The Role of Interest Rates in Federal Reserve Policymaking: Discussion

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I cannot think of a better way to honor Frank Morris's memory than to have this kind of conference. One reason for Frank's success as a manager and as an economist was his willingness to listen and his respect for other people's opinions. If Frank were here, he would be taking notes.

I thought that was a very good paper, and I had very little disagreement with it. I just want to elaborate on a couple of points. Benjamin Friedman points out that one advantage of framing policy decisions in terms of free reserves was the opportunity to duck responsibility for changes in interest rates, on the grounds that the market sets interest rates. "Nobody here but us chickens" has long been the Fed's response to complaints.

In the 1970s, the Fed responded to criticisms about management and money supply by setting targets for both money growth and the federal funds rate, but in practice until 1979 it usually hit the funds rate target while often missing the money growth target. Frank Morris had some monetarist leanings, although they seldom got in the way of his better judgment. But at Board meetings when the staff reported the money growth rate, Frank often expressed regret that the Fed had once again failed to catch the monetary rabbit.

I will not spoil the party by giving a review of the 1970s. But finally, after the second oil shock, Paul Volcker and his colleagues concluded that drastic action was necessary. Their instrument was a very sharp rise in interest rates, but the stated target was a money or reserve base growth rate certain to produce a spike in interest rates. The money growth target provided some cover, but the viability of the disinflation project ulti-

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mately depended on public acceptance of the rate increase and the resulting recession.

Postmortems of the inflation of the 1960s and 1970s are still being held, and it is widely recognized that maintenance of price stability requires public support for restrictive policy in response to supply shocks or fiscal folly. Nominal anchors, gold standards, fixed exchange rates, or inflation targets may strengthen that support if it is already there. They provide a sharply defined basis for criticism of monetary policy, but by themselves they do not create the necessary support for price stability, and the history of nominal anchors is one of having one and dropping it. Like second marriages, those devices represent the triumph of hope over experience.

Let me turn now to another aspect of monetary management. Friedman has a good deal to say about targets and objectives for monetary policy, and I agree with most of what he says. However, the discussion of the nominal anchor problem gives little attention to what I think is the most difficult nonpolitical problem of monetary management: At any one time a monetary manager has to choose what to do in the short term, in order to move to a feasible and satisfactory combination of output and inflation.

The problem is complicated, to say the least, by three facts. First, monetary policy, whether expressed in terms of money growth or interest rates, works "with long and variable lags," as Milton Friedman so wisely said many years ago. Second, our forecasts of what will happen during the lag periods are not very good, considering the record of the past few years. Third, we should know what responses to expect from any change or sequence of changes in monetary conditions.

If the Fed waits to take action until it is sure of its ground, higher inflation or a recession may be well under way before the action has any effect. If, to avoid that result, the Fed takes early action, it risks damaging a healthy expansion by fighting hypothetical inflation or, conversely, accelerating a boom by fighting a hypothetical recession. Those dangers may be averted if the Fed follows a policy of moving interest rates incrementally in the direction indicated by the forecast, with the size of the increments related to the certainty of the forecast. Bob Solow has said, "If you're not sure where you're going, you don't go very fast."

In the past few years, the Fed has acted that way, with small interest rate changes. Fortunately, demand growth was quite steady, commodity prices were stable or falling, and wages rose only gradually in spite of increasingly tight labor markets. The situation required only the mildest restrictive action by the Fed. Things worked out well even though our forecasts were not very good.

The remarkable record of the last few years seems to have led not only to irrational exuberance about the stock market, but to an irrational faith in the power of monetary policy as well. A couple of weeks ago, I asked one of my fifty-year-old friends whether he thought plans to use the Social Security surplus to repay federal debt would cause any serious problems. He expressed complete confidence that monetary policy had the necessary power to offset any fiscal drag and that Chairman Greenspan would know how to use that power.

That vote of confidence should be gratifying to Greenspan, but he would be the first to agree that more difficult problems lie ahead. We may have to deal with serious supply shocks or sharply rising demand. Alternatively, there may be a fall in stock prices or a loss of confidence in the dollar. Do we know what we need to know to deal with those situations?

To do the management job properly, we should know how to forecast demand, how to forecast wages and prices given demand, and how to predict the effect of monetary policy action taken today on demand several months from now. Can we do those things? Judging from recent forecasts, we cannot. We will have to continue to rely on incremental responses in the direction indicated by the forecast. But unless placid times come, money managers seeking to avoid the risks of doing too little, too late, will have to take the risk of having to reverse policy because they have done too much, too soon.

Friedman ends his review of Federal Reserve policymaking by saying that we have returned to a world in which the central bank sets interest rates, interest rates influence output, and output in part determines inflation. In many respects this is where Frank Morris entered in 1968. I must add, however, that the links between interest rates, output, and inflation are no better understood today than in 1968. At the 1969 conference on controlling monetary aggregates, I gave a paper and concluded that the limitations in our ability to quantify the effect of any sequence of monetary actions had become apparent under the severe pressures that had been at work during the past four years. We continue to suffer from those limitations.