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FEDERAL RESERVE POLICY AND THE ECONOMIC OUTLOOK

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

to the

Chesapeake Chapter of Robert Morris Associates

Bethesda, Maryland

Wednesday, December 3, 1980

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I am happy to speak to you tonight about Federal Reserve policy and the economic outlook. My most useful contribution to your view of the outlook, I should think, would be to comment on what I would regard as a desirable and, I hope, realizable pattern for 1981, and then to discuss the role of monetary policy in such a recovery.

A Desirable Path

The economy has become highly sensitized to short-run influences. This suggests that we cannot count firmly on having the kind of steady expansion that we used to enjoy after the recessions of the past. At 10 percent inflation, developments inherently become unstable. Desirable would be a moderate rate of expansion that would allow enough slack in the economy to begin winding down the inflation. In the past, cyclical expansions have almost invariably been accompanied by price increases at the raw material level, although unit labor costs have fallen as productivity gains increased. The outlook for productivity gains, in this round of the cycle, is not strong.

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Accordingly, we must lean on the side of caution and strengthen all our defenses against inflation. Monetary policy is only one of these and cannot be expected to do the job alone. I would like to make this point clearly even though I shall address myself principally to monetary policy.

Monetary Policy Concerns

Monetary policy, as I have said before, will have to play an important role in the development of the economic outlook. Currently, a number of concerns have arisen, as a result of the movements of the aggregates, of interest rates, and of output and prices that have given rise to widespread debate about the conduct of monetary policy. I would like to comment on some of these criticisms and to state the case as I see it.

For about a year now, monetary policy has operated under a new procedure. It has shifted from a looser to a tighter form of control of the monetary aggregates, and accordingly to a diminished emphasis on interest rates. This shift was made because in practice interest rates were not moved sufficiently, especially when the economy was strong, to maintain adequate control of the aggregates. Under the new system, both the rate of growth of the aggregates and interest rates have been very volatile. This has caused concern on the side both of those concerned primarily with high interest rates and those concerned primarily or exclusively with the growth rate of the monetary aggregates.

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"High interest rates." Concern has been voiced with the level to which interest rates have risen -- levels which are regarded by many observers as likely to slow significantly the immediate recovery prospects. This rise in interest rates is to some extent the logical consequence of a more rigorous control of the aggregates. When the economy strengthens, the demand for money and credit picks up. In the face of a stably growing money supply, the market will drive up interest rates. The only way to avoid this would be by accommodating the increased demand for money and credit, which would mean to give up tight control of the aggregates and to overshoot the targets.

Beyond that, however, one must ask whether interest rates are "really" high. If we consider that the average mortgage and business borrower probably pays a marginal tax of at least one-third, an 18 percent prime rate becomes 12 percent after taxes. That is about the present rate of inflation according to the CPI. In the short run, therefore, the present prime rate is barely positive in real terms.

To be sure, this rate may pose a cash flow problem for the borrower. Even though very moderate in real after-tax terms, interest payments need to be financed. However, for the taxpaying borrower the kindly government makes its contribution every three months and to that extent relieves the burden.

The situation is different for a borrower who has no profits and who at best gets a loss carry-forward from a high interest rate. It is different also for a borrower who takes the standard deduction. However, at today's mortgage rates it is reasonable to assume that most new mortgage borrowers itemize their deductions.

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Historically high interest rates, to be sure, also have a psychological deterrent effect. They are in collision, moreover, with institutional rigidities such as usury ceilings and lenders' rules of thumb concerning the debt-carrying ability of borrowers in different income brackets. Nevertheless, these institutional restraints seem to be diminishing. Usury ceilings have been preempted or are in process of being lifted. Lenders find ways, in effect, of basing their assessment of debt-carrying capacity upon borrowers' income a couple of years from now. A changing attitude on the part of borrowers is characterized by the not unusual comment that a rate that seemed an outrage some time ago now looks like a bargain.

