

For release on delivery
Monday, May 12, 1969
(Approximately 1 P.M., C.D.T.
(1 P.M., E.D.T.))



TASKS OF MONETARY POLICY

Remarks of

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Board of Governors
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at the

22nd Annual Conference
of the
Financial Analysts Federation

St. Louis, Missouri

May 12, 1969

TASKS OF MONETARY POLICY

I imagine I was invited today because of the problems that most of you face in formulating an analytical concept with which to treat monetary policy. The type of questions you probably have in mind are those I am asked daily. Why are prices rising so fast when interest rates are so high? Do the high interest rates cause the high prices? Is gradualism in fighting inflation possible, or logical? How does the Federal Reserve expect to halt the price rise? Is monetary policy frustrated by bank innovations of new ways of raising money that avoid reserve requirements? Must stock prices and output be depressed to end inflation?

In the words of the famous bishop, "Those are real questions." Unfortunately, I don't plan to answer them for you. While I have my own views on each question, on some and perhaps many they would not be at the consensus of Federal Reserve opinion (if there is such a thing!). Instead, I thought it would be more useful to you simply to outline some of the concepts useful in judging these and similar problems.

I have picked the title, "Tasks of Monetary Policy," because it seemed to me simplest to organize analytical concepts by first outlining the divergent views of many as to what logical tasks or limits exist for the Federal Reserve and then to show some of the factors leading to these varying views.

Note that I have used the term, "task," rather than, "goal." Everyone can agree with the general goals of national economic policy, namely, full employment, maximum sustainable economic growth, relative stability in prices, and a viable equilibrium in international financial relationships. These are the objectives of the entire Government, including the Federal Reserve. But controversy arises when it comes to implementing policies to serve these ends. Debates continue with respect to the channels and timing of monetary policy, the appropriate mix of monetary and fiscal policy, and to the relative priorities to be assigned to the different objectives in differing economic environments.

There are at least three contrasting views as to the task monetary policy should attempt to achieve. I speak of the choice of a task as the choice of a specific target which is used to guide the rate of expansion in money or credit.

One view is that monetary policy should aim at achieving a more or less constant rate of growth in the monetary aggregates. The aggregate chosen may differ among proponents--some take total reserves, or the monetary base, or the narrow money supply, or money in a broader

definition, or total bank credit--but the objective in any case is to establish a neutrality in monetary policy by allowing the demand and supply for goods to adjust themselves through interest rates, velocity, prices, and employment without being influenced by any shifts in monetary responses.

A second view of monetary policy--the one traditionally held by policy-makers and the financial community--is that monetary policy should be contra-cyclical, i.e., monetary expansion should be controlled so as to add to or subtract from the demand for goods and services when they are below or above some normal growth line. It is argued that the non-monetary factors in the economy, such as demand from military, international, fiscal, and private sources cause large fluctuations in spending. The task of monetary policy is to work against these factors in a manner calculated to produce the proper equilibrium of aggregate supply and demand. If these other factors are inflating the economy, monetary policy should be deflationary and vice versa.

A third view is that monetary policy has a special obligation to defend the value of the dollar, both at home and abroad. Although the multiple objectives of national economic policy are recognized and accepted, this view holds that prices and the balance of payments are first-order priorities for monetary policy. Thus, so long as prices are rising significantly, or if prices are rising faster than is occurring generally abroad, monetary expansion should be restrictive even if this requires a slowing up in the growth rate for the economy as a whole and an increase in unemployment.

To many the idea that there are differing views as to even what task monetary policy is to perform may seem strange. Daily I read stories and look at cartoons picturing the Federal Reserve's battle against inflation. Most seem to imply a direct relationship between monetary policy and prices. They jump the tremendous gap which actually exists between these two. A great deal of confusion seems to surround the question of how monetary policy works. Partly this arises because the operational techniques employed in monetary policy are complex. Partly it arises from the central banking tradition that objectives can be achieved more easily if they are left ill-defined instead of being spelled out. Partly it arises because of lack of knowledge or agreement as to how monetary policy does work.

