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

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Friedman's skepticism with regard to the use of monetary aggregates as intermediate targets of monetary policy derives mainly from U.S. experience, the upheavals in the financial system there, and the consequent instability of the money demand function. To this extent, the quest for new approaches is quite understandable and, indeed, necessary. However, the conclusions presented in his paper cannot necessarily be applied to other countries where the financial sector has been subject to less pronounced changes. I should like to illustrate this point, using Germany as an example.

The Bundesbank was one of the first central banks to set itself a formal monetary target; this policy has now been pursued for almost twenty years without the strategy as such having been fundamentally called into question by the academic advisers of the policymakers in Germany or by the public at large. Not that I am oblivious to the technical difficulties we have been having with our monetary targeting for the past three years or so. Quite a number of special factors have been affecting the growth of the money stock and have disrupted, at least in the short run, its indicator quality and its manageability—for instance: German reunification, the introduction of a tax on interest income early in **1993,** the prolonged inverse interest rate pattern, or the speculative inflows of foreign funds. Despite the short-term disruptions, however, the underlying relationships among the money stock, interest rates, prices, and incomes have remained intact. Our econometric

computations suggest, by and large, that the money demand function has remained stable—a finding which has just been impressively confirmed by the Bank for International Settlements (BIS) in its latest annual report. The forecast values obtained with econometric estimations diverge sharply from the actual values in only a few quarters—a result that came as a surprise to many observers, including the BIS.

The reason for the stability of the money demand function in Germany is the great continuity of the institutional framework, compared with that in other countries. The financial markets were almost completely liberalized—both externally and internally—at an early date, namely in the late 1950s and early 1960s. Interest rate formation was left to the markets, without the government or central bank having any possibility of intervening directly. There were no quantitative controls on lending. The universal banking system ensured that a wide range of competitive products was available. Financial innovations tended to evolve naturally, rather than in abrupt surges, even if this also owed something to a certain innate conservatism of the banks and their customers. The lasting availability of a relatively stable currency was of particular significance in this connection. At all events, innovative hedging strategies, with all their adverse effects on the stability of macroeconomic structural relationships, could largely be dispensed with. Despite occasional—and in part still persisting–disturbances, there was, all in all, no reason to depart from the strategy of monetary targeting, with annual targets announced in advance, which in German eyes has stood the test of time.

Friedman makes a clear-cut distinction between intermediate targets and information variables. In intellectual terms it is no doubt important to distinguish these two concepts. In the day-to-day implementation of monetary policy, however, the dividing lines are blurred. Friedman explicitly draws attention to the temporal aspect of the reviewing of monetary targets. The shorter the review period is, the more the intermediate target and the information variable tend to coincide. Quite apart from this, in practice the monetary policy approach is not simply a matter of "rules *versus* discretion," but rather a matter of the meaningful linking of rules *and* discretion. To this extent, I think that Friedman's definition of the intermediate target is too strict. No central bank has ever and will ever interpret an interme-

diate target so stringently that monetary policy is therefore pursued "as if its objective were not to influence nonfinancial economic activity but to achieve a designated rate of monetary growth." Failures to meet intermediate targets do not normally lead to "automatic responses" in Friedman's sense. Even if a monetary target is set, monetary policy is not a mechanical deployment of technical instruments, but remains a political operation with the inclusion of all the available information. "Judgment" will never be superseded by mechanical rules.

In the very derivation of the intermediate target, there is considerable discretionary latitude. For instance, the starting point of monetary policy must be analyzed carefully before a monetary target is set. One of the key questions involved is whether, if the final target is missed, abrupt, shock-like adjustments are to be made or, rather, gradual adjustments. Moreover, the level of the envisaged monetary target depends on the responses to supply-side shocks and the estimation of money demand. The parameters of the econometric models merely offer initial indications of that. Any remaining uncertainties can likewise be countered by means of a target corridor. Ultimately, the intermediate target also owes a great deal to political decisions, which, however, must be subjected to economic consistency tests.

