The public spends large sums monitoring and analyzing the Federal Reserve, attempting to predict what it will do. People place bets every day on future inflation through their decisions to allocate resources across markets and time. By being more explicit about what it is trying to accomplish—and what it is not—the Federal Reserve could make this process work better.

The Federal Reserve Board, in its actions and statements regarding financial-market regulations, has been sensitive to the costs that regulators cannot impose on the public when resources are not free to flow to their most valuable uses. Enhancing the available information about monetary policy should be regarded as a vote of confidence in the market process.

In the course of being more explicit about desired inflation, timetables, and methods, the Federal Reserve may encounter some problems. It may have to work hard, from time to time, to command support for its goal. It may encounter an inflation path that differs from its multiyear projection. It may find that its announced operating procedures require modifications. In fairness, however, I think the Federal Reserve is already subject to these pressures and has experienced each of them during the past decade.

Conclusion
For the past several years, we have tolerated an inflation rate that has eroded the dollar’s purchasing power considerably. Chances are that inflation will accelerate further this year. The Federal Reserve has stated goals of achieving price stability over time, where price stability means zero inflation, but it has provided no timetable. Each year that inflation deviates substantially from zero, the Federal Reserve could lose some credibility. In addition, as larger rates of inflation become embedded in our economy, the costs of eliminating that inflation escalate.

I think the public recognizes that inflation is neither costless nor an acceptable solution to other economic problems. I also believe the Federal Reserve could reduce or eliminate the economic dislocations that sometimes accompany its monetary policies by providing more information about its goals, methods, and timetables.

W. Lee Hoskins is president of the Federal Reserve Bank of Cleveland. The material in this Economic Commentary is based on a speech presented to the Akron Roundtable, Akron, Ohio, on January 14, 1989.

Monetary Policy, Information, and Price Stability
by W. Lee Hoskins

In the last decade, economic research about information—what people know, how they learn it, and how they react—has created a revolution in how economists analyze macroeconomic policies.

Economists recognize that households, businesses, and government agencies invest considerable amounts of time and other resources monitoring economic policy and that they base private decisions on what they expect to happen. They then strive to make themselves as well off as possible if their expectations are realized. For example, if people expect their tax liabilities to rise in the future because of large budget deficits today, they have an incentive to shelter their future income from taxes by altering their pattern of spending and investment. Consequently, tax revenues may even be lower in the future than the government expected.

Contemporary thinking about market expectations recognizes that markets often make mistakes about what policies the government will pursue. But people work hard to form correct and unbiased opinions about future events, including government policies. If people are correct on average about future policies, then government policymakers should not count on being able to persuade or influence the public for long periods of time. For example, if federal deficits rise every year despite announced plans to reduce them, future announcements will be discounted and eventually ignored. Policymakers need to reconsider their own roles in our economic system in light of these views about information.

Monetary Policy and Price Stability
Our society has established many goals for economic performance, including low rates of unemployment and poverty, more balanced federal budget and trade positions, and price stability. Opportunities for accomplishing these goals are assigned to various government agencies, and the actions of some policymakers can clearly affect the operating environment faced by others.

The Federal Reserve System seeks to maximize our nation’s production and employment by maintaining price stability over time. Over short intervals, the Federal Reserve can strongly influence production and employment, but its long-term influence is weak or nonexistent. Growth of output, employment, and wealth in the long run usually depends on a nation’s resourcefulness in utilizing land, labor, and capital. The Federal Reserve’s monetary policy can best promote an efficient economic system by establishing a stable price-level environment. This environment encourages decisionmakers—private and public—to make long-term plans and contracts without concern that future inflation will later penalize them.

Balancing inflation rates over the last several years has eroded the purchasing power of the dollar and have impaired economic efficiency. The Federal Reserve could move more effectively toward its stated goal of price stability through an information program stating its goals, methods, and timetables for achieving zero inflation.

I am especially interested in how the Federal Reserve could enhance our nation’s economic efficiency by providing and disseminating monetary policy information in a different way. Our inflation rate has hovered around 4 percent for about half a dozen years; this year, the rate could easily exceed 5 percent. Some people recall that inflation rates were about twice that amount only eight years ago, and regard 4 to 5 percent as an acceptable standard for success. But a 4 to 5 percent inflation rate means that the overall price level increased by 30 percent during the last six years, severely diminishing the purchasing power of the dollar. I am deeply disappointed by this performance. Continuing inflation rates of this magnitude do not seem today to be regarded as a pressing economic problem, yet cumulatively they have eroded the value of our dollars and have impaired our economic efficiency.
I suggest that as a nation embrace the goal of monetary policy to be the complete elimination of inflation. The Federal Reserve could make such a program more credible by clearly announcing this goal and a timetable for achieving it. Through periodic statements, the Federal Reserve could communicate its stance that any positive rate of inflation was being taken as a trade-off citizens by eliminating inflation. For example, if the Federal Reserve announced its intent to begin immediately to attain zero inflation, the public might think that the Federal Reserve would set by policymakers. This goal needs to be feasible, clearly understood, and publicly supported; if it is not, then any policy designed to attain the goal will ultimately be not credible. The more clearly the policy is understood, the more effective it will be. An ineffective policy will eventually be abandoned and replaced with another policy designed to attain the goal.

