

The Goals and the Implementation of Monetary Policy\*

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\*The views presented here are personal and not necessarily the views of the Federal Reserve System. I suspect that my colleagues would find little to quarrel with in my statement of goals. However, my views on the implementation of policy are, unfortunately, not widely shared in the System.

The principal goal of monetary policy is to keep the economy on a moderate growth path--one which can be sustained without generating a reacceleration of the inflation rate. A long economic expansion, uninterrupted by recession, offers both the best option for reducing the unemployment rate to more accustomed levels and the best environment for modernizing our capital stock. By contributing powerfully to a revival of growth in world trade, a sustained expansion in the United States would also do much to resolve the financial problems of the developing nations.

We are very sensitive to the enormous price that was paid to get inflation under control and we are determined that this investment shall not be wasted in another round of demand-generated inflation. For this reason, at a very early stage in this expansion the Federal Reserve moved to moderate a growth rate which was threatening to drive us off the moderate growth curve.

A related objective is to improve the investment climate in the United States by reducing the cost of capital--both equity and debt capital. To accomplish this it will be necessary to create an environment which will change the current state of the long-term expectations in the investment community. We have learned that long-term expectations are not changed very readily. It took a number of years and many disappointments before the investor demanded a sizable inflation premium in bond yields. It is likely to take a number of years of unexpectedly good news on inflation before that premium will be reduced substantially. The bond

investor is not impressed with a deceleration of inflation associated with a recession. What will be required to reduce the inflation premium in bond yields is a showing that we can sustain a long economic advance without a substantial rise in the inflation rate.

These goals represent a rather tall order for a single policy instrument. When I was a graduate student at this great institution, a flexible, stabilizing fiscal policy received much more attention than monetary policy. It is something of an understatement to say that our hopes for a flexible fiscal policy as a stabilizing force have not been met. Fiscal policy is sometimes stabilizing, as it is today, and sometimes destabilizing, as seems likely in 1985, but flexible it is not.

Even the automatic stabilizers of fiscal policy are being weakened. I refer specifically to the decision to index the income tax. Whatever the merits of indexing, we will have lost the dampening influence of a disproportionate rise in federal revenues as an automatic response to an acceleration in the inflation rate. Fiscal policy has been reduced to simply another exogenous force that monetary policy must contend with.

What are the prospects for realizing these ambitious goals for monetary policy? In racking up the pluses and the minuses in the situation, perhaps the most important plus could turn out to be strong productivity gains in the next few years. Most economic

models assume a productivity gain of around 1.7 percent in 1984, producing an increase of unit labor costs in the neighborhood of 4 percent. I am inclined to be more optimistic--to think that the 1984 productivity gain may be about 1 percent higher than this and unit labor costs about 1 percent lower.

The years 1980-82 marked the most sustained effort on the part of the business sector to reduce costs and improve efficiency that we have seen since World War II. Corporate support staffs have been thinned out, unions have made substantial concessions on work rules and most corporations can be profitable at a substantially lower volume of output than in earlier years. All of this attention to cost control, which is not likely to weaken very soon, plus demographic changes that will mean a more experienced labor force, should result in strong productivity gains in the years ahead.

During the 70s, the productivity numbers in the United States were much lower than traditional analysis could explain. I think there is a good chance of the opposite situation prevailing in the 1980s. The poor productivity performance of the 1970s gave little or no cushion to absorb wage increases. With a productivity cushion restored we should again be able to sustain real growth with less impact on the price level.

In addition, we have seen a much greater deceleration in wage advances than anyone would have dared to forecast. The rate of growth of total compensation has declined from a peak of 10.5 percent during the year ended in the fourth quarter of 1980 to a

level of 5.4 percent during the latest four quarters. Assuming no external shocks and good productivity performance, the pattern of wage advances should remain in a moderate range. The forecasts of 7 percent to 9 percent price increases in 1984 and 1985 currently seen in the financial press do not seem compatible with the most likely course of unit labor costs.

The current high level of the dollar in the foreign exchange markets is also a strong anti-inflationary force, curbing price advances not only for imports but for import-competitive industries. This current plus for inflation control, which is being purchased at the cost of severe damage to our export industries, is likely to turn negative in 1984. At current exchange rates we should expect a trade deficit in 1984 well in excess of \$100 billion, which means a current account deficit to be financed in excess of \$70 billion. At some point, the willingness of foreign investors to hold dollars at current exchange rates seems certain to wane and a decline in the dollar will occur. In fact, one could make a case that the process has already started.

