

# Office Correspondence

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Date February 3, 1972

To Chairman Burns

Subject: Comment on Use of a Fixed

From J. Charles Partee

Rule for Monetary Growth

*No required - JEC*

*Partee defends flexible policy and presents his view of monetary policy quality from 1948 to present.*

*He is negative about Fed's period but thinks policy was correct for the past two periods of recession and the post two periods of inflation.*

You have asked me for a comment on the deficiencies of adopting a fixed rule guiding monetary growth and also for a brief review of the record as to policy flexibility at critical junctures over the postwar period. Milton Friedman published a column in the current issue of Newsweek arguing in favor of a fixed monetary rule (copy attached), so that the subject could well come up in Congressional questioning at the JEC hearing and in other situations.

Friedman's arguments are the ones that he and others have used time and time again. He asserts that on the basis of past Federal Reserve performance and in view of the limits of our ability to predict the future and to specify the precise nature and timing of the lags with which monetary changes affect the economy, it would be preferable to aim policy at the achievement of "a steady and moderate rate of growth of the quantity of money". This cannot be done from day to day or week to week, but "no serious student of money denies that the Fed. . . can come very close from month to month and quarter to quarter". Additional advantages cited for a steady rate of monetary growth would be that it would promote business confidence in monetary stability and neutralize the Federal Reserve from political pressure.

We, of course, have always denied that monetary policy operating on a fixed rule would work as satisfactorily as a flexible policy, although

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there is more support in the System now than for a long time past for achieving rates of growth over time that vary around normative values for  $M_1$  and  $M_2$  relative to GNP. There have been numerous arguments advanced in favor of flexibility, but the ones that appeal most to me are as follows:

✓ 1) Adoption of a fixed monetary growth rule would require that all other factors affecting credit markets be ignored. The Federal Reserve does have a responsibility to encourage appropriate credit conditions, and it also has responsibilities for Treasury finance, the viability of financial institutions and the conditions influencing international capital flows. These considerations argue that we cannot ignore interest rate and credit flow developments and that, at times, such developments will put constraints on our ability to follow a fixed course as to monetary growth.

2) Every instinct argues that we should be capable of providing more assistance to our national economic objectives than is implied by the neutralist policy of an unchanging monetary stance. In contra-cyclical terms, particularly, we should be prepared to give more support to the economy in recession and less in boom, and we should be able to anticipate these developments with sufficient accuracy to alter policy in advance of the needs of the economy. It seems to me that our ability to do this has improved steadily over the years, and that it would be most unfortunate to surrender to a fixed rule approach now. I would also argue that national

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priorities as to the allocation of credit might well create situations in which we should be prepared to depart somewhat for a time from our notions as to the appropriate rate of overall monetary growth.

3) Use of a fixed monetary rule assumes that there is a fairly constant relationship between monetary growth and its influence on economic activity. This may be correct as a generality over time but it cannot be true in the short run. The public's appetite for liquidity obviously shifts from time to time, depending on the confidence with which they view the future, changes in inflationary expectations, and the like. If we do not provide the additional liquidity associated with an upward shift in preferences, or absorb the liquidity released by downward shifts, constant rate of growth in money is likely to result in variable rates of growth in the economy. In other words a constant monetary growth, if precautionary demands for liquidity are shifting, would be a source of economic instability.

4) A monetary rule requires that the monetary variable, or the weighted combination of variables, to be controlled be specified in advance. Friedman does not specify which variable is to be controlled in the Newsweek article, but in the past he has sometimes focused on  $M_1$  and sometimes on  $M_2$ .  $M_3$  would be an equally good candidate, since depositors in thrift institutions surely regard

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these deposits as the equivalent of bank time deposits in all respects. And  $M_4$  would also be a likely candidate, since only by including CDs and other money market instruments do we incorporate a measure of corporate liquidity. All of these quantities do not move up and down at anything like the same rates in the short-run, of course, so it is not enough to use one M as a proxy for all of the others. Nor is expansion in all of the Ms closely related to the provision of bank reserves.

5) The relationships between rates of change in the various Ms, and between these definitions of money and economic activity, are clearly subject to a host of influences, including structural, competitive and technological change. Thus, the postwar emergence of the savings and loans clearly impinged on the growth of bank time deposits. Similarly, the increasing sophistication with which money is managed, partly a function of the upward trend in interest rates, has served to reduce idle non-interest bearing cash balances ( $M_1$ ) relative to total liquid assets ( $M_4$ ). Technological improvements, such as jet aircraft and bank automation, must have reduced the float of checks in transit on which depositors formerly counted (we measure money in terms of balances on the bank's books, not in customer records), and future advances (such as wire transfer) clearly will reduce such float dramatically further. All of this makes it extremely difficult to measure the real impact of monetary policy over time. It also strongly suggests to me that targeted growth

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A very narrow view

rates in money--however defined--need to be modified in order to produce an unchanged secular stimulus to economic activity. I would think that this need is most pronounced in the case of  $M_1$ , since cash balances are most subject to technological obsolescence.

