REMARKS

from

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Questions & Answers

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Dear Lisa:

The transcript is enclosed as well as a diskette in Word Perfect.

I have edited my initial remarks and responses to questions. I added a few clarifying sentences, but it is mostly as given. We did not try to edit Frank's presentation or the questioners; it is as our typist heard on the tape.

Good luck in preparing an article.

Sincerely,

Jerry L. Jordan

Enclosures

Copy: Gerry Anderson

THE SEARCH FOR A TARGET FOR MONETARY POLICY

(Fred Furlong) When we are looking at the session, I thought that one of the key parts of the title was a target. Certainly, on a day-to-day basis, when the policymakers are trying to decide what to do that they have to have some idea of the targets to know what they want to do with policy. The real question though, is there a single target that one can agree on that would be consistent to policymakers and also across time? We had three panelists originally scheduled for this session, but Steve Axilrod won't be able to make it. Since Steve's not here, I can tell a story about him before we go on; at least he can have his presence recognized that way. Steve and I think it fits in with what we are trying to do in the session; to say the day-to-day issue is what are you trying to do with policy and how do I know whether or not policy should be moved one way or another as a policymaker. But Steve one day, he is now Vice Chairman of Nikko Securities, but when I knew him he was with the Federal Reserve as the Director of Monetary Affairs. One late afternoon he was trying to find someone to run one of the models, and he came into one of the offices, where a bunch of officers and among them were Tom Simpson and David Lindsey. He asked the people in the office if they knew how to run this model that he needed to get some results and to know what reserves were going to be the next day. The answer was, "no we don't know." Steve said "Well, what do you do then?" And their response was, "We think about the big picture." And Steve's response was "Well, no, no, no, that's my job!" I think what we are here today for is to look at the big picture. And to do that we have two distinguished individuals -- a current and a former representative of the Federal Reserve. Both of these individuals had to tackle this question of search for the target in practical ways in terms of deciding on and implementing monetary policy. They have also had the advantage of looking at this issue as outsiders. I think that anyone who has been in the Federal Reserve will tell you that your view of monetary policy changes once you've been part of the Federal Reserve. But I think the advantage here that both Jerry and Frank have is the advantage of seeing it from both sides. First, we will have Jerry go first. Currently, Jerry is President of the Federal Reserve Bank of Cleveland. Jerry is the insider, turned outsider, turned insider again. Of course, the insider started out with the Federal Reserve Bank of St. Louis. He has made a number of important contributions to monetary policy between St. Louis and coming back to the Cleveland Fed. He has had some practical experience, and maybe some less practical experience. The practical experience is on the commercial bank side (12 years of commercial banking). On the less practical side, is maybe academia and also government. Jerry will present his remarks. I would like to hold the responses and questions until the end, after each of the speakers has presented. I will ask, I will say it now, I will say it later, just to reinforce it later, that when you do get up to ask questions, you use the mike - it is being taped. We will have Jerry go first.

(JERRY JORDAN) Thank you. It is a pleasure to welcome so many fellow search party members here. I'm going to throw the program a little bit of a curve by saying that I'm not sure that the questions should be "searching for a monetary aggregate" or monetary target, but it may be really searching for objectives. Seventeen or eighteen years ago, Karl Brunner, hosted at UCLA a couple of conferences called "Targets and Indicators for Monetary Policy." This was when Lee Hoskins and I were young students at UCLA, trying to learn about all of this monetary kind of thing, and they brought in all of the eminent people in the profession. These were some 50 or 60 of the leading names doing research and writing on the subject of monetary theory and policy, both within the Federal Reserve and the academic profession. It was a fascinating couple of days, both times.

What I failed to appreciate at that time, however, was that those conferences were conducted in the context of more than a decade of under 2% inflation, then inflation had jumped up in 1964 and 1965 into the range of 3 or 4%. It was thought at that time that the problem was only one of having the appropriate targets and indicators. That is, the levers, or handles for monetary policy which would serve as guides to formulation and implementation of our policy objectives. The mindset of the American people at that time, I think, was that increases in inflation and interest rates were temporary, destined to go back down, sometime.

Now, after more than three decades of inflation, the mindset of the American people is that declines of inflation and interest rates are temporary. People believe that the permanent condition is for inflation and interest rates to go back up.

Coming back to the Fed after some 15 or 16 years out of the System, I initially thought the question was "which M" (monetary aggregate)? The subject of this session might imply more debate about M1 versus M2 and the various measures of the monetary base. Or, should we add this or that into some measure of money. In fact, three months before rejoining the Fed I was a consultant, (as the Board of Governors likes to call it) and I did an analysis of what was going on with M2 in 1991. Already there was concern about the extent to which it was or was not giving a reliable indication of the thrust of policy actions. Now, however, I've spent 15 months or so not only going to meetings, but worse, living with the staff that I inherited from Lee Hoskins. The staff persistently over and over said to me "It's the objective -- stupid -- not the target, that is the real issue!" And, I kept saying that I thought the objective was quite clear -- not only to myself, but also to my colleagues. The staff kept telling me I was naive.

Recently, when discussing with my daughter (who's getting married, buying a house as an inflation hedge, and getting a fixed-rate mortgage) I tried explaining my view. And she said, "Dad you need a reality check. If you don't think inflation is going up, you're the only one that doesn't think that. We all know it's going up." So, dealing with daughters is difficult especially when they start learning economics, as I'm sure Frank will agree.

After sitting with the Committee for 10 FOMC meetings, watching the deliberations, the interaction between our decisions and the financial market participants, the people's elected representatives, and the media, I'm now convinced too, it's the objective -- not the target -- that is the real issue of monetary policy.

Some years back, I heard about a thing called "Goodhart's Law." I think it was Henry Wallich who first told me about it and wrote about Goodhart's Law. The idea is that once a Central Bank makes it known that it is using a certain variable as an indicator or intermediate target because of some past empirical relationship to a specific objective, that variable ceases to be reliably related to the objective.

The analogy was something from physics called the Hiesenberg Principle, which I don't understand very well but it has something to do with when you focus a high-powered microscope on an electron, it alters the behavior of the electron. Therefore, you can never see it behaving as it would behave if it was not being observed. The analogy to monetary policy is, once the Central Bank has a target that people know that it is responding to, the behavior of the people is changed -- traders in the markets, such as bond markets, equity markets, foreign exchange market -- as well as real people. Then, because they change their behavior in anticipation of what the Central Bank is going to do based on these indicators, you don't get the same outcome that you otherwise would.

So, we went through the silly season in the later 1970s when the Thursday night money numbers would cause the interest rate futures markets to do wild gyrations. There was a period some years back when it was the norm that the merchandise trade was all the markets responded to for awhile. And, unfortunately, during the last year or two it was nonfarm payroll employment or the jobless claims numbers. The lack of theory or empirical evidence relating these variables to ultimate objective seemed to be irrelevant. What it is now is up for grabs.

I think that Goodhart's Law was valid only if monetary policy is not anchored by clear, well-understood objectives. Goodhart's Law will not hold if everyone understands and acts on the belief that the objective will be achieved. That is because people will not care what the intermediate targets are.

So, I'm going to assert what I will call the "Hoskins' Corollary" to Goodhart's Law (after he kept hammering on this thing for four years while he was in my job). That is, if the monetary authorities have an objective of a stable purchasing power of money, which is known and believed -- it is truly understood by the people, and agreed to by the people -- such that the actions of households and businesses reflect this knowledge and belief in the objectives, then it may be that any target is adequate. It certainly becomes a secondary issue at that point.

