Monetary Policy: Credible Commitments

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Knowing What We Don't Know

Currently, I am living in an area that has many small earthquakes. Earthquakes occur when the plates of the earth shift. Scientists don't completely understand the shifting of the plates, but many believe that this shifting may result in many small quakes or a few large ones. I have no reason to believe that, if geologists suddenly discovered a way to delay the next earthquake, then it would be good to do so. In fact, if the plates must shift, we may only be causing a much worse quake if we try to prevent small ones.

I think that the same is true for economic booms and busts. Shifts are occurring in the economy that economists and policymakers do not completely understand – for example, technology, productivity, and the changing tastes of consumers and investors. Some shifts are considered to be uncontrollable, such as, droughts, oil spills, wars and cartels. If we let market forces operate, these changes will be accommodated or corrected in a natural and gradual fashion. Market forces work best in a stable policy environment. Without a doubt, there will always be short-term difficulties, but it is to our long-term advantage to allow for some shift in the economic "plates" as the world changes.

Perhaps the earthquake analogy seems a bit extreme (although I first made this analogy a decade ago and my house is still standing). But it is no more extreme than the idea that macro economic policy can or should be used to eliminate business fluctuations.

I am not in favor of recessions. On the contrary, I believe that variable and uncertain macro policies exacerbate business fluctuations and often precipitate recessions. Recessions will occur even under ideal monetary policies, but they will not be as frequent or as severe.

Even if we thought that eliminating business fluctuations was a desirable long-term goal, I believe it is impossible to do so. First, we cannot predict recessions with sufficient accuracy to use policy to head them off. And if recessions were predictable there would be no need for a policy change to head them off – people then would be able to anticipate them and adjust their spending and savings plans much as they do with seasonal shifts in economic activity such as Christmas. Seasonal downturns can be larger than cyclical downturns, yet there is no policy response because they are predictable. The point is that if business fluctuations were predictable – a necessary condition to justify an active stabilization policy – adjustments by people would make such policy unnecessary.

Second, monetary policy works with a lag and the lag is highly variable and poorly understood. The length of the lag varies over time, depending upon the conditions in the economy and the public's perception of the policy process. People will not respond to a change in policy as they did the last time such a change was undertaken – they will have learned and they will make adjustments in their economic behavior. Third, we do not understand the linkages between policy and the economy. For example, macro economic ideas about monetary policy and its effect on real output have changed profoundly in the last couple of decades. We have learned that the effect of monetary policy depends on peoples' expectations about future policy.

If we have learned anything about economic policymaking, we ought to have learned to think about policy as a dynamic process. To claim that, "in order to reduce inflation, we must slow growth or have a recession," is a wrongheaded notion that completely ignores the ability of humans to adapt their expectations as the environment changes. So what is it that we don't know and why is it valuable? We don't know how to manage the economy with short- term stabilization policies without doing great harm to our long-term economic

well being. The value of this information is that it points policymakers to long-term objectives and outcomes and away from short expedients. The long-term focus on price stability and the Fed's relative success in achieving it has certainly contributed to the long expansion in the U.S. and improvement in economic performance, new economy or not.

Separating Monetary and Fiscal Policy

Policymakers and others may see the value of adhering to long–term policy objectives, yet pressures remain to take the short course. It is always nice to run as an incumbent when the economy is strong so there is always a temptation to shore up a sagging economy even if the long term costs of doing so are high. Also, politicians continuously seek to satisfy their constituents with tax breaks and spending programs, which generally lead to budget deficits. Separating monetary and fiscal policy is crucial to thwarting these pressures by making the political authorities directly and inescapably accountable for their mistakes. An inability to shift the burden on to monetary policy reduces one channel for mischief and allows the monetary authority to pursue a long-term price stability objective.

The source of the tension between monetary and fiscal authorities is the central bank's ability to create money. Because the creation of fiat money imposes an implicit tax on money balances the monetary authority is one source of government revenues. For the most part, the long-run viability of the government's fiscal operations requires that its real current debt burden plus the present value of its expenditures equal the present value of revenues. Thus, if the path of debt plus expenditures diverges from the path of explicit tax revenues fiscal viability requires that the discrepancy be satisfied by seigniorage from monetary growth. This scenario is typically referred to as fiscal dominance over the monetary authority with the outcome being rising inflation. A newer version of this view claims that even an independent central bank cannot keep inflation at bay when there is an errant fiscal policy.

It certainly is true that poor fiscal policy can make things more difficult for an independent central bank. But can it cause a truly independent central bank to produce inflation? The dramatic increases in government deficits in the U.S. in the early and mid 1980s prompted fiscal dominance believers to predict that it would be impossible to achieve and maintain inflation rates below the disastrous levels of the decade's start. So far, this prediction has not come to pass.

