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SATURDAY, NOVEMBER 7, 1981
10:06 A.M. LOCAL TIME (4:00 P.M. EST)

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Remarks by

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

before the

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Gesellschaft fuer Wirtschafts- und Sozialwissenschaften
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A convergence of views seems to be underway concerning U.S. monetary policy. Differences between monetarists and others, which at one time seemed important, are in the process of being bridged. Positions that earlier seemed matters of principle are becoming questions of degree, and are being revealed as amenable to a pragmatic approach.

This, at any rate, is how I view the progress of the discussion that has been going on in recent years. It has, of course, become increasingly lively since the Federal Reserve adopted its tighter money-supply control measures of October 6, 1979.

At a theoretical level, there remain, to be sure, many issues that separate Keynesians, monetarists, rational expectationalists, and, of late, supply-siders. I shall comment on these here only to the extent that they have implications for the practice of monetary policy.

The Predominance of Money-Supply Targets

The evolution of monetary policy techniques in most major countries has gone in similar directions. Money-supply targets have taken the place of interest-rate objectives. Cyclical fine-tuning has given way to policies aiming at steadiness, with priority given to gradual reduction in the rate of inflation.

In the United States, the shift to a money-supply target began in 1970, and since 1975, this target has been published and announced in periodic Congressional hearings. The frequently cited date of October 6, 1979, marks, not a shift to a new policy or target, but to a new technique and more vigorous pursuit of the money-supply target.

Money-Supply Targets and Interest Rates

One of the consequences of this more vigorous adherence to a money-supply target has been a widening of interest-rate fluctuations. In an economy in which the demand for money does not grow perfectly stably, a tighter control of the money supply is likely to make interest rates and exchange rates more volatile even in the absence of major cyclical fluctuations in the economy. The degree of randomness in the system must find expression in either quantity or price. In the presence of pronounced cyclical fluctuations, however, such as the United States experienced in 1980, steady adherence to a money-supply track is likely to lead to wider fluctuations in interest rates than have ever been deliberately set in motion by the Federal Reserve under regimes in which interest rates played an important role. Thus the anticyclical effects of monetary policy may at times have

been increased rather than diminished. This tended to happen all the more as United States financial markets became increasingly alert to money-supply variations and reacted more rapidly and strongly both with respect to interest rates and exchange rates.

Loosening Relation of Money and the Real Sector

In the United States the increasingly thoroughgoing application of monetarist techniques was accompanied, however, by circumstances and developments that did not, by themselves, seem to make the pursuit of monetarist principles more plausible. One such development was the diminishing stability in the relation between money and economic activity. During the years 1975-76, the United States experienced a massive reduction in the amount of money demanded at any given level of nominal income and interest rates, the two principal determinants of the demand for money. This shift was apparent in the overpredictions of most of the standard money-demand equations. That shift, as measured by cumulative overpredictions to the end of 1976, was estimated at 7 percent, or on the order of \$20 billion. Velocity increased accordingly. This was one of the principal reasons why the seemingly very tight money-supply targets pursued by the Federal Reserve during those years ultimately proved to be not tight enough.

Another major shift of this sort occurred in 1981. The most plausible explanation for permanent downward money-demand shifts is that after each experience of very high interest rates, holders of money balances make renewed efforts to reduce their non-interest-paying balances. At the

same time it appeared as if the lag between changes in money growth and the reaction of the real sector, which Friedman years ago had characterized as "long and variable" and which by rule of thumb was typically put at six to nine months, had shortened, particularly in the housing sector.

Softening of the Money Concept

Another development not in itself propitious to the pursuit of a money-supply target was the softening up of the concept of "money" itself that has occurred in the United States in recent years. In good part this derived from the new techniques of economizing cash balances. The old definition of M1 as currency plus demand deposits became inadequate. Rising inflation and the effort of balance holders to obtain interest on transactions balances that in most economic theorizing bear no interest were at the root of this evolution. Checkable interest-bearing transactions balances such as NOW accounts (negotiable orders of withdrawal) and certain types of money-market mutual funds expanded rapidly. The Federal Reserve found it necessary to include these new instruments in one or another of the monetary aggregates.

In the process the aggregates were substantially redefined. M2 particularly in its new version first published in February 1980, jumped from \$960 billion to \$1,520 billion as of year-end 1979. Many users of the statistic may never have become fully aware that its content had changed, and that its behavior potentially might also have changed, even though that behavior might not, in an immediate sense, be obviously different from that of the earlier version. Moderate reshuffling of some new or old components

would significantly alter the growth rates of M1-B and M2 respectively. That would be the effect, for instance, of inclusion in M1 of some money-market mutual funds or inclusion in M2 of retail RP's (repurchase agreements), which exploded in August and September of this year. The old M1, now M1-A (currency plus demand deposits), began to decline rapidly following the introduction of nationwide NOWs at the end of last year. Had a rigid money-supply target been mandated by legislation or perhaps even constitutional amendment, as had been proposed from time to time, the target would almost certainly have been M1 and probably would have led to an extremely inflationary policy if implemented in terms of M1-A.

