Some Problems and Prospects for Monetary Policy in 1985

I am delighted to have this opportunity to talk about the unfolding economic situation and how it might affect monetary policy. I want to give some indication of where I think we can be going next year, but I also want to point out some of the possible pitfalls for monetary policy I then plan to offer some thoughts on the broader issue of how monetary policy should be structured As you probably know, my official role in monetary policy will come to an end on January 1 But I can assure you that my interest in these issues will remain intense.

The economy has given convincing signs of slowing substantially after an unexpectedly strong first half. This slowing was badly needed. Continued expansion at the earlier pace would have begun to re-ignite inflationary tensions within a matter of months. More recently, the question has become whether the slowing has gone too far. Indeed, some have been questioning whether a new recession might be brewing.

My own sense of it is that the signs of outright weakness are likely to prove temporary. As we all know, the exact timing of consumer spending is very hard to predict. In 1984, for reasons that are hard to pinpoint, consumer spending tended to bunch heavily in the first half of the year This was then offset by a lull in subsequent months. The result of this uneven performance was apparently some overbuilding of inventories The more recent signs of softness in production represent efforts to correct this situation.

Remarks of Anthony M Solomon, who retired as President of the Federal Reserve Bank of New York on January 1, 1985, to the Money Marketeers of New York University at the City Midday Club on November 20, 1984

But the classic preconditions for recession just do not seem to be present The inventory problems have been no more than minor and scattered. Consumer confidence and financial positions have remained basically strong There are no signs of major or pervasive capacity constraints—in good part reflecting our heavy reliance on imports in this economic expansion. On the financial side, credit has continued to expand rapidly and has remained readily available There has been nothing remotely resembling a credit crunch. The effects of the moderate run-up in interest rates earlier in 1984 seem to have been confined to some softening in housing. Now, rates have come down substantially, more than reversing the earlier advances

Looking just at the business cycle picture in the conventional way, the prospects look good for a resumption of the expansion To be sure, we may still see some effects from the inventory blip created by the uneven pattern of consumer spending. But in the absence of major capacity strains, and in view of the fact that overall demand appears to have slowed to a sustainable rate, 1985 could turn out to be a very satisfactory year Real expansion could average close to or somewhat above our long-run capacity to grow We could see some gentle further declines in the unemployment rate. The inflation story could also be very good with, at most, only a very modest acceleration from this year's low rate Assuming no further distortions in the money measures from deregulation, such an evolution ought to be readily accommodated by something like the tentative 1985 growth ranges announced last July.

But as we all know, there are a lot of things in the situation that have to raise questions about the applicability of conventional business cycle analysis to the prospects for 1985. Let me tick off a few of them. One is our still-high level of real interest rates. After the fact, it is easy to think of reasons why we have been able to have a strong expansion even with these levels of rates—the fiscal deficit, changes in business depreciation rules, and financial deregulation are perhaps the most obvious. But even after allowing for these factors, there remains an unexplained element in this situation. For this reason, the continued existence of relatively high rates is bound to make us less confident of any economic forecast. We simply cannot be sure that high real rates will not become more of a barrier to expansion than they have been so far.

A second difference compared with earlier postwar expansions is the persistence of some degree of financial fragility both domestically and internationally. This fragility is the residue of the late inflation, the recession and the related performance of interest rates. As the expansion has proceeded, and as vigorous efforts have been made to deal with the international debt problem, financial health has been returning. But problems do remain. They underscore the importance of sustaining the U.S. economic expansion as a condition for restoring financial health. By the same token, they could also inhibit us in using as much monetary restraint in the event that inflationary pressures returned.

A third obvious difference from the past is our record trade deficit and the extraordinary strength of the dollar—of which more in a moment

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A fourth unusual factor is the relative sluggishness of the economic recovery in much of the rest of the industrialized world. A related feature of this situation is the prolonged and very high levels of unemployment in many of these countries The social implications of this situation—especially as applied to the young people—are already serious They become progressively more serious as the problem continues. Frankly, at this point, I do not see too much basis for near-term optimism on this front The importance of a continued, sustainable expansion in the U.S. economy is obvious in this context.

