

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

A Monetary Policy for the 1990s

by W. Lee Hoskins

We live in an age where information is critical. Households and businesses invest considerable amounts of time and other resources monitoring economic and business developments. These market participants incorporate their expectations of the future into their decisions. Expectations, based on accumulated information, are used to help resources find their highest financial rate of return.

People work hard to form correct and unbiased opinions about future events, including government policies. "Fedwatching" is a good example. The value-added by Fedwatchers shows up in market expectations about the direction of Federal Open Market Committee (FOMC) policies, affecting financial contracts and spending and saving decisions throughout the economy.¹ Uncertainty and mistaken expectations reduce the quality of those decisions and our economic well-being.

How much, when, and what kind of monetary policy information the FOMC should release has been a controversial issue for some time. The conventional approach to these questions addresses them in the context of our existing policy environment. My goal is to contrast this conventional approach with an alternative one, by asking what information the FOMC would want to release and Fedwatchers would want to receive in an "ideal" monetary policy environment. I believe that the opportunities for improving information about policy are greater from clarifying the goals of pol-

icy than from greater and more timely information about the present policy process.

An ideal monetary policy is simply a credible and predictable commitment to an appropriate long-term policy goal. I have spent considerable time recently explaining why long-term price stability is the optimal goal of monetary policy.² By aiming at that goal, monetary policy can make its greatest contribution to long-term real growth and stability of the economy. Setting a goal of price stability and committing to a timetable for achieving that goal will reduce market uncertainty and allow markets to allocate resources more productively, today and in the future.

■ Policy Information in the Current Setting

Despite the progress we have made since the 1970s, inflation has not been eliminated, and many observers can legitimately question our commitment to eliminate it. Three decades ago, inflation uncertainty five years out was probably confined to a range of 0 to 3 percent. Today that range is obviously wider, perhaps 0 to 7 percent.

Markets have become more integrated and efficient in processing information. Information is probably no more *important* today than in the past, but it certainly is more readily available and processed more efficiently. This has changed the short-run policy trade-off faced by the Federal Reserve. We have less opportunity to buy excess output

Lack of credibility and predictability in the monetary policy process can result from a perception of vagueness about the ultimate objectives of policy and the steps that will be taken to correct deviations from economic goals. Rather than providing more information about the current policy process, the Federal Reserve could improve the performance of the economy by committing to the long-term goal of price stability and by announcing a time frame within which to achieve it.

and employment before the inflationary consequences are incorporated into prices and long-term interest rates.

Monetary policy information comes in two forms: *policy actions* and *policy intentions*. Policy actions refer to changes in open market operations.³ The FOMC describes these actions as decisions to maintain or change the degree of reserve pressure, a characterization that at present is generally interpreted in terms of its effect on the level of the federal funds rate.⁴

Policy intentions, sometimes called the "policy reaction function," refer to potential future policy actions in response to evolving economic and financial conditions. Knowledge of policy intentions helps rational agents plan and carry out their market activities with minimum losses due to surprises.

Monetary policy intentions are difficult to characterize because the FOMC has discretion in formulating policy within the scope of its multiple objectives. The Federal Reserve Act of 1913, the Employment Act of 1946, and the Humphrey-Hawkins Act of 1978 all suggest objectives that might guide FOMC management of monetary policy over various time horizons.⁵ High employment, maximum growth in output, balance-of-payments equilibrium, exchange rate stability, and price stability are all cited as relevant objectives.

The FOMC's semiannual Humphrey-Hawkins report to Congress provides information about policy intentions for money and credit growth within a 12- to 18-month horizon. The official Committee position—the only one on which an explicit vote is taken and recorded—is a set of growth ranges, currently for the M2 and M3 monetary aggregates, and for debt.⁶ The report also states the central tendency of FOMC members' expectations about performance of the economy over the next year or more, although it specifies neither the policy assumptions required to produce these outcomes, nor the policy reactions to be implemented should these outcomes not come to pass.

The domestic policy directive voted on at each FOMC meeting represents a combination of an immediate policy action and a statement of intention about how policy should be implemented through open market operations until the next meeting. Typically, the operative sentences in the directive communicate the Committee's decision without stating an explicit funds-rate objective. However, both the direction and the amount of a change become known almost immediately by the nature of open market operations at the trading desk as interpreted by financial analysts.

At one time, the FOMC quantified its short-run policy intentions in terms of target paths for money: it would raise or lower the federal funds rate as weekly and monthly money numbers rose or fell relative to the target path. Vestiges of monetary targeting still re-

main in the expected short-run growth rates for M2 and M3, and in a 400-basis-point range outside of which the funds rate would have to trade in order to trigger another meeting. At present, however, neither the short-run money growth rates nor the federal funds rate specifications convey much information about FOMC intentions, as can be seen in the obvious indifference of the money market to the weekly money supply announcements now, as compared to 10 or 15 years ago.

