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Comment on ON CONSEQUENCES AND CRITICISMS OF MONETARY TARGETING, OR *MONETARY TARGETING: DEAD AT LAST?*

by James Tobin

This is the nth conference session on this topic, and my mth appearance as the obligatory nonmonetarest participant. Both n and m are large numbers, m fortunately a bit the smaller. I cannot control n, but I think m has reached its bound.

Macroeconomic-Performance-Oriented Monetary Policy?

In October 1979 and February 1980 our Federal Reserve announced two monetarist decisions. The first concerned its operating procedures between meetings of the Open Market Committee. The desk would target bank reserves instead of federal funds rates; these reserve targets would be chosen to be consistent with the desired paths of the aggregates. The other concerned its targets for intermediate monetary aggregates: the Fed intended to lower their growth rates steadily year after year until they would no longer accommodate inflation This intention was stated unconditionally; it was to be carried out regardless of the state of the real economy.

In August–October 1982 the same Fed, under the same chairman, abandoned the second of these two decisions, while sticking to its quantitative operating procedures. The aggregate targets were suspended and vastly exceeded, and then in 1983 new targets were announced for growth from the higher bases—"bygones are bygones" is the first principle of economics. Over the sixteen months of recovery that followed the Fed's policy reversal, I think it is safe to say, its operations have been oriented to macroeconomic performance, with the aggregates in a subordinate role.

By policy oriented to macroeconomic performance I mean that the Fed has had in mind a desired track, or range of tracks, of real GNP, unemployment, and prices, and has sought by its sequence of operating targets for nonborrowed reserves to keep

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JAMES TOBIN *is professor of economics, Yale University.*

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the economy on track. This has meant tightening reserve supplies when recovery seemed overexuberant and easing them when it appeared to be stalling.

The goal apparently is a "soft landing" at the natural rate of unemployment. Of course the Fed cannot be sure what that rate is nowadays, but as long as money wages and prices are well behaved and few bottlenecks are evident the Fed seems willing to assume there is some distance yet to go. Prudence, of course, leads the FOMC to diminish the speed of approach as the vehicle it is piloting gets closer to the landing. One might even say that the Fed has been fine-tuning. While critics might complain about the magnitude or timing of this or that move, overall the policy has been a great success.

That is the reason for suspecting that mechanical monetarism is dying in the United States, supplanted by a policy that gears open market operations directly to macroeconomic performance, with little emphasis on intermediate guidance from monetary aggregates. I realize that one cannot be sure, because after the spectacular initial departure of 1982–83 the dictates of macro performance have never placed the aggregates outside their target ranges in any significant way. Perhaps some new big velocity shock will force the Fed to make a visible choice again, as in 1982, between intermediate targets and macroeconomic goals (This happened in the first half of 1985, and once again the Fed chose macro performance over M1 targets.)

We all know the reasons and the rationales for the 1982 decisions. Because of a big negative velocity shock in 1982, adherence to the monetary targets was producing a lot less nominal GNP than expected or intended. The consequences for the real economics of the United States and the rest of the world were scary. So were the prospects of financial disasters, overseas and at home. That financial and institutional innovation and deregulation were altering in uncertain ways and degrees the meanings — read velocities — of the monetary aggregates was both a valid consideration and a useful rationale.

I doubt that the Fed ever felt itself fully committed to a deliberately blindfold "credible threat" strategy as advocated by Willy Fellner here at AEI or as declared and practiced by Mrs. Thatcher. In any case the Fed, to almost everyone's great relief, adapted to the war on inflation the advice of that wise Vermonter, Senator George Aiken, on the Vietnam war — declare victory and get out. To be sure, the Fed was closer to victory in its crusade than the Pentagon had ever been in southeast Asia

That Paul Volcker and his colleagues had earned in the financial markets and elsewhere a reputation as inflation fighters made it possible for them to reverse course without provoking adverse expectations. Not all of their predecessors could have pulled it off. The lesson I draw is that the central bank can discharge its responsibility for providing a nominal anchor for the economy, and carry conviction that it is doing so, without tying its hands by mechanical rules and without giving up countercyclical monetary management.

