

Panel Discussion

*James Tobin**

The question put to this panel was: How can monetary policy be improved? We are supposed to consider not only what improvements to recommend but also how to reconcile public and central bank preferences.

I agree with several previous speakers who have commented that monetary policy did pretty well in the Volcker era. I refer not just to the conquest of inflation between 1979 and 1982 but to the Fed's wisdom in declaring victory at the brink of an economic and financial abyss when inflation was still about 5 percent. If Senator Aiken's formula for ending the Vietnam War—declare victory and get out—had been adopted, the world would be a better place today.

In the 1982-83 period, Paul Volcker saved us from a prolonged and ever deeper recession. At the same time, Volcker's Fed interred intermediate monetary aggregates as a guide to policy. Thus were we spared unnecessary and wasteful fluctuations in economic activity due to shocks in the velocity of one or another M1. In their place, the Fed focused on intrinsically important macroeconomic objectives: real GNP and its growth, employment and unemployment, prices and inflation. The main operating instrument became the federal funds rate. As the Fed fine-tuned the 1983-89 recovery, unemployment fell below what had been regarded in 1980 as the lowest inflation-safe rate, yet inflation continued to subside.

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Business Cycles Are Not Symmetrical Deviations from Equilibrium

Yesterday, several speakers described business cycles as symmetrical fluctuations of real GNP around its equilibrium trend. This symmetry was particularly explicit in John Taylor's ingenious circle diagram. I do not think it is realistically correct. I observe that the economy spends many more years with GNP falling short of potential GNP than with GNP exceeding potential. Full employment, as most economists estimate it, is not a central value but a ceiling seldom reached. Consider quarterly estimates of the "Okun gap" from 1946 to 1992. The average gap is 2.1 percent of potential per capita GNP if negative gaps are counted or 2.7 if they are counted as zeros. The task of macroeconomic policy is not just to moderate fluctuations around the mean but to raise the mean itself.

Some asymmetry is understandable. To bring inflation down a point may take a cut in aggregate demand bigger than the expansionary dose that previously raised it a point. Yet as the 1980s cycle shows, and probably the 1990s cycle also, a Federal Reserve-engineered recession cure for inflation seems to take a shorter time than a Fed fine-tuned recovery from that recession.

The misleading semantics of business cycles probably contributes to complacency about the pace of "recoveries." The NBER arbiters of cyclical dating use zero real growth as the dividing line between recession and recovery. Consequently, positive real GNP change is "recovery," even if it is less than the trend growth of potential and the GNP gap is thus increasing. Naturally, reporters and politicians follow the NBER practice, and pressure for expansionary policy on the Fed and the government in general vanishes once the quarterly real growth report is positive rather than negative. There were 34 recession quarters and 123 recovery quarters over the period 1955:IV to 1994:II by NBER reckoning, but 76 recession quarters and 81 recovery quarters by growth accounting. The NBER committee turns a deaf ear to my protestations.

The semantic illusion seems particularly costly in Europe. It is not too farfetched to say that Europe chose never really to recover from the two worldwide oil-shock, anti-inflation recessions of the decade 1973 to 1982. Europe seems content to return to sustainable growth rates at lower and lower rates of utilization, without ever recapturing the ground lost in those recessions. With chronic double-digit unemployment rates in several members of the European Union, the policy might be described as cutting out of the economy large fractions of the population, buying their acquiescence by welfare-state transfers, and then blaming the "structural" unemployment on the transfers.

I make this point to explain why I am not enthralled by the recommendations I heard this morning, that the United States follow

the European example and gear monetary policy exclusively to price stability. This orientation of monetary policy has been very costly in Europe, and it is likely to be even more costly if it is enshrined as dogma by the Maastricht Treaty.

Improving the Central Bank's Control of Aggregate Demand

I have some modest suggestions for improving Federal Reserve power to manage aggregate demand. Whatever its goals, the Fed can realize them only by affecting aggregate demand for goods and services. I wish the conference had discussed more fully the mechanisms of transmission of monetary policies these days.

The Fed has chosen the shortest interest rate as its operating instrument, presumably in order to minimize its interventions in the economic and financial markets. What is the linkage from the federal funds rate to aggregate demand? The funds rate itself has little direct impact. Its influence is indirect, via interest rates on assets of longer duration and maturity, bank loan rates and lending policies, and equity values. The funds rate seems to be a tiny tail wagging a huge dog. It often works, but how? and how reliably?

The term structure is a weak and erratic link, as illustrated earlier this year by the surprisingly large response of long rates to Fed increases in the funds rate. It seemed that the bond market was making monetary policy and the third and fourth moves by the Fed were just catching up. Cannot the Fed intervene closer to the points of meaningful contact between the financial and real economies?

With the help of the Treasury, the Fed could conduct open market operations in longer maturities. Private debtors have different expectations of inflation and of future interest rates from those of lenders, and certainly different views of the risks of movements in bond values. In symmetrical markets, debtors' views would be a counterweight to the expectations and fears of the lenders' side of the markets. For example, debtors could use opportunities to buy back their debts when bond prices are low. But one big debtor, the Treasury, is inert, and its passivity surrenders power to the lenders.

