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Remarks by

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

at a conference on

"The Search for Stable Money"

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Cato Institute

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In addressing myself to the topic "Changes in Monetary Policy and the Fight Against Inflation," I would like to begin by dispelling two myths that have grown up about monetary policy in the United States. One is that until October 1979 the Fed targeted on interest rates and then switched to a money-supply target. The other is that the Fed recently has given up money-supply targeting and is simply trying to bring interest rates down by inflating the currency. Monetary policy, to be sure, is complicated. But, this is not one of those cases where fact is stranger than fiction. The facts about Federal Reserve policy are readily available. What is puzzling is how such myths get started and proliferated until they are accepted as unquestioned fact.

The Shift to Money-Supply Targeting

As for the alleged switch from interest-rate to money-supply targeting in October 1979, the record shows that the Fed began to target primarily on money supply early in 1970. Beginning in 1975, under a joint Congressional resolution, the Fed began to present its money-supply targets to the Congress at quarterly intervals. Subsequently, the Humphrey-Hawkins Act of 1978 mandated semiannual reports to Congress of intended growth-rate ranges for calendar year periods. All this is readily available in the public record of Congressional hearings, of Federal Open Market Committee (FOMC) meetings, and numerous other public statements.

What changed in October 1979 was not the target, but the techniques of implementing it. Up to that time, the Fed had sought to implement its M1 and M2 and, at times, other targets by moving the federal funds rate, i.e., the interbank rate, so as to influence the demand for money. This was a perfectly workable technique, but it suffered from a reluctance of the FOMC to move the funds rate fast enough and far enough to keep the money supply on track even over intervals of several months or longer. Because nobody, including the Fed, likes to see interest rates go up, there was over time a bias in policy which allowed the money supply to expand excessively.

The 1979 shift in the implementation of money-supply targets was from a funds-rate technique to a reserve technique. By limiting the supply of reserves and, therefore, the amount of money the banks could create on the basis of these reserves, greater control of the money supply became possible. It was understood that this procedure would make interest rate movements more flexible, since the funds rate would be determined by the

market rather than by the smoothing action of the FOMC. That the new technique yielded a better control of the money supply -- at least in the long run -- is indicated by the fact that while under the old technique inflation continued to accelerate, under the new technique it has come down very substantially. It must be noted, nevertheless, that the decline in inflation did not bear a very stable relation to that of money growth and that inflation both accelerated and slowed down faster than money growth, in their respective upward and downward movements. Evidently, allowance must be made for the impact on inflation of many other factors besides money, including unemployment, capacity utilization, oil and food prices, wage pressures, the exchange rate of the dollar, and a wide array of government policies directly contributing to inflation.

Money-Supply Targeting Still Observed

The second myth, as I have already noted, is that some time around the middle of 1982 the Federal Reserve abandoned money-supply targeting. The evidence, it is alleged, is that since that time the monetary aggregates have been allowed to run somewhat above their targets and that beginning in October, the M1 target was sharply deemphasized while M1 accelerated rapidly.

The facts, again, are on record from FOMC meetings, Congressional hearings, and other statements. During 1982, a pronounced precautionary demand for money developed, which was indicated by the sharp fall in velocity of monetary aggregates. In other words, households and firms decided to hold more money in relation to income and transactions than before. They may have been motivated to do so not only by concern about the economic situation, but also by falling inflation and interest rates, which made the

holding of money less costly. Since the targets were constructed on the assumption that the velocity of M1 would continue to rise while that of M2 and M3 would be roughly stable, following their respective historical patterns, the fall in velocity would have made the targets excessively tight.

In addition to these factors affecting all the aggregates, M1 particularly was subject to a series of unique developments. First, there was the repayment of some $36 billion of all-savers certificates which most holders had to reinvest in some form. This caused a temporary accumulation of liquid balances. Then came the prospect of possibly very attractive new deposit accounts, as a result of interest-rate deregulation by the DIDC (Depository Institutions Deregulation Committee). One of the new options, the money-market deposit account (MMDA) could be expected to attract funds out of M1, since the MMDA is a nontransaction account and forms part of the broader aggregates. A second option, the super NOW account, is a transaction account forming part of M1. To the extent that holders are attracted by it, funds may shift into M1. M2, in either case, would not be affected by the bulk of these shifts, since they would be taking place between different components of M2, although M2 would be boosted by shifts of funds into the new accounts from market investments excluded from M2. Whether the rate of growth of M1 is lowered or raised by the public's response to these two options depends on how relatively attractive the banks and thrift institutions make the accounts, and on how the public views the relative benefits of freedom to draw checks without limitation, differential interest rates, and the advantages of deposit insurance.

