THE STEADY MONEY GROWTH RULE IN MONETARY POLICY

Remarks by
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I am pleased to have this opportunity to discuss with you my views regarding the conduct of monetary policy. In view of the present disturbing state of this nation's economic affairs, monetary policy has become a topic of foremost concern and has come under close scrutiny. Monetary authorities share this concern and are attempting to improve the conduct of monetary policy so as to enhance its contribution to economic stabilization. It is in this spirit of seeking such improvement that I offer my remarks tonight.

It is common knowledge that the nation's money stock has gained increasing recognition in the conduct and interpretation of monetary policy. There have been a growing number of

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references to the growth of the money stock in public policy documents of the Federal Reserve System, the Administration, and the Congress. The financial press has made increasing reference to money in its discussions of monetary conditions. A substantial volume of careful research has led many analysts to conclude that changes in the rate of growth of the money stock is the most reliable indicator of the influence of monetary actions on economic activity, and that, within certain limits, the growth of money can be effectively controlled by the monetary authorities. Given this greater acceptance of the importance of money in the conduct of monetary policy, there has arisen a controversy over the appropriate path of monetary growth over time.

Essentially, there are two views on this subject. One view is that it is sufficient to achieve a certain average growth of money over periods as long as a year or so, and that significant deviations in the growth of money over a few months, or even quarters, need be of little concern. According to this view, short-run variations in the growth of money are necessary to offset disturbances that occur in markets for goods and securities. The alternative view is that a steady growth path of money should be achieved not only over a year or longer, but also over a relatively short interval, for example, a calendar quarter.

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As a long-time advocate of steady money growth, I have found the debate over these two views to be simplistic on both sides, in the sense that neither side has expressed its position in a clear and unequivocal manner. Although admittedly partisan, tonight I will try to express my views about a steady money growth rule for the conduct of monetary policy.

My interpretation of this rule is that money should grow at a steady rate, not only for long intervals of time but also over intervals at least as short as a quarter. I want to emphasize that, for the balance of this discussion, the term steady money growth refers to my interpretation. I will touch on three aspects of this topic. First, I will summarize my view of the effects of changes in money growth on economic activity. Second, I will consider the question of the time period over which I believe that steady money growth should be pursued. Third, I will summarize the consequences I expect from adoption of a steady money growth policy.

Let me now turn to the first aspect of the steady money growth rule -- the effects of changes in monetary growth on economic activity. Research, our own as well as that of others, has produced evidence consistent with the view that the trend rate of money growth is a major factor determining the trend rate of inflation, and that variations in the growth rate of money around its trend are an important source of fluctuations in output and

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employment. You will note that I have used the words "major factor" and "important source," and not the words "sole factor" and "sole source." In other words, I do not contend that "only money matters."

At the Federal Reserve Bank of St. Louis we have conducted empirical studies regarding the responses of the price level and real output to changes in the rate of monetary expansion. These studies indicate that the response of the price level and output to a sustained change in the rate of money growth is distributed over a fairly long period of time, probably in excess of five years. Given the prevailing trend of money growth, a marked and sustained deviation from the trend is followed very quickly by a change in the growth of output in the same direction, with very little initial effect on prices. Here I am referring to a change in money growth that is maintained for longer than three months.

If there is a persistent deviation in money growth, the price level begins to change in the same direction as the deviation in money growth. After about four or five quarters the effects on output growth begin to subside, while the influence on prices begins to appear. In the end, after the economy has fully adjusted to a sustained change in trend growth of money, the full effect will be reflected in the rate of change of the price level, and the growth of output will have returned to the long-term potential rate as constrained by resources, technology, and the labor force.

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This evidence, along with that presented in many other studies, leads to the conclusion that the trend growth of money is the major determinant of the rate of inflation. On the other hand, the evidence indicates that variations in monetary expansion lasting longer than three months are an important source of fluctuations in output and employment. I conclude from this that a steady rate of money growth would eliminate an important source of variation in output and employment that has occurred in the past.

Now let us proceed to the second aspect of my topic for this evening -- the time period over which I believe steady money growth should and can be achieved. I am persuaded that deviations in monetary growth that persist for more than three months have an influence on real output and employment. This provides one reason for why I believe fluctuations of that duration should be avoided.

In addition, my observations as an active participant in the monetary policymaking process since early-1966 have supported my belief that the steady money growth rule should be applied to periods at least as short as a quarter. During the past eight years, discretionary monetary actions were used in attempts to achieve many different objectives. Such objectives included: moderation of movements in market interest rates, alleviation of problems of savings flows to financial institutions and the housing industry,

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reduction of unemployment, elimination of inflation, and attempts to correct disequilibria in international markets.

