

THE ROLE OF STRUCTURE IN ECONOMIC DECISION-MAKING

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I. The Value of Economist's Opinions

I learned early in my career as a business economist that perhaps the worst answer an economist can give to a question is; "I don't know". And having spent much of my life in the company of economists, I can honestly say it is a response I've not often heard. I am reminded of the remark Walter Heller once made of Milton Friedman--"I wish I was as certain about anything as Milton Friedman is about everything." And so it is, I suppose, we may be a profession that is frequently wrong, but we're never in doubt.

But the value of an economist's opinion is not in it's "correctness" in the sense that we can always, or perhaps not even often, foresee the chaotic patterns in economic events.

As I started to make notes for this talk, I thought about the criticism directed at business economists and their forecasts. There are basically two types of criticism. The first is simply that economists don't forecast very accurately. The second criticism, which is usually directed from the academic community, is that economists should not be expected to forecast because the pursuit of self-interest on the part of millions of people with 'rational expectations' implies that there is no model that provides a basis for saying anything about the future with consistent accuracy.

To say that economic forecasting can't be done is ludicrous. To borrow from Descartes, "I exist, therefore I forecast." No human action, whether economic or otherwise, is made without at least an implicit assumption about future events. The choices individuals make involve intertemporal considerations, so an opinion about future events is implied in their behavior. Often what the forecaster is doing is helping to make explicit, and internally consistent, what otherwise was implicit in the actions of society.

Arguing that economic forecasting shouldn't be done is equally absurd. Academic economists often malign the worth of forecasts even though the single unifying principle in our science is that consumers, motivated by self interest, generally determine what will be produced and producers, motivated by profit, endeavor to satisfy that demand. I know of no better determination of value than that given in the marketplace. We need only consider the large number of competing forecasts and the expense of producing this information to appreciate that if forecasters even marginally reduce uncertainty about future business conditions, the savings to business is potentially huge.

Nevertheless, I believe that economists' ability to predict macroeconomic variables is a poor standard by which to evaluate most economic models, and an even poorer standard by which to judge the contribution of business economists, and we must not equate economists' forecasting record with the presumption that the role of business economists has been diminished, or that as a profession, economists have in large measure failed to add value to decisionmaking.

What, then, is the value added by the opinions of economists? It is, I believe, our ability to provide a model, a structure, to a complex economic environment.

I use the term 'structure' here in the sense that our judgements are based on a logically consistent framework. And, such a structure is not necessarily built with the goal of foretelling the future. Imagine you're at a ballgame, and consider the question; can you see the game better if you stand up? The quick answer is yes, of course. But, this answer obviously lacks the structure of a model. An economist understands that our ability to see depends upon the combined actions of those around you, and if your action of standing induces those around you to stand, your sight will be obstructed. This is what we mean by a "general equilibrium" framework. This is the proper answer, I think, even though it is likely to be a poor forecasting device. People frequently stand at public events.

II. Forecasting and the Policymaking Process.

Ultimately, a model must be judged by its usefulness. And in some cases, usefulness is defined by the ability to predict future events. For example, time-series models, which possess a mathematical structure but no economic theory, have little value other than their ability to provide a forecast. But clearly, there is no such thing as the best model, for "best" must always be defined in terms of the use to which the model is being applied.

We are all familiar with, and have, perhaps, taken comfort in the classic debate between Ptolemy's model of the solar system, which placed the earth in the center, and Copernicus' model, which put the sun in the center. The Ptolemaic view was based on the moral assertion that the center was the only proper place for the earth to be, and consequently, where we wanted it to be. Despite the glaring inability of the Ptolemaic view to conform with the celestial evidence--obvious flaws of the model known to the scientific community at the time--it nevertheless provided reasonably accurate forecasts of the movements of the planets and was therefore popularly used.

Fundamental to all economic analysis, then, is the simple question; To what end is this model to be applied? Or, even more simply; Why do we want to know? Herein lies an important difference between forecasting in the private sector and forecasting in the public sector.

