MONETARY POLICY— THE NEW LOOK

Remarks of

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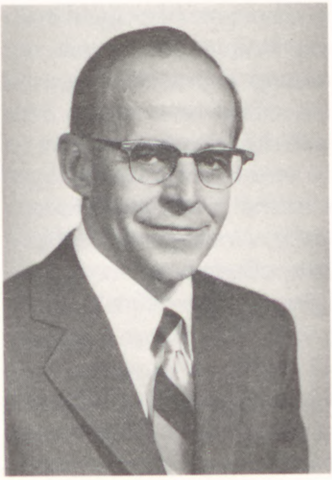

The initial results of the Federal Reserve's October 6 policy shift give the nation hope for surmounting the financial problems of the uncertain 1980's, according to Mr. Balles. The policy shift has involved a change in instruments and tactics to reinforce the Fed's intention to achieve moderation in the growth of money and bank credit. These new steps did not reflect any change in the Fed's basic targets for 1979 for the monetary aggregates—but they did reflect its determination that those objectives will actually be achieved.

I'm glad to have the chance to participate in this now-familiar autumn ritual, the annual business-outlook meeting. We're entering what appears to be a difficult year—and perhaps also a difficult decade—for the national economy. The sessions held here at U.C.L.A., and those held at similar institutions throughout the country, should generate the type of guidance that policymakers need as they develop their plans for the difficult period ahead.

In accepting the invitation to speak tonight, I said that because of my official position on the Federal Open Market Committee, I would not feel free to make any interest-rate forecasts. But that gap in my presentation may not be as important as you think. At a conference which we hosted recently in San Francisco for a number of leading academic figures, a great deal of time was spent discussing the new financial environment which followed the monetary-policy shift of October 6. As you might imagine, the monetarists in the audience were generally encouraged at the recent turn of events, but they remained skeptical about the Fed's ability to remain on the path of virtue which they had long ago urged us to follow. Thus, they are reserving judgment until they see the actual results after a period of some months.

Policy Shift—and Its Background

I rather doubt that you're going to see a complete reversal of policy, but there's no doubt that the FOMC has shifted direction in a significant way. Let me summarize what led up to the events of October 6, and then tell you what we did and why we did it.

From every vantage point, the economic situation this summer and early fall was very disturbing. Following a dip in the economy in the second quarter, and contrary to expectations, the economy heated up during the third quarter, with a 3½-percent annual rate of increase in real GNP. That burst of spending reflected a "buy now" attitude spurred by an intensification of inflationary expectations. With consumer prices rising at a 13-percent annual rate, households and businesses boosted their purchases, and speculative pressures developed in commodity markets. And despite policy efforts to control the situation, measured by steady increases in the Federal-funds rate, money growth actually accelerated; the growth of the M_2 money supply jumped from an 8.9-percent annual rate to a 12.0-percent rate between the second and third quarters of the year.

Those domestic pressures, plus the renewed weakening of the dollar in foreign-exchange markets, led the Federal Reserve to introduce its three-part policy package on October 6. First, the Fed announced a one-percent increase in the discount rate, the rate at which Reserve Banks lend to member commercial banks. Second, it imposed an eight-percent marginal reserve requirement on "managed liabilities"—large time deposits, Eurodollar borrowings, repurchase agreements against U.S. Government and federal-agency securities, and Federal-funds borrowing from non-member institutions. Finally, the Fed announced a greater emphasis, in the day-to-day conduct of monetary policy, on bank reserves—and less emphasis on minimizing short-term fluctuations in the Federal-funds rate, the rate at which banks borrow reserves from each other and from other institutions. The purpose of all these actions was to assist in slowing the rate of growth of the money supply.

The financial markets and the press have devoted considerable attention to the first two of those measures, yet they may have only a short-term effect on the economy's overall performance. But the third measure, while receiving much less attention, could mean a fundamental improvement in the nation's long-run inflation outlook. By focusing its day-to-day operations on bank reserves, the Federal Reserve may now have found a better way of controlling the growth of the nation's money supply. High inflation rates cannot persist for long without rapid money growth, so that better control over the monetary aggregates should help us achieve substantial progress against inflation over the next few years.

Federal Reserve Operating Procedures
Now, the Federal Reserve can influence the growth in money in either of two basic ways—with either a reserves operating instrument or a Federal funds-rate instrument. Both methods operate through the market for bank reserves. Under the Fed's present regulations, member banks must hold reserves against deposits equal to a certain minimum percentage of those deposits. This means that deposit growth is ultimately constrained by the rate at which bank reserves are expanding. Thus the banking system must find additional reserves if more deposits are to be issued. The Federal Reserve, of course, has the power to add to or subtract from reserves through open-market operations, by buying financial assets from banks or by selling financial assets to them.

