IS MONETARY POLICY WORKING?

by

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Rather than waiting to the end to answer this question, let me cut the suspense: my answer is "yes." Now, assuming you're not too shocked by this statement, let's back up and see why this view is not currently shared by the market.

The current market.

The market clearly is saying that monetary policy isn't working. I think there are three reasons it is saying this.

1. The market, along with everyone else in our society, is disillusioned with efforts to deal with inflation. It is skeptical about the determination and ability of officials of all kinds, not just those in the Fed, to bite the bullet, especially in an election year.

I can't fault people for thinking this way. Inflation has gone on too long, it has gotten too bad, there is real question whether public officials know enough to handle this inflation, a phenomenon nobody completely understands. And the likelihood that short-sighted politics will scuttle anti-inflationary efforts is very real. All should not be gloom, however. There are changes in attitudes. Do any of you recall a President predicting a recession in an election year, and then saying he intends to do nothing about it? Fighting inflation not only is good economics, but up to a point, at least, it has become good politics as well.

2. As for monetary policy specifically, a second reason for skepticism is that the market is not convinced the Fed's current method will work. The market did greet with enthusiasm the change in open market procedure announced October 6. Generally it complimented the Fed for throwing out a procedure that hadn't worked well enough and replacing it with a more direct way of hitting its targets

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for money growth. And I must say that, having watched and participated in policy for a number of years, I feel the October 6 decision was one of the most courageous the Fed has ever made. It was based on a forthright admission that procedures had not worked well enough; they were not doing enough to curb money growth and inflation. And it struck out into new unexplored territory with vigor and determination. I believe October 6 was really one of the Fed's shining hours, and the market thought so too--at the time.

Why the skepticism now? Partly because reserves and money growth haven't tracked together the way many people assumed they would. The Fed's argument, you'll remember, was that by focusing on the Federal funds rate it was unable to accomplish, by indirect means, its objectives for money growth. So, by focusing specifically on a growth path for bank reserves it could, by more direct means, more effectively hit its money targets. The implication was that changes in reserves and changes in money supply would move closely together. They haven't, and so many conclude that the new procedure isn't working.

Well, the Fed has since explained why reserves and money may move in different ways in the short run. Reserves may go to support assets that aren't in a specific measure of money (for example, large CD's or Eurodollars), or may go to support currency demand. The mix between time and demand deposits or between deposits of members and nonmembers may change. Lagged reserve accounting delays the effect of a change in reserves. Banks may elect to hold more excess reserves. These are all mismatches or slippages between reserves and money which make it unlikely that changes in the two will match closely in the short run.

One other uncertainty deserves special attention--borrowing from the Fed. The Open Market Desk can exert pretty good control over the supply of nonborrowed reserves, but member banks can also get reserves through the discount window.

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The volume of borrowing can vary, and has in recent weeks. The theory is that banks regard reserves which they get through the discount window differently from reserves supplied by the Open Market Desk. Borrowed reserves, we like to say, have a string attached. In my experience this is true, but I do feel that the string may have more or less elastic in it from one time to another. We are now thinking through the various implications of the new procedures for the discount window.

The fact is that reserves and money, for all these reasons, are not mechanistically linked. A raw reading of reserves, therefore, can be a poor guide to the future course of money growth. Also, even if the reserves-oriented technique were applied perfectly, growth in money can still fluctuate widely from month to month. Monetary control operates in a time horizon of several months. The market should try not to be too near-sighted.

3. A third reason for the market's skepticism, I think, grows out of the strategy the Fed is following to curb monetary growth. We are primarily using price to ration money and credit. The market is not accustomed to this and is not sure the price approach will work.

It is not accustomed to this because several times in the post-war period expansions have been brought to a halt by a money and credit crunch. When that happens there's no question what is going on--money and credit are difficult or impossible to get at any price.

Well, let me remind you that various officials have devoted a great deal of effort in recent years to avoiding credit crunches. They have reduced or eliminated numerous restrictions on the mobility of credit, things like usury ceilings. They have opened up the access of thrifts to the market by inaugurating floating-rate instruments like money-market certificates. All this in the

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belief that fluid and competitive markets work better than markets with a lot of impediments. I happen to share this belief and I would think that you who labor in the money market might have some sympathy for it too.

I also happen to believe that a money and credit crunch now would be a great mistake. It would surely precipitate a serious recession which, in turn, could well release a strong counterreaction in Government spending or taxing that would give inflation another shot in the arm.

Today's interest rates are certainly dramatic, but they don't provide the same kind of clear evidence of restraint as a crunch. So, the market isn't convinced the price route is working or will work except, perhaps, at some level of interest rates so disastrous that we'll end up with a crunch anyway.* I happen to believe that the price route is working. Let's look at some facts.

Facts about restraint.

To judge whether policy is working we have to ask what that policy is. Several years ago the Fed announced that its strategy in controlling inflation is to go about gradually and persistently slowing money growth. This is still the strategy.

