

DEFINING THE ISSUES
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(PAPER FOR CONFERENCE ON
VELOCITY AND MONETARY AGGREGATES TARGETING)

OUR FIRST MONETARY CONFERENCE HELD IN NOVEMBER LAST YEAR, ADDRESSED THE QUESTION OF WHETHER INTEREST RATE DEREGULATION PROMISED TO MAKE MONETARY POLICY A MORE DIFFICULT TASK THAN BEFORE. IN MY OPENING REMARKS, I DEFINED THE CENTRAL ISSUE OF THAT CONFERENCE AS A QUESTION OF "...WILL WE BE ABLE TO RELY PRIMARILY, AS IN THE PAST, ON M1...OR SHOULD WE BE CONTEMPLATING SOME OTHER INTERMEDIATE TARGET?"

IRONICALLY, THIS IS ESSENTIALLY THE SAME ISSUE WE FACE AT THIS CONFERENCE. THIS CONFERENCE ASKS WHETHER OR NOT THE UNANTICIPATED DECLINE IN THE VELOCITY OF MONEY IN 1982-EARLY 1983 HAS CHANGED THE USEFULNESS OF MONETARY TARGETING. SPECIFICALLY, M1 VELOCITY FELL 6.9 PERCENT DURING THE FIVE QUARTERS ENDING 1983/Q1. THIS WAS UNPRECEDENTED IN THE POSTWAR PERIOD, AND IS IN SHARP CONTRAST TO ITS AVERAGE UPWARD TREND OF APPROXIMATELY 3 PERCENT.

BECAUSE OF THE UNUSUAL BEHAVIOR OF THE M1 VELOCITY, THE FOMC IN JULY 1982 REVISED UP THE SHORT RUN PATH FOR M1 AND IN OCTOBER MOVED TO PLACE LESS EMPHASIS ON M1 AS AN INTERMEDIATE MONETARY

TARGET AND TO RELY MORE ON M2. THIS SHIFT IN EMPHASIS WAS REAFFIRMED IN JULY 1983 WHEN CHAIRMAN PAUL VOLCKER, IN HIS MID-YEAR REVIEW OF MONETARY POLICY TO CONGRESS, INDICATED THAT "M1 WILL BE MONITORED CLOSELY BUT WILL NOT BE GIVEN FULL WEIGHT UNTIL A CLOSER JUDGMENT CAN BE MADE ABOUT ITS VELOCITY CHARACTERISTICS FOR THE FUTURE". THUS, WHETHER M1 WOULD BE RESTORED AS A FULL-FLEDGED INTERMEDIATE TARGET OR WOULD BE SET ASIDE INDEFINITELY WAS LEFT AS AN OPEN QUESTION.

THE IMPORTANT QUESTION WE NEED TO CONFRONT AT THIS CONFERENCE THEREFORE IS THE FOLLOWING: DOES THE 1982-83 EXPERIENCE PROVIDE ANY CLUES ABOUT THE FUTURE VIABILITY OF M1 AS AN INTERMEDIATE TARGET OF MONETARY POLICY? I WOULD LIKE TO SUGGEST A SIMPLE FRAMEWORK FOR ANALYZING THIS QUESTION, AND TO SUMMARIZE WHAT I TAKE TO BE THE TWO MAJOR SCHOOLS OF THOUGHT ON THIS ISSUE. FOLLOWING THAT, I WOULD LIKE TO REVIEW THE CASE FOR M2 AS AN INTERMEDIATE TARGET AND TO SAY A FEW WORDS ABOUT OTHER POSSIBLE POLICY TARGETS SUCH AS INTEREST RATES OR GNP. THIS LATTER EXERCISE IS IMPORTANT BECAUSE THE QUESTION OF M1'S VIABILITY CANNOT BE JUDGED IN ISOLATION. AS I BELIEVE WINSTON CHURCHILL ONCE REMARKED OF DEMOCRACY: "IT'S A POOR FORM OF GOVERNMENT UNTIL YOU CONSIDER THE ALTERNATIVES."

