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MONETARY POLICYMAKING: ARE WE MAKING IT MORE DIFFICULT THAN IT OUGHT TO BE?

Notes for Speech to
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I. INTRODUCTION.

A. In principle, monetary policymaking ought to be a straightforward proposition.

1. We have a clear set of goals articulated by Congress.

a) Stability and growth of the economy.

b) High level of employment.

c) Stability in purchasing power of dollar.

2. We have straight-forward tools for implementing policy decisions, the most important of which is open market operations.

3. And we have interim monetary targets that are presumably related to our goals and reflect rather quickly the results of our policy actions; in other words, they tell us whether we're on track in meeting our goals.

B. So, why does monetary policymaking seem so complicated? And why is there frequently such a fuss about whether or not policy is on the right course?

C. Are we making policymaking more difficult than it ought to be? Or are there complications which arise when you look more closely at the tools, the targets and the goals?

D. This is what I would like to explore this afternoon.

II. COMPLICATIONS

A. Let's start with the tools.

1. I mentioned that the principal tool is open market operations.

2. This name is quite descriptive--we either buy or sell U.S. Government securities in the open market, which has the effect of adding or draining reserves from the banking system.

3. Reserves are then the basis for banks to expand or contract money.

4. So far, so good. But now the complications begin to arise.

5. The effects of the Fed's actions in the reserve market are reflected in the price of reserves; we control the supply, demand reflects general economic conditions, and the interaction of supply and demand results in a price, in this case the Federal funds rate.

6. This is the only interest rate the Fed directly controls, and yet in the minds of many, it puts us in the business of setting interest rates--all interest rates!

7. So the first complication is what business are we in? Supplying reserves or setting interest rates?

B. What about the targets?

1. Annually set monetary targets and review them at midyear; process provides basis for Chairman's semi-annual testimony on monetary policy.

2. The theory is that the supply of money multiplied by its velocity (that is, how many times it turns over in a year) equals nominal economic activity, that is the quantity of real goods and services produced multiplied by price.

3. If velocity is stable (or predictable), which is generally true over long periods of time, then we have a direct correlation between money supply and our economic goals; hence, money supply should be a good target as it is also affected by our open market operations.

4. But velocity for M1 hasn't been stable or predictable in recent years.

5. As a result, we "target" broader monetary aggregates, M2 and M3.

6. These broader aggregates include savings deposits, time deposits and money market mutual funds.

7. And while they seem to better reflect what's going on in the economy than M1, the Fed has very little direct control over them because transactions balances are such a small portion.

8. So they aren't really very good targets for policy because they do not reflect its thrust at any point in time; they are simply indicators.

9. Further, this breakdown in the relationship between narrow money and economic activity has led to a myriad of other possible indicators, including commodity prices, foreign exchange rates and interest rates. This further adds to the confusion.

C. Finally, what about the goals? Surely they cannot be a complicating factor; after all, they are set forth in legislation.

1. Indeed, the goals are clearly articulated; that is not the problem.

2. However, unfortunately they can be in conflict, at least in the short run.

3. One of the few things economists agree on is the neutrality of money. That is, in the long run, the only thing that money, and hence monetary policy, affects is prices.

4. Accordingly, we cannot permanently increase the growth rate of the U.S. economy through monetary policy actions.

5. Yet our goals talk also about economic growth and full employment.

6. Indeed, we perhaps can temporarily increase the real growth rate through monetary policy actions; but the residual, unless those actions are reversed, is simply higher inflation.

7. So even in the area of goals, we have problems.

III. CONCLUSION

A. I think we have to admit, despite the conceptual simplicity of the monetary policymaking process, there are indeed some complications in practice.

B. But I don't want to leave you with the impression that our only alternative is to throw up our hands in frustration.

C. Clearly, there are no simple rules to follow which are going to give us the right results; a lot of judgment is required.

D. Which is a good reason for having a broad-based, consensus-oriented process like we have on the FOMC.

E. But in exercising that judgment, there are some important things to keep in mind, at least in my opinion.

F. First, that we're in the business of reserves and money, not interest rates!

G. Second, that money matters, despite some changes in relationship to economic activity over the last decade.

H. Third, included importantly among the indicators we look at should be a narrow aggregate which reflects the thrust of policy actions.

I. And fourth, we must remember that the only thing we affect in the long run is prices.

J. Accordingly, we can maximize our contribution to growth and employment by providing a stable price environment conducive to saving and investment.

K. Short run fine tuning aimed at temporarily increasing growth only jeopardizes achieving this long-term goal.