



INSIDE THE VAULT | SPRING 1997

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Is The Fed On Target?

A Closer Look at our Monetary Policy Objective

When we speak of the Federal Reserve as having responsibility for conducting monetary policy, we are talking specifically about its role in managing the nation's money supply. To do so, the Federal Reserve exercises its main monetary policymaking arm—the Federal Open Market Committee or FOMC—which meets eight times each year. After each meeting, the FOMC issues a directive, which contains instructions for policy until the next meeting. The Fed implements virtually all monetary policy decisions through the process of adding or removing reserves from the banking system at the open market desk of the Federal Reserve Bank of New York.

Ultimately, the goal of any economic policy is to achieve the highest standard of living possible for its citizens. The question is, how can the Fed most effectively contribute to this goal? The answer to this question has evolved over the years. The Humphrey-Hawkins legislation of 1978, for example, assigned the Fed multiple goals, including economic growth in line with the economy's potential to expand, a high level of employment and stable prices. In recent years, however, legislation has been introduced in Congress that would give the Fed a single long-run goal of price stability.

Which Target?

With only one policy action—that of directing the open market desk to manage the nation's money supply—the Federal Reserve is expected to aim at three targets: price stability, economic growth and full employment. But the Fed's direct influence over the long-term trends in output and employment is negligible. These trends instead depend largely on population growth, the skill and educational levels of the work force and the accumulation of capital. The only lasting contribution monetary policy can make to the real output growth trend is to create an environment conducive to growth, one in which relative prices are clear and markets are not distorted by high and variable inflation. The Fed's only power in the long-run then, lies in its ability to manage the money supply, which affects price levels.

Why Price Stability?

In a market system, changes in prices help producers know what and how much to produce. Inflation affects this process by distorting the signal that prices provide. That's because it's difficult for a producer to discern whether changes in prices are due to changing supply and demand conditions or to a change in the overall level of prices. Ultimately, then, inflation distorts decisions about where to use resources, what to produce, what to consume, where to invest, what to save, what to throw away, even what to study—the fundamental decisions on which economic well-being depends. Additionally, inflation creates "shoe leather costs" as consumers and firms expend efforts and resources to attempt to beat inflation—efforts that could have been used in a productive capacity. The monetary goal of price stability alleviates the distortions caused by inflation and contributes to a more efficient economy.

What About Growth?

With current annual inflation rates hovering around 3 percent, the Fed is often encouraged to stop worrying about inflation and to aim for higher economic growth and lower unemployment. In a recent discussion, however, Thomas C. Melzer, president of the St. Louis Fed, stressed the value of the single goal of price stability, contending that the monetary policy that best promotes economic growth is one that prevents inflation from being a factor in the decision making of businesses and consumers. So should we be shooting for growth?"We tend to confuse short-term fluctuations in output with long-term growth," he says. This confusion can be attributed to certain conditions in which a boost in money supply can increase output. For example, if people believe that the underlying inflation trend is 3 percent, but the Federal Reserve begins a series of monetary policy actions that permit money supply growth consistent with 4 percent inflation, then output growth may be temporarily stimulated. The reason is that workers and savers are "tricked" into working at a wage rate or saving at an interest rate that is too low to compensate for the upcoming inflation.

What does all of this imply about the conduction of monetary policy? Melzer explains, "Because under certain conditions monetary policy has the potential to boost output in the short run, some may be tempted to push for faster and faster growth by stepping on the monetary accelerator. Output may indeed go up for a time, but eventually inflation will be the only outcome." Thus, long-term growth is best sustained in an environment of stable prices.

Bulls-eye!

To hone in on a single objective, we could apply one familiar axiom of economic efficiency—"Do what you do best." Individuals, firms and nations follow this fundamental rule in order to maximize their incomes and improve their standard of living. By the same token, monetary policy can be most credible and effective by following this simple rule and, in the Fed's case focusing on price stability as its target.



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Q & A

This year the U.S. Treasury began offering inflation-indexed bonds. How do these bonds differ from conventional bonds?