I no longer think that monetary targeting is a <u>sufficient</u> condition for a satisfactory monetary policy. Whether or not it is a necessary condition is still debatable. I do think that having a clear objective of monetary policy is necessary. I'm still waiting for people to persuade me whether it is or is not sufficient.

Milton Friedman had taught us that having and hitting any monetary growth target was superior to a pure discretionary policy. I think what was left unsaid about this Friedman dictum was that it was valid in the absence of policy being anchored by a clear objective. I'm not so certain that a policy that is anchored is flawed, just because implementation involves discretion. All of the debate about rules vs. discretion that we saw in the profession for a couple of decades. I think now implies an absence of an unambiguous long-run objective.

Back in the 1960s -- 20 or 30 years ago when all of that lively debate was going on -- we had the Friedman-Meiselman research relating money growth to measures of income or output, and the response by Ando-Modigliani. (Karl Brunner once called that the battle of the radio stations - AM and FM). Then we had Deprano, Mayor and Hester and a number of other people involved in the debate and the economists at the St. Louis Fed, with some responses by the New York Bank and the Board of Governors' staff, and other participants.

I now think that whole framework was wrong. That framework related money growth to total spending -- nominal GDP -- and then we derived from that implications for the rate of change or prices, and the rate of change of output and employment, and so on. We sort of decomposed spending into its output and price components. I think there was a fundamental mistake in our research strategy at that time, and all of the rhetoric of "demand management" was wrong because both the research strategy and the rhetoric assumes knowledge that we did not have -- knowledge about the economic structure and factors aggregate supply of output.

A lot of what we did at St. Louis, including my own writing at that time, was in the context of demand management. Think about the message that is implied by that. It says that the role of monetary policy is to manage demand or spending. That clearly is wrong.

It left a lot of people with the idea that you could pursue an activist discretionary monetary policy to hit certain objectives in terms of output growth, the rate of inflation, employment, levels of employment, unemployment rate, and so on. And, that monetary policy was appropriate to pursuing "countercyclical stabilization policy" to either offset real shock affects, or shocks emanating from the rest of the government sector --fiscal policy, and so on.

And, we hear right up to present time references to the ideas of a monetary policy being adjusted based on what happens on the fiscal side.

In one important respect, monetary and fiscal policy actions should be thought of in concert. That is, that in a fiat money world, monetary policy is a fiscal instrument -- a way to finance government. No one can possibly know the effects of proposed changes in explicit tax rates without knowing what is going to happen to the purchasing power of money. The Chairman of the House Ways and Means Committee should be just as interested in the Central Bank's intentions regarding future inflation as the Chairmen of the Senate and House Banking Committees.

While I now think that most of the discussion about activist monetary policies is nonsense, it did derive from the work that I and others were involved in back in the '60s and '70s. We should not have allowed the emphasis of our work at the time to turn out to sound to people as though monetary targeting was about creating alternative levers for monetary authorities to push and pull in order to achieve some sort of unspecified and frequently changing objectives. People thought that it was substituting money growth for free reserves, nonborrowed reserves, Fed Funds or whatever. It was sort of operating on a quantity axis in a discretionary way, instead of on a price axis in a discretionary way.

What we failed to make clear was a crucial underlying premise of monetarism -- the Hayekian principle that a market system, based on private property and using prices to allocate resources, is inherently resilient and naturally gravitates toward full utilization of its productive resources in absence of various types of shocks emanating from the government sector. That means that the true ultimate objectives of monetary policy would be to achieve the highest sustainable growth over time that is consistent, not only with the endowment of resources, but also with the various fiscal policies and regulatory policies of government, but not trying to compensate or offset the affects of those policies.

It implies a rejection of all the rhetoric about hawks and doves. It is just nonsense to talk about some members of the FOMC being hawkish and others being a dove. Lee Hoskins was often labeled a hawk, and the rhetoric in the press was that he was antigrowth because he was antinflation, and that was a conceptual mistake and one that we need to clarify. It is a false dichotomy; there is no choice between inflation and growth over time. It also implies a rejection of all of the jargon of "tightening" and "easing" of monetary policy, but most of all, it implies a rejection of the Phillips curve -- the notion of some sort of a social/political tradeoff between the rate of change of prices and the level for the employment, or unemployment.

The persistence of that idea of a social, political tradeoff is what's behind the recent Congressional efforts to alter the FOMC, to take the Presidents of the Reserve Banks off the Committee, or make them subject to presidential appointment or confirmation by the Senate. It is a line of argument that says, " because this is a political decision, it must be made by people that are politically accountable." But, I reject the premise, so the conclusion does not follow. The basic inherent resiliency proposition implies a role for monetary policy in the economy means that there is no political influence in the formulation and implementation of monetary policy.

We have other problems in our language with the terminology of monetary policy. Lee popularized this idea of "zero inflation." Homer Jones at the St. Louis Fed once said, "If people see something often enough, they come to believe it whether they understand it or not." I think that was a part of Lee's operating strategy. Just keep saying "zero inflation" over and over again until it became respectable to talk about price stability and zero inflation.

I believe in "stable prices" in a certain manner of speaking, but I realized that we have problems with our language when I started meeting people from the former Soviet Republics and eastern block countries. These are people that have been listening to the messages from us as their regimes were starting to break up, and we would tell them two things: "among the various things you need to do, such as establish property rights and so on, is that you need to end all forms of price controls. Let prices be free to move, create flexible prices, and achieve price stability at the same time!" And, they say, "well wait a minute, which is it you want? Do you want prices to be stable, or do you want them to be flexible?" We'd say, "Well, both." And, we have had trouble explaining to them what price stability means. It doesn't mean <u>constant</u> prices fixed by government, but rather some other notion. I struggled with this idea of trying to explain to them what it was that we wanted to be stable.

I think that we sometimes miscommunicated with our own people when we talk in these terms. What we really want to be stable is in the minds of the people - the national standard of value, or unit of account, or something. So following Brunner and Meltzer -- or Armen Alchian's piece on "Why Money." -- "Society chooses to use as money, that entity that economizes best on the use of other real resources in gathering information about relative prices and conducting transactions." The implication is that money belongs in the production function because a less than optimally efficient money means that you are under employing real resources. Uncertainty about the trend in the price level lowers the production possibility boundaries. So, given the state of knowledge and technologies, what we are trying to do is create the condition that achieves the highest production possibility boundary obtainable over time, consistent with the other things that the government is doing, such as reallocation of command over resources. Any uncertainty about relative prices -- both current output prices and asset prices, and the present price of future consumption -- moves us to a lower production possibility boundary. That condition of achieving the highest production possibility boundary is what we really mean by price stability.

While fiscal and regulatory policies might be used by government, for redistribution, I don't think it would be appropriate for monetary policy to either intend to cause redistribution, or to have an unintended consequence -- neither interpersonal nor intertemporal -- of redistribution.

None of that should be taken to mean that I don't think that money targeting is not desirable, or that it is not useful. When we are starting from a position of past inflation -- having conditioned people to act in the belief -- that the purchasing power of money will be eroded over time -- then I think it is a question of how do we proceed to restore credibility in the commitment to what we call price stability, or sound money.