Interest rates too variable? Another criticism has focused on the wide variability rather than the level of interest rates under the new procedures. This was, of course, foreseen when these procedures were instituted. But even so the extent of the swings, from a federal funds rate of 19-1/2 to one of 8-3/4 and a Treasury bill rate of 15-3/4 to one of 6-1/2, has been surprising. One would have thought that while the funds rate might become very bouncy, other rates would become somewhat detached, since the funds rate is a daily rate and most other money-market rates are for longer periods up to one year. This, by and large, has not happened, or only to a slight degree and quite recently. One might also have expected that, if a sharp rise in short-term rates were regarded as evidence of a more effective anti-inflationary policy, long-term rates would not go up and perhaps might even come down. This, too, has by and large not happened,

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which raises some question about whether the market regards even nominally very high interest rates as adequate to curb excessive money creation and inflation.

Concern about wide volatility of interest rates has been expressed particularly in the international sector, including, of course, by foreign observers. These rates have caused exchange rates to move in ways not clearly justified by underlying economic factors. It has made it more difficult for other countries to move their interest rates as their domestic conditions made advisable. Thus, the new procedures are being pursued at some cost to our own international sector and to foreign countries. They will have to be justified in terms of their ultimately better anti-inflationary results.

Wide interest-rate fluctuations have also accelerated considerably the impact of monetary policy on the domestic economy. Typically, monetary policy has worked with a lag of 6-9 months, without this relationship being at all reliable. In the words of Milton Friedman, the lag has been long and variable. But very sharp swings in interest rates may well have quicker effects, particularly on housing and perhaps automobiles. The drop in interest rates that began in April of this year preceded the first traces of an upturn that began in July or August by only three or four months. Had the money-supply targets been fully achieved during the intervening months, interest rates presumably would have dropped still further, the economy might have reacted even earlier or at least more strongly, and the subsequent bounceback of interest rates and their impact on the recovery would likewise have been still greater.

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Wide swings in interest rates, of a sort that older techniques would not have produced, thus may have some advantages. They seem to accelerate control over the cyclical fluctuations of the economy. On the other hand, they are doing so at some cost. Among the costs conceivably might be a deterioration of financial and economic institutions, such as the bond market, financial intermediaries, and the housing industry. International relations and perhaps freedom of trade and capital movements could also suffer.

Fluctuations in money growth too wide? It has been said, probably correctly, that under the new procedures we have had the widest fluctuations in both interest rates and monetary aggregates. This fact must be seen against the unusual cyclical background of the year 1980 -- an inflationary boom, a long-predicted recession, and an unexpectedly early recovery. The rapidly shifting demand for money and credit under these circumstances combined with the imposition and removal of credit controls accounts for the sad record of the monetary aggregates -- an overshoot during the inflationary boom, a collapse during the recession, with substantial shortfall from the targets, and rapid resumption of growth in the recovery phase leading to serious overshooting of some though not all of the targets.

If the interest rate fluctuations had been the result of changes in supply, overshooting of the monetary targets presumably would have brought a decline at least of short-term interest rates, and undershooting would have brought a rise. But since the monetary undershoots and overshoots were the result of changes in demand, interest rates moved in the same direction

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as the growth rate of the aggregates. The central bank could have moved more forcefully to keep the monetary aggregates on track. That would have increased the response of interest rates to demand shifts and would have widened their swings. By, in part at least, accommodating the supply of money to changes in demand, interest-rate movements were "moderated."

It has been argued that the aggregates should have been kept on track rather than allowed to over- and undershoot. The ensuing wider interest-rate fluctuations would then have had the effects I have already sketched -- stronger and quicker impact on the real sector, wider exchange-rate fluctuations, probably some damage to the financial system.

The experience of this year supports the view that the causal relationship of monetary-policy action runs from the money supply to interest rates to the economy. It does not run directly from the money supply to the economy, regardless of interest rates. High interest rates up to April (together with the credit control program) curbed the boom. Sharply dropping interest rates from April through June restimulated the economy. Resurgent interest rates beginning in July once more dampened the expansion. Each of these effects was achieved with an unusually short lag. To attempt to trace a direct effect of the money supply upon the economy, one would have to assume zero lags. Money supply and the economy both boomed until April, both contracted thereafter, and both reaccelerated at almost the same time. In this relationship, it is, of course, far more plausible to assume that movements in the economy more or less instantaneously changed the demand for money, than that changes in the money supply more or less instantaneously changed the economy.