Under the reserves operating instrument, as adopted essentially on October 6th, the Fed attempts to hit certain target growth rates for the *quantity* of bank reserves. Once this quantity is expanding at a set rate, the rate at which banks can issue deposits (the main element in the money supply) will be largely determined—at least over the short-term.

Under the funds-rate instrument, as used prior to October 6th, the Fed attempted to influence deposit growth not through the quantity of bank reserves but directly through the *cost* of these reserves. Banks can borrow reserves from other institutions in the Federal-funds market. The Fed can affect the interest rate on these reserves (the Fed-funds rate) by injecting or withdrawing reserves. A rise in the funds rate, for example, increases the cost of reserves, which in turn leads to increases in other market rates of interest. With increasing yields on financial assets, such as Treasury bills, we experience a decline in the rate at which the public chooses to add to its stocks of low- or non-interest-bearing deposits—and we experience a decline in money growth rates.

Many economists have argued about which technique does a better job of controlling money. As a technical matter, the race seems to be a draw: using either the funds rate or reserves as the operating instrument could produce equally good results—provided that the range of movement permitted in the funds rate is sufficiently broad. This conclusion, however, leaves out a crucial factor—namely, the cautious path followed by the Federal Open Market Committee in reacting to deviations of the aggregates from their official longer-run targets. With such an approach, a funds-rate operating instrument has resulted in less control over the monetary aggregates than was either desirable or feasible. The cautious-control approach is now likely to carry over to the new reserves operating instrument. But for reasons that I will discuss, control over the aggregates is likely to be significantly improved.

Cautious Funds Rate Control

In evaluating the experience under the previous funds-rate instrument, we should recognize that growth rates in the (M_1) money supply are influenced primarily by two factors. First, if the Fed increases the funds rate, M_1 growth rates tend to fall as the public finds non- or low-interest-bearing deposits and currency less desirable. Second, as aggregate economic activity rises and falls over the business cycle or in concert with inflation, M_1 growth will also be pulled up and down as the public's need for transactions balances changes.

Presumably, in targeting the aggregates the Fed wishes to avoid increases in money growth rates in recoveries which would "overheat" the economy, and decreases in money growth rates in recessions which would aggravate unemployment. Such undesired procyclical money-supply movements could of course be avoided by changing the funds rate fast enough to "fight off" the procyclical effects of changes in economic activity on money growth rates.

Unfortunately, it hasn't worked out that way in practice. In recent years, the Fed has moved the funds rate in the right direction—increasing in recoveries to restrain monetary accelerations, and decreasing in recessions to hold back monetary decelerations. But these actions have not been sufficiently aggressive to keep money growth from moving in concert with the business cycle. As a result, monetary policy has generally added to inflationary pressures in cyclical expansions and to unemployment in recessions.

Reasons for Cautious Control

This raises the obvious question: Why hasn't the Federal Reserve in the past moved the funds rate more actively? A partial explanation involves the substantial amount of uncertainty which surrounds the current condition of the economy at any point in time and the precise timing and impact of policy actions. This uncertainty reflects the current state-of-the-art in the economics profession, and is not likely to be eliminated in the near future. Under these circumstances, the rational policymaker should react cautiously in changing the operating target when money growth appears to be off target. Since the impact of potential policy actions is uncertain, the fact that the economy functioned tolerably well in one month provides strong support for not substantially changing the target for the operating instrument in the following month. In this way, significant swings in policy are quite rationally delayed "until next month".

Several institutional factors also have contributed to this tendency toward cautious control. First, policy is made by a committee (the FOMC), and the Committee's inevitable compromises sometimes lead to only modest changes in the level or range of operating targets. Second, public and political attitudes generally view the risk of doing something to be greater than the risk of maintaining the status quo. Since the mistakes resulting from activist policies tend to generate a greater outcry than those stemming from status-quo policies, the Fed is frequently cautious in its policy actions. Third, frequent changes in policy impose costs on the private sector by forcing it constantly to revise its decisions, and so tend to undermine the performance of the economy. Thus, in addition to being concerned with inflation, unemployment, and the foreign-exchange value of the dollar, the

Fed wants to provide a stable policy framework—which means essentially a cautious policy stance.

Interest Rate Variability

Now, all of these considerations apply equally well to any operating instrument the Fed might use, including either the funds rate or bank reserves. Thus, in my personal view, the Fed's recent decision to focus on reserves could mean that the reserves instrument will now be moved as cautiously as the funds-rate instrument was in the past.

If that happens, then the Fed would not accommodate many short- and long-term fluctuations in banks' demand for reserves. Consequently, the Federal-funds rate could become much more variable than it has been in the past. This possibility has prompted some observers to argue that such funds-rate variability would be unacceptable to the Fed—indeed, would cause the Fed to revert to a funds-rate instrument, leading again to interest-rate smoothing.

