government of a higher, though hopefully steady, inflation rate would influence expectations in such a way as to make prices rise more rapidly and less steadily.[1]

In my view, this statement turned out to be, unfortunately, an accurate prophecy of the events of the 1970s.

When the United States experienced double-digit inflation rates, there was general agreement among the public and among policymakers that spiraling inflation had to be stopped. In an improved environment with a lower rate of inflation, it would be more difficult to retain the consensus needed to eliminate inflation. It is critical to our future economic well-being to do so. The economic hardships that we have endured in the past decade should remind us of the dangers of tolerating even a little inflation. If we want to steer clear of such hardships in this decade and in the next several decades, it is imperative that we adopt zero inflation as our goal—and that we achieve it. The best way to do that is to continue to reduce the growth ranges for the monetary targets.

1. See Arthur M. Okun, "The Mirage of Steady Inflation," in Joseph A. Pechman, Ed., *Economics for Policymaking*, Cambridge, Mass.: MIT Press, 1983, p. 37.

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