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REFLECTIONS ON MONETARY POLICY

Remarks

of

SHERMAN J. MAISEL

Member
Board of Governors
of the
Federal Reserve System

at the

Salomon Brothers Center
for the
Study of Financial Institutions

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When I was appointed to the Federal Reserve Board in 1965, I spent a good deal of time explaining to my fellow Californians that I was joining a government agency and would be spending full time in Washington. Most did not recall hearing of the Federal Reserve Board. Those who had confused it with either the Bureau of Printing and Engraving or the Federal Reserve Bank of San Francisco.

Looking back over these past seven years, I wish the Federal Reserve Board were still as little known as in the early 1960's. I hope that in the future the Federal Reserve will once again be as little known. That is, I am hoping that over the next few years the "Fed" will have receded in the opinion of news editors below headline news value and will be operating not in secrecy, but in the valuable obscurity of relatively small type on financial rather than news pages.

What I am saying -- perhaps somewhat heretically -- is that I think we would all be better off if the Fed were not required to play such a central role in the economy. There are three obvious reasons -- it seems to me -- why the country would be better off if monetary policy (and, therefore, the Federal Reserve) were to occupy a less prominent spot in the news (and, therefore, the economy) in the future than it has in the recent past.

1. Sharp variations in monetary conditions have high and frequently under-estimated costs. If our economic stabilization objectives could be achieved with more stable monetary conditions in the future, we would all be better off.

2. In an attempt, primarily, to offset extremely inflationary and erratic spending policies of the government and large businesses, monetary policy and conditions here varied drastically and expensively. Monetary policy has helped smooth the economy by partially offsetting or containing these pressures, but at the expense of those sectors primarily affected by money and credit. A less newsworthy performance could reflect a more stable and responsible fiscal and business expenditure policy.

3. Political debates and pressures on the Federal Reserve have always been prominent. Within reason this is proper, but recently they have been increasing unreasonably. If the Fed succeeds in taking up a stance permitting it to disappear gracefully from the headlines, this will mean that these political pressures will have diminished to the benefit of the country.

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Knowledge and Action

People are clearly dissatisfied with economic policy. Why? Our ideas and concepts of economic policy in the monetary and fiscal fields are subject to major uncertainties. Policies outside these fields are extremely under-developed. Furthermore, people's expectations are probably too high.

Why are the expectations of what can be accomplished unrealistic? Because our desired goals stretch existing knowledge, data, and institutions too far. We want to operate at levels of output and employment that require fine tuning. We lack the requisite knowledge to do so. In the critical sphere of inflation, we don't know how control can be accomplished successfully through monetary and fiscal policy. Forecasting and explaining changes in spending are difficult enough, but it is far harder to link spending movements to prices and unemployment. Our present price and wage controls arose because even the deflationary and costly policies pursued had only limited effects on inflation.

Even though I believe the record of monetary policy over the past seven years has been relatively good, I do think the Federal Reserve has erred because it has not emphasized sufficiently the informational and operational difficulties inherent in an activist monetary policy. Similarly, it has not spent enough time and energy explaining the high costs of using monetary policy in contrast to other possible policies to influence spending and capital flows.

As a result, too much is expected of monetary policy. It is used too readily and with insufficient attention to its costs. People recognize the ease with which monetary policy can be changed. Reliance on monetary policy avoids many political hassles. Because a change in monetary policy is simple to set in motion, many assume it should be the first type of policy used. I think this is wrong. Because the impacts are so uncertain, and the costs so high, large changes in interest rates and credit availability should probably be saved for only critical situations.

The Federal Reserve should be the loudest lobby against the use of monetary policy to solve problems outside the monetary sphere. It knows the problems and difficulties better than anyone else. It should broadcast the facts while stressing the great advantage to the economy of using non-monetary policies. There is no reason to assume spending will not remain erratic in the future. Even so, the total cost of economic stabilization may well be reduced if more specifically tailored policies such as tax and spending changes or those aimed at shifting supply replace fluctuating monetary conditions.

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Why hasn't the Fed spoken out? One reason is the traditional reluctance of central banks to operate in the spotlight. Secrecy is claimed as a necessary ingredient of a successful monetary policy. A mystified public is supposed to increase operational flexibility and reduce undesirable market impacts. Furthermore, if errors and failures are not spread so clearly on the record, the reputation of the central bank is enhanced. I happen to believe the opposite. The Fed should make clearer what it is trying to do, how, and why. More public knowledge would lead to a better and more effective role for the Federal Reserve.

