INHERENT CONFLICTS OF U.S. MONETARY POLICYMAKING

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I have come to the realization that perhaps the best contribution I can make to the debate over monetary policy is to discuss the "inherent conflicts" of monetary policymaking as it is currently conducted in the United States. I do not presume to be able to discuss all the problems of policymaking, nor can I presume to prescribe acceptable solutions to the multitude of problems that have vexed so many for so long. Instead, I would like to present a few of the most meaningful impressions that I gathered during the seven years in which I participated in monetary policymaking. I will leave it to you to decide which of these impressions are valid and how the problems they suggest might be corrected.

In line with the present emphasis on "truth in labeling," I must remind you that my impressions are somewhat subjective. I anticipate that some of my colleagues in the policymaking process will, no doubt, disagree with each and every one of them, and that some may even have a totally different view of what the process is all about.

A Policymaker's View of the Policymaking Process

What Monetary Policy Should Be

First, let me state what I believe monetary policymaking should be. Under our institutional arrangement, the Federal Reserve System possesses, for all practical purposes, only one tool of policy implementation: open market operations that inject or withdraw bank reserves into and from the banking system. It follows that, if there is a primary goal, or a set of *consistent* goals that we desire to achieve, monetary policy must be, simply, a process for producing the changes

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Cato Journal, Vol. 5, No. 3 (Winter 1986). Copyright © Cato Institute. All rights reserved.

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in bank reserves necessary to achieve such goals. This, in turn, requires both a theory that describes the relationship between changes in reserves and the achievement of goals, and empirical estimates of the magnitude of the impact of such changes and the timing involved. In addition, there must be some agreement among policymakers about whether and how to respond to "shocks" or "surprises" that might occur along the way to achieving desired goals.

Because we live in an open and free society—in the political sense—monetary policy goals must be agreed upon by, and known to, the public. And the method chosen by policymakers to achieve those goals must be clearly understood by the public. Policy actions must be easily observable, well explained, and, of course, consistent with the goals sought. And finally, it is essential that policymakers be held accountable for the achievement of their announced goals.

Shortcomings of the Policymaking Process

In reality, very few of these elements that I believe to be so crucial to policymaking currently exist. To start with, there are no clear, achievable goals promulgated by monetary policymakers. Never once in my participation in meetings of the Federal Open Market Committee (FOMC) do I recall any discussion of long-range goals of economic growth or desired price levels. It was like trying to construct a house without agreeing upon an architectural design. Instead of seeking a few achievable goals, the Federal Reserve is supposed to solve all sorts of problems, including inflation, unemployment, lagging real output growth, high interest rates, balance of payments disequilibrium, volatile exchange rates, depressed stock prices, a sagging housing industry, and the world debt crisis. Now, asking monetary policymakers to do all this is sheer nonsense. Such diverse goals represent a "wish list" designed for achieving utopian objectives; those who would have the Fed seek them pay no attention either to their consistency or to what monetary policy is capable of achieving. Imposing such a laundry list of goals and wishes on the Fed reflects a total lack of understanding as to what the Federal Reserve is able or not to do. This kind of thinking hampers the workings of the FOMC. For within the FOMC, there were usually as many goals as there were chairs around the table. In my experience at the Fed, I cannot recall any significant ranking of objectives or if the diverse goals considered were mutually consistent either with one another or with the policy actions being considered. To be sure, everyone agreed that they wanted full employment, stable prices, low interest rates, a booming housing sector, thriving farmers, and a

prosperous financial community. But I recall no consensus on long-range goals nor do I recall serious efforts to set policy on other than the shortest time horizons.

One can, of course, say that at different times, different goals are appropriate; this has been the conclusion of those who delight in econometric estimations of Fed "reaction functions." However, the net result of such a disorderly pursuit of transitory goals is likely to be precisely what we have experienced over the past decade—namely, highly variable money growth, volatile financial markets, and real growth that has swung from boom to bust. Perhaps because there was no clearly defined set of long-range consistent goals, there has been no general agreement among policymakers as to the effects of policy actions.

The existence of the "eclectic" school of policymakers, which encourages shifting from one indicator to another and thus opts for having multiple indicators to choose from, reflects the fact that there are many different theories about the relationships between actions and goals. We are all familiar with past disagreements over whether interest rates, M1, M2, or M3 are the most appropriate indicators, and the heated discussions of such issues in the public press. I must agree that there may be some legitimate disagreements, as there always are when theories are compared. But as long as there is no consensus as to which goals are being sought or what theories are to be used in achieving them, there can be neither consistent monetary policymaking nor achievement of desired goals.

