

Commentary

Raymond Lombra

In the two years since we last convened in this majestic setting to discuss monetary policy, real output has expanded rapidly and inflation has slowed significantly. However reluctant policymakers are to take credit for the economy's exceptional performance and pat themselves on the back in public, the critique presented by Bob Hall must come close to provoking a response. Serving as a force for moderation and so as not to foster the widespread notion that economists rarely agree on anything, especially policy issues, my plan is to focus on the core of Bob's paper, around which I believe most economists and policymakers may be able to rally. Moreover, leaving most of the technical nitpicks to Stigler's conference handbook should help engender a constructive dialogue more in concert with the intoxicating beauty and dignity of our surroundings.

The economy's evolution over the past two years has proceeded within a policy strategy often characterized as "pragmatic, eclectic, and flexible." However well such a strategy appears to have worked, many, including the farsighted prime movers behind this conference—Roger Guffey and Thomas E. Davis—have become increasingly concerned about the absence of a reliable, strong, well-understood *anchor* for policy. Skilled sailors know that reliable anchoring entails good holding ground, proper equipment, and informed technique. Designed to absorb the shocks of winds and currents as they change direction and velocity, an essential ingredient of successful anchoring is adequate "scope"—the ratio of anchor line to the depth of the water. The lower the ratio (i.e., the less scope), the tighter is the tether linking the boat and the anchor. Although quite serviceable in calm waters, such a configuration is not very tolerant of shocks. As a result, the anchor can easily slip or break loose, becoming dysfunctional. In contrast, adequate scope builds in sufficient flexibility to absorb shocks. At the other extreme, a huge ratio (i.e. very large scope) comes to

approximate a vessel drifting aimlessly. The message of this analogy, and indeed of Hall's paper, is that a policy anchor and a policy strategy with a moderate degree of built-in flexibility are not mutually exclusive.

There are four general characteristics of Hall's specific policy proposal that I would like to highlight and discuss.

Precommitment

An increasing number of academics agree in principle with the notion that policymakers should announce a specific, credible, understandable, defensible trajectory for monetary policy covering the short to intermediate term (say, six months to two years). Differences do, of course, exist concerning the specifics of such a **strategy**—e.g., which **variable(s)** to focus on, how frequently to review the policy stance, the necessary and sufficient conditions for revising policy, etc. Without down-playing the importance of such nuances, these differences should not be allowed to obscure the agreement regarding precommitment.

Although exhibiting a superficial attachment to precommitment, as exemplified by the Fed's twice-yearly policy dances with Congress under the aegis of the reporting requirements embedded in the Humphrey-Hawkins Act, most policymakers view meaningful precommitment as economically and politically naive, and possibly even injurious to the nation's economic performance. Trumpeting the overriding need for judgement, a flexible, pragmatic, and eclectic—that is, sensible—policy allegedly emerges. Manifested by ever-changing emphases **accorded** the various monetary aggregates; changes in the relevant bases, ranges, and definitions; and shift-adjustments, few would confuse the Fed's approach with the type of precommitment advocated by Hall and others.

We live in an uncertain world; on this we all presumably agree. And, as many have said, the future is unknowable but not unimaginable. Yet, as the past 20 years so vividly demonstrate, and as Brunner and Meltzer have forcefully argued, we should be profoundly humble about our ability to distinguish between, much less anticipate, permanent and transitory shocks to the economy.

While I have an abiding respect for the work of Steve **Axilrod**, his large and talented staff, and indeed for the staffs throughout the Federal Reserve System, the Fed's flexible approach to policy is predicated on a degree of confidence in their collective abilities to sort things out—a confidence that, in my judgement, is not wholly justified. Moreover, the alleged short-run economic benefits of flexibility, which are almost by definition transitory, need to be weighed against the long-run costs. Policy adjustments,

reversals, and errors erode credibility and complicate intertemporal decision-making in the private sector. At a deeper level, Fed attempts to reoptimize at each month's FOMC meeting must face rather than finesse the problem of "dynamic (time)inconsistency" first discussed by Kydland and Prescott (1977), and now immortalized by Rick Mishkin's two-year-old son.