A fifth unusual factor is what might be called the "fragility of inflationary expectations" The recent inflationary experience of the American people has been very uneven. First we had very high rates of inflation for several years in the late 1970s and early 1980s. Recently, inflation has been much lower and I am pleased to see that inflationary expectations also seem to have come down. But given this major transition, many people probably have a very hard time figuring out what should be regarded as "normal" as far as inflation is concerned. I would therefore guess that views about the prospects for inflation are likely to continue for some time to be unusually volatile.

If my comments on these various matters seem to add up to a plea for the exercise of a large measure of judgment, let me say at once that I plead "guilty"—guilty with an explanation, but not with an apology!

A final unusual factor is of course our fiscal situation. It is unusual in terms of the large cyclical stimulus it continues to provide us well into a business expansion. It is also unusual in terms of its structural implications for interest rates, inflationary expectations, our balance of payments, and the dollar.

Now I do not mean to imply that all these unusual features of our situation are necessarily going to be sources of trouble or that all the risks are on the downside. For example, the international debt situation has clearly been improving rather than deteriorating recently. And a general consciousness of financial fragility does have some virtues! It encourages a desire to improve balance sheets, to shun extreme risks and, in general, to avoid the kind of unrestrained and ultimately self-destructive optimism that has always been a feature of inflationary booms. Moreover, on the fiscal problem, with the election over, we can hope that serious negotiations to deal with our fiscal imbalance will bear fruit. And of course while the strong dollar is hurting our export industries it is holding down prices.

For monetary policy, the real point about these special features of our situation is that they raise doubts that the course of policy can be as smooth next year as it looks at first blush Given the various special features of our situation, it looks even more dangerous than usual to be dogmatic about the appropriate course for policy in 1985. Even absent these special factors, we would have the normal problems in anticipating the strength of the economy and therefore the appropriate stance of policy But that is at least a problem made familiar by long experience in dealing with the postwar business cycle It is the *special* features of our situation that create the potential for unfamiliar problems

Suppose, for example, the economy expands significantly more rapidly than capacity and price pressures re-emerge. Normally, in the context of steady money growth rates, such a development would put some upward pressure on interest rates. This would be an appropriate and constructive result in such a context But under present conditions, the response of the economy could be very hard to judge. For example, if the resulting rise in rates led to another jump in the dollar, depressing our trade balance further, the restraint on the economy could be unusually large In that case, even a mild rise in rates could prove a powerful offset to inflationary pressures. On the other hand, if, as some believe, only quite large jumps in interest rates have any significant effects on our deregulated economy, we would have to consider how much restraint could be tolerated in a world with significant remaining financial fragility So either way, new factors have created new uncertainties about how policy should respond to any resurgence in inflationary pressures.

Another policy issue that could arise from the special conditions of our present situation is how to factor in movements in the dollar. I myself have long believed that our domestic monetary policy should take greater account of the performance of the dollar. Certainly there have been instances—November 1978 and October 1979 are examples—when the dollar has been an important factor in domestic monetary policy But the performance of the dollar has generally been only a background consideration in routine month-to-month decision-making. Now, however, given the extent of the dollar's rise and given its apparent over-valuation in purchasing power and trade terms, further advances in the dollar next year might provide a valid reason for some shading towards an easier position.

Conversely, while a gradual and moderate decline in the dollar would be welcome, a sharp drop could raise other problems for domestic monetary policy Such a sharp drop would, even without any change in monetary policy, tend to put upward pressure on our interest rates and I could imagine circumstances where international considerations could contribute to a tightening of monetary policy

Now just how we should respond to any of these contingencies for the dollar would of course depend on the context of domestic developments But I suspect that the foreign exchange markets will, and should, come to play a more prominent role in our thinking about domestic monetary policy than has been true in the past

A third policy issue created by our special circumstances could arise from significant action to reduce the deficit Action on this front, substantial enough to convince the markets, would of course put downward pressure on interest rates This would be true even in the context of unchanged money growth But the case can also be made that in the short run at least, the economic restraint exerted by actions to reduce the deficit should be actively offset by speeding up money growth Again, this is one of these decisions that would have to be made in light of all the developments in the economy at the time.

