

THE SHIFTING FOCUS OF MONETARY POLICY
Remarks by Thomas C. Melzer
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Good afternoon. I am delighted to be with you and appreciate the opportunity to talk to you about monetary policy. As you heard from the introductory remarks, I am a newcomer to the "art" of monetary policymaking. 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. Given the recent debt impasse and the associated threatened insolvency of the Federal government, I am just as happy to have that career behind me. My experiences in the government securities market, however, have provided me with some helpful insights into policymaking. In particular, one thing I always found fascinating about the securities market was how it would react quite differently, from one time to the next, in response to what appeared to be virtually identical events or information. I believe that the same thing can be said about monetary policy actions and their impact on the economy. I would like to talk to you today about the shifting focus of policy--particularly as it relates to how the rate of growth in money is viewed, and should be viewed, by policymakers and observers alike.

Compared to past periods, money growth has been extremely rapid this year. M1, which consists of currency and checkable deposits, has grown at an annual rate of nearly 13 percent since April; in the past twelve months, it has grown in excess of 11 percent. To put this in some slight historical perspective, M1 growth over the previous four years has averaged about 7 percent per year; last year, money growth was only about 5 percent.

Accompanying this acceleration in money growth this year have been other signs of an easing in monetary policy. The discount rate was cut 50 basis points, and the federal funds rate has declined by approximately 50 basis points over the year.

What factors might have justified the move toward easing of monetary policy? First, real GNP growth was at an anemic 0.3 percent annual rate in the first quarter, and continued to be weak in the second quarter. Furthermore, there were strains in the financial system--for example, the Ohio thrift crisis and the mounting numbers of bank failures. Thus, concern about the continuation of the current economic

expansion and some liquidity problems facing certain financial institutions called for an easier policy stance.

Measured against the concerns of policymakers earlier this year, easier monetary policy has yielded considerable gains. The economy has strengthened over the year, with real output and employment rising, and the unemployment rate falling. At the same time, inflation and interest rates have remained relatively low. Finally, the dollar's value in foreign-exchange markets has come down considerably in recent months; it is currently about 22 percent below its February peak.

Perhaps because of the apparent success of the policy actions pursued earlier this year, there are calls for further easing, for the Federal Reserve to "do it again." After all, the economy is still sluggish, the unemployment rate is still above 7 percent, and the dollar's value is still too high to have produced a sizeable reduction in our trade deficit. Those who call for renewed, or continued, easier monetary policy actions point out that, despite the current rapid money growth, inflation remains subdued. So what's to worry? In my opinion,

there is a lot to worry about if rapid money growth should continue for another year or so.

To see what the problem is, we must first ask what is the goal of monetary policy? That is, what can it do and, therefore, what should we try to do with 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. Or, in the terms so dear to economists, to supply that amount of money that people demand. If more money than that is provided, people will attempt to get rid of their excess money balances by spending more on goods, services, and securities; this produces a temporary increase in economic activity and, ultimately, a permanent increase in the rate of inflation and interest rates. If less money is supplied, the opposite occurs; people try to conserve money balances by spending less, reducing output temporarily, and, eventually, reducing inflation and interest rates.

Of course, monetary authorities desire neither to accelerate inflation nor to produce a recession. The obvious "best" policy is to

provide precisely the "right" growth in the money supply; neither "too much" nor "too little." It sounds simple; unfortunately, however, we don't know, at any time, precisely how much money people want to hold.

Furthermore, monetary policy becomes even more complicated when the public changes its demand for money. In particular, when money demand is changing, policymakers must adjust the rate of money growth to "keep up" with the new demand. Thus, what would clearly be excessive money growth in a period when money demand was unchanged may turn out to be precisely the right policy to follow when money demand is increasing.

There are several reasons to believe that the public's demand for money may have increased in 1985, with the result that faster money growth was required to sustain an acceptable level of economic activity. Three major reasons have been put forth.