In fact, however, how and when monetary policy affects prices remain the subject of great debates. People's ideas as to what a logical task is for monetary policy depend upon their judgment as to how changes in policy influence the economy, how long it takes for a change to be effective, and also on value judgments as to who gains and who loses if

the path to achieving a particular task requires greater sacrifices in certain fields, and among particular individuals, than for the average person.

The Channels of Monetary Policy

At the most general level, there is agreement as to how monetary policy works. To fight inflation, monetary policy must lower demand for goods and services. If the ability of the economy to produce rises faster than demand, excess capacity will appear in both plant and labor. Such excess capacity should lead to smaller increases or to actual decreases in profits, wages, and prices.

The tools of monetary policy, however, do not have a direct impact on demand. There are missing links and unknown factors. The Federal Reserve affects the cost and availability of bank reserves. Changes in reserves influence money and credit. Money and credit influence demand. Demand influences output, employment, and prices. On this path, the Federal Reserve's actions have a unique and known result only with respect to reserves. In each of the other steps, the impact of monetary policy is diffused. It is just one among many forces active in the economy. The channels, the degree of influence, as well as the time path by which monetary policy affects prices remain subject to much debate.

The Federal Reserve does influence the cost and availability of money and credit. We need not delay by detailing the ways in which this influence is exerted nor need we discuss the offsetting or reinforcing pressures from other sources. The question is how are the movements in money and credit transmitted into changes in demand. How do higher interest rates and smaller increases in money and credit create deflationary pressures?

The literature lists five possible methods of transmission from money and credit to spending. After the change in money and credit has influenced the amount of spending, different estimates also exist of the way in which spending changes are divided between real output and prices and in the time it takes each to be effective.

1. The stock of money. The simplest and most direct view is that changes in the amount of money are directly transmitted into changes in spending. Questions do arise in this sphere as to what constitutes money, whether the changes in money and spending are or are not proportional, what time lags exist, and as to the impact of interest rate movements. On the whole, however, people are expected to spend less when they hold less money. A decrease in the rate of money creation will be followed by a fall in the rate of new spending.

2. The cost of capital. The level of interest rates is an important factor determining the amount purchasers will spend on real estate and other long-lived goods. If interest rates rise, abstracting from the effect of other forces, less should be spent on plant and equipment, housing, consumer durables, and governmental investment. When financial interest rates rise, a fixed unit of physical capital is a less desirable purchase.

3. The wealth effect. Consumers' spending is influenced by their net worth. Consumers will demand less when their net worth falls. Monetary policy has a deflationary impact insofar as it tends to lower the prices of stocks and bonds. The fall in stock prices may result either from lower earnings or from the fact that earnings are capitalized at higher interest rates.

4. The availability of credit. The decrease in reserves implied by monetary restraint means funds for lending by institutions are likely to become less readily available. Some potential borrowers will find that they cannot obtain loans from their normal suppliers. Nonprice rationing will prevail. Either because of changes in down payments, terms, requirements for balances, or simple refusals, less will be borrowed. Less will be spent. The clearest example is in housing where because of limited funds, usury laws, or liquidity factors, institutions may sharply curtail lending. Those desiring to buy a house may find funds available only at prohibitive rates if at all.

5. Psychology or expectations. Some argue that people will buy less because of lower expectations of future income or of future ability to borrow. Others point out that psychology may influence lenders' willingness to make loans. A perverse effect is, of course, also possible with people rushing to buy or get available credit if they believe it will be less available in the future. While much of the impact of expectations may primarily influence the timing of expenditures, if the shifts in timing are great enough they can affect the level of demand--clearly so in short periods--but also over a longer run.

The Timing of Monetary Policy

Estimates of the time it takes a change in monetary policy to influence spending, and then prices, vary. Most studies of past history, however, agree that movements occur slowly. There is a considerable lag between an action and its results. What the final time path looks like will, of course, depend on how great a change occurs in monetary reserves (with the related movements in money and credit); on how long the changed levels are maintained; and probably on the intensity of the force against which monetary policy is acting.

