Better Forecasting or Better Rules?

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For sometime I have argued that the Federal Reserve needs better rules because it cannot forecast well. I have also felt that better forecasts probably would not help much. The reason is simply that I do not share the same policy goals as those who spend so much time and effort in trying to forecast the real economy. The Fed cannot eliminate the business cycle; the best it can do is minimize the instability coming from monetary policy by stabilizing the price level. For several years, I have argued that the better rule would be a target path for a general price index. Although somewhat of a misnomer, this policy has become known in the press as "zero inflation."

Forecasts and Forecasting Accuracy

The Fed maintains an elaborate process for economic forecasting because it is asked to fine-tune the economy. Congress delegated this objective to the Fed through legislation that mandates a variety of economic goals including stable prices, stable exchange rates, and maximum production. When exchange rates shift or trade accounts become imbalanced, pressure is placed on the Fed to correct the situation through monetary policy. Similarly, when the economy slows, pressure is placed on the Fed to turn its attention toward economic growth. In effect, the central bank is often in the position of a person who, in attempting to serve all masters, is ultimately able to serve none. Relying on monetary policy to achieve multiple goals—many of which are beyond the Fed's reach—may cause us to make mistakes, possibly serious ones.

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Using monetary policy to fine-tune the economy is fraught with peril. The record suggests that near-term, real GNP projections are too inaccurate to be of much value in determining the appropriate course of monetary policy from quarter to quarter. A recent study at the Federal Reserve Bank of Cleveland found that quarterly forecasts up to one year ahead reduced uncertainty by roughly 14 percent for the growth rate of real GNP and by 52 percent for inflation. For example, the mean quarterly growth rate of the economy between 1968 and 1985 was 2.6 percent (at an annual rate). On average, that is just about what forecasters predicted. But policymakers usually concentrate on the near term, and here the forecasting record is poor: The average one-quarter-ahead forecast error between 1968 and 1985 was about 4.2 percent. If we compare this average error to the 2.6 percent average quarterly growth rate of the economy over this period, we see that the representative forecast is unable to distinguish between an economy headed for prosperity and one on the verge of recession.

I often argue that this sort of uncertainty precludes a fine-tuning policy. But perhaps there is a more important point to make. The problem is not forecasting accuracy; the problem is that the Fed has accepted a responsibility to try to achieve an objective that requires both a degree of forecast accuracy and a detailed knowledge of economic structure that do not exist.

Improving the Policy Process

Any attempt to stabilize a price index directly will also require some data gathering and forecasting, but the success of the policy will not require such a high degree of knowledge or forecasting accuracy as is needed to stabilize real GNP. The key to effective policy is not the accuracy of economic forecasts but rather the credibility and predictability of policy actions. The more credible the commitment to price stability, the more limited will be the market reaction to adverse events. The more predictable the policy reaction to unforeseen economic events, the fewer wrong decisions will be made.

The policy process today, with its focus on the near-term economic outlook, does not provide as clear or credible policy objectives as I would like. More specifically, policy lacks an explicit, attainable objective. Under the current policy process, the relative importance of the various objectives changes with economic fluctuations. To accurately assess past and future decisions, market participants must constantly update their best guess about the central bank's long-run objectives. In the current environment, the market monitors policy actions to detect policymakers' intentions. But the lack of a clearly defined, long-term goal causes market expectations of the goal to vary with the latest economic news. This uncertainty reflects a monetary policy that is neither predictable nor credible.

Economic decisionmakers require more information about the long-run goal of monetary policy; they also require more compelling reasons to be confident that the Fed will indeed achieve that goal. Such confidence requires a monumental change in the current policy process. House Joint Resolution 24, sponsored by Rep. Stephen L. Neal (D., N.C.), would help bring about this critical change in policy by mandating that the Fed make price stability its primary objective.

A Stable Monetary Yardstick

Experience has shown that there are no quick fixes in the promotion of economic growth. We have no evidence that a faster trend rate of output growth can be bought with a higher rate of inflation. In fact, inflation reduces the general welfare by creating inefficient decisionmaking and thus lowering wealth-enhancing productivity. Viewed in this light, a monetary policy that best encourages long-run economic growth is one that is designed to eliminate inflation and the uncertainty associated with inflationary policies.

In theory we could eliminate the uncertainty about inflation with a 4 percent inflation rule, but in practice it would not work. I prefer a target of zero inflation. Zero is special. It eliminates the economic costs of the interaction between inflation and the tax system, and it is more likely to be credible. The costs of achieving zero inflation would be quite low in a policy regime with precommitment, and there is a substantial social benefit to a stable monetary yardstick.