When Lee took this job in 1987, he started talking in public about M2 growth. I would see the FOMC (in what they then called, "Record of Policy Actions"), talking about M2, and I would badger Lee about M1, or the monetary base, or something else, and the problem about control of M2, let alone what it implied. He would explain to me that the Board staff had developed a model based on an idea of opportunity cost of holding M2 balances that allowed them to jiggle short-term interest rates -- the Fed Funds rate, relative to something else -- that gave them pretty good predictions of what M2 growth was going to be over subsequent months and, what's more , based on longer-term historical correlations -- the so-called "p-star model" that Alan Greenspan helped give birth to -- that they had some pretty good idea of the implications. So, the idea was: use open market operations to influence short-term interest rates, which influences M2 growth, which achieves objectives for the price level, or the rate of inflation. The model seemed to work pretty well, roughly from the time Lee got there until 1989 or 1990.

My dissents last year at 3 of the 7 meetings that I attended in 1992, were conditioned by that experience. The idea was that in order to achieve credibility in the objective of monetary policy, we had to hit the targets that we actually announced. And, if we wanted people to believe in the upper limits of the target range, we had to hit the lower boundary of the target range. It simply wasn't credible to me to give ad hoc explanations for being below the minimum limit, but not doing anything to try to get it back up, while saying to the people "but don't worry, you can trust the upper limits, we will act decisively when the time comes."

Some weeks back, I was talking to a member of the Board staff about what we call the Blue Book -- which is the input to policy and the tradeoffs of various money growth and interest rates -- and about the experience of the last couple of years about what has happened to their opportunity cost model and M2 growth, how lousy the projections have been, and the velocity of the M2 problem (the linkage between money growth and inflation or something.) The Board staffer said, "Well, with no casualty intended, it worked pretty well before you got here."

To some of the people that try to advise us on policy, it seems to be the case that we don't know how to hit our monetary growth targets, and we wouldn't know what it meant if we did. Other than that, we don't have any problems.

It's pretty clear to most people that the linkages are broken. That the link between open market operations and money growth, at least in terms of the broader money measures, is not as reliable as once thought, and also the linkage between some measure of money and the rate of inflation, or the price level is not working.

Back in 1980, we had some legislation that was in part intended to enthrone M1. We had had a couple of decades where the M1 velocity (really the variance around the trend of the M1 velocity) was quite good compared to the other things leading us to believe that if we conducted monetary policy (open market operations) in such a way so as to hit an M1 target, we had a pretty good idea of what was going to happen to a nominal GDP growth, and that could help us achieve what we wanted. So, the legislation was to move toward what we called uniform and universal reserve requirements -- to have reserve requirements <u>only</u> on transactions liabilities, and have the <u>same</u> reserve ratio on all transactions liabilities at all institutions, so as balances bounced around from a credit union, to a savings and loan, to a bank -- from a big bank to a little bank, and so on -- we did not release and absorb reserves in an erratic way, causing noise in the multiplier. The legislation was intended to improve monetary control because we thought all we needed to do is tighten up on our control of M1 and everything would be fine. Along about that time, or maybe shortly after --some people say it was the 1982 Garn/St. Germain legislation -- M1 got dethroned. While we were trying to work on improving the monetary control side, the connection to something we cared about seemed to go haywire as the velocity of M1 started to become less predictable.

The Committee then shifted to an emphasis on M2, based on the historic relation between broad measure of money and the rate of inflation. But, we had the wrong institutional arrangements in order to hit a money growth target when we defined it as a broad measure. That is what gave rise to this opportunity cost model. If we still believed that we had a reliable linkage between M2 growth and what we really care about, then the objectives should be to seek institutional arrangements -- in the form of something like a change in reserve ratios -- to stabilize the multipliers. We could have one standard reserve ratio, say about 4 or 5%, on all noncapital liabilities of all depository institutions, and that would improve the link between open market operations and M2 in order that M2 growth would then produce results we wanted.

But, given the problems of velocity of the last couple of years, I don't think that anyone has the conviction that we could enthrone M2 through legislation and regulation, and achieve a better result. So, there is no support for that at the moment.

In the past two years, after the Gulf War, there have been two rival conjectures about monetary policy, and the role that it played. And they are sort of revealing about how the people that give us solicited and unsolicited advice view the world. One view was that the recession was caused by an oil shock and war fears. According to this view, all you had to do was remove this shock that was depressing economic activity, and you would naturally get a rebound. And, for a couple months, in the spring of 1991, it appeared that was happening. Then the economy simply went flat for about 4 quarters or so, and it's been kind of bouncing around on a fairly low growth trend since. That view says that it was a restrictive monetary policy, summarized by M2 growth, that held back total spending, causing subpar economic performance. According to that view, all that is necessary is to get our foot off the brake, to be more generous in reserve supplying operations, and allow M2 growth to move up into the middle of its target range, and the economy will be fine.

A second view, quite a different one, is that various regional and sectoral depressants have been at work over the last couple of years, and these include such things as cuts in defense spending; the unwinding of the commercial real estate overhang, and the redeployment of those resources to something more productive; the corporate restructuring that's going on -- including all of the reengineering, or right sizing that partly is technology driven, the balance sheet restructuring related to the unwinding of leverage buyout and junk bond phenomenon of the '80s; the overhang of consumer indebtedness; commercial bank recapitalization; and the demise of the savings and loan industry. This set of depressants constitutes what Alan Greenspan calls the "50 mile an hour headwinds." According to that view, monetary policy has been very expansionary, as summarized by either the exceptionally rapid growth of narrow measures of money (M1 grew 14% in 1992, the highest rate for a year in the post-war period). Or, the low level of short-term interest rates, (fed funds being the lowest level in 30 years) and the steepest yield curve in post-war history. According to that view, the trick is to back off of the accelerator as these headwinds dissipate, so that we do not sow the seeds of soaring inflation.

The first view says it is a question of "easing" monetary policy. The second view says it is a question of when is the

appropriate time to begin to "tighten". I think that both of those divergent movements of the money measures can be reconciled in the environment we have been in. Nevertheless, what gives rise to my concerns is the lack of understanding on the part of the American people, and their elective representatives, as to where we're going.

If households and business do not believe the Central Bank has both the intent and the ability to achieve and maintain price stability, they will naturally look for evidence of changes in Central Bank policies. They will assume that changes in the political party occupying the White House, or controlling the U. S. Congress, will affect the objectives and results of monetary policy. They will assume that success or failure to achieve certain fiscal policies will have implications for monetary policy. In short, they will base their own plans and decisions on the assumption that any society that does not have the political will to constrain the growth of government spending within the range of tax revenues will ultimately resort to debt monetization and the consequent debasement of the currency. That means they do not believe the stated objectives of the monetary authorities; there is a lack of credibility in the commitment to price stability. Our challenge is one of trying to reinstitute a regime in which people once again

believe that any increase in inflation and interest rates is temporary; the longer-term trend is toward price stability.

(Intro for Frank)

Frank was President of the Federal Reserve Bank of Boston for 20 years, and currently is the Peter Drucker Professor of Management at Boston College. I guess now you can tell us everything that was done right or wrong over the last twenty years.

