Ohio Council on Economic Education
Economic Policy Issues for the 1990s
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I. Introduction

A. As 1990 draws to a close, it has proved to be a very interesting and challenging one for the Federal Reserve (the Fed has not been without its critics)
   1. in an election year, have pressures from politicians and special interests for an easing of monetary policy
   2. as the economy slowed throughout the year, many representatives of the business community hoping that they can get a boost from an easing Fed
   3. and more recently, the oil crisis has caused people to look to monetary policy as a potential quick-fix

B. This afternoon, I want to respond to these objections and argue that the Fed should have a primary, overriding responsibility -- protection of the value of the currency

II. The Foundation for Monetary Policy -- The Federal Reserve Act

A. Act of Congress
   1. establishes a broad framework for conduct of monetary policy
   2. calls for 2 policymaking bodies within the Federal Reserve
      a. seven member Board of Governors, located in Washington, D.C.
      b. Federal Open Market Committee (FOMC), includes the Board, President of NY Fed, and 4 of the other 11 regional Reserve Bank presidents (rotating basis)
         1. meets 8 times a year
         2. decides what adjustments need to be made in the policy instruments

B. Goal for monetary policy set out in the Federal Reserve Act
   1. "maintain long-run growth of monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."
   2. many believed that the Federal Reserve could manipulate the supply of money to directly serve all of these objectives

III. Lessons of the 1970s and 1980s

A. Found out that could not control the economy the way we thought we could
   1. in the 1960s, many believed that unemployment rate could be reduced permanently if only a higher rate of inflation was accepted
   2. experiences of the 1970s (simultaneous rising of inflation and unemployment) and the 1980s (inflation and unemployment both falling) cast grave doubt on such a simple relationship

B. Importance of expectations
  1. correct explanation of relationship between inflation and unemployment depends on expectations of inflation
  2. trading off a little inflation for reduced unemployment involves surprising people or violating expectations
  3. and because people will not be "fooled" indefinitely, repeated attempts for such a tradeoff will only result in inflation

IV. Inflation is Costly and Leads to Recession

A. Excessive inflation leads to recessions
  1. monetary policy that is too expansionary will eventually lead to a rise in the rate of inflation
  2. eventually the Fed must tighten that may lead to a recession

B. Even at moderate levels, inflation hinders economic growth and productivity
  1. inflation can depress investment by increasing the effective tax rate on capital
  2. inflation muddies price signals so that resources cannot find their best use today
  3. inflation causes uncertainty for tomorrow so that an inflation premium increases long-term interest rates, thereby raising the cost of capital and lowers investment
  4. resources devoted to protecting against inflation is wasteful in that it takes resources away from producing real goods and services

V. The Oil Price Shock

A. Many believe that monetary policy should react to the recent oil price shock because it <u>causes</u> inflation and, ultimately, a recession
  1. all but one of the 8 post-WWII recessions were preceded by an oil price shock
  2. Iraq's invasion of Kuwait and consequent UN embargo has seemed to touch off another round
     a. soaring oil prices
     b. declines in stock and bond prices
     c. renewed speculation about economic recession

B. What does economic theory tell us about the shock's impact on prices and output?
  1. at a given level of work effort, output declines because of fewer energy resources and energy prices rise
  2. drop in output reduces wealth and income derived by wealth (decline in equities and real money balances)
  3. consumers reaction depends on their perception of the length of the crisis
     a. if it is perceived as short-term
        1. hold to current spending levels
        2. borrow to offset temporary income loss
        3. produce upward pressure on interest rates
     b. if situation is perceived to persist
        1. prolonged income and wealth loss
        2. reduce spending to correspond with smaller budgets
        3. leaves borrowing and real interest rates relatively unchanged

C. How should monetary policy react?
   1. If the shock is perceived as a short term effect (expected real interest rates rising)
      a. this was the case during the Iranian revolution (1979) and outbreak of Iran/Iraq war (1980-81)
      b. monetary policy should not react to bring interest rates down
      c. if the shock is widely regarded as temporary and the Fed does not accommodate, the price level will eventually return to the baseline value

   2. If the shock is perceived to be an ongoing phenomenon, not soon to be reversed (expected real interest rates do not rise)
      a. this was the case during the OPEC oil embargo of 1974 and the current Iraq/Kuwait conflict
      b. monetary authority cannot forestall the slowdown in business activity stemming from an oil shock
      c. no increase in the money supply will make foreign oil more available

   3. In fact, an easing monetary policy will only exacerbate the situation

VI. Past Reactions to a Slowing Economy -- The Inflation-Recession Cycle

A. The economy is slowing and there are pressures for the Fed to ease monetary policy

B. How should monetary policy react? -- Above all else, should protect the long-term value of the currency -- price stability or zero inflation

C. Will a business cycle continue to exist?
   1. Yes, nonmonetary surprises will always exist that the Fed cannot do anything about
      a. technological changes
      b. wars
      c. political change
   2. these shifts will be magnified by improper monetary policy
   3. Zero inflation is a pro-growth policy -- will not have recessions induced by inflation and the persistent need to eliminate it

VII. Appropriate Objective for Monetary Policy -- Zero Inflation

A. inflation rate of zero will reduce any uncertainty associated with inflation (not everyone will understand why inflation is 4%)

B. credibility in the Fed's policy is important since expectations can play a powerful role; unfortunately, credibility can only be established over time

C. appropriate legislation can play an important role
   1. give White House and Congress a vested interest to see that goal is met
   2. give decisionmakers something firm to judge the performance of the Fed against

VIII. Conclusion

A. Accept the limitations of discretionary monetary policy

B. It is time to dismiss the wrongheaded notion that money should be thrown at our problems
   1. oil shock
   2. sluggish growth

C. We should support a single, overriding goal of price stability in the form of a legislative mandate
   1. contributes to credibility for the Federal Reserve in fighting inflation
   2. will result in an environment conducive to maximum long-term growth