Failure to speak out also arises because of the belief that an activist monetary policy may be vital at critical times. In popular terminology, the Fed may be the only force available "to save the dollar." Given an over-riding need for monetary policy, authorities hesitate to make clear its costs. They fear that such knowledge would lead to critical and expensive delays.

Monetary Policy

Most students of monetary policy, both traditionalists and monetarists, have urged that it be used strongly in an attempt to stabilize spending. In their view, when an expansion proceeds too rapidly (and _vice versa_ in a recession), monetary policy should raise interest rates and cut the relative availability of money and credit in order to lower the demand for goods. I believe that, considering all problems and costs, monetary policy may do the most good if it plays a less active role.

The traditionalists' view of monetary policy. The Federal Reserve, as do most central banks, attempts to alter money and credit market conditions to help the nation achieve its spending goals. In the pursuit of this objective, it follows a strategy that has become a tradition in central banking. That is based on a forecast of spending -- public and private -- for the next year or two, it decides how much money -- at what interest rates -- would best smooth the way toward this goal.

In accordance with this conception of its role, when aggregate demand appears too low, the Fed attempts to encourage spending. Money is expanded rapidly, and interest rates fall sharply. At other times, such as 1966 and 1969, the availability of money has been restricted and interest rates driven sky high in an effort to lower spending judged out of line.

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This traditional approach contains at least three major problems: (1) The fluctuations in interest rates engender high costs as discussed later. (2) Adjustments of rates and availability to achieve goals may be fatuous, for we don't know how much change in money or rates will achieve what effect under given circumstances. (3) A small desirable movement in monetary conditions may lead to cumulative and undesired changes.

While it is not hard to pick the proper direction for policy, it is hard to say how large the swings in money should be and how long they should last.

The monetarists' view. Because of the difficulty of deciding how money and rates should move, monetarists have suggested an opposing decision rule. They would pick a particular concept of money from the many available and then would supply this so-called money in a more or less steady flow according to a fixed rule.

This policy strategy also leads to difficulties. (1) The amount of money supplied may restrict the desired growth of the economy. (2) The definition of money picked may be wrong and may not furnish the proper supply of true money. (3) More financial transactions, or expectations of price changes, or a desire for greater liquidity, may increase the demand for money relative to economic activity. (If increases in the supply are kept constant, fluctuations in rates and the problems listed below may occur.) (4) Similarly, rates will rise if the demand for goods increases because of accelerated business, consumer or government spending leading again to the high costs discussed later.

Basically, monetarists believe that in too rapid an expansion if some of the demand can be forced out of the market through higher interest rates and lowered availability, economic stability will be enhanced. Conversely, in a weak economy, they expect the lower interest rates associated with sustained monetary growth to bring forth additional spending.

As an example, those who had picked as just right a 4 per cent growth rate for the narrowly defined money supply (currency and demand deposits) felt that monetary policy was over-expansive during most of 1970 and 1971 even though unemployment was rising and long-term interest rates were near record high levels. In contrast to most observers, they would have reduced the funds furnished by monetary policy. Monetarists usually do not say what, if any, limits to high unemployment or to business failures ought to be set for this "right on" type of activist monetary policy, but such costs evidently could be high.

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In my view, changes in monetary policy may be desirable, but they should be used only to a limited degree (and far less than in the past) in attempts to control movements in demand arising from non-monetary sources. The amount of money supplied should normally rise and fall with the demand for money. Some leaning against the wind may be proper if an unusual increase or decrease occurs in spending, i.e., money may be related to the desired level of spending, but fluctuations in the rate at which money is supplied should as a rule be smaller than in the past. Massive movements in interest rates and availability brought about by shortfalls or overages in the supply of the monetary aggregates should be far fewer. They should only be generated as a result of policy decisions which clearly weigh their costs compared to costs when severe interest rate fluctuations are avoided. In my judgment, such decision rules would lead to a far less activist policy course.

The less activist monetary policy I would propose rejects the fixed rule of the monetarists because shifts in demand for money not matched by supply can cause major reactions in interest rates, the availability of funds, and real demand for output and jobs. Similarly, it rejects too activist a traditional monetary policy because it too may lead to excessive fluctuations in real demand and unwanted side effects in money and financial markets.

We lack accurate knowlege on which to base either type of policy because of uncertainties, a rapidly changing economic structure, and poor information as to when and where monetary policy impacts.

The Lack of Knowledge

Let us consider this point first. Far more stress is needed on these gaps in the information on the use of monetary policy. There are at least three well thought out conflicting views as to how monetary policy works and how it ought to be conducted. An activist policy following one theory is likely to be judged wrong by another.

At the academic level, most agree that our knowledge is too slight to prove any claims to monetary truth. No one has shown that his specific model of the economy and monetary policy is better than others.