ANALYTIC FRAMEWORK

AS STEVE AXILROD REMINDED US AT LAST YEAR'S CONFERENCE, THE CASE FOR A MONETARY TARGETING RESTS ON THE PRESUMPTION THAT

DISTURBANCES IN THE REAL SECTOR -- SPENDING ON GOODS AND SERVICES -- ARE MORE LIKELY THAN DISTURBANCES IN THE MONETARY SECTOR. SUPPORT FOR THIS PRESUMPTION COMES PRIMARILY FROM THE LARGE BODY OF EVIDENCE DOCUMENTING THE STABILITY OF MONEY DEMAND, ESPECIALLY M1 DEMAND. HOWEVER, AS MR. AXILROD ALSO REMINDED US, THERE HAVE BEEN SOME LAPSES FROM THIS RECORD, MOST NOTABLY THE 1974-76 EPISODE WHEN FINANCIAL INNOVATION CAUSED THE DEMAND FOR M1 TO SHIFT DOWN UNEXPECTEDLY.

FOCUSING ON THE STABILITY OF THE DEMAND FOR MONEY ALLOWS ONE TO DISTINGUISH TWO MAJOR VIEWS ABOUT THE BEHAVIOR OF VELOCITY IN 1982. THE FIRST -- WHICH I WILL CALL THE DEREGULATION VIEW -- TENDS TO VIEW THE 1982 EXPERIENCE AS SYMPTOMATIC OF A SIGNIFICANT DECLINE IN THE STABILITY OF M1 DEMAND RESULTING FROM THE PROGRESSIVE RELAXATION OF INTEREST RATE CEILINGS ON TRANSACTIONS DEPOSITS, MOST NOTABLY THE NATIONWIDE INTRODUCTION OF NOW ACCOUNTS IN 1981. THE ALTERNATIVE VIEW -- WHICH I CALL THE STABLE DEMAND VIEW -- ARGUES THAT THE 1982 DECLINE IN VELOCITY IS CONSISTENT WITH A STABLE DEMAND FOR MONEY. THIS IS THE VIEW TOWARD WHICH WE AT SAN FRANCISCO LEAN.

THE DEREGULATION VIEW

THE SHARP DROP IN M1 VELOCITY COINCIDED WITH A PERIOD OF SUBSTANTIAL DEREGULATION OF INTEREST RATES ON TRANSACTIONS DEPOSITS. THE YEAR BEFORE SAW THE NATIONWIDE INTRODUCTION OF NOW ACCOUNTS, WITH AN INTEREST RATE CEILING OF 5¼ PERCENT. AT THE

END OF 1982, SUPER-NOW ACCOUNTS, AND MONEY-MARKET DEPOSIT ACCOUNTS, BOTH WITH NO INTEREST RATE CEILINGS, WERE INTRODUCED. TO MANY OBSERVERS THIS COINCIDENCE WAS NO ACCIDENT. FOR THEM, MUCH OF THE UNUSUAL BEHAVIOR IN M1 VELOCITY IN 1982 COULD BE TRACED TO THE SUBSTANTIAL SHIFT OF CONSUMER DEPOSITS INTO NOW ACCOUNTS IN 1981. THUS, BY THE END OF 1981, 24 PERCENT OF TOTAL CHECKABLE DEPOSITS REPRESENTED NOW ACCOUNTS, AND THIS FRACTION INCREASED FURTHER DURING 1982. THIS SHIFT, IT IS ARGUED, HAS "CONTAMINATED" M1 IN THE SENSE THAT A SIGNIFICANT PART OF M1 BALANCES NOW ARE SAVINGS BALANCES RATHER THAN TRANSACTIONS BALANCES.

IF THE DEREGULATION VIEW IS THE CORRECT EXPLANATION FOR THE DECLINE IN VELOCITY, IT WOULD SUPPORT CONTINUED DE-EMPHASIS OF M1 AS A MONETARY TARGET. THAT IS BECAUSE UNTIL DEREGULATION IS BEHIND US, AND WE HAVE SUFFICIENT EXPERIENCE TO EVALUATE THE STABILITY OF THE "NEW" M1, IT CANNOT BE USED AS A RELIABLE GUIDE TO POLICY.