Overall, I think it's clear there are many issues monetary policy may have to face in 1985 that could go beyond the routine. So it would be even more foolish than usual to try to tie policy rigidly to specific money growth targets set in advance. And this would be the case even if no new problems turn up with the money measures themselves In fact, such problems have been pervasive throughout my tenure on the Open Market Committee We of course have multiple money targets—three to be precise—and an associated total credit measure. Moreover, these multiple targets are defined in terms of ranges rather than points The existence of multiple targets and the use of ranges, plus our ability to reset the ranges if appropriate, provides us with considerable flexibility within the targeting approach. I think this flexibility may be needed again in 1985 as it has in the past

Fundamentally, the basic need is for the central bank to show that it can and will take the actions needed to control inflation.

If my comments on these various matters seem to add up to a plea for the exercise of a large measure of judgment, let me say at once that I plead "guilty"—guilty with an explanation, but not with an apology!

I think I understand and appreciate the arguments of those who favor some form of explicit rules to govern central bank performance. Basically, their argument is that rules are needed to protect central banks from pressures to focus on short-run problems at the expense of a long-run commitment to price stability. Monetary rules provide, it is argued, protection against an inflationary bias inherent in the political process Moreover they can, on this view, provide a form of accountability for the central bank

These arguments for some form of rule have appealed to some observers as long as central banking has been a subject for public discussion. The reason for the enduring appeal of this position is that the arguments clearly have some elements of validity The case for some form of monetary rules—and against discretion and judgment—is one of those perennial philosophies that tends to re-emerge, though in changing form, from generation to generation As a student of Henry Simon in my early days at the University of Chicago I can personally attest to the durability of this position

Nevertheless, a position that would rule out major elements of judgment in making monetary policy is not one that I find congenial. First, there is the problem of finding a rule that works. The most popular proposal in recent years has been to fix on some growth rate for some definition of money But as almost everybody is now willing to concede, all of the various money measures have given us major problems in recent years. The reasons are too well known to need repetition here. Basically they involve the effects of financial innovation and deregulation These forces have at times produced major and unpredictable aberrations in velocity. Perhaps the worst of these aberrations are behind us and we are returning to more "normal" behavior. But no one can be sure about this. In any case, the new version of "normal" is not likely to be the same as the "normal" of earlier postwar years. At this point, we just can't be sure what "normal" really is.

Leaving aside the problem of finding a rule that would "work", my own feeling is that monetary rules are really not the requirement for success in achieving reasonable price stability The reason is that in the end, it is results that really count. Monetary targets provide necessary long-run discipline when applied with a measure of flexibility to deal with changes in velocity. But fundamentally, the basic need is for the central bank to show that it can and will take the actions needed to control inflation. If it does this, whatever the precise approach, it will acquire the credibility it needs to do the job of controlling inflation at reasonable cost

I do think it is clearly true that financial markets, notably including the exchange market, are far more sensitive to the inflation implications of policy than they were in the past.

In my view, the Federal Reserve has in fact acquired credibility in recent years This is not because of the performance of the money measures it targets It is because inflation has in fact fallen sharply and because the public has become convinced of the Federal Reserve's determination to conduct an anti-inflationary policy. The key has been results, not monetary targets, let alone monetary rules

And that is true not just in the United States Other countries with relatively good inflation records, such as Germany, Switzerland, and Japan, pay attention to money growth and, in the case of Germany and Switzerland, set targets But my evaluation would be that it is not monetary targets that have produced a successful record on inflation in these countries Instead, it is the well-earned confidence that the central bank will act overall as needed to do the job, even if it does not pursue monetary targets closely in each and every year. The success of these countries in limiting inflation has generally been reinforced by fiscal policies compatible with anti-inflationary objectives

Now one objection to actual performance as the test of a successful anti-inflationary monetary policy might be that the price effects of policy show up only with a lag. If so, a satisfactory current price performance may not warn you of troubles lying ahead from a too expansionary policy So, especially if the lags are long, the ill effects of such a monetary policy might become apparent only when it was too late.

