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U.S. MONETARY POLICY: FINE-TUNING THE OBJECTIVES

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I am pleased to have this opportunity to address the Fraser Institute's 1991 Benefactor Summit. Although, I confess to having some reservations about delivering a talk on U.S. monetary policy with the dean of monetary economists, Milton Friedman, on the program.

As you are all aware, we are currently experiencing a significant decline in economic activity, largely, in my view, as a result of the uncertainties of the Persian Gulf situation, the economic adjustment to higher oil prices, and a sharp and sudden change in the mood and expectations of consumers. With respect to monetary policy, public discussion often centers on whether central banks can reverse economic slowdowns or stabilize exchange rate fluctuations. My message for you today is that central banks cannot fine-tune the economy. By trying to do so, they jeopardize the one economic objective they can achieve over time -- price stability. This is not an insignificant objective. By achieving price stability, a central bank can reduce at least some of the uncertainties that businesses face, laying the foundation for a more efficient, and ultimately, more prosperous economy.

The Current Economic Environment

The current decline in business activity is cause for concern in both Canada and the United States. As is always the case, it is impossible to foretell with precision either when the decline will end or what the shape of the ensuing recovery will be. At the moment, the data we are seeing are consistent with the idea that the decline will be brief and, indeed, may be largely behind us. In both countries, the run-up in business inventories to date has been slight compared with previous recessions, and liquidation of inventories is proceeding. In addition, export markets may provide the economy with a lift. But the contour of business activity in the months ahead can only be discerned with large elements of conjecture, as I will argue later.

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The fears of inflation that arose last summer with the surge in oil prices seem to be diminishing. The sharp increases in consumer prices in August and September have slowed. Moreover, there is little evidence that higher oil prices have spread in a substantial or compelling way to higher prices elsewhere in the economy. The monetary policy response has been appropriate and an increase in inflation does not seem to lie ahead of us, as was the case in the 1970s. Of course, it is too soon to be very sure about this. The outcome will depend upon many factors, including how the situation in the Middle East is resolved. However, I believe that U.S. monetary policy over the past several years has established the foundation for a more promising inflation outlook for the next several years.

Growth in the U.S. money supply was moderate in 1990. Indeed, the slowdown in the monetary aggregates, especially toward the end of the year, may have been more than desirable to support a policy of gradual disinflation. In response, the Federal Reserve has reduced short-term interest rates in the last several months. This reduction should have boosted money growth. Yet money growth remains slow, and this behavior is somewhat difficult to interpret. It may be that the recent weakness in U.S. money growth is the result of restructuring in the financial industry -- the shift of deposits from the thrift industry to other financial institutions -- or a different attitude toward credit by borrowers and lenders. It may also be that the Federal Reserve, confronting these uncertainties, did not provide reserve growth aggressively enough.

As monetary policymakers struggle with these issues, public pressure mounts for the Federal Reserve to reverse the current economic slowdown. I believe that monetary policymakers should proceed with caution. First, monetary growth may soon respond to recent policy adjustments. Second, the slowdown in the economy was caused primarily by an increase in oil prices. Lowering interest rates further will not

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alter this situation. Finally, experience shows that the Federal Reserve cannot fine-tune the economy. We do not have the knowledge or the foresight to base policy on expected near-term fluctuations in business activity.

Multiple Objectives and Fine-Tuning

The Federal Reserve is called upon to fine-tune the economy because the Fed, like many central banks, has been assigned a variety of economic goals, including stable prices, stable exchange rates, and maximum production. When exchange rates shift or trade accounts become imbalanced, pressure is placed on the Federal Reserve to correct the situation through monetary policy. Similarly, when the economy slows, pressure is placed on the Federal Reserve to turn its attention toward economic growth. In effect, the central bank is often in the position of the man who, in attempting to serve all masters, is ultimately able to serve none. Relying on monetary policy to achieve multiple goals, many of which are beyond its reach, may cause us to make mistakes, possibly serious ones.