These objectives often were in conflict, and it was difficult to resolve such conflicts. As a result, monetary authorities frequently shifted their emphasis from one objective to another. The shifting of priorities among the diverse objectives, often within a calendar quarter, frequently resulted in actions which produced re-occurring accelerations and decelerations in money growth lasting longer than three months, and a constantly accelerating trend rate of monetary expansion. Such swings in money growth rates, according to our view, had much to do with producing observed variations in output, employment, and interest rates, in the late 1960's and early 1970's. Furthermore, I am convinced that the accelerating trend rate of monetary expansion was a major cause of the present high level of inflation and interest rates. So, in order to avoid actions within a calendar quarter which may lead to significant accelerations and decelerations in money growth, I conclude that steady growth should be sought within a quarter.

Questions are frequently raised regarding the technical aspects of implementing the steady money growth rule. As I see it, monetary authorities would specify a trend rate of money growth from a given point in time which is consistent with a relatively low rate of inflation. In order to avoid uncertainty regarding monetary actions, it would be best if full public disclosure of this decision was made.

In selecting the appropriate trend growth rate, knowledge regarding most likely long-run trends in productivity, resources,

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and money demand would be taken into consideration. If a fundamental change occurred in any of these factors, a new trend rate of money growth would be called for. But, until there is firm evidence of such a change, the authorities would direct their actions toward achieving specific levels of the money stock at set points of reference in the future, such as every month within a quarter, so as to achieve steady money growth on a quarterly basis.

Some persons contend that monetary authorities do not have sufficient control over the money stock to use it as the basis for their actions. I recognize that control of money is not absolute, especially over such short periods as a week or even a month. But this is not a serious problem for the steady money growth rule. One reason is that there is evidence that a deviation of money from its specified path will have little impact on output if the deviation is corrected within three months. A second reason is that empirical research indicates that control of money can be quite close on a quarter-to-quarter basis if it is implemented through the ability of authorities to control movements in the monetary base and provided efforts are made to regain the path quickly whenever a deviation occurs. But this policy implies that monetary authorities would have to stop responding to interest rates and other money market conditions.

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Let us now examine the third aspect of my topic -- some of the consequences that I would expect from adoption of the steady money growth rule. In this examination, I will also attempt to answer some criticisms directed toward this rule.

A first and foremost consequence is that, regardless of the rate of money growth adopted, there would be less variability in the growth of output and employment. This is because a very important source of variability -- movements in money lasting longer than three months -- would be eliminated. I point out, however, that the influence of other sources of economic fluctuations, such as labor strikes, weather, changes in foreign markets, and changes in business and consumer expectations, would still remain. Many economists are convinced, however, that in the absence of reinforcing monetary actions, which have occurred all too often in the past, the influence of these disturbances would be dissipated within a relatively short period of time through the normal functioning of markets. Nevertheless, some variations in output and employment would remain under the steady growth rule.

A second major consequence which we might expect would be the possibility of achieving a less rate of inflation. Given the proposition that the trend rate of money growth is the major cause of inflation, I would expect that an appropriately low trend

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rate of money growth would result in less inflation. The influence on prices of such other factors as crop failures, energy shortages, and foreign demand for our products, would exist. But, just as in the case of output and employment, the normal operation of markets would be expected to return the rate of inflation back to the rate consistent with the trend growth of money. As a result, there would be movements in the rate of inflation around the rate implied by the trend growth of money.

Since there are other sources of economic fluctuations and inflation, a frequently raised criticism to the steady money growth rule is that monetary actions could not be used to offset the influences of these other factors. Thus, it is argued, there would be lost opportunities to produce even greater economic stability.

My answer to this criticism involves two points. First, as I have just mentioned, many economists believe that the influence of these other factors would be dissipated through the normal functioning of markets. Second, at the present time it is apparent that monetary authorities do not have sufficient knowledge of the distribution over time of the responses of output and prices to a change in money growth, and that they do not have the ability to forecast the occurrence of disturbances. Given these shortcomings, it would be very difficult to plan and conduct successful offsetting operations. Moreover, past experience demonstrates that even with the best of

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intentions, monetary actions may cause more harm than good. Under these conditions, it appears to me that there is little to be gained from a discretionary use of short-run monetary actions in attempts to offset the influence of other disturbances.

A third consequence is that steady money growth would produce both a lower level of, and less variability in, market interest rates. It is quite generally accepted that changes in money growth influence market rates of interest in three ways -- a temporary liquidity influence, a short-run output influence, and a long-run inflation influence. For example, an increase in the rate of money growth first decreases interest rates. This is the temporary liquidity influence. If the change persists for several months, output growth increases, demand for credit expands, and market interest rates rise. This is the short-run output influence. Then, if the change is maintained for several quarters, inflation increases and, as a result, an inflation premium becomes incorporated in market interest rates. This is the long-run inflation influence.