By viewing flexibility as diametrically opposed to precommitment, it can be argued that the Fed overestimates the economic benefits and underestimates the economic costs of its pragmatism. As economists, however, we should not underestimate the political benefits generated by the Fed's vague, incomplete strategy (Lombra [1984]); precommitment and specificity go hand in hand with enhanced accountability for principals and their agents! The short-run political shock absorber comprising current arrangements and the inevitable tension between political and economic forces go a long way toward explaining the gulf separating many economists from policymakers on the notion of precommitment.

Focus on nominal magnitudes

Two propositions underlie recommendations that monetary policy should focus on nominal magnitudes. First, the longer the run, the larger the price effects of policy actions and the smaller the real effects. Second, the ability of economists to forecast the short-run effects of particular policy actions on real output, employment, and prices is limited. Thus, with policy approximately neutral in the long run and central bank independence supposedly providing a shield permitting policymakers to take the long view in conducting policy, a focus on nominal magnitudes—on price stability, to be precise—is advanced as appropriate, prudent, and welfare-enhancing.

The profession's forecasting performance has been chronicled and analyzed in a series of important articles by McNees. Table I extracts some data from his most recent evaluation (McNees and Ries [1983]).

The size of the mean absolute errors and root mean square errors appear nonnegligible. Moreover, the mean error measure, an indicator of bias, suggests that while the forecasts of nominal GNP are on the mark on average, this reflects a tendency to overestimate real output and underestimate inflation. Such indications, which are broadly consistent with similar evaluations of the Fed staffs forecasts (Lombra and Moran [1980], Karamouzis and Lombra [1984]), suggest that attempts to pin down the slope and position of the short-run Phillips curve and handle expectations adequately have not been wholly successful. If a Hall-like proposal can be shown to be

TABLE 1
One-Year-Ahead Forecast Errors
1971-83

<u>Variable</u>	<u>Error Measure</u>		
	<u>Mean Error</u>	<u>Mean Absolute Error</u>	<u>Root Mean Square Error</u>
Nominal GNP	0.0	2.2	2.8
Real GNP	0.5	1.6	2.1
Implicit Price Deflator	-0.7	1.4	1.8
Unemployment Rate	-0.3	0.7	0.9

Notes: From **McNees** and **Ries (1983)**, Table 3. Error measures are calculated from the median of forecasts by the ASA-NBER survey, Chase, DRI, Wharton, and BEA. Errors for the first three variables are calculated as predicted minus actual growth at compound rates. Unemployment rate errors are the difference between predicted and actual unemployment rate levels.

flexible enough to handle such forecasting difficulties, the fact that it gives primary emphasis to nominal magnitudes, and should have a salutary effect on expectations suggests it dominates alternative strategies predicated on estimated empirical relationships between policy instruments and real variables which, in the language of **Leamer (1983)**, are characterized by whimsy and fragility.

A forward-looking policy

Hall's proposal conditions policy on forecasts for unemployment and the price level a year ahead. Current outcomes and expected outcomes over the next six months are treated as water under the bridge. Existing empirical work (**Lombra and Moran (1980)**) and my experience within the system suggest the formulation of policy has often taken almost the opposite tack: incoming data on *past* outcomes drive policy discussions and adjustments. To be sure, discussions do include simplistic extrapolations of trend-cycle indications in the data, with a dash of regression to the mean experience thrown in, as lip service is paid to the staffs forecasts. However, the perception that short-run forecasts are unreliable precipitates heavy discounting and an overriding focus on current conditions.

Many, myself included, have long felt that a policy that is in many respects backward-looking will often prove unduly procyclical. It is certainly true that short-run forecast errors are not small and that forecasts tend to deteriorate as we move from a one-quarter to a four-quarter horizon. However, the overwhelming portion of forecast errors is usually concentrated

in the first two quarters, and little further deterioration is evident over a **four-** to eight-quarter interval (McNees and Ries [1983], **Table 2**). In all likelihood, the dynamic behavior of prices and output, discussed above, contributes to longer-run forecasts being in some sense more reliable than short-run forecasts; the longer the run, the more prices will have adjusted. Even more fundamentally, the fact that forecasts are almost always wrong does not imply that they contain no usable information and that **policy-**makers are free to ignore them. Of course, with high discount rates in the political arena reinforcing the existing economic uncertainties concerning the near-term outlook and the short-run transmission mechanism for monetary policy, such behavior is hardly surprising.

