Objectives and Strategy for Monetary Policy

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Seattle Business Economists
Seattle, Washington
April 15, 1988

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It is my pleasure to have this opportunity to address the Seattle Business Economists. My remarks today will focus on the objectives and strategy for monetary policy. The monetary system is a complex network of rules, procedures and institutions. Ideally, it promotes the efficient allocation of resources by reducing transaction and information costs. Our monetary system provides a unit of account, an efficient medium of exchange and a stable store of value. How well the monetary system operates depends on the Federal Reserve -- specifically on what objectives it seeks to achieve, and its success in achieving them. The Federal Reserve Act of 1913, the Full Employment and Balanced Growth Act of 1946, and subsequent amendments to those Acts have given the Federal Reserve the responsibity for multiple objectives including: stability in the purchasing power of the dollar, stability and growth of the economy, and a high level of employment.

The Basic Objective of Monetary Policy

In my view, the basic objective of monetary policy should be to stabilize the price level. The variables we as a nation care about most, employment, output and incomes, for example, cannot be controlled directly. The supply of goods and services available to consumers depends on the quantity of productive resources and how they are used. Monetary policy can do little to affect the total quantity of land, labor, and physical capital that is available. The Federal Reserve can control the price level and can encourage investment and real economic growth by providing a stable price environment. It cannot, except through controlling the price level, affect other objectives

directly. But, if the Federal Reserve provides a stable environment, the other economic objectives stand a better chance of being met.

The role of money, and therefore, the role of monetary policy, is to provide transactions services and information. If the Federal Reserve stabilizes the price level, then transaction and information costs in the economy will be reduced, and we will have an optimum climate for decision-making and resource allocation. If the Federal Reserve fails to achieve an inflation-free environment, it will obscure relative price signals, raise transaction costs and add to uncertainty. By increasing uncertainty about future inflation and its own policies, the Federal Reserve adds to the instability of the economy.

The Role of Money

If monetary policy cannot control real variables why do people believe it can and what is the rationale for stabilizing the price level? According to economic theory, people attain the highest possible level of welfare in a competitive economy with perfect information and no transaction costs. Money has no role to play in such a simple textbook economy. In the real world, money and monetary policy do have a role to play because there are transaction costs and people do not have perfect information. Macroeconomic models with fixed nominal contracts to represent transaction costs can be used to analyze the consequences of imperfect information and role of money in the economy. For example, the existence of fixed wage contracts can generate a short-run trade-off between inflation and unemployment. People take expected inflation into account when entering into these contracts. Once wages are fixed, firms then choose output and employment levels to maximize profits. If inflation is

higher than originally expected when the contracts were signed, the real wage rate will fall. Firms will increase output and employment to take advantage of higher profit margins. After the adjustments are complete, output and employment will be no different than they would have been without inflation because people are not likely to make systematic errors in predicting inflation.

Because it is costly and difficult to renegotiate contracts, there can be a temporary period in which unexpected inflation affects output and employment. Monetary policy should be designed to prevent unexpected changes in the price level and thereby keep the problems associated with fixed wage and price contracts to a minimum. In short, inflation reduces economic performance, holding output, employment and income below their longer-term sustainable levels.

Another important role for money and monetary policy is to provide information. For example, people face uncertainty when choosing whether to save or consume. Not knowing what inflation will be is a significant problem. People do not know the real interest rate, which represents the return to savings in terms of future consumption. The real interest rate is simply the nominal interest rate minus the expected rate of inflation. If people could predict inflation accurately the problem would disappear. But because people are uncertain about future inflation and the real interest rate, they are unable to plan optimally for current and future consumption. The monetary authorities can reduce the problem by making the price level predictable.

Businesses also face this sort of uncertainty. Investment decisions depend on the cost of capital and on the expected return. Expected returns

depend importantly on how accurately current interest rates reflect future inflation. Not having this information is costly. We know it is because we see firms paying for insurance in financial markets. Many of the developments in financial markets in the last 20 years represent an attempt by the private economy to protect itself from the uncertainty about inflation. Even if the price level cannot be made perfectly certain, the costs associated with inflation uncertainty can be reduced if the Federal Reserve focuses more sharply on a stable price level. These examples illustrate why I conclude that the best monetary policy is to produce a stable price level.