(Frank will now speak)

I remember that debate in the 80s was at Berkeley with Jerry Jordan where we had quite diverse opinions on the whole issue of monetary targeting, and I now find that there is very little difference between us. So this session is going to be much less heated than the one at Berkeley was. I think we have all learned something of the events of recent years. What I would like to do is to take a look at the history of monetary policy since the Treasury - Federal Reserve Accord in 1951, and try to pick out some of the lessons that I think we should have learned from that 42 year period. I find it useful to break down this whole period into four periods. Two of which were successful interest rate targeting periods, one from l951 through the mid 60's. The second successful interest rate targeting period, is the current period. The one from 1982 up to date. We also have one period of one policy failure in the 70s using interest rate targeting, and one brief period of targeting nonborrowed reserves from 79-82. Now the first period ran from l951 through the mid 60's. This broadly viewed is one in which the Federal Reserve conducted an extremely successful monetary policy. It was in a sense, the high water mark for the U.S. economy that 61-65 period and perhaps the high water mark for U.S. monetary policy. And it is ironic that the Chairman during this period, William McChesney Martin, Jr., who during his regime, accomplished probably the most successful job of controlling the monetary aggregates. This man did not believe in targeting the money supply. Now if you look at that period, compared to others, the conditions for monetary policy were generally pretty favorable. We have no supply shocks, such as we had in the 70s. We had one war, the Korean war, but it was a well financed war, and we did not get any sustained, fiscal pressure in the financial markets. And we had in place throughout the period Regulation Q. Now Reg Q had a great many faults. And nobody was terribly sorry to see it go. But the fact remains that Regulation Q was a wonderful device for monetary control because all the Fed had to do to begin tightening up the economy was to move short term rates a little bit above the ceiling which meant that money would flow out of the banks and thrifts into the open market instruments and you would have an immediate impact on all of the parts of the economy that were sensitive to the position of the banks and the thrifts. And that meant with very small, relatively small interest rate movements you could control the economy quite well. Once Regulation Q died, and we didn't have the kind of credit rationing that it produced, it took much higher interest movements to have the same effect that small movements had in earlier years. Now there was no great theoretical structure guiding monetary policy in those years. There was a very successful structure which Martin encompassed in two sayings, one - leaning against the wind. And the other, taking away the punch bowl when the party was just getting going. Both of those meant that what we should do is lean against the wind when every the economy began to grow at a rate that could not be sustained without generating increasing inflation rates. And conversely, leaning against the wind in the opposite direction when the economy moved into the recession. And in fact, this very simple construction produced as a byproduct very stable rates of growth in the monetary aggregates. Now when the Accord initially took affect, the Federal Reserve targeted free reserves. Now there is no theoretical basis whatsoever, for choosing free reserves as a target for monetary policy. It was done because the Fed at that time wanted to demonstrate to the market that it would no longer peg interest rates as it had for the whole period of World War II and that was the rationale for adopting free reserves. Well, as time went on and the market began to understand that the Fed was not going to continue to peg rates, they dropped free reserves and went to overt interest rate targeting. Now the leaning against the wind doctrines produced four mild recessions in l9 years if you send it through 69-70. But all recessions were very mild, the average unemployment rate was very low and the inflation rate was low. We have not succeeded since that time in sustaining periods of that kind of inflation, low inflation rate and low unemployment rate.

