THE SHIFTING FOCUS OF MONETARY POLICY

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to the Harry J. Loman Foundation
of the Society of Chartered Property and Casualty Underwriters
Mariott Pavilion Hotel, St. Louis
October 14, 1985

Good afternoon. I am delighted to be with you and appreciate the opportunity to make some remarks about monetary policy. As you could tell from the introductory remarks, it was not too long ago that I was an outside observer of policy as head of Morgan Stanley's U.S. Government Securities department. One comment I would hear from time to time from other securities traders was how boring the Government bond business must be in comparison to stocks or even corporate bonds. After all, they would say, you are dealing with straight-forward securities and only one credit, that of the U.S. Government. My response, while these were undeniable facts, was that the main event was not the specific securities, but rather the market. The fascinating thing to me about the market is that it would behave quite differently over time with apparently similar sets of inputs. I think the same thing might be said about monetary policy, and what I would like to talk about today is the shifting focus of policy, particularly as it relates to how the rate of growth of money is viewed.

Late this Spring, as we all know, monetary policy was eased. In May and June adjusted monetary base grew at a 14.6 percent annual rate compared to a 6.3 percent rate from January through April. M1, which had grown at about a 10 percent rate from the beginning of the year, grew at a 16.0 percent rate from May to the present. The discount rate was cut 50 basis points, and market interest rates, from mid-April through mid-June, declined by approximately 100 basis points.

What factors were associated with this easing? First, GNP growth was at an anemic 0.3 percent annual rate in the first quarter, and more current indicators pointed to continued weakness in the second quarter. In addition, the dollar was still strong, having just reached its highs in March. Inflation continued to be well behaved, and in fact with talk of lower oil prices there was even a whiff of deflation in the air. Finally, there was evidence of strains in the financial system with the Ohio thrift crisis and mounting numbers of bank failures. All of these factors pointed in the direction of monetary ease. A further confirming note was struck in mid-May when there was a breakthrough in the Federal budget impasse which would apparently lead to reduced government spending and deficits.

The only factor which seemed to point in the opposite direction was the rapid rate of growth in M1 (currency and checkable deposits), which at about 10 percent was well in excess of the Fed's 4-7 percent target range. However, because of the weight of the other factors and certain special considerations relating to M1, which I will discuss later, rapid M1 growth did not act as a constraint to easing.

Now, as we enter the fourth quarter, there continue to be occasional calls for further easing and certainly is no anticipation of tightening. The economy, while growing at a stronger 2.8 percent rate in the third quarter, is still thought by some to be too sluggish. The dollar, although lower by 6-7 percent since the recent G5 accord and by 20 percent from its March highs, is still not down enough, some would say, to reduce the trade imbalances that have developed, particularly in manufacturing and agriculture. Inflation certainly continues to be well behaved. And there are still strains in the financial system, as the number of bank failures through September had already reached the total for all of last year and will probably exceed 100 by year-end. Finally, while M1 growth continues to be rapid, in fact more rapid than earlier in the year, it was ignored then and presumably can be now.

Or can it? The ultimate goal of monetary policy is to supply, at some given rate of inflation and growth of real output, that amount of money that people are willing to hold in the form of cash and checkable deposits. In economic jargon, to supply that amount of money that people demand. If more money than that is provided, according to monetarist theories, people attempt to get rid of excess money balances by increasing their spending on goods, services, and securities, thus temporarily increasing economic activity and ultimately causing an increase in the rate of inflation. If less money is supplied, people try to conserve money balances by reducing their spending, and thus reducing output and eventually the rate of inflation. Monetary authorities, in most cases, do not wish to accelerate inflation; nor do they wish to produce a recession. It sounds simple, but, unfortunately, there are no precise measures or estimates of how much money people desire to hold. Consequently, monetary policy can be frustrated by the public's changing desires.

There is substantial evidence that the public's demand for money may have increased in 1985, with the result that more money was required to sustain an acceptable level of economic activity. Four major reasons have been put forth.

The first one is the declining rate of inflation since 1980. When people observe lower rates of inflation and expect inflation to decline further, they are more willing to hold noninterest-bearing, or less-than-market-bearing deposits. The value of those assets declines more slowly than during periods of higher inflation.