THE STABLE DEMAND VIEW

THE DEREGULATION EXPLANATION OF WHAT HAPPENED IN 1982 HAS A GREAT DEAL OF PLAUSIBILITY. THERE IS, HOWEVER, AN ALTERNATIVE VIEW WHICH IS EQUALLY PLAUSIBLE IN THEORY, AND IN MY VIEW MORE CONSISTENT WITH THE EVIDENCE. THIS VIEW ALSO DRAWS ON CONVENTIONAL ECONOMIC ANALYSIS. SPECIFICALLY, IT TRACES THE DROP IN VELOCITY TO A STABLE DEMAND FOR M1 COMBINED WITH A SHARP

DECLINE IN INFLATION, AND WITH IT, THE DECLINE IN INTEREST RATES THAT OCCURRED IN 1982.

THE DROP IN INFLATION MEANT THAT THE DIFFERENTIAL BETWEEN NOMINAL AND REAL RATES OF INTEREST HAD TO SHRINK. THUS EITHER REAL RATES HAD TO RISE OR NOMINAL RATES HAD TO DECLINE. ONE POSSIBILITY IS TO HAVE NOMINAL RATES DROP BY THE FULL DECLINE IN INFLATION, LEAVING REAL INTEREST RATES UNCHANGED. TO DO THAT REQUIRES ACCOMMODATING THE INCREASE IN THE QUANTITY OF MONEY DEMANDED CAUSED BY THE DECLINE IN NOMINAL RATES. IF THAT IS DONE, THE QUANTITY OF MONEY RISES, WHILE AGGREGATE INCOME, WHICH DEPENDS ON REAL INTEREST RATES, REMAINS UNCHANGED. AS A RESULT, VELOCITY DECLINES.

AN ALTERNATIVE WAY OF SHRINKING THE NOMINAL-REAL RATE DIFFERENTIAL IS TO HAVE REAL INTEREST RATES RISE, KEEPING NOMINAL RATES UNCHANGED. IN THIS CASE, THE RISE IN REAL RATES BRINGS A DECLINE IN INCOME. THIS DROP IN INCOME CAUSES VELOCITY TO FALL, SINCE AT LEAST IN THE SHORT RUN, THE QUANTITY OF MONEY DEMANDED CAN BE EXPECTED TO FALL BY LESS THAN THE DECLINE IN INCOME.

THE EXPERIENCE OF 1982 WAS JUST SUCH A MIX OF THESE TWO POSSIBLE OUTCOMES. IN THE FIRST PART OF 1982 THE DECLINE IN VELOCITY WAS LARGELY ACCOMPLISHED BY A FALL IN INCOME. THE FEDERAL RESERVE THEN WAS FOCUSING ON PULLING MONEY GROWTH DOWN TO BRING M1 BACK ON TARGET. AS A RESULT, THERE WAS NO ROOM FOR NOMINAL INTEREST RATES TO FALL MUCH, AND MOST OF THE DECLINE IN THE INFLATION PREMIUM THEREFORE WAS TRANSLATED INTO HIGH REAL RATES, CAUSING AGGREGATE DEMAND TO WEAKEN.

IN CONTRAST, THE LATTER HALF OF 1982 SAW NOMINAL RATES DECLINE SUBSTANTIALLY, AND THE FOMC'S DECISION TO ALLOW M1 TO GO ABOVE TARGET ESSENTIALLY ACCOMMODATED THE CORRESPONDING INCREASE IN THE QUANTITY OF MONEY DEMANDED. IN THIS CASE, THE DECLINE IN VELOCITY WAS ACCOMPLISHED LARGELY BY A RISE IN THE QUANTITY OF MONEY, WHICH, BY TAKING THE PRESSURE OFF REAL INTEREST RATES, ALSO SET THE STAGE FOR THE RECOVERY IN INCOME THAT STARTED LATE LAST YEAR.