Some observers have seen in this development an economic analogue to the Heisenberg principle of uncertainty which implies that the observed object changes as a result of being observed. The attempt to control a monetary aggregate may well contribute to the motivation of market participants to avoid this control. More specifically, however, it is the high rate of inflation and the consequent high level of interest rates interacting with deposit interest-rate prohibitions or ceilings that has fueled these endeavors.

Unexplored Properties of Money

More fundamental uncertainties also underlie these shifts in the relation of money to economic activity and changes in the components of money itself. Not much is known, or better is specifically agreed, concerning the properties that an asset would have in order to be regarded as "money." Academically, the usual approach seems to be that "money is as money does." Econometric tests are run to determine the relationship of money to economic activity. Whatever variable comes out ahead in the race, giving the best fit,

is declared "money." One might have preferred a more fundamental approach, examining different candidates for the title in terms of characteristics such as liquidity, acceptability, character of the issuer, nature of the asset being monetized, the rate of return, and many others. At the Federal Reserve Board, extensive and in-depth research was done in connection with the redefinition of the aggregates in 1980. Currently, research is being conducted into methods of weighting different components of the aggregates. Whether the inverse of the rate of return, which features as the principal weighting variable in this technique, offers the best weighting system or not is debatable. But in any event one is bound to suspect that there must exist better systems of grouping, let alone weighting different types of money, than are presently employed, even though at present it is difficult to say which they might be or how the available data could be made to yield them. It is hard to believe that the optimum is achieved by the existing system of discriminating among deposits, characterized as transactions and nontransactions balances, which is the distinction presently drawn between M1 and the higher aggregates, or by the denomination and maturity of the instruments, which is the distinction between M2 and M3. Any process of weighting, of course, so far is foregone altogether.

Likewise, there should be some information content in such attributes of money as its ownership. The Federal Reserve's data, which distinguish consumers, nonfinancial and financial businesses, foreign holders, and others have been used effectively in research done on money demand at the Board, but overall do not seem to have attracted many users, in part perhaps

because of the modest quality of the data. In fact, most attempts to subdivide financial assets into categories that ought to have some informational content quickly seems to lead researchers into a flow-of-funds approach, the relationship of which to the real sector and to monetary policy making has remained frustratingly vague.

An examination of the data of the U.S. flow-of-funds statistics very quickly reveals that the narrow money supply has represented a rapidly shrinking fraction of total financial assets of domestic nonfinancial sectors, while these total financial assets have retained a fairly constant relationship to GNP. In other words, the narrow money supply has lost some of its importance as an asset. The chances, of course, that any financial variable can exert a stable controlling influence over the real sector diminish as the size of the supposedly controlling variable diminishes relative to the size of the variable to be controlled. It is intuitively more plausible that a large financial variable should have such an effect than a small one. If a close correlation were to be found between such a small variable and GNP, it would be more plausible to assume that the causal relation was running from GNP to the small financial variable than vice versa.

Inflation Requires Money-Supply Targets

It is remarkable that, in the face of all these unpropitious circumstances and developments, the money supply has achieved its present preeminent role as a central bank policy guide. The reason, I believe, is inflation.

Interest rates become an inappropriate policy guide, are hard to read, difficult to justify, and likely to mislead. During inflation, a stable rate of money growth means at least a roughly stable rate of inflation, barring major shifts in the money demand function. A stable interest rate very likely means an accelerating inflation, unless the interest rate is set so high as to produce an accelerating price decline.

Even if the relationship of money to economic activity is not stable over time, it will always be plausible in the short run that less money means less inflation. Once the effort to bring down inflation has become the number-one policy objective, a constant policy of slowing the growth of money becomes appropriate, largely independent of cyclical considerations. All this helps to explain why, during inflation, central bankers become monetarists. If and when prices are stabilized, the temptation will be great to return to interest rates as a guide.

