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Statement by

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before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I appreciate the opportunity to appear before this Committee today to discuss appropriate guides for the conduct of monetary policy, including more specific discussion of the changes you have proposed, Mr. Chairman, in the Humphrey-Hawkins Act.

There has been a broad array of suggestions put forward in recent years -- by those in and out of Congress -- to change the way monetary policy is conducted and the way it is communicated to the Congress and the public. Of course, there are always debates and proposals on how to improve the development and implementation of policy -- it's part of our democratic governing process.

My sense, however, is that the number and diversity of these suggestions, and their attention in the Congress, has been increasing. The concern about monetary policy reflects broader concerns about the performance of the American economy over the last decade and more, which has included the worst inflation and the longest period of economic stagnation in the postwar era. Moreover, economic doctrine has seemed less settled in recent years, and a period of rapid change in financial markets has raised new questions. Perhaps most important recently has been the heavy burdens placed on monetary policy to deal with inflation and concern about how monetary and fiscal policy mesh at a time of unprecedented federal budget deficits.

Although the specifics of different suggestions vary greatly, it seems to me that at least three considerations -- articulated clearly or not -- underlie the various proposals.

First, there is a desire for information so that the objectives and techniques of Federal Reserve policy are as clear as possible, in the interest of improved understanding, over-sight, and coordination.

Second, some urge the desirability of reducing the uncertainties they see as inherent in human judgment. They want to substitute some simple and easy-to-understand rule that specifies how monetary policy is to be operated, and that will serve as a clear and unambiguous standard against which to measure Federal Reserve performance.

Finally, some proposals could be motivated -- whether explicitly or not -- by a desire for the Congress (or an Administration) to exert direct control over setting and implementing monetary policy. That is not usually a professed objective; but, in fact, the effect of some proposals would be to facilitate or even encourage such an outcome.

I would like to take a few minutes to explore each of these approaches.

Plainly, a full exchange of useful information can enhance the ability of the Congress, the Administration, and the central bank to formulate appropriate economic policies; and it can increase the public's understanding of monetary policy objectives and intentions. A formal mechanism for furnishing you with information on monetary policy was established in the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act). Over time, we have modified our reports in response to requests for additional information, or certain types of information, and we are ready to work with the Congress to make them more useful.

At some point, of course, mere multiplication of data or report pages may be more confusing than helpful. Conversely, the beguiling simplicity of some ways of providing information could turn out to be counterproductive. For instance, proposals along these lines sometimes ask for specific, single-number forecasts of economic variables such as GNP or interest rates. But, the record of the last few years confirms that economic forecasts are not precise; to give a single number may well imply a false sense of both precision and controllability.

As you are well aware, the governing bodies of the Federal Reserve are a Board and Committee composed of independent members with diverse views. Those views cannot, except artificially, be condensed into a single forecast or specific short-term objective. I continue to believe a more desirable approach, and all we can legitimately do, is provide ranges -- such as those given now -- that encompass (and give some flavor of the inevitable uncertainties of) our expectations for future economic performance. In that light, I was interested to note that the latest proposal of Chairman Fauntroy incorporates the concept of ranges of growth in GNP in setting objectives.

In the case of interest rates, there would be the obvious prospect of misinterpretation and misunderstanding were the Federal Reserve required to announce regularly forecasts or targets. The forecast -- ultimately right or wrong -- would itself become an important market factor, obscuring and distorting the underlying trends and pressures. In the event, the result would often be to mislead market participants and provide false signals, especially since monetary policy alone has at best a limited ability to achieve stated interest rate objectives.

Proposals that suggest fixed rules for the conduct of monetary policy usually have two aspects: first, that some hard and fast formula for guiding monetary policy be adhered to in practically all circumstances; and second, that the formula be fairly simple -- typically calling for "ease" or "restraint" in accordance with movements in a single economic variable.

The appeal of a simple rule is obvious. It would simplify our job at the Federal Reserve, make monetary policy easy to understand, and facilitate monitoring of our performance. And, if the rule worked, it would reduce uncertainty about the course of the economy, and would assist consumers and investors in planning their spending and saving.

I have a certain sympathy for these calls for a monetary rule. But, unfortunately, I know of no rule that can be relied on with sufficient consistency in our complex and constantly evolving economy. Changes in technology and government regulations, shifts in the asset preferences of households and business, unexpected supply shocks such as food or energy price disturbances, as well as events in foreign economies and financial markets all can alter the relationships between the performance of the economy and the target variables suggested in the various rule proposals.