LET ME EMPHASIZE THAT THERE IS NOTHING PARTICULARLY NEW OR CONTROVERSIAL ABOUT THE ECONOMIC THEORY WHICH UNDERLIES THIS ARGUMENT. IT IS PART OF THE STANDARD ECONOMIC LITERATURE. THE IMPORTANT POINT IS THAT THIS ARGUMENT ASSUMES THROUGHOUT THAT MONEY DEMAND IS STABLE. THE CHANGES IN THE QUANTITY OF MONEY DEMANDED POSITED IN THIS ARGUMENT REPRESENT MOVEMENTS ALONG A MONEY-DEMAND FUNCTION, NOT SHIFTS IN THAT FUNCTION.

BOTH THE DEREGULATION AND STABLE DEMAND ARGUMENTS ARE LOGICALLY CONSISTENT, AND BOTH ARE COMPATIBLE WITH THE OBSERVED DECLINE IN VELOCITY. NEVERTHELESS, THERE ARE TESTS THAT ALLOW ONE TO DISCRIMINATE BETWEEN THEM. I WILL NOT REVIEW THAT EVIDENCE IN DETAIL. HOWEVER, I WILL SAY THAT THE EVIDENCE DOES SUGGEST THAT M1 FUNCTIONS REMAINED STABLE IN 1982-83 WHICH LENDS SUPPORT TO THE INFLATION AND INTEREST RATE ARGUMENT OVER THE DEREGULATION ARGUMENT.

I WANT TO EMPHASIZE THAT IN SUPPORTING THE STABLE DEMAND VIEW, I AM NOT ARGUING THAT THE EVENTS OF 1982 WERE EXPECTED OR

PREDICTABLE. I AM SUGGESTING THAT THE SOURCE OF THE SURPRISE WAS THE UNEXPECTED BEHAVIOR OF INFLATION -- NOT OF MONEY DEMAND. FEW OBSERVERS EXPECTED THAT INFLATION WOULD FALL AS FAR OR AS FAST AS IT DID IN 1982. A SURVEY OF 10 MAJOR FORECASTERS, FOR EXAMPLE, SHOWS THAT ON AVERAGE THEY EXPECTED INFLATION TO FALL BY 1 TO 2 PERCENTAGE POINTS COMPARED TO THE $4\frac{1}{2}$ PERCENTAGE POINT DECLINE THAT ACTUALLY OCCURRED.

LET ME ALSO BE VERY CLEAR THAT THIS ARGUMENT DOES NOT DENY THAT THE LARGER-THAN-EXPECTED DROP IN VELOCITY POSED A REAL PROBLEM FOR MONETARY POLICY IN 1982. AT THE BEGINNING OF MY REMARKS I REFERRED TO STEVE AXILROD'S DISCUSSION LAST YEAR OF THE CASE FOR MONETARY TARGETING. IN THE COURSE OF HIS DISCUSSION, STEVE EMPHASIZED THE NEED FOR THE MONETARY AUTHORITY TO BE FLEXIBLE, AND IN PARTICULAR, TO BE READY TO REVISE ITS TARGETS IF AN UNEXPECTED DEVELOPMENT INDICATES THIS IS NECESSARY. TO MY WAY OF THINKING, THE FOMC REACTED IN THE RIGHT WAY BY ALLOWING M1 TO RUN ABOVE THE ORIGINAL TARGET IN 1982.

THE STABLE DEMAND VIEW IS MORE OPTIMISTIC THAN THE DEREGULATION VIEW ABOUT THE FUTURE USE OF M1 AS AN INTERMEDIATE TARGET FOR THE FUTURE. THE VELOCITY DROP IN 1982 WAS A TRANSITIONAL PHENOMENON AS THE PUBLIC ADJUSTED THEIR PORTFOLIOS TO A LOWER RATE OF INFLATION. NOW THAT INFLATION APPEARS TO HAVE STABILIZED AT ITS NEW, LOWER LEVEL, VELOCITY SHOULD REVERT TO MORE TRADITIONAL, AND THEREFORE PREDICTABLE BEHAVIOR, THUS ALLOWING M1 TO BE A USEFUL TARGET AGAIN. AS I MENTIONED AT THE OUTSET, RECENT EVIDENCE SUGGESTS THAT THIS IS INDEED OCCURRING.