Now when we turn to the second period, the period of failure and interest rate targeting of the l970s clearly the conditions were much more difficult than in the 60s and 50s. We had the two oil price stocks, which were very difficult to contend with. We had continuing what was at least then thought to be a wise government deficits although it looks much smaller in these days and of course we had the demise of Regulation Q. Now the Federal Reserve moved vigorously in response to the 1973 oil shock and produced the biggest recession we have seen. The deepest recession since the l930s. The problem was that the recession while the amplitude was about right the recession was too short and the inflationary expectations that were generated by the oil shock and the Viet Nam war build up emerged for the 74-75 recession pretty much in tact. I think the big problem from the policy maker in the 70s was a fixation on nominal interest rates. First we had been accustomed to very small interest rate changes, having big results. When the Q ceiling was taken off and we needed much larger interest rate moves to have the same effect, I think policy makers were a little bound down by the earlier experience and looked upon what they considered to be very high nominal rates and which of course were much higher than anybody had seen since going back to the 20s. But rates then in real terms were negative. There was not any real focus on real interests either inside the Federal Reserve or in the bond market. The bond market was taken in by the same fixation in a nominal interest rates that the Fed was taken in by. In retrospect it seems almost unbelievable that for l0 consecutive quarters the real rate on l0 year Treasury's was negative. And I calculate that using a 3 year average, the average inflation rate of 3 preceding years. And in fact, if you look at the period l971-l980 and half of the quarters during that period the real rate of return on 10 year Treasury was less than 1%. Now the Fed for this reason did not move. Did not move to lean against the wind in 75, 76, 77 - the years when big trouble was building up. And when they did begin to move in 78, 79 driving rates up to as high as 1 l/2% and the funds rate in Sept. 79 it was too little and too late. The Fed was behind the curve, the horse was out of the barn, and when we went into the most dramatic FOMC meeting of probably the life of the Federal Reserve System. A Saturday meeting in October 79 where the FOMC by unanimous vote moved not only to move interest rate up sharply but to change their operating procedure to quit targeting the federal funds rate and begin to target nonborrowed reserves. The rationale for this was not that the whole committee had all of a sudden turned monetarist in their thinking but simply that we all came to the conclusion about the same time that it was obviously going to take very high interest rates. Higher than any of us even conceived of to turn around this powerful tide in inflationary expectations and that if we were overtly targeting interest rates we would have great political difficulties accomplishing those very high interest rates. So it was felt that moving to a program of targeting nonborrowed reserves would give us a little political shelter in this difficult time and in fact it worked. The Chairman of the Federal Reserve appeared before the Congress, the Congress was concerned about high interest rates and the Chairman would say well we don't control interest rates anymore, were controlling the rate of growth of bank reserves and the money supply. Now the Congressman get a lot of letters about interest rates, they get damned few letters complalning about the rate of growth, the money supply, or the bank reserves. And it is quite amazing that the Fed was able to get away with this in this situation. And that is one reason why in 1982, when we had to abandoned targeting nonborrowed reserves I think most of the members of the FOMC were very reluctant to do so because they valued so much the political sheltering that targeting reserves rather than interest rates gave to the Fed. But they had no alternative in 82 because while Bill Poole's doctrine that targeting interest rates can be procyclical when the economy is stronger or weaker than is expected and we had plenty of that evidence in the late 60 and 70s the other part of his doctrine that interest rate targeting is superior when faced with a increase in liquidity preference. And what we found in 82 was that all though the economy was contracting (we had the most serious recession since the 30s) that all of the monetary aggregates were growing at very high rates. The impetus for this increase in liquidity preference this was not related to a strong economy but quite conversely existed despite a very weak economy and the Federal Reserve was forced to supply that liquidity or face a financial crisis of possibly quite fast proportions. And so with this reluctance to leave the political sheltering the nonborrowed reserve had given them we move back to interest rate targeting in the summer of 1982. Now when we did sell we did not announce that we were overtly targeting interest rates again. We picked another concept that we are now targeting borrowing from the Fed. This may sound very similar to the decision of the Fed in l951 to cover up the fact that there was interest rate targeting by using a free reserve _________. And of course, bolster reserves and borrowing as this targets has the same characteristics as interest rate targeting because the FOMC manager because if he is controlling free reserves or if he is controlling borrowings has got to give to the market whatever nonborrowed reserves they require or demand. Because to do otherwise would be to increase or reduce the level of borrowing which he is charged by the FOMC to keep at a certain level. So we went back to interest rate targeting with this very fragile coverup with our directors still saying to this day that we are controlling reserves meaning borrowed reserves. But I think the Federal Reserve learned a great deal from the experience of the l970s. I think there is an unspoken doctrine, maybe spoken now, Jerry, that we're not going to allow short-term interest rates to stay in negative real levels. If you look back in the 70s the short term rates they were negative in real terms based on the trailing 12 month inflation rates for 7 years. From the 4th Q 1973 to the 4Q of l980, 7 years of negative real short term rates. I think if in the 70s, the Fed had been operating with a rule that real short term rates should not be permitted to fall to negative levels. I think the recession of 74-75 would have lasted quite a bit longer and the subsequent of the growth rate of the economy would have been smaller and inflationary expectations could have been in pretty good shape between the second oil price shock hit. So if this one lesson the Fed has already learned, but if you haven't you might tell them Jerry, that we should not permit negative short term rates except perhaps under conditions of extreme emergency conditions that none of us have seen in the past 50 years or so. Ok - where does that leave us for the future. I've had little contact with academia lately and I see them targeting things like nominal GNP or commodity prices or change rates or the yield curve. And the fact is that none of these can be targeted by the Federal Reserve in the same sense that we targeted M1. The Fed has only two instruments at it's disposal. It can control short term interest rates or it can control the rate of growth of bank reserves. A target has to be something that is acceptable to fairly precise controls by one of these two instruments. And it would be certainly wonderful if we could by setting a certain level of short term rates all be setting a certain rate of growth of bank reserves to attain a fairly precisely a given nominal GDP. But we have no model that would permit us to work this magic. So I think that the Fed's policy has got to be what it was during the Martin years, one of leaning against the wind. Now a lot of these variables that are suggested as targets for the Fed will supply information (end of tape - side A) . . . . policy. It will tell us a lot about, (I keep slipping into the us, thinking I'm still in the Federal Reserve) it will tell them a lot about the wind direction velocity and permit them to shape a result leaning against the wind program. But none of these things can be targeted in that sense and the only sense that is meaningful for the word target. What about the monetary aggregates. The things we can target and I suppose the only one can target now is M1 and M1 unfortunately has become too interestsensitive to be a satisfactory target for monetary policy. The problem is the pricing of interest-bearing M1 accounts which is very sticky. And therefore, because of this price stickiness in a NOW account you get big swings in the spread between NOW account interest rates and CD rates. And when the spread is very wide such as it was back in early 80 when the spread between the average NOW account rate and the average six month CD rate was 375 basis points. And at that time of spread, you are going to get very low rate of growth and interest bearing M1 accounts and very low rate of growth as consequence in M1 in general. In the past two years, that spread has dropped to between 65 and 80 basis points. The spread between a 6 month CD and a NOW account. The evidence suggests that whenever that spread drops below 1% the opportunity cost of holding interest bearing M1 accounts becomes so low that you begin to see a very rapid rate of growth in M1 - and that is what we are getting. For that reason, the next time we see the Fed push interest rates up you're going to see a big decline in the rate of growth of M1 as the opportunity costs of holding M1 interest rate and bearing deposits when those opportunity costs rise. Now what M2 and M3? I find it amazing to read works written by such formally sensible people as Martin Feldstein and Paul McCracken, and I think Jerry and I agree on this point, arguing the Federal Reserve policies too tight because M2 is not growing very much. The question is that M2 growth rate a function of monetary policy being too tight and I think no - the slow rate of growth of M2 and M3 does not reflect monetary policy these deposits the none M1 deposits in M2 and M3 carry no Reserve Requirement. They are not constrained by Fed policy in any way. They are constrained by the capital position of banks. A lot of the big banks have found themselves in difficulty with respect to the new capital requirements. They find that one way of improving their capital ratio is to reduce the volume of their assets and the best way to accommodate a reduction in the volume of the assets is to let their managed liabilities run off. And we've seen over the past two years almost every time you get the account of what the wise banks in the country are doing you see a further decline in the CD position of the banks in the country. The only way the Fed could make M2 grow faster to any sizeable degree would be to increase M1 at an even faster rate which would make no sense at all. Now in time, I suppose you could conjecture that A) the banks change there way of pricing NOW account interest rates, which I probably think is not likely, so I don't see a comeback for M1, but you could see a period some time ahead when M2 and M3 begin to gain some respectability as targets for monetary policy. Presumably, at some point, banks are going to feel comfortable about their capital position and be willing to go into the marketplace and to increase their managed liabilities again. And in time, conceivably see M2 and M3 grow at something like their normal rates in the 60s and 70s. But even if this happens, this is going to take a long time to establish the fact that we have renewed stability in the M2, M3 GDP relationship. So until this happens, I think the Federal Reserve has no choice but to target the Federal Funds rate. There are no targets in sight that it can sensibly use and achieve by varying the rate of growth of nonborrowed reserves. So if they were making book on the floor below us they make book on almost everything down there. If they were making book on what the Federal Reserve would be targeting 5 years from now I would bet that they would targeting in a discretionary way the Federal Funds rate. Because I think it would take at least 5 years of data to generate any confidence in stability of the relationship of any of the monetary aggregates to the GDP. So I think I will stop at that point for questions.

Just before we open it up to more general discussion to give you a chance - I think Jerry has some comments then we will take questions. When you have questions, go up to the mike.

Couple thoughts, and a question. Your noting the role of Reg Q and interaction with policy Reg Q as a instrument in that period. Whatever, we thought of them or since, about the efficiencies and desirability the effectiveness of that, when you put into political economy or public choice context it did involve identifying victim sectors as we call them. But those interest sensitive sectors that took the brunt of monetary policy action. (Mr. Morris - they always take the brunt of monetary policy actions) Well, but it was very, very focused when you created disintermediation at that time, in which created a political reaction from the housing and the auto sectors, and so that I think is the politics of it that killed it as much as any argument in the profession about desirabilities and efficiencies and all of that. (I think what killed it was the money market fund.) That was an innovation that came from that environment. What is intriguing to me is to think back hindsight, is in the 70s City Corp., City Bank, wanted to issue a VISA card, I believed passed in Maryland with a credit balance of which they were going to pay a positive market rate of interest and the Board of Governors says if quacks like a deposit, it is a deposit, it's subject to Reg Q and Reg D, therefore its on economic and Merrill Lynch says Gee, we can do that. We can have a credit balance on a brokage account and pay a market rate of interest and the Board of Governors in effect regulatory prohibition that created a alternative vehicle transmission mechanism and killed a part of the banking industry. The other comment that intrigues me is your emphasis on the role of free reserve as a transmissions vehicle after the accord to unhook political and market sensitivities to interest rate targeting until the time was receptive to go back and then your characterization of the 79, 82 reserve targeting is again, political shelter and nonhooky(sp). Can you think about what you might do in this environment if were in a highly politicized focus on short term interest rates. We've had 5 years of cuts in the Funds rate and the very first time after, is it 4 years or 5 years?, anyway, after 4 or 5 years of cutting the funds rate 23 times or whatever its been by 7 percentage points, the first increase is headline news. So, in order to again whether your bet about 5 years from now targeting the funds rate - I'm not going to bet against that for sure, but that doesn't mean that between now and 5 years from now during that whole period we would also target. Can you imagine using some other instrument as a transition devise to unhook the markets and the political sensitivities from this preoccupation with the funds rate until sort of a time we could go back to it, and if so what would it be?