Another plus factor, which is not likely to be reversed, is the new responsiveness of the housing market to relatively small changes in interest rates. The mortgage rate was formerly rather sticky--lagging changes in the corporate bond market for considerable periods. This is no longer the case. Thrift institutions, finding themselves paying a market rate on deposits, are forced to keep their mortgage rates in step. In addition, many thrift institutions

have converted themselves into mortgage brokers, packaging mortgages for resale, which requires that the mortgages they acquire bear rates competitive with corporate bonds.

At the May 24 FOMC meeting, the Committee voted by the very narrow spread of seven to five to tighten policy. The monetarists on the Committee were content to tighten policy simply because M1 was rising rapidly, but a majority of the seven acted because the economic expansion was clearly much stronger than expected and threatened to gather a head of steam which might be difficult to deal with later. While I was one of the dissenting five, because I thought it was a bit premature to be concerned about the strength of an expansion that was only five months old, the action did have the virtue of demonstrating the new responsiveness of the housing sector to changes in monetary policy.

From late May through early August the Federal funds rate moved up by about 100 basis points. This was accompanied by a simultaneous rise of about 125 basis points in corporate bond yields and in mortgage yields. The response in real activity was remarkably swift. New home sales declined in July, housing permits peaked in August, and housing starts peaked in September. The new structure of the mortgage market gives the Federal Reserve a powerful tool for moderating the pace of the economic advance. We are likely to see more such "mid-course corrections" in the future.

Thus far, I have painted a rather optimistic picture, one which rests admittedly on better productivity assumptions than most analysts are using. The major cloud on the horizon is a unique phenomenon--a federal government deficit that does not decline as the economy expands. Reference to the normal cyclical pattern of the flow of funds accounts suggests that a federal government deficit that consistently absorbs 35 to 40 percent of total credit flows poses a serious threat to the sustainability of the expansion.

In the expansion which began in 1975, for example, the demands of the federal and state and local governments upon the credit markets declined during the first eight quarters of expansion so as to absorb only 20 percent of total credit, while household and business credit demands, which had been depressed during the recession, rose to absorb the remaining 80 percent, divided roughly equally between the household and business sector. If we premise that going into 1985 the federal government and state and local governments are absorbing 40 to 45 percent of credit flows and we further premise that the household sector takes its normal 40 to 45 percent share in a mature expansion, the arithmetic requires the business sector to get by on only 10 to 20 percent of total credit flows, in rather sharp contrast to its normal mature expansion share of 35 to 40 percent.

It seems probable, in fact, that the corporate demands on the credit markets will be unusually modest through the end of 1984. Corporate cash flow should be unusually large both because of a

sharp rise in profits and because of the impact of changes in the tax code. A sizable piece of the deficit has its counterpart in higher corporate cash flow.

As we move into 1985, the environment ought to be ripe for a capital goods boom. Most industries should be operating close to the limits of their most efficient plant and the perceived rate of return on capital should be high. At some point in time, probably by mid to late 1985, the increase in corporate financing needs for plant and equipment and inventory accumulation is likely to produce a substantial increase in demands on the credit markets. Interest rates will have to rise enough to reduce the demands of the more interest-sensitive household sector. The resulting decline in housing and consumer durable goods is likely to generate a recession and a subsequent decline in business investment. This is the scenario; the only question would seem to be the precise timing.

I like to think that if a problem is sufficiently well advertised in the American democracy, it will be dealt with ultimately. Certainly, the problem of the structural deficit has been well advertised. One can only hope that action will be taken soon enough to avoid the recession of 1985-86.

Turning from the goals to the implementation of monetary policy, it seems to me that the most fundamental issue is whether we still seek to continue to control money or whether we shift to controlling liquidity or credit.

I have been arguing for several years that we can no longer measure money in the United States; i.e., that we can no longer

separate transaction balances from short-term investment funds. This was, of course, not always the case. In earlier years money was relatively easy to define for two reasons. First, payments could be made only by currency and demand deposits. Second, no interest could be paid on demand deposits. Therefore, there was a strong economic incentive to keep demand deposit balances at levels needed for transaction purposes. These two conditions which clearly distinguished money no longer prevail. Payments can be made today by checks drawn on a number of different types of accounts bearing a market rate of interest. As a consequence, there is no way of calculating an M1 number today which would be comparable to the M1 numbers of earlier years. The M2 of old, which used to be dominated by passbook savings accounts, has also undergone radical change. Since the character of the redefined M1 and M2 has changed so dramatically, there is no reason to expect the new M1 and M2 to have the same behavioral characteristics relative to the nominal GNP as in earlier years. Until we have established a long track record with the n<sup>th</sup> redefinition of M1 and M2, I think we must conclude that M1 and M2 no longer have a predictable relationship to the nominal GNP and, therefore, are unsuitable as targets for monetary policy.