Areas of Convergence of Views

To be sure, this ordering of priorities has still to stand the test of both prolonged high interest rates and of recession. It is perfectly possible that, as has periodically occurred in the past, recession might generate a public demand for reversal of priorities, and for action to reduce unemployment. However, it is in the nature of a money-supply target to accommodate such demands. In a recession, maintaining a stable growth of money very likely means injecting into the economy much more liquidity than is demanded at anything like prevailing interest rates. The very low interest rates that would result from firm adherence to an unchanging money-supply target would of themselves provide powerful stimulation to an economy

in recession. Demands for antirecessionary policy would thus be met automatically. Pursuit of a money-supply target, by sharply depressing interest rates in recession and sharply raising them in expansion, builds a floor and ceiling into the economy that tends to limit cyclical fluctuations.

The movement of U.S. interest rates in 1980 gives evidence of this, even though the money-supply target was not continuously met. More rigorous adherence to the target would, in all probability, have produced even wider swings in interest rates. Thus, recession would probably not lead to demands for abandonment of a money-supply target. On the contrary, in recession the vigorous pursuit of a money-supply target would probably satisfy the popular demand for easy money and would most likely be interpreted by many as an easy-money policy.

It is within this broad framework of ideas that it is possible to perceive the degree of convergence on a range of monetary-policy issues in the United States.

(1) Priority of fighting inflation. The priority of fighting inflation seems to be well established and accepted. This contrasts with, in the past, a predominantly anti-cyclical orientation of policy. Steadiness in the application of this policy is viewed as necessary.

(2) Moderate and declining targets. A need for a moderate money-supply target, declining over time, seems to be generally accepted. The targets established by the Federal Reserve involve reliance on considerable gains in velocity. For instance, an M1-B target of 3-1/2 - 6 percent (adjusted for shifts into NOW accounts out of assets other than M1) is

certainly a very moderate target in relation to a nominal GNP growth on the order of 10 percent which this money supply is expected to finance. Targets of 6-9 for M2 and 6-1/2 - 9-1/2 for M3 likewise are moderate. Yet annual velocity gains on the order of 5 percent for M1-B have at times occurred historically even without a sizable increase in interest rates. On the contrary, failure to anticipate large velocity gains has contributed to the expansiveness of monetary policy in the past and has repeatedly frustrated efforts to curb inflation during the 1970's.

(3) 'Week by week and month by month?' There seems to have been some narrowing of the distance between those who believe that money supply must be rigorously kept on target week by week and month by month, and those who believe that deviations from target for one or even two quarters have little impact on the real sector. On the one hand, it is becoming increasingly apparent that very tight control is precluded by the inherent instability of both money demand and money supply. The amount of "noise" in the system is reflected in a standard deviation of weekly M1-B figures of \$3.3 billion although opinions may differ as to the degree to which control could be improved by still more rigorous techniques governing the supply of reserves. Techniques are available and under study that might serve this purpose -- the use of contemporaneous rather than lagged reserve requirements, staggered reserve requirements, and a floating discount rate. There are divergences of views as to whether these techniques, while improving the accuracy of monetary control, would do so at the expense of greater volatility of interest rates or whether interest rates also would move more

smoothly under these procedures. It does seem to be increasingly recognized that wide volatility of interest rates represents a cost that cannot be ignored.

On the other hand, those who stress the long lags between movements of money and their real-sector effects have come to be aware of the damage that prolonged deviations from target, even if economically innocuous, may cause to the credibility of monetary policy in the current U.S. environment. In the first place, in a market that is highly sensitized to any deviations of the aggregates from track, the danger of misinterpretation of a temporary deviation as a policy move is always present. It has been argued that this kind of "Fed-watching" could be discouraged by foregoing the publication of weekly data. But aside from possible legal impediments to such action, the chances are that it would be counterproductive, in addition to being inherently distasteful to an economist. The market very probably would construct its own data and, if they turned out to be unreliable, would be in all the more danger of misinterpreting policy. Moreover, there is some evidence that the market fundamentally interprets the data correctly, derived from the fact that the term structure of Treasury bill futures, after each weekly publication of the monetary data, tends to move in the direction of the spot rates that eventually will materialize for Treasury bills at the respective future dates. Thus, at least while the market remains highly sensitive to short-term deviations from target, such deviations involve a cost in terms of possible misinterpretation of policy and loss of credibility which, if possible, should be avoided.

Furthermore, deviations from target remain without real-sector effects only if the aggregates return to track subsequently, in the absence of shifts in the money-demand function. Otherwise, even though the original growth rate may be reestablished after, say, a temporary upsurge, that growth will thereafter proceed on a path with a higher level. With more money permanently in the economy, there will be real-sector consequences. Bringing the aggregates back on track may not be easy, however, if the initial deviation was the result of a shift in demand rather than of supply. If the aggregates are pulled above their target by a surge in real spending, this overshoot of the target presumably occurs despite Federal Reserve efforts to hold them down. To bring them back to track against the same strong pull would take a much greater effort. It is better, therefore, not to allow too large a deviation in any case.

