

For Release:
7:30 p.m. E.D.T.
May 4, 1992

WHAT MONETARY POLICY CAN AND CANNOT DO

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The Money Marketeers
New York, New York
May 4, 1992

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One of the peculiar aspects of returning to the monetary policymaking arena has been the media's interest in labeling me a "hawk" or "dove," or someone who is anti-inflation or pro-growth. I regularly receive calls from reporters when economic statistics are released asking about my reactions to the numbers so that they can speculate about how I might vote at the next Federal Open Market Committee meeting. "Fedwatchers" -- a fraternity I once belonged to, other market participants, and the media have increasingly focused on interpreting policymakers' actions and on the minutia of implementing policy. This focus has contributed to confusion about what monetary policy can and cannot do and has added to the age-old confusion between money and credit.

This evening I will argue that this obsession with the detail of implementing policy has detracted from long-term policy goals. I will present my views on the essential principles underlying monetary policy and describe what monetary policy can and cannot achieve. Finally, I will give my prescription for what a central bank should focus on.

The America's Cup trials, currently underway in San Diego Bay, can serve to illustrate the problem of communicating the logic behind monetary policy formulation and implementation. If you have had the opportunity to watch the television coverage of this preeminent sailing race, you have observed that it is rather difficult to discern how a yacht is doing relative to the finish line because the bow of the yacht is almost never pointing towards the ultimate destination, or even the next buoy. Television viewers most often are given two vantage points of the race. One camera, affixed to the mast, is

focused on the actions of the crew and the captain. Watching the operations of the crew provides no information about the progress of the boat along the course of the race. For that information we must go to a camera located in a blimp high above. But even well above the fray, the course of the race is difficult to follow, and the progress towards the finish line may appear to be unclear. Depending on the wind, the boats will be tacking first in one direction and then in another. The television commentator helps by drawing lines on the screen marking a course line, the relative position of the boats, and the ultimate destination. The helmsmen exercise a considerable amount of judgement, while abiding by age-old principles of sailing, to reach the finish line.

Principles Underlying Monetary Policy

The implementation of monetary policy actions has much in common with sailing. Just as watching the crew adjust the sails provides little information about the boat's destination, the technicalities surrounding the monetary policy process provide little information about the outcome. Just as the principles of sailing go back to the time of the Vikings, the principles of monetary policy go back at least to Henry Thornton in the early 19th century. Thornton, a banker and economist in England, recognized and clearly articulated the dangers associated with a volatile supply of money. In particular, Thornton linked changes in the supply of available money and credit to the general price level. Leading scholars, such as Milton Friedman, have periodically restated these basic principles. Unfortunately, these principles are often overlooked or perhaps forgotten by some Fedwatchers and financial journalists.

In 1967, Milton Friedman, in his Presidential Address to the American Economic Association, presented a clear description of the role of monetary policy. He began by reminding his audience about the limitations of monetary policy; that is, it cannot be used to produce real goods and services or create employment. Furthermore, monetary policy cannot peg the real interest rate and it cannot peg the unemployment rate. Rather, monetary policy can create an environment in which the economy will operate most efficiently. Ignoring this contribution, as central banks have done at times in the past, can have disastrous consequences.

The Phillips Curve Illusion

Output is negatively correlated with inflation over the long run. At any point in time, however, it may appear that output and inflation are positively correlated. Indeed, this positive short-run correlation, known as the Phillips curve, underlies most public discussion of monetary policy. It is worthwhile to reconsider the history of this relationship.

Back in 1958, an English economist, A. W. Phillips, noted an apparent inverse relationship between unemployment and **real** wages. He observed that an increase in real wages tended to be associated with a decline in unemployment. Such an association should be expected if employers respond to a shrinking labor pool by raising real wages. This idea is perfectly sensible when viewed in terms of real wages and unemployment. When the demand for labor rises, we expect the price of labor to rise.

However, the logic fails if this relationship is viewed in terms of money wages. There is no obvious reason to think that a rise in the money wage would be associated with a shrinking labor pool. Nevertheless, as an empirical matter, economists noted that changes in nominal wages were also inversely related to unemployment for the period Phillips considered.