The first reason centers on the declining rate of inflation since 1980. When people observe lower rates of inflation, and expect inflation to remain low, interest rates decline in line with the change in inflation expectations. With lower and declining interest rates, it becomes less costly to hold money balances; the return on alternative

assets is smaller. Consequently, the amount of money that people will hold rises.

The second reason focuses on the wealth effect of the rising international value of the dollar. Although some industries and sectors of the economy are hurt by the high value of the dollar, the general effect is to raise the wealth of U.S. citizens as a whole; their international purchasing power has increased. This increase in wealth will result in an increase in their money holdings.

And, finally, the introduction of NOW and Super NOW accounts which pay interest has possibly caused some savings deposits to be shifted into what is now defined as M1. With some monetary assets now including some features of savings deposits, these assets would not necessarily be held for spending purposes alone. Thus, increases in the measured money supply may not be translated immediately into additional spending.

The bottom line of this analysis is that the rapid growth of the money stock so far this year may not necessarily have had the same impact on economic activity and the rate of inflation as it would have had in the past. Typically, such rapid increases in the rate of growth of money

have resulted in temporarily increased economic activity with a two- to four-quarter lag and higher inflation with an 18-month lag. However, if the demand for money has increased for the reasons given, the rapid money growth was necessary just to "tread water." It need have no deleterious impact on inflation at all.

However, it is questionable that such rapid growth can continue without adverse side-effects, given changes that have occurred in the past six months. Recently, we have begun to observe the following.

The inflation rate is no longer declining--it stabilized at around 4 percent in the past three years. While people's inflation expectations may change with a lag, thus inducing larger money holdings for the past three years, it is unlikely that they will continue to do so. Interest rates also have leveled off, and it is doubtful if we will see further significant declines. The international value of the dollar has declined significantly from its recent high, contributing to reduced wealth if the dollar continues to drop. Finally, barring some new innovations, it is unlikely that there will be continuing sizeable growth of savings components of M1.

Thus, given these recent events, it is unlikely that the public's demand for money will continue to increase in the near future as it has done in the recent past. Accordingly, much lower rates of money growth may be sufficient to sustain economic growth. Continuation of current double-digit rates of money growth would only contribute to an outburst of inflation in the future.

Acceleration of U.S. inflation would produce further problems for the economy. Our large current account deficits have been accompanied by the resulting increase in foreign holdings of dollar-denominated assets. We have become accustomed to using foreign capital flows to meet our domestic financing requirements, including our large federal budget deficits. The ability to attract these flows at current interest rate levels is dependent on the inflationary outlook in the U.S. relative to other countries. If people everywhere come to expect higher inflation in the U.S. as a result of overly-stimulative monetary policy and excessive rates of money growth, the dollar would decline precipitously; foreign investors would sell their dollar assets to preserve their future purchasing power. In addition, a lower value of the dollar would, by

itself, increase the price level simply because imported goods would become more expensive. Therefore, we must look beyond the low current inflation to what is likely to happen in the future; long-run inflationary expectations are heavily influenced by current and expected monetary growth rates.

To sum up, then, I would argue that monetary policy has less latitude in the direction of ease now than it did earlier in the year, despite what appear to be many similarities between the two periods. Economic activity has improved; the third quarter GNP is about 3.5 percent, about equal to the economy's long-run potential. As to the dollar, while further gradual downward adjustment over time would be desirable, we need to be concerned in the short-run about the consequences of too rapid a decline. Consequently, while special factors may have justified higher money growth for a time earlier this year, it is questionable whether continued faster growth is desirable.

Of course, a sharp slowing in money growth would be ill-advised and must be avoided. Sharp declines in money growth in the past have produced recessions, virtually every time they occurred. 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 economic growth has been a high priority and continues to be one. However, price stability and expectations as to such stability in the future are also vitally important. Policymakers, like the gambler in Kenny Rogers's song, have "to know when to hold 'em, and know when to fold 'em." It may now be time to "fold" the rapid growth in money gradually to a lower level that will assure price stability and continued economic growth.