Commentary on 'Monetary Policy in the 1990s: Lessons and Challenges'

Lyle E. Gramley

Charles Freedman's paper, "Monetary Policy in the 1990s: Lessons and Challenges," is at once lucid, interesting and informative. That is no small accomplishment. I find myself in broad agreement with most of what Mr. Freedman says about the challenges for monetary policy in the decade ahead. The best use of my time can perhaps be made, therefore, by focusing largely on one subject: how well will the monetary authorities in a country like the United States succeed in accomplishing their objectives in the environment described by Mr. Freedman? I am not terribly optimistic, because the road ahead may turn out to be a virtual mine field.

Let me begin by considering what it is the monetary authorities should seek to accomplish. Freedman argues that monetary policy ought to take a longer perspective, seek to control the growth of a quantity like nominal GNP, avoid focusing on real variables or interest rates, and aim principally at achieving price stability. "Fine tuning" is to be avoided. That sounds like very sensible guidance, given the lessons of the 1970s. But does that mean essentially ignoring the earlier role that monetary policy tried to play as a short-run economic stabilizer? Central bankers might like to do that, but I doubt that the political process will permit it.

Consider the flak shot off at the Federal Reserve by the Bush administration in recent weeks. The Fed managed to nip in the bud a flowering inflation in 1988 and turn the comer to an easier monetary policy early enough in 1989 to avoid a recession—or so it seems to me. That is a remarkably good performance. But it's not good enough for the administration. Moreover, the criticism of the Fed for focusing too strongly on bringing down inflation, and not enough on sustaining adequate growth, comes from the political party that appointed all of the sitting members of the Board. Meanwhile, two members of Congress from the other political party have introduced a bill designed to bring the Fed under tighter control by making the Secretary of the Treasury a member of the FOMC, reducing, to a degree, the Fed's historic budgetary independence, and requiring the Fed to publish immediately its policy directive. Developments such as these are not new, of course, but they suggest that the politicians may not have learned the same lessons of the 1970s that central bankers did.

In short, the next decade is not likely to feature a course of monetary policy in the United States that aims serenely at long-run price stability, while ignoring the economy's short-term proclivities to grow at an inappropriate speed. If that judgment is correct, what do we make of Freedman's suggestion that the monetary authorities should avoid focusing on real variables and instead, focus on one or more nominal variables?

First, selection of the appropriate long-run growth rate of nominal GNP, which would probably be the best choice of a nominal quantity variable for the United States, cannot be accomplished without knowledge of the economy's real long-run growth potential. That is not too demanding a requirement. Fairly robust estimates of potential GNP growth can be made without too much difficulty, since abrupt changes in long-run growth rates of the labor force and productivity are relatively infrequent.

Second, and more important, the choice of an appropriate growth rate of nominal GNP for the next year or two requires at least crude estimates of the full employment unemployment rate, where the economy is in relation to it, how fast the gap will be closed with any actual growth rate of real GNP, and the probable breakdown of nominal GNP growth between its real and price components. The monetary authorities can't avoid focusing a lot of attention on real variables, nor should they seek to do so. What they need to remember, as they focus on real variables, is that the effects of monetary policy on real variables are largely transitory, while the effects on prices are lasting.

While the political pressures on the monetary authorities to achieve economic nirvana are as formidable as ever, the economic and financial environment that Mr. Freedman describes seems likely to make it increasingly more difficult to achieve the ultimate objectives of monetary policy for several reasons.

First, the automatic stabilizing properties of the financial system leave much to be desired. As Mr. Freedman indicates in his discussion of the monetary aggregates as intermediate targets, the short-run elasticity of money demand with respect to market interest rates is quite high. A recent Federal Reserve study, for example, estimates the short-run elasticity of demand for M2 with respect to the Federal funds rate to be -0.14, roughly twice as high as the long-run elasticity.[1] The short-run elasticity of demand for M1 with respect to market rates is much higher still.[2] Prior to deregulation of interest rates on deposits, it was often assumed that market-determined deposit rates would reduce the elasticity of money demand with regard to market interest rates, and thus help to stabilize money velocity. That has not happened, at least not in the short run. Indeed, for M1, the short-run elasticity of demand appears to be much higher since NOW accounts have become part of M1. As a consequence, short-run growth rates of the monetary aggregates have to be managed aggressively if shocks coming from shifts in aggregate demand are to be cushioned. Perhaps there never was a good time to put monetary policy on automatic pilot by adopting a constant money growth rate rule. But now is clearly not the time to go in that direction.

