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# Reply to Comments by Kunio Okina

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I am grateful to Dr. Okina for clearly and forcefully expressing a point of view that is held by many central bankers and some academic economists. There are several aspects of his argument with which I can wholeheartedly agree. But it includes a few statements that I feel compelled to dispute and, more generally, its presentation distracts attention (in my opinion) away from the actual issue. To keep this reply as brief as possible, I will focus in what follows on these areas of disagreement.

To begin with, Okina's first paragraph states that my paper "concluded that monetary base was preferable" to a short-term interest rate as the central bank's instrument variable. But my conclusion was actually that the base is evidenly preferable *from the macroeconomic perspective* — *see* my Section VIII last two paragraphs and footnote 48. The purpose of that qualification is to recognize that the paper's study does not take account of possible effects on the economy's degree of financial stability. My more recent paper for the Bank of Japan (BOJ) conference of October 1993, cited in the references below, begins an attempt to take account of both of these principal goals of central bank behavior — macroeconomic and financial stability.

Turning now to more substantive matters, on Section I of Okina's comment he says that "the central bank cannot control currency in circulation unless it drives up short-term interest rates dramatically so as to affect nominal consumption." Here no justification is provided for inclusion of the word "dramatically," despite its importance in this context and despite the large quantity of inconclusive analytical literature on the transmission process. But the main difficulty with this statement is that it does not properly belong in his argument. That is because the statement suggests that the BOJ *can* control currency in circulation, if it is willing to accept an increase (dramatic?) in the variability of short-term interest rates. But that represents no disagreement with my paper's position, since the latter recognizes that more short-term variability of interest rates would occur if the base were used as the instrument. (*See* Section III, second paragraph.) Such variability is, of course, one of the possible effects on financial stability mentioned above.

Perhaps the most troublesome aspect of Okina's paper is that, throughout most of the argument, it presumes a system of lagged reserve requirements (LRR). Doing so provides a case that is analytically interesting, but which distorts or fails to engage my position on objections to use of the base as an instrument. In that regard it should be noted that my Section III states that "The basic reply, of course, is that reserve require-

ments could be changed so as to be of the contemporaneous type. And, indeed, such a change would probably be warranted if the BOJ were to adopt a base instrument." Now, Okina's discussion of the difficulties of using a base (or other reserve) instrument with LRR is quite graphic and provides a useful complement to theoretical studies such as the one in my 1983 paper with Hoehn. In fact, it has led me to believe that my current paper is guilty of understating the difficulty. But this does not overturn the point that base control *could* be exerted — preferably with institutional change — or the point that the basic tradeoff at issue involves the macroeconomic advantages of using the base versus the cost in terms of a possible reduction in financial system stability.[1]

There is one place in which Okina very briefly refers to the possibility of adopting a system with contemporaneous reserve requirements (CRR), namely, his footnote 3. There it is stated that "the fact that the Fed abandoned non-borrowed reserve targeting in the early 1980s is suggestive." But presumably the suggestion is that this abandonment reflected the difficulty of using a reserve quantity as an instrument, even with CRR. But if so, the example is not appropriate because this abandonment actually occurred during the third quarter of 1982, at which time U.S. reserve requirements were still of the lagged type. The Fed's switch to predominantly contemporaneous requirements came about in early 1984.[2]

Finally, with respect to Okina's brief remarks on the stability of interest rates reflected in the simulation of my Figure 13, I find his argument unconvincing. For it does not logically follow that, if observed movements in the base and consumption do not "contain much information about short-term interest rates," then "the impact... on short-term interest rates should be small" in relations estimated with actual historical data. Instead, the justified conclusion would be that the *accuracy* of estimated coefficients would be poor — standard errors large — not that the coefficients themselves should be small. Also, I found the results in Figure 13 striking partly because of their contrast with the case in my simulations with models estimated for the United States: Since the monetary base has not been used as an instrument there either, it is unclear why (on the basis of Okina's argument) these results should be as different as they are.

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[1]In this regard it is important to recognize that poor macroeconomic performance can be a major — and sustained — source of financial sector difficulties.

[2]It shoud be said, however, that the change was voted upon in June 1982. The adjective "predominantly" in the text reflects the fact that a two-day lag remains in the U.S. system of reserve requirements. For more discussion of both of these matters, *see* Goodfriend (1984).

## References

Goodfriend, M., "The Promises and Pitfalls of Contemporaneous Reserve Requirements for the Implementation of Monetary Policy," *Economic Review* 70, Federal Reserve Bank of Richmond, May/June 1984, pp. 3-12.

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