

THE ROLE OF STRUCTURE IN ECONOMIC DECISION-MAKING

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I Introductory Comments

- A. My experience in the Fed gave me a better perspective for my later work in the private sector, and my work in the private sector gave me a better perspective for the job that I now have.
- B. Today, I want to discuss the roles of economic forecasts. The roles of forecasts are different in the private sector than in the public sector.
- C. Reporters recently asked me for my forecast of GDP.
 - 1. Response: "I have no GDP forecast, because I don't need it in my job."
 - 2. At First Interstate, I always had a forecast for GDP.
 - 3. I also won't tell a reporter if I am optimistic or pessimistic about the outlook for GDP because he would be likely to interpret it as indicating what I think is the appropriate direction for monetary policy.
- D. Forecasts are valuable because they help to improve decisions.
 - 1. So a forecast should be appropriate to the decision that is to be made.
 - 2. I told my staff at First Interstate: Don't answer questions that are not being asked.
 - 3. MBAs want to decide a question in no more than 48 hours. So, to be relevant, economists should respect that time frame.
- E. At St. Louis Fed, 25 years ago, our simulations were being misinterpreted by the media as forecasts. Consequently, I decided to stop distributing the simulations.
- F. Private sector decision-makers want simple forecasts, and they act on them.
 - 1. Don't utter casual forecasts in a trading room.
 - 2. Don't hedge forecasts with assumptions.

II. The Importance of Having an Opinion

- A. Worst answer an economist can give; "I don't know".
 - 1. Answer not often heard from economists.
 - 2. Walter Heller of Milton Friedman -- "I wish I were as certain about anything as Milton Friedman is about everything."
 - 3. Michael Evans said economists are "frequently wrong, but never in doubt"

- B. Two criticisms often directed at business economists and their forecasts:
1. First, forecasts are not accurate. But, to say that economic forecasting can't be done is ludicrous.
 - a. To borrow from Descartes, "I exist, therefore I forecast." No human action is made without an assumption about future events.
 - b. Economists' forecasts make explicit, and internally consistent, what otherwise was implicit.
 2. Second -- usually academic community -- economists should not be expected to forecast. The self-interest of people with 'rational expectations' implies there is no model that can say anything about the future with consistent accuracy.
 - a. Arguing against the worth of economic forecasts is equally absurd -- the marketplace reveals value.
 - b. The fact that people are paid to produce forecasts reveals that forecasts have value.
- C I test the consistency of people's forecasts.
1. It is inconsistent to expect inflation to rise and interest rates to fall.
 2. It is inconsistent to predict the great California earthquake and not sell your home and move to Arizona.
- D. Ability to predict macroeconomic variables is poor standard to evaluate economic models; even poorer standard to judge contribution of business economists.
1. Must not equate economist's forecasting record with presumption that our profession has failed to add value to decision-making.
 2. What is value added? Ability to provide model, or structure, to complex economic environment.
 - a. 'Structure' in the sense that opinions based on logically consistent framework; not necessarily built with the goal of foretelling future.
 - b. Example -- Question: Can you see the game better if you stand up? MBA approach.
 - c. This is what we mean by a "general equilibrium" framework. Economists understand feedback effects, aggregation problems, and the tyranny of small decisions.

III. Forecasting and the Policymaking Process

- A. Model must be judged by usefulness: some cases defined by the ability to predict future events.
 - 1. Example: time-series models (ARIMA and Autovector analysis) have little value other than their ability to provide a forecast. They have no relevance to policymaking.
 - 2. But, models must be judged based on the use to which model is applied.
 - a. Classic debate between Ptolemy's (TOL e me's) model of solar system with earth in center, and Copernicus' model, which put sun in center.
 - b. Ptolemic (tol EM ik) view provided reasonably accurate forecasts of planetary movements, despite inability to conform with other evidence.
- B. Fundamental to economic analysis is question: "To what end is model to be applied?" Or, "why do we want to know?"
 - 1. Difference between use of forecasts by private and public sector.
 - 2. In private sector, forecasts used as devices not only to reduce uncertainty, but as a framework for comprehending risks business should be aware of, and if possible, protect against.
 - a. As business economist for a bank whose goal is to maximize the wealth of shareholders, potential tilt in term structure of interest rates, shift in loan demand, or change in the probability of borrower default, are contingencies needed to be evaluated and acted upon.
 - b. A commercial bank cannot put together profit plan or prepare budget without assumptions about future interest rates, deposit growth, and numerous other variables. But, not true for economic policymaker.
 - 3. Role of forecast in public sector, it would seem, is as conduit of control.
 - a. Greenspan: "The policy forecaster necessarily focuses on those aspects of the economy that policy most directly influences."
 - b. We must distinguish between that which we can predictably influence and that which we only wish we could!

