

## Chapter 10

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# Reflections on Recent Monetary Policy

**Federal Reserve** monetary policy procedures have undergone significant modifications since the late 1970s. While policy procedures have changed, the formal long-run goals have not. The Federal Reserve has continued to seek price stability and sustainable economic growth. Indeed, the experiences of the last few decades have emphasized the importance of eliminating inflation and adhering to a policy that promotes prolonged price stability.

Addressing the long-run goals has been complicated because traditional relationships among economic variables have become less dependable under the pressures of an evolving economy and financial system. Consequently, the Federal Reserve has found it more difficult to identify satisfactory indicators on which to base policy actions. In particular, a range of innovations has blurred the lines separating financial instruments that have some of the characteristics of money, making relationships among money, real economic activity, and prices harder to interpret. Consequently, new ways have been sought to gauge whether the stance of monetary policy is tight, neutral, or easy.

Two tools of policy—reserve requirements and Federal Reserve lending at the discount window—have also lost some of their effectiveness. Reserve requirements have fallen to levels that make them largely irrelevant to most depository institutions, and routine adjustment borrowing at the discount window has almost disappeared. Consequently, depositories have lost some

of the flexibility in reserve management that these tools used to provide. Execution of open market operations has had to take into account the banking system's reduced options for managing reserves, but so far the diminished effectiveness of the policy tools has not prevented the Fed from implementing monetary policy.

Fortunately, despite the breakdowns in traditional relationships among economic and policy variables, the Federal Reserve has achieved a considerable measure of success in moving toward price stability while sustaining economic expansion. The process is not complete, but good progress has been made.

## Fighting Inflation

The last seventeen years have been marked by serious efforts to battle the inflation that began in the latter half of the 1960s and became embedded in the economy during the 1970s. Inflation rates since 1992, mostly in the 2 1/2 percent to 3 percent range (as measured by the consumer price index), are the lowest in a generation and are a vast improvement over the 13 1/2 percent peak rate in 1980. Nonetheless, even lower inflation rates are feasible, as demonstrated during the years from 1952 through 1965, when prices rose at an average 1.3 percent annual rate.

The experiences since the mid-1960s brought the costs of inflation and the difficulties of conquering it into sharp focus for those at the Federal Reserve who worked to overcome inflation and for governments, businesses, and consumers who struggled to plan around it. The inflationary period demonstrated that the benefits from pumping up the economy were short-lived. The so-called Phillips curve trade-off between the level of resource utilization and prices proved to be a temporary phenomenon that depended on "money illusion," or mistakes in distinguishing between nominal and real values. For example, workers may initially interpret changes in money wages as changes in real wages. With time, they would realize that what they cared about was the purchasing power, rather than the numerical value of their wages.

Indeed, because inflation distorts resource allocation, the relationship between economic activity and prices appears to be the reverse of the Phillips curve relationship over longer periods of time: *higher* average inflation rates tend to be associated with *lower* average real growth rates. For example, between 1952 and 1965, negligible inflation in the United States was accompanied by an average growth rate in real GDP of 3.3 percent.<sup>1</sup> The period from 1967 through 1980, when inflation was accelerating, was accompanied by an average real growth rate of 2.7 percent—a rate significantly

lower than that for the earlier period despite the stimulus to growth provided by the Vietnam War.

The costs of inflation were manifold: uncertainties about the likely return on investments discouraged long-term investment and savings. Interactions between the tax system and inflation raised some effective tax rates, discouraging related activities, and lowered other tax rates, encouraging those activities. Planners diverted resources from productive uses to the pursuit of strategies for minimizing the losses from inflation.

Because the U.S. dollar served as an international reserve currency, the inflationary pressures spread to other countries, even though some countries attempted to insulate their economies. For a time, the U.S. dollar's preeminent position as a world currency was threatened.

Ending inflation involved new costs. The Federal Reserve had to keep monetary policy tighter than it would have otherwise for extended periods, which held down average growth. Indeed, reining in inflation proved to be a long and difficult process. Several attempts during the 1970s to reduce inflation were cut short because of weakness in economic activity. Each round of renewed stimulus pushed the peak inflation rate to a new high. In consequence, the increased inflationary expectations became more and more embedded in the public's decision-making procedures. By the late 1970s, many observers questioned whether the Federal Reserve would ever reduce inflation permanently.

Consequently, in 1979, the Federal Reserve decided that substantial progress against inflation would have to be achieved quickly if the gains were to be sustained. It recognized that its efforts might involve greater short-run costs than a more gradual approach that gave people more time to adjust, but the evidence suggested that, in the circumstances prevailing, an aggressive approach was needed. By 1982, inflation had been brought down significantly. The lower 3 to 5 percent range of annual price increases was sustained through the balance of the decade, and signs of a pickup near the end of the 1980s were addressed promptly. These actions helped to build Federal Reserve credibility as an inflation fighter.

Efforts to guard against inflation cannot be relaxed, even when prices appear to have reached a point where inflation is no longer a concern in routine economic planning—the Federal Reserve's working definition of effective price stability. The risks that the political process will generate pressures for money expansion to pump up the economy, especially ahead of an election, or to pay for additional government-provided services will always be present.