Targeting Nominal Income

When we get to the bottom line in Bennett McCallum's paper we find that he does not favor a return to the primacy of intermediate monetary aggregates He recognizes

the problem of velocity volatility and uncertainty, and he is willing to let the obligatory nominal anchor take the form of nominal GNP targets, or "velocity-corrected aggregates." I gather also that he does not mean to fix forever the numerical target growth of dollar GNP. Rather, this number could be set in the short run by reference to the cyclical state of the economy and adjusted in the long run to changes in the trend of potential output. Let us rejoice that views are converging.

The main problem with targeting nominal income, or nominal anything, comes from supply-related price shocks. The oil shocks of unhappy memory are the most dramatic example. A contemporary possibility is a rise in dollar prices of internationally traded goods because of a speculative collapse in the foreign exchange value of the dollar. Internal cost-pushes have occurred in the past, as in 1970–71, and can recur. How much, if any, of such stagflationary shocks should the central bank accommodate? What can and should the central bank say in advance about what it will do in these contingencies?

Sticking to a nominal income target is a tough line, requiring sacrifice of 1 percent of real GNP for every 1 percent of unexpected price increase during a year. Robert Hall, in the article cited by McCallum, argues for a much lower sacrifice ratio and a stretchout of the time allowed for erasing a price bulge. The acceptable degree of accommodation depends on the secondary wage and price effects of the initial shock. A one-shot price increase can be accommodated; a stubborn attempt to raise nominal wages and prices to sustain infeasible real wages and markups cannot be. The Fed may be able to judge the probabilities at the time, while finding it almost impossible to cover all contingencies in an advance Arrow-Debreu contract. This is one substantial reason for the Fed's reluctance to tie its own hands as much as "rules" advocates like McCallum wish.

Another, and less creditable, reason is that the central bank does not want to be held responsible for any outcomes really important to the Congress and the public. A great virtue of intermediate aggregate targeting is, from this standpoint, that it enables the Fed to shed visible responsibility for interest rates, unemployment, prices, and other sensitive matters. If its targets are important, it is true, the Fed will be criticized for missing them, and the reasons will be hard to explain even when they were circumstances beyond the Fed's control. But making life easy for central bankers is not a high national priority.

What would be ideal is that the Fed be a party to, and then at least loosely committed to, the economic projections underlying the annual budget adopted by the Congress. Then there would be some coordination of monetary and fiscal policy, and the budget and economic documents of administration and Congress would not refer to monetary policies and events as if they were controlled exogenously by a foreign power with whom the United States has polite but cool diplomatic relations.

The Controllability of M1

In view of the final three sections of McCallum's paper, which cast doubt on the usefulness of intermediate targets, it is hard to get excited about the first four sections, which argue that it is feasible to control M1 without excessive interest rate volatility.

Inspection of Table 1.10, the first one in the statistical section of any *Federal Reserve Bulletin,* discloses large discrepancies among rates of growth of base and reserve aggregates and intermediate aggregates, month to month and quarter to quarter. Likewise there are big differences between net changes in the Open Market Account and changes in the nonborrowed base and nonborrowed reserves. Let us remind ourselves of the many slips between cup and lip, that is between the Fed's instruments and M1 — there are many more en route to the broader targeted aggregates. Slippages include: the sources of reserve funds other than Federal Reserve credit; the uses of reserve funds other than the monetary base; the division of the base and of M1 between currency (100 percent reserve requirement) and deposits (now generally 12 percent); borrowing from the Fed, regular, seasonal, and "extended"; items in M1 not subject to reserve requirements and deposits not in M1 but subject to reserve requirements, stochastic variations in public demand for M1 and in institutions' demands for net free reserves; finally, the fact that within-year targets are seasonally adjusted whereas operations necessarily take place in unadjusted dollars. McCallum concerns himself with some of these slippages but by no means all.

