

“U.S. MONETARY POLICY: PROBLEMS AND PROSPECTS”

Lecture by  
Thomas C. Melzer  
President  
Federal Reserve Bank of St. Louis

The City University Business School  
Centre for Banking and International Finance  
London, England  
March 18, 1987



I am delighted to have this opportunity to talk to you today about the problems that confront monetary policymakers and the prospects for the conduct of monetary policy in the midst of these problems. Charting an appropriate course for monetary policy depends critically on having a reliable intermediate target--a barometer or compass for measuring the pressure or direction of monetary policy. Unfortunately, the reliable policy targets of the 1960s and 1970s have become the will-o'-the-wisps of the 1980s in the United States and many other industrial countries. As a result, monetary policy prescriptions are now much more difficult to make and to monitor.

At the same time that policymakers have become less certain about the impact of policy actions, a second problem has arisen. Considerably more and diverse short-run demands are being placed on monetary policy. Because U.S. fiscal policy is being directed primarily at reducing the Federal government's budget deficit, the responsibility for achieving short-run policy objectives is being increasingly thrust on monetary policymakers. Frankly, these increased demands could not have come at a worse time.

Prior to the 1980s, there was a fairly close and reasonably reliable relationship between money growth and the growth of spending and prices. For example, for nearly 35 years before the early 1980s, real output growth in the United States and the growth of M1 velocity--the relationship between the money stock M1 and nominal GNP--were essentially equal, growing at about 3 percent per year. Thus, during this period, spending grew about 3 percent faster than M1 while the domestic inflation rate was roughly equal to the rate of M1 growth. The predictability of these

relationships meant that M1 growth could be used in setting an appropriate course for monetary policy.

Since the early 1980s, however, the relationships between money (measured by M1, M2 or M3) and both spending and inflation have become much more erratic and much less predictable. For example, while M1 grew almost 11 percent per year from 1982 to 1986, nominal GNP grew at only about a 7 1/2 percent annual rate. For a variety of reasons not yet clearly documented or understood, M1 velocity has decreased at almost a 3 1/2 percent annual rate since 1982, and at almost an 8 1/2 percent rate over the past two years.

Why are individuals in the U.S. now willing to hold larger M1 balances relative to income than they were previously? While numerous factors have contributed to this change in behavior, the dramatic decline in the costs of holding money balances since 1982 has surely played a major role. Financial innovations and deregulation since 1981 have lowered the cost of holding money directly by permitting interest to be paid on checking accounts and indirectly by increasing competition in the banking industry.

Moreover, nominal interest rates have fallen considerably in the past few years. For example, after reaching a high of over 16 percent in mid-1981, the three-month Treasury bill rate has fallen over 1,000 basis points. This decline in interest rates reflects lower actual and expected future rates of inflation, produced by a combination of monetary policy actions in the early 1980s, falling oil prices and, until early 1985, a rising dollar in foreign exchange markets.

These factors, however, do not fully explain the behavior of M1 velocity in recent years. Consequently, we still do not know if or when new, stable relationships between money and income or between money and prices will emerge or what these will be. All we can say for certain is that the breakdown in the historical relationship between M1 and economic activity has made it virtually impossible to link any specific rate of money growth with any specific rate of inflation or nominal spending growth. For the time being, at least, M1 has been rendered an unreliable intermediate target of U.S. monetary policy.

If not M1, what can be used as a reliable intermediate target of policy? One alternative might be to use the broader measures of the money stock: M2, M3, or a measure of total liquid assets such as the Federal Reserve's L. Unfortunately, although the relationship between these aggregates and nominal GNP has not deteriorated as badly as has the M1-income relationship, their relationships were much weaker to begin with. In fact, the current troubled relationship between M1 and economic activity still remains superior to those of the broader aggregates. Moreover, the bulk of the components of these broader aggregates are not reservable; consequently, the Federal Reserve exerts little influence over them. It is unlikely, therefore, that the larger aggregates can tell us much about the thrust of policy actions.

