Communication and the Humphrey-Hawkins Process

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The Federal Reserve’s ultimate policy objective is to create a stable price environment so that the economy can achieve maximum sustainable growth of output and employment. The target ranges for the M2 and M3 aggregates are announced as a means to achieve that broader objective. The H-H Act requires the Federal Reserve to report in February its money and credit target ranges for the current year, but this legislation was enacted when the short-run relationship between money and economic activity appeared to be more stable and predictable than has been the case since the early 1980s. Recognizing that monetary and economic activity growth rates may not move together as closely as they once did, the Federal Reserve’s Federal Open Market Committee (FOMC) has emphasized a more flexible approach to monetary targeting over the past few years.

This Economic Commentary reviews the Monetary Policy Report to Congress, examines the informational value of the monetary target ranges, and discusses a possible improvement for communicating the FOMC’s long-run goals to the public in the Humphrey-Hawkins process.

The 1989 Monetary Policy Objectives

The Federal Open Market Committee lowered the target ranges for money and credit expansion this year (see table 1). The 1989 ranges, as measured from the fourth quarter of 1988 to the fourth quarter of 1989, are 3 to 7 percent for M2 and 3.5 to 7.5 percent for M3. The monitoring range for domestic nonfinancial debt (DNFD) is 6 to 10.5 percent. The range for M2 was reduced a full percentage point from last year, while the ranges for M3 and DNFD were each reduced one-half percentage point. As in 1987 and 1988, no range was set for the M1 aggregate.

The lower target ranges are an expression of the Committee’s determination to resist any upward tendencies in inflation in the coming year and to promote progress toward price stability.
in the long run. The vigorous perform- 
ance of the economy, and the signs of 
inflationary pressure in 1989 made the 
Committee more inclined toward restraint 
than toward stimulus.

The FOMC retained the four-percent- 
age-point-wide target ranges first 
adopted for the broader aggregates in 
1988. The report noted that "...it is 
difficult to specify in advance a narrow 
range for the appropriate growth of M2 
and the other aggregates in the 
coming year." One reason for this 
difficulty is the significant interest-rate 
sensitivity of M2. Fairly wide deviations 
from the midpoint of the target 
range are possible as the opportunity 
cost of M2 fluctuates. M2 opportunity 
cost can be measured by the difference 
between the 3-month Treasury bill rate 
and the weighted-average of the rates 
paid on M2's components.

Depository institutions were unusually 
slow to raise deposit rates as market 
interest rates increased during the second 
half of 1988. Rising opportunity cost 
was reflected in slower M2 growth, 
and in rising M2 velocity, which in 
creased by a 3.4 percent annual rate 
in the last half of 1988. Velocity is the 
ratio of nominal income to money. 
Potentially wide swings in velocity as 
associated with changes in opportunity 
cost mean that broader target ranges 
are needed to yield satisfactorily 
successful monetary performance. The 
FOMC believes that M2 velocity will 
continue to rise in 1989, in lagged 
response to earlier increases in market 
interest rates, especially if deposit rates 
remain slow to adjust. M2 growth could end 
in the lower half of its target 
range if this occurs.

Because of the short-run variability in 
the relationship between the aggregates and economic activity, the FOMC has 
emphasized a flexible approach toward 
monetary targeting over the past few 
years. Since the aggregates have draw- 
backs as rigid guides for policy im- 
plementation, money growth will also 
be assessed in light of "...indicators of 
inflationary pressures and economic 
activity, as well as developments in 
financial and foreign exchange 
markets." 

■ Economic Projections for 1989 
The economic projections of the 
FOMC are also included in the report 
to Congress (table 2). The projections 
for nominal income, real income, and 
inflation in 1989 were revised upward 
from the tentative projections reported 
last July. The Consumer Price Index 
(CPI) was reported for the first time, 
replacing the gross national product 
(GNP) implicit price deflator as the 
inflation measure. The CPI offers some 
advantages over the deflator in that the 
deflator is sensitive to changes in the 
composition of GNP and is revised 
more often than the CPI. Another ad- 
vantage is that the CPI is reported 
monthly, while the deflator is reported 
quarterly, thus providing more frequent 
information about price pressures.

Chairman Greenspan stated that price 
pressures seem to have some moment- 
mum, explaining the increase in the infla- 
tion projections since last July. If this 
year's inflation actually matches the 
FOMC's 1989 projection, it would "...represent something of a setback rela- 
tive to the Committee's disinflationary 
objective." The Chairman also indic- ated that "...this acceleration is trou- 
bleshooting, especially with inflation already at a level that would be unsatisfactory if it persisted." However, any increase in inflation this year is thought to be limited because of actions already taken 
by the FOMC, and by "...the restraint 
on aggregate demand expressed in the 
target money rates for 1989." 

