Formulating Monetary Policy in the 1980s

Introductory Remarks
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The first three papers on the conference program deal with important issues which the monetary authorities must face as they determine the course which policy is to take. These issues are the appropriate relationship between monetary and fiscal policies, the role of expectations in policymaking, and the possibilities and need for coordination of policy among countries.

Questions relating to the monetary policy-fiscal policy nexus have rarely seemed more timely — indeed, perhaps more urgent — than at present, with the Federal Reserve attempting on average to conduct a rather tight monetary policy as a means of realizing conservative growth targets for its aggregates and wishing to keep policy on a steady course to engender and confirm expectations that inflation will be reduced, while at the same time the Federal budget is shifting from a deficit of about $60 billion annually to one which some analysts predict will reach $135 billion or more in fiscal 1983. Is it surprising that we find ourselves in such a situation? Is it obviously the case that coordination between the monetary and fiscal authorities is lacking, and could clearly be improved? Some novel and interesting ideas on these questions will be presented by Alan S. Blinder in the program's first paper.

I have already mentioned the word "expectations" in my brief remarks on the relationship between monetary policy and fiscal policy. There is probably no livelier set of issues in macroeconomics today than those concerning the role of expectations, both at the theoretical and practical levels. The idea of efficacious discretionary policy in particular has come under heavy attack'with the advent of the rational expectations theory, which made itself felt in macrotheory and policy discussions around the middle of the 1970s. The basic proposition of this view—that expectations on economic variables should be formed using all available information, including knowledge of the structure of the system which determines those variables—must certainly be seen as an important innovation and advance in macroeconomic theory. Yet, in its most extreme form, the proposition is used as a basis for arguing that discretionary stabilization policy is totally impotent. Sharp divisions of opinion on particular aspects of this debate continue to exist, but certainly there is a great deal more skepticism today among economists concerning the usefulness of discretionary policy than there was, say, 10 or 15 years ago. However, the pendulum now seems to be swinging away from the extreme rational expectations view and its implications for modeling and for analysis. Our second paper will indicate in some detail where this debate stands and some possible new directions. It is by John B. Taylor.

We live in a world made up of interdependent economies. We tell our students that the demise of the Bretton Woods fixed-exchange-rate system made it possible for policymakers to concern themselves much more exclusively with domestic problems than previously was the case. In the imperfect real world, however, it is apparent that we are a long way from complete policy interdependence. One need only refer for example to the recent Versailles summit meeting and the concerns expressed there about the effects abroad of current U.S. monetary and fiscal policies to realize that this is so. In this real world, policy innovations, especially those originating in a large economy such as the United States, may still entail important consequences—at least in the shorter run—for its smaller neighbors and trading partners. These consequences are examined in the third paper on the program, by Charles Freedman.