## Guidelines for Federal Reserve Monetary Policy

The Federal Reserve, and in particular the Federal Open Market Committee (FOMC), has long sought advance indicators of future changes in prices and economic activity because policy actions can take several years to have their full effects on the economy, especially on prices. But rapidly changing financial and institutional relationships have made traditional money and credit measures more difficult to interpret and less reliable as guides to appropriate policy.

One alternative approach is to “look at everything.” A large array of information is almost certain to contain conflicting signals, however. The need to sort out contradictory information could delay the implementation of needed policy changes. Hence, the Federal Reserve has searched for a short list of potentially helpful indicator variables.<sup>2</sup> Nonetheless, none of the measures is infallible, and the Fed has continued to be guided by a relatively large number of variables.

Some of the indicators that the FOMC watches are based on the members’ understanding of several aspects of the monetary policy process. Strains on the productive capacity of the economy are believed to encourage inflationary tendencies. Thus, the FOMC observes the estimated gap between actual and potential GDP, several measures of labor market tightness, and capacity utilization. Inflation arising from resource shortages can only be sustained if supported by accommodative monetary policy, but strains on capacity often signal that monetary policy has been on the easy side.

The Committee members also watch other indicators of future inflation. These include commodity prices, the monetary aggregates, estimated real interest rate levels, the shape of the yield curve, exchange rates, and trade patterns. Because conflicts among these indicators are common, considerable judgment is needed to discern the proper course of monetary policy.

## Implementing Policy

Day-to-day implementation of monetary policy by the Trading Desk at the Federal Reserve Bank of New York has evolved both because of changes in the way the FOMC has formulated policy and because of the diminished roles of reserve requirements and the discount window. During the 1980s and early 1990s, routine discount window borrowing for other than seasonal needs almost disappeared in conjunction with the banking system’s financial difficulties. Thus, varying the degree of reserve pressures could no longer be achieved by adjusting the amount of discount window borrowing forced on the banks.

The role of reserve requirements in establishing the banks' demand for reserve balances has also diminished as reserve requirement levels have fallen, both as a result of reductions in formal ratios instituted by the Board of Governors of the Federal Reserve System and as a result of actions by depository institutions to reduce their transaction deposits artificially.

Near-term policy has focused in recent years on achieving a relatively stable Federal funds rate. Doing so depends in part on depository institutions' having a reasonably predictable demand for reserve balances at the Federal Reserve. Depositories aim to hold enough reserves to avoid inadvertent overnight overdrafts and the associated penalties. They also seek to avoid unusable excess reserve balances on which they earn no interest. Recent reductions in reserve requirements have narrowed the range of reserve levels that a bank will find acceptable at day's end. The changes have introduced an element of instability to reserve demands. Even for many large depositories, meeting reserve requirements is no longer the prime motive for holding reserve balances. Most of the large banks compensated for the lower required reserve balances by holding required clearing balances that pay indirect interest. These balances restore some of the predictability and flexibility to reserve management strategies. But the cushion has still narrowed and the day-to-day margin for error has fallen. Furthermore, these banks seem to be uncomfortable about turning to the discount window in the event of a late-day reserve shortfall.

As of this writing, the difficulties in managing reserves stemming from the reduced roles of reserve requirements and the discount window have not been serious, although episodes of increased Federal funds rate volatility late in the day, along with heightened intra-maintenance-period variability in banks' desired excess reserves, have raised warning flags. Increased volatility in the overnight Federal funds rate could make day-to-day reserve management harder for depository institutions. It could also make gauging appropriate reserve provision more difficult for the Federal Reserve. Previously, as long as the Desk took actions to avoid very high or very low reserve balance levels on any day, it could direct most of its attention to achieving the two-week average objective for reserves keyed to average reserve requirements. As the banking system's ability to cope with moderate daily deviations of reserves has diminished, the Desk has found it necessary to pay more attention to daily levels of reserve balances.

Fortunately, the risk that funds rate volatility might mislead banks and other market observers about Federal Reserve policy intentions has been removed by the FOMC's decision to announce changes in intended interest rates right after the decisions are made. When no policy change has been

announced, observers can be confident that a move of the funds rate away from the previously indicated target does not signal a policy change.

Because volatility in the Federal funds rate is no longer likely to mislead observers about the thrust of Federal Reserve policy, it may not do much harm, but such volatility is not beneficial either. The policy implementation process would benefit from higher reserve balances to make the demand for operating balances more stable over the two-week maintenance period. Higher target balances would also allow more flexibility in day-to-day reserve management because depositories could absorb more of the unexpected end-of-day reserve surpluses and shortages.

Depository institutions will only wish to hold higher reserve balances if they are compensated in some way. Paying interest on required reserve balances would be the most direct way to accomplish this goal. In the past, objections have been raised on the grounds that the Treasury would lose revenue. But required reserve balances have fallen to such low levels recently that revenues from this source have dropped well below \$1 billion a year and continue to decline. Thus, further losses from paying interest would be relatively small. Interest on required reserve balances would permit higher required reserve ratios without reducing the revenues of either the Treasury or depository institutions. (If reserve ratios were raised, the Federal Reserve would provide the reserves to meet them through additional securities purchases. The interest earned on those securities would cover the interest payments to the depositories.) Additional changes in the reserve structure may be part of the story in future editions of this book.