BEFORE I END THIS DISCUSSION OF M1, LET ME COMPARE THE 1982-83 EXPERIENCE WITH THAT IN 1975-76, WHEN THE DEMAND FOR MONEY WAS NOT STABLE. THESE PERIODS HAVE ONE THING IN COMMON. THEY ARE THE ONLY PERIODS SINCE 1951 WHEN INFLATION HAS SHOWN A LARGE DECLINE. WHY THEN DIDN'T VELOCITY DECLINE IN 1975-76 AS IT DID IN 1982-83? IN FACT, VELOCITY IN THAT EARLIER PERIOD REMAINED WITHIN A NORMAL CYCLICAL PATTERN. THE REASON WAS THAT, SIMULTANEOUS WITH THE DECLINE IN INFLATION AND INTEREST RATES, WHICH BY ITSELF WOULD HAVE REDUCED VELOCITY, THERE WAS A WELL DOCUMENTED DOWNWARD SHIFT IN THE DEMAND FOR M1 CAUSED BY FINANCIAL INNOVATION -- I.E., IMPROVED CASH MANAGEMENT BY CORPORATIONS (E.G., AS PAYMENT OF INTEREST ON CORPORATE SAVINGS ACCOUNTS WAS PERMITTED, USE OF REPURCHASE AGREEMENTS, CASH MANAGEMENT PLANS, ETC.) -- BY ITSELF WOULD HAVE INCREASED VELOCITY. THE NET EFFECT WAS THAT VELOCITY GROWTH APPEARED TO BEHAVE NORMALLY.

AT THE TIME OF THE 1975-76 DOWNWARD SHIFT IN THE DEMAND FOR MONEY, I TOOK THE POSITION THAT M1 WAS AT LEAST TEMPORARILY CONTAMINATED AS A GUIDE TO POLICY AND URGED THE FOMC TO SHIFT TO M2, WHICH HAD NOT BEEN SO AFFECTED IN 1975-76. IF THE CONTINUED STABILITY IN THE VELOCITY OF M1 WAS A FORTUITOUS RESULT OF TWO OFFSETTING DEVELOPMENTS, IT COULD NOT BE RELIED UPON BY POLICYMAKERS TO CONTINUE. IT WASN'T UNTIL IT BECAME CLEAR THAT M1 DEMAND HAD STABILIZED AT A NEW LOWER LEVEL THAT I FELT

CONFIDENT ABOUT RE-EMPHASIZING THE ROLE OF M1 AS A GUIDE TO POLICY.

THERE IS AN IMPORTANT LESSON TO BE LEARNED FROM THIS EXPERIENCE THAT CAN BE APPLIED TO THE CURRENT EPISODE. SOME ANALYSTS HAVE POINTED OUT THAT THE VELOCITY OF M1 WITHOUT NOW ACCOUNTS (WHAT THE FED CALLED M1A IN 1981) HAS BEHAVED IN ITS NORMAL CYCLICAL PATTERN IN 1982-83. THIS WOULD SEEM TO SUPPORT USING M1 WITHOUT NOW ACCOUNTS AS A MONETARY TARGET. I WOULD DISAGREE. MY STAFF TELLS ME THAT IN 1982-EARLY 1983 M1A SUFFERED THE SAME DOWNWARD SHIFT IN ITS DEMAND FUNCTION AS OCCURRED WITH M1 IN 1974-76. THE APPEARANCE OF A STABLE VELOCITY FOR M1A IN 1982-EARLY 1983 WAS SIMPLY THE FORTUITOUS RESULT OF TWO OFFSETTING SHIFTS. (THE DOWNWARD SHIFT IN MONEY DEMAND WOULD BY ITSELF HAVE RAISED VELOCITY, WHILE THE SHARP FALL IN INFLATION AND INTEREST RATES BY ITSELF WOULD HAVE REDUCED THE VELOCITY.) M1A WOULD NOT BE A RELIABLE GUIDE TO POLICY UNTIL SUCH TIME AS WE HAD CONVINCING EVIDENCE THAT IT HAD A STABLE DEMAND FUNCTION. ONLY THEN CAN TARGETING THIS AGGREGATE LEAD TO PREDICTABLE EFFECTS ON FUTURE LEVELS OF INCOME AND PRICES.