Unfortunately, macroeconomists inappropriately replaced changes in the nominal wage with general inflation to generate the relationship that we know as the Phillips curve.

But the Phillips curve is an illusion. The data used were from an earlier period, 1861 to 1959, in which the price level fluctuated, but without a secular trend such as the U.S. has experienced since World War II. Because there really wasn't much inflation on balance, we should not be surprised to see a Phillips curve in the data. When people expect price stability, perceived real wages will equal money wages. However, this equality disappears in an inflationary environment. On occasion in the last 30 years, policymakers have tried to exploit the Phillips curve to lower unemployment below its prevailing rate even though the simple inverse relationship between inflation and unemployment does not exist. Indeed, the common experience in the United States and Europe is the opposite. With rising inflation, unemployment has risen, and it has risen to the highest levels in countries that have had the most inflation. Yet, the financial press, many members of the Congress and the Administration, and perhaps some of you here tonight, continue to use the Phillips curve framework when thinking about the effects of monetary policy.

This has been particularly evident during the past two years of weak or contracting economic growth. Financial market participants have become conditioned to the idea that monetary policymakers will "ease" policy -- cut the federal funds rate -- following reports suggesting a weak economy. The most notorious indicator is the monthly unemployment rate, or its companion report, nonfarm employment. There are numerous examples where a cut in the federal funds rate was linked by the financial press to the announcement of weak real variables. From December 1990 to December 1991, the federal funds

rate was reduced four times on the same day that weak employment data was released, and on one occasion the rate was reduced three business days following the release of weak employment numbers. One problem of "easing" when these measures are weak is that traders then believe that the inverse is also true -- policymakers will "tighten" following reports of strength. On April 26, 1990, bond prices fell sharply, reportedly because of expectations that the first-quarter gross national product data, due out the following day, would indicate a stronger-than-expected economy which would lead the Federal Reserve to "tighten" monetary policy.

Controlling Real Interest Rates

The Fed cannot control real variables, such as the level of employment. Likewise, it cannot control the real interest rate, the interest rate that matters for real activity. Real interest rates will rise when the marginal rate of return to capital increases. Real interest rates also rise when people become more impatient to consume now rather than in the future.

On one occasion towards the end of the 1970s, I was testifying before a Congressional committee responsible for the oversight of the Federal Reserve and monetary policy. Another witness for the committee (an eminent professor from a major university and, subsequently, a Nobel prize winner) said that interest rates were too high and the Federal Reserve should increase the money supply at a faster rate and push interest rates down. When I got my turn, I said, "That's not the way it works. Look at what happens in the U.S. Treasury bill futures market on Friday mornings, after the Thursday night money numbers are released. If it is reported that there is a big increase in the money supply (compared to what was expected), the prices of futures contracts fall--interest rates rise. If there is only a small increase (or a decline) in the money supply, security prices rise and interest rates fall. It's just the opposite of what they teach in the classroom."

The professor then responded that the LM curve needed to be shifted to the right. I could tell that we were not going to have the kind of debate that would persuade members of the U.S. Congress or the American public that the Federal Reserve cannot reduce interest rates by expanding the money supply. His simplistic, incorrect notion -- that faster growth of the money supply results in lower market interest rates -- is still with us today.

I would not hesitate to try to explain to a high school economics class that the reason Brazil and other places in Latin America have experienced high nominal interest rates in past decades is because they have had very high inflation resulting from excessively rapid money growth. Conversely, the reason that countries like Switzerland, Germany and Japan had low nominal interest rates was because they had low inflation resulting from slow money growth. Yet, for some reason we have not been able to persuade journalists and members of the Congress that rapid money growth causes high interest rates, and slow money growth produces low interest rates.

What Monetary Policy Can Do

Since we know that monetary policy cannot control the real interest rate or the unemployment rate, what can it do? As Friedman explained so clearly back in 1967, it can achieve two objectives. First, it can avoid being a source of economic disturbances. Second, it can foster sustainable high real growth by stabilizing the aggregate price level. These two objectives are related. Failing to stabilize the price level is itself a source of uncertainty and risk in our economy which depresses output and employment.

