

Commentary: The Role of Judgment and Discretion in the Conduct of Monetary Policy

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Making monetary policy is about forecasting. Given costs of adjustment, sluggishly adapting expectations, and other factors, the actions of the central bank in the reserve market have their effects over a considerable period.

The intermediate **target/indicator** discussion is a subset of this forecasting exercise. The potential value of such indicators or targets is particularly high when the central bank is using short-term interest rates as a proximate target. The difficult question of when to change short-term rates and by how much is complicated by the attention focused on the central bank's target rate—in financial markets and in the body politic. Intermediate indicators help the central bank check on its forecast and signal the potential need to adjust interest rates; they can discipline the policy process, working against tendencies toward inertia; and, statements about their likely behavior can communicate the central bank's strategy and intentions to the public, reinforcing credibility.

Ben Friedman has given us an interesting and thoughtful essay on the properties and use of **intermediate** targets and indicators, the effects on them of recent developments in the U.S. financial system, and the implications of those effects for techniques of making monetary policy.

Ben draws two main conclusions for intermediate targets and indicators, and I find I am in broad agreement with them both. First, he notes that the biggest effects seem to have been on those old standby indicators involving the growth of money and credit. Financial change has widened the array of instruments available to savers and borrowers, modified the character of existing instruments, and reduced transaction costs of shifting among financial instruments. In this environment, demands for particular sets of instruments—labeled, for example, M2 or bank credit—become much more difficult to specify, have much higher interest elasticities (as do their supplies), are more subject to changes in tastes and technology, and therefore have considerably looser and evolving connections to spending.

His second main point is that as a consequence of the process of change, the Federal Reserve must look at all types of incoming information—and must re-examine and reassess this information frequently. This certainly has been the practice of the Federal Reserve for most of its history, including since the fall of 1982. Throughout this most recent period, monetary aggregates, including M2, have played a role in policy, but as information variables rather than as targets. And that role has been reduced as atypical velocity behavior called into question the *information* content of first one aggregate and then another. Quite frankly, I don't see an alternative to the current inclusive, intensive procedure, as Ben has labeled it.

Although I agree with the underlying thrust of Ben's paper, I believe some cautions are in order. These are not intended as criticisms but are more on the order of ruminations the paper has provoked.

The first such caution concerns the difficulty of separating underlying changes in the financial system that are likely to persist from the temporary products of the current, peculiar, business cycle. Ben notes this point in assessing the possible future usefulness of the commercial paper-bill rate spread, but it has more general applicability. The current cycle has been marked by an abnormal pattern in monetary policy, which began to ease well before the cyclical peak, by an unusually moderate recovery in which persistent expectations of rising interest rates and higher inflation reflected in extraordinarily steep yield curves have been repeatedly proven wrong, and by *mas-*

sive and unprecedented balance sheet restructuring by borrowers and lenders—including the demise of a huge number of depository institutions, with new regulatory and cost burdens placed on the survivors. Moreover, atypical business cycle patterns have not been confined to the United States. It would be extraordinary if such developments had not affected both the response of the economy to policy and the signaling content of traditional indicators, including those involving interest rate relationships as well as money and credit aggregates.

Unless we expect future business cycles to look like this one, we need to exercise caution in interpreting the financial and real developments of the last few years as necessarily being the result of longer-term trends. I don't expect the imminent resurrection of P-star or a reliable credit aggregate, but we should pause before discarding a good deal of history on the basis of an unusual business cycle.

Ben suggests that with the increasing **unreliability** of money and credit aggregates, central banks should pay more attention to interest rate relationships. And some have read Chairman Greenspan's discussion of real interest rates in his recent testimony as pointing in a similar direction. My second set of cautions concerns this topic.

Interest rates and other price-type variables in financial markets are natural alternatives to money and credit as intermediate indicators. Indeed, there is a body of analysis in support of such an emphasis when, as now, uncertainties about money demand are heightened. Moreover, interest rates are attractive indicators because they are clearly along the transmission mechanism. As a consequence, they have a more forward-looking flavor than many other variables, such as recent data on prices or output.

There are, however, pitfalls involved in very heavy reliance on interest rate indicators. One problem is that innovations in capital markets likely have affected the relationship of these indicators, as well as money and credit, to spending. The demise of Regulation Q and usury ceilings clearly have had an impact, but other changes, for example, involving new markets and instruments and freer international flows of capital, may also be affecting interest rate-spending relationships in more subtle ways. Even the cyclical behavior of rate

spreads, such as the yield curve or paper-bill, may be modified as financial markets evolve, if their previous patterns had reflected in part the costs of shifting among instruments or the lack of available alternatives for lenders or borrowers.

As a more fundamental problem, interest rates or spreads do not, by themselves, have unambiguous implications for spending or inflation. A given paper-bill spread, though it may have some indicator value for real activity, could be consistent with any inflation rate; and, the slope of the yield curve, while suggestive of the direction of market inflation expectations, by itself says little about the level of such expectations or of actual inflation now or in the future. The problems with targeting nominal rate levels themselves are well recognized. A particular short-term nominal rate can be consistent with ever increasing or ever decreasing output gaps and accelerating or decelerating inflation. Interest rate targets and indicators need to be accompanied by attention to variables that anchor the system in nominal terms, perhaps even the price level or the inflation rate themselves.

