Three Lessons for Monetary Policy

Remarks By
Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City
Kansas City, Missouri

Fed Correspondents Association
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Discussions of monetary policy often take a very short-run perspective. Much attention is focused, for example, on what the FOMC is likely to decide at its next meeting. As intriguing as this process may be, such a short-run emphasis has a myopic element, which diverts attention from other important longer run considerations. Today, I would like to step back and offer a longer term view on monetary policy. I believe that this is a particularly appropriate time to do so because the challenges facing the Federal Reserve going forward are likely to be somewhat different from those of recent years. Indeed, over the past 30 years, a principal concern of monetary policy has been to reduce inflation—to return to price stability. As we get closer to our goal, our challenge will be somewhat different—how to consolidate and maintain our hard-won gains against inflation. So, today, I would like to look back over the history of the past three decades to see what lessons can be learned that might help guide monetary policy in the future.

I am going to divide my comments into three parts. I will begin with a brief look at the historical record of inflation from the mid-1960s to the present. I will then discuss some of the factors behind the rise and fall of inflation and the evolution of monetary policy over this period. Finally, I will highlight three important lessons that we have learned from this experience that may help guide us in making monetary policy in the future.

The Rise and Fall of Inflation

As you know, the inflation record of recent years has been very good. Inflation, as measured by the core CPI, has fallen in six of the past seven years. Last year, core CPI came in slightly above 2 percent. Looking back, this is the best inflation performance since the late 1950s and early 1960s. Then, over the eight-year period from 1958-1965, core inflation averaged only 1.5 percent. Over the intervening period, however, the inflation picture was far less benign as the U.S. economy experienced first a dramatic rise and then a subsequent fall in inflation.

The uptrend in inflation occurred over the period from1966 to 1980. Inflation first edged up in the late 1960s and then ratcheted up further over time. The ongoing buildup in inflationary pressures was temporarily dampened by recessions in 1970 and 1974-75. In the business cycle expansions following these recessions, however, inflation rose to new highs, finally peaking at 13.5 percent in 1980.

The subsequent decline in inflation was also prolonged and sometimes painful. Although inflation initially fell sharply to around 5 percent following the 1981-82 recession, we made little headway during the remainder of the 1980s. Further sustained progress against inflation has only occurred in the last few years following the 1990-91 recession.

Understanding the Inflationary Process

A variety of factors lie behind the inflation experience of the past three decades. During the rise in inflation from1966-1980, two contributing factors were a strong economy and adverse supply shocks. The initial buildup in inflation in the late 1960s, for example, was demand driven and coincided with the Vietnam defense buildup. Similarly, the inflationary surge in the last 1970s occurred in an expanding economy. Supply shocks related to dramatic oil price increases in1973 and 1979 also were important factors adding to inflationary pressures already in play.

Unfortunately, monetary policy also played a contributing role in the inflationary process, as it most often does. Indeed, the general consensus is that monetary policy was too accommodative and too slow to respond to inflationary pressures during the late 1960s and the 1970s. For example, a declining real federal funds rate and rising money growth accompanied the increase in inflation in the late 1960s. Similarly, the inflationary increases of the late 1970s occurred in the context of a low real funds rate and strong money growth.

Just as significantly, monetary policy also played a crucial role in containing and reducing inflation after 1980. The disinflationary process that began in 1980 started with a move to a restrictive policy stance taken by the Federal Reserve in October 1979. Moreover, I think that it is particularly important to note that, unlike earlier periods, we did not experience a renewed inflationary spiral as the economy recovered from the 1981-82 recession. I would attribute the success in preventing a rebound of inflationary pressures in the 1980s in some part to the Federal Reserve's willingness to act in a more timely and pre-emptive manner to signs of inflationary pressures in 1983-84 and again in 1987-88. Indeed, even the low real funds rate in the early 1990s did not lead to higher inflation, in part, because the Federal Reserve responded promptly in 1994 and 1995 to signs that pressures were building to cause higher inflation. Admittedly, however, and in contrast to the 1970s, our objective of restoring price stability has been aided in recent years by favorable supply shocks in the form of lower energy prices and stronger productivity growth.

Lessons for Monetary Policy

Let me turn now to the issue of how we can learn from the experience of these past three decades to provide better policy in the future. It seems to me there are three important lessons that can be drawn from this experience.

Lesson #1

The first lesson is: ***do not let the inflation process get started.*** I think it is clear from the U.S. experience and in other countries as well, that once inflation starts to increase, it can easily get out of control. Furthermore, the record clearly shows that inflation is persistent and very difficult and costly to reverse once started.

The experience of the past three decades also highlights the costs to the economy of letting inflation get out of hand and the benefits of lower inflation. We experienced major recessions in 1974-75 and 1981-82 as restrictive monetary policy attempted to break the inflationary cycle. We also saw how inflation and disinflation impacted asset prices. During the 1970s, rising inflation coincided with poor performance in equity prices. For example, the growth rate of the S&P 500 stock index averaged less than two percent a year during the 1970s. More subtly, we saw how high inflation worked its way into nominal interest rates through higher inflation expectations, distorting investment decisions and resource allocation. In the 1980s and early 1990s, as inflation was contained and then reduced, economic growth has accelerated and equity prices have reached record highs.

The implication of this first lesson is that we can never be complacent about inflation, even in the best of times. While inflation now seems far removed from everyday concerns, at the same time, we do not want to give up hard-won gains. Indeed, if we truly heed this lesson, we will need to continue to think preemptively and tighten policy when inflation is expected to increase and not just when it already has increased.

