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ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

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 caused 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 be even 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. Responsibilities for accomplishing these goals are assigned to various governmental 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 surely 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.

Inflation rates over the last several years have 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.

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I suggest that we as a nation embrace the goal of price-level stability and begin immediately to attain zero inflation in a few years. The Federal Reserve could make such a program more credible and effective by clearly announcing this goal and a timetable for achieving it. Through periodic statements, the Federal Reserve could comment specifically on how current economic developments are likely to affect the inflation rate over time, and how the Fed plans to react. In other words, it could initiate an information 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 hampers our ability to discriminate between changes in relative prices and changes in the overall price level. Inflation leads to socially inefficient resource deployment because people demand protection from inflation's consequences. Financial institutions and instruments arise that would be unprofitable in the absence of inflation. Inflation interacts negatively with our tax system, which adversely influences the allocation of resources across sectors of the economy, the timing of investment, and corporate financial structures. In short, inflation can be regarded as an information impurity that reduces economic growth. Any nation could improve the welfare of its citizens by eliminating inflation.

Why push all the way to zero inflation? The reason is that any positive rate of inflation is rather arbitrary and would likely be viewed as such by the public. For example, if the Federal Reserve announced a goal of 5 percent inflation, the public would assume that 5 percent inflation was being taken as a trade-off for some other economic objectives (otherwise why not a goal of zero inflation?). The following year, the Federal Reserve might accept some different inflation rate because of changing economic or political circumstances.

If inflation is greater than zero, it seems to me that people have little reason to expect inflation to be stable over time. Zero 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 through 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 already 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 reputation for integrity, could more consistently conduct monetary policy with a higher degree of credibility. The Federal Reserve has the authority to set a specific numeric goal for the inflation rate over time, to announce that goal to the public, and to implement policies designed to accomplish the goal. The Federal Reserve does not presently operate in exactly this way, however; there are several goals. Among them is price stability, but we 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 move over time in an acceptable manner.

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 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, attaining zero inflation in the next few years probably has very little public credibility.

Information and Credible Monetary Policy

In theory, a nation's monetary authority need not provide much public information to maintain its credibility. A central bank could select 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 will spend little time or effort 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 goal. Unforeseeable 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. If the central bank does not provide the public with enough information about its activities, the public may think that the stated goal was replaced with some other goal—one that it may or may not support. Or, 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 became larger and more highly variable than they had been in several decades. Frustrations mounted over inflation's intractability. The Federal Reserve repeatedly took actions that it thought would reduce inflation, but the public had come to expect that inflation nevertheless would accelerate. As confidence in the Federal Reserve slipped, the public concluded that the Federal Reserve should provide more information about its goals and operating procedures.

With the enactment of the Full Employment and Balanced Growth (Humphrey-Hawkins) Act of 1978, Congress and the administration essentially agreed that the Federal Reserve should regularly and publicly discuss its view of current economic conditions and its projections for economic growth, inflation, and unemployment. Moreover, the Federal Reserve was required to report its objectives for various monetary aggregates, the policy variables over which it has indirect control. The basic premise was that the Federal Reserve should commit publicly to achieving certain objectives for monetary aggregates which, in turn, were loosely associated with more meaningful economic goals. The required semiannual testimonies to Congress have become prominent sources of public information about monetary policy, partly because there are so few additional sources.

The law does not require the Federal Reserve to set successively lower monetary growth rate targets until money grows at some predetermined rate (say, 3 percent) thought to be consistent with zero inflation. The required reporting format is flexible enough to permit the Federal Reserve to change its monetary aggregate targets whenever and however it deems necessary. The framework is attractive and sensible because it does not presume a constant relationship between economic events most directly controlled by the Federal Reserve and economic results most desired by the public. During the past 10 years, as the customary relationships between money and economic activity broke down, the Federal Reserve has varied emphasis among the aggregates, moved target ranges around considerably, and even added and removed particular monetary aggregates from the list of those targeted.

Aside from Humphrey-Hawkins testimonies, the Federal Reserve regularly releases information in the form of Policy Directives about each Federal Open Market Committee (FOMC) meeting. These 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. Those people seeking additional or more timely information believe that individuals could make better decisions about their economic affairs if they knew more about the Federal Reserve's goals, objectives, views of economic conditions, and policy intentions. This is an argument for which I have much respect.

Although I personally have no qualms about immediately releasing the FOMC Policy Directives, I do think a fair amount of the Policy Directive debate falls wide of the mark. After all, the Policy Directives are already released, although 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 may inform the public that the Federal Reserve has chosen to tighten or loosen the money supply, but the public cannot tell by how much, for how long, or to what end.

Despite the very valuable public information provided by the Federal Reserve, I sense that something even more valuable is missing: a clear message about the Federal Reserve's inflation goals, stated in a way that the public can actually use for its own decisions. This information would indicate how much inflation the Federal Reserve envisions during the next few years and why that amount constitutes a reasonable goal.

The Federal Reserve could also explain the policy it thinks is most sensible and how it plans to exercise judgment as it executes this policy. A sharper distinction could be made between the goal and the methods used to attain that goal. Because the Federal Reserve has very broad authority to decide on and implement the kind of monetary policy it considers appropriate, I think the public will tend to believe that the Fed can effectively accomplish what it sets out to do.

Beyond Humphrey-Hawkins

Our economy has an enormous capacity to absorb and transmit information. In the aftermath of the 1987 stock-market crash, Federal Reserve Chairman Alan Greenspan's remarks about proposed stock-market reforms indicated substantial respect for the ability of the nonfinancial economy to function smoothly while financial markets react to surprise events. In a similar vein, I would argue that financial markets can absorb additional information about monetary policy, can use it effectively, and that the entire economy will ultimately benefit. Financial markets would be surprised less frequently by the Federal Reserve if they received more information from it.

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 regulation, has been sensitive to the costs that regulators can 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 a stated goal of achieving price stability over time, where price stability means zero inflation, but 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 19, 1989.*

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