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# THE SUPPLY AND COST OF MONEY--AS GUIDES TO MONETARY POLICY


Remarks of

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## THE SUPPLY AND COST OF MONEY--AS GUIDES TO MONETARY POLICY

I am pleased to be with you at this annual forecasting conference and to share with you some thoughts about the supply and cost of money and their relation to monetary policy. You will find no forecasts of precise monetary aggregates, interest rates, or loan levels in my remarks. Nor have I attempted to second guess your other speakers on the levels of gross national product, unemployment, or inflation. Instead I decided to spend my time this evening on a crucial policy debate, about the appropriate guides to the formulation and execution of monetary policy.

For many years economists, politicians, businessmen, and the practitioners at the Federal Reserve have discussed this problem. Fundamentally the debate has centered upon the use of monetary aggregates as a proxy for the supply of credit or alternatively interest rates as a reflection of the demand for credit. Both measures and subsets to each are, of course, merely intermediate approaches to the ultimate goal of a growing economy providing new job opportunities and a dynamic use of resources at a fairly stable price level.

Events of recent months have accentuated the debate as the monetary aggregates rose sharply and adherents to these measures clamored for a tighter policy. At the same time those favoring an interest rate approach began a more insistent campaign for policy attention. With the monetary aggregates expanding at rates considered potentially more inflationary and short-term interest rates advancing as the Federal Reserve sought to contain the money supply growth, the elements of confrontation have become more pronounced. On the one hand, monetarists insist that the central bank constrain money supply growth and some even suggest a retrenchment to offset what they consider excessive growth over the past nine months. On the other hand the interest rate advocates say that further increases in such rates to curtail money supply growth will jeopardize the economic expansion.

The Federal Reserve is obviously very much in the center of the controversy and its decisions will have an important impact upon the future health and vitality of our economy in coming months and years.

Having highlighted the problem, though without spelling out all of its ramifications, let me turn to Federal Reserve monetary policy development and our use of measures on the supply and cost of money. Obviously our starting and ending points must be the economic position of the nation and the way in which monetary policy -- however indexed -- can contribute toward improvement in the economic and financial environment both at home and abroad. Just as obviously the central bank cannot do the whole job of economic stabilization nor can it control fiscal policy, wages, import prices, or a host of other factors affecting our economic position. However, we do recognize the importance of our actions and accept the responsibility for them.

Having said this, how do we establish policy and implement it? More importantly, in the context of the procedural debate, how do we use the monetary aggregates and interest rates as guides for policy?

Let us assume the following: (1) that the national economy is still growing at a reasonable pace, (2) that credit demands are rising and will continue upward in 1978, (3) that inflation is a persistent and perhaps growing threat, (4) that unemployment and underutilization of resources will remain at unsatisfactory levels, and (5) that our balance of trade will remain in heavy deficit. Without all the refinements necessary to create a full forecast but with this general outline, how should the Federal Reserve set its policy for the coming months?

In our Federal Open Market Committee meetings we are provided a staff forecast of the near-term expected rate of growth in monetary aggregates and the impact of such growth on the economy. Similarly, we are given the expected level of interest rates from the forecast of the economy and the monetary aggregate assumptions. The Committee is given a choice of several different paths of monetary growth and several choices concerning the interest rate constraints within which policy is to be implemented. If the Federal Reserve were following a strict monetarist approach it would have no interest rate constraints and would set its monetary aggregate guides for the long run expected needs of the economy. If the Federal Reserve were following a strict interest rate approach, it would have no monetary aggregate guides. Obviously, we are using both, to the considerable unhappiness of both groups of advocates. Our policy development has stressed aggregates at some meetings but interest rates at others.

In my view the two approaches to monetary policy are separated primarily by dimensions of time, causal relationships, and certainty. The monetarists argue, with some factual grounding, that inflation persists only if money is furnished in sufficient supply so as to permit upward price competition for transactions. The time frame for the monetarist is usually 18 to 24 months before the full impact of money supply changes is complete. In a policy sense therefore, the monetarist wants a money supply growth objective oriented to the one to two year future and since forecasts of economic conditions for such a long-term span are extraordinarily difficult, he suggests provision of money supplies at a steady non-inflationary long-term rate.

The interest rate advocate looks at the economy in a somewhat shorter time frame of three to twelve months. To him monetary policy should be tied to the relatively immediate prospects for the economy and policy should react quickly to developing troughs and peaks. Such a policy would mean stimulus by lowering interest rates when the forecast future is uncertain or when the economy is failing to achieve its full potential without overt inflationary pressures.

Thus the time frame of the two approaches diverges and while the more moderate advocates of each approach can accept some deviation of recommended policy for the intermediate period, the hard line advocates are clearly opposed to such deviations.