One of the most vexing problems in monetary policymaking is the question of timing. Substantial evidence exists that the timing of the impact of changes in bank reserves differs across various measures of economic activity. The price level, for example, is affected by changes in bank reserves, and associated changes in money, with a relatively long lag—upwards of three to five years, depending on whose empirics you trust. Output, on the other hand, is affected by changes in bank reserves, and the associated change in money, with a considerably shorter lag, perhaps only two to three quarters; and the output effect is only transitory. Thus, if one's goal is to achieve reduced inflation, or price level stability, one's policy horizon must be three to five years distant; on the other hand, if you want to achieve some transitory impact on output, you will lower your horizon to several quarters ahead. In reality, although policymakers discuss economic activity projections for a year in the future, there is little attention paid to formulating policy as a means of achieving clearly defined goals. Policy prescriptions are set, generally, from one FOMC meeting to another; thus, the span of these prescriptions is no longer

than two or three months. As a result, we experience base drift, frequent violation of longer-term targets, and undesired variations in economic activity.

Moreover, by dealing with such very short time horizons, it is easy to come to believe that monetary policy has no effect on economic activity; that, instead, the reverse is true. Since over short periods of time much of economic activity is indeed predetermined, the only effect that monetary policy can have is on money market conditions. As a result, the focus of policymakers, and of policy itself, is channeled toward interest rates, especially short-term rates; the longer-term goals receive scant attention, except when inflation or output problems reach crisis proportions.

Finally, given a multiplicity of goals, targets, and indicators, there can be no real accountability to Congress or to the public in general. While a lack of accountability may be comforting to policymakers, it produces its own set of problems. There is an old saying that "thieves and gypsies never return to the same place twice"—presumably because they will have to account for their previous actions. Monetary policymakers, on the other hand, have no such qualms or constraints; they can, and do, return again and again to the same policies despite previously unsatisfactory results.

I would like to emphasize that, while these impressions are critical of the monetary policymaking process, I do not believe that they reflect on the conscious desires of policymakers. Policymakers want to do the right thing! The problem lies in the absence of a set of consistent goals for monetary policy to achieve. Without such goals, it is impossible to reach consensus about the theory to use or a specific monetary target to seek. Without these, it is uncharitable to demand accountability on the part of monetary policymakers.

Difficulty of Consensus and Persistence of Ignorance

Whether such clearly definable goals can be agreed upon in the present political environment is not at all clear. In a climate of diverse and differing philosophical beliefs, it is difficult to achieve a consensus. Another major stumbling block is the "plain ignorance" of economics that seems so widespread. For example, it is commonly believed by the public, and thus by politicians, that the Federal Reserve can control interest rates at will. Despite reams of evidence to the contrary, such erroneous beliefs inevitably produce political pressures on monetary authorities to lower interest rates by speeding up money growth, even at the expense of all other goals.

In sum, my main point is simply that we must have clearly defined and achievable goals on which to base policymaking decisions. Furthermore, it is not enough to hammer out clear and consistent goals if public and political pressure is expected to be exerted on the Fed to abandon them whenever it seems like "the politically expedient thing to do." Finally, there must be a clear recognition by the public of what the Fed can and *cannot* do. Without such a consensus, even the best conceived goals will not stand a chance of surviving.

Addendum: Economic Forecasting and Monetary Targeting*

In theory, there is a direct relationship between M1 growth and output in the short run and prices in the long run, after a lag period. I do not think the FOMC ever really tries to set, within its own closed-door deliberations, specific targets for output in the future or for the price level. When the discussion is held, I have always had the feeling that the discussion was "Where do you think the economy will be a year or two in the future, and how can we best set targets so we won't have egg on our face if this doesn't come about?" Most of the people I knew in the FOMC did not really feel that policymaking could have an impact on what was going to happen. Instead, it was viewed as being reactive and defensive. In terms of policymaking, whatever was done was not too far out of sync with what was going to happen economically due to all of these uncontrollable (in their mind) factors that move the economy. In other words, policymaking was not looked at as I interpreted it—as a means of getting from here to there. Rather, it was looked at as a means of trying to defensively protect the Fed from being out of step with what most of the members felt would happen despite monetary policy decisions.

Moreover, I do not think that the leaders and the staff of the Federal Reserve actually feel that money growth can be controlled, even over a one- or two-year period. I can tell you without violating any confidences that more than once when we met, when the money growth M1 figure was disclosed since the previous FOMC meeting, someone would say that we lucked out this time. There is not a serious belief

*This addendum is Mr. Roos's reply to the following questions asked by Godfrey Briefs of the House Banking Committee during the Cato Institute's third annual monetary conference (February 21–22, 1985): "Mr. Roos, could you tell us more about the relationship between the forecast of the economic outlook and the manner in which the monetary aggregates are decided? Is there a cause-and-effect relationship? Is there mutual interdependence? What is the role of the forecast in arriving at the monetary aggregates?"—ED.

that this machine can be guided by controlling money. Indeed, I do not believe that the control of money growth ever became the primary priority of the Fed. I think that there was always and still is a preoccupation with stabilization of interest rates.

When anything goes haywire, the Fed does the most convenient thing. When M1 grew too quickly, all of a sudden the Fed in its brilliance said "M1 has been distorted." M1 was not really distorted all that much. They adopted other multiple targets instead of M1. When something is not working, you gather a bunch of other things. If you have enough "other things" when you go to Congress, you are bound to hit the target on one or two of your objectives even though they have no relevance to output or the price level.