Whereas, strictly speaking, intermediate targets are nothing but statements of intent on the part of central banks, the deployment of the monetary policy instruments constitutes definite action in the central bank's field of operations proper, namely the money market. The money stock—irrespective of its definition--cannot be regulated directly. Instead, the central bank must gauge conditions in the money market in such a way that the target can actually be attained. Hard and fast rules cannot be laid down for this; indeed, I think there is no alternative to a process of trial and error. The instruments of interest rate and liquidity policy must continually be coordinated with one another. Exogenous influences on money market rates must be recognized as such and counteracted, where necessary. Furthermore, the short-term operational targets constantly have to be reviewed to ensure that they are still consistent with the intermediate target (and the final target).

Monetary policy calls for incessant observation of the market in three respects. First, it cannot disregard macroeconomic developments. The Bundesbank, too, constantly analyzes all relevant economic indicators in order to be informed about the current state of the economy. Second, the future disruption potential that might arise in the domestic financial markets as a result of innovations and structural changes has to be estimated. Third, external economic trends have to be monitored carefully—in particular, from the German standpoint, exchange rate movements in the European Monetary System and vis-à-vis the U.S. dollar.

In such a comprehensive information system, although the central bank looks "at everything," it does not attach equal importance to all data. In the German case, it is the monetary indicators which merit particular attention. The Bundesbank's monetary target is a reflection of the historical experience that inflationary processes are always accompanied by an expansion of the money stock. However, this does not imply a reduction of monetary policy to monocausal analysis or inflexible operating instructions. The Bundesbank has always permitted shorter-term deviations from the target path of monetary growth and, in particular, has responded flexibly to changes in macroeconomic conditions. This is reflected, for instance, in the fact that a downturn in interest rates was initiated as early as autumn 1992, even though there were already signs of the monetary target being overshot. The Bank acted in this way in anticipation of envisaged trends, that is to say, of a future slowdown in the pace of monetary growth on account of the sluggishness of business activity, and of an easing of inflationary pressures due to the appreciation of the deutsche mark.

But flexibility and pragmatism need to be oriented toward suitable "guidelines." Central banks have no particular advantage with respect to the information on the transmission mechanism and on the structure of the economic and financial system. In practice, their actions, too, are marked by uncertainty and an incomplete information base––despite all their sophisticated methods of analysis. In particular, distinguishing between ephemeral and permanent shocks is not possible until a fairly long period has elapsed; when such shocks occur, it is not usually possible to recognize their nature. A hyperactive monetary policy that tried to head for the final target directly by means of

feedback rules would be bound to come up against barriers quickly, especially since the final target is affected by numerous influences which are outside the reach of central banks. Additional difficulties might arise in the event of disagreements about,the final target to be pursued. Friedman refrains from giving a clear definition of this target in his paper; he juxtaposes, with equal priority, "income" and "prices." But if the indicators that are to be analyzed are chosen unduly pragmatically, there is a risk that, where monetary policy is concerned, factors of demand management will push their way into the foreground relative to the goal of price stability. A published intermediate target would make it clear which final target the central bank is in fact pursuing.

Information variables need supplementing by normative ideas on certain indicators which are regarded as particularly important for the transmission mechanism. Failing this, there would be a danger—particularly in a volatile political environment—f monetary policy becoming disoriented and ultimately reinforcing the fluctuations of economic activity by means of a stop-and-go policy, rather than exercising a stabilizing influence. This is the underlying rationale of formalized intermediate targets. They are intended to make the central bank's actions transparent by making manifest the intermediate stops on the road from the deployment of the instruments to the final target. In addition, they enable responsibilities to be assigned unambiguously in the field of stabilization policy. Even if, as Friedman sees it, monetary policy is based solely on information variables, central banks must necessarily elaborate ideas as to whether the course of the evaluated information variables is appropriate, and how to respond to undesirable movements. The road from such implicit assessments to explicit target variables announced in advance is not so very far. But that has not shed any light on the more difficult problem of what the intermediate target should look like in detail.

In view of the instability of money demand in many countries, in the indicator and intermediate target debate, attention is increasingly being focused on interest rates, the level of which should be steered by the central bank in such a way that the final target proper can be attained. While short-term interest rates are largely under the control of central banks, long-term rates, which are far more important (at

least for the German economy) mostly elude central bank control. Fluctuations in economic activity, public sector budget deficits, inflation expectations or interdependent global interest rates are superimposed upon, and sometimes counteract, monetary policy effects. Hence interest rate changes may give rise to wrong signals. For instance, an increase in long-term interest rates owing to higher inflation expectations can hardly be seen as a tightening of monetary policy. As it is not possible here to separate the endogenous factors of the economic process from the exogenous factors of monetary policy, the level of interest rates or the change in that level would seem to be unsuitable for use as a monetary policy indicator and thus likewise as an intermediate target.

