24. The Limits of Monetary Policy

Congress should

- uphold its constitutional duty to maintain the purchasing power of the dollar by enacting legislation that makes *long-run* price stability the primary objective of Federal Reserve monetary policy;
- recognize that the Fed cannot fine-tune the real economy but can achieve monetary stability by following a rule that confines nominal growth of gross domestic product to a noninflationary path;
- hold the Fed accountable for achieving zero expected inflation over a reasonable time frame;
- abolish the Exchange Stabilization Fund, since the Fed's role is to achieve zero inflation, not to stabilize the foreign exchange value of the dollar by intervening in the foreign exchange market; and
- offer no resistance to the emergence of digital currency and other substitutes for Federal Reserve notes, so that free-market forces can help shape the future of monetary institutions.

History has shown that monetary stability—money growth consistent with a stable and predictable value of money—is an important determinant of economic stability. Safeguarding the long-run purchasing power of money is also essential for the future of private property and a free society. In the United States, persistent inflation has eroded the value of money and distorted relative prices, making production and investment decisions more uncertain. In the early 1970s, wage-price controls were imposed that attenuated economic freedom and increased government discretion, thus undermining the rule of law. Although those controls have been removed and inflation appears to be under control, there is no guarantee of future price-level stability.

Current law specifies no single objective for monetary policy and lacks an enforcement mechanism to achieve monetary stability. The multiplicity of goals and the absence of an appropriate penalty-reward structure to maintain stable money is evident from section 2A of the amended Federal Reserve Act:

> The Board of Governors . . . and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates. . . . Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved.

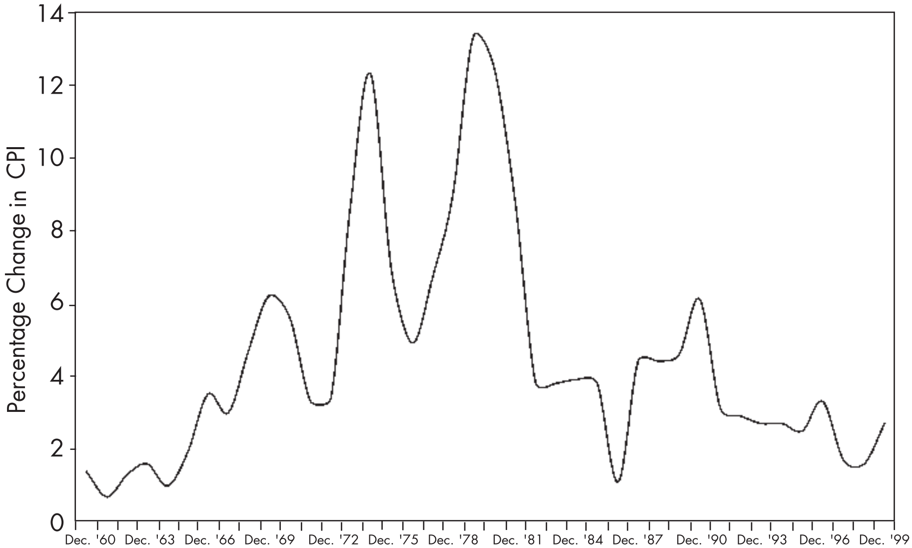
Since 1975, the Federal Reserve has reported its monetary targets to Congress, but basic monetary arrangements have remained unchanged. Although Fed chairman Alan Greenspan has done a commendable job of keeping inflation relatively low since he took office in 1987, his performance is no guarantee of future success in achieving money of stable value.

The U.S. monetary system continues to be based on discretionary government fiat money, with no legally enforceable commitment to long-run price stability as the sole objective of monetary policy. Clark Warburton's 1946 characterization of U.S. monetary law as "ambiguous and chaotic" still rings true.