Performance has not been as consistently good as you or I might like, but there has been progress. Here are a few numbers: annual growth of M_1 (old definition) in 1976, 1977, 1978, and 1979 was 6%, 8%, 7%, and 6%. For M_2, 11%, 10%, 9%, 8%. For M_3, 13%, 12%, 9½%, 9%.
These figures do oversimplify the picture because there were all kinds of confusing things going on with ATS accounts, NOW accounts, and other new instruments.

* This is by way of saying, too, that the availability and price routes aren't as separate and distinct as they are often made out to be. I agree.

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After rough allowance for these, the reduction doesn't look as good, but still shows modest progress.

Since October 6, we've redoubled our efforts and the result so far has been very good. But as I said a minute ago, even our best efforts will still mean fast growth in some months and slow growth in others. We intend to hit the targets Chairman Volcker recently announced and that means still lower growth in money for 1980.

Also, as you look at specific markets, it's clear that high interest rates are having an impact on most of them. The cost of carrying inventories and receivables/obviously is strongly influencing business policies. Many capital projects have been made unprofitable by the level of interest rates. Mortgage rates are discouraging prospective home purchasers. The major exception is consumption. Rates on consumer loans have risen less than other rates and consumers seem not to have been daunted by the increases that have taken place, especially in an environment in which they are saving at the lowest rate in many years. My guess, however, is that some slowing of consumer spending is in the offing.

In short, the differential impacts on various markets may not be what everyone might like, but there can be no question interest rates are biting. One place where credit tightening is appreciated is in foreign exchange markets; the dollar has fared well in recent months. Interest rates have played a part in this, but on the whole amid all the pessimism about U.S. policies, foreigners emerge relatively optimistic. Perhaps people in our money markets should talk to more of them.

Rx for policy.

Let's stop for a minute to take stock. The money and credit markets are in disarray because they lack confidence in efforts to deal with inflation and,

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particularly, are skeptical about whether the Fed's policy is working. I've tried to point out first that the market is under a misapprehension about how well the Fed can control money growth in the short run by following a reserve path. Over a meaningful period it can. Second, the market is not accustomed to policies which use price rather than a crunch to slow the growth of money and credit. And third, the market underestimates how much has already been accomplished.

Yet the market obviously isn't happy with the way things are, and neither am I. The economy is too strong. Inflation is too strong. So what should the Fed do to be more effective? I think we should stick to our plan: keep our eye on the longer-run goal; keep on gradually reducing money growth; not be panicked into quick fixes. I arrive at that conclusion after weighing the risks and alternatives.

Risks.

I see at least three big risks in staying on our present course:

1. One is political. High interest rates have never been politically popular. Up to now most politicians have been remarkably neutral about or supportive of the Fed's policy, but as interest rates stay high or even rise further, the political tide could turn. Exactly what form this reaction would take is hard to predict, but probably would be either pressure to relax restraint or to impose direct controls.

2. A second risk is a credit crisis. Fear and uncertainty can produce strange results. We are all navigating in uncharted waters and there is always fear we may sail off the edge. It may be that there is some level of interest rates out there that will put undue strain on the whole system. The ability of some

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institutions to survive could be severely tested. It is clear that the Fed would act quickly and decisively to meet specific problems should they develop. This has always been the first tenet of central banking.

3. A third risk is time. If the economy stays strong for several more months, credibility will erode further. The market, indeed the entire public, is looking for dramatic results. Unfortunately, inflation shortens everyone's sights; planning beyond the immediate future is too risky. So the Fed is asking a great deal. It is asking people with increasingly short time horizons to bear with a policy fixed on a long time horizon. There is great risk that the public will not sit still long enough for the Fed's strategy to work.

<u>Alternatives.</u>

But what are the alternatives? I see four:

1. Draw back from our strategy and ease up. This, obviously, would completely pull the plug on credibility.

2. Shock the economy with severe restraint. As I've already said, this would be counterproductive.

3. Put on credit controls. There are problems here. You are familiar with the administrative and regulatory morass controls can impose. The old types of controls on car and home purchases would be clearly superfluous; these markets are already depressed. A new element since the credit controls of three decades ago is the credit card. Handling that part of the credit market would present a new challenge. Imposing quotas on lenders--limits, say, of X percent of a base period--can be very unfair. Besides, limits on banks and other lenders simply stimulate the ingenuity of the market to get around the controls. Yet credit controls have the appeal of demonstrating decisive new action and authority for them already exists.

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4. Put on wage and price controls. The best argument is that they might have some short-term shock value and provide some time to put more basic longer term policies in place. But the economic costs could be great. I think we can all agree that direct controls inevitably break down and in the meantime are a nightmare to administer. A greater cost, however, is that they could paralyze monetary policy. It is hard for me to believe that in the clamor for price and wage controls we could avoid interest rate controls. But as we found out during and after World War II, freezing interest rates is one of the most inflationary actions you can take. Result: holding down the price and wage lid with one hand while turning up the fire under the kettle with the other.

Conclusion.

So I share the market's unhappiness, uncertainties and fears, but I see no good alternative to the Fed sticking to its course, even with all the risks involved. Obviously, the Fed needs help, especially in the fiscal and energy areas. Our chances of success would be much improved with that help. My conclusion from all this is a paraphrase of something Ben Franklin once said: if the Fed doesn't hang in there we will surely all hang separately.

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