Monetary Policy Is Still Too Tight

President Bush faces the prospect of a jobless recovery during the 2004 election year, the same condition that contributed to his father's defeat in 1992. Whatever one's views on the reelection of George W. Bush, a jobless recovery is not a condition to be welcomed. So some policy should be changed, both to sustain the recovery of total output and to initiate a recovery of total employment. An increase in money growth is the only policy that would achieve both of those objectives, and that should be the primary focus of the meeting of the Open Market Committee of the Federal Reserve System in September. For total demand has been growing at too low a rate to increase employment.

Let's review the arithmetic: During the seven quarters of the current economic recovery to date, total nominal demand (final sales to domestic purchasers) has increased at only a 4.5 percent annual rate. Given an inflation rate of 1.2 percent during this period, the demand for goods and services has increased at only a 3.3 percent annual rate. During this period , however, nonfarm business sector productivity has increased at an unusually high 4.5 percent annual rate. Those conditions, by themselves, suggest that the demand for labor during this period declined at a 1.2 percent annual rate. In fact, total nonagricultural employment during this period declined at a 0.8 percent annual rate, the difference due to a small decline in average weekly hours. All of the output growth during the current recovery has been due to increased productivity, with no increase in output due to an increase in employment.

"I suggest that the Fed replace the federal funds rate with some measure of the money supply as its primary policy instrument."

Switching to unconventional monetary policy targets and instruments may be necessary to avoid the continuation of a jobless recovery. First, may I suggest that the Fed replace its inflation rate target with a demand level target. The case for this change should be understood. An inflation target requires tighter money in response to an adverse supply shock and increased money growth in response to a favorable supply shock, increasing the variance of real economic conditions. A demand level target, in contrast, absorbs a supply shock by a temporary change in the inflation rate. Given a 4.5 productivity growth rate, aggregate demand must increase at a 5.5 percent annual rate, the same trend in the demand level that the Fed maintained with very little variance for six years prior to the bubble, just to maintain the *current* level of employment. If, as expected, the productivity growth rate falls to a 2.5–3.0 percent range, a 5.5 percent annual increase in demand would be sufficient to absorb the annual increase in the labor force without an increase in inflation.

Second, may I suggest that the Fed replace the federal funds rate with some measure of the money supply as its primary policy instrument. After a 550 basis point reduction since January 2001, the federal funds rate is now only 1 percent; this has led to some unfounded speculation that the U.S. economy is now in "a liquidity trap," that the Fed has lost any potential to increase demand. This is misleading; the Fed can always buy longer-term government securities. The main point, however, is to increase the money supply enough to achieve the demand level target on a sustainable basis, whatever the maturity of the government bonds that it chooses to buy. The objective, again, is to stabilize the path of aggregate demand, not to stabilize inflation, interest rates, or the rate of money growth.

And third, these major changes in monetary policy targets and instruments should be made as soon a possible, preferably at the September meeting of the Open Market Committee. The important issue at stake is whether the United States will avoid the policy mistakes that led Japan into a stagnation that has now lasted more than a decade.

A wise but cynical economist at the American Enterprise Institute recently observed, "Central bankers have an exasperating habit of abandoning the right policy course, but only after careful consideration." I am more optimistic about the Federal Reserve, which often adopts the right policy course but only after convincing themselves that they discovered it without any outside help. So be it. More is at stake in this issue than any one economist's professional pride.

—William A. Niskanen

Join Cato in New York

November 7, 2003

For a seminar featuring Nadine Strossen, president of the ACLU, and Anne Applebaum, author of *Gulag: A History*

www.cato.org