Political Guidance on Monetary Policy

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This paper focuses on a narrow but important topic: the nature of political guidance to the Federal Reserve on monetary policy. The Constitution authorizes Congress "to coin Money [and] regulate the Value thereof." As a rule, however, Congress has delegated this authority to the Federal Reserve, either without guidance or, more recently, with sufficiently confused, redundant, or contradictory guidance to permit the Fed to chart its own course. We could do worse. The performance of the Federal Reserve has usually been better than that of most other central banks.

I believe we can also do better—much better—and will summarize a proposal for a new monetary rule along with a process for approving, implementing, and monitoring this rule.

Selecting a Monetary Policy Rule

First, I shall focus on the choice of a monetary rule. There are only three viable monetary rules. One is to maintain a path of the price of some specific commodity such as gold or some broader price index. Second is to maintain a path of some monetary aggregate such as the monetary base or M2. And third is to maintain a path of some measure of total demand in the economy such as nominal GNP or domestic final sales.

Any one of these rules would be better than guidance based on interest rates or exchange rates, or on any real variable such as the growth of output or the level of the unemployment rate. Some comments are in order, however, concerning the reasons for choosing one or the other of these three rules.

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A Price Rule

Wayne Angell and others have performed a valuable service by reviving the case for a price rule that is based on gold or some broader commodity index. The primary problem with a price rule is that the price of commodities depends on both demand and supply conditions, and a price rule can lead to considerable instability in other markets. The long experience with the several types of gold standards, for example, included several short periods of inflation caused by major gold discoveries, long periods of deflation, frequent recessions, and the Great Depression. The primary value of the gold standard was to prevent cumulative inflation over a much longer period of time. As best we can measure, for example, the U.S. price level in 1939 was about the same as in 1789. A price rule based on a broader set of commodities, however, would have the same general types of problems, although the variability of conditions in other markets would probably be smaller than one based on a commodity such as gold. In the modern world, for example, a price rule would require the Fed to deflate the general economy in response to an oil shock. I believe that we can do much better than that.

A Monetary Aggregate Rule

For about 20 years, most monetary economists promoted a rule to stabilize the path of some monetary aggregate such as M2. The case for this rule was based on a belief that there was a roughly stable relation between the level of the money supply, however measured, and the level of some measure of total demand in the economy. In other words, the objective of the monetarists was to stabilize the path of total demand, and they believed that a stable path of some measure of the money supply would best serve this objective. In response to this advice, the Fed has set targets for several monetary aggregates since 1970, and Congress has reviewed and approved these targets since 1975.

For most of the postwar years through 1981, the relation between total demand and money appeared to be roughly stable. There was a reasonable case that the increasing inflation and occasional recessions were primarily due to the Fed's failure—with rare exception—to stay within the approved target ranges for the money supply.

Since the end of 1981, however, the relation between total demand in the United States and each of the monetary aggregates has changed sharply. Specifically, total demand has continuously declined relative to the level of the money supply. The reasons for this continued decline in the velocity of money are not too clear, but it was probably due to the effect of the decline in market interest rates, the increase

in interest rates on bank deposits permitted by deregulation, and, I think importantly, the substantial increase in the value of other financial assets.

Moreover, the accumulating econometric evidence indicates that the relationship between *changes* in total demand and *changes* in the money supply is roughly stable, but the relationship between the *levels* of these conditions is not stable. In technical terms, this relationship appears to be difference-stable but not trend-stable.[1] The most important implication of these findings is that a stable growth of the money supply will not lead to a stable growth of total demand. For this reason, the primary policy rule promoted by what I call the "high church monetarists" does not appear to be the best rule.

A Target Path of Total Demand

Another alternative is for Congress to approve a target path of total demand in the American economy.[2] This is best measured, I suggest, by what the Department of Commerce defines as "final sales to domestic purchasers." It would also be valuable to exclude purchases by the Federal Commodity Credit Corporation from this aggregate. These purchases, although they are measured as final sales, are actually increases in government inventories of farm products and are unusually volatile. The primary reason for selecting this variable rather than nominal GNP is that the demand for money in the United States appears more closely related to total purchases by Americans than to the dollar level of total output by Americans.

It is important to recognize that a demand rule is consistent with any desired price-level path, including a stable price level. (For this paper, I will avoid the issues that bear on the choice of the desired price-level path.) My primary point is that a demand rule is superior to a price rule, whatever is the desired price-level path, because of the different response to changes in supply conditions. A central bank following a demand rule would not respond to either positive or negative supply shocks; such shocks would lead to a one-time change in the combination of price and output changes in that year but would not lead to a long-term change in the inflation rate. A central bank following a price rule, however, would increase the monetary base in response to a positive supply shock and would tighten the base in response to a negative shock, thereby increasing

[1]This characteristic of the velocity of money was first identified by Gould and Nelson (1974), who used annual data, and confirmed by Haraf (1986), who used quarterly data.
[2]The case for a demand rule was first made in the early 1980s by Hall (1981), McCallum (1984), and Gordon (1985).

the variance of output. Both rules are consistent with any desired price-level path. The primary case for a demand rule is that it reduces the variance of output.

