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# MONETARY POLICY ISSUES FOR THE 1990s

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**Introduction**

I am very pleased to have this opportunity to speak at the American Farm Bureau's Conference on Monetary Policy. These are troubling times with much uncertainty. We as a nation have many important economic objectives, and we have made much progress toward achieving them in the past decade. Yet, much remains to be done to consolidate and extend the progress of the past decade. Farmers and organizations like the American Farm Bureau will play an important role in the outcome.

My message for you today is a simple one. First, price stability is an important economic objective. Second, price stability is the only economic objective that our central bank, the Federal Reserve, can achieve. Third, by achieving price stability the Federal Reserve will have created an environment in which farmers, businessmen, bankers, and consumers can make efficient decisions -- and those efficient decisions, in a market economy, will maximize economic well-being. Without price stability, those other important economic objectives -- maximum production, employment, balanced growth, and so forth -- cannot be achieved.

I can think of few other sectors of the economy that would benefit as much from price stability as the farm sector. The history of agriculture in this country is replete with periods of boom and bust. Some of these were caused by real factors -- weather and the vagaries of nature here and elsewhere in the world. But some also reflect inflation, which has come in waves, cresting and receding, leaving in its wake people with fixed obligations, sometimes unable to service them. While much uncertainty cannot be removed, the uncertainty associated with inflation can be and should be eliminated.

Since only the Federal Reserve can provide price stability, I would like to spend my time with you today discussing how we operate, why we have not achieved price stability, and what needs to be done to achieve this important objective. I do not want my remarks today to be interpreted as criticism of what the Federal Reserve has accomplished in the past several years. Indeed, I find our policies since 1986 to be a foundation for lower inflation in the future. Even the reduction in interest rates in the last several months is appropriate and seems quite consistent with continued future progress toward lower inflation. Lower short-term interest rates, in my view, are an appropriate response to the slower money growth since October -- a slowdown which may be more than desirable for gradual disinflation.

My concerns are not with current policy but, rather, with the monetary policy process, the lack of clarity in the Federal Reserve's goals, and public expectations of what those goals should be. In effect, the Federal Reserve often seems to be in the position of the man who is attempting to serve all masters, and is ultimately able to serve none.

**Why Does the Federal Reserve Do What It Does?**

The Federal Reserve's Legislated Mandate: Although Congress has given the Federal Reserve a substantial degree of independence, the Federal Reserve has received direction from Congress on a number of occasions. Beyond what was specified in the original Federal Reserve Act of 1913, Congress has adopted various pieces of legislation that spell out goals for the Federal Reserve, without indicating specifically what methods should be used to achieve these goals or the priorities to be given to these often-conflicting objectives.

The Employment Act of 1946 requires the government to pursue "maximum employment, production, and purchasing power." This law was enacted at the end of World War II in response to concerns that the discharge of millions of military personnel and sharp reductions in government purchases of military equipment might cause unemployment to rise to the levels experienced in the 1930s.

The Full Employment and Balanced Growth Act of 1978, also known as the Humphrey-Hawkins Act, attempted to refine the objectives of the Employment Act of 1946. The Humphrey-Hawkins Act requires the government to pursue several national goals, including "...full employment and production, increased real income, balanced growth, a balanced federal budget, adequate productivity growth...an improved trade balance...and reasonable price stability."

Responding to Multiple Goals: Because of the multiplicity of goals established for the Federal Reserve, the Federal Reserve can choose which goal to emphasize at any given moment. Such discretion increases the likelihood that political and special-interest groups could try to influence the Federal Reserve to pursue the policy that is currently important to that group.

In this respect, the Federal Reserve's situation is different from that of West Germany's central bank, which is also independent. More than one goal is specified by law for that bank, but West German law states that the goal of price stability is to be given highest priority whenever another goal might conflict with it. This is a major reason why West Germany's price level only doubled between 1950 and 1988, while the U.S. price level quadrupled.

