

Remarks by Thomas C. Melzer  
Joint Board Meeting  
Mark Twain Banks  
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Thanks Bob. I appreciate being invited to your joint board meeting today and having the opportunity to make a few remarks about monetary policy. With not yet two months on the job, I am not sure I could be termed a monetary expert as yet. And then again, based on a rule a Senator uses to tell whether a man is a monetary expert, I am not sure I want to be. He said, "If he talks about money and makes you listen, and when he is through, you ask yourself, what is he talking about?, then you know that the man understands the money situation."

In its Monetary Policy Report to Congress last week, the FOMC announced two modifications to its M1 target for 1985. First, the base period has been moved from the fourth quarter of 1984 to the second quarter of 1985. Second, the M1 growth target range has been widened; the new range calls for M1 growth at annual rates to fall between 3 to 8 percent for the second half of 1985. The old growth range had been 4 to 7 percent.

Almost immediately, the public leaped to the wrong conclusions about what these modifications imply about policy actions for the rest of this year. The Wall Street Journal commented that they "allow the central bank leeway to continue its recent easy credit policy in an effort to invigorate the sluggish economy." Similar comments have popped up in financial commentaries elsewhere. I think that this view, despite its wide acceptance, is wrong for two basic reasons. First, the M1 target modifications do not, in fact, permit any leeway for continuation of the

rapid monetary expansion that took place earlier this year. Second, I do not believe that monetary policy at this time should be used to further stimulate the economy. These are the two points that I would like to emphasize this afternoon.

First of all, it is pretty easy to show that the M1 target modifications provide no leeway for fast money growth in the second half of this year. The new base for the M1 range is the level of M1 in the second quarter of 1985; this is about \$583 billion. In June, the average level of M1 had already reached \$591 billion--a substantial \$8 billion over the base level. As a result, if M1 is to end up within its new target range by the end of the year, it cannot grow more than about a 5 percent annual rate from July to December. This growth is approximately the midpoint of the FOMC's original target for M1 growth. It certainly does not represent continuation of the easy conditions that produced 12 percent M1 growth in the first half of this year.

If popular opinion and Wall Street Journal wisdom about the modifications are wrong, a question that naturally arises is "Why did the FOMC make these changes?" The best way to answer this is to consider what would have happened had no modifications been made. Basically, two things could have occurred--and neither of them would have been good. First, the FOMC might have attempted to achieve the original target range by year-end; if so, M1 growth from July to December would have to be negative. I don't have to tell you what such an abrupt shift in money growth--from 12 percent in the first half--would do to the likelihood of continued expansion by early next year. The second alternative would

have been for the FOMC to ignore the M1 target altogether and let actual M1 growth overshoot the announced target range. While this action would not jeopardize the expansion by slowing money growth abruptly, it would erode the central bank's credibility with Congress and the public at large. In particular, this action would have been viewed quite negatively in financial and foreign exchange markets; people there know the historical relationship between fast money growth and higher inflation only too well. Abandonment of the M1 target could well have been interpreted as a weakening in the central bank's resolve to deal with inflation.

Therefore, in my opinion, the modifications that the FOMC announced represent the best alternative that was available. It means, of course, that the rapid money growth in the first half has, in effect, been "grandfathered"; the presumption being that there were valid reasons for this growth. Such reasons as the weakness in the economy, some strains in financial markets, concern about the strength of the dollar and the possibility that a one-time drop in the velocity of money occurred have been pointed to as justifications for the faster money growth. However, the FOMC, by announcing the modifications, has established a range that directly implies the desire for monetary discipline in the second half of this year.

And this brings me to my second point: I do not believe that monetary policy should attempt to further stimulate the economy at this time. First, a great deal of stimulus has already been applied. We have had

strong money growth during the first half; that stimulus, with the usual lags, should show up in spending and income growth in the second half of the year.

In addition, there have been substantial interest rate declines this year; interest rates have fallen about 100 basis points since early April. Consequently, as you know, the interest-rate sensitive sectors of the economy are performing well. New home sales in May were at a high level of 676,000, at an annual rate, up almost 9.7 percent from the year earlier level. Housing starts in June were up 1.9 percent from May and at a relatively high annual rate of 1.7 million. Total construction expenditures in May were up 1.5 percent from April and almost 9 percent from year earlier levels. And earlier this week, non-defense capital goods orders for June were reported up 6.8 percent from the prior month. It is hard to argue that these sectors need further stimulation.

There are, to be sure, sectors in the economy that have remained weak-- primarily certain manufacturing sectors and the farm sector. However, there is little that further monetary expansion can do to aid these sectors; in fact, further stimulation, despite what you might believe, could easily make them worse off. A large part of their problems are structural in nature; they arise from shifts in international comparative costs that monetary policy can do nothing about. However, to some extent, these industries have also been adversely affected by the high and, until recently, rising value of the dollar. If monetary policy were used to provide additional stimulus to the economy, the dollar could rise again in foreign currency markets and these industries, already weak, would suffer additional losses.

Why would additional stimulus raise the value of the dollar? Simply put, the strength of our economy relative to those in Europe and Japan has contributed importantly to the dollar's strength. When we were growing first and faster, the dollar was rising as economic success attracted foreign capital and kept U.S. investment home. However, perceptions about economic growth began to change in early July when a weak employment report signaled a weaker U.S. economy. This was confirmed by the 1.7 percent GNP report for the second quarter released last week; and since July 1, the trade weighted value of the dollar has declined approximately 5 percent. This downward adjustment in the dollar is occurring primarily because the European and Japanese economies are beginning to gain some momentum at the same time ours is slowing down.

The current drop in the dollar's value will provide some, although probably minor, relief to those industries that have been adversely affected by the strong dollar. However, if we attempt to reverse the current pattern of relative economic growth--if we try to "goose up" the economy so that, once again, it might outgrow the rest of the world--we could, for a time at least, drive up the value of the dollar. This will simply further weaken those sectors that remained behind when the rest of the economy was expanding.

The final reason why I believe it would be inappropriate to provide more monetary stimulation at this time relates to what it might do to the public's inflationary expectations. Our experience with inflation in this recovery so far has been almost miraculous; as a result, inflationary expectations have settled down. This, perhaps more than anything else,

has contributed to declining interest rates, rising stock market values and our ability to attract foreign capital. If the Federal Reserve is perceived to be following policies that can only over-stimulate the economy, inflationary expectations will revive quickly. The initial results would show up first in financial markets--higher long-term interest rates, lower stock prices, and a major decline in the dollar's value as foreign capital departs for less inflationary shores. The later effects would include higher inflation and reduced economic growth. Needless to say, this is not a pretty picture. However, it is one that we could see again if we mismanage our economic policies.

In summary, I do not think that the new M1 range was intended to allow the Fed leeway to continue an easy money policy. In my opinion, it was designed to assure the public that the Fed intends to provide the appropriate monetary discipline for the remainder of this year. Moreover, I do not believe that stimulating the economy further should be the primary focus of monetary policy at this time. Such a focus would be counter-productive under the present conditions.

Clearly, the monetary policy trade-offs at this time are not easy ones. However, I am confident that the FOMC will continue to identify and pursue policies that will both encourage long-run economic stability and, at the same time, contribute to low rates of inflation. I hope my remarks today have been enlightening, but certainly not to the extent that you, in the words of the Senator, have concluded I am a "monetary expert." Thank you.