■ Communication Intentions 
The Humphrey-Hawkins Act specifical- 
ly directs the Federal Reserve to report 
to Congress on major factors influencing 
its decisions. The FOMC has been following its disinfla- 
tionary policy since it became evident, so that the FOMC considered such factors 
as the foreign exchange rate of the dol-

| TABLE 1 | RANGES OF GROWTH FOR MONETARY AND CREDIT AGGREGATES |  |
|---|---|---|---|---|---|
| 1989 | 1988 | 1987 |
| M2 | 3 to 7 | 4 to 8 | 5-1/2 to 8-1/2 |
| M3 | 3-1/2 to 7-1/2 | 4 to 8 | 5-1/2 to 8-1/2 |
| Debt | 6-1/2 to 10-1/2 | 7 to 11 | 8 to 11 |


lower the cost of a disinflationary 
policy. Avoiding inflation "surprises" 
and reducing uncertainty about future 
policy moves are some of the benefits of 
good communication. In this instan- 
cce, good communication can be 
described as having a plan, and telling 
others how it will be executed. 

■ Communication Problems 
The emphasis on annual targets for 
money growth arose largely as a conse- 
quence of the apparent inability of 
the growth of M1 velocity. The FOMC de- 
emphasized the role of the monetary ag- 
grégate as they became less reliably 
linked to economic performance during 
the 1980s. Of the money measures, M2 
has received the most attention in recent 
years, but its short-run sensitivity to 
changes in its opportunity cost means 
wide swings in its growth are possible as 
market interest rates change. This fac- 
tor was recognized by widening the tar- 
get ranges from 3 to 4 percentage points 
in 1989. The trend in M2 velocity, how- 
ever, does seem relatively stable over 
larger periods of time, potentially 
making that aspect of its behavior use- 
ful in the policy process. 

Because M2 growth is so sensitive to 
the state of the economy, there are 
shortcomings to using only its current- 
year target ranges as a means to com- 
municate the Federal Reserve's long- 
run objective for inflation. First, there is 
a good deal of uncertainty surrounding the 
economy's performance, and that translates into uncertainty for money 
growth. M2 growth for 1989 provides a 
good example. Early in the year, money 
growth surged after the Federal Reserve 
released reserve restraint because of con- 
cerns about potential weakness in the 
economy and financial markets in the 
wake of the stock-market crash. Money- 
market rates fell, which reduced M2's 
opportunity cost and promoted brisk 
growth through June 1988. As signs of 
continued economic strength and infla- 
tion became evident, the FOMC grad- 
ually tightened restraint on reserve posi- 
tions from the spring of 1988 through early 1989. The reduced availability of 
reserves increased money-market rates, 
and hence M2 opportunity cost rose 
when deposit rates lagged behind. 

Once tightening actions cease, deposit 
rates will likely adjust toward market 
rates, and money growth should begin 
to accelerate in response to reduced op- 
nportunity cost. This pattern of mone- 
tary acceleration and deceleration in 
response to changes in opportunity cost 
could continue for some time. 

Second, setting annual target ranges to 
reflect expectations about money 
growth does provide pertinent informa-
tion about the current stance of policy, 
but much less about policy's long-run 
direction. Long-term policy intentions 
cannot be explicitly communicated by a 
single year's target range. This year's 
M2 range is only meaningful in terms of 
last year's range, and in February's 
report there are no explicit quantitative 
projections or policy target ranges for 
periods in the future beyond 1989. 

The less-reliable linkage between the monetary aggregates and economic performance makes targets for the ag- 
grégates less useful indicators of longer- 
run policy intentions and objectives.

Recognizing these shortcomings, the 
Humphrey-Hawkins testimony and 
report to Congress, as noted above, are 
structured to supplement the target 
ranges by providing some information 
about policy designs for the future. 

■ Improving Communication 
The Humphrey-Hawkins process 
provides a framework for discussing 
and planning policy, not only for the 
coming year, but also for future years. 

Throughout its Monetary Policy 
Report to Congress, the Federal 
Reserve presents its short-run 
monetary policy intentions and long- 
run economic goals. Maintaining a 
meaningful dialogue with Congress 
and the public about economic issues 
and goals seems paramount to the suc- 
cess of this process, especially if the 
Federal Reserve is to continue to 
influence expectations about the future 
course of inflation. 

Short-run policy plans seem fairly well 
communicated by the monetary targets 
in conjunction with the economic pro-