Conventional, or nominal, bonds repay investors principal plus some stated interest; indexed bonds repay principal adjusted for inflation and a fixed interest rate applied to the adjusted principal. The Treasury calculates semi-annual interest payments on its indexed 10-year notes by adjusting the principal for inflation according to the Consumer Price Index (CPI)

What's the attraction of inflation-indexed bonds?

For investors, the major benefit is the guarantee of a real yield. In contrast, conventional bonds use nominal interest rates, composed of the real interest rate plus the expected inflation rate. Thus, if an investor purchases a bond with a 7 percent nominal interest rate and inflation is expected to be 3 percent, the real yield would be 4 percent. If, however, the actual inflation rate turns out to be 4 percent, the investor's real yield has fallen to 3 percent. To compensate investors for assuming such risk, an inflation risk premium is built into nominal bond yields—estimated to be at least 50 basis points, or 1/2 percent, for short-term bonds and even more for longer-term bonds.

An advantage of inflation-indexed bonds for the issuer is that it does not have to pay the inflation risk premium since inflation risk has been eliminated.

What are the negative features of indexed bonds?

For investors, the tax treatment and the real rate of return when compared with alternative investments can be unattractive. The tax consequences are twofold: First, because the U.S. tax code does not distinguish between increases in real income and increases in nominal income due to inflation, the indexed bondholder's tax liabilities will increase, lowering the after-tax real yield. Second, investors will pay taxes on the inflation-adjusted increase in principal accrued each year (as well as interest received), even though it is not paid out until maturity. This tax treatment can neutralize the primary incentive of indexed bonds—that of protection from inflation. The yield on indexed bonds may also be a disincentive for investors. Even after adjusting for inflation and risk, historic yields over the long term on stocks and many corporate bonds outperforms the yields on less risky indexed bonds.



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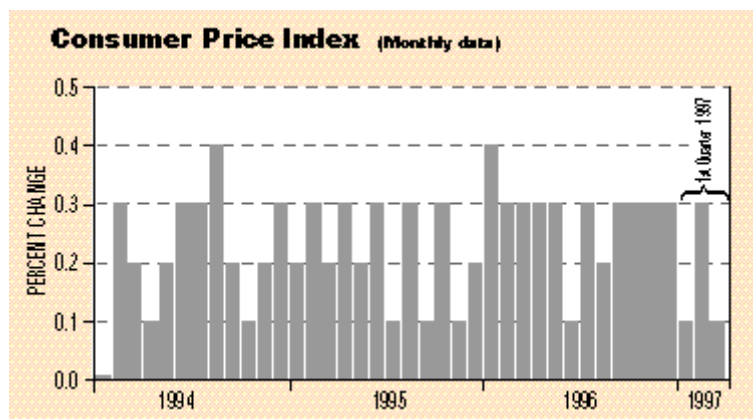
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Economic Snapshot

1st Quarter 1997

	Q2-96	Q3-96	Q4-96	Q1-97
Growth Rate—Real Gross Domestic Product	4.7%	2.1%	3.8%	NA
Inflation Rate—Consumer Price Index	3.4%	2.7%	3.3%	2.4%
Civilian Unemployment Rate	5.4%	5.3%	5.3%	5.3%



How is the CPI calculated?

Every few years the U.S. Census Bureau conducts a Consumer Expenditure Survey to see what the typical urban family buys, and compiles a list of goods and services. The CPI is a weighted average—goods such as salt and toothpicks on which people spend small fractions of their income receive less weight on the average than goods like housing and energy on which people spend a larger percentage. Then each month the Bureau of Labor Statistics (BLS) visits thousands of stores to check the prices of approximately 90,000 items.

Rule of 72

To estimate how fast prices will double, apply the Rule of 72 by dividing 72 by the rate of inflation. For example, if our economy experiences a 6 percent annual inflation rate, prices for cars, houses, and other

goods and other services you buy would double every 12 years ($72 \div 6$). On the other hand, if the inflation rate is 3 percent, prices would double every 24 years ($72 \div 3$).