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Challenges Facing Monetary Policymakers

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I. INTRODUCTION

A. Monetary policy has been the focus of the financial press in recent weeks.

1. Referring to domestic monetary policy, a recent headline read: "FED FIDDLES AS ECONOMY BURNS."
2. Referring to monetary policies abroad: "CONFLICTS OF INTEREST, CURRENCIES IN TURMOIL, Germany's Monetary Policy Sinks the British Pound, and EC Goals Are at Risk."
3. These headlines suggest that monetary policy can produce real goods and services and that a trade-off exists between growth and inflation.

B. I argue that those who are anti-inflation are pro-growth. Those who believe inflation is necessary to achieve growth, or that central banks can produce growth through stimulus, are mistaken about the long-run relationship between inflation and growth, or else they don't care about the long-run.

C. Journalists want to label monetary policymakers as Hawks or Doves (some think we are turkeys) – false dichotomy.

Hawk -- anti-inflation

Dove -- pro-growth

In banking, the purpose of inflation is to turn bad loans into good loans.

II. THE CURRENT MONETARY POLICY SITUATION

A. Current Economic Recovery Is Weaker than Past Expansions

1. Structural imbalances have proven to be large and persistent.
 - a. Unrealistic expectations of rising incomes and asset prices led to:
 - 1) Excessive use of debt by business and consumers.
 - 2) Excessive commercial real estate construction.
 - b. The result has been that:
 - 1) Borrowers have cut spending and investment.
 - 2) Lenders have become more cautious.
2. Cutbacks in defense spending involves lags and structural adjustments which affect individuals, firms, and communities.
3. Budget problems of state and local governments are resulting in tax increases, layoffs, and cutbacks in transfer payments.

B. Laying groundwork for longer, sustained growth.

1. Structural imbalances cannot be corrected with easier monetary policy.
2. Recessions are like hangovers -- excesses cause hangovers/recessions, can postpone hangovers with more drinking, cannot prevent or cure hangovers by continued drinking.

C. Over the Past Several Years, Yield Curve Has Steepened, Fed Has Been Lowering Short-term Interest Rates

1. The Fed has been lowering the discount rate and the federal funds rate gradually since mid-1989.
 - a. There have been 24 separate reductions in the federal funds rate.
 - b. Each cut was small. An exception was December, 1991, when the federal funds rate was cut 50 basis points and the discount rate was cut 100 basis points.
 - c. Small cuts characterized as tentative and cautious.
2. The cumulative reduction in rates has been quite large.
 - a. Short-term rates have fallen by about two-thirds since mid-1989.
 - b. The discount rate was lowered from 7.0% to 3.0%.
 - c. The federal funds rate was lowered from almost 10% to 3.0%.
 - d. Lowest short-term rates in 30 years.
3. Despite the reductions in short-term interest rates, the recovery has remained sluggish, growth of key monetary aggregate (M2) is below target, and long-term interest rates have remained relatively high--yield curve is very steep.
4. Yield curve will flatten--don't know from which end.
 - a. From short end if expansion is vigorous
 - b. From long end if expansion is moderate and inflation expectations continue to improve.

D. Indicators of Monetary Policy

1. Another key determinant which end the yield curve will flatten--credibility of the Federal Reserve.
2. Policy statements by a credible central bank should be the best indicator of the Fed's policy goals and tactics.
 - a. Unfortunately, the Fed lacks credibility.
 - b. So, people look for other indicators of policy.
2. Easing vs. tightening: nominal interest rates can be a misleading indicator of policy.
 - a. If the Fed tries to slow a decline in market interest rates, interest rates are falling but the Fed is tightening (restrictive).
 - b. If the Fed acts to slow a rise in market interest rates, interest rates are rising but the Fed is easing (stimulative).
 - c. So, the direction of interest rate movement is not always an accurate indicator of the direction of monetary policy.
3. Money supply growth also has shortcomings as an indicator of monetary policy--long and variable lags; control problems.
 - a. Money supply growth does not always move closely in accordance with the Fed's intentions, because there are lags between policy actions and money supply responses.
 - b. There are several measures of money supply, and they sometimes grow at substantially different rates.
 - c. Growth of the monetary base and of M1 might be used as indicators of the thrust of monetary policy, while growth of M2 might be used as a signal of nominal aggregate demand.

E. Which M Do You Believe?

1. The Fed sets target ranges for money growth that it believes are consistent with moderate inflation and steady economic growth. Choose monetary measure based on what your objective is.
2. Target range for M2 for 1992 is 2.5% to 6.5%.
3. Year to date, money growth is well below the target range: M2 has grown at 1.5% annual rate; therefore monetary policy has been highly restrictive.
4. The monetary base and M1 have been growing more rapidly
 - a. Monetary base has grown at 8.8% annual rate.
 - b. M1 has grown at 12.4% at annual rate.
 - c. Therefore, monetary policy has been highly expansionary and Fed has been sowing seeds for future inflation.
5. Past, reliable relationships between interest rates and M2, and M2 and inflation have broken down.
 - a. Theory tells us that if you reduce interest rates, M2 will grow.
 - b. Recently, interest rates have been reduced and M2 has contracted because CDs are declining as depositors switch to other instruments.