I WOULD SUMMARIZE MY VIEWS ON THE M1 VELOCITY ISSUE WITH FOLLOWING POINTS.

1. THE DEMAND FOR M1 IS ONE OF THE MOST STABLE RELATIONS IN ECONOMICS. SPECIFICALLY, THE EVIDENCE SUGGESTS THAT THE DEMAND FOR M1 WAS STABLE IN 1982-83. THE ONLY MAJOR EXCEPTION IN RECENT TIMES WAS 1974-76.

2. THE UNPRECEDENTED DECLINE IN VELOCITY IN 1982-EARLY 1983 WAS DUE TO THE UNPRECEDENTED DECLINE IN INFLATION AND INTEREST RATES IN 1982. SUCH EPISODES ARE RELATIVELY RARE. THERE IS ONLY ONE OTHER EXAMPLE OF THAT OCCURRING IN THE POST WAR ERA -- 1975-76.
3. IF WE EXPECT INFLATION TO REMAIN STABLE IN THE 4-6% RANGE IN 1984, WE CAN EXPECT, WITH REASONABLE CONFIDENCE, THAT THE VELOCITY WILL BE STABLE AND THAT THE M1 TO GNP RELATION WILL BE PREDICTABLE.

IS M2 A REASONABLE ALTERNATIVE?

NOW I WOULD LIKE TO TURN MY ATTENTION TO M2 AS AN INTERMEDIATE TARGET. I HAVE ARGUED THAT THE STABLE DEMAND VIEW OFFERS GROUNDS FOR REINSTATING M1 AS AN INTERMEDIATE TARGET. THERE IS, I BELIEVE A SECOND REASON FOR DOING SO, NAMELY, THAT M2 GIVES EVERY SIGN OF BEING A HIGHLY UNRELIABLE GUIDE TO MAKING POLICY.

THIS WAS NOT ALWAYS THE CASE. AS I SAID EARLIER, I SUPPORTED M2 AS THE PRIMARY TARGET IN RESPONSE TO THE SHIFT IN M1 DEMAND IN 1974-76. MY MAIN REASON FOR DOING SO WAS THAT IT APPEARED TO BE LESS AFFECTED THAN M1 BY THE MAJOR EPISODE OF FINANCIAL INNOVATION THAT TOOK PLACE IN THE MID-1970s. MOREOVER THE CHARACTER OF M2 WAS DIFFERENT THEN. REGULATION Q CEILINGS MEANT THAT ASSETS IN M2 WERE CLEARLY DIFFERENTIATED FROM OTHER FINANCIAL ASSETS. AS A RESULT, THERE WAS A WELL-DEFINED DEMAND

FOR M2, SEPARATE FROM OTHER LIQUID ASSETS. THIS STABLE DEMAND TRANSLATED INTO A FAIRLY PREDICTABLE RELATIONSHIP BETWEEN M2 AND GNP. AT THE SAME TIME, BECAUSE M2 TYPICALLY PAID BELOW-MARKET INTEREST RATES, THE FED WAS ABLE TO EXERT REASONABLE CONTROL OVER ITS QUANTITY BY ALTERING THE SPREAD BETWEEN MARKET RATES AND REGULATION Q CEILINGS.

ALL OF THIS HAS CHANGED AS DEPOSIT RATES ON MUCH OF M2 HAVE BEEN PROGRESSIVELY DEREGULATED. IN FACT, I BELIEVE THAT THE DEREGULATION HYPOTHESIS MAKES MORE SENSE FOR M2 THAN IT DOES FOR M1. DEREGULATION OF M2 HAS IMPAIRED ITS USEFULNESS AS AN INTERMEDIATE TARGET IN AT LEAST TWO IMPORTANT WAYS.