A number of ideas have been put forward over the years, focusing on such things as the growth rate of a particular monetary aggregate, the foreign exchange value of the dollar, levels of nominal or real interest rates, and the price of gold or other commodities. Attention to all of these variables may be useful at times -- indeed, most of the time. But experience shows clearly that these indicators often give conflicting signals, and choices must be made. For instance, the relationship between monetary growth and prices or nominal GNP has been long studied, and has demonstrated a certain stability over time. It is a relationship we would ignore at our peril. But it is also true that, historically, there is considerable variability in the relationship over periods of several quarters. Much more rarely, for a variety of reasons, the relationship may change more fundamentally, and during those periods focus on a particular aggregate could be a misleading guide to policy.

Given the enormous changes in financial markets and regulations during the past few years, we may be in the midst of such a change in "velocity" now. For example, last year some measures of money growth exceeded the expansion of nominal income by an exceptionally large amount -- more than at any other time in the postwar period. Individuals and businesses apparently desired to hold more money than usual relative to incomes. Under those conditions, attempts to follow a preset and inflexible money growth rule based on historical trends with M1 would have resulted over the past year, in my judgment and the collective judgment of the FOMC, in an appreciably "tighter" policy than intended at the start of the period. That, as I indicated repeatedly in reports to you through the year, is why we acted as we did in accommodating relatively rapid growth of M1 for a time.

A rule that targeted some market rate of interest would have potentially more serious pitfalls. Recent events provide a great deal of evidence with regard to our inability to judge with any precision a level of interest rates -- nominal or "real" -- needed to obtain a desired performance of the economy. For instance, the recovery of aggregate demand recently -- particularly in the credit-sensitive sectors -- has been much stronger at prevailing interest rates than most forecasters expected six or eight months ago. The difficulty of setting an interest rate rule is that the appropriate rate level shifts over time with variations in the strength of private demands and their sensitivity to credit conditions as well as the stance of fiscal policy.

I do not suggest that monetary policy should ignore the variables advocated by the proponents of the various rules; quite the contrary, I am suggesting that there is a degree of analytical and empirical validity to most of them.

As you know, we have placed particular weight upon "targeting" and monitoring several monetary and credit aggregates, and there should, I believe, be a presumption -- usually a strong presumption -- that past patterns will recur. But I doubt -- during a time of profound institutional and economic change -- a single rule or indicator will be so reliable that it can substitute for a degree of judgment and flexibility at times, particularly when various possible "rules" are giving conflicting signals. In other words, care must be taken in selecting the indicator or indicators used in guiding policy; their reliability must be constantly monitored; and the appropriate emphasis on any particular indicator must be reevaluated in times of rapid change.

I must emphasize, too, a rule for monetary policy, however soundly based, cannot substitute for poor policies in other areas of governmental responsibility. In fiscal policy, we have long since abandoned a simple rule -- an annually balanced budget -- for good and sufficient reason. In the process, I fear we have lost some of the sense of continuing discipline embodied in that proposition -- an example of the danger implicit in avoiding any sense of a continuing rule.

As I understand it, the broad thrust of your proposal, Mr. Chairman, is not to establish a simple operational rule for monetary policy in terms of one intermediate, and presumably closely controllable objective, such as the money supply, or interest rates, or the price of gold. Rather, it would eschew such rules in favor of directing policy actions toward a particular rate of growth of economic activity and prices -- objectives that would be approximated in a targeted path for the nominal GNP.

Specifically, your proposal would have us establish and announce objectives for a new target -- growth in nominal GNP -- for the year ahead, would call for our forecasts of real growth, inflation, and unemployment consistent with the nominal GNP for that period, and would require that we extend those objectives and forecasts over the ensuing three years. We would continue to announce plans for the growth of money and credit, but in addition we would now be required to report our plans for interest rates.

The appeal of such a proposal on the surface is not hard to understand. If a chosen path for GNP could be achieved, the uncertainty in the economic outlook would be greatly reduced, allowing businesses and consumers, as well as Congress and the Administration, to make specific plans for output, employment, and budgets with greater assurance. If interest rates are predictable and closely controlled by the Federal Reserve, so much the better for orderly planning. The public could turn its attention from such arcane matters and abstractions as the money supply and velocity, and from economic forecasting generally, secure in the belief that the Federal Reserve could and would make it all come out right.

Unfortunately, the implied promise of a fixed GNP objective -- and therefore the foundation for the benefits that would flow from it -- is not valid: the Federal Reserve alone cannot closely achieve a particular GNP target it or anyone else would choose, especially over the one-year span envisioned by the proposed legislation. Even less could it control the distribution of a given nominal GNP among prices and real output, or predict or control the level of interest rates.

