Monetary Policy Strategies: A Central Bank Panel

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Speakers at Jackson Hole normally draw out the lessons of economic theory for a particular area of economic policy. But this year we are doing the reverse. We are trying to distill lessons from the *practice* of monetary policy in the United States—over an extraordinarily successful quarter century under the leadership of Alan Greenspan—for the *theory* of monetary policy.

I want to describe the three important lessons that I have learned from Alan during my time at the Bank of England.

First, to be a successful central banker requires an extraordinary degree of objectivity, something which is not always easy to maintain. The key is to recognize that economics tells you how to think, not what to think. Economics is not a set of settled conclusions. Above all, it is vital never to confuse the world with a model. The whole point of a model is to abstract from a wide range of factors in order to think clearly about one particular issue.

Let me describe an example of what I shall call "the Greenspan approach to economics." It concerns the "Lucas critique." Robert Lucas' 1976 paper encouraged economists to construct models, which incorporated explicit optimizing behavior by households and firms. Unfortunately, some of them urged policymakers to apply the lessons from their models as literally as the enthusiasts of the engineering approach to macroeconomic policy had done in the 1950s and 1960s. The Greenspan approach to economics would advise great caution. The insight of the Lucas critique is that we need to think about the responses of rational households and firms when analyzing the consequences of alternative policies. But the likelihood that any particular model captures how the real economy would respond to a given change in policy is vanishingly small.

The *second* lesson is that empirical knowledge is not confined to the econometric analysis of official statistics. There are other and often crucially important pieces of information that come to us in more qualitative form. These include information from businesses about what they see happening in the economy. Perhaps the most famous example of this in recent years is the productivity acceleration in the United States in the mid-1990s. The extensively revised official U.S. data *now* show that productivity began accelerating in 1995. However, that was not visible until the vintages released in 1998. But as Alan Blinder and Ricardo Reiss have reminded us at this conference, Chairman Greenspan did not wait until 1998 to conclude that the underlying rate of productivity growth might be increasing. The key reason was that he talked with, and listened to, people who work in business. Already in May 1996, when the Fed's model was forecasting increasing inflationary pressures going forward, Alan said "it is very difficult to take the existing structure of the NAIRUs, capacity limits, and the usual potential analysis that we do and square it in any measurable way with what we sense from anecdotal reports."[1]

In the United Kingdom, by contrast, there does not seem to have been a productivity miracle. But we have had many examples of the importance of qualitative data in making judgments. For instance, over the past year or so, significant migration of labor from eastern Europe has expanded the United Kingdom's potential labor force. By its nature, such flows are not accurately reflected in official data. But the Bank of England's business contacts were able to tell us that the ability to recruit new migrant workers was a growing and significant response to a tight labor market.

The third lesson is that it is the consistency over time of a policy framework that sustains a market economy, as the achievements of the United States over the last 200 years show very clearly. Alan, of course, has stressed this in the context of price stability. But it applies equally well to the system of taxes, property rights, and public goods provision on which prosperity in a market economy relies. Alan famously defined price stability in the following terms: "price stability is best thought of as an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms."[2] I would suggest that implicit in this is a prescription that Alan might write for all economic policies, not just monetary policy. Namely, that economic policy stability is best thought of as an environment in which the decisions of households and firms are not materially affected by the need to insure against future arbitrary or mischievous changes in government policy.

In the last decade, we have had a debate about whether price stability should be implemented by quantitative targets or not. In monetary policy we have seen the spread of "inflation targets," and targets have begun to permeate other areas of economic policy, too. You will not be surprised to learn that I think that such numerical targets do have a role—and I share the views of Lars Svensson and Michael Woodford expressed earlier about the importance of transparency and the source of new ideas on that subject. But the question of whether numerical targets are appropriate or not concerns the political economy of how to ensure the transparency of policy, the accountability of those responsible for it, and the way in which households and firms form expectations of policy—monetary, fiscal, or other. Since the political economy varies from one country to another, so will the appropriate method of achieving price stability in particular and economic policy stability in general. The crucial and overriding point is that a market economy cannot flourish if policymakers behave in ways that lead private agents to expect future economic policies—be those future monetary, fiscal, or legal policies—to be subject to arbitrary or capricious changes.

Of course, an expectation of a stable regime rarely will translate into stable outcomes, and it would be irresponsible of policymakers to let such a misconception take hold. A well-designed set of institutions will lead to responses being predictable, but it cannot guarantee that outcomes will be.

And there is a pressing issue here. In the United States, inflation has been both low and rather stable. Over the past decade, it has varied between 1.0 percent and 3.8 percent, so with some justification we can say that inflation no longer "materially enter[s] into the decisions of households and firms." In the United Kingdom, inflation has been even more stable. But this success carries a risk for the future. Inflation expectations may be sensitive to a large but temporary shock that moves inflation outside the range within which it has remained for some years. With their belief in stability jolted, households' inflation expectations might move by much more than was justified by the temporary nature of the shock. That would make it more difficult for the central bank to bring inflation back to target. The moral of this particular story is that it may be risky to infer from the observation that inflation expectations are stable that all is well. There will be times when large and persistent shocks occur, and it would be unwise to count on inflation expectations remaining stable when actual inflation starts to deviate substantially from its recent range.

So, those are the three lessons that I have learned from Alan: (1) a recognition that economics is not a set of doctrines but a way of thinking; (2) the importance of using qualitative and quantitative information from a range of sources; and (3) there are a small number of fundamental objectives that are crucial and which we can judge by the Greenspan yardstick of whether we have freed businesses and households from the burden of expending resources to deal with unnecessary policy volatility.

Alan's departure from the central banking scene will deprive us of a source of wisdom, inspiration, and leadership. To be sure, his words, whether spoken or written, will still reach us from the sidelines. To use a tennis analogy, I see Alan in the future as the central banking equivalent of the captain of a Davis Cup team, not actually playing but encouraging the younger and less talented members, and stressing the importance of footwork, timing, and getting into position early—otherwise known as preemption, good judgment, and careful analysis.

Alan, thank you for raising the respect which others give to our discipline of economics and our profession of central banking.

Endnotes

[1] Transcript of FOMC meeting on May 21, 1996.

[2] *Transparency in monetary policy*. At the Federal Reserve Bank of St. Louis, Economic Policy Conference, St. Louis, Mo., Oct. 11, 2001. This definition was set out much earlier, in similar terms, in Alan Greenspan's statement before the FOMC on "Ways and Means," U.S. House of Representatives, Jan. 25, 1990.