# MONETARISM WITHOUT MONEY*

by

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*The views expressed are personal and not the views of the Federal Reserve System.

The central issue of this conference is: why have interest rates been so high in recent years and what needs to be done to bring them down? It is probably the central issue for the economy in the next few years, because it is unlikely that we can sustain a prolonged economic expansion unless the cost of capital, both equity and debt capital, can decline substantially below the current levels.

In attempting to address this issue it is useful to differentiate the short-term debt market from the long-term, since they are driven by different forces. The short-term debt market is dominated by simple demand and supply forces. The long-term debt market is driven by the state of long-term expectations with respect to the future level of inflation and the consequent future level of interest rates.

The short-term market can be dominated in the short-run by the central bank, since the central bank is the residual supplier of liquidity. The degree of influence of the central bank on the long-term debt market is much more limited. Keynes argued that the investor making a long-term commitment can never have enough information to make that commitment with any high degree of certainty. Therefore, the final decision must rest largely on what he called "animal spirits" (or which most people call business confidence). It is this viceral rather than cerebral impulse which is dominant in long-term investment decisions.

With this minimal theoretical background, let us begin with the short-term debt market, where we find interest rates at unusually high levels, given the extremely depressed state of the economy. Perhaps we may gain some enlightenment by comparing two years of severe recession, 1974 and 1982. In both cases, the preceding business peak was established in July of the preceding year. As Table 1 shows, 91-day Treasury bill yields averaged almost 3.4 higher in 1982 than in 1974 and high-grade corporate bond yields averaged more than 5 percent higher.

If the short-term market is a pure supply-demand market, can the higher short-term yields of 1982 be explained by slower rates of growth of money, liquidity and debt, in nominal terms or in real terms? The answer given by the statistics in Table 1 is--no. The monetary aggregates and total liquid assets grew significantly more rapidly in 1982 than in 1974. Our preliminary estimate indicates that total nonfinancial debt grew at only a slightly slower rate in 1982 than in 1974.

Moreover, the increase in the GNP deflator was substantially larger in 1974 than in 1982--8.8 percent versus 6.0 percent. Thus, if cast in real terms, all of the measures of money, liquidity and debt grew at significantly higher rates in 1982. It would seem that the answer for 1982's higher short-term rates is not to be found on the supply side of the market.

Table 1

Percent Rate of Growth

| | 1974 | 1982 |
|---|---|---|
| M1 | 4.4 | 8.6 |
| M2 | 5.6 | 9.1 |
| M3 | 8.5 | 9.6 |
| Total Liquid Assets | 9.3 | 10.3 |
| Total Nonfinancial Debt | 9.5 | 8.3[1/] |
| GNP Deflator | 8.8 | 6.0 |

Average Yields -- Per Cent

| | 1974 | 1984 |
|---|---|---|
| 91-Day Treasury Bills | 7.87 | 10.72 |
| High-Grade Corporate Bonds | 9.42 | 14.68 |

[1/] Estimated

Looking at the demand side, one major difference stands out. In 1974 the U.S. Government absorbed only 6 percent of total credit flows.[1] During the first three quarters of 1982 the corresponding figure was 40 percent and in the third quarter it was in excess of 50 percent. While the overall supply of funds was growing more rapidly in 1982 than in 1974, the funds available for all sectors other than the U.S. Government was smaller.

If the unusually heavy absorption of total credit flows by the U.S. Government is the principal reason why short-term interest rates are high, it is the expectation of $200 to $300 billion deficits in the foreseeable future years which account for the very high long-term rates. The investment manager sees one of two scenarios if the outlying years deficit problem is not resolved. Under one scenario the Federal Reserve does not monetize an excessive amount of the debt. Interest rates must rise enough to limit the growth of private credit demands so that room is created for financing the government deficit. Under scenario two, the Federal Reserve, in the face of strong political pressures, monetizes an excessive amount of debt. Interest rates may decline temporarily but they will rise later on as the inflation rate accelerates. Under neither scenario does the investor find long-term bonds attractive,

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[1]Total funds advanced in credit markets to nonfinancial sectors. Source: Flow of Funds Accounts.

even though the current yield is extraordinarily high relative to the current inflation rate. The current inflation rate is not very relevant to the long-term investor if he views it solely as a cyclical phenomenon.

