

## *Panel Discussion*

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*Lyle E. Gramley\**

I would like to begin by picking up on a point made by William Poole, who noted that the results of monetary policy in the 1980s were remarkably good. That is particularly true during the period from 1983 on. The point gains significance in light of the obstacles to achieving a successful macroeconomic performance faced by monetary policymakers during that period. An enormous increase in the federal deficit occurred early in the 1980s, and as the decade went on the explosion of private debt led to a huge rise in the debt burdens of businesses and consumers, to a weakening in the condition of banks and thrifts, and ultimately to a credit crunch. Moreover, the cyclical behavior and the longer-term trend growth of M1 changed in 1981 when banks began to pay interest on the checking deposits of individuals, and in the latter half of the decade the historical relation between M2 and nominal GDP broke down.

Yet, despite these difficulties, monetary policy succeeded in keeping the economy reasonably on track. The reasons for this successful performance need to be studied carefully. One obvious reason for the achievement of low inflation during the 1980s was the elevation of price stability to a position of much greater prominence in the Federal Reserve's priorities. A second contributing factor to the achievement of both low inflation and a relatively low variability of output may have come from a more forward-looking monetary policy, as Jeffrey Fuhrer's paper suggests.

Three notable instances of forward-looking monetary policy occurred in the 1980s. The first was in 1983, when the Fed began to tighten

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monetary policy when the economy was barely six months into a recovery from the deepest recession of the postwar period. That action was taken, not because inflation was accelerating, but because the economy was growing much too rapidly. The second instance was in the latter half of 1984, when growth slowed abruptly. While no immediate danger of recession was present, the Fed eased monetary policy to sustain the expansion—only the second time in the postwar period that monetary policy was eased before the onset of recession. The third case of forward-looking policy occurred from roughly mid 1989 through the middle of 1990, when the Fed lowered interest rates in an attempt to achieve a “soft landing.” While the effort was not fully successful, and a mild recession began in the latter half of 1990, that downturn conceivably might have been avoided in the absence of the Gulf War and the jump in oil prices it occasioned.

My second point is that the Fed ought to adopt, and I would urge permanently adopt, a short-term interest rate as its instrument variable or short-term intermediate target. There are three reasons for this recommendation. First, it can work, as the experience of the 1980s indicates. Second, using a short-term interest rate as an instrument variable has an inherent advantage because it avoids the costs imposed on businesses and individuals by high variability of interest rates. Third, no practical alternative is available, a point that needs to be amplified.

Poole’s paper points out clearly that M2 (and by extension broader monetary aggregates) do not serve well as intermediate targets of monetary policy. While he considers the possibility of using M1 as an intermediate target or instrument variable, he acknowledges that targets for M1 growth for, say, a year in advance would be impractical because of the high interest-elasticity of demand for M1. Another limiting characteristic of M1 for this purpose is a high short-run variability of demand, which leads to very large errors in short-run forecasts of reserve needs, as Donald Kohn pointed out. Moreover, the Goodhart-Viñals paper notes that lags are long in the adjustment of money demand, real GDP, and prices to changes in interest rates. Add a dollop of uncertainty to all of these relations, and the result is good reason to expect that efforts to target closely on M1 will produce wild fluctuations in interest rates, the monetary aggregates, and real output. That was the experience from October 1979 through August 1982, the only period in postwar history in which the Fed tried to target the short-run growth of M1.

However, some well-known problems are associated with using short-term interest rates as an instrument variable. Real interest rates are not measurable, and the appropriate level of real interest rates cannot be known in advance. Poole suggests that a strategy of continuous adjustments of the instrument variable can help to deal with that problem. But what should the Fed focus on to decide whether its instrument variable

needs to be changed? I strongly believe that the Fed should not shy away from judgments about the size of the gap between actual real output and its estimate of potential output, and about how fast actual and potential output are converging (or diverging). Such judgments are inherently imperfect, but they are essential to sensible policy decisions. I would far rather see the Fed make judgments of that kind than see it react to information about expectations of inflation read from the yield curve.

Whatever one may think of the particular decision rules implied by the John Taylor and Jeffrey Fuhrer papers, monetary policy decisions ought to be made with more conscious attention to the short-run trade-off between unemployment and inflation, as well as to the lack thereof in the long run. The Fed might experiment with specifying in advance (for internal purposes, not for publication) what its response function will be to deviations in output and inflation from targeted levels. I am not suggesting slavishly following a rule; but tentative decision rules could serve to focus attention on whether levels of the instrument variable are consistent with what is going on in the economy.

A second, perhaps larger, problem with a short-term interest rate as the instrument variable of monetary policy is that the central bank almost invites political criticism by accepting responsibility for interest rates when it has to raise them. For this problem, as well as the difficult decision of choosing the appropriate level of nominal short-term interest rates, letting a monetary aggregate like M1 play a role in the decision-making process can help. M1 growth provides useful clues about how stimulative or restrictive monetary policy is, and the growth of M1 may at times provide political cover when the Fed needs to boost interest rates.

For example, the Federal Reserve has explained its tightening actions this year mainly as a need to increase real short-term interest rates from abnormally low to "neutral" levels. It has taken a lot of political flak for its action. A strong case could have been made that growth of M1 in recent years was about double the rate consistent with avoiding an upturn in inflation as the recovery proceeded. That argument might have been easier to sell to the public and to politicians skeptical of the need for higher interest rates. But the Fed could hardly use it after a decade of largely ignoring the behavior of M1.

Turning to the issues highlighted in the Debelle-Fischer and Goodhart-Viñals papers, I would favor a legislated definition of the Fed's responsibilities—making the Fed goal-dependent, while leaving it free to use the instruments of monetary policy as it sees fit to achieve legislatively mandated goals. Identifying price stability as the Fed's principal goal would be a step in the right direction; it would increase the likelihood of extending the good inflation performance of the 1980s. The legislative mandate, however, needs to be stated in language that

recognizes that trade-offs exist in the short run between the variability of output and the variability of inflation. A sensible mandate should recognize that price stability is not a number, but a state of affairs in which economic decisions are little affected by expected price changes. It needs to recognize, also, that circumstances such as supply shocks or policy mistakes may lead to deviations from inflation targets, and that it takes time to get back on track.

Finally, two extremely important empirical issues were discussed at the conference that have been left largely unresolved. The first is the impact of inflation on long-run productivity growth and hence on growth of potential output. Obviously, that is a crucial question in deciding how tough a central bank should be in fighting inflation. While some interesting evidence suggests a significant negative relation between inflation and productivity growth, I share Richard Cooper's skepticism on how solid the evidence is. The second question is the issue of whether gradualism is a cheap or an expensive way of bringing down inflation. Here, too, the evidence is not terribly robust. Research in both areas ought to be very intense but also very skeptical.