Market participants in the United States and around the world recognize that only the Federal Reserve can control the U.S. price level over time through the quantity of dollar-demonized money it allows the banking system to create. People who trade in foreign or domestic markets with U.S. dollars do so with expectations about the future purchasing power of those dollars. If dollar-users think that their command over real resources is likely to erode because of zero inflation, they will require an offsetting interest-rate premium. Such expectations will certainly cause the U.S. economy to operate less efficiently than if people had more faith in price-level stability over time.

If the social benefits of zero inflation are so significant and so obvious, then why do we lack a consensus not only among economists but also among policymakers that zero inflation is a goal and implement policies that actually attain this goal regularly, over a long period of time. As long as the monetary authority achieves the goal, people may still spend time little effort or expense in monitoring central-bank policies and actions. People will consistently get the results they expect.

In practice, central banks do not always find it easy to achieve their goals. Unpredictable events pose problems: oil price surges and collapses, droughts, dramatic exchange-rate fluctuations, changes in the use of money, and large public deficits are just a few. Even if the central bank does not abandon its goal, it may occasionally or even periodically fail to attain it. If those periods become frequent enough, people may reasonably question whether the central bank has changed its goal.

A central bank can improve its credibility by telling the public that it has not changed the goal. Furthermore, it can explain why its policies are not efficacious and can adopt and announce new policies designed to achieve the goal. The Federal Reserve does not presently operate in exactly this way; however, there are several goals. Among them is price stability, but they have not provided a timetable for achieving this goal. Essentially, we ask the public to trust us to do the right thing: to allow the price level to rise over time in an acceptable manner. If the Federal Reserve lost some credibility during the 1970s by not acting forcefully enough to arrest inflation. It restored some credibility in the 1980s by reducing inflation substantially and, beyond this, through an occasional willingness to err on the side of monetary tightness. Market participants would probably say that the Federal Reserve policies today are credible if our goal is to keep inflation in the 4 to 5 percent range. Based on our current actions, however, reducing zero inflation in the next few years probably has very little public credibility.

Information and Credible Monetary Policy

In theory, a nation’s monetary author-

ity need not provide much public infor-
mation to maintain its credibility. A credible monetary policy is one that is designed to eliminate inflation would be a qualitatively different policy. People would recognize it as a declar-ation that the Federal Reserve will not attempt to trade off any inflation for other economic objectives.

Money Policy and Central Bank Credibility

Why is it important that monetary policy be credible, and what are the likely elements of a credible monetary policy? A credible monetary policy is one that an informed public believes will be successful at attaining the goal set by policymakers. This goal needs to be feasible, clearly understood, and publicly supported; if it is not, then any policy designed to attain the goal will ultimately be not credible. The more clearly the policy is understood, the more effective it will be. An ineffective policy will eventually be abandoned and replaced with another policy designed to attain the goal.

Market participants in the United States and around the world recognize that only the Federal Reserve can control the U.S. price level over time through the quantity of dollar-demonized money it allows the banking system to create. People who trade in foreign or domestic markets with U.S. dollars do so with expectations about the future purchasing power of those dollars. If dollar-users think that their command over real resources is likely to erode because of zero inflation, they will require an offsetting interest-rate premium. Such expectations will certainly cause the U.S. economy to operate less efficiently than if people had more faith in price-level stability over time.

If the social benefits of zero inflation are so significant and so obvious, then why do we lack a consensus not only among economists but also among policymakers that zero inflation is a goal and implement policies that actually attain this goal regularly, over a long period of time. As long as the monetary authority achieves the goal, people may still spend time little effort or expense in monitoring central-bank policies and actions. People will consistently get the results they expect.

In practice, central banks do not always find it easy to achieve their goals. Unpredictable events pose problems: oil price surges and collapses, droughts, dramatic exchange-rate fluctuations, changes in the use of money, and large public deficits are just a few. Even if the central bank does not abandon its goal, it may occasionally or even periodically fail to attain it. If those periods become frequent enough, people may reasonably question whether the central bank has changed its goal.

A central bank can improve its credibility by telling the public that it has not changed the goal. Furthermore, it can explain why its policies are not efficacious and can adopt and announce new policies designed to achieve the goal. The Federal Reserve does not presently operate in exactly this way; however, there are several goals. Among them is price stability, but they have not provided a timetable for achieving this goal. Essentially, we ask the public to trust us to do the right thing: to allow the price level to rise over time in an acceptable manner. If the Federal Reserve lost some credibility during the 1970s by not acting forcefully enough to arrest inflation. It restored some credibility in the 1980s by reducing inflation substantially and, beyond this, through an occasional willingness to err on the side of monetary tightness. Market participants would probably say that the Federal Reserve policies today are credible if our goal is to keep inflation in the 4 to 5 percent range. Based on our current actions, however, reducing zero inflation in the next few years probably has very little public credibility.
I suggest that we as a nation embrace the goal of monetary policy, that is, to set a price-level stability and begin immediately to attain zero inflation in a few years. The Federal Reserve could make such a program more plausible by clearly announcing this goal and a timetable for achieving it. Through periodic statements, the Federal Reserve could communicate its belief that sound economic developments are likely to affect the inflation rate over time, and how the Fed plans to react. In other words, if the Fed promptly and effectively program designed to enhance the attainment of this goal. Although the Federal Reserve might sometimes make mistakes, I believe this process would maximize our nation’s economic performance over the long run.