4. Are macroeconomic conditions exogenous or endogenous to a forecast?
 - a. Exogenous for private forecasters.
 - b. Some think it should be endogenous for policymakers
 - c. I believe that the economy tends naturally toward full employment so the economy is exogenous for me in my role as a monetary policymaker.
- C. Three parts of the policymaking process: (1) a goal, (2) controllable instruments, and finally (3) a model linking instruments to the goal.
 1. As I review my own experiences with policymaking process, I recall the 1970s as a time when System attempted to manage real economic events by judiciously altering fed funds rate.
 - a. Like a Copernican in a Ptolemaic world, there are logical flaws in a model that presumes to link the level of short-run nominal interest rates to GDP and employment growth.
 - (1) "Gap" model founded on empirical observation we all know to be theoretically flawed, in sense that it is not consistent with fully informed, optimizing behavior.
 - (2) As control mechanisms, gap models proved to be unstable when policymakers attempted to exploit the inefficiencies they implied, and in the long-run, they made us dead.
 2. What about policy today?
 - a. Some economists, like Milton Friedman, look only at slow growth of M2 and say policy is too tight.
 - b. Others, like Alan Meltzer, look at the rapid growth of M1 and the monetary base and argue policy is too easy.
 - c. Perhaps, with Friedman saying monetary policy is too tight and Meltzer saying we are too easy, we are just right.

IV. A Long-Run Framework (Structure) For Policymaking

- A. No central banker today believes there is a tradeoff between inflation and output. Friedman taught us 25 years ago that money cannot affect real variables.
- B. Lessons of 1970s pointed way to new procedure for implementation of monetary policy.

- C. Fed stated in 1980: "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."
 - 1. Chief among objectives was restoration of price stability, or: "wringing the inflation out of the economy over time."
 - 2. Instrument for achieving price stability: strict adherence to monetary targeting. Such targets have two benefits, both necessary to impart sense of long-run stability:
 - a. they provide a benchmark against which to judge performance of policy.
 - b. they are a clear means of conveying policy intent.
- D. Unfortunately, several developments recently WOULD SEEM to some observers to have diminished our ability, if not our resolve, to eliminate inflation.
 - 1. Recession of 1990 and slow recovery helped divert attention once again to performance of real economic variables.
 - 2. Linkage between short-run policy instrument -- the fed funds rate -- and M2 growth, has not maintained its former reliability.
 - a. Some monetarist economists argue that a sluggish economy is a good indication that M2 is still a valid indicator of the thrust of monetary policy and we must not be so quick to dismiss it.
 - b. Others, including Shadow Open Market Committee and several of my own staff, have advised me that monetary stimulus implied by M2 may be understated because of diminished importance of commercial banks as financial channels.
 - 3. It is tempting in such an uncertain environment to allow more discretion in the decision-making process. However, precisely at times such as this that economic structure (policy framework) is most important, so the stance of monetary policy is not among the uncertainties that business must guard against.
- E. Changes in structure are inevitable; may be years before a change is clearly identifiable.
 - 1. We do not now know significance of the M2/fed funds rate discrepancy; may not know for an indefinite period of time.
 - 2. That is why it is important for policymakers to target long-run outcomes, not short-run instruments.

V. Actual and Implicit Promises of Policy Behavior

- A. Long-run objective of monetary policy: still the promotion of economic growth through the elimination of inflation, in sense that inflation no longer enters into the decisions of households and firms.
 1. Historical relationships between money and prices give reason to believe that monetary policy has been consistent with continued reduction in rate of inflation.
 2. But, inflation expectations still integral part of decision-making by private sector.
 3. Steep yield curve, surveys of households, and private forecasts, all reveal a long run inflation expectation at, or above, post-WWII average inflation rate.
- B. Part of the problem today, is that the public is conditioned to the idea: policy actions determined by current state of real economy.
 1. Including the recent cut in fed funds rate to 3%, there have been SEVEN occasions since December 1990 on which the funds rate was reduced on the same day as a weak employment report.
 2. Timing of policy actions implies a commitment to, if not responsibility for, short-run employment patterns.
 3. Without an explicit commitment to a long-run inflation objective, with inconsistency in monetary targeting, 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?
- C. Implied responsibility for monthly employment conditions has no doubt been uncomfortable for Federal Reserve.
 1. 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?
 2. Among policy deficiencies for which Fed is likely to be held accountable, implicit employment target we seem to have set will be given greater significance than shortfall from explicit M2 target.
 - a. By appearing to dismiss shortfall in M2, risk damaging credibility about resolve to achieve future targets.
 - b. May be very good reasons to be skeptical about interpretation of slow M2 growth. But, must endeavor to provide clarity and stability -- structure -- to monetary decision-making process.
 - c. Having and hitting any monetary target is better than pure discretionary policy.

V. Conclusion

- A. Economists are human, therefore have opinions.
 - 1. Whether more-informed opinions than non-economists depends on rigorous adherence to framework of analysis -- a model.
 - 2. May not be able to reduce most of uncertainties facing business, but economists nevertheless provide consistent basis for discussing and evaluating problems businesses face.
- B. For policymaker (whose actions affect the private sector), structure (or policy framework) is necessary, not only as a guide to policy decisions, but as a means for transmitting significance of policy decisions to marketplace.
 - 1. For this reason, it is crucial that policymakers pre-commit to goals that they can be counted on, and held accountable to, achieve.
 - 2. Accountability is necessary for credibility.
- C. In 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.'"

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