Friedman concluded his discussion of monetary policy with a call for monetary targeting. During the late 1960s and early 1970s (while working at the St. Louis Federal Reserve Bank), I was associated with an effort to get

people, both inside and outside monetary policy circles, to pay more attention to the money supply. However, using the money supply as a target instrument for formulating and implementing monetary policy actions (versus an indicator variable summarizing the thrust of those actions) has not advanced much during the more than 16 years I have been out of policymaking circles.

The challenge today still is to focus on the long-run issues. Just as the captain of a sailboat cannot control the direction or force of the wind, or water currents, or the chop of the water, neither can the Federal Reserve control the real variables that receive so much attention. To return to my analogy, we should expect the crew to do its job, but if we want to understand where the yacht is headed, we should not dwell on the action on the deck. Instead, we should take the view from the blimp and study the commentator's course line so that we can see where monetary policy and the economy are headed.

What a Central Bank Should Focus On

Knowing the long-term objectives of monetary policy is critical for successful planning, whether you are an individual planning for retirement or a corporation planning for the next century. U.S. corporations are often criticized for being short-sighted. Suggestions are frequently made to adopt an industrial policy or other government-driven mechanisms to produce better outcomes. Yet, the government and its agencies have failed to provide the most important basic building block for improved, private market-driven planning. That, of course, would be a credible commitment to price stability which would produce low and steady nominal interest rates.

If the policy process is well-managed, prosperity will follow. In general, average output growth will be higher the lower the average inflation

rate and the less the uncertainty about future prices. This occurs for many reasons. Increased uncertainty about the future price level leads to a waste of resources and sub-optimal decision-making. For example, we so far have failed to index the tax rates on the income generated from the capital stock. At even a 4 percent inflation rate, an 8 percent market interest rate, and a 35 percent tax on income from capital, the effective tax rate on real income from capital is 70 percent.

Another consequence of vague long-term objectives and tenuous commitments is the obsession of the media with the minutia of policy -- the daily open market operations, weekly changes in the monetary aggregates, short-run changes in the federal funds rate, employment reports, etc. The focus on the short-run has caused an undue preoccupation with the Phillips curve. Not only do people begin to assign the Fed responsibility for the business cycle, but the press transforms the policy debate into a conflict over the perceived short-term effects of policy. The classification of monetary policymakers as "hawks" or "doves" is misplaced and is entirely a consequence of failing to produce long-term plans. Policies that deliver low inflation will deliver low interest rates. Artificially pushing down the federal funds rate will not bring about lower bond yields and mortgage rates. Indeed, on several occasions in the past few years, a cut in the federal funds rate resulted in higher long-term interest rates.

The effects of monetary policy actions are difficult to gauge, even when we observe monetary growth averaged over a year. The annual targeting exercise still includes considerable tacking. As we learned in the early 1980s, the winds pick up and tacking becomes more critical when the Fed tries to reduce the inflation trend. Missing are the buoys and the TV commentator with a course line drawn for M2 or a price index. M2 velocity has been relatively stable for the last 30 years, making me willing to rely on it as a

long-run guide for policy actions. Yet, changes in the tides and currents of financial markets cause changes in the components of a broad monetary aggregate such as M2. The seasoned hand at the tiller must know when to make near-term adjustments without altering the basic course.

In 1967, Milton Friedman argued that money was a good short-run target. I think it is still. However, if we are drawing a course line to define the standard for price stability, then perhaps we ought to do it with some measure of prices. Such a course line would not prohibit the Fed from tacking into the wind. However, it would take the focus of the camera away from the activity of the sailors and put it on the long-run course of the economy. That does not mean that Fedwatchers like you would not still be interested to see how we set the sails and tie the knots. But members of the Congress, the Administration, and the financial press would not be focusing on variables that the Fed has no control over, unnecessarily rocking the boat.