The pitfalls of Fed-style pragmatism

Has the Fed moderated, aggravated, or initiated economic fluctuations? The never-ending character of this debate and the intransigence of relative positions on the role of monetary policy testify to the limitations of our analytical and empirical tools and offer strong support for Keynes' dictum that in economics it is virtually impossible to **convict** someone of error, and extremely difficult to **convince** someone of error.

The Fed sees policy as a stabilizing force, more often than not deftly responding to emerging disturbances. Many academics, particularly monetarists, see policy as often aggravating economic fluctuations. **Accus-**ing policymakers of being deaf rather than deft, and suffering from both myopia and amnesia, Fed bashing has seldom been in short supply.

The correlation between the Fed's plans and its performance has, in my judgement, been variable, difficult to predict, and not **particularly** high on average. Moreover, policymakers strain credulity beyond reasonable limits by contending that virtually all departures of the record from the rhetoric result from bad luck, fiscal policy, unanticipated nonpolicy shocks, financial innovation, and the like. While Hall's **Figure 7** and accompanying discussion surely exaggerate the degree to which policy has exacerbated economic fluctuations, it does appear that, despite good intentions, Fed flexibility and pragmatism often produce policies that become part of the problem rather than the solution.

I recognize that what looks like a policy error *ex post* from an economic perspective might have looked quite different *ex ante*. I would also contend that the last 20 years have seen their share of successful policy episodes. Further, it must be granted that alleged economic policy errors have occasionally been associated with short-run political successes. However, assuming a high **discount** rate and a multi-dimensional objective function

defined over political and economic outcomes, inattention to the longer-run economic effects of policy emerges naturally. The result is a focus on the short run, wherein knowledge deficiencies about the transmission mechanism and the source and duration of shocks are particularly acute.

That the absence of an anchor for policy may be a part of the problem can probably only be seen by standing back from the day-to-day fire fights that permeate policymaking. I have long felt that Reserve Bank presidents and their staffs, being somewhat less involved in shorter-run policy operations, have displayed a comparative advantage in gaining a perspective on policy; over the years many have asked, What precisely are we doing? How are we doing it? And is there a better way? In this spirit, the collective wisdom advanced during this conference raises fundamental as opposed to technical questions about the conduct of policy. Fed bashing aside, I doubt the current configuration of the Bluebook and Greenbook and the accompanying policy strategy in place are an adequate response to such questions.

Lest I be accused of being too easy on the author, let me make some specific observations and suggestions motivated by reading Bob's provocative paper. While I am not sure how seriously to take some of the details, I accept and am sympathetic to the spirit of the exercise he conducts. However, it was startling to read a paper written in 1984 where price and policy expectations are not prominent. Wouldn't the Fed's choice of parameter A effect the economy's wage-price-setting mechanism? One need not buy short-run neutrality to believe the system depends on the policy rule. In the empirical section, I would counsel against relying too heavily on results generated by what Bob Weintraub used to call a **Tinker-Toy** model. Why not utilize the one-year-ahead forecasts provided by **McNees** and **Ries (1983)**, and the errors and biases embedded therein, to put the elastic price standard through its paces? Although still vulnerable to a modified **Lucas** critique, the results would be less model-dependent and somewhat more realistic. Lastly, I wonder how to treat fiscal policy within such an exercise. Is it reasonable to assume fiscal policy will be invariant to the stance of monetary policy? I think not, and suggest the implications of such an interdependence for the variance of the price level and unemployment need to be explored.

Constrained optimization is what policymaking is all about. Logically, then, we need to be fairly precise about the nature of the constraints and the objectives if we are to produce useful policy evaluations and prescription. Reflection and research on such issues suggest to me that, specifics

aside, approaches like those advanced by Hall that are predicated on pre-commitment are forward-looking, and focus on nominal magnitudes go a long way toward avoiding the pitfalls of Fed pragmatism. It is often said that sailing is like standing in a cold shower and tearing up \$20 bills. It strikes me that an inflationary and periodically destabilizing monetary policy can also be so characterized.

References

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