I would like to see the Treasury issue indexed bonds. They would be closer substitutes for equities and real capital than fixed-dollar securities, and the Fed could buy and sell them. My reason for favoring indexed bond issues is not the same as Alan Greenspan's. He thinks he would be able to read inflation expectations off the rate differential between indexed and ordinary bonds. The trouble is that those are the inflation expectations, along with the risk aversion premiums, of a very nervous group of people whose interests and worries do not coincide with those of ordinary Americans.

The Fed Must Have Discretion and Be Accountable for Its Use

Should the Fed commit itself to certain formal rules? I think not. The reason is that blind rules, like Friedman's k percent growth of M1, independent of the state of the economy and of events affecting the impacts of monetary operations, are bound to go wrong. If there are to be rules, they have to allow for feedbacks from observations and forecasts of economic circumstances. But you cannot hope to cover all contingencies. The central bank has to retain a good bit of discretion to decide how to meet unforeseen circumstances.

Neither is it possible to prescribe quantitative goals in legislation. The Humphrey-Hawkins Act does so, but since its unemployment and inflation goals are incompatible, they are simply ignored.

In practice, I think, we have no choice but to give the central bank a broad mandate, with considerable discretion about both goals and instruments. That makes the issue of accountability particularly acute.

The Humphrey-Hawkins reports include what are described as macroeconomic *projections* by members of the Federal Open Market Committee. The captain of a ship controls its course and speed. If he estimates the ship's position tomorrow noon, that is hardly a projection. It is a plan—subject, to be sure, to weather and other events beyond the skipper's control. It is disingenuous for the FOMC to forecast or "project" the economy, pretending that they have no control over it. I would like to see the report contain the consensus of the FOMC as to the macroeconomic path they will use their powers to achieve over coming quarters and years.

I also believe (1) that all voting members of the FOMC should be, like the Governors, federal officials appointed by the President and confirmed by the Senate; (2) that a President should have the opportunity early in his term to designate the Fed Chairman; and (3) that the Secretary of the Treasury and the Chair of the Council of Economic Advisers should be present at FOMC deliberations and allowed to express their views even if they do not have votes.

After all, it is the President who pays the political price for any adverse consequences of the central bank's management of the economy. The prospectus for this panel mentions the problem of reconciling public and central bank "preferences." I am not sure of the political legitimacy of central bank preferences.

The Fed Should Not Aim Solely at Price Goals, Certainly Not at Zero Inflation

I was appalled this morning at the support in this conference for central banks to ignore employment and real growth and to aim

single-mindedly at inflation stability or, what is more appalling, price level stability. Who, if not the central bank, is supposed to worry about real macroeconomic outcomes? Fiscal policy confronts increasing barriers to its use in management of aggregate demand. Insisting on fiscal prudence in bad weather and good, the Maastricht Treaty formally rules out the use of fiscal policy for macroeconomic stabilization. I do not see evidence that markets by themselves will do the job. The record of Europe in the 1980s is discouraging.

What is the desirable trend rate of price inflation? This is an old issue, and I would remind you of three arguments against literal zero inflation and in favor of a moderate positive trend of prices. We are talking, of course, about single-digit inflation rates, higher or lower or zero, not about choices between hyperinflation and one- or two-digit rates.

First, it is harder and more traumatic to reduce individuals' nominal salaries and wages than to keep them from rising. Maybe some irrationality is involved here, but an actual cut in dollar wages is an outright insult. If markets dictate a fall in the real salaries of some or all Harvard and MIT professors, I think less strain would be imposed on the social fabric if it happens by a bit of inflation than by cutting dollar salaries.

Second is a similar argument on adjustment of real interest rates. There are times, believe it or not, when the appropriate real rates on safe short assets are negative. But you cannot get there from here, given the floor of zero on nominal rates, if trend inflation, actual and expected, is zero or negative.

Third, considerable ambiguity remains about what price indexes measure, and how well they fit the motivations in the minds of advocates of zero inflation. Most economists agree, I think, that the U.S. Consumer Price Index overstates annual inflation by at least 2 percentage points, because of unmeasured quality improvements in existing goods and services. Taking account of additions to the menu of goods and services available is an even thornier problem. If the central bank tries to stabilize the CPI, it may actually be deflating indexes of product prices. It would not be wise to freeze into constitutions, treaties, or statutes any particular price index, statistical or conceptual.

One final comment: As Jacob Marschak gently reminded Henry Wallich in a memorable Yale seminar years ago, prices are not in anybody's utility function. Price or inflation stability is not an ultimate social good, but must be justified as an instrument that will deliver more utility-laden goodies to the society. The evidence that it will is weak. Recently Chairman Greenspan has suggested that lowering the trend inflation rate, presumably by monetary policy, will raise long-term productivity growth, a dubious hypothesis yet to be successfully tested.