Steady money growth would minimize the temporary liquidity influence on interest rates and reduce the short-run output influence. With a steady growth of money there would be a more steady rate of inflation. As a result of these three developments, I would expect that there would be less variability in market

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interest rates. Moreover, if a non-inflationary trend rate of money growth is adopted, as I have suggested, there would be a lower level of market rates.

Some critics contend that following what they call "single-minded" pursuit of a long-run money target in the very short-run would produce wider day-to-day movements in interest rates, because monetary authorities would no longer engage in market smoothing operations. There does not appear, however, to be any solid empirical evidence indicating that these smoothing operations have been successful. On the other hand, economic theory and evidence indicate that market forces can be expected to smooth out very short-run movements in money market rates if longer-run stability in rates is achieved. Experience also suggests that open market operations designed to smooth short-run interest rate movements have been a major cause of variations in money growth and, as a result, have probably induced greater variability of interest rates.

Contrary to claims of the critics, a strong case can be made that adoption of the steady money growth rule would tend to reduce short-run interest rate variability. In the absence of knowledge regarding monetary policy, market participants attempt to guess its stance. In doing so, they follow daily open market operations, daily movements in money market rates, and short-run

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movements in money and other monetary aggregates. In the process, expectations are frequently generated which lead to an over-reaction on the part of market participants. As a result, large short-run movements in interest rates occur. This Fall's experience is a case in point. The steady money growth rule, because of the greater certainty regarding actions of monetary authorities, would most likely reduce the occurrence of over-reaction to relatively short-run market developments.

Even if greater short-run variations in market interest rates did occur, this would not necessarily close the case against the steady growth rule. Up to the present time, little evidence has been produced regarding the alleged harm to financial markets from wider day-to-day movements in interest rates which would outweigh the widespread benefits to be derived from steady money growth. Empirical evidence also suggests that short-run fluctuations in interest rates have little effect on output, employment, and the price level.

Now let us examine a few specific consequences which should be expected to follow from less variability in output, employment, the price level, and market interest rates. I shall focus mainly on consequences for financial markets, but I will also discuss some consequences for Government finance.

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Steady money growth would have a profound impact on financial markets. Those of you in attendance this evening would find your market decisions less complicated, because of less uncertainty regarding interest rate movements and the actions of monetary authorities. Moreover, market churning would probably be less if open market operations were directed at controlling money growth than if they were directed at attempting to smooth money market conditions on a day-by-day basis. As a result of less uncertainty for your operations, there would be less need to have in your employ, or to consult, "Fed Watchers."

The stock market could also operate within a more certain environment if the steady money growth rule were adopted. Less variability of output and the general price level would result in less uncertainty regarding corporate profits. Individual investment decisions could give greater consideration to relative yields and the profit outlook for industries and individual firms, and less consideration to expectations regarding the direction of monetary actions.

I want to make a few brief remarks regarding some consequences of steady money growth for Government financing. Adherence to a steady trend of money growth would, hopefully, produce a change in the deliberations of Congress regarding expenditures and their financing. Under this change in the conduct of monetary

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policy, it would be difficult for Congress to ignore the interest rate consequences of relying on borrowing rather than on taxes for financing expenditures. Recent experience suggests that many Congressmen all too often are inclined to ignore these consequences, because they appear to believe that it is proper to rely on monetary authorities to offset the interest rate consequences of their decisions. If the rule were adopted, Congressmen would be likely to weigh the political aspects of expenditures, taxes, and interest rate changes. Another consequence for Government finance is that less variation in economic activity should produce a more certain flow of tax revenue.

In conclusion, I believe there is a powerful case for the steady money growth rule in the conduct of monetary policy. If followed, our economy would most likely experience less inflation and fewer large fluctuations in economic activity. Financial markets, as well as product and resource markets, would operate within a more certain environment. Congress and the Administration, by having to face the financing question squarely, should come to realize that their expenditure programs necessarily involve the allocation of scarce resources.

One final point. Since I am concerned about output and employment, as well as inflation, I do not believe it would be desirable to move immediately to a steady, non-inflationary trend growth

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rate of money. With the high and accelerating growth of money over the last four years, an immediate move to a much lower trend rate for the purpose of rapidly reducing the rate of inflation would cause a temporary, but possibly quite sharp, reduction in output and employment. In order to avoid a severe shock to the economy in the transition to the new mode of monetary operations, the growth of money would have to be gradually reduced over the next two to three years.

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