

OUTLINE

for

**FINE TUNING OR PRICE STABILITY:
THE MONETARY POLICY ISSUE FOR 1993 AND BEYOND**

presented by

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to

ECONOMIC OUTLOOK SEMINAR

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Event: Economic Outlook Seminar

Sponsors: William E. Simon Graduate School of Business Administration, Rochester Chamber of Commerce

Date: December 7, 1992

Time: Noon

Place: Hyatt Hotel, Rochester

Audience: Rochester business community

Size: 300-400

Intro: Lowell Patric, president and chief operating officer, Rochester Community Savings Bank

Thank you, Lowell, and good afternoon, everyone. It's a pleasure to be here.

I always feel a little uneasy when I'm asked to make specific predictions about the course of the economy. It seems to me that forecasting economic trends is a lot like predicting the weather: People only remember when the reality turns out to be worse than what you predicted.

So rather than making specific projections, I will use my time to focus on some of the underlying monetary issues affecting the economy. Specifically, I will be illustrating the importance and difficulties of (pick up at II, A)

I. Introductory comments.

See above.

II. Purpose of the speech.

The purpose of my remarks today is to illustrate the importance and difficulties of:

- A. Evaluating the stance of recent monetary policy and its effects on the recent performance of the economy.
- B. Assessing the likely course of monetary policy and inflation.
- C. Choosing an appropriate monetary policy in 1993 and beyond.

III. Indicators of the stance of monetary policy appear to be conflicting.

- A. Short-term interest rates have fallen sharply in recent years..
 - 1. The Fed has lowered the discount rate and the federal funds rate in 24 separate steps since mid-1989.
 - 2. The discount rate was lowered from 7.0 percent to 3.0 percent.
 - 3. The federal funds rate was lowered from almost 10 percent to 3.0 percent.
- B. But, interest rate changes can be an ambiguous indicator of monetary policy.
 - 1. If the Fed tries to slow a decline in market interest rates, interest rates are falling but the Fed is being restrictive.
 - 2. If the Fed acts to slow a rise in market interest rates, interest rates are rising but the Fed is being stimulative.
- C. Growth of M1, the narrow measure of the money stock, has been rapid. M1 increased about 14.7 percent from November 1991 to November 1992.
- D. Growth of M2, the broad measure of the money stock, has been slow. M2 grew about 2.4 percent from November 1991 to November 1992.

- E. Inflation, which after all is the proof of the pudding, has declined gradually from 4 to 5 percent in 1985-1990, to 3 to 4 percent in 1991, to perhaps 3 percent in 1992, with the real possibility of moving to 2 to 3 percent in 1993.

IV. Expert opinions differ strongly about the stance of monetary policy.

- A. At one end of the spectrum, Milton Friedman and others (e.g. Paul McCracken writing in the Wall Street Journal last Monday), argue that monetary policy has been too restrictive. They cite the slow growth of M2 as evidence.
- B. Some of these critics assert that an incipient boom period following the Gulf War was stymied by restrictive Fed policy.
- C. At the middle of the spectrum of opinion is the view that monetary policy has been appropriately stimulative, and that it prevented an incipient cumulative downturn that would have been caused by the process of making major structural adjustments to the economy.
- D. At the other end of the spectrum, the Shadow Open Market Committee, of which Charles Plosser here is a member, argues that monetary policy has been too expansive. They cite the rapid growth of M1 as evidence, and fear that the base is being laid for an acceleration of inflation.

V. Disagreement about the stance and effects of recent policy is matched by skepticism about the probable stance and effects of future policy.

- A. Inflation currently is low but, unfortunately, the public expects the inflation rate to rise. This skepticism about the future course of monetary policy and inflation is evidenced by the disparity between what people see versus what they expect.
 - 1. On one side, is evidence that inflation has been trending down for several years and is likely to stay down:
 - a. The recent inflation rate is around 3 percent.
 - b. An economic model that we use in the Federal Reserve to forecast inflation suggests the inflation rate will be lower in 1993 than in 1992.