Finally, a money supply that is above or below target part of the time will not remain without real-sector consequences even if from time to time it is brought back on track. On average, the money supply will have been higher or lower than if the target had been continuously adhered to. A deviation would be neutralized fully only if it were matched by an equivalent deviation in the opposite direction. This would not be easy to accomplish, and represents one more reason for not deviating too much in the first place.

(4) Credibility. Convergence of views seems to be occurring with respect to the broad concept of "credibility," of which strict adherence to the money-supply target is only one aspect. It is increasingly becoming realized that expectations, important as they are, are not formed by

announcements, but by observation of performance. Expectations do shape events, but primarily it is events that shape expectations. A committee of twelve in Washington cannot by either announcement or performance determine the beliefs of 227 million people if the 227 million do not like what they hear or see. There is at present a bill in the House of Representatives impeaching each of the members of the Federal Open Market Committee. There is a bill in the Senate that would fire the entire Board. The issue is not whether my colleagues and I would yield to such threats. The fact is that Congress could make them come true and that the voters, moreover, conceivably could change the Congress at the next election if Congress does not. Ultimate credibility, in a democracy, can be established only by the electorate.

(5) Direct effect of money vs. transmission via interest rates.

An incipient convergence of views also seems to be present in analysis of the transmission mechanism of monetary policy. Under the impact of high interest rates, and their visible consequences, it is becoming increasingly obvious that the effect of a restraining money-supply policy is transmitted to the economy through interest rates, rather than through some direct effect. As a result, less is heard of the proposition that monetary policy by itself should act to restrain inflation while fiscal policy should be eased to stimulate investment. It is recognized that interest rates affect investment, and that they restrain inflation by restraining aggregate demand.

(6) Liquidity preference vs. Fisher effect. A pragmatic sort of agreement seems to be on the horizon regarding the relation of money and interest rates. The classical Keynesian proposition that an increase in

the money supply lowers interest rates (liquidity preference) seems to be challenged by the weekly observation of reactions to newly published money-supply data. Whenever a strong rise is observed, and particularly if it continues for more than one week, interest rates will go up. One possible interpretation of this phenomenon is that the market views the increase in the aggregates as signaling more inflation ahead and discounts this immediately by moving to higher interest rates (Fisher effect). A more mundane interpretation is that when the market sees the aggregates moving above their track, it knows that reserve demands will tend to strengthen relative to supplies as the Fed attempts to bring them down again and that this effort will be associated with higher interest rates which the market, therefore, implements immediately.

Both interpretations lead to the same conclusion -- an increase in the money stock raises interest rates. It is nevertheless important to differentiate between them because an increase in the money stock may reflect a shift either of the supply curve or the demand curve for money.

The first view -- that an increase in the money stock raises the inflationary expectations -- implies a shift in the supply curve of money. This occurs when the central bank supplies reserves at a faster pace or the banks convert these reserves into deposits with a higher money multiplier by demanding less excess reserves, or because more of the deposits shift to banks with low or zero reserve requirements, or any of the other factors that may increase the multiplier. The second view -- that an increase in the money stock will be followed by stronger efforts to bring it back on target -- implies a shift in the demand curve for money. An upward movement

simultaneously of price and quantity is the normal result of a demand shift. A supply curve shift normally causes opposite movements in price and quantity. It seems more plausible, therefore, to attribute a simultaneous rise in money supply and interest rate to a demand-curve shift than to see in it a supply-curve shift with instant repercussions on inflation expectations and interest rates.

Nevertheless, there is enough plausibility to the supply-curve shift/inflation-expectations nexus to make it an important factor in policy determination. The positive correlation between money and interest rates that is observable almost every week when the money-supply data are published, probably is due, as just noted, to demand-curve shifts and does not indicate that any easing by the central bank, through accelerated money supply, is immediately followed by higher interest rates. But any such easing, if and when it were to occur, would nevertheless be followed, with a lag, by higher inflation expectations and therefore interest rates. Thus the inability of the central bank to influence interest rates by moving the supply curve seems extremely limited. An increase in the rate of growth of money supply generated by the Federal Reserve in the face of unchanging money demand probably brings down short-term rates for some period ahead. But given the probably shortening lag between money and its economic effects, inflation will soon increase and expectation of inflation will increase even earlier. Long-term rates, therefore, might hardly come down at all in response to a Federal Reserve induced acceleration of the money supply. An acceleration of inflation, moreover, would quickly compel the Federal Reserve to reverse its expansionary action. Thus, the ability of the

central bank to lower interest rates by accelerating the money supply is extremely limited. That is the truth content of the statement that "an increase in money raises interest rates."