Lesson #2

The second lesson that I would draw from our experience in combating inflation over the past 30 years is: ***you cannot rely on any single indicator to guide monetary policy*.** Just as portfolio diversification is the hallmark of a prudent investment strategy, central bankers need to look at a variety of indicators of economic activity and inflationary pressures.

Over the past three decades, we have seen a number of examples of once-reliable indicators whose performance has been affected by the changing structure of financial markets and the economy. One example is the monetary aggregates. Prior to the mid-1970s, the relationships between inflation and the two primary measures of money—MI and M2—were generally stable. The M1 relationship began to break down in the mid-1970s, and after several attempts to redefine M1 to fix the relationship, in 1987 the Federal Reserve de-emphasized MI in favor of M2. M2's relationship with inflation lasted for a few more years, but eventually deteriorated also, leading us in 1993 to drop M2 as a formal indicator.

In retrospect, it should not be surprising that the relationships between our measures of money and inflation have changed. Over the past 20 years, we have experienced extensive financial de-regulation and numerous innovations in financial assets and markets. As a result, businesses and households no longer have to keep large amounts of their wealth in deposits for purposes of purchasing goods and services. Instead, they have at their disposal a wide variety of assets that can be easily liquidated when they want to make a purchase. Consequently, it is difficult to find a measure of money that is a good indicator of spending and inflation. Thus, in discussions of the monetary aggregates, I believe that the key issue is not whether excessive money growth causes inflation. Rather, the key issue is which measure of money is most useful in gauging inflationary pressures. Our experience in recent years confirms the difficulty of finding a single and consistently reliable measure of money in a rapidly changing financial and economic environment.

A second example of a seemingly stable indicator that lost some of its reliability is the unemployment rate at which inflation remains stable, also known as the natural rate of unemployment. According to natural-rate theories, inflation will rise when the actual unemployment rate is below the natural rate and inflation will fall when the unemployment rate is greater than the natural rate.

The key to using the natural rate in policy analysis is to identify what the natural rate is, or at a minimum, a fairly narrow range surrounding it. As recently as three years ago, for example, the consensus view was that the natural rate was around 6 percent. As it turned out, the unemployment rate is now 4.7 percent and has been less than 6 percent for 3 ½ years. Over the same period, however, inflation has steadily declined, suggesting that the natural rate is substantially less than 6 percent. Whether the apparent decline in the natural rate is just a temporary change or more permanent is still an open question. In any event, like the monetary aggregates, the natural rate has not proved to be as reliable a gauge to inflationary pressures as was once thought.

The point of this discussion is not that the natural rate framework is a bad way to think about the relationship between inflation and unemployment. However, the recent experience shows the difficulty in making the jump from the theoretical concept to an empirical natural rate that can be measured with some degree of certainty and used as a guide to policy.

More generally, looking over the past 30 years, there are a variety of indicators that have been useful sometimes but not at other times. Examples include the yield curve, real interest rates, exchange rates, commodity prices, and various measures of labor compensation. None have proved to be consistently reliable because, while they may bear some relationship to future inflation, they are also affected by a variety of factors, such as fiscal and regulatory policies, economic events abroad, and market psychology.

Based on this experience, I think that the search for a single indicator to guide monetary policy is a futile exercise. There is no magic bullet. While the monetary aggregates, the natural rate of unemployment, and other variables all provide potentially useful information, none of them will always be correct. Moreover, the various indicators may often point in different directions. For example, today’s real federal funds rate is relatively high, suggesting that a modest easing of policy might be appropriate. In contrast, the relatively low unemployment rate and strong M2 growth suggest that a modest tightening might be appropriate. What this tells me is that lesson number one, to act preemptively, is easier said than done and that monetary policy decisions will always require judgement in deciding how much weight to put on the various indicators and when those weights should be changed.

Lesson #3

The final lesson that I would draw from the inflationary experience of the last thirty years is: ***never lose sight of the long-run objective of price stability***. As members of the FOMC have repeatedly stated, the broad objective of macroeconomic policy is to promote maximum sustainable economic growth. The main contribution of monetary policy to this objective is to achieve and maintain price stability. The consensus of a substantial amount of research and historical experience is that countries with low levels of inflation enjoy consistently higher standards of living.

At the same time, a long-run monetary policy goal of price stability does not mean that we do not care about business cycle fluctuations. In the short-run, monetary policy can and does have a significant impact on business conditions and real growth. In my view, using monetary policy to stabilize the business cycle at times is both necessary and appropriate.

But, I also believe that we have in past times compromised our long-run objective of price stability by putting too much emphasis on temporarily and artificially reducing unemployment and increasing real growth. Indeed, as I noted earlier, the rise in inflation in the late 1960s and late 1970s can be partly attributed to an accommodative monetary policy that paid inadequate attention to the long-run goal of price stability. The lesson from this is that we must not lose sight of the long-run objective of price stability when making day-to-day policy decisions. We must carefully balance our short-run objective of stabilizing the business cycle with our long-run objective of price stability.

At present, we are experiencing strong growth and moderate inflation. If history is our guide, however, we will again be confronted with situations in which the economy is weaker than we would like while the inflation outlook is less favorable. It is in these situations that we will benefit most from the lessons that we have learned over the past 30 years.

Summary

Monetary policy must be forward looking and preemptive. This need is only complicated by the dynamics of our global economy and our inability to rely on any single indicator. Thus, judgment and experience are no less critical than ever. Finally, while mindful of short-run issues, maintaining a long-run perspective is most critical to keeping monetary policy and, more generally, the economy on track.