The large amount of discretion exercised by the Fed and the uncertainty it entails reflect Congress's failure to provide an adequate legal framework for stable money, as intended in Article I, section 8, of the Constitution. It is true that inflation has been reduced significantly from the double-digit rates of the late 1970s to about 3 percent today, but zero expected inflation should be the norm. Greenspan's performance has been good, but not good enough. Since 1987, inflation, as measured by the percentage change in the consumer price index (CPI), has fallen below 2 percent only briefly in 1997–98 (Figure 24.1). And in 1998–99, nominal income growth shot upward, a warning sign of excessive money growth, which the Fed will have to reverse to avoid future inflation.

Chairman Greenspan may engineer a "soft landing," but, if the Fed were subject to a monetary rule, stop-go monetary policy—an extremely important factor in generating business fluctuations—could be avoided. There is a growing consensus among economists and Fed officials that long-run price stability should be the focus of monetary policy, but Con-

Figure 24.1
The Chase after Long-Run Price Stability
(annual % changes in the CPI)



SOURCE: *Economic Report of the President*, February 2000.

gress has yet to enact legislation that would bind the Fed to that objective and hold the chairman accountable for erratic changes in the quantity of money and persistent rises in the price level.

In his July 2000 "Monetary Report to the Congress," Greenspan stated: "Irrespective of the complexities of economic change, our primary goal is to find those policies that best contribute to a noninflationary environment and hence to growth. The Federal Reserve, I trust, will always remain vigilant in pursuit of that goal." But will it? And should the public trust the discretionary power of an "independent" central bank not bound by any rule?

William Poole, president of the Federal Reserve Bank of St. Louis and a proponent of zero inflation, has pointed to the market disruption caused by the lack of a clear monetary rule to guide Fed policy:

> The fact that markets so often respond to comments and speeches by Fed officials indicates that the markets today are not evaluating monetary policy in the context of a well-articulated and well-understood monetary rule. The problem is a deep and difficult one.

Congress should face that problem and retain the power to regulate the value of money by mandating that maintaining price stability is the Fed's primary duty.

Mandate Price Stability as the Fed's Primary Duty

The 107th Congress should amend the Federal Reserve Act to make long-run price stability, in the sense of zero expected inflation, the sole goal of monetary policy. The Fed's function is not to set interest rates or to target the rate of unemployment or real growth. The Fed cannot control relative prices, employment, or output; it can only directly control the monetary base (currency held by the public and bank reserves) and thereby affect money growth, nominal income, and money prices. In the short run, the Fed can affect output and employment, as well as real interest rates, but it cannot do so in the long run.

Trying to exploit the short-run Phillips curve is not a viable monetary policy option, especially in the new economy. Market participants learn quickly and will revise their plans to account for the inflationary impact of faster money growth designed to reduce unemployment below its so-called natural rate. The results of those revisions—such as demanding higher money wages to compensate for expected inflation—will frustrate politicians intent on using monetary policy to stimulate the real economy.

The Fed cannot attain more than one policy target with one policy instrument. The only instrument the Fed has direct control over is the monetary base; the surest target is *long-run* price stability—that is, zero expected inflation. The Fed could use either an adaptive feedback rule, such as that proposed by Carnegie Mellon economist Bennett McCallum, or an inflation-targeting rule, such as New Zealand has successfully used, to obtain zero expected inflation. With the feedback rule, the Fed would adjust the growth of the monetary base to keep nominal GDP (or domestic final sales) on a smooth noninflationary growth path. With an inflation target, the Fed would adjust the monetary base so that the growth rate of the price level was approximately zero in the long run. There would be some rises and falls in the price level due to supply-side shocks, either positive or negative, but expected inflation would remain close to zero over time.

Congress need not dictate the exact rule for the Fed to follow in its pursuit of long-run price stability, but Congress should hold the Fed accountable for achieving that goal.

The Economic Growth and Price Stability Act of 1999 (S. 1492), sponsored in the 106th Congress by Sen. Connie Mack (R-Fla.), would make "price stability" the primary objective of monetary policy but let the Fed define that term. The proposed law still leaves too much discretion to the Fed. That problem could be resolved by defining price stability as zero expected inflation. In fact, that definition is already implicit in the act, because S. 1492 would not require the Fed to respond to supply shocks that would lead to one-time increases or decreases in the price level.

