President's Message

The view that, in the long run, monetary policy can affect only nominal variables is now widely held, both within the Federal Reserve and among economists generally. Moreover, there is a growing consensus that to achieve maximum achievable sustainable economic growth, the main objective of monetary policy should be price stability. On the other hand, there has never been agreement about how monetary policy actions are transmitted through the economy to prices. Certainly, if we could reach a consensus about this process, we might better agree on how best to achieve our long-run goal.

Many believe that monetary policy works through interest rates. By influencing short-term real interest rates, they contend, policy actions have an effect on long-term real rates and, in turn, spending, output and, eventually, prices. The extent to which interest rates respond to policy actions, however, is unclear, as is the degree to which interest rate changes affect spending. I confess that I am skeptical about our ability to consistently and predictably influence longer-term real interest rates. For this and other reasons, I am uneasy about trying to achieve price stability by adjusting nominal short-term rates.

Some researchers have argued that monetary policy actions affect the real economy by influencing the availability of credit. Indeed, some contend that the sharp decline in bank lending at the beginning of this decade—the so-called credit crunch—was evidence that monetary policy was too restrictive. All firms do not have equal access to credit markets. Thus, monetary policy actions may affect some more than others. What this tells us about the formulation and implementation of monetary policy is unclear to me, however. Nevertheless, I believe readers of this issue of *Review* will be intrigued about the discussion on the credit channel and its implications for the conduct of monetary policy.

Of course, the money channel is not without its problems. In the past, setting monetary target ranges and reducing them over time "operationalized" the Fed's resolve to contain inflationary pressures and move toward price stability. The apparent breakdown in the short-run relationship between nominal spending and the monetary aggregates—first M1 and, more recently, M2—has made the aggregates less useful in guiding policy, at least for now. What's more, a reduced emphasis on the aggregates may undermine the credibility of the Federal Open Market Committee's commitment to price stability.

Perhaps it is time to follow the lead of other central banks and quantify our long-term objective through an explicit inflation target. That, however, is a topic for another time, except that in debating channels of monetary policy, we cannot lose sight of what a central bank ultimately influences: prices. Nor can we lose sight of what a central bank does, which is influence reserve availability. What we need to learn more about is how these actions are transmitted through the economy to prices. A clearer understanding of this transmission mechanism can enhance policy credibility as well.

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