I agree this could be a problem. But my feeling is that the lags have shortened a lot in recent years. The truth seems to be that the inflationary experience of the '70s and early '80s has greatly sensitized the financial markets and the public at large to any signs that monetary policy may be loosening its grip on inflation. Indeed, one school of academic economists apparently now takes it as a working assumption that all markets can more or less immediately foresee the price implications of excessive monetary growth. If this were true, an inflationary monetary policy would have immediately visible effects on actual inflation And in this case, in turn, the inflation results of policy could be continuously monitored.

To be sure, such an extreme claim seems unjustified. But I do think it is clearly true that financial markets, notably including the exchange market, are far more sensitive to the inflation implications of policy than they were in the past And perhaps commodity and even labor markets respond more rapidly to policy. So I suspect the problem that lags could represent for judging policy by its results is much reduced in today's world. Hence I come back to the working proposition that monetary policy can be and will be most meaningfully judged by its results rather than by adherence to some particular formula

I think I should add that the "rules versus judgment" debate has a somewhat academic ring looked at from the point of view of working central bankers Within the Federal Reserve, the practical issue that has really gotten attention is the degree of reliance on mechanistic as against judgmental responses to changing developments. In particular, the post-October 1979 approach allowed for a relatively mechanical response of interest rates to short-term movements in money growth—although even in this period there were clearly major elements of discretion in the process. More recently, purely mechanistic responses have been essentially eliminated

In practical terms, what kind of monetary policy approach is going to bring about a sustained period of rough price stability? We have to recognize that as much as we have accomplished in recent years, the problem is not yet solved Inflation is still at levels that would have been unacceptable in earlier years And our progress to date is partly hostage to a foreign exchange rate that will probably sooner or later move down Further, the progress we have made continues to co-exist with levels of unemployment, both here and abroad, that are just too high to be acceptable over the longer run

Our goal should be a peak cyclical rate of inflation in each business cycle expansion that is lower than the one we had in the previous expansion.

If we follow the usual cyclical script, moreover, price inflation will not improve further in this economic expansion. Instead, it could worsen somewhat—although the actual outcome obviously depends importantly both on the dollar and on some crucial commodity markets, notably the oil market. This suggests to me that a strategy for really defeating inflation will have to look beyond the current business cycle expansion At the same time, I also believe there is a good chance that carried through one more full cycle, such a strategy can come close to the desired objective. Our goal should be a peak cyclical rate of inflation in each business cycle expansion that is lower than the one we had in the previous expansion. Under normal circumstances—that is, assuming no major further shocks from financial innovation and deregulation—such a strategy should imply a similar downward ratchet in the peak rates of money growth. It is this downward ratchet in money growth from one cyclical expansion to the next that should be our principal objective so far as money is concerned.

Gradual year-by-year slowing in money growth rates certainly remains a generally desirable objective Indeed, the ideal of gradual, year-by-year reduction in monetary growth has continued to be a factor in the minds of most FOMC members in setting the annual targets But the actual results, for all the Ms, have in fact differed substantially from this pattern. The need to take account of the various effects of deregulation on the Ms is one reason for the difference The sharp and essentially unpredictable drop in all velocity measures in 1982 and the continuing weakness of M1 velocity over much of 1983 is another This experience—plus my belief that we have to look at ending inflation over a multi-cycle horizon—is what leads me to a cycle-by-cycle reduction in monetary growth rates as the more critical test.

Obviously labor market issues are not part of monetary policy But to me, the other side of a successful long-run anti-inflation strategy would have to do with the functioning of our labor markets The level of unemployment rates consistent with nonaccelerating inflation has been too high in recent years given the social costs. If I were to name the single most important issue in domestic macro-economic policy, I would say it is the need to lower the average unemployment rate consistent with price stability This is too large a subject to go into here. Some reasons for moderate optimism may be changing demographics and a prospective improvement in our productivity performance relative to the dismal record of the 1970s. Admittedly, however, such an improvement has not yet shown through in the figures.

What about the *tactics* of monetary policy? Personally I am reasonably satisfied with the approach the Federal Reserve has taken since about late 1982. At that point we set aside the approach adopted in October 1979. That approach, as I noted earlier, allowed interest rates to respond semi-automatically to deviations of money growth—especially M1—from target paths. The problem with that approach was that M1 was giving out unreasonable signals. For a brief period we tried to adapt the same general approach to an emphasis on M2. But since about the beginning of 1983 we have had what I would call a "tripartite" approach This approach allows us to continue to take account, in a judgmental way, of the performance of money growth as before, but also of the economy itself and, indirectly, of the behavior of short-term interest rates.