In 1983 the federal budget deficit was 3.8 percent of GNP, a level far above the post-World War II average and nearly equal to the postwar peak realized in 1975. In the same year, inflation measured by the consumer price index fell to 3.2 percent—a 16-year low. As the decade proceeded, the deficit relative to GNP rose, fell, and rose again to above 5 percent before declining. The inflation rate was impervious to these patterns. I am left with the strong suspicion that if any period in recent history was ripe for the emergence of fiscal dominance, it was this one. Although deficits may have been detrimental to economic performance, the ability of the Fed to resist monetizing debt protected the economy from even worse consequences. The Fed's decision to resist monetizing federal debt resulted in lower inflation and contributed to fiscal reforms that started with Gramm-Rudman-Hollings legislation.

How do we insure that monetary and fiscal policy remains separate? The Fed has sufficient independence to achieve price stability. The problem is that the Fed is not accountable for that objective. Without accountability, the policy process will be neither credible nor predictable. 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.

The extraordinary achievement of the Greenspan Fed is its long-term focus on price stability and its most important failure is the lack of institutionalization of that objective and the associated policy process. What objective will a new chairman choose to pursue and how will he pursue it? History gives us little basis for expecting price stability or even a stable rate of inflation because the Fed has no mandate or accountability for that result. In

order to bind tomorrow's Fed to price stability, today's Fed needs legislative action that sets price stability as the primary objective and makes the Fed accountable for achieving it in a specified time period by providing a penalty for not doing so. The problems of conflicting objectives and the lack of secure independence and explicit accountability are common to all central banks in varying degrees.

Productivity, Technology and Policy Separation

Much has been made of the economy's superior performance over the past 5 years. It truly has been a high performance economy powered by strong productivity growth and technological innovation in the computer and telecommunication business. Will high productivity growth and technological innovation continue to boost economic performance in the future? No one knows the answer to this question yet the term "new economy" implies that the economy will operate on a higher performance level for sometime to come. And this new economy view raises several policy questions. What should be done about the projected surpluses and should monetary policy be used to offset the resultant fiscal drag? Is monetary policy rudderless because of an inability to assess how fast the economy can grow without triggering a bout of inflation?

Both presidential candidates have plans for the projected surpluses. They call for reducing or eliminating them with spending increases and tax cuts. If the economy gets and extra bit of stimulus because such plans are enacted, then the Fed is trapped and must react with tighter monetary policy, right? Wrong. The Fed does not know how fast the economy can grow and it should not limit its growth. On the contrary, the Fed's goal should be to maximize economic growth overtime by achieving price stability. By focusing on price stability the Fed supplies the best environment for long-term growth. Old economy models that project a positive relationship between economic growth and inflation are inappropriate

for monetary policymakers in any economy old or new. Growth does not cause inflation, excess money creation does.

Currently, two issues could distract the Fed from focusing on price stability. First, the rise in oil prices could slow economic growth. The Fed accommodated the oil price shock in the early 1970s with faster money growth and produced a costly inflation problem for the economy. The Fed can avoid this mistake now by keeping policy focused on price stability.

Second, the floundering Euro brought pressures for coordinated intervention in currency markets by central banks. Intervention will not cure the problem and it distracts central banks from their primary mission of price stability. If the intervention is sterilized then it will have no lasting impact on exchange rates. If it is not sterilized then monetary policy is targeting exchange rates and not price stability.

Moreover, interventions create uncertainty about policy objectives and reduce policy credibility. In the late 1980s the Fed, at the direction of the Treasury, engaged in large - scale intervention in exchange markets. The Fed was acting as agent for the Treasury when conducting these operations yet the Fed booked half the value, some $25 billion. In the process the Treasury ran out of funds to continue and activated a "warehouse" procedure with the Fed which allows the Treasury to borrow from the Fed using foreign currency as collateral. Congress held hearings on this dubious practice and the Fed stopped lending to the Treasury yet the Fed retains the ability to do so. The Fed needs to eliminate the warehouse facility and to stop booking the proceeds from interventions for the Treasury.

Fed policymakers should focus on estimates of future inflation not real growth, oil price shocks or the exchange value of currencies. Investing old economy modeling resources into efforts to better measure monetary growth and future inflation could pay dividends as could using indexed versus non-index securities or other market based estimates of future inflation. In short, the Fed needs to focus on price stability not short- term fluctuations. It should have a credible and predictable policy. Even without a legislative mandate for a price stability objective, the Fed could clearly state its objective and provide a transparent

policy process that has verifiable outcomes and rules that are consistently applied. In sum, we benefit from credible and predictable long-term policies in a new or old economy. *

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