

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

and with a trend rate of 3 percent for real economic growth, the upper limit of the expected inflation rate should be 4 percent.

The outlook for real GNP shows that the FOMC expects some slowing in the real economy over the next six quarters. After growing rapidly in the first half of the year, the economy is expected to slow to 2 to 2½ percent in the second half. The slowdown is expected partly because the economy is not thought to have the capacity to maintain such a rapid rate of expansion, and partly because the Federal Reserve has increased restraint on bank reserve positions in an attempt to restrain monetary growth and inflation expectations. The unemployment rate is expected to average 5¼ to 5¾ percent in the fourth quarter of 1988 and to rise slightly to 5½ to 6 percent by the fourth quarter of 1989.

■ Conclusion

The testimony in July 1988 shows a Federal Reserve ready to respond to indications of higher inflation. Although the monetary aggregates

have drawbacks as indicators of monetary policy in the short run, "the demonstrated long-run connection of money and prices overshadows the problems of interpreting shorter-run swings in money growth."⁸ For this reason, the gradual reduction of the monetary targets is a commitment to a strategy of price stability.

In his H-H testimony, Chairman Greenspan restated the fundamental long-run goal of the Federal Reserve. "The strategy for monetary policy needs to be centered on making further progress toward and ultimately reaching stable prices. Price stability is a prerequisite for achieving the maximum economic expansion consistent with a sustainable external balance at high employment."⁹

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The views stated herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

■ Footnotes

1. The Humphrey-Hawkins Act is an amendment to the Employment Act of 1946. For an interesting review of this legislation, see G.J. Santoni, "The Employment Act of 1946: Some History Notes," *Review*, Federal Reserve Bank of St. Louis, November 1986, pp. 5-16.
2. For a definition of the composition of the monetary and debt aggregates, see the *Federal Reserve Bulletin*, table 1.10.
3. The Federal Open Market Committee is the policy-making body of the Federal Reserve System.
4. Congressional testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System; February 23, 1988; *Monetary Policy Objectives for 1988*. Chairman Greenspan alluded to this discussion in his July 1988 testimony as well.
5. Congressional testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System; July 13, 1988; *Monetary Policy Objectives for 1988*.
6. Congressional testimony of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System; July 23, 1986; *Monetary Policy Objectives for 1986*.
7. Congressional testimony of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System; February 19, 1987; *Monetary Policy Objectives for 1987*.
8. Greenspan, op. cit., July 1988.
9. Greenspan, op. cit., July 1988.

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Humphrey-Hawkins: The July 1988 Monetary Policy Report

by William T. Gavin and John N. McElravey

Twice each year, the Chairman of the Board of Governors of the Federal Reserve System appears before Congressional banking committees to report on the economy and to present objectives for monetary policy. These reports are required by the Full Employment and Balanced Growth Act of 1978, better known as the Humphrey-Hawkins Act (H-H), which describes the responsibility of the federal government with respect to economic policy.¹

In February, the Chairman reviews the economy and Federal Reserve's performance during the previous year and formally announces money and credit targets for the current year. In July, the Chairman reviews the economy and policy for the current year and presents preliminary targets for the following year. These semiannual reports provide a way for Congress, and for the public, to monitor the Federal Reserve's policies.

A combination of deregulation and disinflation has led to increased uncertainty about the role of monetary aggregates in the policy process.² Because neither the Federal Reserve nor the public is confident that the

actual performance of these aggregates is a reliable indicator of the thrust of monetary policy, the statements of the Federal Open Market Committee (FOMC) and its forecasts of economic conditions have become more important in the policy-monitoring process.³

This *Economic Commentary* reviews July's Monetary Policy Report to Congress, discusses the decline in the role of the monetary targets, and explains how the FOMC's projections of inflation and economic growth may contain information that is useful in the policy-monitoring process.

■ The 1988/1989 Monetary Policy Objectives

Federal Reserve Chairman Alan Greenspan appeared before Congress in July and reaffirmed the decisions the FOMC made in February. The monetary targets for 1988 remain at 4 to 8 percent growth for both M2 and M3. For the second straight year, the FOMC did not establish a target for M1, reflecting the narrow aggregate's heightened short-run interest-rate sensitivity.