The American investor, having gone through three decades in which every attractive long-term bond he purchased was deeply under water within a few years, has become very skeptical. Reflecting this skepticism, the long-term debt market has become much too thin for a healthy economy. Changing the mindset of the investing community to a belief that the current level of long-term yields represents a historic buying opportunity is the most critical job for public policy. We have a long way to go.

In addition to bringing the projected deficits down to levels which would permit an adequate volume of private investment, we must also be concerned about the image of monetary policy in the marketplace. With a healthy state of long-term expectations so critical to our economic success, what the market perceives the Federal Reserve to be doing may be almost as important as what we are actually doing. To nurture optimistic expectations, the Federal Reserve must set credible targets for policy and systematically achieve those targets. For this purpose we must target aggregates which are both predictably related to the nominal GNP and not subject to distortion by the wave of financial innovation around us.

This leads me to my principal theme. We are approaching a critical watershed in the formulation of monetary policy. The policy structure of recent years, which has been oriented toward controlling the growth rate of the money stock, is being unravelled by a wave of financial innovation which is making it more and more difficult to measure the money stock, i.e., to differentiate money from other liquid assets. We are left with three alternatives: to go back to managing interest rates, to continue the present course of redefining the money supply as best we can to reflect the latest innovations, or to shift from controlling money to controlling the growth of liquidity and/or debt.

Since there is some Congressional sentiment for returning to the pre-October 1979 practice of managing short-term money rates, it is timely to look back at the reasons we abandoned that practice. Prior to October 1979, we had money supply targets which we attempted to achieve by manipulating short-term money rates. The critical flaw in that approach was that the FOMC never knew what level of interest rates was required to meet its objective, whether that objective be the intermediate target, the money supply, or the ultimate target, the nominal GNP. There is no economic model that can predict with even modest accuracy the level of the Federal funds rate required to achieve any given level of the money stock or GNP. Given this fact, and given also the knowledge of FOMC members

that large changes in interest rates will produce major changes in the U.S. economy and, through the foreign exchange markets, in foreign economies as well, there was a consistent tendency on the part of the Federal Reserve to move interest rates in smaller increments than were necessary in hindsight to accomplish our objectives. Policy was almost always moving in the right direction but often too slowly, with the result that policy was too often pro-cyclical in its impact. Given this history, there is no sentiment within the Federal Reserve to return to managing short-term interest rates.

The new policy regime initiated in October 1979 was unique, not in that we established money growth targets, but that we sought to achieve them by managing the rate of growth of bank reserves, allowing short-term money rates to be largely market determined. The new regime has proven to have a number of important advantages. First, it has brought a greater public understanding of the objectives of the Federal Reserve. There is a broad public understanding that, if we are to deal with inflation, we must decelerate the rate of growth of the money supply. Second, it has produced a much more rational dialogue on monetary policy between the Federal Reserve and the Congress. The level of interest rates is always a very sensitive political issue; the rate of money growth is usually not. Third, it has imposed a very considerable discipline upon the FOMC itself.

Having voted on a path for money growth, the Committee must be willing to accept the market-determined consequences of that path for interest rates.

It is ironic, therefore, that the new regime, which undoubtedly would have produced better monetary policy in the 1970s, was introduced at almost the precise time that serious problems would be encountered in measuring the money supply.

There was a time, not too long ago, when it was easy to differentiate transactions balances from short-term investment funds. First, payments could only be made by demand deposits and currency. Second, the law prohibited the payment of interest on demand deposits. As a consequence, there was a financial incentive to limit demand deposit balances to levels needed to support transactions. Third, while it was recognized that "near monies" existed, there were costs involved in shifting from "near monies" to money.

In recent years, all of these features which differentiated money from other liquid assets have been seriously eroded. Payments are now made by checks drawn on NOW accounts and Super-NOWs, on the new money market deposit accounts, on money market mutual funds and on cash management accounts at brokerage houses. Furthermore, all of these accounts pay interest on balances. With the single exception of the ordinary NOW

account, the interest rates paid are unregulated and market determined. The incentive to minimize non-interest-bearing balances to that level needed for transaction purposes is lost or greatly diminished.

Finally, the cost of transfers from "near monies" to money has been virtually eliminated by the computerization of the financial system. The importance of the computer to this revolution in the way people manage their liquid balances cannot be over-estimated. Many of the innovations which are blurring the line between money and other liquid assets would not have been feasible in the precomputer era.

