March 18, 1991

ECONOMIC FORECASTS AND MONETARY POLICYMAKING

Notes for Remarks to Mercantile
Bank Chairman's Forum on
March 20, 1991

I. Introduction.

A. Would like to talk about usefulness of economic forecasts in guiding monetary policy.

B. Start with consensus forecast for 1991 & 92.

C. Then address whether such a forecast is helpful in making monetary policy.

D. Suggest an alternative.

E. Finally give you some of my thoughts on outlook for inflation.

II. Economic outlook (based on Blue Chip Economic Indicators).

A. Consensus of 50 top economists (3/10/91).

B. Real GNP growth of 0.1 percent in 1991, 2.5 percent in 1992 (about equal to average annual growth rate during past 10 years).

C. Recession ending in Q1, with peak to trough decline of 0.9 percent--short and shallow.

D. CPI increase of 4.6 percent in 1991, almost a full percentage point lower than 1990. Further decline to 4.0 percent in 1992.

E. No reason to dispute, but is it useful?

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III. Usefulness in guiding monetary policy.

A. Outlook clearly dependent on some policy assumptions; but if assume policy held constant, in theory could do forecast, decide whether or not you like what you see and adjust policy accordingly.

B. In fact, updated staff forecast is an input to the FOMC at each of its meetings.

C. But are forecasts really useful? Analysis performed by one of our economists on a comparable, quarterly consensus forecasting series indicates that standard error of actual outcomes from the forecast for the current quarter is about 4 percentage points for real GNP. In other words, assuming a 2 percent real GNP forecast, only 2/3 of the time will actual outcome for that quarter be between +6 percent growth and -2 percent growth! We cannot forecast whether we're booming or in recession in the current quarter, not to mention looking quarters or a year down the road.

D. So, while may be theoretically appealing to base policy on forecasts, as a practical matter, uncertainties of forecasting are simply too great to rely on; to do so would like result in volatile policy and volatile economic outcomes.

IV. What's the alternative?

A. Money supply still has intuitive appeal.

1. Controllable - direct relation between what we do day-to-day and how money behaves.

2. Linkage to goals.

Trend M affects inflation.

Short-run M vs. trend affects real growth; but only temporary--lasting effects on inflation alone.

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3. Observable.

B. Despite breakdown in quantitative linkages during 80s, qualitative still hold.

C. Much better than interest rates.

1. Only affect Fed funds.

2. Other interest rates determined by real forces of supply & demand plus inflation expectations.

3. So cannot set interest rates, and don't know how changes in such rates might affect goals.

4. Recent (Q4) experience misleading (i.e., declining Fed funds rate, yet tighter policy).

D. I submit what we should be trying to do is gradually bring trend M down, consistent with maintaining economic expansion. This will reduce inflation over time.

E. How have we been doing?

V. <u>Implications of monetary policy actions in recent years.</u>

A. Trend growth in money has come down from 11+ percent in 1986 to about 3 percent today.

B. An almost staggering decrease--some would say too rapid--which, nonetheless, brings trend money growth to a level we haven't seen since late 50s/early 60s.

C. That was a period when measured inflation ran at 1 1/2 to 2 percent, which many today would accept as effectively zero inflation.

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D. But unfortunately, that result is not "in the bag;" if it were, we would see long term rates down 2-3 percentage points from where they are now.

E. Why not? Because the Fed lacks credibility that it will stick with this kind of policy over time. (In post-war period, easing during recession has produced higher trend money growth and higher inflation in each successive recovery).

F. And perhaps, rightfully so. Since early November, money has been growing at a 6.7 percent rate, reflecting Fed actions in response to pressures to get the economy moving again. Since early January, growth rate has been almost 9 percent.

VI. Conclusion.

A. Forecasts not particularly useful.

B. Instead, need to pay attention to monetary aggregates.

C. Viewed from that perspective, have almost unprecedented opportunity to bring inflation down to "zero".

D. Also at point where at greatest risk of making mistake.

E. Let's hope we don't--only thing Fed can affect in long-run is inflation.

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