FOMC intentions now are captured by the "mights" and "woulds" found in the second sentence of the directive.

To quote the intention in October 1989, Taking account of progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or slightly lesser reserve restraint would be acceptable in the intermeeting period.

What information is contained in such a statement? Knowing the "mights" and "woulds" may at least suggest the Committee's predisposition toward raising or lowering the federal funds rate before the next meeting. But how useful is that statement? None of the contingencies is defined in terms of an available measure of conditions in the various sectors of the economy. Nor are the relative intensities of concern for all of the sectors indicated, so it is difficult to predict how the Committee will respond to mixed signals in the short run. Nonetheless, in the current setting, this statement suggests the likely direction of the next policy action, given the state of affairs suggested by the emerging internal and external view of the economy.

■ Why Is the Committee So Vague About Its Intentions?

Vague statements of policy intentions are nothing new. Except for the period when the FOMC pegged minimum securities prices during and after World War II, and except for the brief period

of explicit M1 targeting that ended in late 1982, the FOMC always has been vague about its intentions. The typical, but incorrect, explanation for this vagueness is that it confirms a fundamental theory of bureaucratic behavior: if you can hide your intentions, then no one can evaluate your actions.

The correct explanation, I think, is more fundamental: even though each individual FOMC member may have policy intentions, the FOMC as an official body has not specified either its ultimate objectives or its intended reaction to new information. And, in the context of multiple goals, it is not always clear in advance how the Committee will respond to new information about the economy, or how the Committee will decide how fast or slow policy should move to correct deviations from those goals.

A rotating committee of 12 people pursuing multiple objectives surely would be expected to have difficulty trying to reach agreement both on a single, unambiguous policy intention and on a policy action consistent with that intention. Reaching agreement at each meeting has been the official ground on which the 12 FOMC members have reconciled their individual longer-run intentions until the next meeting.

■ Improving the Policy Process

An ideal monetary policy would produce a credible, predictable commitment to stabilizing the price level. Inflation wastes resources, and uncertainty about the future rate of inflation wastes even more resources. It is by avoiding such waste that monetary policy strengthens real growth and stability of the economy.

The lack of credibility and predictability of the policy process is the problem. The more credible the commitment to the policy goal, the fewer wrong decisions will be made by the markets. The more predictable the policy reaction to unforeseen economic events, the more limited will be the market reaction to those events. Yet, with the disintegration of the monetary aggregates as intermediate policy guides, discretionary

monetary policy actions may seem especially hard to predict because policy objectives are unclear. The existing policy process, with its focus on immediate policy action, does not provide clear objectives or credibility.

How could we change the process to reinforce the credibility of a consistent goal? I think the most secure way would be to give the FOMC a legislative mandate to meet a consistent, attainable, and unchanging economic goal. Passage of House Joint Resolution 409, introduced in September 1989 by Congressman Stephen Neal (D-N.C.) would provide that crucial reinforcement.

The Neal Resolution simply directs the Federal Reserve to make price stability the primary goal of monetary policy. History gives us little basis for expecting price stability or even a stable rate of inflation to prevail because the FOMC has had no mandate to produce that result. Giving the FOMC that mandate—knowing that the intention was to stabilize the inflation rate at zero—would provide one gigantic piece of policy information. The System would remain independent; it would retain complete discretion about how to carry out policy. The only change is that Congress would provide more direction about basic policy objectives.

The Neal Resolution would make the Federal Reserve's legislated jurisdiction more like that of West Germany's Bundesbank, which is also independent. More than one goal is specified by law for the Bundesbank, but West German law states that the goal of price stability is to be given highest priority whenever another goal might conflict with it. This legislated priority is one reason that West Germany's inflation experience has been more favorable than our own.

The FOMC could deliver lower inflation as well. Inflation is a monetary phenomenon, and the FOMC is the sole custodian of the quantity of money in the United States. Short-term deviations from zero inflation may occur, but, one way or another, the FOMC can provide a stable price environment.

An alternative to legislation is simply for the FOMC to adopt the price stability goal. As many scholars have urged, the FOMC might impose a "rule" on itself, tying policy actions to some intermediate target variable by an agreed-upon formula that should assure achieving price stability. The most popular candidates for an intermediate policy target seem to be nominal GNP and M2, either of which is thought capable of producing reasonable price stability. Another approach would be for the Committee to specify that achieving the ultimate policy goal is the rule, using discretion in choosing actions to achieve the goal.

Of course, having today's FOMC adopt an explicit rule tying an instrument to a goal is not a foolproof way to assure achieving an official policy goal. Credibility would have to be earned through predictable actions consistent with the goal. To adopt an explicit rule, at least a majority of today's FOMC members not only must agree on an overriding macroeconomic goal, but also must renounce some discretion to pursue other goals. Moreover, tomorrow's FOMC could decide to change the goal and hence the rule. In the current policy regime, there is no way that today's policy choice can bind tomorrow's. Unless directed by society through specific mandate, tomorrow's FOMC always has the discretion to change the goal.