In summary, a demand rule is superior to a price rule because it does not lead to adverse monetary policy in response to unexpected—either favorable or unfavorable—changes in supply conditions. Similarly, a demand rule is superior to a money rule because it accommodates unexpected changes in the demand for money. For these reasons, I suggest that implementation of a demand rule is the most appropriate next step for U.S. monetary policy.

Establishing and Monitoring a Demand Rule

How might a demand rule be approved, implemented, and monitored? The beginning of this process would be much like the current process. In February of each year, the administration would propose a target path of nominal domestic final sales for a several-year period as part of its projections in the budget and in the economic report. This proposed target path would reflect the combined effect of the administration's forecast of real final sales plus a recommended price-level path, reflecting how fast the administration proposes to reduce inflation. The Joint Economic Committee (JEC) would then review the proposed target path, in addition to those targets that may be proposed by the Fed, the Congressional Budget Office, and private economists. There need be no review or approval of the target ranges for any of the monetary aggregates, as is currently the case. This procedure would focus the attention of Congress on a value issue (the desired price path), not on the technical issues affecting the choice of the path of some monetary aggregate.

At this stage some change in procedure may be desirable. My preference would be to have the JEC approve a bill that would formally instruct the Fed to follow a specific target path of nominal domestic final sales, a bill that would then have to be approved by both houses of Congress and the president. Some formal legislative authority by the JEC, I believe, would also contribute to reviving this once important committee. My only reservation about this process is that Congress, as a body, has usually had an inflationary bias. But the central role of the JEC and a potential presidential veto, I think, probably should be enough to discipline this bias.

Once the target path for final sales is selected, the Fed would set an instrumental target for the monetary base, which is the sum of currency plus bank reserves, to implement the approved target path of nominal domestic final sales. This instrumental target would be

selected based on the historical relation between the change in nominal final sales, which is what Congress has approved, and the change in the monetary base, which is what the Fed can control.

At this stage, there may be some opportunity to use current data from forward-looking auction markets, such as the several first suggested by Manuel Johnson (1988), to determine whether there is a likely change in the relation between changes in final demand and the monetary base. I am intrigued by this suggestion, but I am not yet convinced that one can improve on the type of adaptive rule suggested by Bennett McCallum (1984) that is based on the historical data on demand and the base, even though both series are subject to frequent revision. In any case, it is important to use data on commodity prices, interest rates, and exchange rates only as clues to setting the base target, rather than the current and quite dangerous practice of using the federal funds rate as an instrumental target.

There is no reason for an external review of this instrumental target for the monetary base. Most importantly, as often as once a quarter, the Fed would compare the actual final sales in the previous quarter with the approved target and would then change the target for the monetary base for the current quarter in order to return to the approved target path. This process, over time, should be designed to minimize the variance of actual final sales relative to the approved target, even though the process may increase the variance of changes in the monetary base. Over time, the path of nominal GNP will roughly track the path of nominal domestic final sales but with a somewhat higher variance due to changes in inventory accumulation and exports that are less affected by U.S. monetary policy. This process would not lead to a stability of all macro conditions, but minimizing the variance around an approved target path of nominal domestic final sales is probably the most that can be expected of monetary policy.

The third step in this process would be for the administration and Congress to monitor the Fed's performance, maybe as often as once a quarter. This review should focus on the reasons why actual final sales may have differed from the target path in the previous quarter. An increasing difference between the actual and the target final sales over a period as long as two quarters should automatically trigger such a review. There is ample reason to criticize the Fed for an accumulating difference between the actual final sales path and the approved target path. But as long as the Fed maintains a roughly stable level of final sales relative to this path, both the administration and Congress should refrain from criticizing the Fed because of a concern about a wide range of other conditions.

Conclusion

In summary, we now expect the Fed to do too much. As a consequence, the Fed does not perform its most important function very well. At various times, our political system pressures the Fed to sustain the recovery, to reduce inflation, to reduce interest rates, to reduce the unemployment rate, to strengthen or weaken the dollar, to finance the government debt, or whatever.

One of the most important lessons of political economy is that a government must have at least as many policy instruments as it has goals. The Fed has only one policy instrument, specifically the level of the monetary base. It is important to focus this instrument on the single, most-important, achievable goal of monetary policy. That goal, I suggest, is a stable path of nominal domestic final sales. At the same time, it is important to recognize that we need to put our fiscal and regulatory house in order if we are to achieve our other economic goals.

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