Since current law requires the Federal Reserve to promote maximum employment, stable prices, and moderate long-term interest rates, the Federal Reserve must choose a viable strategy to accomplish these objectives. Trying to achieve often-conflicting goals can be likened to a person on a teeter-totter who is constantly trying to stay in balance, without regard for the fulcrum. By trying to fine-tune the economy, the Federal Reserve is put in a position of following a stop-go policy, expanding the money supply more rapidly when the risk of recession is higher, and restricting monetary expansion when the threat of inflation seems to be greater. The result is a monetary policy that creates uncertainty.

Both economic theory and actual experience indicate that fine-tuning the economy through monetary policy is fraught with peril. While monetary policy is capable of influencing the economy in the short run, over longer periods of time, monetary policy can only affect the rate of inflation. Whatever rate of inflation is generated, everything else -- interest rates and asset prices including land, labor, and the other productive inputs in our economy -- adjusts to the expected rate of inflation. Inflation, consequently, affects all dimensions of economic performance, including employment and interest rates. Maximum production and employment and low interest rates can be achieved only at low inflation rates. Efforts to manipulate the lever linking the different goals are destined to fail, because the long-term level of prices is the only variable that monetary policy can control. Moreover, uncertainty for consumers and businessmen will be reduced by the assurance of a stable price level. The point is that as long as we entertain many economic objectives, uncertainty will be higher than it need be, reducing productivity and economic well-being.

**The Current Monetary Policy Process**

Monetary policy is made by the Federal Open Market Committee (FOMC) -- the policy arm of the Federal Reserve. The FOMC is made up of the 7 governors of the Federal Reserve Board, the president of the New York Fed, and 4 of the remaining 11 Federal Reserve Bank presidents. All the Bank presidents participate in FOMC meetings, but the 11 presidents outside of New York vote on a rotating basis. The FOMC meets 8 times a year, every six to seven weeks. Our next meeting will be in the first week of February. At every meeting the FOMC decides whether to increase, maintain, or decrease the degree of reserve pressure, which will affect the amount of money and credit available.

Setting Monetary Target Ranges: The February meeting has particular importance because it is at this meeting that the FOMC votes on its annual monetary target ranges for the desired growth path for the money supply. The Committee sets the target ranges with the intention of managing the growth in money. Given our knowledge of the behavior of the monetary aggregates, maintaining price stability will require an average growth rate of M2 (one measure of money) over time approximately equal to the trend growth in output in the economy. Based upon the performance of our economy over long periods of time, that trend rate of growth would appear to be around 2 to 3 percent. In February 1990, the FOMC adopted a 3 to 7 percent target growth range for M2. In July 1990, the FOMC set a tentative target growth range for M2 of 2-1/2 to 6-1/2 percent for 1991 -- one-half percentage point below the 1990 range.

These ranges for M2 and the other monetary aggregates have been adjusted downward gradually since 1986 when the range for M2 was 6 to 9 percent. The downward adjustment is consistent with the Committee's intention to reduce monetary growth rates gradually over time, and ultimately, to lower inflation rates. Even more important than the ranges, M2 growth was limited to about 4-1/2 percent in the three years prior to 1990, and M2 growth last year was about 3 percent. Ultimately, price stability would appear to require M2 growth of 2 to 3 percent sustained for prolonged periods of time. At next month's meeting, the FOMC will reconsider the tentative 1991 target ranges set last July for M2 and the other aggregates.

Results of the Policy Process: At each FOMC meeting, the governors and the voting presidents vote to ease, tighten, or maintain current policy. The decision itself is conveyed in the directive to the Trading Desk at the New York Federal Reserve Bank. It is here that the Fed buys and sells government securities, frequently referred to as open market operations. The decision of the FOMC is framed in terms of bank reserves, but it can more easily be thought of as a short-run target for the money market interest rate on federal funds, an overnight interest rate that banks pay in the market for bank reserves.