For the purpose of reviewing the responsiveness of flexible monetary management over the post-war period, we have developed the attached two tables--one on monetary aggregates and the second on interest rate and credit market indicators. Both show changes in the variables in the six months before and after each upper cyclical turning point and before and after the three points at which excess aggregate demand threatened generalized inflation. (These three points were arbitrarily chosen as May 1951, when the unemployment rate had declined to 3 percent under war-time conditions, and June 1955 and January 1966, when the unemployment rate in each case had dropped to 4 percent.) My conclusions on the record of performance for each of these nine periods, taken chronologically, as follows.

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1. November 1948 cyclical peak. The record is not good.  $M_1$  drifted off both before and after the turning point, and  $M_2$  showed no net growth. Net free reserves did move in the correct directions, though only slightly, but the discount rate was raised just prior to the turning point and not reduced after. Interest rates did not show appreciable cyclical variation.

2. May 1951 period of excessive demand. The record is not good, despite the accord reached with Treasury on debt management support in March 1951.  $M_1$ ,  $M_2$  and bank credit all increased more

rapidly after May 1951 than before. Net free reserves expanded in the six months after May, following an earlier tightening, and interest rates stabilized. No change during period in the discount rate.

3. July 1953 cyclical peak. The record is not good.  $M_1$ ,  $M_2$  and bank credit increased less in the six months after the cyclical peak than in the six months before. Free reserves also increased less rapidly after the turn--though still substantially--and the discount rate was not changed. Both short- and long-term interest rates did decline substantially after the peak, however, reflecting reduced credit demand.

4. June 1955 period of excess demand. The record is quite good, assuming that a primary national objective was to curb aggregate demand.  $M_1$ ,  $M_2$  and bank credit all increased at lower rates after June 1955 than before. Free reserves declined substantially, and the discount rate was raised by a total of one full percentage point over the one year period. Interest rates moved upward both before and after June 1955, on balance, with a particularly sharp rise in short-term rates over the six months following that date.

5. July 1957 upper turning point. The record is quite bad.  $M_1$  turned strongly negative in the six months following the turning point, after having shown no growth before.  $M_2$  and bank credit also grew at smaller rates after July 1957. The discount rate was raised after the turning point (it was subsequently lowered), but free reserves expanded substantially. Interest rates declined,

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being increased both before and after the turn, and the discount rate was cut once, by 1/2 per cent, in early 1967. Short-term rates declined substantially after January, but long-term rates rose following an earlier decline. In retrospect, one could argue that the easing was overdone, since the recession movement was very mild and relatively brief. Also it may be argued that monetary ease persisted too long into the year, producing large increases in  $M_1$  (6.7%) and  $M_2$  (10%) for the year as a whole. But in timeliness and speed, the initial policy turn seems to me to have been excellent.

9. November 1969 upper turning point. The record appears quite good. Expansion in  $M_1$ ,  $M_2$  and bank credit all accelerated in the six months after the turn, but to rates that were still relatively moderate (perhaps a bit below normal in  $M_2$  and bank credit). Net free reserves increased both before and after the turn, again moderately, but the discount rate was not reduced. Short-term interest rates declined after the turn, but again-- as in 1967--long-term rates continued upward (The major decline in long-term rates, you will recall, commenced in the summer of 1970 and continued to the early months of 1971.)

In summary, I would conclude that the best performances in monetary policy, in terms of timing, were in the two most recent periods of inflation--following June 1955 and January 1966--and the two most recent periods of recession--following January 1967 and November 1969. The performance in the early stages of the 1960 recession was also fair, but in all earlier postwar episodes it was poor. In the 1967 episode,

although the drop in long-term Treasuries was not much greater than the rise in the preceding 6 month period.

6. May 1960 upper turning point. The record was fair, and notably better than in 1957.  $M_1$ ,  $M_2$  and bank credit all increased significantly on an algebraic basis, though growth in  $M_1$  was still quite nominal in the six months following the turning point. The discount rate was cut twice, by a total of 1 per cent, in the six months following the turn, and free reserves increased substantially both before and after the turn. Interest rates also were declining substantially both before and after the May 1960 cyclical peak.

7. January 1966 period of excess demand. The record is quite good.  $M_1$ ,  $M_2$  and bank credit all rose substantially less rapidly in the six months after than before January 1966. The discount rate was raised 1/2 per cent in early December--a notable conflict with Administration desires. Net free reserves declined substantially in the six months after January 1966 and long-term interest rates were rising throughout. (Interestingly, the Treasury bill rate dropped slightly from January to July, following a sharp earlier increase.)

8. January 1967 informal cyclical peak. The record looks very good. As signs of economic slowing developed, the Federal Reserve turned promptly and substantially toward ease. The reaction probably was stronger because of the severe squeeze that had been promoted in 1966.  $M_1$ ,  $M_2$  and bank credit all expanded sharply faster in the six months after January 1967 than before, and all were at historically high rates. Net free reserves were

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also, it can be said that the shift was a little excessive and that policy remained easy too long into the year. Moreover, although the growth in money (both  $M_1$  and  $M_2$ ) did slow in the last quarter of 1967 and in early 1968, it then accelerated sharply, producing two consecutive years of relatively rapid monetary growth. Friedman refers in the Newsweek article to this 1967-68 period as an example of too rapid growth.