At a recent conference, I was approached by a business reporter and asked the question: "What's your outlook for the economy?" My unintentionally flip response was, "I don't have one." The quizzical look on the reporter's face was that of disbelief. How is it that someone who has always had an economic outlook in the past, now rather suddenly is unable, or unwilling, to see into the future, particularly when that person is now in a policy-making position?

The answer to that question is at the center of the policy-making debate in the country, I think. Why is it that I no longer find value in

business cycle forecasting when just a few months ago such information was an indispensable tool of my work? Quite simply, it's because as a policymaker, I don't need one.

In the private sector, forecasts are used as devices not only to reduce uncertainty, but as a framework for comprehending the risks that business should be aware of, and if possible, protect against. Unfolding economic events affect the probabilities of alternate economic states that eventually impact business profitability. As a business economist for a bank whose goal is to maximize the wealth of its shareholders, a potential tilt in the term structure of interest rates, a shift in loan demand, or a change in the probability of borrower default, are contingencies that need to be evaluated and acted upon. A commercial bank cannot put together a profit plan or prepare a budget without assumptions about future interest rates, deposit growth, and numerous other variables. But, this is not true for the economic policymaker.

Two years ago tomorrow, Alan Greenspan addressed the annual meeting of this organization on the topic of forecasting. "The policy forecaster," he said, "necessarily focuses on those aspects of the economy that policy most directly influences."¹ So the role of forecasting in the public sector, it would seem, is as a conduit of control.

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¹ Alan Greenspan, "Economic Forecasting in the Private and Public Sectors," Annual meeting of the National Association of Business Economists, Washington D.C., September 24, 1990.

Regarding the act of forecasting as a control device forces us to clearly identify those variables that are endogenous to the system and those that are exogenous. For the policymaker, that means we must distinguish those outcomes which we can predictably influence from those which we only wish we could!

We can think of the policy setting process in three parts: (1) a goal, (2) controllable instruments, and finally (3) a model linking instruments to the goal. As I review my own experiences with of the policymaking process, I recall the 1970's as a time when the system attempted to manage real economic events by judiciously altering the federal funds rate. Stabilizing short-run fluctuations in the business cycle and maintaining a low rate of unemployment among our citizenry are, without question, admirable goals. And, I certainly recognize that the Federal Reserve has been able to control the federal funds rate when it chooses to (although I have never accepted this instrument as an appropriate policy indicator.)

But, like a Copernican in a Ptolemaic world, I believe there are logical flaws in a model that presumes to link the level of short-run nominal interest rates to GDP and employment growth. This Phillips curve (or "gap" model), is founded on an empirical observation that we all know to be theoretically flawed in the sense that it is not consistent with fully informed, optimizing behavior. And, as control mechanisms, gap models proved to be unstable when policymakers attempted to exploit the economic

inefficiencies they implied, eventually contributing to exaggerated business cycles and reduced productivity growth. To rephrase an old expression, in the long run, it made us dead.

III. The Importance of Long-Run Structure to Policy-making

The lessons of the 1970s pointed the way to a new procedure for the implementation of monetary policy. In 1980, the Federal Open Market Committee expressly recognized the limits of monetary management, confessing that it is not within the powers of policy to always ensure a fully satisfactory economic performance. "Nonetheless, the appropriate direction of policy is clear. The greatest contribution the monetary and fiscal authorities can make is to impart a sense of long-range stability in policy and in the economic environment."²

Chief among Fed objectives was the restoration of price stability, or in the words of the 1980 monetary Report to Congress; "wringing inflation out of the economy over time," a goal that is understood to be the exclusive province of the monetary authority.³ The instrument for achieving price stability was a strict adherence to monetary targeting. Such targets have two benefits, they provide a benchmark against which to judge the performance of

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² Monetary Policy Report to Congress, March 1980, pg. 2.

³ Monetary Policy Report to Congress, March 1980, pg. 3.

policy and are a clear means of conveying policy intent, both of which would seem to be necessary preconditions for a policy that "is to impart a sense of long run stability."

But, as you are no doubt aware, several developments recently seem to have diminished our ability, if not our resolve, to eliminate inflation. For one, the recession of 1990 and our subsequently slow economic recovery have helped to divert attention once again to the performance of real economic variables, such as employment growth. At the same time, the linkage between the short-run policy instrument, the fed funds rate, and M2 growth, has not maintained its former reliability.