Mistakes arise as policymakers attempt to pursue goals that, at times, will conflict with each other. For example, in the late 1970s, limiting rapid dollar depreciation through intervention was compatible with a contractionary monetary policy to eliminate inflation. As often as not, however, these two policy objectives will be incompatible. U.S. sales of dollars in early 1989, for example, seemed inconsistent with a goal of price stability and with Federal Reserve actions at that time to slow monetary growth. That intervention carried a risk of sending confusing signals to foreign exchange and bond markets, since the markets may have thought that U.S. monetary policy had become less focused on lowering the inflation rate.

Interventionists argue that a sterilized approach, in which the central bank offsets any monetary effects of intervention, can influence the exchange rate without compromising domestic policy. If this view has any merit at all, the effects are small

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and very short-lived. Furthermore, distinguishing between the two types of intervention -- sterilized and unsterilized -- is difficult in practice and bound to create additional uncertainty on the part of private decisionmakers.

The oil price shock is a more recent illustration of the difficulty that central banks face in attempting to achieve multiple goals by balancing price stability and economic growth. Iraq's invasion of Kuwait was accompanied by soaring oil prices, declines in stock and bond prices, and speculation about economic recession. Such concerns would seem to be well-founded. Since World War II, large oil price increases have been a harbinger of higher inflation and recession. Yet, without an overriding objective for monetary policy, it is unclear how the Federal Reserve will respond in the face of real disturbances.

The rise in oil prices reduces national output and may potentially trigger a period of adjustment during which the economy may recede. Such would seem to be the case today. But no amount of money will compensate for the fact that an important raw material, oil, is expected to be more scarce. The economy must adjust to the increased relative scarcity of an important input in the production process. Furthermore, the decline in national output creates a surplus of money relative to output that puts upward pressure on the price level. As policy now stands, the Federal Reserve is torn between its desire to keep the economy growing and its desire to keep the economy's inflationary pressures in check.

As we consider monetary policy adjustments in 1991, we should recognize the limits of monetary policy in the current economic environment and the risks that inappropriate policies pose for 1992 and beyond. It is important to understand what monetary policy can and cannot do. Contrary to public expectations, the central bank cannot and does not control long-term interest rates. Nor can the central bank fine-tune economic growth. Efforts to do so in the past, while seemingly successful for awhile, have proved to be technically difficult and have produced costly, inflationary side effects.

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<u>Forecast Accuracy</u>: Using monetary policy to fine-tune the economy is fraught with peril. The record suggests that near-term real GNP projections are too inaccurate to be of much value in determining the appropriate course of monetary policy from quarter to quarter.

Economic forecasts have been shown to reduce some of the uncertainty concerning the direction of the economy. A recent study at the Federal Reserve Bank of Cleveland found that quarterly forecasts up to one year ahead reduced uncertainty by roughly 14 percent for the growth rate of real GNP and by 52 percent for inflation. But these forecasts are not accurate enough to be clear guides for monetary policy. Indeed, on average, the most accurate forecasters cannot predict at the beginning of a quarter, with any reasonable degree of certainty, whether the economy will be receding or booming that quarter.

The mean quarterly growth rate of the economy between 1968 and 1985, for example, was 2.6 percent (at an annual rate). On average, that is just about what forecasters predicted. While forecasting economic growth over a 20-year horizon is not particularly difficult, it is not very useful for policymakers. Policymakers usually concentrate on the near-term, and here the forecasting record is poor. For example, the average one-quarter-ahead forecast error between 1968 and 1985 was about 4.2 percent. If we compare this average error to the 2.6 percent average quarterly growth rate of the economy over this period, we see that the representative forecast is unable to distinguish between an economy headed for prosperity and one on the verge of recession. How should monetary policy respond to quarterly real GNP forecasts if their range of precision is so wide that it almost always includes the possibility of both economic decline and rapid expansion?

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While the errors in quarterly real GNP forecasts do not necessarily preclude some countercyclical policy, they do suggest that policy actions based on near-term forecasts should be conservative. Simply put, the greater the uncertainty associated with the forecast, the smaller the policy response the forecast should induce.