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The companies reacted to the complaint with outrage. Kellogg, the largest producer with 45 per cent of the cereal market, angrily noted that it has acquired another cereal company since 1913, and a vice president of General Foods said of the advertising charges: "They're 150 degrees off course, and we're going to court to prove it." But the companies were frankly worried that the FTC seemed to be saying that bigness in itself is bad. "The charges would apply to maybe 60 per cent of American industry," one executive said. "The FTC has bitten off an enormous new theory of antitrust law, and if carried out, it would revolutionize the American economy and break up all kinds of industries."

That may well be just what the FTC



Cereal consumer: No fair choice?

has in mind. Previous antitrust cases have focused on one-company monopolies, and last week's move against the cereal titans was the first time that direct government action has been taken against an oligopoly, a few large corporations dominating an industry. The implication is that if such firms use their power unfairly, they have in effect created a "shared monopoly," even if they have plotted no wrongdoings. "We don't have to depend on any kind of a conspiracy," an agency official told NEWSWEEK's James Bishop Jr. "We are saying that in view of the consequences for the marketplace, it might just as well have been a conspiracy."

Still, the FTC has a long way to go before it proves that existing law can be used against shared monopolies. If the companies decide to fight, the case could drag on for years before ending up in the Supreme Court. And if an out-of-court settlement is negotiated, as is more likely, no new legal precedent would be established at all.

February 7, 1972

## THE CASE FOR A MONETARY RULE



and most other monetarists have long favored a policy of a steady and moderate rate of growth of the quantity of money. We have strongly opposed the Fed's trying to fine-tune the economy.

Recent policy conformed to our prescription only in 1970.

Critics ask why we are so modest. Why not use the powerful instrument of monetary policy to offset other forces pushing the economy toward inflation or recession? Why tie the hands of the Fed? Why not trust their discretion in adapting to changing circumstances?

We favor the rule of steady monetary growth for several reasons.

1. *The past performance of the Fed.* Throughout its history, the Fed has proclaimed that it was using its powers to promote economic stability. But the record does not support the claim. On the contrary, the Fed has been a major source of instability.

The Fed was responsible for converting what would have been a serious recession after 1929 into a major catastrophe by permitting the quantity of money to decline by one-third from 1929 to 1933, even though it had ample power to prevent the decline.

In recent years, the Fed set off the accelerating inflation that Mr. Nixon inherited by expanding the money supply too rapidly in 1967 and 1968, then stepped too hard on the brake in 1969, and too hard on the accelerator in the first seven months of 1971. Federal Reserve officials have often admitted their errors after the fact—as chairman Burns did in July 1971, in testimony before the Joint Economic Committee—and have promised better performance in the future. But then the same forces have produced a repetition of the same errors.

We conclude that the urgent need is to prevent the Fed from being a source of economic disturbance.

2. *The limitations of our knowledge.* Economic research has established two propositions: (1) there is a close, regular and predictable relation between the quantity of money, national income and prices over any considerable period of years; (2) the same relation is much looser from month to month, quarter to quarter, or even year to year. In particular, monetary changes take time to affect the economy, and the time delay is itself highly variable.

The first proposition means that a

steady price level over the long period requires that the quantity of money grow at a fairly steady rate roughly equal to the average rate of growth of output.

The second proposition means that any attempt to use monetary policy for fine-tuning is likely simply to introduce additional instability. And this is indeed what has happened.

3. *The promotion of confidence.* As announced, and adhered to, policy of steady monetary growth would provide the business community with a firm basis for confidence in monetary stability that no discretionary policy could provide even if it happened to produce roughly steady monetary growth.

4. *Neutralization of the Fed.* An independent Fed may at times be insulated from political pressures—it was in the early '30s—and yet other times unduly affected by political pressures. If we really knew enough to use monetary policy for fine-tuning, we would probably experience a four-year cycle, with unemployment reaching its trough in years divisible by four and inflation reaching its peak in the succeeding year.

A monetary rule would insulate monetary policy both from the arbitrary power of a small group of men not subject to control by the electorate and from the short-run pressures of partisan politics.

Is the rule that we have proposed technically feasible? Can the Fed control the quantity of money? No serious student of money—whatever his policy views—denies that the Fed can, if it wishes, control the quantity of money. It cannot, of course, achieve a precise rate of growth from day to day or week to week. But it can come very close from month to month or quarter to quarter.

As I wrote some five years ago, if the monetary rule were followed, "other forces would still affect the economy, require change and adjustment, and distort the even tenor of our ways. But steady monetary growth would provide a monetary climate favorable to the effective operation of those basic forces of enterprise, ingenuity, invention, hard work and thrust that are the true springs of economic growth. That is the most that we can ask from monetary policy in our present stage of knowledge. If that much—and it is a great deal—clearly within our reach."