At the polemic, popular level -- as in newspaper debates and many technical articles -- this lack of knowledge is frequently brushed aside. The media are full of predictions or statements of assumed relationships made with claims of far greater precision than can be justified. Conflicting doctrines are oversold in an attempt to win the public mind. These debating arguments do not form a sound platform for conducting policy.

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Furthermore, the substance of these statements and debates is far inferior to that required for policy action. Theories may indicate the proper direction for policy action, but they frequently lack information as to the required size or timing of changes. Assumptions are made as to the availability and accuracy of data which are patently false. Dealing daily with data makes one humble. Information is always less than desirable for decisions.

Unfortunately this lack of information does not allow decisions to be postponed or avoided. Our system is geared to create money and credit. The choice is between determining the amount by chance or by policy. Past history demonstrates that either a free market or poor central bank theories can lead to disaster.

Lack of knowledge and uncertainties should, however, lead to less active policies. Since no one is certain as to what is occurring and what it will do to the economy, we should change policies less frequently and less dramatically. Both theories and model simulations of the economy seem to show that lack of information should lead to a more moderate policy.

The Costs of an Activist Policy

In the same way, more attention needs to be given to the costs of current monetary policies. When monetary policy shifts bring about sharp fluctuations in interest rates and the availability of money, the following are among the high costs to the economy. While often unacknowledged, they are quite evident.

... The burdens of monetary policy are not shared equally. Even though recognized as undesirable and unwanted, the impacts upon different sectors are grossly uneven. The hardest hit by tight money, such as small businesses, housing, and local governments seem those with a high social priority. Thus, the costs of an activist monetary policy are regressively distributed. As examples: In 1966, housing starts dropped by nearly 50 per cent, while plant and equipment expenditures of businesses were virtually unaffected. In 1969, the differences were not as large, but housing decreased by 20 per cent, while businesses raised their expenditures nearly 10 per cent.

... But it is not only a case of soak the weak. Rapid changes in interest rates have large-scale impacts on monetary wealth and well-being. In 1969, the current yield (including changes in capital values) on bonds was 12 per cent less than in 1968. Common stock yields were 19 per cent lower. The actual movements from the top to bottom month were much greater. No wonder few owners of financial assets were happy by the end of 1969.

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... Nevertheless, lenders are richer than borrowers. When interest rates move up, those with wealth to lend get more income and those who must borrow have a larger drain on current resources -- even though, as we have just noted, both may have less wealth.

... In contrast to any indirect impact, the direct effects of interest rate rises are inflationary. Interest has a major role in the consumer price index especially through the housing component. It is a large factor in utility costs. Regulatory agencies allow its increases to affect rates and prices almost immediately. When interest rates rise, the direct effects of higher interest rates immediately enhance the tendency toward inflation.

... Movements of interest rates increase the uncertainties and therefore the risks and costs of doing business. Investment will be less in 1972 and its costs more because of the interest rate gyrations of recent years.

... Large-scale shifts in interest rates and in the availability of money shake even the strongest corporations and financial institutions. They can topple those that happen to be caught with their liquidity down. In 1970, most corporations even though hurt were saved from bankruptcy. But the danger lies in the possibility that many essentially sound businesses might be unable to withstand the vagaries of financial pressures, and the uncertainties, imposed by hairpin turns of activist monetary policy.

... Finally, shifts in monetary policy cause rapid movements of "hot-money" through foreign exchanges. International trade and the well-being of many countries may suffer.

Clearly, since an activist use of monetary policy has many supporters, the majority of analysts must either believe that its costs are lower than I do, or that the costs of not using monetary policy are higher still. Everyone wants the lowest cost policies. However, a costless or riskless choice is impossible. A proper choice may mean that even though the lowest cost policy has been picked, it still is expensive.

Quantities and Interest Rates

What type of policy should be advocated by those who fear the activist prescriptions of both the traditionalists and monetarists? I believe monetary policy should strive for greater stability in interest rates and credit conditions -- taking into account information on both quantities of money and interest rates -- rather than either holding money rigid or attempting to move it contra-cyclically.

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The critical and most difficult task of the Federal Reserve is determining how much money should be created in the next three to six months. Some relationship exists between the amount of money demanded, the amount supplied, and interest movements. Some relationship exists between interest movements, shortfalls or overages of money supply, and spending. Unfortunately, our knowledge of these relationships is most tentative and uncertain.

Uncertainties. When demand for money increases faster than supply, interest rates (the price of money) should rise. Interest rates should also rise, however, with the general price level and with expectations of further price changes. How much current price movements do affect interest rates is far from clear. Estimates by good scholars, cogent theorists, and careful empiricists range all the way from 5 per cent to 100 per cent of the past year's price trend.