These fears could be exaggerated. First, under a reserves instrument, funds-rate fluctuations probably will not be transmitted to other money-market rates—say, to the Treasury-bill rate or the commercial-paper rate—to the same extent that they were under a funds-rate instrument. Formerly, current changes in the funds rate contained policy information about what the Fed would do in the future; thus, funds-rate changes almost immediately became reflected in other money-market rates. But under a reserves-operating instrument, the essentially random day-to-day and week-to-week changes in the funds rate will convey less information about its future levels, and will have a much smaller impact on other money-market rates.

Second, under the funds-rate regime, the Fed came to be held publicly responsible for interest rates—and thus came under considerable pressure to keep rates down. Now, the Fed of course can keep interest rates down in the short-run, but this is not true in the long-run. Attempts to lower rates in the face of strong money and credit demands result in fast money growth and ultimately inflation. And given the inclusion of an inflation premium in nominal interest rates, attempts to resist interest-rate increases in the short run often cause higher rates in the long run. Today, by emphasizing reserves, the Fed may avoid some of the public pressure to control interest rates, and thus may promote a more accurate public perception of its actual ability to control rates.

Cautious Control Over Reserves

In sum, our past experience has shown that a cautious funds-rate strategy can lead to procyclical swings in money and reserves, which ultimately lead to undesirable economic results. A cautiously controlled reserves instrument should work in just the opposite direction—it will tend to resist, rather than accede to, the forces producing procyclical swings in money. With the supply of bank reserves expanding at a relatively stable rate, the maximum rate at which banks can issue deposits will be relatively stable also.

Cautious control applied to a reserves operating instrument thus is likely to insulate the growth in money more thoroughly from cyclical swings in output and prices. The outcome should be a better record in moderating economic fluctuations, and especially in containing the rate of inflation. Under the old system, inflationary pressures often led to faster money growth and thus even more inflation later. Under the new system, more inflation now is likely to be met by higher nominal interest rates and unchanged money growth, which means that higher rates of inflation cannot be permanently sustained. For this reason, the new look in monetary policy has definitely improved the long-run outlook for inflation control.

Developments After October 6

The key question is whether the new approach to policy has actually worked. I must confess that the millenium didn't dawn on October 6, much to the surprise of the many proponents of the new look in the academic community. Instead, the initial reaction was a nose dive in the stock market and substantial turmoil in other financial markets. Short-term rates rose substantially, with, for example, the Fed-funds rate jumping 350 basis points within a month's time. More surprisingly, long-term rates also increased, with corporate Aaa bond rates rising 110 basis points within the month—perhaps because of securities dealers' uncertainty over the day-to-day costs of financing their security positions.

With the further passage of time, however, the markets recovered considerably. For example, 90-day commercial-paper rates dropped from 14.30 percent to 12.86 percent between early November and early December, and newly-offered Aaa corporate-bond rates declined from 11.52 percent to 11.24 percent in the same time-span. And of course the last several weeks have witnessed a welcome turn-around in the prime business-loan rate, from its peak of 15¾ percent to 15¼ percent today.

The foreign-exchange market initially responded well to the October 6 policy shift—and that stability was achieved without any major U.S. intervention in the market, contrary to our experience after the November 1978 policy moves in defense of the dollar. The Iranian crisis later led to some weakness in the dollar, and in the yen as well, but that crisis of course reflected other forces than the monetary-policy package. But meanwhile, a substantial slowdown occurred in the money-growth figures. M_1 growth declined from a 9.7-percent annual rate in the third quarter to a 2.5-percent rate in October and a 2.2-percent rate in November. Similarly, M_2 growth declined from a 12.0-percent rate in the third quarter to 8.6 percent in October and to 6.5 percent in November.

The tightening of policy led many observers to fear the onset of a severe credit crunch. But as Federal Reserve Chairman Volcker said in a late-October letter to member banks, the System "fully intends that sufficient credit will continue to be available to finance orderly growth in economic activity." I would only emphasize, as Chairman Volcker did, that when banks experience sharp but temporary variations in the cost of marginal funds, they should not consider that a signal to boost their basic lending rates. And I would also emphasize that banks should keep in mind the special problems of smaller customers who have limited financing alternatives. Specifically, banks should take special care to maintain the availability of funds for groups such as small businesses, consumers, home buyers and farmers. But bankers and their borrowers may perhaps now feel more confident about this situation, given the recent decline in interest rates.

Concluding Remarks

The October 6 policy package, as it has developed up to the present, gives us strong hopes for surmounting the financial problems of the uncertain 1980s. The policy shift has involved a change in instruments and tactics to reinforce the Fed's intention to achieve moderation in the growth of money and bank credit. These new steps did not reflect any change in our basic targets for 1979 for the monetary aggregates—but they did reflect our determination that those objectives will actually be achieved. In doing so, the new measures should emphasize the Fed's unwillingness to finance an accelerated inflation, as well as our goal of reducing inflationary pressures in the decade ahead.