The time at which results can be expected will depend upon the channels through which monetary policy transmits its force. Thus, those who believe expectations are important would not be surprised if a change in monetary policy were followed by a sudden and dramatic shift in spending. At the other extreme, those who assume monetary policy primarily affects business spending on plant and equipment would expect to see little if any impact during the first year or two of a changed policy.

While the estimates from history of the time relationships involved are extremely crude and subject to all types of analytical and statistical questions, they are worth examining. They give some idea of the kinds of delays and lags which may exist, although it is important to recall that the variations around the estimates are great and that the forecasting record is not too good. In order to compare various estimates, let us assume that a change in monetary policy is maintained for a year. How long will it take before the new monetary policy begins to change spending significantly? How long into the future will this year's change in policy still be cutting into the expansion in demand?

Those studies based upon a direct relationship between changes in the amount of money (however defined) and movements in spending show the most rapid impacts. However, because measures of even past relationships are sensitive to specific assumptions, they vary considerably among themselves. As an example, some studies show that from 15 to 25 per cent of the expected total decrease in spending rates will occur in the first six months after a deflationary policy is enacted. From 55 to 60 per cent of the decrease can be expected in the first year. The remaining impact on the economy's growth rate should be felt during the year after the policy has ended. (As an aside, I might note that two of three major monetary aggregates show no growth over the past five to six months.)

In contrast, the models which assume monetary policy is effective through other channels show much slower impacts. Several econometric studies I have seen, for example, show that if monetary growth is retarded for an interval of one year, the first six months of the period will witness less than 5 per cent of the total decrease expected in spending's growth. For the whole first year, the share of the total decrease is less than 20 per cent, and for the first two years it is about 60 per cent. Three years after monetary policy returns to its original state, a depressing effect is still being exerted on the growth of spending.

These same models estimate that a balanced fiscal program (half tax increase/half expenditure cut) will have more than three times as great an effect on the economy's first-year spending as will a monetary change with the same ultimate impact. Those who follow monetary effects through the spending channels believe that fiscal policy has a

comparative advantage over monetary policy in timing as well as in equity and certainty. This is why such stress is placed on having a large surplus in inflationary periods such as the present.

All of these studies show additional lags between the time when spending is curtailed and the time when prices come under measurable pressure. For example, the large-scale models with a slow reaction to monetary change show very little price impact in the first year. It is not until the third year after a monetary policy change occurs that even half of the estimated pressure on prices is felt. Of course, a faster reaction of spending to monetary changes speeds up the pressure on prices.

Still, except for purely psychological theories, most analysts probably would not expect any appreciable price impact until at least a year after monetary policy alters. Even a more direct channel between monetary policy, spending, and prices would still probably show that the peak of price reactions would not be reached until the third year after monetary policy changes.

Relationship to the Choice of Tasks

An understanding of the diverse ways in which monetary policy may influence spending, output, and prices is one of the factors leading to people's choice of the task for policy. However, different valuations of risks, of the ability to forecast, and of particular goals also create separate choices.

Those who choose the simple rule of a constant growth in the monetary aggregates believe that the time lag before monetary policy takes effect is relatively long and policy-makers--influenced inordinately by current developments--are very likely to make the wrong decisions. Therefore, the results of policy will be maximized if the long-run monetary needs of the economy are determined and then provided month by month and year by year. Other factors may influence the short-run performance of the economy, but in the long run steady growth in the monetary aggregates will prevail and the best over-all performance of the economy--in terms of all of our major objectives--will be achieved.

There would be little debate over the tasks of monetary policy if everyone agreed that this golden result would follow from a simple rule. Unfortunately, doubters exist. Interestingly enough they hold that the rule may be either too restrictive or not sufficiently restrictive depending on particular circumstances.

