Monetary Policy as an
"Inflation Fighter"

Remarks of Mr. Robert P. Mayo, President
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I am pleased to have an opportunity to meet with you today and talk to a financially oriented audience about the Federal Reserve System. I hope that you won't be disappointed if my remarks are somewhat narrower in scope than suggested by the title in the announcement for this meeting. I don't intend to cover all of the Federal Reserves System's many functions and responsiblities. I couldn't within the allotted time anyway. Rather, since this is an investment seminar, I want to focus on the System's monetary policy role and, in particular, on some of the more substantive problems and issues confronting monetary policy formulation and implementation.

I can't recall a period when so much radio and television time and press coverage have been given to monetary policy. And there haven't been many times when the Fed has been confronted with such a number and diversity of opinions as to what it has done wrong in the past, how it should be acting now, and what its policies should be in the future. This reflects, I think, the concern and frustration that so many have about the choice of appropriate public policy efforts to return our country to reasonable price stability. Everyone is frantically searching for a simple answer. And there isn't any.

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Obviously, the major problem confronting economic policy today is unprecedented inflation--an undesirably rapid and dangerous increase in prices buffeting the national and the world economic scene. Like the weather, everyone talks about it. Unlike the weather, we are, in various ways, trying to do something about it. I wish I were, as the phrase goes, "beating a dead horse." But the horse isn't dead; it is still very active.

What makes economic policy prescription so difficult in this environment is that we must develop and implement a set of actions to return to reasonable price stability that will not produce excessive costs either in foregone output or unemployment. Nor can we afford to set in place conditions that will defeat efforts to achieve long-term economic growth within the bounds of reasonable price stability. And compounding this is the fact that individuals and groups have different judgments as to what the costs are, what risks are excessive, and how the costs should be distributed over time and among the various sectors of our economy.

Monetary policy formulation cannot and does not escape from this difficult and perplexing decision environment. And as a result, it is frequently difficult even for investment specialists to understand just what is going on and, consequently, for observers to ascribe objectives or operational abilities to the monetary authorities that are only fantasies.

What I hope to do today is to tell you something about my views on monetary policy's role in inflation fighting. Obviously, I cannot tell you what monetary policy should be or will be over the year ahead--the specifics haven't been decided by the Federal Open Market

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Committee, which is the major policy group in the Federal Reserve System. But I can give you some guides to thinking about the role and operation of monetary policy that may be helpful to you as regular "Fed watchers."

In assessing alternative economic policies--whether monetary or fiscal--we must keep in mind that events in the past continue to influence today and will influence tomorrow as well. We cannot wipe the slate clean; we have to start with where we are and how we got there. The U. S. economy responds only gradually over time to the majority of forces leading to change. Therefore, we must take into account forces already set in motion even if their effects are not as yet evident.

The factors playing a very important role in the unprecedented inflation of 1973-74 have been noted frequently. They include the coincident rapid expansion of all of the industrialized nations of the world, crop failures abroad, successive devaluations of the dollar, and the termination of a U. S. wage-price control program which in its latter phases probably did more harm than good. These events produced 1973 agricultural export demands far exceeding expectations. They added price pressures to an economy already operating at full capacity. And then an oil embargo occurred with its unnerving substantial price impact.

In the perspective of 20-20 hindsight, it seems to me that monetary policy also played a role in adding to inflationary pressures. The growth of the money supply during 1972 and the first part of 1973 was higher than many of us wished in view of the way the underlying economic situation turned out.

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And fiscal policy is certainly not without blame. In terms of budget deficits, fiscal policy became far too expansionary in 1971 and 1972. When the Administration recommends--and the Congress authorizes--expenditures in excess of revenues, the Treasury has no alternative but to issue more securities to pay for its spending. And the Federal Reserve, charged with the responsibility to maintain an effective, viable financial system--as well as being a prudent manager of monetary policy--cannot ignore the responsibility to see that the Treasury is successful in acquiring necessary funds without significant distortions and disruption in financial markets. The net result is that the Fed is under pressure to allow more rapid increases in monetary aggregates than would be the case in the absence of debt management demands and in an economy that has already generated momentum to achieve very high employment levels, the next step is inflation.

Now, however, many would argue that we have had a restrictive monetary policy during the past year--and particularly since last summer--and, therefore, prices should be falling--some would say rapidly. Does this mean that the monetary authorities have not been restrictive enough? Is it because "old style" policies no longer work? Or is it because we are looking for instant responses?

I think we have been restrictive enough. And I refuse to believe that traditional policies no longer work. I agree then that we are too impatient in looking for immediate results.