Although my efforts to date have not had much influence on my colleagues in the Federal Reserve, they have succeeded in gaining me a certain notoriety by being made part of the KKM Syndrome, so named by Professor Karl Brunner as the protagonists of the "death of money"--Irving Kristol, Henry Kaufman and myself.

Professor Brunner displayed the reluctance of the monetarist to recognize the problems we now have in measuring money when he wrote:

When "nobody knows what money is" transactions are settled by random transfers of assets. But we do not observe this pattern. Most agents, including Kristol, Kaufman and Morris, exhibit little difficulty in distinguishing between the majority of items in the small monetary subset and all other non-monetary assets. Kristol should, according to his own assertion, be indifferent between receiving currency, a check on a deposit account, a car load of eggs or cucumbers for his learned contribution to the Wall Street Journal. His actual behavior hardly reveals such indifference, i.e., he knows, as most everybody else, what is money and what is not money.<sup>1</sup>

This begs the issue. Certainly, Mr. Kristol would be a bit appalled to be paid by the Wall Street Journal in eggs or cucumbers. He would be indifferent, however, to being paid by demand deposit or NOW account, which are in M1, by a check on a money market deposit account, which is not in M1 but is in M2, by a check drawn on an institutional money-market mutual fund, which is not in M1 or in M2 but is in M3, or by a check drawn on a cash management account at a brokerage house, which is in none of the M's. If all of these are perfect substitutes, as they are, the problem of measuring the money supply should be apparent even to Professor Brunner.

Twice in the past year and a quarter we have had to abandon M1 as a target or revise the target range because its behavior

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<sup>1</sup>Shadow Open Market Committee, Policy Statement and Position Papers, Sept. 18-19, 1983.

relative to the nominal GNP was very different than had been expected when the ranges were established. In the third quarter of 1982 we found that the widely forecast third-quarter upturn was not occurring. The economy was still contracting even though M1 was substantially exceeding the upper limit of its range. Common sense dictated that M1 be abandoned as a target.

A so-called monitoring range for M1 was reestablished for 1983. In mid-'83 we found the typical 5 percent rise in M1 velocity in the first year of an expansion was not occurring. In fact, M1 growth was substantially greater than both the nominal GNP and the top of our monitoring range. The FOMC met the situation by rebasing the M1 range on the second quarter.

It seems to me that only one conclusion can be drawn from this experience: M1 is no longer predictably related to the nominal GNP and is, therefore, no longer suitable as a target for monetary policy.

As a substitute for money as targets for monetary policy I have been advocating total liquid assets and total domestic nonfinancial debt. Both of these are as predictably related to the nominal GNP as the old M1 used to be and they have the great value of being such broad measures that they are not impacted by financial innovations.

Even though they are not as closely related to the rate of growth of the reserve base as M1 is, I am persuaded that we could control those variables about as well as we can control M1.<sup>2</sup> Of course, it would be much better under such a regime to have a different reserve base, one which would impose a small reserve requirement against all liabilities of depository institutions. This would be politically feasible, however, only if the Federal Reserve were permitted to pay a market rate of interest on reserve balances.

The new entrant in the field of monetary targets is the proposal that we target the nominal GNP. Targeting the nominal GNP would not change the requirement that the FOMC operate with some sort of intermediate target. The FOMC manager has only two variables with which to conduct operations, interest rates and the rate of growth of bank reserves, neither of which is predictably related to the nominal GNP. The Federal Reserve would need a financial proxy for nominal GNP and the instructions to the FOMC Manager would need to be couched in terms of the reserve growth path most likely to be associated with the desired growth path of the financial proxy.

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<sup>2</sup>See Richard W. Kopcke's "Must the Ideal 'Money Stock' Be Controllable?" New England Economic Review, Federal Reserve Bank of Boston, March/April, 1983.

Targeting nominal GNP has its problems, not the least of which is the implication that the Federal Reserve, wielding a single instrument of policy, has the power to fine-tune the nominal GNP regardless of what other policy instruments are doing. Another is the assumption that economists and policymakers are smart enough to specify an optimum nominal GNP target.

A year ago, if the participants in this meeting had specified a 1983 nominal GNP target, I suspect it would have been something like nine percent--with 4 percent real growth and 5 percent inflation. In fact, we are getting 11 percent nominal with both faster real growth and a lower inflation rate than had been forecast. I don't think anyone would have thought it sensible policy in mid-'83 for the Federal Reserve to seek to squeeze nominal GNP growth down to nine percent for the year. If nominal GNP targeting is to be tried, and I am not an advocate, the Federal Reserve should be given a range of acceptable outcomes with the understanding that the upper part of the range should be attained only if it is associated, as it has been in 1983, with a better than expected inflation experience.

In any event, the more pressing decision for monetary policy implementation is whether we continue with money as the intermediate target for policy or shift to something we can still measure--liquidity or debt.