CHAPTER SIX

THE CAUSES OF SIGNALING FROM THE ADMINISTRATION AND THREATS FROM CONGRESS TO THE FEDERAL RESERVE

You see to it, no recession.

The Reaction Function Perspective

The previous chapter considered the effects of executive branch signaling to and legislative branch threatening of the monetary authority. The present chapter will consider their causes. The first part of the Chapter investigates the causes of signaling; the latter part investigates the causes of threatening. It is reasonable to view the quantities of signaling or threatening to the Federal Reserve, as dependent variables, which, at a minimum, may be influenced by measures of the state of the economy, as explanatory variables. The perspective is that of the standard reaction function. A conventional reaction function estimates how policymakers react to measures of the state of the economy as well as to other variables which reflect political or partisanship considerations. Therefore, reaction functions typically relate a policy instrument or policy control variable, as a dependent variable, to the state of the economy variables that the policymaker is ultimately seeking to
Causes of Signaling from Administration to Federal Reserve

1. Reaction functions are usually intended to provide a means of analyzing the factors which influence the decisions of the monetary authority. They may be thought of either as solutions to constrained optimization problems or as reflections of the rule-of-thumb behavior of policymakers. The optimization perspective assumes that economic policy is made by a monetary authority with well-defined preferences and discretionary control over policy instruments. The solution to the optimization problem depends on the parameters of both the monetary authority's objective function and the structure-of-the-economy constraints. Therefore, one cannot draw inferences about monetary authority's preferences without first determining the parameters of the economic system. Thus, changes in reaction function coefficients cannot be taken to reflect changes in preferences unless one assumes an invariant economic structure.

Another problem with interpreting reaction functions is if policy actions affect the way market participants' expectations are formed, then their behavior is not invariant and the structure of the economy is not invariant with respect to those actions. Therefore, reaction functions cannot be reasonably interpreted as representing solutions to constrained optimization problems. However, while the interdependence of policy actions and the structure of the economy may be important for major policy changes, such shifts are ordinarily not frequent. Thus, it may not be unreasonable to consider policy regimes and the economic structure to be relatively stable. Under such circumstances, reaction functions can still be used to study the behavior of policymakers.

Yet another problem in interpreting reaction functions is that they may not represent optimal policy. For example, if the monetary authority has an incentive to create inflation in order to achieve lower unemployment and if market participants know and anticipate this, the monetary authority will be forced to create higher inflation. Otherwise, there will actually be higher unemployment as participants' inflation expectations are not fulfilled. The creation of inflation in order to avoid an increase in unemployment is a time

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1 The reaction function literature is highlighted by the following studies: Dewald and Johnson (1963), Reuber (1964), Wood (1967), Havrilesky (1967), Friedlaender (1973), Havrilesky, Sapp and Schweitzer (1975), Potts and Luckett (1978), Abrams, Froyen and Waud (1980), Barth, Sickles and Weist (1982), and Khoury (1990).