The second one is declining interest rates since the 1981-82 peaks. With lower and declining interest rates, the holding of cash becomes less costly because the return on alternative assets is smaller.

The third one is the rising international value of the dollar. Even though there are industries and sectors of the economy which stagnate because of the high value of the dollar, it raises the perceived wealth of society as a whole because of the increased purchasing power. Such an increase in wealth also acts to increase cash holdings.

And, finally, the introduction of NOW and Super NOW accounts has probably shifted some savings deposits into what is now defined as M1. With cash assets including some features of savings deposits, one would expect that these assets would not all be held for spending purposes, and thus increases in these assets may not be immediately translated into additional spending.

While some of these pieces of evidence, individually, may not produce a large increase in money demand, all of them together have had a significant effect. The bottom line of this analysis is that the rapid growth of the money stock in 1985 may not necessarily have had the same impact on economic activity and the rate of inflation as it has had in the past. Typically, such increases in the rate of growth of money have resulted in increased economic activity with a one to two quarter lag and higher inflation with an 18-month lag.

However, there is a question as to whether such rapid growth can continue without adverse side-effects given some changes occurring in the past six months. In terms of the factors that I have enumerated as affecting money demand, we are beginning to observe the following.

The inflation rate is not declining--it stabilized at around 4 percent in the past three years. While people's expectations may have changed with a lag, thus inducing larger cash holdings for the past three years, it is unlikely that they will continue to do so. Interest rates have leveled off, and given our tax structure and four percent inflationary expectations in the short run, and somewhat higher in the long run, it is doubtful that we would see further significant declines. The international value of the dollar, as mentioned earlier, has declined significantly from its highs, presumably contributing to a leveling off, if not a decrease, in perceptions of wealth. And finally, barring some new innovations in cash-holding instruments, a significant reduction in the growth of savings components of M1 should be occurring.

Again, adding all these factors together, it is reasonable to expect that people's desire to hold higher cash balances will begin to decrease. Accordingly, much lower rates of money growth than we have been experiencing may be sufficient to sustain economic growth. Continuation of current double-digit rates of money growth could well contribute to an outburst of new inflation down the road.

There is another aspect of our current situation that I would like to comment on--namely, we are particularly vulnerable to changes in inflationary psychology at the present time. This has developed as a result of our large current account deficits and the resulting increase in foreign holdings of dollars which must be invested in dollar assets. Because of the magnitude of these deficits, we have become quite dependent on foreign capital flows in meeting our domestic financing requirements, which include the large budget deficits.

The ability to attract these flows at current interest rate levels is very dependent on the inflationary outlook in the U.S. relative to other countries. Were inflationary psychology here to revive--and this might very likely be associated with overly-stimulative monetary policy and excessive rates of money growth--the dollar would decline, perhaps precipitously, as foreign investors sell dollar assets to preserve their future purchasing power. While the trade imbalances would improve with a lower dollar, less net foreign investment would be available, and there would be upward pressures on interest rates. In addition, a lower dollar would increase the price level simply because imported goods would become more expensive, reinforcing the inflationary psychology. Therefore, we must be especially mindful of not only inflationary performance in the short run, but also long-run inflationary expectations, which are influenced by monetary growth rates.

To sum up, then, I would argue that monetary policy has less latitude in the direction of ease than it did earlier in the year, despite many similarities between the two periods. Economic activity has improved, and in fact some observers are predicting third quarter GNP will be revised upwards to the 3-3.5 percent area. This is not much below the economy's long-run potential. As to the dollar, while further downward adjustment over time would be desirable, if anything, we need to be more concerned in the short-run with too rapid a decline because of implications for foreign capital flows. Finally, as to M1 growth, while special factors may have justified higher growth for a time, it is questionable whether that will continue to be the case.

On the other hand, a sharp slowing in money growth would be counter-productive. Sharp declines in such growth have resulted in recessions in the past. The Fed's fundamental objective is to foster a financial environment conducive to sustained growth of the economy consistent with progress over time toward price stability. Sustained growth has assumed a high priority in view of the strains in our financial system and appropriately so. However, price stability and expectations as to such stability in the future, particularly when dealing with markets as large and as volatile as the foreign exchange market, must have a high priority as well.