Since under these circumstances the probable near-term evolution of M1 became unforeseeable, targeting on this aggregate ceased to be advisable. The FOMC had little alternative but to downgrade it at least for the time being in favor of other targets. As is evident from the last published policy record of the FOMC for its November 16, 1982 meeting released on December 27, 1982, the FOMC chose to give greater emphasis to M2 and M3.

Interest-Rate Targets

But, while the Fed has not given up on money targets, today the argument is increasingly heard that the Federal Reserve ought indeed to abandon them and instead target on interest rates. This idea is supported by the myth to which I have already alluded, that before October 1979 the Fed did in effect target interest rates. The fact is that the Fed did so only in a much more distant period, during World War II and the late 1940's, and to a lesser degree during the 1950's and 1960's. In those days, people were far less conscious of inflation than they are today. Potentially inflationary policies could be pursued for some time without having their full consequences. Even then, it was recognized by Chairman Eccles of the Federal Reserve that the policy of pegging interest rates turned the Fed into "an engine of inflation." Following the pegging episode, which ended early in 1951, the Fed devoted much of its energies to getting as far away as it could from a rigid pegging of interest rates. Some progress was made, but in the event not enough. Efforts to keep interest rates low led to acceleration of the money supply, especially during the second half of the 1960's. It was realization of this defect of interest-rate targeting that in early 1970 led to a shift to money-supply targeting.

To go back to interest-rate targeting now presumably would have analagous effects. But businesses, consumers, and home owners have meanwhile become sophisticated about inflation. The whole economy now is highly sensitized. The inflationary results, therefore, would come much more quickly. By the same token, the ability of the Federal Reserve to keep interest rates down in such conditions would be much less than it was decades ago.

Low interest rates are highly desirable as a stimulant to investment and, thereby, economic activity. But they have to be earned, and earned by a low rate of inflation. If they are brought about artificially by the flooding of the economy with liquidity, their stimulative effect will soon be terminated by accelerating inflation. The way to bring interest rates down lastingly is to bring down the inflation. The effort to do so did temporarily add to upward pressure on interest rates. But, as inflation came down, interest rates also have come down. It would be a tragedy to jeopardize this solid success for the sake of a brief stimulus likely to be followed by even greater pain than we have suffered so far. Both inflation and, eventually, unemployment could become more severe than we have seen.

Real Interest-Rate Targeting

Suggestions have been made also that the Fed target on real interest rates. Real interest rates, i.e., interest rates adjusted for inflation, are a key variable affecting the economy. It is on them that investment and perhaps even saving largely depend.

The problem with targeting on real interest rates in the first place is that the Fed cannot measure them with any precision and, even

if it could, it cannot achieve them except very temporarily. If the Fed tried to set them higher or lower than required for market balance, forces of contraction or expansion would be set in motion. For a short period, the impulse so imparted to the economy presumably would be of the sort desired by the central bank. But if maintained continuously, the impulse would overshoot and defeat the central bank's purposes.

Furthermore, low real rates, while highly desirable, are so only in the same sense that low nominal rates are desirable -- when they are achieved in a noninflationary way. Low real rates, to be sure, can be achieved also by inflation, for temporary periods. But that would merely assure that inflation will continue or accelerate further. When a real interest rate of say, one percent, is achieved by a nominal interest rate of 20 and an inflation of 19, the unwisdom of this form of interest-rate targeting quickly becomes obvious. Low real interest rates have to be attained by nominal rates coming down faster than inflation, rather than by inflation rising faster than nominal rates.

In our process of disinflation, short-term interest rates have come down from their peaks about as far as inflation has from its own peak. Thus, real short-term rates are about unchanged. For instance, the prime rate has dropped from a peak of 21-1/2 percent to 11 percent and the commercial paper rate has dropped from nearly 20-3/4 to 8 percent, while inflation, as measured by the CPI over 12-month periods, has come down from a peak of 14.7 percent to 4.6 percent. Long-term nominal rates have not come down proportionately, which perhaps indicates that people are still not optimistic on the long-term outlook for inflation. Their peak was about

18 percent compared with a present 11-3/4 percent for AAA utilities. More progress needs to be made in bringing real rates down. But, it will not be durably achieved by a self-defeating increase in the money supply.

"Easing"

Frequently, the Fed is being urged to "ease" without specific indication of what manner of easing is meant. Is it a lowering of interest rates? Is it an increase in the growth of the money supply induced by the Federal Reserve? In the short run, the two tend to go together, especially as regards short-term rates. For long-term rates, the effect is less certain and, in any event, probably much more short-lived.