Because the outcome of this meeting is a short-term target for an overnight interest rate, neither the FOMC nor anyone else knows for sure whether the inflation rate will accelerate, stay the same, or decelerate if the fed funds rate is kept at this target level. The FOMC will continue to monitor the economy, the inflation rate, the growth of the money supply and long-term target ranges, and a large number of other factors and make future adjustments that will depend on the relative risks as seen by a future Committee.

In this policy process, the policy actions are not tied closely to a specific outcome for the inflation trend. Policy actions are, instead, the result of a deliberative process, attempting to take account of a wide range of factors and events, many of which are far beyond the control of the Federal Reserve. These events include: government tax and spending policies, the weather, technological advances, oil prices, the prospects of war, and so on. Most of the time, real shocks to the economy are just not predictable, and even when they are, we can never be sure how they will affect the economy.

While the current process may give us good information about the short-term interest rate and how it will move in the short run, it gives us very little confidence about the long-run inflation trend. There is no doubt that my colleagues and I want price stability, but in a very real sense the lack of a specified time frame for reducing inflation can result in short-term developments receiving too heavy of a weight. Because short-term problems take precedence, the time never seems appropriate to reduce inflation. By expecting the Fed to fine-tune the real economy, the Fed's commitment to a stable price level and its ability to achieve that goal is weakened.

**Problems with the Process**

Forecast Uncertainty: While monetary policy can influence the growth rate of the economy only in the short run, monetary policy affects the price level in the long run. Setting monetary policy on the basis of a combined short-term real GNP and long-term inflation outlook is risky because near-term real GNP forecasts are not very accurate and are unlikely to show whether the economy will be strong or weak, even over the immediate future. Indeed, on average, the most accurate forecasters cannot predict with any reasonable degree of certainty at the beginning of a quarter whether the economy will be receding or booming that quarter.

One way to measure our confidence in the near-term real GNP forecast is to examine the size of the typical forecast error relative to the average forecast. For example, the mean quarterly growth rate of the economy over the past 20 years was about 2-3/4 percent (at an annual rate), and the median one-quarter-ahead root mean square forecast error was about 4 percent. That is, if the forecast for real GNP one quarter ahead was 2 percent, the realized growth rate would have ranged between approximately -2 and 6 percent roughly two-thirds of the time.

How should a policymaker respond to a typical forecast if the range of error is so wide that it includes both decline and rapid expansion? The large errors in quarterly real GNP forecasts suggest that policy actions based on near-term forecasts should be conservative. Simply, the greater the uncertainty associated with the forecast, the smaller the policy response the forecast should induce.

Short-Term Focus Risks More Inflation and Recession: Even if we could predict recessions and wanted to vary monetary policy to alleviate them, we still face another almost insurmountable problem -- monetary policy operates with a lag. Moreover, the length of the lag varies over time, depending on conditions in the economy and on public perception of the policy process. The effect of today's monetary policy actions will probably not be felt for at least six to nine months, with the main influence perhaps two to three years in the future. The act of trying to prevent a recession may not only fail, but may also create a future recession -- via inflation -- where otherwise there would not have been one.

People do their best to forecast economic policies when they make decisions. If the central bank has a record of expanding the money supply in attempts to prevent recessions, people will come to anticipate the policy, setting off an acceleration of inflation and misallocation of resources that will lead to a recession. Economic agents -- such as businessmen, farmers, bankers, and consumers -- do not act in a vacuum. The political forces operating on a central bank make inflation always a possibility. Indeed, the record of the past half century suggests it is more than a mere possibility. Moreover, inflation comes in waves and the uncertainty about future inflation adds risk to future investments. What seems a sensible price for land or other real assets today may prove to be foolhardy tomorrow if the inflation outlook changes abruptly. Uncertainty about future inflation will raise real interest rates, drive investors away from long-term markets, and delay the very adjustments needed to end the recession. The more certain people are about the stability of future monetary policy, the more easily and quickly inflation can be reduced and the economy can recover.