■ Credibility and Policy Information

The ideal policy would improve the performance of the economy by achieving price stability with a credible and predictable policy. The ideal information to accompany that policy requires a credible statement of the goal, preferably reinforced by a legislative mandate such as the Neal Resolution, a time frame in which the goal will be achieved, and explanations of policy changes if they occur.

One major benefit of imposing an explicit intention on monetary policy is that policy actions in the money market would become far less momentous than they now are. Currently, detecting a

change in the federal funds rate target from the pattern of open market operations is a crucial activity because it provides markets with one of the few clues as to where policy is evolving. Canvassing the positions of individual FOMC members is a way of predicting future policy. Policy actions, when detected, then provide a test of those predictions of the direction in which policy is evolving. However, if policy intent were explicit and credible, finding the clues in open market operations would have less significance.

Unfortunately, talking about the Neal Resolution and rules and self-imposed price level targets may be whistling in the dark. Suppose no clarification of a basic policy objective or intent is forthcoming. Are there ways in which clues about the evolution of policy could be made more certain?

Open market operations inevitably involve some mystery about whether an operation is simply a defensive adjustment of nonborrowed reserves that will maintain the level of the federal funds rate, or is an offensive intervention that will change the level of the funds rate. Memories of Thanksgiving 1989, when financial markets misinterpreted open-market action to add reserves prior to the holiday as an easing step, lead to questions about whether the FOMC should provide additional information in order to clarify the funds-rate implications of policy. If it is better for the market to be more certain about the immediate policy objective, perhaps we could provide additional information that would allow Fedwatchers to replicate reserve management decisions at the trading desk more accurately.

I am not sure that there is a good way to provide that additional information. Inevitably, reserve management involves a healthy dose of judgment—of art, if you will. Even if we were to open the books of the Fed on a daily or hourly basis, judgment about the market factors and other uncertainties that the trading desk inevitably must confront would still be required. Some uncertainty about the intention of policy would remain.

A simpler way to reduce uncertainty might be for the Federal Reserve to treat the federal funds rate just as it does the discount rate. When the funds rate objective changes, the Fed could issue a press release explaining why. Or, perhaps the whole approach to policy implementation through open market operations should be scrapped. The open market desk could simply announce that it stands ready to do repurchase agreements at one price and matched sales at another.

Providing further information about policy actions will help markets operate more efficiently, but except for those unusual times such as last Thanksgiving, the improvements may not be very large and may risk diverting attention from the fundamental information problem. More information about reserve restraint will not provide more information about the goal of monetary policy. Ideal policy and efficient markets need that information, and to produce it, changes in the current policy process are needed.

■ Conclusion

The ultimate goal of monetary policy must be to provide the credible and predictable commitment to price stability required for peak performance of our market economy. Achieving this ideal at the least cost requires that policymakers provide markets with certain

basic information that will minimize uncertainty about the commitment and about the time frame within which it is to be accomplished.

This emphasis is in marked contrast to conventional concerns for more certainty about the current degree of reserve restraint. There are many ways we could reduce uncertainty about the immediate funds rate implications of policy, just as there are many time schedules by which we might release the FOMC directive. Being more certain of the immediate federal funds rate implications of policy might make Fedwatching a bit easier, but would not do much to help identify policy intentions beyond the shortest of policy horizons. Releasing the directive early might provide a slightly brighter glimmer of policy intentions, but only for a slightly longer policy horizon. What is needed is not better information about items in the directive, but better information about the policy goal for the long run.

More information about policy intentions is where I see the greatest payoff. An explicit FOMC commitment to price stability would allow markets to shift resources from watching the Federal Reserve to watching the economy for productive investment opportunities.

■ Footnotes

1. The Federal Open Market Committee, the Federal Reserve's policymaking arm, comprises the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and a rotating group of four of the other 11 Reserve Bank presidents.
2. See "The Case for Price Stability," *Economic Commentary*, Federal Reserve Bank of Cleveland, March 15, 1990; and "Breaking the Inflation-Recession Cycle," *Economic Commentary*, Federal Reserve Bank of Cleveland, October 15, 1989.
3. Policy actions might also include discount rate and reserve requirement changes, but comments here refer exclusively to changes in open market operations.
4. The federal funds rate represents the interest rate that banks and other depository institutions charge for surplus reserves that they lend to one another.
5. For a brief discussion of these legislative acts, see the Federal Reserve Bank of Cleveland's 1989 *Annual Report* essay, p. 7.
6. For a definition of the composition of the monetary and debt aggregates, see the *Federal Reserve Bulletin*, table 1.10.

W. Lee Hoskins is president of the Federal Reserve Bank of Cleveland. The material in this Economic Commentary is based on a speech presented to the Money Marketmakers in New York City on March 1, 1990.

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