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Communication and the Humphrey-Hawkins Process

by John N. McElravey

The Federal Reserve reports its monetary policy goals for the coming year to Congress in what is known as the Humphrey-Hawkins testimony. The report includes a discussion of the economic projections of the Federal Open Market Committee (FOMC) and of the Federal Reserve's target ranges for growth of the M2 and M3 monetary aggregates. The process seems to work well for reporting short-term goals, but perhaps could be improved upon to better communicate the Federal Reserve's long-term monetary objectives.

Federal Reserve Chairman Alan Greenspan appeared before Congressional banking committees in February to report the Federal Reserve's monetary policy objectives for 1989. His remarks also included a review of policy actions and the economy during 1988.

These reports are required by the Full Employment and Balanced Growth Act of 1978, better known as the Humphrey-Hawkins (H-H) Act. The H-H Act states the federal government's macroeconomic policy goals. Through this process, Congress and the public regularly receive information about the Federal Reserve's monetary policy intentions and procedures.

The Federal Reserve's ultimate policy objective is to create a stable price environment so that the economy can achieve maximum sustainable growth of output and employment. The target ranges for the M2 and M3 aggregates are announced as a means to achieve that broader objective.

The H-H Act requires the Federal Reserve to report in February its money and credit target ranges for the current year, but this legislation was enacted when the short-run relationship between money and economic activity appeared to be more stable and predictable than has been the case since the early 1980s. Recognizing that monetary and economic activity growth rates may not move together as closely as they once did, the Federal Reserve's Federal Open Market Committee (FOMC) has emphasized a more flexible approach to monetary targeting over the past few years.

This *Economic Commentary* reviews the Monetary Policy Report to Congress, examines the informational value of the monetary target ranges, and discusses a possible improvement for communicating the FOMC's long-run goals to the public in the Humphrey-Hawkins process.

■ The 1989 Monetary Policy Objectives

The Federal Open Market Committee lowered the target ranges for money and credit expansion this year (see table 1). The 1989 ranges, as measured from the fourth quarter of 1988 to the fourth quarter of 1989, are 3 to 7 percent for M2 and 3.5 to 7.5 percent for M3.[1] The monitoring range for domestic nonfinancial debt (DNFD) is 6.5 to 10.5 percent. The range for M2 was reduced a full percentage point from last year, while the ranges for M3 and DNFD were each reduced one-half percentage point. As in 1987 and 1988, no range was set for the M1 aggregate.

The lower target ranges are an expression of "...the Committee's determination to resist any upward tendencies in inflation in the coming year and to promote progress toward price stability

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in the long run."[B] The vigorous performance of the economy, and the signs of rising inflation early in 1989 made the Committee more inclined toward restraint than toward stimulus.

The FOMC retained the four-percentage-point-wide target ranges first adopted for the broader aggregates in 1988. The report noted that "...it is difficult to specify in advance a narrow range for the appropriate growth of M2 and the other aggregates in the coming year."[B] One reason for this difficulty is the significant interest-rate sensitivity of M2. Fairly wide deviations from the midpoint of the target range are possible as the opportunity cost of M2 fluctuates. M2 opportunity cost can be measured by the difference between the 3-month Treasury bill rate and the weighted-average of the rates paid on M2's components.

Depository institutions were unusually slow to raise deposit rates as market interest rates increased during the second half of 1988. Rising opportunity cost was reflected in slower M2 growth, and in rising M2 velocity, which increased at a 3.4 percent annual rate in the last half of 1988. Velocity is the ratio of nominal income to money. Potentially wide swings in velocity associated with changes in opportunity cost mean that broader target ranges are needed to assure consistency with satisfactory economic performance. The FOMC believes that M2 velocity will continue to rise in 1989, in lagged response to earlier increases in market rates, especially if deposit rates remain slow to adjust. M2 growth could end the year in the lower half of its target range if this occurs.

Money growth may also be affected by the resolution of problems in the thrift industry. Changes in the deposit pricing practices of these institutions, the reaction of depositors, and any restraints on the growth of their assets each adds to the uncertainty surrounding money growth for 1989.[2]

Because of the short-run variability in the relationship between the aggregates and economic activity, the FOMC has emphasized a flexible approach to monetary targeting over the past few years. Since the aggregates have drawbacks as rigid guides for policy implementation, money growth will also be assessed in light of "...indicators of inflationary pressures and economic growth, as well as developments in financial and foreign exchange markets."[B]

■ Economic Projections for 1989

The economic projections of the FOMC are also included in the report to Congress (table 2). The projections for nominal income, real income, and inflation in 1989 were revised upward from the tentative projections reported last July. The Consumer Price Index (CPI) was reported for the first time, replacing the gross national product (GNP) implicit price deflator as the inflation measure. The CPI offers some advantages over the deflator in that the deflator is sensitive to changes in the composition of GNP and is revised more often than the CPI. Another advantage is that the CPI is reported monthly, while the deflator is reported quarterly, thus providing more frequent information about price pressures.

