Research Department
Federal Reserve
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Business & Financial Letter

The Debate: Keynesians

In a recent article in the *Christian Science Monitor,* David Francis summarized the current debate over monetary policy: "Once again, as in the 1960's, there is a debate between two schools of economists known as 'monetarists' and 'neo-Keynesians.' The monetarists believe that strict control of the nation's money supply is the best means for achieving a steady growth pattern in the economy. The neo-Keynesians hold that monetary officials must pay more attention to interest rates than changes in money supply when setting credit policy." But the scope of the debate is even broader than Francis indicates, extending beyond disagreement over how policy should be set to differing views on where the economy is now and where it should be heading.

Recent statistics provide conflicting evidence on the state of the economy. Real GNP grew at a 4.7 percent annual rate in the third quarter, down sharply from the first half's average rate of 7.0 percent. Does this slowdown portend the end of the recovery, or is it merely a healthy reaction to the earlier unsustainably high growth? Inflation, as measured by the GNP deflator, declined to a 5.0 percent rate in the third quarter (from 7.0 percent in the previous quarter). However, most published forecasts suggest that the underlying inflation rate is around 6 percent, which is clearly disturbing. Similarly, the overall unemployment rate continues to hover near an unacceptably high 7 percent.

Policy dilemma

Taken together, these statistics pose a dilemma for monetary policy makers: should they be more concerned about the danger of a new recession or about the danger of continuing high inflation? This dilemma is compounded by the apparent change in some of the economic relationships – involving GNP, the money supply, and interest rates – which are crucial to the formulation of monetary policy. Since the start of 1976, the broadly-defined money supply (M_2) – which consists of currency plus commercial-bank and time deposits (except large negotiable time certificates) – has been growing at a 10.7 percent average rate. That rate is high by historical standards. Over the last six months, the narrowly-defined money supply (M_1) – consisting only of currency and demand deposits – has also been expanding at a rapid (9.2-percent) rate. On the basis of past experience, one would expect such strong monetary stimulus to lead to a booming economy. Yet the most recent GNP figures, although above the long-term trend, are relatively low in the context of the unused resources remaining in the economy.

The ratio of GNP to the money supply – called the "velocity" of money – measures the rate of turnover of money. In past business cycles, increases in velocity in the early stages of the recovery have usually been associated with rising interest rates. In 1975 and 1976, however, the velocity of M_1 grew rapidly while interest rates generally declined. In the last six months, the situation has changed, with velocity growing slowly and short-term interest rates rising rapidly.

In this letter, we present the Keynesian view on how to interpret the recent

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movements in GNP, the money supply, velocity, and interest rates. In the next weekly letter, we will present the monetarist view, along with an examination of how recent Fed policy has attempted to forge a compromise between these two opposing positions.

Keynesian analysis
The Keynesian position has been expressed in the majority report of the Joint Economic Committee, *The 1977 Midyear Review of the Economy,* and also in articles by Walter Heller, the former chairman of the Council of Economic Advisers. Writing recently in the *Wall Street Journal,* Heller declared: "When the Open Market Committee meets next Tuesday, it will face a hard choice, implicitly if not explicitly, between money supply and interest rate targets. Mounting evidence suggests that its choice will not have much impact on inflation in a still slack economy. But it could be the margin of difference between a sustained and a fading recovery in the year ahead." According to this view, the major risks now are on the downside, judging from the recent slowdown in real GNP growth and the lack of signs of an impending investment boom. The reason for this perceived softness is the insufficient stimulus provided by government policies—both fiscal and monetary.

Keynesians note in particular, that short-term interest rates have risen almost two percentage points since last spring. They interpret that rise as *prima facie* evidence of a tight monetary policy. So far, the rise in short-term rates has had very little impact on long-term rates, which have remained near their levels of six months ago. But the Keynesian fear is that any further rise in rates at the short end of the maturity spectrum would be transmitted to the long end as well. Should long-term rates rise significantly, the already none-too-strong investment sector would be hurt.

Keynesians do not ignore the growth of the money supply in their discussions of monetary policy. However, in judging the adequacy of money growth, they tend to focus on the real (i.e., inflation-adjusted) money supply. Thus, the Joint Economic Committee staff report concluded that monetary policy had been extremely tight over the last five years, on the basis of a decline in the real money supply over that period. Even over the last twelve months, the real money supply grew less than 1 percent despite a rapid 7-percent rate of actual M_1 growth. In the words of one Keynesian, Albert Sommers of the Conference Board, the inflation has "devoured liquidity."