We must always remind ourselves that any actions taken will have their principal effects not today but some months hence. We should not expect immediate price restraint from restrictive monetary actions. We know that lags exist, that they are variable and that they are not

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precisely measurable after the fact, much less predictable. We know too that the expectations of consumers, businessmen, government officials, and financial market participants play a critical role in a situation of persistent inflation. These expectations are affected primarily by performance, not by promises--and even then slowly. Unfortunately, the response may be even slower today because of the experience since the mid-1960s with what appears to be successively more difficult bouts with successively more stubborn inflationary periods.

But the lagged response to policy sets a difficult stage for policy decisions. Great care must be taken not to overstay whatever restriction is adopted and precipitate a serious economic downturn. Yet you cannot move away from restraint too soon or too rapidly lest you lose all that you are after--reduced price pressures. And the timing poses serious problems since a restrictive monetary policy can result in increased unemployment far more quickly than it can result in decreased inflation. Thus, in my view, we must move cautiously yet firmly with our restrictive actions and be prepared to adhere to those policies long enough for the effects to be felt. So let's not dump the baby out with the bath water.

What I've been describing here may appear to be very obvious. But it seems to me that much of the "instant analysis" of the press, radio, and TV fails utterly to see the point. They compare what they interpret as today's policy with what exists in the economy today. And in effect they frequently dig themselves in even deeper--ignoring even another lag and uncertainty--by interpreting policy in terms of an intermediate goal such as currency and checking accounts--our old friend M_1--and naively assuming week-to-week or month-to-month direct control by the Federal Reserve.

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My reason for bringing in money supply at this point is not simply to castigate members of the media. The concept of a causal effect between the behavior of the money supply and the behavior of economic activity is a respectable view with many supporters. But I do feel that there is more confusion than necessary about the extent to which this concept enters into monetary policy deliberations and the ability of the Fed, even if it desired to do so, to hit a specific money supply target over the very short run.

As you all know, Professor Milton Friedman has long argued that we do not know enough about the links between changes in the money supply and changes in income to be able to employ discretionary monetary policy effectively. He reasons, therefore, that money should grow at a relatively steady rate in order to stabilize the rate of growth of other economic variables. Obviously, on the basis of my earlier comments, I don't share Milton's view even though he has been a good friend of mine for 30 years.

However, this does not mean that his views as well as those by the "Keynesians" are not considered in the policy process. They are. But neither view can be accepted fully by everyone involved in the policy process. Our economy is simply too large and too complex for us to know everything about the structure of the economy and how it adjusts to fluctuations in both real and financial behavior and how it adjusts to monetary policy, passive or active.

Much of the confusion about monetary policy does not arise, however, from whether or not the System considers M_1 in its decisions but rather from the fact that there are in effect various "levels" of goals or targets. For example, it is well known that the ultimate goals of

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monetary policy involve the behavior of employment, prices, economic growth, and international equilibrium. But monetary policy does not affect these ultimate goal variables directly with sufficient speed for purposes for policy making, so it is necessary to select intermediate goals that the Federal Reserve can attain relatively quickly and more directly.

There is little question that the Federal Open Market Committee has moved in the direction of emphasizing monetary aggregate behavior as an intermediate goal of policy. In part, the choice is a matter of subjective judgment but it is supported by the results of available studies. Generally, the intermediate goals are in terms of the narrowly defined money stock M_1 and the more broadly defined money stock, including some commercial bank time deposits, M_2.

However, these aggregates are not under the direct control of the Federal Reserve. Consequently, for operational purposes it is necessary to translate these intermediate goals into operational targets to be used by the manager of the System Open Market Account in New York. These targets must be related closely to the intermediate goals and the behavior of the target must be known to the manager of the Open Market trading desk quickly.

Currently, the operating target is reserves against private nonbank deposits--RPDs. But the federal funds rate as a sensitive measure of money market conditions also enters into the operation as the desk attempts to achieve the intermediate targets.

Given the existence then of what might be considered a hierarchy of goals, it no wonder that observers can on occasion be confused and

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confusing in their analysis of current monetary policy. It is nice, very easy to explain, and simple to latch on to something like M_1 as a sole guide to monetary policy. But it is full of danger since a desired rate of M_1 growth cannot be achieved on any day-to-day, week-to-week, or even month-to-month basis.

Nor can I for one accept the philosophy that we shoot for a constant rate of money supply growth and stick with it regardless of the consequences. Today's economic environment is a new experience. We must be able to use monetary policy as a flexible instrument.

The period ahead will not be easy. We do not have the ability to perform miracles. We have no magic wands to wave. Hopefully, useful legislation will emerge as a result of the President's summit deliberations and his anti-inflation recommendations. Hopefully, too, federal spending will be brought under firmer control. With these assists, the restraining forces set in place by monetary policy should act as an effective brake on inflation in the year ahead. But we should not as a nation ask monetary policy to carry the entire burden of inflation control. The social costs and adverse sectoral impacts of relying on a single general type of policy are simply excessive. Specific and general fiscal policy measures must be coordinated with monetary policy if we are to dampen inflation and resume normal economic growth.

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