While the Federal Reserve is given the responsibility to maintain both stable prices and full employment, I believe the way to achieve both goals is to stabilize the price level. By price stability, I mean that people expect and therefore act as though prices will be stable. By price stability, I mean zero inflation. I don't mean that all the different price indexes will be constant. Each price index has its own peculiar characteristics. There will always be non-monetary factors and measurement problems. But the short-term variation in the indexes should be just that -- short-term variations around a zero trend.

The Strategy

This brings me to my second point, the strategy. Having chosen a stable price level as the appropriate objective for monetary policy, what is a sensible strategy for achieving it? Indeed we have made much progress in recent years. There are some lessons in that progress for us to consider.

The first, and most important, part of a successful strategy must be to enlist the support of market expectations. This is done by announcing clear, explicit goals and acting in a credible manner to achieve them. When

inflation was at double digit rates at the end of the 1970s, people did not believe that inflation would stop rising. The often promised end to inflation was not delivered. In that environment, stating policy goals simply was not credible.

Today, we have gone through a 5-year period with inflation fluctuating in a 2 to 4 percent range. Markets seem to believe that the Fed will not let inflation rise above 4 percent without taking corrective actions. When markets expect inflation to rise above that range, markets seem to expect the Federal Reserve to adopt a tighter monetary policy and interest rates tend to rise in anticipation. Because the Federal Reserve has been credible in fighting inflation in the 1980s, it should be possible to contain inflation by using very small policy changes as long as these changes are initiated in advance of rising inflation.

I think we can improve our economic performance by announcing a goal of zero inflation to be achieved over some relatively short time period -- 3 to 5 years. If, as I believe, 4 percent is the rate of inflation today, then I suggest the acceptable upper limit should be 3 percent a year from now. With zero as the lower limit, the upper and lower limits would converge by 1992. If clearly announced, I think this is an acceptable goal.

This is the first part of an acceptable strategy, announcing a clear explicit goal. The second part is demonstrating a determination to achieve it. The goal of price stability must be the focal point of our policy discussion. The Federal Reserve can enhance its credibility and reduce the cost of achieving this goal by explaining its policy decisions within the context of the plan to achieve price stability over the stated period of time.

We must be able to recognize when policy should be changed and we must change it accordingly. The Federal Reserve may need support and assistance in following policies to achieve a stable price level. The Federal Reserve is independent, but it has a strange sort of independence. We exist within a social and a political compact, and that compact must clarify our role and encourage us to do our job. The Fed should be held accountable for providing price stability.

Having a clear objective is particularly important because of the breakdown in the reliability of the monetary aggregates. The lack of a reliable linkage between the monetary aggregates and the price level adds to the difficulty of knowing what is the appropriate monetary policy to bring inflation down. It also adds to the difficulty of others outside of the Federal Reserve in judging whether the Federal Reserve's actions are indeed consistent with the desired outcome. Without a well understood policy guide and a reliable policy instrument, which connects policy to objective, the only proof of the pudding will be in the eating. Because policy works with a long and variable lag, it becomes more difficult than ever to know whether the Federal Reserve is using a good recipe or a bad one. Externally, markets must be able to form judgments about how well we are doing.

Adopt Consistent, Systematic Operating Procedures

The Fed should adopt short-run guides or operating targets that are appropriate. Just as it is important to choose objectives that can be achieved, it is important that these operating rules or targets be connected meaningfully and reliably to the ultimate objective. It is also important to choose short-run operating targets that can be controlled without reducing the efficiency of the monetary system.

The framework which we adopt must allow for uncertainty and mistakes in human judgment. Any successful procedure should take account of that uncertainty and, whenever possible, minimize the costs associated with mistakes in judgment. Within that context some risks are more acceptable than others because some mistakes are less costly. One lesson of the 1970s is that inflation is very costly to deal with once underway and embedded in expectations, contracts and resource allocation decisions.

We are in a quandary on procedures today largely because the rules of thumb or policy guides which seemed to work in the past are not reliably or significantly connected today to the policy outcome we wish to seek. Over the long run, the Federal Reserve can directly control only the quantity of high-powered money, the monetary base. Nevertheless, in the short run it can operate by fixing either the price or the quantity of bank reserves, the part of the monetary base we control directly. It can follow an operating procedure which fixes the interest rate on reserves, the federal funds rate. At the other extreme it can fix the quantity of the total reserves. Or, it can follow some intermediate policy of establishing a relationship between the federal funds rate and total reserves, allowing the federal funds rate to rise and fall with changes in reserves.