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We use the money supply as our policy instrument not because it directly controls the economy, but because it leads to better setting of interest rates. Historical experience shows that so long as the monetary authorities tried to set interest rates, they were likely to act too late and, on the upside at least, also too little. Setting the money supply, and letting it, in interaction with the market, set interest rates, is better procedure. That, as I see it, is the rationale for preferring a money supply to an interest rate focus for monetary policy. This argument gains in persuasiveness the higher the rate of inflation, because the appropriate level of interest rates becomes increasingly hard to discern.

It is sometimes argued that tight control of the monetary aggregates, adhering firmly to preannounced targets, would lead to stabler and ultimately lower interest rates than a procedure that accepts temporary over- and under-shoots. In the longer run, this seems very plausible. Firm control of monetary growth at a diminishing rate will help bring down inflation. Diminishing inflation will bring down interest rates. With prices reasonably stable, interest-rate fluctuations should also be minor. But in the short run monetary restraint, however steady, cannot quickly bring down inflation nor interest rates. The most plausible view is that the main impact of monetary restraint on prices occurs with a two-year lag.

Expectations as the crucial factor? A sophisticated version of the "tight money-supply control" view holds that even though the inflation itself will not be immediately affected, a credible monetary restraint will reduce inflation expectations. These in turn will immediately reduce interest rates,

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especially at the long end. Monetary restraint will be the more credible the more stable it has been. This calls for a completely steady rate of growth of the aggregates, free from temporary overshoots and undershoots. Hence, it is argued, it is not enough to hit the targets over the period of a year, as the Federal Reserve has done to an approximation, or even over one or two quarters. Even though this would probably be sufficient to avoid real-sector impacts, the intervening monthly or quarterly deviations would destabilize expectations.

This view raises fundamental questions. In a democracy with freedom of speech and inquiry, is there a way in which firm expectations can be established? Probably a large majority of the population judges monetary policy by interest rates, not by the growth of the money supply. Quite possibly a majority of the economics profession takes the same view. Many people believe that if policies are pushed to extremes, they sow the seed of their own reversal. There are enough uncertainties and loose ends about a money-supply strategy, such as the shifting character of the individual aggregates to inject reasonable doubt into any money-supply proposition. Moreover, the relation between the monetary aggregates and GNP has suffered major shifts, including one from 1974 to 1977 which reduced the amount of money demanded at a given level of income and interest rates very substantially.

Under such circumstances, it may be risky to become irrevocably committed to a numerical set of targets. And it may take a philosopher-king, rather than a Congress and President, not to interfere subsequently with a target that for some reason has become unpopular.

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The difficulty of forming hard expectations under such conditions is pointed up by experience abroad. The countries that have been most successful in conducting a noninflationary monetary policy are Germany and Switzerland. Both countries have money-supply targets. But both countries have been quite relaxed about their adherence to these targets. Switzerland in 1979 altogether dropped its target and accepted an 8.5 percent increase in M-1. Germany overshot its targets in 1977 and 1978. Comment that reaches us from German and Swiss sources usually is to the effect that reacting to weekly data means overreacting, so long as the target is observed over longer stretches of time. Evidently, the citizens of Germany and Switzerland do not lose their expectation that inflation will be fought successfully if the central bank overshoots occasionally. But, it must be added, their expectation probably derives from belief in a stronger commitment of the entire government and the private sector to price stability than exists in the United States.

Even so, it is hard to believe that the people and the markets should change their long-run expectations fundamentally with every month of high or low numbers that is published. Interest rates do move up and down with over- and undershoots of the aggregates. But surely interest rates move because most market participants reason that the Fed will eventually have to counter the deviation and thereby cause interest rates to go up and down. It seems unlikely that they should interpret a deviation as a permanent change in policy implying higher or lower inflation later on and interest rates to match.