A second dimension of difference appears to be in the causal relationships between excess capacity, money supply, and real growth, especially when an economy is faced with unacceptably high levels of unemployment and inflation. The monetarist stresses the impact of inflation upon the economy and ultimately upon job creating opportunities. Therefore, advocates of the monetary aggregates approach favor a long-range gradual reduction of inflation by curtailing money supply growth. Such a program is expected to lay the foundation for improved economic gains and reduced unemployment in the future.

In contrast, those favoring a shorter time frame and an interest rate approach believe that appropriate monetary and fiscal stimulus, creating prompt job openings, will raise economic activity and the resulting increases in the supplies of goods and services will not aggravate price pressures and may over time reduce such pressures.

Finally, the two approaches are differentiated by certainty of data. The monetary aggregates are subject to very large swings in projections and great uncertainty of relevance in the short-term. With the problems of incomplete and untimely reporting, of shifts in definition of transaction balances, and of the unknowns in velocity, the monetary aggregates have proved to be a highly unreliable and inadequate guide to short- or intermediate-term policy formulation. Despite extensive analytical and computerized efforts, there have been very large unexplained shifts in the rates of growth of the aggregates. These have caused increased caution in the use of the aggregates and a widened band of tolerance for changes between meetings of the FOMC.

Our staff makes estimates of aggregate growth rates for the short and long term. The short-term forecasts relate to the month the FOMC meeting is held and one additional month. Thus, at our October meeting, estimates for October and November were provided and the mid-point average of these two estimates formed the reference point for a range within which policy was to be directed. At our November meeting the Committee was given an actual figure for October, a revised estimate for November, and a new one for December. Thus for each month there is an original and revised estimate and eventually a fully revised actual figure. Both original and revised estimates of $M_1$ measured against the actual missed the range of tolerance adopted by the FOMC of plus or minus 2 percentage points in about half of the 21 months from February 1976 to October 1977. For $M_2$, while the original estimate showed a similar error, the revised estimate showed such wide deviations about one-fourth of the time. Given the fact that the staff is dealing with incomplete data which are seasonally adjusted and annualized and that there were significant regulatory changes relating to deposits available for transactions, such estimates are remarkably close. However, the FOMC is making policy on such highly unreliable data and is guided by estimates with a 50 percent chance of error of more than two percentage points.

In contrast, there is a certainty to the interest rates of the moment and a certainty of Committee control over the short-term rate for interbank borrowing. These, coupled with the natural bias of policy-makers toward factual analysis and the uncertainties of the aggregates, have led to greater reliance upon the Federal funds rate as a constraint on policy reaction to changes in aggregate growth rates.

The monetarists are likely to say that this focus of the Committee away from reliance upon the aggregates has resulted in the Committee accepting higher rates of aggregate growth but unrealistically low levels on interest rates. On the other hand, the money market advocates are likely to be unhappy because of the rise in short-term rates.

In point of fact, the Committee has temporized on both approaches and probably for the best. Policy is not made in a vacuum of theory but must respond to a host of pressures including recently the impact of the uncertainty in energy and tax legislation, the high level of trade deficits, the decline in the exchange rate of the dollar, and the public perception of a marked slowing of the economy. It would be a very pleasant life to make policy in an ivory tower devoid of these day-to-day and month-to-month pressures but this is not the life of a central banker. He must blend a healthy respect for the theoretical structure of policy formulation with both the immediacy of political and social pressures and the business, market, and consumer perceptions. His time frame must be a continuum, with some actions aimed at short-run impacts and others with an intermediate time frame but still keep a strong sense of long-run purpose. The proper balance to this blend is of course a matter of individual perspective. Some people strongly favor emphasis upon the short run while others have equally strong preferences for the long run. I have a bias toward the shorter time frame but with a strong dose of caution to ensure that cumulative short-term actions do not cause an inappropriate long-run result. This time frame problem separates many of the current commenters on monetary policy. It seems clear that some members of the Joint Economic Committee much prefer an interest rate approach and a short-run focus of policy. But it is also clear that some leading advocates of the monetarist approach favor exclusive concentration on the long run. There seem to be no special qualifications for participation in either group. Both have their young and old adherents, their professors or politicians, and their policy practitioners.

Having laid this groundwork of the policy debate of the Federal Reserve, what can we say about the policy for 1978 and the implications of alternative courses of action? First it seems to me that if the monetary aggregates continue to grow at rates even approaching those of the past nine months, there may develop a crisis of confidence. Those who follow the monetarist line will preach a doctrine of incipient double digit inflation and, given business and market sensitivities to potential inflation, decision-makers' attitudes could be affected. If the Federal Reserve resists such growth rates, short-term interest rates will move up again and this time long rates may follow and savings flows to thrift institutions could weaken. These rate movements could, of course, dampen capital spending programs and reduce the funds available for housing. Similarly, with short-term rates advancing, creating an upward cost pressure on bank non-deposit borrowings, bank lending rates will increase and exert a dampening influence on borrowing from banks. To some banks, this statistical trap reflects the short-term rate pressures of the central bank rather than an excessive borrowing demand from customers. To many others the borrowing pressures reflecting high levels of economic activity are strong enough to force rate increases. The public perception has reflected a softening in the rate of advance in recent months but the gains in credit demand may presage a quickening in the economic pace.