Some monetarist economists argue that the sluggish economy is compelling evidence that M2 is still a valid indicator of the thrust of monetary policy and we must not be so quick to dismiss it. Others, including the Shadow Open Market Committee and several of my own staff at the Cleveland Fed, have advised me to be wary when interpreting the behavior of M2. The monetary stimulus implied by recent M2 growth may be understated because of the diminished importance of commercial banks as financial channels. It is tempting in such an uncertain environment to allow more discretion in the decision making process. However, it is precisely at times such as this that structure is most important, so that the stance of monetary policy is not among the uncertainties that business much guard against.

IV. The Implicit Promises of Policy Behavior

Changes in structure are, of course, inevitable, and it may be years before a change is clearly identifiable. We do not now know the significance of the M2-fed funds rate discrepancy and we may not know for an indefinite period of time. This is why it is important for policy makers to target long-run outcomes, not short-run instruments.

The long-run objective of monetary policy is still the promotion of economic growth through the elimination of inflation, in the sense that inflation no longer enters into the short or long run decisions of households and firms. Historical relationships between broad measures of money and price indexes give me reason to believe that the monetary policy of the past several years is consistent with a continued reduction in the rate of inflation.

But, while I may believe that a disinflation groundwork has been laid, inflation expectations are still an integral part of decision-making by the private sector. The historic steepness of the yield curve, surveys from households, and private forecasts, all reveal a long run inflation expectation at, or above, the post-WWII average inflation rate. And why not? In the past several years, the public has become conditioned to the idea that policy actions are determined by the current state of the real economy, and in particular, monthly employment growth. With the recent cut in the federal funds rate to 3%, there have been ^{seven} ~~six~~ occasions since December 1990 on which the funds rate was reduced on the same day as a weak employment report--a timing of policy actions that implies a commitment to, if not a responsibility for, short-run employment patterns.

Without an explicit commitment to a long-run inflation objective, with inconsistency in the targeting of the monetary aggregates, and with policy actions taken in concert with data on the real economy, can we expect households and firms to take seriously our disinflation rhetoric?

Given the relatively poor performance of the labor market since 1989, the implied responsibility for monthly employment conditions has no doubt been uncomfortable for the Federal Reserve. And, so it should be. If we act as though we are trying to affect monthly employment growth, then is it unreasonable to be held accountable for not achieving better results?

Indeed, among the deficiencies for which the Federal Reserve is likely to be held accountable in 1992, I fear that the implicit employment target we seem to have set will be given greater significance than the shortfall of our explicit M2 target. By appearing to dismiss the shortfall in M2, we risk damaging credibility about our resolve to achieve future targets.

I understand that there are very good reasons to be skeptical about the interpretation of slow M2 growth and I will not recount them here. But, we must, above all else, endeavor to provide clarity and stability--in a word, structure--to the monetary decision-making process.

V. Conclusion

Economists are human, therefore they have opinions. Whether they are more informed opinions than non-economists depends on their rigorous adherence to a framework of analysis--a model. While we may not be able to reduce all, or, perhaps not even most, of the uncertainties facing business,

economists nevertheless provide a consistent basis for discussing and evaluating the problems businesses face. Such frameworks are useful even in their shortcomings, by revealing that which we do not understand.

As a policymaker, whose actions affect the private sector, structure is necessary not only as a guide to policy decisions, but as a means for transmitting the significance of policy decisions to the marketplace. For this reason, it is crucial that policy pre-commit to goals that it can be counted on, and held accountable to, achieve.

In the year of his death, Copernicus wrote:

"Finally we shall place the Sun himself at the center of the Universe. All of this is suggested by the systematic procession of events and the harmony of the whole Universe, if only we face the facts, as they say, with both eyes open." "

For the astronomer, this meant placing the center of the Universe not where you want it to be, but rather where the facts tell us it must be. For the policymaker, it means we should be careful what we promise, either by our implied actions or by our explicit neglect.