Thus far, the Federal Reserve has been responding by revising the definition of the monetary aggregates to reflect the changes occurring in the marketplace. There are two problems with this approach. First, because the new accounts provide a blending of a transaction vehicle with a short-term investment vehicle, the redefinition must necessarily be highly arbitrary. We can illustrate the problem by reference to a new innovation not yet reflected in the latest redefinitions announced on February 11. Money market mutual fund shares owned by individuals are classified in M2 because, although they are checkable, minimum denominations for checks are typically imposed. However, a few money market funds, to compete with the Super-NOW accounts at banks and thrifts,

are now offering unlimited checking. Presumably, if this practice becomes widespread, all of these funds will be moved into M1 on the occasion of the next redefinition, even though to most owners of the accounts only part of the account is truly a transactions balance.

The second basic problem with the redefinition approach is that the character of the aggregate is continually changing. A great body of theory and a vast amount of empirical work preceded the decision of the Federal Reserve to target transactions balances--with the expectation that the rate of growth of those balances would have a predictable relationship to the nominal GNP. But this expectation rests critically on our ability to measure transactions balances accurately. It means that we must be able to develop an M1 series in 1983 which is functionally equivalent to the M1 of the 1960s and 1970s. This we cannot do. We, therefore, have no scientific basis for expecting that the new M1 of the latest redefinition is going to have the same behavioral characteristics relative to the nominal GNP as the M1 of earlier years.

The situation with M2 is not much better. As late as May 1978, less than 2 percent of M2 paid an unregulated, market-determined rate of interest. The M2 of the future will be dominated by accounts carrying market-determined rates. Its growth rate will be determined, in part, by the degree to which banks seek

to fund their operations in money market deposit accounts, which are in M2, or in large CDs, which are in M3 but not in M2. The structure of M2 has been so radically altered from the M2 of the 1960s and 1970s that we cannot assume that its behavioral characteristics will remain unchanged.

M3 will be least affected by the latest innovations, since funds attracted by the new accounts are likely to be offset by a shrinkage in funds obtained in the large CD and term RP markets. M3 is a vast collection of liquid assets, comprising most of the liabilities of the banking and thrift systems plus all money market mutual funds. It constitutes about 82 percent of total liquid assets. M3, while it would probably be a serviceable target for monetary policy, is subject to distortion by shifts of funds between open market instruments and M3 accounts. For this reason, it would seem more logical to target on total liquid assets rather than M3.

If we were to abandon the concept of controlling money and move to the concept of controlling liquidity and/or debt, the two most promising candidates as monetary policy targets are total liquid assets (L) and total domestic non-financial debt (D). The debt of the financial sector is removed from the latter aggregate in order to avoid double counting. At its February, 1983 meeting the FOMC adopted a range of 8½ to 11½ percent for D in 1983. In the words of Chairman Volcker:

> "While the credit range during this experimental period does not have the status of a 'target', the Committee does intend to monitor developments with respect to credit closely for what assistance it can provide in judging appropriate responses to developments in other aggregates."*

There was not much to choose between L and D on their performance through 1980. They have both been very stably related to the nominal GNP historically. In 1981 and 1982, however, net debt proved to be a superior target for policy. Those years were characterized as years of strong liquidity preference among investors. The growth of L accelerated in 1981 and remained at a high level in 1982. At the same time, the rate of growth of D continued to decelerate from the 1980 pace. (See Chart 1) The reason for these disparate movements was that the strong liquidity preference of investors, which was reflected in a strong growth in liquid assets, was also reflected in an aversion to investments in long-term debt. As a consequence, the decline in the rate of growth of long-term debt, principally mortgages and corporate bonds, more than offset the increased rate of growth of short-term debt.

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*Testimony before the Senate Committee on Banking, Housing and Urban Affairs, February 16, 1983.

Targeting concepts of the money supply, the definitions of which are frequently being changed and the character of which are never quite the same from one year to the next, is certain to led to difficulties. A case in point was the decision of the FOMC at its October, 1982 meeting to set aside M1 as a target. This was unquestionably a correct decision. If the Federal Reserve had followed a course designed to bring M1 in within the top of its 5½ percent range, a very substantial rise in interest rates would have been required, despite the severely depressed economy, and the upturn which began in January, 1983 would have been aborted.