The public's trust and confidence in the future purchasing power of the dollar can be permanently increased by a legal mandate directing the Fed to adopt a monetary rule to achieve long-run price stability. According to Poole:

> The logic, and the evidence, both suggest that the appropriate goal for monetary policy should be price stability, that is, a long-run inflation rate of approximately zero. . . . A central bank's single most important job is preserving the value of the nation's money. Monetary policy has succeeded if the public can reasonably trust that a dollar will buy tomorrow what it will buy today. . . . I am confident that our economy's long-run performance would be enhanced by a monetary policy that aims at, achieves, and maintains a zero rate of inflation.

That institutional change—from a fully discretionary monetary authority to one bound by law to a single target—would not only bolster the Fed's reputation but enhance the efficiency of the price system and allow individuals to better plan for the future. People's property rights would be more secure as a result. Congress should not miss the opportunity to return to its original constitutional duty of maintaining the value of money and thus safeguarding property rights.

Recognize the Limits of Monetary Policy

Current legislation, including the Humphrey-Hawkins Act of 1978, asks too much of the Fed and of monetary policy. The Fed cannot permanently increase the rate of economic growth or permanently lower the rate of unemployment by increasing money growth, nor can it permanently lower real interest rates. But it can throw the economy off track by policy errors—that is, by creating either too much or too little money to maintain stable expectations about the long-run value of the currency. The most grievous error of discretionary monetary policy, as Milton Friedman and Anna Schwartz have shown in *A Monetary History of the United States*, was the Fed's failure to prevent the money supply from shrinking by one-third between 1929 and 1933, which turned a sharp but otherwise ordinary recession into the Great Depression.

Economics, like medicine, is not an exact science. The guiding principle of economic policy should be the great physician Galen's (A.D. 160) admonition to "first do no harm." Instead of pursuing in vain an activist monetary policy designed to fine-tune the economy and achieve all good things—full employment, economic growth, and price stability—Fed policy ought to be aimed at what it can actually achieve.

Three questions Congress must contemplate in its oversight of monetary policy are (1) What can the Fed do? (2) What can't it do? (3) What should it do?

What the Fed Can Do

The Fed can

- control the monetary base through open market operations, reserve requirements, and the discount rate;
- provide liquidity quickly to shore up public confidence in banks during a financial crisis;
- influence the level and growth rate of nominal variables, in particular, monetary aggregates, nominal income, and the price level;
- control inflation and prevent monetary instability in the long run; and
- influence expectations about future inflation and nominal interest rates.

What the Fed Cannot Do

The Fed cannot

- target real variables so as to permanently reduce the rate of unemployment or increase economic growth;
- determine real interest rates;
- peg the nominal exchange rate *and at the same time* pursue an independent monetary policy aimed at stabilizing the price level, without imposing capital controls;
- fine-tune the economy; or
- make accurate macroeconomic forecasts.

What the Fed Should Do

The Fed should

- keep the growth of nominal GDP on a stable, noninflationary path so that expected inflation is close to zero by controlling the monetary base;
- let market forces determine exchange rates so that the dollar and other key currencies are free to find their equilibrium value in the foreign exchange market; and
- avoid predicating monetary policy on stock market performance.

By recognizing the limits of monetary policy, Congress will also recognize the importance of enacting a law that establishes a clear framework for such policy. Mandating long-run price stability as the Fed's sole objective is a goal the public can understand and a target the Fed can achieve and be held accountable for.

Hold the Fed Accountable for Zero Inflation

If a law making zero expected inflation the sole aim of monetary policy is to be effective, the Fed must be held responsible for failure to meet that target. That means the law must clearly state the price-stability target while letting the Fed choose how best to achieve it.