If a new resurgence of economic growth is heralded by greater credit demands and a swelling of the money growth rates, then central bank resistance would be entirely appropriate. If, however, the economic pace remains sluggish and real output, jobs, and capital spending reflect this sluggishness, then a trend of rising monetary aggregates growth may only mirror slower velocity and financial restructuring largely disassociated from the trends in the real economy. In such an event policy resistance would seem much less desirable.

As noted above, one of the principal problems in using the monetary aggregates as guides to policy is their volatile nature and their unpredictability over the near-term policy period. To remedy these difficulties, I have a number of suggestions:

1) We need to clarify the nature of the aggregates and define them so that sudden moves or shifts can be identified and corrected. One possibility is to change the regulations governing transfers from and to demand and time accounts to eliminate the present indefinite nature of transactions balances. Such a move would require greater emphasis on an aggregate that encompasses more than the present $M_1$.

2) Another change of some value might be to focus policy attention on the quarterly data with two-thirds weight on known figures. Such a procedure would obviously reduce the element of uncertainty but would also orient monetary policy more toward the past than the future. Nevertheless, the change warrants consideration if policymakers remain alert to the hazards of the use of back data.

3) Similarly the Federal Reserve might widen the band of interest rate and aggregate guides thus reducing the degree of desk intervention in the market and further de-emphasizing the weekly data. This change has a number of attractive features permitting the money market to fluctuate over a wider spectrum of rates while retaining to the central bank the flexibility to counter adverse trends once they are clearly identified.

4) Finally, to reduce market sensitivity to weekly aggregates and lift the horizons of decision-makers, we should consider the elimination of weekly calculations and publish adjusted data only on a monthly and quarterly basis. It would seem to me that when government publishes data as uncertain as the weekly money supply figures,

it has a responsibility to either correct or eliminate such suspect data. Since we are unable to provide a definitive weekly figure, I would favor deletion.

These proposed changes are refinements of the present system and do not change the fundamental focus of policy guides. However, they could be helpful in reducing "street noise" and statistical aberrations which presently interfere with both policy formulation and the public's perception of policy intent.

Regarding 1978, I have little to offer in the way of forecasting assistance. I expect monetary policy to react cautiously to unfolding developments in the real economy as well as the financial pressures of the domestic and foreign situations, while keeping a watchful orientation on long-run supply conditions. Excessive movements in interest rates or monetary aggregate changes are likely to be resisted but hopefully the trends will be toward a more stable, less inflationary environment. It is also my hope that all of us pay less attention to questionable data and strongly resist those who believe in mechanistic policy responses regardless of the developing situation.

It is of considerable importance for the economic and financial health of the nation to have an appropriate and balanced monetary policy, but it is also of great importance to have a fiscal policy which is responsive to the needs of the nation. Recently there has been talk of tax reform, incentives and reductions. Reforms are contemplated to simplify the tax structure and redistribute the tax load. Tax incentives are being considered to stimulate capital spending and accomplish special social priorities. Tax reductions are being discussed as a way to offset the proposed tax increases for Social Security and unemployment compensation and alleviate the tax burden on low income families. Given the deficit position of the Federal budget, there seems little leeway for large-scale tax cuts, so whatever is done should be in small doses with rifle-shot impact.

In my opinion discussions on broad-scale tax reform have created an uncertainty which has kept business from planning ahead for new plant capacity. On the other hand, an investment tax credit could stimulate capital spending and might be formulated to provide for tax credits to be steadily recycled into new plant and equipment. In other words, investment tax credits could be earmarked for reinvestment into sequential rounds of capital spending.

Another unknown element for 1978 will be the international position of the dollar. With the very large deficit in our trade account the dollar exchange rate has been under some downward pressure. In the past ten months, the dollar has depreciated considerably against the Swiss franc and the Japanese yen and has slipped moderately against the market basket of primary currencies worldwide. The dollar exchange rate in 1978 will be affected by the rate of increase in foreign economies, the import volume and prices for oil, consumer electronic items, autos, and foodstuffs and the willingness of foreigners to continue to hold large dollar investments. How all of these and the myriad of other forces work out next year is a real forecasting challenge. However, I suspect that the international factors will have considerable effect on our domestic position throughout the year.

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