Another alternative might be to use one or more short-term interest rates. The rationale for this choice is that investment spending--the most volatile component of aggregate spending--is sensitive to changes in interest rates. Consequently, policymakers might be able to stabilize spending by smoothing or stabilizing interest rates. Unfortunately, there is no long-run relationship between spending and the level of

interest rates which can be used to gauge even the long-run effects of policy. The vague notion that lower rates may stimulate the economy and higher rates may retard it adds no precision whatsoever to the conduct of monetary policy. With interest rates as targets, we cannot reasonably tell, until it is too late, how much monetary expansion is too much or how little is too little.

A third alternative that may deserve more recognition than it has received to date is an asset over which the Federal Reserve exerts direct control--bank reserves or the monetary base. Here, the Federal Reserve might benefit from the experience of the Bank of England in targeting their monetary base, M0. Targeting a very narrow aggregate, however, is not a panacea. Breaks in the historical relationships between aggregate spending and both bank reserves and the monetary base have also occurred. Hence, it is more difficult to translate desired growth in economic activity into the appropriate path for reserve or base growth. But the same can be said for any of the alternatives. Furthermore, regardless of which intermediate target is used, the appropriate growth path for the target must be translated into a growth path for reserves or base in order to implement monetary policy. Thus, a reserve aggregate or base is perhaps our best measure of the amount of liquidity in the economy; indeed, such a narrow aggregate may emerge, as it has in Britain, as a reasonable choice for a policy guide.

Other suggested alternatives for targets have included the general price level and the prices of various commodities. Some have even suggested targeting GNP itself. These alternatives, however, present even more problems than the other targets already considered.

Monetary policymaking, however, has been victimized by more than the lack of a reliable intermediate target; it is also faced with the short-run demands generated by the current fiscal policy stance and the persistent trade deficit in the United States. These demands exemplify and intensify the conflict between short- and long-run policy objectives.

Monetary policymakers generally agree that the primary goal of policy is to maintain price stability while encouraging full employment of the nation's resources. As economic and social conditions change over time, policymakers also change their perceptions of what constitutes "price stability" or "full employment." The double-digit inflation experienced in the late 1970s has made policymakers more tolerant now of inflation in the 3-4 percent per year range than they were in the late 1960s and early 1970s. In addition, the norm for "full employment" has changed somewhat. Today, many U.S. policymakers would consider it a success to reduce the rate of unemployment to 5 percent; twenty years ago, however, a rate of unemployment as high as 5 percent would have been a source of major concern.

At times, policymakers have abandoned temporarily (or at least drastically compromised) one goal in their quest for the other. For example, reducing inflation was the chief objective in the United States in the early 1980s, even though achieving this goal brought with it a period of increased unemployment. Now that inflation in the United States is at relatively low levels, it is tempting for policymakers to focus more attention toward increasing employment.

Any monetary policymaker walks a tightrope when attempting to influence real economic activity. While changes in money growth can affect real economic variables for a time, there is considerable evidence

that this effect is strictly temporary. Changes in money growth have a lasting impact only on the rate of inflation. Of course, there is nothing wrong per se with trying to "do well" in the short run. The problem that has generally arisen in the past, however, is that policy actions focused on short-run objectives have often resulted in price instability. The history of U.S. policy actions during the early and mid-1970s demonstrates this all too clearly.

These short-run demands ebb and flow with the tide of economic and societal priorities. Growing concern about the adverse macroeconomic consequences of the rising U.S. trade deficit in late 1984 and early 1985 prompted calls for the Federal Reserve to ease monetary policy in order to drive down U.S. interest rates and generate a lower foreign exchange value of dollar. Later in 1985, concern over the trade deficit was replaced with concern over the Federal government budget deficit. The Gramm-Rudman legislation, designed to balance the government budget eventually, brought a new demand on monetary policy: to provide additional short-run stimulus to offset any contractionary impact of deficit reduction.