**Improving the Policy Process**

An ideal monetary policy would produce a credible, predictable commitment to stabilizing the price level. I will not repeat my zero-inflation speech, presenting all the powerful arguments for stabilizing the price level, for I'm sure you know them. Inflation wastes resources, and uncertainty about the future rate of inflation wastes even more resources. It is by avoiding such waste that monetary policy strengthens real growth and the stability of the economy.

The lack of credibility and predictability in the policy process is the problem. The more credible the commitment to a price stability goal, the fewer wrong decisions will be made by the markets. The more predictable the policy reaction to unforeseen economic events, the more limited will be the market reaction to those events. The existing policy process, with its focus on the near-term economic outlook, does not provide clear objectives or credibility.

A Legislated Goal: How could we change the process to reinforce the credibility of a consistent goal? I think the most secure way would be to give the FOMC a legislative mandate to meet a consistent, attainable, and unchanging economic goal. Legislation, such as the resolution introduced by Congressman Stephen Neal in the last Congress, would provide that crucial reinforcement.

The Neal Resolution simply directs the Federal Reserve to make price stability the primary goal of monetary policy. History gives us little basis for expecting price stability or even a stable rate of inflation because the FOMC has had no mandate to produce that result. Giving the FOMC that mandate and knowing that the FOMC had the intention of stabilizing the inflation rate at zero, would provide a truly significant piece of policy information to any rational decisionmaker in any dollar-denominated market. The Federal Reserve System would remain independent; it would retain complete discretion about how to carry out policy. The only change is that Congress would provide more direction about basic policy objectives. The Neal Resolution would make the Federal Reserve's legislated mandate more like that of West Germany's Bundesbank, which gives the goal of price stability the highest priority whenever another goal is in conflict with it.

A Self-Imposed Goal: An alternative to legislation is for the FOMC to adopt the price stability goal itself. As many scholars have urged, the FOMC might impose a "rule" on itself, tying policy actions to some intermediate target variable by an agreed-upon formula that should assure achieving price stability. These days, the most popular candidates for an intermediate policy target seem to be nominal GNP and M2, either of which is thought capable of producing reasonable price stability. Another approach would be for the Committee to specify that achieving the ultimate policy goal -- zero inflation -- is the rule, using discretion in choosing actions to achieve the goal. Credibility would have to be earned through predictable actions consistent with the goal. To adopt an explicit rule, at least a majority of today's FOMC members must not only agree on an overriding macroeconomic goal, but also must renounce some discretion to pursue other goals. Moreover, tomorrow's FOMC could decide to change the goal and hence the rule. In the current policy regime, there is no way today's policy choice can bind tomorrow's. Unless directed by society through specific mandate, tomorrow's FOMC always has the discretion to change the goal.

**Conclusion**

In short, monetary policymakers have made progress over the past decade. Policymakers have had the discipline to align the growth rates of money and credit more closely with the economy's long-term ability to grow. The result has been moderate inflation. Moderate inflation is better than rapid inflation. Moreover, the steady money supply growth of the past several years bodes well for a slight further reduction in inflation in 1991 and thereafter -- despite the serious price pressures caused by oil prices and more recently by adverse weather in the fruit and vegetable

growing areas of the west coast. But a slight further reduction in inflation is not good enough. Our goal should continue to be price stability -- achieved over a reasonable time frame. Price stability will require steady discipline when implementing monetary policy. If there is a danger to this process, it would be the possibility that the Federal Reserve, in reacting to short-term events, like recession, oil prices, or similar events beyond its control, will be distracted from its primary responsibility -- price stability.

To help guard against this danger, the monetary policy process should be improved. Legislation mandating the Federal Reserve to achieve and maintain price stability would help guard against short-term objectives and special interests that undermine the achievement of long-run price stability. I congratulate the American Farm Bureau for taking a strong position in favor of price stability and for supporting the Neal Resolution. I encourage you to continue your efforts.