The New Zealand inflation-targeting law is instructive. The Reserve Bank Act of 1989 states that the sole objective of monetary policy is price stability. A target range is set for inflation (0–2 percent, as measured by the CPI), which the governor of the Reserve Bank must achieve within a specified time horizon, with exceptions made for supply shocks. The governor is required to sign a contract, the Policy Targets Agreement, with the finance minister, in which the governor agrees to a target range for inflation, the terms for achieving it, and the penalty of dismissal for failing to meet the target. That arrangement has served New Zealand well in terms of achieving a low rate of inflation while letting its currency float on the foreign exchange market. Unlike countries with pegged exchange rates and no monetary rule, New Zealand sailed through the Asian financial crisis quite smoothly.

Congress should draw on the experience of New Zealand to create a credible monetary law that holds the chairman of the Fed accountable for achieving long-run price stability.

Abolish the Exchange Stabilization Fund

If the Fed is to focus solely on maintaining the purchasing power of the dollar, then it cannot also use monetary policy to peg the foreign exchange, or external, value of the dollar. The dollar must be free to float without exchange market intervention. Halting such intervention requires that Congress abolish the Exchange Stabilization Fund, which was created in 1934 by the Gold Reserve Act. The ESF has been used by the Treasury to try to "stabilize" the external value of the dollar, but without success. It has also been used to make dollar loans to support the currencies of less-developed countries. It is time to get rid of this relic of the New Deal and let markets, not the state, determine the relative price of the dollar.

Welcome the Evolution of Alternatives to Government Fiat Money

While Congress should hold the Fed responsible for maintaining the value of money, in terms of its domestic purchasing power, Congress should also welcome the emergence of alternatives to government fiat money, such as digital cash. New monetary institutions should be allowed to evolve as new technology and information become available.

The growth of electronic commerce will increase the demand for new methods of payment, methods that economize on paper currency. As consumers' trust in electronic cash grows, the demand for the Fed's base money may decrease. That may actually make it easier for a monetary rule to be implemented because the Fed need not worry about complications arising from changes in the ratio of currency to deposits, according to University of Georgia economist George Selgin. Indeed, Milton Friedman's simple rule of zero growth of the monetary base may work quite well in the information age, and it may be a step toward private competing currencies, as advocated by F. A. Hayek. Consumers would have greater monetary freedom and money with the best record of stable purchasing power as a result.

Conclusion

Monetary disturbances have been either a major cause of or a key accentuating factor in business fluctuations. Reducing uncertainty about the future path of nominal GDP and the price level would help remove erratic money as a disrupting influence in economic life. As Friedman has pointed out, one of the most important things monetary policy can do is "prevent money itself from being a major source of economic disturbance."

It is time for Congress to accept its constitutional responsibility and make the Fed accountable for long-run price stability. In testimony before the Joint Economic Committee of the U.S. Congress in March 1995, economist David Meiselman summed up the case for limiting Fed discretion and mandating a stable price level rule:

> It is . . . dangerous folly to expect or depend on the Fed to achieve what is beyond its power to attain. The best possible monetary policy cannot create jobs or production. It can only prevent the instability, the uncertainty, and the loss of employment and income resulting from poor monetary policy. In my judgment, the best possible monetary policy aims to achieve a stable and predictable price level.

Congress should now heed that advice and prevent stop-go monetary policy from ending the unprecedented U.S. economic expansion—a natural result of free markets and monetary stability. The Greenspan record can be extended by moving from discretion to a clear rule for price stability, thereby converting trust in a particular individual into confidence in a rule that will long outlast any single Fed chairman.

The major thrust of this chapter has been to call on Congress to make the Fed accountable for maintaining the long-run value of the currency. But Congress should not limit its vision to a monetary system dominated by a government-run central bank, even if that institution is limited by a monetary rule. Rather, Congress should welcome the vision of a future in which the free market plays an important role in supplying money of stable value, in competition with the Fed. The choice of monetary institutions should ultimately be a free choice, made by the market, not dictated by law.

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—Prepared by James A. Dorn