I would like to respond to two things. One with respect to Reg Q. When Fidelity Fund first decided to permit customers of this money market fund to withdraw their funds by use of a check, I called up Ned Fitzgerald and I told him you're destroying the concept of the money supply in the United States. You've got checkable money market funds. And he said, "We didn't have anything like that in mind. What we found out was that the cheapest way for us to handle withdrawals was to give them a bank account and let them write checks out. It was purely a dollars and sense administrative thing. With respect to the second thing is something the FOMC has got to be thinking about now. How to reduce the political flack when you have to start pushing interest rates up. I wish I could have had a concept that I could give to you to meet this. I don't think you go up before the banking committees and make credible a response that we are not controlling interest rates, we're controlling borrowings from the Fed. I just wonder how long that would fly. I think the FOMC is simply got to do what was done during the Martin regime. Of doing what they thought was right and standing up to Congress. Why can't the committee get like this when it gets you away from that kind of pressure. Ok, thank you. Let's open it up to some questions. First question, please identify yourself and then go to your comment.

My name is David Fand, and I'm with the Center for Study of Public Choice. I would like to ask Jerry Jordan a few questions. First of all, I think the juxtaposition of M2 vs. zero inflation is incorrect. In other words, one is saying I want to end up in Jerusalem and the other is saying I'm going to fly or should I go by ship. You're talking about different animals there. Let's take the zero inflation first. I'm as anxious for zero inflation as Lee Hoskins. But the real question is how soon do you want to get there? Do you want to get there in six months, or eight months, or three years, or four years? If we want to get to zero inflation in six months, we may produce 30% unemployment. I think even Lee Hoskins would question if that is wise. So to talk about zero inflation, you're just talking about where you want to end up. You're not telling me how to get there. That's where M2 comes in. M2 is the target that the Federal Reserve can achieve. Now, you mentioned that some staffer said something to the effect, "we don't know how to get to the M2 target, and we wouldn't know what it meant if we got there. Now let me be precise. When he implied he couldn't get an M2 target, did he mean he couldn't get M2 or as Frank Morris put it he couldn't get an M2 target without most of the increase being M1. I would say, so what? Who has told you, or on what basis do you know, that the composition of M2 between M1 and nonM1 is the critical factor. Second, with respect to saying he wouldn't know what it meant if he got there is it or is it not a fact that most of the regressions will show that the M2 target gives you a much better indication of GDP than any other M. Next, you mentioned that there were regional and sectional depressants. True. But were these depressants helped by the FOMC consistently missing targets which already incorporated an attempt to reduce inflation. Next, you mentioned that many think the Fed was very easy because short-term rates were low. Is it or is it not a fact, that short- term rates, all rates, were very low during the Great Depression after several years of very low growth of money. In fact, a 35% reduction. The question I ask, is it or is it not a fact that it is true, in general, that most of the time when interest rates are falling they are the result of monetary easing. But is it also not true that interest rates could be falling and very low as a result of 3, or 4, or 5 years of tight money? Is it or is it not a fact, that since '87, '88 you've taken M2 from 9, to 4, to 3, to 2, to 1 point days. So, these low interest rates could have been the result of a very restrictive policy and not in the elements of easing. Let me just sum it all up. The summation really is this: we all want zero inflation, believe me, I'm just as much for it as Lee Hoskins. You may not believe me, but believe me I am. But, the real problem is if you continue with a tight policy, and you produce a week economy as we've had the last three years, the real question is '90, '91 and '92 what the Fed has done, and why it consistently fails to hit the midpoint of their own targets. Now, you're going to get a weak economy. You've got an army of engineers from Yale Law School ready to do all kinds of things, which incidently they would have done already, were it not for Ross Perot, we're just lucky Ross Perot has thrown a monkey wrench in. They've got all the programs ready, all the initiatives. Is there not a danger that by continuing with a tight money policy, in a weak economy, you're going to give the Robert Reichs of the world the material they need for their new program.

(Jerry Jordan) Thank you, David. We just published an article in one of our publications in our Bank saying that all evidence still supports that M2 is in fact the best measure. The authors of that publication -- who do not work for our Bank -- now think that the article is wrong. We got it out just in time. You've used the reference to "tight" money a couple of times. But, that of course, implies that you know which indicator relates to something down the road. You also made reference to "low real interest rates" in the Depression. I would say that is wrong. You had deflation in the '30s and the low level of nominal interest rates was misleading people to think that policy was expansionary when in fact it was contractionary. This is back to Frank's point -- nominal interest rates are not real interest rates. How do you know what real interest rates were. It depends on the expected rate of inflation. With the asset prices and other prices dropping absolutely in the 1930s it was an illusion that there were low real rates. You had low nominal interest rates. It's an ex ante, not an expost, concept.

Our problem today, is in part knowing what is in the minds of households and businesses in America as they make their plans and take actions that influence the future. What we see is we've had a record corporate calendar of debt issue -- a lot of it at fixed rates at what they perceive as being fairly low. It may be low compared to the past, but the important thing is whether or not it is low compared to what it's going to be in the future. We have households refinancing mortgages in the belief that 7 or 7 1/2% on intermediate and longer-term mortgages is going to, in the future, turn out to be low. But, if we're successful in moving toward stable money, then that is going to turn out to be a high expost real rate. The Committee does discuss real rates. There are some differences as to how to measure real rates -- over how many months of the rate of change of which index, and with and without this or that component in the various inflation measures. Some put it in a Wicksellian concept of a natural rate. They are trying to interpret whether a 3% fed funds rate is high or low. You obviously think it's high.

You're also saying "tight money" because of slow growth of GDP. We don't want to gauge what we're doing in monetary policy over some perception about statistical indicators of economic activity. Milton Friedman's '67 Presidential Address told us we didn't know enough then to do that and I don't believe we know enough now to gauge monetary policy actions by what happens to nonfarm payroll employment, or real output growth, or all of these other measures. You cannot control a real variable with a nominal instrument.

Monetary analysis comes down to excess supply and excess demand, and you have to have independence between the demand function and the supply function. Part of Frank's analysis was that when you move into these periods where you do not have independence between the demand for a certain measure of money and the supply of it -- whether it's M1, M2 or some aggregation -- then you're not going to have effective monetary policy. When I think that we are faced with those situations, I fall back to the monetary base where clearly we have independence between supply and demand. The current construction of M2 is not the same as what was in the Friedman-Schwartz studies. It is a different aggregate and if you go back and look at an M2 today that consists of the same component parts as the Friedman- Schwartz studies, you get different results than what is implied by the published M2.

I dissented three times out of my first 7 FOMC meetings on the grounds that it's our target, we announced it, we communicate this way, and we should hit it because it is our target. But, not out of any conviction that empirical results are going to tell us we are going to get a certain outcome in terms of short-term output or employment growth.

(Fred Furlong) We've heard from Lee indirectly throughout this session. Right now I think we will hear from him directly.

(Lee Hoskins) I'm just going to ask a question or two, and make an observation. One observation - as many people in this room have established, a very large body of information, research about instruments and targets and it has always surprised me the paucity of research about the value of price stability relative to that. So, I agree with Jerry. I think we focused on the wrong thing through most of our academic efforts in terms of looking at these interest rates or money growth. There are two large central banks and large economies that have a better record than the U.S. Central Bank in terms of inflation in the last 25 years; one is Germany, the other is Japan. One uses monetary targets, and the other uses interest rates as targets. I think all we are talking about is a very built-in inflation around the mean in terms of choosing which target. In terms of zero inflation, and the question I want to pose, and may be a little directed to David, is I think really if the Central Bank truly wants to get zero inflation, it can do it with either set of targets. That is interest rate or money growth. The point is we don't have a clear cut objective about what we want to do as a Central Bank.