The ranges for M2 and M3 were widened last February to four percentage points from the traditional three

A review of the Federal Reserve's Monetary Policy Reports to Congress over the last few years reveals a decline in the role of the monetary aggregates in the policy process. The Federal Open Market Committee's projections of economic conditions supplement the money targets in evaluating current policy intentions, particularly in regard to price stability.

percentage points in recognition of the "...unusual degree of uncertainty in the economic outlook and the large movements of money relative to income in recent years..."⁴ The range for domestic nonfinancial debt (DNFD) for 1988 remains at 7 to 11 percent. In the first half of 1988, both M2 and M3 have grown in the upper halves of their target ranges.

The tentative growth ranges for 1989 are 3 to 7 percent for M2, 3½ to 7½ percent for M3, and 6½ to 10½ percent for DNFD. The 1989 range for

M2 is one percentage point lower than the 1987 target. This gradual decline in the targets is consistent with the Federal Reserve's disinflationary policy over the last several years. Nevertheless, the ranges for next year are so wide that they could be associated with a policy to continue toward price stability and zero inflation, or they could be associated with a policy to stabilize the inflation trend at around 4 percent.

Chairman Greenspan noted in his testimony the difficulty of deciding on appropriate growth ranges for the aggregates, especially given their increased sensitivity to movements in interest rates. He admitted that the monetary aggregates have an important role, but in a shorter-run context, "monetary aggregates have drawbacks as rigid guides to monetary policy implementation."⁵ The targeted monetary aggregates are "among the indicators" that influence adjustments to FOMC policy. He did add, however, that their importance could grow in the future as the short-run relationships between money and output become better understood.

■ The Decline in the Role of the Monetary Targets

The monetary targets are the centerpiece of the H-H legislation and are meant to provide a guide to the Federal Reserve's intentions for policy. For the last several years, Federal Reserve policy has been to promote economic growth and full employment by gradually eliminating inflation. While the transition from rapid inflation has not always been smooth, the gradual decline in the annual growth targets has been associated with a decline in the inflation trend.

The combination of disinflation and the introduction of interest-bearing checkable deposit accounts has created considerable uncertainty about the relationships between the

monetary targets and the inflation rate. In response to this uncertainty, the Federal Reserve has become less willing to use monetary growth as a leading indicator of inflation and economic activity.

A review of the H-H testimony over the past two or three years reveals that the appropriateness of money growth is judged more within the context of other economic factors than it was previously. The target ranges for growth of M2 and M3 in 1986 were 6 to 9 percent, and the range for M1 was a relatively wide 3 to 8 percent because of the uncertainties associated with its behavior (see table 1).

Although concerned about the inflationary potential of excess money growth, Chairman Paul Volcker declared in his July 1986 testimony that "...the significance of changes in M1 could only be judged in the context of movements in the broader aggregates, and against the background of movements in interest rates and the economy generally."⁶ Monetary growth was above the targets, yet the FOMC adopted a more expansionary policy during 1986.

In 1987, the FOMC further de-emphasized the monetary targets by declining to set a target range for M1. The Committee cited uncertainty about the velocity of M1 (the ratio of GNP to M1) and about its short-term sensitivity to movements in interest rates as reasons for not setting the target. Chairman Volcker explained that the M1 range would have to be so wide "...as to provide little guidance for the FOMC's operational decisions or reliable information for the Congress or for market participants."⁷ The Committee would continue to monitor M1 growth closely, but only against the backdrop of M2, M3, and other economic information.

The report to Congress included some of the important criteria that the FOMC would use for judging appropriate money growth: growth in the economy, price pressures, and the performance of the dollar in exchange markets. Throughout 1987, the FOMC adopted a restrictive monetary policy stance even though monetary growth was below the lower limit of the target ranges.

Clearly, the FOMC has not relied on the announced targets as the primary guides for policy in the last few years. The Congressional hearings provide a public forum for the Federal Reserve to indicate its policy intent and for Congress to ask questions about FOMC policy. With reliable monetary targets, the FOMC would tend to need less discretion in forming monetary policy, and Congress and the public would have a better reference for understanding the stance and likely outcome of policy. Without reliable targets, Congress and the public find it more difficult to analyze monetary policy and, more important, to anticipate changes in it.

