NOTES FOR STIFEL BOARD DINNER
January 24, 1994

I. INTRODUCTION

Discuss my approach to monetary policymaking and why I am concerned right now about stance of policy

Also comment briefly on recent attacks on Fed

Will divide the first part into three areas: objectives - growth or price stability; channels - credit or money; and indicators of thrust - current economic statistics or narrow money growth

II. OBJECTIVES OF MONETARY POLICY

Clearly, all want to achieve maximum sustainable growth over time

Trend growth of U. S. economy 2.5 - 3.0 percent - good proxy for potential, and that is where growth has been for last five quarters, if not somewhat above

But what is monetary policy's role? Stable price backdrop or short-term fine tuning of real growth

Many on FOMC now are short-term fine tuners; trend in next several years likely to be further in that direction (possible turnover: Angell, Mullins (VC), Greenspan (C), others?) 1/94
7/95 / 1/96 3/96 / 1/06 1/98 earlier

Monetary policy's only long-term effect is on prices; can impact real growth in short run, but only for relatively brief periods of time for any single monetary policy action

My view is that effects are uncertain enough (both in magnitude and timing), could easily add to instability of economy in fine tuning mode, despite good intentions

Not to say should not offset sagging money growth in recessions, but also recognize need to return to monetary stability in due course

III. CHANNELS

Conventional wisdom is that Fed sets interest rates, or price of credit in various markets

To stimulate economy, Fed lowers fed funds rate, which affects cost and availability of bank credit, which in turn affect conditions in other credit markets

But this view ignores fact that interest rates are market prices influenced by a myriad of supply and demand factors of which the Fed is just one, and a small one at that (typical open market operation is less than 2 percent of average daily trading volume in U. S. Government securities)

Also ignores fact that interest rates are influenced by inflation and, especially for longer-term securities, inflationary expectations

So it is quite plausible that an easing action intended to lower interest rates could, in fact, have the opposite effect on long-term rates if result were an increase in inflationary expectations

Other view, which I share, is that Fed's influence is felt through its impact on supply of money over time

Quite compatible with point of view that objective of monetary policy should be price stability, inasmuch as inflation is a monetary phenomenon (i.e., too much money chasing too few goods)

Idea is that over long periods of time would want to provide monetary growth that is consistent with sustainable real growth and some concept of price stability (if velocity stable, potential growth 2.5 percent and notion of price stability is 1.5 percent measured inflation, then 4.0 percent money growth over time would be appropriate)

Because money growth is directly related to Fed's provision of reserves, stable money could possibly imply volatile fed funds rate, just as stable fed funds rate might (and has) imply volatile money growth rates

Can stabilize price or quantity in a market, but not both

IV. INDICATORS

If you are a short-term fine tuner who believes in credit channel, tend to look at current indicators of economic activity as a guide

Two major problems with this:

First, statistics are backward looking, released with considerable lags in some cases, and subject to revision which can be significant (GDP is arguably most important, yet does not come out until middle of next quarter and is revised twice in subsequent months)

Second, monetary policy affects the economy with lags

So while it is often argued that a particular economic statistic demands a monetary policy response, in fact such a view usually ignores the effects of prior actions which have yet to be fully manifested in economic activity.

Especially true with respect to reported inflation, which does not fully reflect monetary policy actions for two, even three, years.

But there are not easy answers with respect to indicators for proponents of the money channel either

Question is, which monetary aggregate, and is its velocity reasonably stable?

For last couple of years, M1 has signalled very accomodative policy, whereas M2, less accomodative, at times even tight, policy

To me, that is consistent with the financial restructuring which has been going on in the U. S. over the last two or three years

M1 reflects the thrust of Fed's actions

M2 reflects activity in bank credit market; if bank loans were expanding rapidly (which generally follows pickup in economic activity), banks would be issuing liabilities and M2 growth would be strong

In current circumstances, though thrust of monetary policy has been very accomodative, bank loan growth has been sluggish (until recently) because of financial restructuring; economy has expanded faster than M2 growth would have suggested based on past experience

Which brings me to the nub of my concern: the thrust of monetary policy has become increasingly more accomodative in the almost three years since the end of the recession

Why? Because we are pegging the funds rate at 3 percent, which is viewed by most as a neutral posture while we wait for further assurance that something is not going to upset the expansion, taking comfort in the fact that inflation has not ticked up

But we have got three years of considerable monetary stimulus in the pipeline, and if we wait to see an uptick before reacting, it will be too late

And of course, the low long-term rates we are enjoying right now (lowest in 30 years) are based on rather benign expectations of future inflation

V. ATTACKS ON FED

Issue is accountability; legitimate for public debate (Fed should be independent of short-term political pressures, but still must be accountable)

Congressional tactic has been to try to make the Fed look unaccountable by requesting reams of data, picking out isolated instances and sensationalizing through press releases before any opportunity to respond

As a System, we have been naive in the form of our response; only recently have begun to play the same public relations game

As to substance, two issues relating to accountability: Presidents on FOMC and disclosure of FOMC actions and deliberations

Presidents not politically appointed (therefore, some assert, not accountable), though get regional representation and greater independence from short-term political influence

In fact, FOMC is accountable as a committee, not as a collection of individuals; strong desire to reach consensus

Nonetheless, if analyze individual makeup, Governors have majority of votes, appointment of Presidents must be approved by Governors and Governors can remove a President

Furthermore, Presidents receive top secret clearance, sign an oath of office when voting and are subject to Federal conflicts statute

Bottom line: we view ourselves as public servants; how we are appointed in no way affects our responsibilities as members of the FOMC (same as Governor's)

With respect to disclosure issue, there is a tradeoff between what is disclosed and when, and the integrity of the deliberative process

Some would have us make monetary policy on TV

Easy to point at Fed and accuse us of being secretive; yet provide more disclosure on a timely basis than any comparable policymaking body I can think of

Willing, in fact obligated, to provide as much disclosure as we can so long as do not lose ability to interact and come to a consensus; doubt this would be possible on TV

Bottom line: need to be responsive to obligation to provide the public with information, but cannot destroy the deliberative process that we are charged to carry out