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I. Introduction

A. Would like to talk generally about present monetary policy options.

B. As always, must be viewed in context of long-term goals of growth and price stability.

C. Also, pattern of international transactions must be taken into account; if not a goal, sustainability of pattern (or lack thereof) certainly a constraint at this time.

D. But how should external imbalance be taken into account? Should dollar be "depreciated" or defended?

E. These two approaches capture the extremes of present policy options.

II. Background

A. During 1987, increasing emphasis placed on price stability goal in conduct of monetary policy.

B. Given accelerating pace of growth in money in 1986, St. Louis Bank supported this shift and in fact argued for restraint beginning in mid-1986.

C. As 1987 progressed, however, we became increasingly concerned over dramatic slowdown in money growth in relation to trend, particularly when it was clear that third quarter growth would come in low.

D. Two months ago, expressed concern that degree of monetary restraint was increasing risk of recession in 1988.

E. I do not pretend to know all the factors that contributed to stock market crash, but one might have been perception we had run out of good policy options: a declining dollar was associated with higher inflation and high interest rates, and defense of the dollar was associated with the prospect of recession.

F. By changing outlook for real growth and inflation, crash has provided greater policy flexibility, albeit at tremendous cost. Also, may have provided greater impetus for budget cuts here and for international coordination.

G. So what do we do with this new found flexibility?

III. Monetary policy options

A. In looking at policy options, people tend to look only at short-run effects; forget there are intermediate and long-term effects with much different consequences.

B. "Depreciate" the dollar--i.e., accelerate money growth.

1. Short Run: (Liquidity Effect)

a. interest rates decline; reducing capital inflows from abroad

b. value of the dollar declines: increasing exports and reducing imports

c. net effect: trade deficit narrows.

2. Intermediate Run: (Spending Effects)

a. increased spending from faster money growth raises real output and income

b. interest rate rises with increased spending: increased capital inflows

c. imports rise as domestic spending rises

d. net effect on value of dollar depends on relative strengths of interest rate effects on foreign capital inflows vs. increased demands for foreign goods as income rises

e. trade deficit increases.

3. <u>Long Run</u>: (Expectations Effects)

a. inflation increases as increased spending produces higher prices

b. interest rate increases solely due to higher inflation

c. value of the dollar falls as U.S. inflation rises relative to foreign inflation

d. net effect: no real consequences at all; higher inflation and interest rates and declining value of dollar.

C. Defend the dollar--i.e., slow down money growth (or maintain slow growth).

1. <u>Short Run</u>:

   a. interest rates rises--attracting capital inflows

   b. value of the dollar rises--reducing exports and increasing imports

   c. net effect: trade deficit widens.

2. <u>Intermediate Run</u>:

   a. reduced spending from slower money growth reduces real output and income

   b. interest rate falls with reduced spending: reduced capital inflows

   c. imports fall as domestic spending declines

   d. net effect on value of dollar depends on relative strengths of interest rate effects on foreign capital inflows vs. reduced demands for foreign goods as income falls

   e. trade deficit declines.

3. Long Run:

   a. inflation falls

   b. interest rates decline to reflect lower inflation

   c. value of the dollar increases as U.S. inflation falls relative to foreign inflation

   d. net effect: no real consequences at all; lower inflation and interest rates, higher value of dollar.

IV. Conclusion

A. Cannot correct external imbalance with monetary policy; intermediate effects tend to reverse short-term effects, and in long-term only impact is on inflation.

B. Not to say that monetary policy cannot be used to accomplish short-run objectives (e.g., provide liquidity in time of crisis), but must not lose sight of long-term consequences.

C. Do not have latitude to pursue domestic economic policy without regard for rest of world; external imbalance too great.

D. Therefore, avoid temptation that present flexibility apparently provides to pursue a policy in direction of depreciating the dollar.

E. Rather, move to middle-of-the-road policy and stay with it; avoid extremes in policy, which tend to raise uncertainty.