The fact of the matter is monetary policy is not the only force determining aggregate production and income over several quarters ahead, and the policy actions taken affect those variables only with substantial and variable lags. Large swings in the spending attitudes and behavior of businesses and consumers can affect overall income levels. In recent years we also have seen the effects of supply-side shocks, as from oil price increases, on aggregate levels of activity and prices. Among the tools of public policy, budgetary decisions play an important role in determining economic activity and interest rates.

I recognize that your latest proposals, Mr. Chairman, explicitly recognize these concerns by suggesting that the GNP and related objectives be stated as ranges; in that sense, they are closer to present practice. I am still concerned, however, that attempts to target GNP within a narrow range would, deliberately or not, provide an unwarranted sense of omnipotence for monetary policy, or economic policy generally, ultimately leading to a sense of disappointment. That danger would be all the greater to the extent the focus was on the relatively short run -- and I strongly suspect that various pressures would push the Congress into concentrating on that time horizon. In addition, the impression conveyed that monetary policy would be "held responsible" for meeting the targets would, I suspect, only weaken the will of the Congress and the body politic to deal with other difficult issues, such as the budget, essential to the success of economic policy as a whole. After all, why cut spending or raise taxes if, in the end, monetary policy can, on its own, produce the desired smooth trajectory of GNP?

Moreover, uncertainties about the timing of the effects of Federal Reserve actions on GNP may actually make attempts to implement a GNP objective counterproductive. For example, an effort to stimulate lagging GNP growth might have its greatest impact only after a considerable period when activity already was expanding again, adding to potential inflationary pressures and accentuating, rather than damping the business cycle. Because of lags in the reporting of data, chances for such perverse results would be heightened if the Federal Reserve took corrective actions only after receiving confirming evidence that GNP was deviating from target paths. However, to shorten the lags, reliance would have to be placed on forecasts of the economy. As I indicated earlier, the uncertainty and unreliability of economic forecasts has been amply demonstrated over recent years, and while prediction is necessary and useful, I would be loath to grant forecasts such a formal and potentially inflexible position in the execution and formulation of monetary policy.

In light of such considerations, we could presumably alter, with explanation to the Congress and the public, our GNP targets as needed through the year. But if this needed to be done frequently -- as it might -- it would undermine the purpose of the proposal.

The independent status of the Federal Reserve that makes a longer-term view possible might well be compromised with GNP targeting, since the Federal Reserve could be under great pressure to conform its targets to some immediately attractive number and then to act to achieve those targets. It is not hard to imagine that such pressures might be particularly intense in election years, and that calls for a more expansionary policy would dominate those for moderation, especially since the inflationary penalty of such a policy may come only after considerable delay.

In sum, Mr. Chairman, an emphasis on short-run GNP objectives seems to me likely in many circumstances to run against our continuing basic interest in achieving sustained economic growth at reasonably stable prices. It is not difficult to imagine circumstances in which pressures to achieve short-run results would be counterproductive in terms of the continuing goals. The temptation would constantly be present to "shade" objectives in an optimistic direction, or to trade short-term expansion for more inflation -- an inflation that in time would only undermine the continuing long-term objectives. Those dangers would be magnified by attempts to forecast -- or, as some would have it, to target -- interest rates. Those forecasts would be a focus of public attention, and hesitancy in allowing interest rates to fluctuate in accordance with emerging -- and possibly unanticipated -- market pressures would in time be a destabilizing force for the economy as a whole.

I do not mean to imply with these arguments that monetary policy should ignore incoming information on GNP or forecasts of what effect a planned policy course is likely to have on future growth of income. We in fact pay attention to a broad array of economic indicators, and we have refined and amplified the presentation of projections and forecasts to the Congress. We have, based upon our analysis of economic developments, been willing to change the emphasis on or within our announced monetary targets when unusual behavior of velocity or other forces seemed to indicate that they were conflicting with the need to foster a recovery without reigniting inflation. When such judgments have been reached, we have described the change in operating approach promptly to the Congress and to the public, as would be required in your proposals.

We have also seen, in these last six months, more economic growth than was felt likely earlier, or that we would have felt secure in setting forth as an "objective." The lesson of the last year, it seems to me, is that the Federal Reserve cannot key its policy process entirely on any one variable -- that we need to evaluate a variety of incoming data from the economy and financial markets -- and that there is no substitute for a degree of judgment in weighing this information and determining a course for policy.

All of this reflects my concern about certain of the particular changes you propose in the language of the Humphrey-Hawkins Act. But the interest of this Committee and others does suggest that current arrangements for the statutory guidance for reporting the intentions and implementation of monetary policy do need debate and discussion -- a clearing of the air. I hope these hearings will themselves contribute to that process, and help provide the basis for consensus and improvement, whether or not change in the statutory language proves necessary or desirable in the end.

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