F. Which Inflation Numbers Do You Believe?

1. Our model (P^*), based on recent slow M2 growth, tells us that inflation will be around 2% next year.
2. Surveys tell us that consumers and businesspersons believe inflation will be between 4% and 5%.
3. Yield curve tells us markets believe we will have higher inflation -- very steep yield curve.

G. Long-term Interest Rates Have Remained High Despite Declines in Short Rates

1. Long-term rates have remained high because:
 - a. Investors fear stronger inflation because:
 - 1) Federal deficits exert pressure for monetary accommodation.
 - 2) Congress and administration have eschewed the Neal Amendment.
 - b. The shift toward market systems in many nations might raise the marginal productivity of capital.
2. Long-term bond yield of 7.4% has 4% inflation built in (interest rates = real rate of interest plus expected inflation).
3. Lower long-term rates would:
 - a. Encourage balance sheet restructuring.
 - b. Encourage spending on business fixed investment and residential construction.

III. WHERE DO WE GO FROM HERE?

A. It is Easier to Determine Monetary Policy Goals Than Monetary Policy Tactics

1. It is clear that the fundamental goal of monetary policy is to foster long-run prosperity.
2. It is also clear that long-run prosperity is best fostered by a stable price level.
3. Moreover, it is clear that we need to move from inflation to price stability gradually.
4. The proper month-to-month tactics to use to slow the rate of inflation are not clear.

B. We Should Try To Get M2 Growth Within Its Target Range Without Reigniting Inflation Fears

1. We should try to get M2 to grow faster, so it will move up within its target ranges, for two reasons:
 - a. This is necessary in order to enhance the Fed's credibility. If we don't observe the lower limits of the target ranges, markets are less likely to expect that we will observe the upper limits of the target ranges.
 - b. While we have some insight into why growth of M2 is slow, we are by no means certain that the relationship between this money aggregate and nominal income has permanently changed.
2. Our efforts to get M2 back within its target range should be pursued cautiously (perception vs. reality).
 - a. Use caution as we expand bank reserves sufficiently to get M2 back into target range.
 - b. If this expansion is perceived as inflationary, lenders will drive long-term interest rates up, which could discourage investment and economic expansion.
 - b. We might have already eased policy enough to speed the growth of M2, and that growth will occur with a lag. Excessive ease could lead to excessive growth of M2.
3. Once hand is on the accelerator, it is hard to turn back to the brake.

IV. SOME PRINCIPLES OF MONETARY POLICY

A. What Monetary Policy Cannot Do

1. Monetary expansion cannot:
 - a. Produce real goods and services.
 - b. Create employment.
 - c. Permanently lower the unemployment rate.
 - d. Peg, or permanently lower, the real interest rate.
2. Motto of a central bank should be "do no harm."

B. What Monetary Policy Can and Should Do

1. What monetary policy can do:
 - a. It can stabilize the aggregate price level.
 - b. It can avoid being a source of economic disturbances through unexpected changes in policy.
 - c. Both of these foster real economic growth.
2. What a central bank should focus on:
 - a. Price level stability.
 - b. Creating a climate of certainty about future price levels.
 - c. The capital of a central bank is its credibility. The Fed should seek to restore and enhance the credibility of its pronouncements about its goal of price level stability.
3. How such a focus would help the economy:
 - a. Confidence in price level stability would enable business people, investors, workers, and consumers to make wiser plans for consuming, saving, and investing. Plans made on the basis of inaccurate assumptions about future prices are often inefficient.
 - b. Price level stability would eliminate the incentive for people to hedge against inflation by acquiring physical assets such as houses that are larger than needed and inventories larger than needed. This would free these resources for productive uses rather than inflation-hedge uses.
 - c. Price level stability would eliminate the need for people and companies to spend time and effort trying to find ways to predict inflation and to hedge against it.
 - d. Price level stability would foster stability of banks and the financial system. When investments are made on the basis of price projections that prove to be wrong, the banks that lend to the investors are often hurt along with the investors.
 - e. The transition costs of achieving price stability are reduced when the public has confidence in the central bank, and when the public is correctly certain about the goal of monetary policy. This is why central bank credibility is so valuable.

V. Conclusions: Gradualism in Pursuing Price Stability

- A. It takes time for the central bank to gain credibility for its anti-inflation program.**
 1. The public has long experience with inflation.
 2. The public knows that even though the Fed has often espoused price stability as a goal, inflation has continued.
 3. The Fed has often cut interest rates immediately following announcements of adverse changes in employment or unemployment numbers, sending the wrong signal.
- B. It is less costly to society when the Fed moves slowly, while strengthening its credibility.**
- C. When/if credibility is obtained, it should be carefully preserved—very expensive to get there, once pay the price don't want to repeat efforts.**