One problem resulting from the aggregates' impaired reliability as policy guides is maintaining a meaningful dialogue about policy intentions and accountability. If the reliability of the links between the monetary aggregates and output (whether temporary or permanent) is questionable, then it is potentially confusing to the market for the Federal Reserve to report targets that subsequently may not be met.

By signaling to the market that some factors could warrant the FOMC's acceptance of deviations from its monetary growth targets, additional uncertainty is unavoidably introduced into the analysis of monetary policy. The current H-H Act allows for deviations from the monetary targets as long as the Federal Reserve explains the reasons for the departures.

TABLE 1 MONETARY TARGETS AND ANNUAL GROWTH
Percent, fourth quarter over fourth quarter

	1986		1987		1988	
	Target	Actual	Target	Actual	Target	Actual ^a
M1	3—8	15.6	—	6.3	—	5.3
M2	6—9	9.4	5.5—8.5	4.0	4—8	7.1
M3	6—9	9.2	5.5—8.5	5.3	4—8	7.0

a. June/fourth quarter annualized growth rate.

SOURCE: Board of Governors of the Federal Reserve System.

TABLE 2 ECONOMIC PROJECTIONS FOR 1988 AND 1989

Central Tendency of FOMC Members and Other Federal Reserve Bank Presidents^a
Percent, fourth quarter over fourth quarter

	1988	1989
Nominal GNP	5.75—6.75	5—7
Real GNP	2.75—3	2—2.5
Implicit deflator for GNP	3—3.75	3—4.5
Civilian unemployment rate ^b	5.25—5.75	5.5—6

a. Central tendency is the clustering of values of a statistical distribution that is usually measured by the arithmetic mean, mode, or median.

b. Average level in the fourth quarter.

SOURCE: Board of Governors of the Federal Reserve System.

Although there are problems with the targets as policy guides, the current legal structure seems to offer the most useful format for the Federal Reserve to communicate its intentions for monetary policy.

■ The Economic Projections

The FOMC now meets eight times a year. The two most important meetings are those just preceding the February and July H-H testimonies. Prior to these meetings, each FOMC member and each nonvoting Federal Reserve Bank president formulates projections

for inflation, real GNP growth, and unemployment based on his or her judgment about appropriate policy. These projections may be revised after the FOMC adopts a specific policy. The revised projections are presented in the H-H report to Congress.

The projections are an important supplement to the monetary aggregate targets because they provide information for evaluating current monetary policy intentions and because they indicate what FOMC members think will be the likely economic effects of their policies.

Congress and market participants generally believe that the FOMC could set aside its monetary targets if the economy appeared to be headed in a different direction than was expected at the time the policy was adopted and the targets were set.

Table 2 presents the central tendency of the FOMC economic projections. The projections reflect a monetary policy that is expected to be consistent with the stated monetary target ranges and with assumptions about a variety of other economic conditions. The inflation rate, as measured by the GNP deflator, is expected to be in the range of 3 to 3.75 percent in 1988. The range of expected inflation is slightly higher and wider in 1989—between 3 and 4.5 percent.

The FOMC's expected increase in inflation appears, on the surface, to be inconsistent with the 1 percentage point decline in the M2 target range. However, there does not seem to be a close short-run connection between policy and changes in the price level. Moreover, as Chairman Greenspan noted in his most recent testimony, the GNP deflator is likely to be affected by special factors such as this summer's drought, the recent increase in import prices relative to domestic prices, and the shift in the composition of output in the first quarter of the year.

It seems highly unlikely that inflation can accelerate for long if the Federal Reserve continues its long-run policy of reducing the monetary targets by 1/2 to 1 percentage point each year, and if it attains the targets on average. While M2 velocity (the ratio of GNP to M2) has been quite variable on a quarter-to-quarter or even year-to-year basis, the average growth rate has been near zero over three-to-five-year periods and over the last century. This suggests that the upper limit of a nominal GNP growth trend should correspond closely over time to the upper limits of the M2 target range. With a 3 to 7 percent M2 target range,