Second, I suspect that aggregate demand shocks are likely to become larger and more difficult to manage, if not more frequent. The international sector is a prime candidate for more serious shocks. Trade plays a far more important role in the U.S. economy than it once did, so that shocks originating from abroad have more potent effects through the trade route. Shocks coming through the exchange rate route are perhaps even more worrisome, and as Freedman indicates,

---

1 David H. Small and Richard D. Porter, "Understanding the Behavior of M2 and V2," *Federal Resewe Bulletin,* April *1989.*

2 George R. Moore, Richard D. Porter, and David H. Small, "Modeling the Disaggregated Demands for M2 and M1 in the 1980s: The U.S. Experience", in *Financial Sectors in Open Economies: Empirical Analysis and Policy Issues.* Washington: Board of Governors of the Federal Reserve System (forthcoming). Paper originally presented at a Conference on Monetary Aggregates and Financial Sector Behavior in Interdependent Economies, sponsored by the Board of Governors in May 1988.

the process of globalization has not yet run its course. Another potential candidate for generating damaging shocks is the financial sector, as Henry Kaufman keeps telling us. Price volatility has increased, equity cushions of many nonfinancial businesses are razor thin (as are those of a number of depository institutions), and developing countries in Latin America and elsewhere still confront crushing debt burdens. Shocks may originate in financial markets; alternatively, as Ben Friedman argues, shocks to aggregate demand may be magnified there by cascading defaults in the private sector when interest rates rise or when the economy heads into recession.

But why worry about aggregate demand shocks when we have just been through a decade in which there were some blockbuster shocks to aggregate demand in the United States that didn't cause particularly untoward short-run consequences? The reason is that the shocks of the 1980s were, fortuitously, rather well-timed. A gargantuan fiscal stimulus package was introduced in the United States early in the 1980s, when growth of the U.S. and other industrial economies was floundering. In mid-1984, as the danger of renewed inflation in the United States was increasing, the effects of the dollar's rise over the previous three and one-half years dramatically slowed growth of the U.S. economy. And when the impact of the dollar's decline from early 1985 onward began to increase demands for U.S. exports in late 1986, the stimulus to aggregate demand came at a welcome stage of the business cycle. During the next decade, we may not be so lucky.

Third, I would speculate that, over time, aggregate demand may become increasingly less responsive to fluctuations in interest rates. Indeed, I suspect that process is already under way. Mr. Freedman recognizes this possibility. He notes that floating rate debt—a byproduct of the violent fluctuations of interest rates in the late 1970s and early 1980s—has probably reduced the substitution effects of interest rate changes on spending. That seems to be the case in the housing markets during the past several years, as changes in the mix of adjustable and fixed-rate mortgage loans soften the impact of changing market interest rates on sales and starts. Income effects, Freedman argues, may go the other way, however, and how it all comes out is an empirical issue. Clearly, he is right; we don't know the final outcome yet.

The point I would make is that Darwinism may work in economics as well as in ecological environments. Violent fluctuations in interest rates, such as those experienced in the late 1970s and early 1980s, may engender innovational changes—such as floating rate debt and interest rate swaps—that permit economic units to survive. The burden of interest rate risk gradually is shifted to those economic units best able to manage it, units whose day-to-day business activity is least disrupted by interest rate variability.