Talking about nominal GDP targeting seems to hit or miss the point. Fed does not control nominal GDP. Fed controls one thing over time and that's the price level. Period. That's what it controls. So why not target the price level, and how would you go about doing it? That's my question. I guess to David Fand's point, yea, I mean I never wanted to get to zero inflation tomorrow because credibility is an important thing but I don't think credibility has to come from an M2 target or an interest rate target. Credibility can come from a clear statement of objectives, that is, we want price stability in a timeframe in which to achieve it. I picked five years because contracts have a chance to adjust to it within that timeframe. So the question is, why not target the price level?

(Morris) Well, I think the reason the Fed cannot be that focused on the price level is that very often we're the only tool of economic control in Washington. It would be nice if the Fed could say we're going to focus on inflation, and we're going to let the real economy be determined if need be if something has to be done to spool or restrain. The real economy is up to fiscal policy to take care of that. Unfortunately, we don't live in that kind of a world. I've never stated a zero interest rate target, not that I'm opposed to it. But I think in terms on realism, if we could get back to the kind of inflation rates we had during the Kennedy years of 1, 1 1/2%

where most of that inflation very well reflect failure of poverty adjustments, where you had an inflation low enough so that it wasn't going to distort investment decisions. It seems to me that would be a perfectly reasonable objective, and I think if we could in the next five years get the inflation rate down to 1 1/2 to 2% I would consider that a considerable triumph for the Federal Reserve.

(Jerry Jordan) Now you know the difference between Frank and me. Frank wants to get back to the 1 to 1/2% inflation of the Kennedy years. I want to get back to the 1 to 1 1/2% inflation of the Eisenhower years.

I would adopt a multiyear objective for the price level. This multiyear path would be a long-term objective, not an operating target. To make the price objective explicit and measurable, I recommend that the FOMC choose a time-path for the intended inflation rate that leads gradually to a horizontal trend in the level of prices. For example, today I would choose a path that achieves price stability in 1998. It would imply 2.5 percent inflation in 1993, 2 percent in 1994, 1.5 percent in 1995 and so on until the intended inflation rate is zero in 1998.

In the short-run, between meetings and within a year, the FOMC would continue to use its best judgement in achieving this objective, based on monetary growth targets, its best models and a wide variety of other indicators. But these judgements would be exercised within the context of the multiyear objective that, in effect, would provide the benchmark for setting annual monetary targets. This is particularly important when velocity is misbehaving. I would tie our announcements as to what we are doing to the Humphrey-Hawkins requirements on the budget and try and put some teeth in it. First, that the administration, the Office of Management and Budget, and the Congressional Budget Office, should agree with the Fed on 5 year out - I would call them price levels with a variance at that unexpected level and tie together what the monetary authorities are aiming for down the road -- sort of like long-term strategic planning in the corporate world -- and work backwords from that to intermediate annual price levels (or rates of inflation -- year-to-year changes that will produce that price level). It is important that the public has in their mind that five years or seven years down the road, plus or minus two or three percentage points -- here's what a dollar will buy.

Think about 4% inflation, which a lot of people have in their minds as low or moderate. Yesterday, John Taylor said that he thinks that the Fed -- his empirical results implied, he says -- that the Fed has shifted up from 2% inflation measured by some index to a 4% rate of inflation. A 4% inflation to the parents of a baby born this year means that when their kid is ready to be a college freshman, the purchasing power of the dollar will be cut in half -- or the cost of going to college, other things the same, will double. That has to go into their planning. To me, that is unacceptable. What we ought to do is try and say to them, and effectively communicate it through our actions (and this does involve reserve or money targeting), that the purchasing power of money is going to be thus and so some years down the road and you can count on it.

(Morris) I think the problem here, Jerry, as you well know, is that it is very difficult to get the Administration and the Congress to think in any long-term context. I remember one time back when Jerry was on the Counsel of Economic Advisors and the rosy scenario came out. Rosy scenario showed 4% real growth rate forever accompanied by a declining interest rate. I said, Jerry, how did you come up with this rosy scenario and Jerry said it was simple. He said that the supply side did the real economy and the monetarists did the inflation rate.

(Mr. Jordan) It was worse then that because the eclectic did nominal GDP and it turns out Y didn't equal X plus P.

(Fred Furlong) One thing in this discussion seems to be that we are talking about interest rate targeting in some sense and why can't we target the price level. Others have come up and suggested more nominal GDPs and obviously some people disagree with that. But the fundamental question is the FOMC agrees and no one knows exactly what the right level of interest rate is in some sense. You have to have something you are reacting to. The FOMC deciding. "well do we not change the Fed Funds rate or do we change the Fed Funds rate." We are reacting to something. I guess Jerry's suggestion that maybe the price level but I guess the question for Frank is well if it's not the price level what's your alternative. What is it that you are basing your decisions on in terms of how you move that interest rate around.

(Morris) Well, I think that any FOMC meeting it seems to me that most of the members have a concept of what the optimal realistic expectation for nominal GNP ought to be over the next period. That may not be zero inflation 4% real growth rate. It may be a higher inflation rate that you like to get over long-term and a lower rate of growth then you would like to have long term. But you have to have some concept of what the best mix you can reasonably get in the next four quarters. That's what I always had in my mind when I approach the monetary policy decisions and sometimes I made them right and sometimes I was wrong.

(Jerry Jordan) That response surprises me a little bit because in your initial remarks you focused on the level of real interest rates. The lesson of the '70s was the problems of having persistent negative real interest rates, and you said we would not make that mistake again. I thought you would say that in today's environment with inflation measured over some period, we do have a negative short- term real interest rate. You would use as your target, raising the nominal rate to a level so that it was nonnegative. The problem with responding to nominal GDP, or worse, real output, is that any pickup in nominal GDP growth in the current context, given lags and all of that, is almost certainly going to be the result of faster real output and employment growth. So, if we use nominal GDP as the trigger to raise the funds rate it will cast the Fed as being antigrowth. That gives us a real political problem. The reason I was disturbed by last year's action to cut the funds rate on the day of, or the day after, release of the nonfarm payroll employment, was that it conditioned the market to believe that all we cared about was employment. They concluded that with the first sign of strength in employment we were going to raise the funds rate. That casts the Fed as a scrooge, because we would be viewed as anti-employment and anti-growth.

(different speaker) This is really following up on discussion with Jerry Jordan. We've got the objective and in your discussion/presentation, Jerry, you very clearly set out that in order to obtain that objective you need credibility and you need a nominal anchor. Now, I don't agree with Lee Hoskins here that you get creditability by announcing something. In fact, I think you lose credibility because we've announced so many things in the past that we haven't done, that another announcement won't do it. It's got to be actions over sustained period of time, and that links whether the actions are going to be successful, it seems to me that you're right that we need the nominal anchor. Do you have a suggestion for nominal anchor that will work in this environment?

(Jerry Jordan) Not one that I can sell. In order to reconcile the problem of interpretation of current M1 and various combinations of things to produce a broader measure of M2, I use the monetary base -- adjusted for increases in foreign holdings of U.S. currency. However, we do not have timely information. It does involve doing something that I am not at all comfortable with as saying, "Well, if you take this measure and either add to it something or other, or subtract from it something or other this is what you get." And there is no way to sell that to the Committee, let alone to try to communicate it to a larger audience through the media or political people.

