Thank you. I am delighted to be here in The Hague and honored by the invitation to deliver this 6th annual Tinbergen Lecture. I have been an admirer of Professor Tinbergen since my days as a graduate student when I first studied his theory of economic policy.

The subject of my lecture is the recent failure of monetary policy in the United States. Since the spring of 1990, the rates of growth of real income, of nominal income, and of the broad monetary aggregate have been substantially less than the Federal Reserve had set as targets and than most observers regarded as appropriate. In the language that Professor Tinbergen taught the economics profession, the link between the instrument of economic policy (the Federal Reserve’s open market operations) and these targets of economic policy have not operated recently in the way they did in the past. Moreover, the Federal Reserve did not respond by changing the instrument values (the extent of open market operations) sufficiently to compensate for the decline in its potency in affecting the monetary aggregates and total GDP.

It is important to stress that the breakdown of the traditional economic relation has not been between the broad money supply ($M_2$) and nominal GDP but between the increase in reserves caused by open market operations and the subsequent change in the broad money supply. The velocity link between the $M_2$ money stock and the subsequent level of the nominal GDP has not declined; if anything, it has been slightly higher in the past two years than previous experience would have implied. But changes in bank reserves brought about by open market operations have had much less effect on the money supply than the Federal Reserve had anticipated.
Two fundamental conditions have caused a reduction in the impact of open market operations on the broad M2 money stock: the lack of reserve requirements on all but a small fraction of total M2 and the recent imposition of bank capital requirements that limit the banks' ability to lend. The Federal Reserve failed to appreciate the importance of these conditions and misjudged the strength of the monetary policy stimulus that it was providing.

In this lecture I will discuss these ideas in more detail, will consider why the Fed did not react more aggressively when it became clear that the money supply and the economy were stagnating, and will indicate how the link between open market operations and the broad monetary aggregate could be reestablished by a change in Federal Reserve rules.

My comments focus exclusively on the role of monetary policy in the management of aggregate demand, ignoring the potential use of fiscal policy. This may seem particularly surprising in a lecture in honor of Professor Tinbergen since one of the general lessons that the economics profession learned from Professor Tinbergen's early work is that it is usually incorrect to assign particular policy instruments to particular targets. Each of the instruments should depend in principle on all of the policy targets.

In practice, however, we have come to recognize that fiscal policy is a very blunt tool to use for macroeconomic stabilization and that monetary policy should therefore bear primary responsibility, indeed generally sole responsibility, for guiding the level of aggregate demand. Particularly with the American Congressional form of government, changes in taxes and government spending take a long time to enact and are difficult to modify.

At the present time, the very high level of the U.S. government budget deficit relative to our private saving also hampers the use of stimulative fiscal policy. Because of the large projected future budget deficits, a fiscal policy that seeks to stimulate the economy by increased spending or lower taxes could actually be counterproductive. If financial markets interpret policies that increase the current deficit as evidence that there will be even larger deficits in the future, long-term interest rates might rise by so much that current aggregate demand is actually reduced. Only the politically elusive fiscal package that combines an increased short-run deficit with a reliable decrease in future deficits would unambiguously raise near-term economic activity.

American economists therefore generally look to the Federal Reserve to manage short-run variations in nominal GDP. The Federal Reserve itself, like other central banks, does not literally announce a nominal GDP target but takes price stability as its medium-term goal while at least implicitly selecting a short-run target for nominal GDP that is designed to combine reduced inflation with acceptable changes in unemployment.

Unfortunately, in attempting to implement this goal during the past 18 months, the Federal Reserve has produced increases in nominal and real GDP that have been far smaller than the Fed anticipated and than would have been expected at this stage in the business cycle.