Chairman Greenspan stated that price pressures seem to have some momentum, explaining the increase in the inflation projections since last July. If this year's inflation actually matches the FOMC's 1989 projection, it would "...represent something of a setback relative to the Committee's disinflationary objective."[B] The Chairman also indicated that "...this acceleration is troubling, especially with inflation already at a level that would be unsatisfactory if it persisted."[A] However, any increase in inflation this year is thought to be limited because of actions already taken by the FOMC, and by "...the restraint on aggregate demand expressed in the monetary targets for 1989."[B]

■ Communicating Intentions

The Humphrey-Hawkins Act specifically directs the Federal Reserve to report its target ranges for money and credit aggregate growth, taking into account a variety of economic variables. While the FOMC is not obligated to achieve money growth within the target ranges, deviations must be explained in the next testimony. The ranges provide information about policy intentions for the coming year. The FOMC's price-stability goal has been communicated over the past several years through public statements, and by a gradual lowering of the monetary target ranges. The FOMC has been fairly successful at achieving a lower rate of inflation during the 1980s.

The economic projections of the FOMC are an important supplement to the target ranges. They provide an indication of economic conditions the FOMC thinks are likely to be associated with its monetary policy. Even so, the FOMC could set aside its monetary target ranges if the economy appeared headed in a different direction than was expected at the time the policy was adopted. In addition to the economic variables formally reported to Congress, the policy record indicates that the FOMC considers such factors as the foreign exchange rate of the dollar and financial market conditions when judging appropriate policy. The communication of policy intentions, though, becomes more complicated as multiple guidelines are introduced.

The Chairman's testimony before Congress is the Federal Reserve's most visible opportunity to communicate its intentions for monetary policy. The FOMC has been following its disinflationary policy for a decade, but the public still closely analyzes each year's testimony to ascertain the Federal Reserve's continued resolve as an inflation fighter. Clear communication about its goals helps reinforce the Federal Reserve's credibility, and may

TABLE 1 RANGES OF GROWTH FOR MONETARY AND CREDIT AGGREGATES (Percent change, fourth quarter to fourth quarter)

	1989	1988	1987
M2	3 to 7	4 to 8	5-1/2 to 8-1/2
M3	3-1/2 to 7-1/2	4 to 8	5-1/2 to 8-1/2
Debt	6-1/2 to 10-1/2	7 to 11	8 to 11

SOURCE: Monetary Policy Report to Congress, February 21, 1989. Board of Governors of the Federal Reserve System.

TABLE 2 ECONOMIC PROJECTIONS FOR 1989. CENTRAL TENDENCY OF FOMC MEMBERS AND NONVOTING FEDERAL RESERVE BANK PRESIDENTS

Fourth quarter to	Nominal GNP	6-1/2 to 7-1/2
fourth quarter	Real GNP	2-1/2 to 3
percent change:	Consumer Price Index	4-1/2 to 5
Average in fourth quarter:	Civilian Unemployment Rate	5-1/4 to 5-1/2

SOURCE: Monetary Policy Report to Congress, February 21, 1989. Board of Governors of the Federal Reserve System.

lower the cost of a disinflationary policy. Avoiding inflation "surprises" and reducing uncertainty about future policy moves are some of the benefits of good communication. In this instance, good communication can be described as having a plan, and telling others how it will be executed.[3]

■ Communication Problems

The emphasis on annual targets for money growth arose largely as a consequence of the apparent stability in the growth of M1 velocity. The FOMC deemphasized the role of the monetary aggregates as they became less reliably linked to economic performance during the 1980s. Of the money measures, M2 has received the most attention in recent years, but its short-run sensitivity to changes in its opportunity cost means wide swings in its growth are possible as market interest rates change. This factor was recognized by widening the target ranges from 3 to 4 percentage points in 1988. The trend in M2 velocity, however, does seem relatively stable over longer periods of time, potentially making that aspect of its behavior useful in the policy process.[4]