Even though the FOMC made the correct decision in setting aside M1 during the closing months of 1982, the action was disturbing to at least some elements in the market--raising questions about the real objectives and the steadiness of the resolve of the Federal Reserve. The fact that this concern was unjustified does not mean that it had no harmful effects.

The case for reorienting Federal Reserve policy from the control of money to the control of liquidity and/or debt seems to me to be a strong one. We have made a small step in this direction in setting the guidelines for 1983, but we have a lot farther to go.

CHART 1

# The Growth of Net Debt and L

(growth rate over preceeding 12 months, in percent)

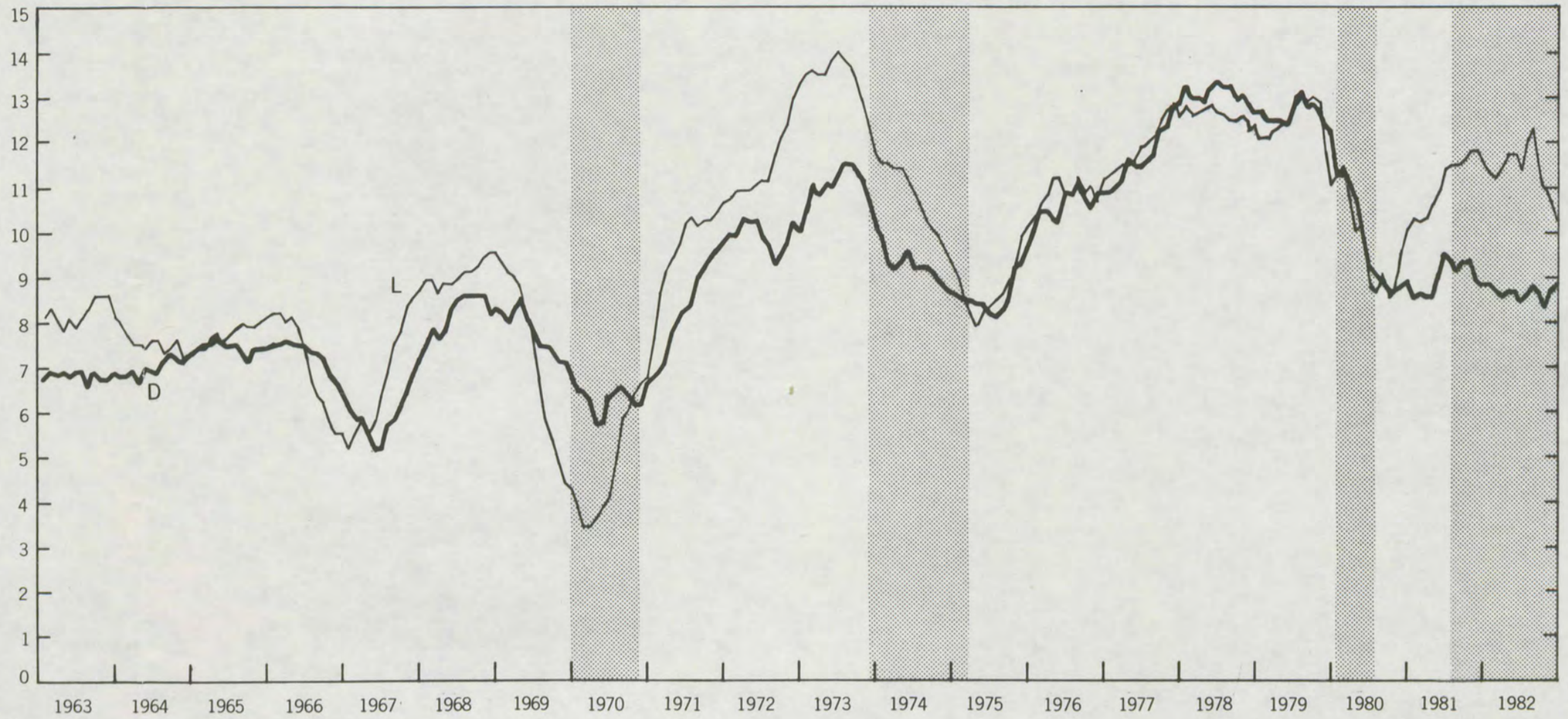

CHART 2

# The Growth of Net Debt and M1

(growth rate over preceeding 12 months, in percent)