An Interest Rate Target

Before October 1979, the Federal Reserve operated with an explicit target for the federal funds rate. The open market desk kept the rate in the targeted range by entering the market to buy or sell, sometimes both in the same day, whenever the rate threatened to move outside the specified range. At each Federal Open Market Committee (FOMC) meeting, the committee members

evaluated the state of the economy and used their best judgment to decide whether the interest rate target was consistent with the objectives of policy. During much of this period, the FOMC had many objectives, some of which may have been unclear and unstated. Perhaps inflation would not have gotten out of control if there had been a clear, overriding, publically stated objective of price stability.

In principle, price stability could be achieved using an interest rate operating procedure. If inflation expectations have risen, the federal funds rate would have to be increased enough to reverse the increase in inflation expectations. The problem with this approach in practice is that we do not have a reliable connection between the funds rate and the price level.

A Total Reserve Target

The Federal Reserve might operate at the other extreme, it could fix the level of total bank reserves between FOMC meetings. At each FOMC meeting the committee would use its judgment to choose a path for total reserves that was thought to be consistent with the desired price level. Between meetings money market interest rates would automatically rise if the demand for reserves grew above the target path and fall if demand for reserves grew below the target path. Shifts in the reserve/money multiplier, as well as shifts in the demand for nominal money balances, would induce changes in the federal funds rate. The change in interest rates would move total reserves, back toward the desired path, similar to what was done to during the 1979-82 episode.

As it does today, the Fed would have to monitor the factors that affect the relationship between total reserves and the price level. The FOMC would

have to use judgment to decide whether an increase in the demand for reserves was associated with real factors or with an increase in inflation expectations. At each FOMC meeting, the committee would estimate changes in the relationship between total reserves and the price level objective and then make the appropriate changes in the total reserve path. The problem with this approach is that we do not have a reliable short-run connection between the monetary base and the price level.

A Middle Course

There are other problems associated with relying solely on either the funds rate or total reserves. Using an interest rate target, as was done in the 1970s, made it very difficult for the Federal Reserve to make changes in policy adequate to control the acceleration of inflation. Inflation expectations rose faster than the FOMC raised the interest rate target. Even though interest rates rose, monetary policy in effect was eased, allowing inflation to become embodied in expectations and in contracts, adding further to the difficulty of preventing a further increase in inflation.

While the Federal Reserve has never used the other extreme policy, fixing the level of total reserves between meetings, it did approximate such a policy between 1979 and 1982. This period was characterized by a great deal of short-term volatility in the bond and money markets. This volatility was attributed to short-run variations in money demand, to operating techniques which did not provide adequate cushioning against those variations and sometimes, to confusion about what the Federal Reserve was trying to accomplish. As a practical matter the very short-run variations in money demand should be accommodated by an elastic supply of reserves. This suggests a need to reexamine the operating procedures in order to find a middle course

-- an operating scheme that allows the federal funds rate to rise and fall with the level of total reserves, but also accommodate the short-run transitory shifts in the demand for reserves without allowing the accumulation of reserves needed to support rising inflation expectations. What we do not know yet is how to accomplish both of these objectives: combining some measure of short-term stability with an inflation free long-term trend. Developing such a middle course is an important task.

Conclusion

Twenty years ago, in his presidential address to the American Economic Association, Milton Friedman said, "If, as the (monetary) authority has often done, it takes interest rates or the current unemployment percentage as the immediate criterion of policy, it will be like a space vehicle that has taken a fix on the wrong star. No matter how sensitive and sophisticated its guiding apparatus, the space vehicle will go astray."

Monetary policy cannot hope to solve all the complex problems of a market economy, but it can provide an efficient monetary system with a stable price level. In such an economy, markets will be better able to provide the best information for resource allocation decisions. Business cycles will still occur, but will be more attributable to real events and not to unexpected changes in the inflation rate. It seems to me that our terrible inflation experience of the 1970s amply demonstrates the wisdom of that conclusion. Equally, it seems to me that the substantial costs incurred in reducing inflation and inflationary expectations in the 1980s is a very powerful argument for avoiding an acceleration in inflation in the future. Finally, I belive that there are important benefits for the performance of our economy in reducing inflation further -- to zero.