I should add that you can often learn things from looking at the economy, money, and interest rates *together* that you could not learn from looking at each of them separately.

Each of these three elements has a legitimate role to play in decision-making. The relevance of looking directly at the performance of the economy is obvious The broad, longer-term trend in money growth is a component of our anti-inflation strategy along the lines I have already described And interest rates themselves clearly warrant explicit consideration for the manifold effects they have on the functioning of markets and the economy. Indeed, the intrinsic importance of interest rates becomes greater in circumstances where sharp exchange rate movements and financial fragility in credit markets are a factor

I should add that you can often learn things from looking at the economy, money, and interest rates *together* that you could not learn from looking at each of them separately. For example, if money growth is slowing down, does that mean policy is tightening? Does it mean that the economy is weakening? Or just that money demand has shifted? Looking at what interest rates are doing can help solve this puzzle and help indicate the proper course of action. For example, the sharp slowdown in M1 growth that worried some monetarists in the last half of 1983 looked considerably less significant when the continuing strength of the economy along with reasonably stable interest rates was taken into account.

On a day-to-day operational basis, our focus since early 1983 has been on bank reserve "availability", measured in terms of member bank borrowing and/or net free or net borrowed reserves (excess reserves less borrowings). Now there is a loose and shifting, but nonetheless real relationship between borrowings and the level of the Federal funds rate and other short rates for any given discount rate. So when a particular level of borrowings is sought, we have some rough range for the Federal funds rate in mind as the expected result. Of course it is possible that changes in banks' willingness to borrow at the window—due to changing levels of financial market anxiety, for example—could push the funds rate out of line with the rough range we had expected. In such a case, we could, of course, always adjust the level of borrowings we seek accordingly Whether we would actually make such an adjustment would depend on the surrounding economic and market circumstances. It would be a judgment call.

Moreover, all recent Directives to the Open Market Desk here in New York have made the desired level of reserve availability conditional on unfolding events. In general, these Directives allow for the possibility of increasing or decreasing the levels of borrowings or net free reserves during the inter-meeting period Such possible adjustments may, but need not necessarily result from substantial deviations of money behavior from the expected performance as stated in the Directive. What I want to emphasize again is that such adjustments are discretionary, not automatic The Directive language has always made it clear that any decision to change reserve availability would be made in the context of unfolding developments in the economy and the financial markets—with the precise emphasis varying from Directive to Directive.

Now what does all this mean for interest rates? Clearly it means we have moved a substantial distance from the post-October 1979 procedures where an automatic mechanism could set in motion large and often volatile rate movements. On the other hand, we have definitely not returned to the pre-October 1979 situation where the Federal Reserve sought, usually successfully, to control the funds rate week to week with a rather high degree of precision.

Within limits, the present approach gives significant room for market forces alone to generate movements in the funds rate. I realize that this fact at times creates uncertainty about Federal Reserve intentions for those who try to read those intentions from the funds rate itself. But I think there is a lot to be said for a procedure that gives scope to market forces. Market pressures can themselves be a source of valuable information to the policymakers. Moreover, rigid interest rate targeting seems to have a built-in weakness in making policymakers too slow to act when action is needed. This was the lesson that brought about the changes of October 1979.

Now I know none of this tells you what is going to happen to interest rates next week or, for that matter, next year. But I am sure none of you really expect that from me. What I have been trying to say is that my years on the FOMC have convinced me that there is no simple formula for making monetary policy even in the easiest of times. And these last four and a half years have certainly not been the easiest of times! Nineteen eighty-five may be a relatively smooth year to negotiate. But for the reasons I have spelled out, there are plenty of grounds of suspecting it may not be Never, I think, has the kind of generally pragmatic approach to policymaking I favor been more clearly called for than at present. Certainly I will miss not being with my colleagues in the Federal Reserve as they work on these problems next year But I wish them the best of luck in an endeavor that is so important to all of us.