Easing is desirable if it takes the form of lower interest rates resulting from lower inflation. But a reduction in interest rates achieved by a sustained acceleration of money growth eventually has to be paid for by higher inflation. Higher inflation also means higher interest rates, that is, a reversal of any initial reduction. To be sure, "higher" inflation is higher only relative to what inflation would have been if such "easing" action had not taken place. If there are strong downward pressures on prices and wages from high excess capacity and unemployment, inflation may nevertheless continue to decline. But, it will decline more slowly and less far than it would in the absence of monetary acceleration. Once excess capacity and unemployment have been reduced to a level where they no longer work against inflation, which indeed will take some time, all that is left of the exercise is a greater amount of money in the economy than there would have been otherwise, and a higher level of prices.

The Fiscal-Monetary Mix

Easing is urged upon the Federal Reserve particularly as a "quid pro quo" for budget tightening. It is generally recognized that the large structural component in our present huge budget deficit, now of the order of $70 billion or more and in danger of going much higher if nothing is done, is at the root of many of our problems, including high real interest rates. A reduction in the deficit, to become effective at a time when the economy no longer needs the stimulus in order to recover, is urgently needed. But, would it make sense to ease monetary policy to compensate for the reduction in purchasing power resulting from a lower deficit? Reducing the deficit will make a large contribution toward reducing real interest rates, as the government's demands on the national supply of saving diminishes. Accelerating the money supply for an extended period would mean temporarily lower interest rates but more inflation and higher interest rates eventually, relative to the results of a stable money-supply policy. There is a lasting benefit to be gained from a lower budget deficit but not from combining it with greater monetary ease. Trying to change the fiscal-monetary mix in the direction of greater fiscal tightness and greater monetary ease is not a meaningful policy for more than a short period. All the lasting benefit to be obtained comes from the reduction in the deficit. That should be our major objective in the fiscal-monetary area. It is fiscal policy, not monetary policy, that can lastingly change real interest rates.

A temporary change in the fiscal-monetary mix is a theoretical possibility. If a temporary acceleration of the money supply were reversed in a timely fashion, and the extra money put into the economy taken out

again, no lasting damage and some temporary benefit would result. But, this is a degree of fine tuning that our experience shows to be virtually beyond our powers. Slowing the growth of money sufficiently to make up for temporary overexpansion is difficult and painful. It would also create credibility problems for the Fed. Certainly, it would be a high-risk operation.

The best contribution that monetary policy can make is to continue to bring down inflation. That is entirely consistent with a moderate rate of economic growth and a decline in unemployment to less unacceptable levels. Only if economic growth becomes very rapid, which does not seem likely at this time, would the inflation-reducing effects of high excess capacity and, unfortunately, high unemployment be nullified and perhaps reversed. The best way in which the Federal Reserve could contribute to this continued reduction in inflation would be to continue its discipline on the growth of money and credit.

Targeting in the Face of Monetary Innovation

Despite what has been happening to M1, M2 and M3 seem to be continuously usable. They are somewhat harder to control than M1, because the bulk of their components are not reservable and because their market-interest-related components make them less sensitive to interest-rate changes. A credit aggregate target conceivably also could serve. There is a choice across the spectrum from bank credit, which is a relatively small variable, to total credit raised by all nonfinancial sectors, including government. Even the monetary base could serve, although a serious problem results from the fact that three-quarters of the base

consists of currency and that nobody knows where much of this currency is. Targeting on nominal GNP I would regard as inadvisable because it is technically difficult and because there is a clear danger of an upward bias. While most people intuitively sense that where money supply is concerned, less is better than more, most would probably assume that, in the case of nominal GNP, more is better than less. Obviously, "more" resulting from a higher inflation component in nominal GNP is not better.

There has been a great deal of debate over techniques of monetary targeting. Such debate, however meritorious, runs the risk of distracting our attention from the principal goal, which is to overcome the inflationary forces in the economy. Techniques of money-supply targeting do matter. There is a need for continuing improvement, and for adaptation to changing conditions of regulation and changing payments techniques. But, the effect of targeting on money-supply or credit does not basically depend on the techniques employed. It depends on its being done in a way designed to reduce inflation while helping the economy to recover. What matters is that policies having these effects not be given up in favor of others that, in the long run, if not immediately, would have the opposite effect. It would be unfortunate if those of us who regard price stability as an essential condition of sustainable economic growth were to weaken our own cause by continuous debate over techniques and so, in effect, put form over substance.

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