I would not suggest carrying this line of thought to its logical limit, arguing that monetary policy might be unable to affect the temporal course of aggregate demand. Rather, I would argue that if monetary policy works to a larger degree through balance sheet effects, or cash flow effects, or exchange rate effects, and less through the more traditional route of impacts on credit-financed spending, then we will know less about the magnitude and timing of the economy's response to monetary policy than we used to know, or thought we did. This would not be a problem if the sole objective of monetary policy were to achieve long-run price,stability; it is a problem if the objectives are more ambitious, and extend to short-run economic stabilization.

Mr. Freedman warns us, moreover, that we cannot realistically hope that the narrower monetary aggregates will bail us out of difficulty by reemerging as usable formal targets of monetary policy to guide the monetary authorities through the mine fields. Continuation of unstable demand for money is one reason. Innovations are likely to persist, he argues, and patterns of deposit rate adjustment will be difficult to predict. I agree. But Freedman also contends that formal monetary targeting would probably be impossible under current circumstances even if money demand were stable, because of the high short-run elasticity of demand for money with respect to market interest rates. This is an extremely interesting point and, I believe, a valid one.

To see why this is the case, imagine Alan Greenspan going to the House Banking Committee next February to deliver the Humphrey-Hawkins testimony, with the following story. The economy's growth, he says, has slowed somewhat, so that real interest rates need to come down a bit to sustain a reasonable rate of economic expansion. Since inflation is abating, nominal interest rates will have to fall somewhat more than real rates. To achieve these modest objectives, he says, the Fed's target range for M2 has been raised from 3 to 7 percent in 1989 to 9 to 13 percent in 1990. This small and prudent step, he tells the committee, is fully consistent with the Federal Reserve's long-run objective of restoring price stability. And he implies that, in the following year or two, the M2 range will be lowered enough to maintain the long-run growth rate of money consistent with stable prices.

Clearly, the FOMC would be unlikely to adopt such widely differing growth rates of money even if that constituted a correct and sensible course of monetary policy. More important, the monetary authorities probably won't act that way either. That is to say, the FOMC won't set out ***ex ante*** to change the growth rate of money markedly, even though the course of policy it adopts may lead to that result ***ex post.*** A cautious central banker will probably be reluctant to manage money growth aggressively if even he believes his own forecasts and his staffs estimates of the interest elasticity of money demand. One reason is that if the course of policy chosen turns out to be inappropriate, everyone knows about it. Another reason is that sharp increases in money growth may upset participants in financial markets, who then worry that the monetary policy has become an engine of inflation, while sharp declines in money growth upset the Congress and the administration, who always worry about impending recession.

A high degree of shod-term variability of monetary velocity, together with considerable uncertainty about the magnitude and timing of the economy's response to interest rate changes, are severely damaging to the ability of monetary policy to work effectively as a short-run economic stabilizer. These are conditions that invite gradualism. Counteracting aggregate demand shocks will tend to be done in small steps—say, 25 basis points per month in the federal funds rate, to take a random example. Such a course of action worked in **1988** and early **1989;** it may not work so well under less favorable circumstances. And what the monetary authorities will be using as an intermediate policy target as they probe cautiously toward higher or lower money growth rates very likely will be short-term interest rates. Interest rates are likely to come in the back door, despite Mr. Freedman's warnings about the dangers of paying too much attention to them. We have not yet heard the end of policy mistakes that stem from too much focus on interest rates by the monetary authorities.

This is not a particularly happy state of affairs, but there is no present way out of the box. Moving to the use of broader monetary and credit aggregates as policy targets really won't do, as Mr. Freedman notes, because they seem to respond to monetary policy about as sluggishly as nominal GNP. Perhaps use of commodity prices, exchange rates, or the slope of the yield curve as formal monetary targets will fill the gap vacated by the monetary aggregates. I doubt it, however, and I suspect Mr. Freedman does too, since he doesn't mention the issue.

On the way to achieving their ultimate goals, Freedman argues, the monetary authorities have to look at everything. He recognizes that this may be a recipe for poor policymaking, but he hopes that the monetary authorities will learn from their past mistakes. I hope so, too. And I hope the political process will permit the exercise of good judgment in the conduct of monetary policy. If not, the monetary authorities and our respective economies may be in for some rocky times.