While fiscal deficit reduction proved to be elusive last year, new demands on monetary policy were not hard to find. The major item on the 1986 legislative agenda was tax reform. While most economists agreed that, in the long run, the proposed tax reform would benefit the economy, there was less agreement concerning its short-run impacts. Nonetheless, monetary policy was asked to provide the flexibility needed to help the economy adjust to the impacts, presumed to be contractionary, of the new tax legislation.

These short-run requests of monetary policy could hardly have come at a less appropriate time. The fine-tuning operations that are required to achieve these tasks call for a precise and predictable relationship between the intermediate target of monetary policy and economic activity. As I have noted earlier, the search for such an intermediate target continues.

Furthermore, it is not clear that these objectives can be accomplished with monetary policy or, more importantly, what the appropriate policy stance should be. Monetary policy actions premised on the expectation that Congress will adhere to the Gramm-Rudman guidelines, for example, could well be too expansionary if these guidelines are exceeded.

The appropriate policy actions to help the economy adjust to recent changes in the U.S. tax code are equally, if not more, elusive. Some believe that the lengthening of depreciation schedules and the repeal of the investment tax credit will limit investment sufficiently to depress the economy early in this year. Others contend that lower marginal tax rates for some businesses and the increased disposable income for households paint a more optimistic picture of the short-run outlook. The appropriate policy actions are highly uncertain without some consensus about the net impact of the tax changes on the economy.

In a similar vein, stimulative policy intended to weaken the dollar further could have potentially deleterious effects on the U.S. economy. A weaker dollar will raise U.S. import prices, intensifying domestic inflationary pressure. More importantly, continuing dollar weakness may reduce the attractiveness of holding dollar-denominated assets, thereby diminishing the inflow of foreign capital that has played such an integral role in financing the current economic expansion. Furthermore, monetary

expansion stimulates aggregate demand--demand for both foreign and domestically-produced goods and services. To the extent that the monetary expansion weakens the dollar exchange rate, this effect on the U.S. trade balance is offset, at least partially, by increased domestic demand for imported goods.

Thus, even with an accurate intermediate target for monetary policy, achieving these short-run objectives would be extremely difficult and surrounded by enormous uncertainty. Without an effective target, achieving these short-run objectives is nearly impossible. Moreover, there is always the risk that, by directing monetary policy at these short-run objectives, policymakers may lose sight of or, more devastatingly, lose their grasp on the long-run objective of price stability. Erring on the side of excessive monetary ease in response to short-run pressures will rekindle inflation in the long run. We may be unsure of exactly how much higher future inflation will be as a result of the 15 percent M1 growth last year. We can be sure, however, that it will be higher than if M1 had grown at, say, a 10 percent rate. With the U.S. economy awash with liquidity at present, the risk of rekindled inflation appears to be rising.

In conclusion, monetary policymaking in the United States is confronted with substantial uncertainty at the present time. The predictability of the impact of monetary policy actions has declined just as the demands for short-run cures have risen. Moreover, the short-run demands appear to be little more than disguised requests for faster money growth. Within this tense and troubled environment, I can see that the general acceptance of the notion that "money matters" may have been a mixed blessing. It is undoubtedly true that changes in the money stock

have significant impacts on aggregate demand and, hence, cannot be ignored in the formation of macroeconomic stabilization policy. It is also likely, however, that the demands on monetary policymakers to "do something" have gotten out of hand.

The current call for activism asks monetary policymakers to attempt tasks that they cannot hope to achieve even with reliable targets. Moreover, given the current state of policy imprecision, the diverse set of short-run demands now thrust upon policymakers can be fulfilled only through incredible luck, not through conscious effort or design. Unless policymakers can guarantee that their luck will continue to hold, the wisest course would be to resist the pressures and temptations to "do good" on a variety of fronts in the short run and focus, instead, on preserving long-run price stability. This is the only goal that monetary policy can accomplish consciously and by design.