Because M2 growth is so sensitive to the state of the economy, there are shortcomings to using only its current-year target ranges as a means to communicate the Federal Reserve's long-run objective for inflation. First, there is a good deal of uncertainty surrounding the economy's performance, and that translates into uncertainty for money growth. M2 growth for 1988 provides a good example. Early in the year, money growth surged after the Federal Reserve relaxed reserve restraint because of concerns about potential weakness in the economy and financial markets in the wake of the stock-market crash. Money-market rates fell, which reduced M2's opportunity cost and promoted brisk growth through June 1988. As signs of continued economic strength and inflation became evident, the FOMC gradually tightened restraint on reserve positions from the spring of 1988 through early 1989. The reduced availability of reserves increased money-market rates, and hence M2 opportunity cost rose when deposit rates lagged behind.

Once tightening actions cease, deposit rates will likely adjust toward market rates, and money growth should begin to accelerate in response to reduced opportunity cost. This pattern of monetary acceleration and deceleration in response to changes in opportunity cost could continue for some time.

Second, setting annual target ranges to reflect expectations about money growth does provide pertinent information about the current stance of policy, but much less about policy's long-run direction. Long-term policy intentions cannot be explicitly communicated by a single year's target range. This year's M2 range is only meaningful in terms of last year's range, and in February's report there are no explicit quantitative economic projections or policy target ranges for periods in the future beyond 1989. The less-reliable linkage between the monetary aggregates and economic performance makes targets for the aggregates less useful indicators of longer-run policy intentions and objectives.

Recognizing these shortcomings, the Humphrey-Hawkins testimony and report to Congress, as noted above, are structured to supplement the target ranges by providing some information about policy designs for the future.

■ Improving Communication

The Humphrey-Hawkins process provides a framework for discussing and planning economic policy, not only for the coming year, but also for future years. Through its Monetary Policy Report to Congress, the Federal Reserve presents its short-run monetary policy intentions and long-run economic goals. Maintaining a meaningful dialogue with Congress and the public about economic issues and goals seems paramount to the success of this process, especially if the Federal Reserve is to credibly influence expectations about the future course of inflation.

Short-run policy plans seem fairly well communicated by the monetary targets in conjunction with the economic projections and the Chairman's testimony. But current economic projections and money and credit target ranges are not sufficiently forward-looking to carry much information about long-term inflation prospects.

The Federal Reserve's long-run goal of price stability might be more effectively communicated by announcing an explicit plan for achieving it. A specific numeric goal for inflation, and an expected path and timetable to achieve it, would set an unambiguous goal for the Federal Reserve.[5] The Humphrey-Hawkins process would seem to be an appropriate forum for discussing such a goal, and how to achieve it.

Multi-year inflation targeting, of course, has drawbacks, and would need to be administered flexibly to respond to significant and unforeseen events, similar to the present money and credit targeting procedure. The H-H testimony would continue to fulfill an important role in the monetary policy reporting process, emphasizing the policy intentions of the Federal Reserve. Adding an explicit inflation target range, though, would clearly communicate the Federal Reserve's long-run objective. It could further reduce uncertainty about policy, and could further enhance the credibility of the Federal Reserve.

■ Footnotes

A. Quotes from Chairman Alan Greenspan's February 21, 1989 testimony before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate.

B. Quotes from the Monetary Policy Report to Congress, February 21, 1989.

1. See the *Federal Reserve Bulletin,* any recent issue, for a complete definition of the monetary aggregates. Generally, M1 includes currency plus transactions balances, while M2 includes M1 plus household savings assets. M3 includes M2 plus institutional savings assets.

2. See pages 2 and 11 of the February Monetary Policy Report for a discussion of the possible effects of thrifts' problems on the growth of the monetary aggregates.

3. See Hoskins, W. Lee, "Monetary Policy, Information, and Price Stability," *Economic Commentary,* Federal Reserve Bank of Cleveland, February 1, 1989.

4. For more details, see Jeffery Hallman, Richard D. Porter, and David H. Small, *M2 Per Unit of Potential GNP as a Price-Level Anchor,* Staff Studies (Board of Governors of the Federal Reserve System, forthcoming).

5. For example, Representative Stephen L. Neal, Chairman of the House Subcommittee on Domestic Monetary Policy, has proposed a zero inflation objective and a path to achieve it. See the appendix to *Review of the Course of Monetary Policy in 1988,* Subcommittee on Domestic Monetary Policy, committee print 101-1, pp. 43-46, Feb. 1989.

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