- c. Moreover, the avowed intent of the FOMC is not only to keep the inflation rate down but to seek further gradual reductions in inflation towards the 1 to 2 percent price stability zone. Quote Chairman Greenspan or the FOMC Directive.
2. On the other side, there is much evidence that the public expects higher inflation:
- a. Long-term interest rates have remained stubbornly high, the yield curve is the steepest in history, and people seem to expect the yield curve to flatten by short rates rising rather than by long rates falling.
 - b. Surveys show consumers expect inflation of 4 percent over the next 12 months (University of Michigan Survey of Consumers), and 5 percent average for the next 5 to 10 years.
 - c. The consensus of the Blue Chip Financial Forecasts is for the 30-year Treasury bond rate to be 7.5 percent next year and 7.7 percent in 1997.
 - d. Consumers are refinancing their mortgages at fixed interest rates that will be high real rates unless the rate of inflation rises.
 - e. Corporations are borrowing long-term money at real rates that will be high unless the rate of inflation rises.

VI. Skepticism about the future course of monetary policy and inflation is costly to the economy.

- A. Long-term investment is discouraged because the high expected inflation rate creates the expectation of a high effective tax on real capital income, because taxes are based on nominal rather than real income.
- B. Skepticism results in an inflation risk premium that reduces long-term investment as managers establish higher hurdle rates for proposed projects.
- C. Also, more resources than necessary are expended in designing, marketing, and seeking out financial instruments to be used as inflation hedges.
- D. More physical assets than necessary are tied up in inflation hedges, with overinvestment in such physical assets as inventories and houses, at the

expense of investment in other physical assets that would be more productive for the economy.

VII. The monetary policy issue for 1993 is fine tuning versus long term price stability.

- A. Pressures on the Federal Reserve System to engage in fine tuning in 1993 are likely to be strong because:
1. Economic growth has been sluggish in the current recovery.
 2. The recent election reinforced the perception that weak economic growth is perilous to an incumbent Administration.
- B. The fact is, though, that fine tuning is not a sensible use for monetary policy. We cannot fine tune because:
1. Our forecasts of the economy are subject to too much error.
 2. Monetary policy affects the economy with a lag of variable duration.
 3. Attempts to push economic output beyond its potential (to exploit a short run Phillips curve) would lead to more-rapid inflation, but not to more-rapid economic growth.
 4. Furthermore, policies that are intended to be restrictive or stimulative can have paradoxical outcomes. Consider how monetary policy might affect inflation expectations, the yield curve, and real investment.
 - a. A more restrictive policy might reassure long-term lenders and borrowers that the inflation rate will stay down in the long run. If so, long term interest rates might come down, encouraging long-term investment, which would be good for economic growth. Thus, the yield curve could flatten by long rates coming down, and we could get the paradoxical result of a restrictive policy giving the economy a boost.
 - b. A more stimulative policy might confirm long-run inflation fears while accelerating current inflation. Long-term interest rates could remain high while short rates rise. Thus, the yield curve could flatten by short-term rates rising, and again, we could get a paradoxical outcome, in this case a stimulative policy placing a drag on the economy.

- C. However, monetary policy can achieve price stability--and the important benefits that come with it.
1. The strategy to achieve price stability should be to:
 - a. Choose a desired path for the price level that reflects a gradual slowing and then a cessation of inflation.
 - b. Gradually but steadily lower the rate of money stock growth along a path that is consistent with achieving the desired path of the price level.
 2. Application of that strategy is tempered by concern to minimize the cost of lowering the rate of inflation. That is why I am concerned with how policy actions affect inflation expectations, because there is a cost to the economy when inflation expectations differ from the actual path of inflation.
- D. To implement this strategy for achieving a target P in the $MV=PQ$ framework, while minimizing the economic costs of incorrect inflation expectations, monetary policymakers would very much like to know the following things in advance of each FOMC meeting:
1. Which M should be targeted? Which is a better gauge of monetary policy, $M1$ or $M2$?
 2. What is Q ? What is the current growth rate of potential real output, which is being affected by major restructurings of the economy?
 3. What is V ? What is the nominal GDP velocity of $M1$ or $M2$?
 4. How will inflation expectations and interest rates be affected by a change in money growth targets and/or money growth rates?

VIII. Conclusions.

- A. I **don't** think that monetary policy should be directed toward fine-tuning real output.
- B. I **don't** think that the central bank should attempt to trade higher inflation for lower unemployment.
- C. I **do** think that the best goal, the only feasible goal, for monetary policy is to seek long-run stability of the price level. That is the way that monetary policy

can best contribute to national prosperity.