When I refer to price stability, I mean zero inflation. A strong case can be made for having the paramount goal of monetary policy be the complete elimination of inflation. Inflation obscures market information, adds distortion, or “noise,” to prices, and distorts the timing of business cycles. These are all of the reasons why price-level stability and price stability are of the utmost importance to the public. In my view, if policymakers were to make the public believe that the Fed is committed to zero inflation, the public would regard this as a declaration of its intention to eliminate inflation. In short, inflation can be a qualitatively different policy.

The reason is that any positive rate of inflation creates a qualitatively different economic environment, and a monetary policy designed to eliminate inflation would be a qualitatively different policy. People would recognize it as a declaration that the Federal Reserve will not attempt to trade off any inflation for other economic objectives.

**Monetary Policy and Central Bank Credibility**

Why is it important that monetary policy be credible, and what are the likely elements of a credible monetary policy? A credible monetary policy is one that an informed public believes will be successful at attaining the goal set by policymakers. This goal needs to be feasible, clearly understood, and publicly supported; if it is not, then any policy designed to attain the goal will ultimately not be credible. The more clearly the policy is understood, the more effective it will be. An ineffective policy will eventually be abandoned and replaced with another policy designed to attain the goal.

Market participants in the United States and around the world recognize that only the Federal Reserve can control the U.S. price level over time through the quantity of dollar-denominated money it allows the banking system to create. People who trade in foreign or domestic markets with U.S. dollars do so with expectations about the future purchasing power of those dollars. If dollar-users think that their command over real resources is likely to erode due to continuing inflation, they will require an offsetting interest-rate premium. Such expectations will certainly cause the U.S. economy to operate less efficiently than if people had more faith in price-level stability over time.

If the social benefits of zero inflation are so significant and so obvious, then why has the United States not enthusiastically supported that goal and moved closer toward attaining it? The simplest, and I believe most compelling, answer is that historically the process of reducing inflation has been associated with economic recessions. Few observers would deny that there could be short-run costs to achieving price-level stability, but there are ways to minimize these costs. I believe the investment payback period would be rather short, based on a new consideration of how the Federal Reserve could provide information to the public.

I like to think that the Federal Reserve, because of its institutional structure and the system of money it allows the bank to denominate money it allows the banking system to create. This is an argument for which I have considerable confidence. If the central bank does not abandon its goal, it may occasionally or even periodically fail to attain it. If those periods become frequent enough, people may reasonably question whether the central bank has changed its goal.

A central bank can improve its credibility by telling the public that it has not changed the goal. Furthermore, it can explain why its policies are not efficacious and can adopt and announce new policies designed to achieve the goal. If the central bank does not provide the public with enough information about its activities, the public may think that the central bank’s new policies will be ineffectual. Whatever the information shortcoming, economic inefficiency is the likely result.

Conducting monetary policy in the United States became unusually difficult in the 1970s. Inflation rates began to increase significantly, and people began to think that inflation was inevitable. If people had more faith in price-level stability over time.

Aside from Humphrey-Hawkins testi- monies, the Federal Reserve regularly releases Policy Directives about each Federal Open Market Committee (FOMC) meeting. The Policy Directives, issued six or seven weeks after each meeting, contain a brief discussion of how the FOMC viewed economic conditions and a statement about whether the FOMC voted to change policy.

From time to time there are discussions about releasing the Policy Directives much sooner after an FOMC meeting. These people seeking additional or more timely information believe that individual policymakers could make better decisions about their economic affairs if they knew more about the Federal Reserve’s views on economic conditions, and policy inten- tions. This is an argument for which I have considerable confidence.

Although I personally have no qualms about immediately releasing the FOMC Policy Directives, I do think it is important that the Federal Reserve release its Policy Directives much sooner after an FOMC meeting. The Policy Directives are released, on a delayed basis, to the public. I am far more interested in providing some information that is not public—indeed, that does not yet really exist. The Policy Directives are released, although on a delayed basis, to the public. In my view, the Fed is far more interested in providing some information that is not public—indeed, that does not yet really exist. The Policy Directives are released, although on a delayed basis, to the public. In my view, the Fed is far more interested in providing some information that is not public—indeed, that does not yet really exist.
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Continuing inflation rates of this magnitude do not seem today to be regarded as a pressing economic problem, yet cumulatively they have eroded the value of our dollars and have impaired our economic efficiency.