The business recovery has been relatively strong until now, despite "tight money," because of a rapid increase in the velocity of money. In other words, a given stock of money is now consistent with a much higher level of GNP than it used to be. Most analysts, whatever their persuasion, agree that velocity has increased because of various innovations in financial technology and institutions, which have enabled households and corporations to conserve on their holdings of cash balances. (Examples include telephonic transfers of funds, computerized cash management, NOW accounts, and money-market mutual funds.) Keynesians believe that the economy has now adjusted to these innovations, and that the rapid increases in velocity of the recent past will not be repeated.

The velocity of M_1 continued to increase, but only slightly, during the third quarter, as M_1 grew at a 9.3-percent rate while nominal GNP grew at a 10.0-percent rate. When interest rates rise as they did last quarter, one would expect to see velocity increase more, since higher interest rates induce people to hold less of their wealth in the form of M_1, which bears no explicit interest. Keynesians believe that the modest rise in velocity in the face of the steep climb in interest rates implies a possble increase in the demand for money. Thus, they don't view the rapid growth in the (nominal) money supply as inflationary: the Fed is not pushing out excess money to chase after too few goods and worsen inflation, but is merely meeting the desires of the public to hold more assets in the form of M_1.

Keynesians maintain that money growth could even be increased considerably with little danger of increased inflation. Their argument turns on the existence of substantial slack in labor markets and a still-comfortable amount of excess capacity in the nation's factories. They estimate that the gap between actual and "potential" GNP may be as high as $100 billion. As long as actual GNP is so far below potential, the reasoning goes, stimulative policies will result mainly in increased real output, not in more inflation.

Keynesian prescription

This Keynesian analysis leads to a forthright policy prescription: monetary policy should become more stimulative in order to fight unemployment, especially since this can be done without worsening inflation. The growth of the money supply at rates well above the Fed's long-run specified growth ranges can safely be ignored. In particular, interest rates should not be allowed to rise further as a means of bringing money growth back to its specified range.

The Keynesians claim that attempts to fight inflation by reducing money growth are doomed to failure. The price increases due to the excess-demand pressures of 1972-73 and to external shocks (such as the OPEC price hike) have now worked their way through the system, leaving the economy with its present hard-core (6 percent?) rate of inflation. Various "structural" features of modern industrial economies—concentrated industries, labor unions, Federally-mandated price floors, wage escalators—make it almost impossible for monetary policy to deal with this inflation. A reduction in money growth would lead to a reduction in real output—i.e., a recession—but would not stop prices from rising. Or, at least, the public would not tolerate the type of prolonged recession necessary to achieve this price goal. Instead, monetary policy should be used to sustain real output by insuring adequate stimulus to investment, while other measures could be devised to remove or ameliorate the structural features causing inflation.

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BANKING DATA TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/23/77	Change from 11/16/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	103,568	− 2,716	+ 12,472	+ 13.69
Loans (gross, adjusted)—total	80,063	− 2,653	+ 10,890	+ 15.74
Security loans	1,996	− 2,361	+ 520	+ 35.23
Commercial and industrial	24,541	+ 138	+ 1,921	+ 8.49
Real estate	26,685	+ 85	+ 5,484	+ 25.87
Consumer instalment	14,023	+ 73	+ 2,099	+ 17.60
U.S. Treasury securities	8,823	+ 40	+ 46	+ 0.52
Other securities	14,682	− 103	+ 1,536	+ 11.68
Deposits (less cash items)—total*	100,035	− 1,149	+ 10,324	+ 11.51
Demand deposits (adjusted)	28,382	− 1,138	+ 2,932	+ 11.52
U.S. Government deposits	261	− 81	− 30	− 10.31
Time deposits—total*	69,715	+ 445	+ 7,491	+ 12.04
States and political subdivisions	5,407	+ 69	+ 639	+ 13.40
Savings deposits	31,583	+ 1	+ 2,361	+ 8.08
Other time deposits‡	30,207	+ 232	+ 3,979	+ 15.17
Large negotiable CD's	12,555	+ 362	+ 2,629	+ 26.49

Weekly Averages of Daily Figures	Week ended 11/23/77	Week ended 11/16/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 24	− 11	− 3
Borrowings	41	10	0
Net free(+)/Net borrowed (−)	− 17	− 21	− 3
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	+ 32	+ 1,455	+ 643
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 518	+ 820	− 10

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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