Some focus on real interest rates can help to an extent—possibly reducing the odds on some of the most egregious policy errors—but it is no panacea. Like other rate variables, real rates do not tie down prices. Unless set equal to its equilibrium or natural levels, a given set of real rates will not even avoid increasing or decreasing inflation rates, and there is no unique inflation rate associated with real rates at their natural level. Measurements of actual and estimates of natural real rates are complicated by the absence of information on inflation expectations. This problem is especially acute because the most relevant rates for spending are those at intermediate and longer maturities, where uncertainties about expectations are highest. At these maturities, the influence of the Federal Reserve also is attenuated, working through actual and expected paths of real short-term rates, which are under the control of the central bank because inflation expectations adjust slowly.

Finally, equilibrium real rates, so crucial for the evaluation of the implications of actual real rates, may vary quite a bit over relevant policy horizons. Real rates are determined in the very long run mainly by tastes and technology, but factors affecting the supply and demand

for goods and services over shorter periods, such as fiscal policy or financial frictions, can have important effects on actual and equilibrium real rates. The monetary authorities need to take account of these effects if they are to avoid exacerbating rather than damping swings in output and prices.

Although difficulties in using real rates are formidable, in theory as well as in practice, there is a potential significant place for them in policy—not as a target of policy but as an information variable. For all the problems, policymakers can still get a notion of a rough range for actual and equilibrium real rates. Large deviations of actual from equilibrium rates will show through the uncertainties, alerting the central bank to the nature of risks going forward. This gives policymakers important and useful information concerning longer run tendencies in the economy against which they can evaluate other information bearing on whether the current policy stance is appropriate.

That issue—timely decisions on whether the current stance is appropriate—is at the heart of monetary policy, and it is the third topic I want to address. The Federal Reserve was using an intensive, inclusive methodology in the 1970s too, and probably in the early 1930s as well. The historical hallmark of discretionary policy focused on interest rates was too little too late, with the result that the central bank has on occasion increased rather than decreased the amplitude of business cycles. When you look at everything, there always seems to be some piece of information that counsels against a policy change, or it is tempting to await the next bit of data, which may cinch the case for change. Moreover, the bias against acting tended to be greater on the side of raising rates than lowering them, giving policy an inflationary cast.

There are no easy solutions to this problem. Just recognizing it may be the most important step; even central bankers may be capable of learning from the past. Certainly, complaints about the inflationary bias in U.S. monetary policy have been scarce in the last fourteen years. Arms-length relationships between central banks and day-to-day political pressures are important, along with central bankers willing to exploit that scope for action. Another key element surely is

the overall framework for policy, in terms of its ultimate objectives. Many countries have been adopting explicit inflation or price stability objectives. In the United States, where the legislative mandate is somewhat ambiguous, the Federal Reserve has emphasized that it believes its contribution to the longer-run growth of the country comes in seeking and achieving price stability. By measuring themselves against this objective, policymakers have added an element of discipline to discretionary decisions based on inclusive, intensive examination of new information.

Finally, we come to Ben's "more fundamental issue"^w—the potential impotence of the Federal Reserve. His concerns have two aspects: One, that depository institutions will make do without reservable liabilities, and two, that the economy will make do without depository institutions. The second seems more serious than the first. The central bank sets the overnight rate, as Ben points out, by controlling the supply of a unique instrument, one with no effective substitutes—that is, deposits on its balance sheet. In the United States there are no effective substitutes because the Federal Reserve insists that depositories hold reserves against transaction deposits. But this is not necessary for control over **short-term** interest rates sufficient for policy purposes. Clearing balances at the central bank could work about **as** well. Clearing through the central bank may be required, as in Canada, but even without that requirement, reasonably predictable demands for central bank balances may arise owing to the attractiveness to banks and their customers of **riskless** clearing through an institution that can create liquidity in a pinch. Countries without reserve requirements seem to be able to achieve short-term interest rate objectives, even with low average clearing balances. So long **as** commercial banks clear through the central bank, that institution, by manipulating its balance sheet, can force banks to obtain central bank deposits through discount or open market repurchase facilities at predetermined rates that form a basis for other interest rates.

The effects of a shrinking banking system are more difficult to analyze. One can conceive of a situation in which the Federal Reserve set an overnight rate for depositories, but these institutions were so small, and had such limited capital, that their efforts to adjust their portfolios to take account of actual and expected overnight rates had

little effect on other interest rates. The question is whether this is a realistic possibility. I suspect it is not, at least in our lifetimes. First, I would harken back to my first point—it is probably not legitimate to extend the slope of the recent downward trend for depository intermediation. Underlying trends of demands for the services depositories deliver—especially services that require them to issue liabilities and hold assets—are not likely to be as unfavorable. Even with securitization of bank assets, on the liability side there is likely always to be a substantial demand by households and businesses for the liquidity and safety of bank deposits. And, those deposits will have to be put to work. Demands for deposits and the effect of bank arbitrage activities should be enhanced by the continued role of commercial banks and the Federal Reserve at the center of the payment system. I do *not* want to sound complacent about these interesting questions; we need more research and thought—especially on the implications of an evolving payment system. Running monetary policy off of the demand for currency alone may be a possible alternative should Federal Reserve deposit accounts fall into disuse, but would be tricky at best. To date at least, the Federal Reserve has not noticed any degeneration in the fairly predictable response of other short-term rates when we change our stance in reserve markets—though it has been nearly a year since we tried.