A number of recent legislative and administrative changes have been designed to make M1 more controllable. M1 itself has been defined to conform to a concept of assets immediately available for making payments Reserve requirements are being confined to such "transactions" deposits; they apply at virtually uniform rates to all depository institutions; they have been made almost contemporaneous. As interest on deposits is deregulated, the sensitivity of demand for deposits to the *level* of market interest rates is greatly diminished. Further planks in the monetarist reform platform may come: indexing the discount rate to market rates and paying a similarly indexed rate on reserve balances.

In the past administered settings of these rates somewhat diluted the effects of open market operations on total reserves and deposits, while providing partial automatic accommodation of shocks in public demand for money or banks' demand for net free reserves. Flexibility in these interest rates removes these "escapes." On the other hand, such accommodation may have been optimal on grounds familiar to all readers of Bill Poole's classic article. If that degree of accommodation no longer occurs automatically, the Fed should build it into its operating procedures. Indeed the very "reforms" that have tightened the monetarist grip may well have increased the likeihood of financial shocks, which Poole told us should be accommodated, relative to real demand shocks, which should not be.

Both monetary quantities and nominal interest rates are ambiguous signals. In pursuing a strategy oriented to macroeconomic performance, the Fed should be looking for less ambiguous early warnings of departures from the desired tracks. Those indicators could be nonfinancial. It is information that is needed, whether the series has anything to do with "money" or not.

It is ironic that the system should be tailored for M1 control just when the point of targeting M1 is widely and seriously doubted, for reasons McCallum himself

gives in sections 5 and 6. But the idea that the economy could be controlled via the supply of designated transactions media never was a winner, given the variety and quantity of actual and potential close substitutes. I hope, I even believe, we are well on the way to an affirmative answer to the question in my subtitle.

Discussion of On Consequences and Criticisms of Monetary Targeting

Gordon questioned whether the attention to monthly variations in money supply in McCallum's paper is justified if the effect on GNP depends on averages of money over several months or more. McCallum replied that the monthly variations are serially correlated and therefore are relevant for the longer-run movements as his Table 2 indicated. Tobin saw a disadvantage in tight short-run control of money because it would increase the undesirable effects of shocks To counteract shocks Axilrod recommended a nonborrowed reserves targeting procedure as allowing more stability of financial markets as compared with a total reserves procedure.

In his paper, McCallum recommended a single nominal target to avoid the mistakes of mixing nominal and real targets, and thought GNP would be best. To Axilrod's comment that policy does not directly control GNP, McCallum replied that a recent Federal Reserve Board study by Peter Tinsley suggests that unexpected components of output and inflation would be smaller with a GNP than with a monetary target. Poole in his comments on McCallum questioned the use of GNP as a target because velocity movements are generally not known ahead of time and the GNP data are subject to revision at later dates. Gordon argued that velocity movements are serially correlated, however, giving policy a chance to adjust to them while they are occurring, and GNP data revisions are of no importance because policy should focus on forecasts of the future path of GNP.

Cagan thought that, even with a GNP target, monetary targeting was still required as a means of achieving the desired GNP path and of lessening the uncertainty of policy, given the lag in monetary effects. He was concerned that ongoing financial developments be constrained to avoid their diminishing the advantages of monetary targeting.

Several participants spoke against the use of discretion in monetary policy. Goodfriend and Olsen said that, while in recent years some policy actions were appropriate responses to economic changes, these changes were themselves partly the result of previous policy swings; the overall result would have been better had policy followed a smoother path of monetary growth. Keran pointed to the Fed's emphasis on interest rates in conducting policy as a source of instability; yet, despite the same

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flawed operating procedure, it has not led to as adverse economic results in recent years as in the 1970s. The reason is that now the Fed corrects its easy money errors relatively quickly, as soon as GNP becomes unexpectedly high. In the 1970s it corrected its errors only with a long lag when the inflation rate became unacceptably high. McCulloch noted that the monetary volatility since 1980 cited by Poole is dominated by one episode that is often blamed on the credit controls of 1980. He wondered how, and even whether, these controls caused this episode.

Barro said a monetary rule might well be changed when justified by forecasts of economic developments, but the benefits of a rule are compromised if it is changed whenever unexpected developments can be exploited for a temporary economic improvement.