We also know that interest rates can be affected by very large variations in demand for money in any three-to-six-month period -- changes that are not related to spending or prices.

We also are never certain as to whether the existing level of money or interest rates is a balanced one. Both money and economic conditions may be far from equilibrium. We ought not to struggle to maintain an unstable situation. Similarly we must adjust for past changes in levels whose impacts are still at work.

We know that there can be sudden and temporary shifts in the non-income related demand for money. A surge of stock or bond market speculation, a rush to transfer money abroad, a liquidity crisis, all raise the demand for money sharply. If supply fails to increase equivalently, interest rates will spurt.

Another source of uncertainty arises from the fact that our data on changes in the money supply are weak and subject to major revisions. (The series contain a large volume of statistical noise.) How the supply of money changes in any three-month period can vary by 100 per cent depending on which definition of money you use. Similar size errors are known to exist in the estimated change for any given definition.

Even though we do not know very exactly when or by how much current changes in the availability of money and interest rates will alter spending, we are convinced some reactions will occur at various times in the future. We don't want these movements to run counter to the economy's goals, if such adverse reactions can be avoided.

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Policy. Given the degree of uncertainty, I believe that policy should be developed with one eye on monetary aggregates and one eye on interest rates. Movements in either sphere give valuable information.

Quantities. The less activist policy that I would propose would start with the assumption that under normal circumstances sufficient money should be furnished to finance the desired growth in the GNP. Sufficient money should be defined in accordance with acceptable past relationships. Thus, for the past decade, depending on the exact period and definition used, the rate of growth in money has ranged from 70 per cent to 100 per cent of that for the GNP. If the target growth for the GNP in 1972 were 10 per cent, money should normally expand at a 7 to 10 per cent annual rate.

This general rule would mean that unless money were draining into non-income uses or unless correct observations were being drowned out by statistical noise, a growth rate in money within this range would not be retarding desired growth. Furthermore, if income were growing too slowly to meet the economy's goals since the supply of money would be expanding at a rate to meet the desired rather than the actual growth, additional availability and lower rates would help achieve the goals.

Interest rates. Where do interest rates fit in? How should this normal rule be adjusted if interest rates are say rising? Several different factors would have to be considered.

Do all definitions of money show similar movements? Since we are not certain as to how to define and measure money, we should use any information derived from diverging movements in the various measures.

What is the effect of taking into account recent past movements? Rising rates when supplies in prior periods were low are more likely to indicate too low a supply than if previous supplies had been adequate or large relative to income.

What information is available about changes in non-income demand for money? While not exact some information is usually available about movements in funds demanded by market participants, international firms, or as a result of sudden liquidity shifts.

Are all interest rates moving together? At times movements in rates of a particular type or maturity diverge from the average because of special factors that can readily be explained.

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What effects do the movements in monetary supply appear to be having on other economic and financial variables? Sometimes the transmission of impacts from money supply or rates to specific sectors is prompt enough to be visible. Are these transmissions aiding or hindering the achievement of the economy's goals?

Clearly, the policy strategy contemplated is far from an exact rule. The supply of money would be varied depending upon the logic and facts in a particular period. The best informed judgment of the decision makers would be required to estimate what was happening to demand for money and why. While money would normally be allowed to increase if prices were being pushed up from the cost side, some lag in supply might be appropriate when demand in the economy was pulling prices upward. However, the lag in furnishing money would be far shorter and the failure to meet demand would be far less, than has traditionally been advocated from both sides of the monetary debate. At times, it might still be desirable to allow a monetary crunch, but the costs and benefits from such a policy would have to be far more evident than I believe has been true in most of the post-World War II period.

Similarly in economic contractions, since money would be furnished in accordance with the desired goal for spending, it would fight recessions and depressions. There should not be a flood of excess liquidity, however. Such floods raise too many questions of magnitudes and lags.

What is the logic behind a more passive monetary policy? It says that the Federal Reserve should alter the supply of money in order to minimize major movements in interest rates and availability. Under normal circumstances the Fed should assume that, given the uncertainties in the monetary and economic world, a better monetary policy will result if more or less satisfactory past average relationships are picked as a guide to the amount of monetary expansion that should accompany the nation's economic goals. These relationships should not be maintained dogmatically, but should alter somewhat depending on judgment as to what is happening in the economic and financial world. Monetary shocks to the economy should be administered only as a result of a clear decision that the costs are worth the expected gains; that spending must be shifted; and that non-monetary policies will not be used.

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