So, I think that the focus has to be on longer-term objectives in terms of the price level. We should change our rhetoric and our focus. Instead of describing our actions as "tightening" and "easing" -- all of those words that are used about our actions implying stimulus or restraint -- we should instead, just talk in terms of achieving sound money. Plain and simple, nothing else. That's all we are trying to do is stop the debasement of the national currency.

(Walker Todd from the Fed of Cleveland with a question for Frank Morris) on interest rate targeting performance in the l950s and l960s. Even if you think it did work fairly well domestically, isn't it true that from '57 to onward or there abouts that the dollar was in deep trouble abroad either in terms of gold or foreign exchange and a whole host of jerry-rigged solutions kept being patched together over the next decade down to what I view as the most dramatic FOMC meeting of that whole era just reading the old minutes, August 1971. That was a jim-dandy meeting right after Camp David. But isn't it true that the interest rate targeting exercise, while nice domestically, led to ultimately disaster on the foreign exchange side?

(Morris) Well, I think that if you look back at that period in the '60s, we were running a trade surplus and we were running current account surplus. We were running a deficit in capital account that reflected the very large investments being made abroad by American corporations. The dollars going abroad for that purpose on which we are now getting very big returns were flowing into Central Bank hands and the Central Banks around the world were becoming more and more restless about holding that many dollars. Now I think the problem was here you had a domestic economy that was running very nicely with a low inflation rate - if we had a high inflation rate during the '60s that generated this problem and we had a big budget deficit and so on - I mean trade deficit, I think it would be a very different matter. But if you have trade surpluses and you have low inflation rate, low unemployment rate in the country, you've got a very satisfactory situation to alter/ tighten policy solely to make dollars a little more scarce it was not a politically acceptable or even perhaps an economically acceptable proposition. I think the big problem we had at that time was the fact the Brettan Woods system did not permit the U.S. dollar to go down in response to these major capital outflows. We were having these capital outflows which, in the long run, were very beneficial to the world economy and to ourselves which would have put downward pressure on the dollar if it hadn't been for the fact under Brettan Woods the dollar could not be devalued. And in fact, up until I969, the dollar was being revalued upward due to the devaluation of a great many other countries. So I think it was a structurally unstable situation we had there. And I'm not sure that it would have made sense for us to try to push interest rates up to the point where we had enough capital inflow to finance our foreign investments, because the impact of domestic economy would have been extremely negative.

(different speaker) That policy though, might have forced a choice politically in Washington, not at the Fed but among administration, Congress, and others, it would have forced a choice over whether in the long run it was better to devote capital resources to domestic investment vs. playing a leadership role in the world assuming the matter Great Britain had before World War II being the financier of the world and things of that sort. That issue was never really debated explicitly, it was just assumed that we were going to be the new Britain and we went abroad. But the point was, that had you made that opposite policy choice in the '60s, at least you might have had an open debate on the issue and other things that people would view as a disaster, like the Viet Nam War, might have been avoided.

We have time for one more question. (Philip Quayle, Ball State University). The Fed's primarily a political institution, creature of Congress, that the reason why we can't agree upon targets is that there is no agreement among the general populous. If the Fed follows a target that is not consistent with what we the public want, the Fed is not going to last. Evolutionary mechanisms assure that the Fed's not going to do anything extraordinarily painful, at least, perceived to be painful. If they attempt to do that, it's going to be changed. So in essence, the shifting targets you get explicable by the basis of there's no consensus among American public on zero price inflation or anything else that monetary policy should do.

(different speaker) I think the only saving grace is that the Federal Reserve is given, in fact, a lot of leeway in terms of time because of the slowness of the legislative process. You talk about the legislature reacting negatively if we pursue, over the prolonged period, policies that are unpopular. I grant you that the Fed cannot follow forever policies which are not acceptable by the public. This does not mean that for a considerable period, the Fed can as it had followed policies that were unpopular. I think an awful lot of people that would have voted against the kind of policies we undertook in '80 - '82, I'm not sure we could have gotten the majority vote among the public for following policies that were that tough. But we had enough lead time from the System to permit us to do it before and to show some benefits before the rebellion got too hot and heavy.

(different speaker) I agree with the thrust of your comment and '92, to make it very simple. The question I'm asking you - If the Fed had hit the midpoint of their own target, those three years, would we have been better off, would we have had more income, more employment and more jobs than we have now. And would it have been desirable.

(different speaker) You talk about a midpoint for M2?

(different speaker) Just those three years? I don't want to make it complicated. Would we have more income, more employment, more jobs, would we have been better off if they had hit just the midpoint of their own targets?

(different speaker) My answer is no. I think the only way we could have done that would be to increase that more than enough to make up for the drop in the CDs. We're talking here - not small money. We're talking at least 30 billion dollars. Now, if you're saying would it have been good for the country to supply enough additional reserves. Remember, in the two years '91, '92 bank reserves in those two years went up by 30% and you're telling me that is not enough. That we should have increased them by another 30 billion to support, to get up to M2 objectives. I'm saying the whole concept of M2 as a target for monetary policy is simply completely outdated by the real facts of the situation. I don't think there is anything the Fed can do to produce the kind of number that you want which makes any sense at all. The whole idea in my mind of increasing reserves by more than 30% in two years, I find mind-boggling to think that that could produce anything much more satisfactory for the economy. Remember, we have got a bond market very different to 1970 and I think we are lucky that we have. We have a very nervous bond market that has to be persuaded every day that the Fed is concerned about inflation. I think the kind of program you've been advocating here, would have had a negative effect on the bond market.

(Jerry Jordan) I would like to add to that because it is this lack of credible commitment to where we're going to come out at the end of the day. That's our problem. Remember 1990. The CPI shot up to over 6% in the midst of what was being touted as the third oil shock and people remember what happened during the 1973-1974 and 1979-1980 oil shocks. Even aside from the shock you were still averaging between 4 and 5% inflation. The Michigan survey and everything else you looked at showed an expectation of a persistent inflation. You had the badgering by the Brady Treasury and others in the Bush administration about policy being "too tight" and needing to "ease up". That had the effect that more aggressive reserve supplying operations in an effort to get up into the midpoint of the M2 target range would have resulted in simply an "Ah-Ha" experience on the part of the American public; namely that the Fed had thrown in the towel and is sacrificing its objectives for political expediency. The dollar would have plunged and bond yields would have risen. If that had happened, then the economy wouldn't be better off today. Your question was, would the economy be better off? And I'm saying, given the lack of a credible commitment to price stability I don't know if we would have been better off or not. I wish I did.

(Fred Furlong) I just want to thank our panelists and given them a hand. (Applause) Lunch is in about 10 minutes or so, but I think we have another minute. Maybe you could ask a question.

(Warren Coates, International Monetary Fund) There is very interesting literature over the last 15 years or so that Leland Yeager and Greenfelt summarized and extended and I've done the same and some others, which takes very much to heart the point every one seems to agree with here that price stability should be the ultimate objective of monetary policy and it says if that's so then why don't we just fix a system around that directly. It's really a gold standard mechanism with some new modern twists that takes the whole CPI or a very broad basket of commodities. It intrigues me that this quite different approach, but very direct approach, to what everyone agrees to hasn't been touched on as this - you did -

I'm sorry - OK - Is this receiving serious consideration at all by the

(Jerry Jordan) By the Board? I have no idea. I don't understand it. So until I understand it I can't seriously consider it. I'll read yours. Thank you.