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Monetary Policy, Information and Price Stability

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Introduction

The time in which we live has often been described as the Information Age. Countless books, newspaper and magazine articles, and broadcast hours have been devoted to the information explosion and have explored its implications. Economists recognized early on that information could be thought of as a service whose supply, demand, and price could be analyzed like any other commodity. For a variety of reasons, however, economists were slow to incorporate features of information markets into their analysis of other kinds of economic activity. This unfortunate situation has been changing very rapidly during the past decade and the economic aspects of information are now regarded as absolutely central to the understanding of almost all market phenomena.

Economic research on what people know, how they learn it, and how they react has also caused a revolution in how economists analyze macroeconomic policies. Economists now recognize that people invest considerable amounts of time and other resources monitoring economic policy and that they base private decisions on what they expect to happen. Then they formulate plans that are designed 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, in an effort to be correct on average. If people are correct on average about future policies, then government policymakers should not count on being able to pursuade 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 be 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 of time the Federal Reserve can strongly influence production and employment, but its long-term influence is weak or non-existent. Over longer time periods, growth of output, employment, and wealth surely depend on a nation's resourcefulness in utilizing land, labor, and capital. Monetary policy can best promote an efficient economic system by establishing a stable price level environment. This environment encourages decision makers--private and public--to make long-term plans and contracts without concern that future inflation will later penalize them. The Federal Reserve is the only agency that can control the U.S. price level over time.

I am especially interested in how the Federal Reserve could enhance our nation's economic efficiency by providing and disseminating monetary policy information differently than we do at present. Our inflation rate has hovered around the 4 percent rate for about half a dozen years. Last year the rate rose and 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 meant that the overall price level increased by 30 percent during the last six years and the purchasing power of the dollar declined by 20 to 25 percent. I am deeply disappointed by this kind of inflation 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 impaired our economic efficiency.

I'd like to 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 such a 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 Federal Reserve plans to react. In other words, the Federal Reserve could initiate an information program designed to enhance the attainment of this goal. I recommend this process because I think it will maximize our nation's economic performance over the long run, mindful that at times the Federal Reserve will make some mistakes.

When I speak or write about price stability I mean zero inflation. I think a strong case can be made for having the paramount goal of monetary policy be to eliminate inflation completely. Inflation obscures the information otherwise generated by markets. Inflation adds "noise" to all of the prices we see 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 the consequences of inflation. People create financial institutions and instruments that would be unprofitable in the absence of inflation. Inflation interacts with our tax system in costly ways, leading to less total investment. The tax system can influence the allocation of resources across sectors of the economy, the timing of investment, and corporate financial structures. Inflation can magnify these influences leading to undesirable consequences. 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? 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 should assume that 5 percent inflation is being taken as a tradeoff for some other economic objectives (otherwise why not a goal of zero inflation?). But next year the Federal Reserve might accept some different inflation rate because of changing economic or political circumstances. Consequently, 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 is 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 by the Federal Reserve that it will not attempt to tradeoff 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 elements of a credible monetary policy likely to be? A credible monetary policy is one that an informed public believes will be successful at attaining the goal set by policymakers. The goal needs to be feasible, clearly understood, and publicly supported. If the goal is not feasible and does not command public support, any policy designed to attain it will ultimately not be credible. The policy designed to attain the goal will be more effective the more clearly it is understood. If the policy is not effective, it 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 interest rate premium to hold dollars to offset expected purchasing-power erosion. 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 as significant and obvious as I claim they are, 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 a short-run cost to achieving price level stability, but there are ways to minimize these costs and I think the investment payback period would be rather short. I come to this conclusion after considering how the Federal Reserve could more credibly 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. We have several goals. Among them is price stability over time, 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 a way that we think the public will find acceptable.

People attempt to distinguish between credible information and rhetoric. In the final analysis, credibility accrues to those who visibly make choices in support of their announced goals. The Federal Reserve lost some credibility during the 1970s by not acting forcefully enough to arrest inflation. The Federal Reserve 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. And, I hasten to add, the public's judgement about future inflation affects economic activity in important ways today.

Information and Credible Monetary Policy

In theory, a nation's monetary authority need not provide much public information to maintain its own 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 will not always find it easy to achieve their goal. Unforeseeable events could pose problems: oil price surges and collapses, droughts, dramatic exchange rate fluctuations, changes in the use of money, and large public deficits to name a few. Even if the central bank did 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 assist its credibility by telling the public that it has not changed the goal. Furthermore, it can explain why its policies are not efficacious. It 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 goal it had supported 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 likely to result.

Conducting monetary policy in the United States became unusually difficult in the 1970s. Inflation rates became larger and more highly variable than had been the case for several previous 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 (Humphrey-Hawkins) Full Employment and Balanced Growth 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, 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 semi-annual testimonies to Congress have become prominent sources of public information about monetary policy, partly because of the information provided and partly because there are so few additional sources of public information about the Federal Reserve's intentions.

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 aggregates targets whenever it believes changes are warranted. 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 some information (Policy Directives) about each FOMC meeting six or seven weeks after the meeting. The Policy Directive contains a brief discussion of how the FOMC viewed economic conditions and a statement about whether the FOMC voted to change policy in some way. The votes of individual committee members are provided.

From time to time there are discussions about releasing the Policy Directive much sooner after an FOMC meeting. Those people seeking more information (or more timely information) believe that individuals could make better decisions about their economic affairs if they know more about the Federal Reserve's goals, objectives, view of economic conditions and policy intentions. This is an argument for which I have much respect and sympathy.

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 Directive is already released, although on a delayed basis, to the public. I am far more interested in providing some information that is not public at all--indeed, that does not yet really exist. The Policy Directive may inform the public that the Federal

Reserve has chosen to tighten or loosen, 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. What is missing from the public domain is a clear message about the Federal Reserve's inflation goals, stated in a way that the public can actually use for its own decisions. The information would indicate how much inflation the Federal Reserve envisioned during the next few years and why that amount constituted a reasonable goal. The Federal Reserve could also explain the policy it thinks is most sensible, and how it plans to exercise judgement as it executes this policy. The Federal Reserve could draw a sharper distinction between its goal and the methods it adopts to attain that goal. Because the Federal Reserve has very broad authority to decide on and implement the kind of monetary policy it thinks is 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, Chairman Greenspan's remarks about proposed stock market reforms indicate substantial respect for the ability of the non-financial economy to function smoothly while financial markets are reacting to surprise events. In a similar vein, I would argue that financial markets can absorb more 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 receive 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 everyday 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 multi-year projection. It may find that its announced operating procedures do not work as effectively as first-thought, requiring changes. 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 eroded the purchasing power of a dollar by 20 to 25 percent. 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 think 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.