Policy Timing and Uncertainty: Even if we could predict recessions and wanted to vary monetary policy to alleviate them, we still face another problem -- monetary policy takes time to work through the economy. Moreover, the time varies, 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 it may also create a future recession -- via inflation -- where otherwise there would not have been one. 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 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 necessary 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.

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Improving the Policy Process

An ideal monetary policy is one that is based on a commitment to stabilize the price level. The keys to effective policy are credibility and predictability. The more credible the commitment to price stability, the more limited will be the market reaction to adverse events. The more predictable the policy reaction to unforeseen economic events, the fewer wrong decisions will be made. The policy process today, with its focus on the near-term economic outlook, does not provide as clear or credible policy objectives as I would like.

Monetary policy in the United States 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. 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 the FOMC decides on its annual target ranges for the desired growth path for the money supply. The Committee sets target ranges for the growth of various measures of the money supply 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 of economic output. 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. Last week the FOMC adopted target ranges

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for M2. These ranges will be made public on February 20 when Chairman Greenspan testifies before Congress. 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.

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 a 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 federal funds rate, an overnight interest rate that banks pay in the market for bank reserves.

Because the outcome of the FOMC 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 the 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, policy actions are not tied closely to a desired

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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.

More specifically, policy lacks an explicit, attainable objective. Under the current policy process, the relative importance of the various objectives changes with economic fluctuations. To accurately assess past and future decisions, market participants must constantly update their best guess about the central bank's long-run objectives. In the current environment, the market monitors policy actions to detect policymakers' intentions. But the lack of a clearly defined long-term goal causes market expectations of the goal to vary with the latest economic news. This uncertainty reflects a monetary policy that is neither predictable nor credible.

Economic decisionmakers require more information about the long-run goal of monetary policy. Economic decisionmakers also require more compelling reasons to be confident that the Federal Reserve will indeed achieve that goal. This requires a monumental change in the current policy process. House Joint Resolution 24, sponsored by U.S. Representative Stephen Neal, would help bring about this critical change in policy by mandating that the Federal Reserve make price stability its primary objective.

Experience has shown that there are no quick fixes in the promotion of economic growth. There is no evidence that a faster trend rate of output growth can be bought with a higher rate of inflation. In fact, inflation reduces the welfare implied by growth by creating inefficient decisionmaking and thus lowering wealth-enhancing productivity. Viewed in this light, a monetary policy that best encourages growth -- long-term growth -- is one that is designed to eliminate inflation, and our policies since 1986 are a solid foundation for providing lower inflation in the future.

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Policy Outlook: Cautious but Focused

Has the Federal Reserve eased enough? I honestly do not know. For the moment, I believe we have done enough and we should wait until we are able to judge the results of the adjustments we have already made. Lower short-term interest rates helped to support money growth rates in December and January, and we may well see the resumption of more rapid M2 growth in the next month or two. The current target growth range set by the Federal Reserve for M2 has a midpoint of around 4 percent. I would like us to be near that midpoint. But if the inflation statistics begin to decline at an accelerated pace and if the monetary aggregates remain flat, further policy adjustments will be necessary.

In short, monetary policy has made progress over the past decade. Policymakers have had the discipline to align the growth rate of money more closely with the economy's long-term ability to expand. The result has been moderate inflation. Moderate inflation is better than rapid inflation. Moreover, the steady money supply growth of the past several years may portend a further slight reduction in inflation in 1991 and thereafter, despite the serious price pressures caused by higher oil prices.

But a slight further reduction in inflation is not good enough. The gains possible in more efficient resource allocation cannot be realized without a credible precommitment to price stability, the one objective that the Federal Reserve can achieve. Our goal should continue to be price stability, achieved over a reasonable time frame. This will require steady discipline when implementing monetary policy. The danger inherent in the current policymaking process is the possibility that the Federal Reserve, in reacting to short-term phenomena, like recession, higher oil prices, or similar events beyond its control, will be distracted from its primary responsibility -- price stability.

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