It would not be restrictive enough if the economy simply increased the velocity with which money is used. These critics hold that if real demands are sufficiently inflationary, total demand will continue to grow and prices will continue to rise even if the rate at which the monetary aggregates expand is quite slow. While there may be a final limit on the speed at which money turns over, velocity has increased in all except one of the past 20 years for the narrowly defined money supply and in 60 per cent of the years for the broader aggregate which includes bank time deposits. In any case, year-to-year changes in velocity frequently have been great. Thus, the simple rule if applied automatically could still lead to price increases in many years.

The problem at the other extreme is related to the one that faces the use of monetary policy when it attempts to deflate demand. Should major consideration be given to the possibly uneven impacts of a deflationary monetary policy in specific markets? This is in part a question of how much consideration in over-all policy should be given to the possibility of a financial crunch--by which I assume is meant an inability of credit markets to function in an orderly and continuous manner. It is alleged that if a crunch occurs in markets for municipal or corporate securities, or for mortgages, the result will be greater long-run damage to the operations of the economy than would be justified by any short-run policy goals. Indeed, if the market reaction is severe enough, an inability to sell financial assets combined with a marked slowing in flows of funds to banks and other financial institutions could lead to a liquidity crisis and possibly the failure of some of these institutions.

A second kind of market consequence that some would say represents too high a price to pay for the short-run goals of monetary policy would be a "crunch" in particular markets for goods. Thus, if credit flows are sufficiently restrained, some goods markets heavily dependent on credit may be severely constrained. The traditional victim is housing, but State and local capital spending and the orderly financing of small business may also be candidates for such a fate. Involved are not only questions of national priority, but also the possibility that the squeeze could be so severe that resources permanently disappear from the market, thus jeopardizing its ability to recover production potential at a later date. Again, the question is whether there is a point beyond which product market adjustments to tight money are too drastic to warrant the end objectives being sought.

In contrast to the above, many believe that monetary policy will not be performing its proper task unless there is some form of crunch probably in both financial markets and in the markets of particular industries. They believe that in an inflationary period, monetary policy will not have a sufficient impact unless it is definitely hurting many potential borrowers and spenders.

For those who can tolerate a good deal of discomfort in individual credit and product markets, the point marking the outer boundary of monetary restraint may be that where the effects of restraint on the over-all economy begin to bite substantially. Thus, a sharp drop in business profits, or a significant rise in unemployment or a stalling in the real growth of the economy may be judged too drastic a medicine, even though, for example, prices are continuing to rise and the balance of payments continues in an unsatisfactory condition. The longer run effects of these developments--on the nation's investment potential, material welfare and social fabric, respectively--may be regarded as too great for the benefits to be gained. Moreover, it is pointed out that by the time these conditions become evident, it will already be too late to halt them through a reversal in policy, in view of the time lag before such policy change will take effect.

Those who pick the third task--that of using monetary policy primarily with the aim of halting price increases--clearly believe either that no legitimate constraints on policy exist or that they will not be breached. A deflationary monetary stance should be maintained, according to this view, even if particular markets get into difficulty and the unemployment rate is rising significantly. This, in essence, is the old gold standard view of forced internal adjustment; though not often labeled as such in modern parlance. It still represents the position of a significant number of financiers and economists.

Conclusion

While I have merely attempted to sketch some of the diverse views of the tasks of monetary policy, I hope I have given you some feel for the complexities surrounding current debates both as to where we are and where we should go.

It would be nice if all that had to happen to stop prices from rising was to set monetary policy at a given level particularly if such a setting contained no risks of undesirable effects. Unfortunately, this is not the case. Which task is selected depends upon individuals' and institutions' beliefs in how monetary policy works, the period within which its influence will be felt, and the risks of failure from too much or too little action.

The choice of tasks is never static. Views change with surrounding circumstances. Many people, I believe, are now prepared to run higher risks of undesired consequences from a restrictive monetary policy than was the case two or three years ago. This reflects dissatisfaction with the higher rates of inflation we have been experiencing.