FIRST, THE PAYMENT OF CLOSE-TO-MARKET RATES ON SOME OF M2 HAS MADE THIS COMPONENT A CLOSE SUBSTITUTE FOR OTHER LIQUID ASSETS. AS A RESULT, THE PUBLIC'S DEMAND FOR M2 IS LESS CLEARLY DIFFERENTIATED FROM OTHER FINANCIAL ASSETS, DEPENDING MORE THAN BEFORE ON SUCH UNPREDICTABLE FACTORS AS INVESTOR SENTIMENTS ABOUT UNCERTAINTY, AND THE RISK AND MATURITY CHARACTERISTICS OF ALTERNATIVE ASSETS.

THE SECOND PROBLEM WITH CURRENT M2 IS THAT DEPOSIT RATES ON MUCH OF IT NOW ARE ADJUSTED TO MATCH CHANGES IN MARKET RATES. THIS MEANS THAT THE PUBLIC'S DEMAND FOR M2 DOES NOT RESPOND VERY MUCH WHEN MARKET RATES CHANGE. CONSEQUENTLY, THE FED HAS LITTLE CONTROL OVER M2 IN THE SENSE THAT IT CANNOT INFLUENCE THE QUANTITY HELD BY THE PUBLIC VERY MUCH BY ALTERING INTEREST RATES.

EXCEPT FOR A WIDELY EXPECTED SURGE IN JANUARY AND FEBRUARY 1983, RELATED TO THE INTRODUCTION OF MONEY MARKET DEPOSIT ACCOUNTS, M2 HAS GROWN IN A NARROW RANGE OF 8 TO 9 PERCENT SINCE MID-1978. THIS WAS THE TIME WHEN DEREGULATION FIRST PERMITTED THE PAYMENT OF MARKET-RELATED INTEREST RATES ON M2 DEPOSITS. STABLE M2 GROWTH, EVEN THOUGH INCOME AND INTEREST RATES HAVE VARIED SUBSTANTIALLY, HAS MEANT THAT M2 IS NO LONGER PREDICTABLY RELATED TO INCOME. IT IS NOT A RELIABLE GUIDE TO POLICY.

TO SUMMARIZE; THE QUANTITY OF M2 IS NO LONGER EITHER A GOOD INDICATOR OF THE EFFECT OF POLICY ON THE ECONOMY OR A TARGET VARIABLE WHICH THE FED CAN CONTROL IN THE SHORT RUN. THIS MEANS THAT IF WE WERE TO RELY PRIMARILY ON M2 AS A TARGET, WE WOULD HAVE TO LOOK AT INTEREST RATES TO GAUGE THE THRUST OF MONETARY POLICY. IN OTHER WORDS, USING M2 AS AN INTERMEDIATE TARGET WOULD BE TANTAMOUNT TO MAKING INTEREST RATES THE FOCUS OF MONETARY POLICY — AND WE ALL KNOW THE TROUBLE THAT CAN GET US INTO.

BEFORE CONCLUDING, LET ME SAY A FEW WORDS ABOUT OTHER POTENTIAL MONETARY INDICATORS. THE MAIN ALTERNATIVES SUGGESTED HAVE BEEN INTEREST RATES AND GNP.

THE PROBLEMS WITH NOMINAL INTEREST RATE TARGETING ARE WELL KNOWN. THE STANDARD ACADEMIC CRITICISM OF FOCUSING ON INTEREST RATES IS THAT IT CAN EASILY LEAD TO PROCYCLICAL MONETARY GROWTH. THAT CRITICISM, IN MY OPINION, CONTINUES TO BE VALID. SOME COMMENTATORS HAVE SUGGESTED THAT THIS PROBLEM CAN BE AVOIDED BY TARGETING REAL INTEREST RATES. BESIDES THE STATISTICAL PROBLEM