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It would be tragic if the view should gain ground that the Federal Reserve possesses some unexplained power to control inflation if only it will control the aggregates not just on an average basis but month-to-month and perhaps week-to-week, and that the administration, the Congress, and the private sector, having thrown this responsibility upon the Fed, have no further responsibility for causing and curbing inflation.

Improved short-term money-supply control is desirable, so long as it does not, during recessions, lead us to negative real interest rates. But it is no panacea. In particular, any form of money-supply control, whether based on monthly or on semi-annual or annual targets, may become enormously costly unless it is accompanied by a move to a balanced budget as a general rule and by the relaxation of the myriad of government price-raising actions, ranging from all kinds of regulation to import controls, farm price supports, indexing of government pay scales and social security, and the Davis-Bacon Act. A firm monetary policy, moreover, should be accompanied by a constructive dialogue of business and labor recognizing that both sides suffer from inflation, and, as I have said many times before, by a tax-based incomes policy. The Federal Reserve cannot do it alone without great cost and damage. In other words, passing the buck to the Fed is not the answer.

Are the targets excessively restrictive? For the year 1981, the Federal Reserve tentatively has stated the following money supply growth targets: 3 - 5-1/2 percent for M-1A, 3-1/2 - 6 for M-1B, 5-1/2 - 8-1/2 for M-2, and 6-9 for M-3. These targets are to be affirmed or modified by February 20, 1981, the date on

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which the Federal Reserve is required to present its targets to the Congress. The 1981 targets are 1/2 of one percent below those for 1980, following the principle that the money-supply growth should be brought down gradually and steadily. Adequacy of these targets for a period of resumption of growth has been questioned by some observers. Can a rise in nominal GNP of perhaps 9-11 percent, consisting of not much less than the 1980 rate of inflation and a very modest rate of growth, be financed by the aggregates growing at the indicated rates?

This will depend on the behavior of velocity. If there is enough of a rise in velocity, the growth of the "effective money supply," that is money growth plus velocity growth, will be adequate. Otherwise, velocity growth will have to be brought about by rising interest rates, and these could interfere with economic expansion.

Velocity responds to three factors -- higher interest rates, which may be an undesirable way of achieving a velocity increase, increases related to the phase of the business cycle, based on a not altogether reliable tendency for velocity to increase during the first year of a recovery, and shifts in the money demand function. These shifts, which I have already referred to, are a new element in the velocity picture which apparently did not exist before 1974. Since mid-1974, a whole collection of standard money-demand functions used routinely in econometric models has misperformed on a large scale by overpredicting the amount of money that would be demanded at given levels of income and interest rates. By late 1979 this overprediction amounted to anywhere from 9-17 percent of M-1A and M-1B, or something like $35-70 billion.

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This overprediction of the amount of money required in fact made the Federal Reserve's targets, which seemed quite restrictive, turn out relatively unrestrictive. Shifts of this kind raise questions about a stable relationship between money and income upon which the money-supply targeting approach rests. The problem can be remedied only if these shifts can in some degree be predicted and integrated into the target ranges.

The evidence seems to show that shifts of this kind tend to occur after a new peak of interest rates has been reached and passed. This sort of experience encourages firms and households not only to economize routinely on their money holdings but to undertake a thorough restructuring of their techniques for holding money, such as shifting to zero-balance or overdraft arrangements. It seems likely, therefore, that the experience of very high interest rates in 1980 is again motivating change in the practices of holding money, minimizing the use of demand deposits and perhaps currency. This would allow for a shift in the demand function that would make the Federal Reserve targets for 1981 adequate without relying mainly on higher interest rates to achieve higher velocity. The uncertainties inherent in this approach underline the advisability of stating money-supply targets in terms of a range rather than of a single number.

In conclusion, I would like to say that the money-supply targets tentatively indicated by the Federal Reserve hold promise for bringing the rate of inflation down. This should be true so long as the targets are achieved over time, even though not week-by-week and month-by-month. An essential prerequisite, however, is that monetary policy be not required to carry the entire burden of fighting inflation but be firmly supported by a

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move toward a balanced budget and other anti-inflationary policies in the public and private sectors.

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