(7) Influence over interest rates. Following from the foregoing, there is mounting recognition that the central bank can achieve a lasting reduction in interest rates only insofar as it can bring down inflation and inflation expectations. Interest rates could come down also if the economy should weaken significantly and with it the demand for money and credit. This, of course, would not be a lasting solution -- if the economy should recover without any abatement of inflation, interest rates would return to their previous high levels.

At any given level of inflation and income, a lasting reduction in interest rates could be brought about only by an increase in saving, particularly the saving (or reduction in dissaving) of the government. This indeed would produce a reduction in real interest rates. On this analysis a growing consensus is emerging in light of the response of financial markets to the prospect of a much enlarged federal deficit. Under prevailing conditions, the enduring power wielded over interest rates by the budget far exceeds that wielded by the central bank. Fiscal policy, although of late regarded by many as having less power than monetary policy in the determination of interest rates, is revealed to be more powerful. This should not be surprising, since monetary policy cannot, in the long run, influence real variables whereas fiscal policy can. The growing realization that this is so nevertheless makes an important contribution to the convergence of views on monetary policy.

(8) What is "Easing?" One area remains in which little convergence of views is apparent so far, possibly because it is a question of semantics, or at least definition. This is the interpretation of "easing" and "tightening" of monetary policy. In terms of money-stock targeting, an upward deviation, i.e., an acceleration of money growth, presumably should be viewed as easing, a downward deviation as tightening. If such deviations occur at the initiative of the central bank, i.e., represent a shift in the supply function of money, interest rates, or at least short-term rates, at least initially will move in directions suggesting the same interpretation as the movement of the aggregates, i.e., interest rates falling when the aggregates accelerate, and vice versa. If, however, the cause of a deviation from the money-supply target is a shift in demand, interest rates will move in the same direction as the aggregates and will thus throw off an opposite signal. Falling aggregates would signal tightening; falling interest rates would signal easing.

Probably the great majority of observers and certainly the general public interpret monetary policy in terms of interest rates. Considerable sophistication is required to ignore interest rates and be guided by the money supply. Moreover, interest rates do, of course, exert a stimulating or restraining influence on the real sector. Thus, in the case of a recession and a consequent demand-induced deceleration of the aggregates, with a simultaneous drop in interest rates, one could speak of a tightening action only in the sense that the drop in interest rates does not go as far as it would have had the aggregates not decelerated.

Fundamentally, this issue raises the question how "easy" or "tight" monetary policy should be during cyclical expansions and contractions, to which reference was made earlier. Should interest rates move as far down and up as they would have to if the money supply is to be kept rigorously on track? Or should interest-rate fluctuations be more moderate, in order to avoid, during recessions, conveying to the public the impression that the central bank had given up fighting inflation. This issue arose in the second quarter of 1980, when interest rates dropped precipitously but the money stock nevertheless fell below target. Flooding the economy with liquidity under such conditions reduced the danger of a deeper and more prolonged recession. But it may have sent out the wrong signal to the public and laid the groundwork for an excessive subsequent expansion, in addition to possibly causing wide swings in exchange rates. Such swings carry the risk of doing damage to markets, financial institutions, and sensitive sectors of the economy at home and abroad.

Moreover, a policy allowing or indeed promoting very wide swings in interest rates poses the issue of negative real rates. Are negative real rates ever appropriate when the continuing objective is to fight inflation? In the absence of inflation, even the easiest of easy-money policies cannot make real rates negative. Is it possible to fight inflation with interest rates that are lower, in real terms, than the lowest that can be attained when prices are not inflating? Or do negative real rates, especially taking tax deductibility into account, while preventing further contraction of the real sector, just prepare the ground for a resurgence of inflation during the next expansionary phase? Convergence of views on these issues is necessary to avoid serious misunderstandings about policy.

Conclusion

In conclusion, it is necessary to reemphasize that the analytical and policy issues on many of which there is now a convergence of views pertain to a period of high inflation. Inflation gives preeminent importance to the money supply as a target and instrument of policy. In conditions of credibly stable prices, interest rates would again play a major role in central-bank policy. But the lesson of experience surely is that both need to be considered in some degree at all times. During inflation, a money-supply policy that ignores interest rates altogether and, for instance, during a recession, generates severely negative real rates, lacks credibility. In times of stable prices, an interest-rate policy that leads to excessively high money growth is likely to come to grief. The debate over the respective merits of the new kinds of policy guides may continue, but a compromise position, weighted one way or the other according to the rate of inflation, seems appropriate at all times.

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