OF MEASURING REAL INTEREST RATES THERE IS A POLICY PROBLEM — WHAT LEVEL OF REAL INTEREST RATES TO TARGET. ON THE BASIS OF HISTORIC EVIDENCE THROUGH 1980, ONE WOULD NEVER HAVE ASSUMED THAT THE AVERAGE REAL INTEREST RATE OF $4\frac{1}{2}$ PERCENT, WHICH HAS EXISTED OVER THE LAST YEAR ON 3-MONTH TREASURY BILLS, WOULD BE CONSISTENT WITH THE TYPE OF BUSINESS CYCLE EXPANSION WE ARE HAVING. SOMETHING HAS CLEARLY CAUSED THE U.S. ECONOMY TO MOVE TO A HIGHER AVERAGE REAL INTEREST RATE LEVEL. GIVEN THAT ANALYSTS DIFFER ON THE CAUSE, I SUSPECT IT WOULD BE VERY DIFFICULT FOR THE FED TO PICK THE REAL INTEREST RATE TARGET THAT IS APPROPRIATE IN THIS NEW ENVIRONMENT.

AS FOR TARGETING NOMINAL GNP, FRANK MORRIS HAS MADE THE TELLING POINT, THAT IT WOULD HAVE THE UNFORTUNATE CONSEQUENCE OF GIVING THE PUBLIC AND THE POLITICIANS THE IMPRESSION THAT THE FEDERAL RESERVE HAS MORE INFLUENCE ON THE ECONOMY THAN IT REALLY EXERTS. GNP IS STRONGLY INFLUENCED BY MONETARY POLICY, BUT THERE ARE OTHER FACTORS, INCLUDING FISCAL POLICY, WHICH ALSO PLAY AN IMPORTANT ROLE. THE GREAT MERIT OF MONETARY AGGREGATE TARGETING IS THAT CONTROL RULES CAN BE DEVELOPED WHICH ENABLE THE FED TO HIT ITS TARGETS IN A RELATIVELY SHORT PERIOD OF TIME. IF INCOME DOES NOT PERFORM IN THE WAY THAT WAS EXPECTED, I.E., A SHIFT IN VELOCITY, THE FED CAN CHANGE ITS TARGETS AS, IN FACT, IT DID LAST YEAR. THAT PROCEDURE STRIKES ME AS FAR MORE REALISTIC IN TERMS OF THE ACCOUNTABILITY OF MONETARY POLICY TO CONGRESS, THE ADMINISTRATION, AND THE PUBLIC.

CONCLUSION

I BELIEVE M1 HAS SURVIVED REMARKABLY WELL FROM THE DEREGULATION PROCESS; THAT IS, DEREGULATION APPARENTLY HAS NOT FUNDAMENTALLY CHANGED ITS UNIQUE ROLE AS A MEANS OF PAYMENT. M2, ON THE OTHER HAND, HAS BEEN FUNDAMENTALLY FLAWED BY THE DEREGULATION PROCESS BECAUSE IT NOW IS MORE LIKE NON-M2 FORMS OF FINANCIAL WEALTH. THIS CLEARLY LEADS TO THE CONCLUSION THAT M1 IS SUPERIOR TO M2 AS A GUIDE TO POLICY.

THIS DOES NOT MEAN THAT M1 HAS NO PROBLEMS, OR THAT IT WON'T DEVELOP MAJOR PROBLEMS IN THE FUTURE. IT IS POSSIBLE THAT FUTURE DEREGULATION AND/OR TECHNOLOGICAL INNOVATION COULD BLUR THE DISTINCTIONS BETWEEN TRANSACTIONS AND NON-TRANSACTIONS DEPOSITS AND MAKE M1 A LESS UNIQUE TRANSACTIONS MEASURE OF MONEY. HOWEVER, ON THE BASIS OF CURRENT EVIDENCE, M1 IS CLEARLY A SUPERIOR GUIDE TO POLICY THAN M2. FOR THESE REASONS, I AM CURRENTLY PAYING A GREAT DEAL MORE ATTENTION TO M1 THAN M2, AND I EXPECT TO CONTINUE DOING SO NEXT YEAR.