In order to circumvent these difficulties, greater attention has been paid of late (in Germany as well) to the interest rate pattern. It is a fact that the "spread" between short-term and long-term interest rates provides a comparatively good forecast quality of economic activity. Even so, the Bundesbank has not taken up the idea of using the yield curve as the main indicator of monetary policy. First, the measurement of the interest rate pattern is not unambiguous. In Germany the interest rate pattern for a long time looked quite different, depending on whether one used the rate for three-month funds in the money market or the yield on federal bonds with a residual maturity of one year **as** the reference rate for short-term interest rates. In the first case, the interest rate pattern in mid-1993 was slightly inverse; in the second, it was ascending normally. Second, the interest rate pattern should not be considered independently of the interest rate level. For instance, if short-term interest rates are deliberately left unchanged in the light of monetary policy requirements, long-term interest rates may fall because of heavy inflows of capital from abroad—a situation with which Germany has been faced at times, particularly in the past few years. The associated broadening of a negative "spread cannot be regarded as a tightening of monetary policy; if anything, the decline in long-term interest rates signals an easing, which is tolerated by monetary policy. Third, inflation expectations, particularly if they fluctuate markedly, may distort the indicator quality of the interest rate pattern. Even so, the Bundesbank has always analyzed the interest rate pattern carefully and commented on it in its publications. Thus, "the slope of the yield curve" serves as an information variable in

Friedman's sense. However, the interest rate pattern does not appear—in Friedman's view, too—to be suitable for use as an intermediate target and key monetary policy indicator, even if its information content is quite substantial.

I see greater difficulties with regard to the informative value of the "spread" between the interest rates for Treasury bills and those for commercial paper (which is likewise mentioned by Friedman). In German eyes, at least a number of question marks are called for here.

—The impact of monetary policy on the paper-bill spread is but relatively small. Hence this interest rate differential is of only limited value as an indicator for monetary policy.

—The paper-bill spread is ultimately a matter of harnessing a further source of information for monetary policy. To the extent that this was merely a matter of adding an additional indicator to the already well-stocked arsenal of central bank analytic instruments, nobody could object to that. But if a particularly prominent role in monetary policy is envisaged for the new indicator, the question arises of how a central bank is to respond to an increase in the spread and a consequent deterioration in the economic outlook. Is it to lower interest rates in order to stabilize real output, irrespective of the movement of prices (about which the spread admittedly says nothing)? And what role does the spread play in the stabilization of prices? Conversely, in the event of a narrowing of the spread and consequently an expected improvement in business activity, are central bank rates to be raised? Is it possible to use the spread at all as a basis for such rules of conduct?

—If too much emphasis is placed on the spread, the central bank runs the risk of becoming a prisoner of the markets and their sharply fluctuating expectations. The central bank would presumably move away from an orientation toward medium-term stabilization to one toward the short-run fine-tuning of economic activity. It would thus be assuming a responsibility which—given its present range of instruments—it is not equipped to bear.

Furthermore, the paper-bill spread is based on specific financial prerequisites which are not satisfied in all countries. In Germany, for instance, the public sector does not issue any short-term paper at all to finance its budget deficits; it confines itself to issuing medium- and long-term securities. It is only in the very recent past that commercial paper has become more widespread; currently the market is not particularly liquid, and there are comparatively few market players. If a paper-bill spread could be calculated at all, given the underlying scale of operations, it would be fairly insignificant.

This goes to show yet again that monetary policy, and the strategies underlying it, must not be considered in isolation from the institutional framework in which it is embedded. The implementation of monetary policy in every country is based on a particular financial system and particular modes of conduct on the part of banks and nonbanks. In the debate on the instruments and targets of monetary policy, the varying experiences of individual countries therefore inevitably result in different answers, although this does not rule out the possibility and desirability of national central banks learning from comprehensive exchanges of views on their respective problems, and on recent academic approaches to their solution.