Remarks by Thomas C. Melzer
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For many years, the St. Louis Fed has been closely associated with a particular view about monetary policy known as "monetarism." During the 1980's, however, two of the principal monetarist rules of thumb have broken down, primarily because of a relatively sudden and unanticipated drop in the growth of velocity--the relationship between income and the money stock.

Prior to 1982, money growth had considerable appeal as an intermediate policy guide. First of all, the Federal Reserve could control its growth; it still can do so today. Furthermore, money growth also bore a reasonably predictable long-term relationship to the behavior of income and prices. These relationships are based on the quantity theory of money, which states that income, or nominal GNP, is equal to the money stock multiplied by its velocity. Accordingly, assuming that appropriate measures for money and income exist and that the velocity of money, if not stable, at least can be explained, there can be a

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predictable relationship between monetary growth and the growth of income, or total spending. This is one of the principal monetarist rules of thumb.

Similarly, by breaking up total spending into its two components of prices and real output, and holding the growth in real output unchanged, there should be a long-term relationship between money growth and inflation, again assuming that velocity is stable. This is another principal rule of thumb.

What happened to these rules of thumb in the 1980's? With respect of the first, the ratio of total income to money has declined at an annual rate of about four percent since 1981. This extended decline in velocity is clearly unusual; it had risen fairly steadily at a rate slightly above three percent per year from 1946 through 1981. In other words, since 1981, because of a lower rate of turnover of money, it has taken a substantially larger supply to support a given level of economic activity than would have been indicated by the prior 35 years' experience.

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As to the second rule of thumb, inflation since 1981 has deviated substantially and persistently below the trend growth in money; during the prior 35 years such deviations were generally temporary and often attributable to specific nonmonetary events. Stated differently, if the experience from 1946-1981 obtained today, we should be seeing inflation of around 10 percent rather than four to five percent.

Perhaps more disconcerting from a monetarist perspective is that attempts to explain the sudden change in velocity have been inadequate. That is, no explanation alone offers a convincing and consistent story of the behavior of velocity in recent years.

Many people, both within and outside of policymaking circles, have cheered this apparent demise of monetarism. I believe that this celebration overlooks a fundamental problem, however. The lack of an acceptable alternative to some monetary aggregate as an intermediate target has made monetary policymaking increasingly more uncertain. The goals of monetary policy, namely reasonable growth in income and stability of prices, are long-term in nature; therefore, conducting policy without a reliable intermediate guide is an extremely risky

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matter. Moreover, discretionary policy actions based on an ever-changing set of short-run guides and targets, such as interest rates, exchange rates, commodity prices and the like, makes policy much more susceptible to becoming a hostage to short-run political pressures. Which short-run objective should monetary policymakers pay attention to at any point in time? What will the long-term effects of policy be? Without a reliable intermediate target or guide, policy actions are, at best, subject to considerable uncertainty and, even, doubt.

So where do we go from here? Does this experience suggest that monetarism should, for once and for all, be pronounced dead and be buried? I really don't think we can do this. Remember, what we do day-to-day as the central bank is to influence the amount of reserves in the banking system. Reserves, in turn, directly affect the money supply. Unless we can understand the linkages between reserves and money on the one hand and our long-term policy goals on the other, we are on very tenuous ground--in fact, more like quicksand--when discussions of the effects of policy arise. Moreover, political pressures will generally favor short-term growth and tend to discount the long-term

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risks of inflation at any point in time. Unless there is a reliable guide to the longer-run inflationary consequences of policy actions, there will always be a tendency to opt for expansionary policies.

In some interpretations, this happened in 1986; an expansionary was not reversed until the financial and foreign exchange markets finally forced some recognition this year of its future inflationary prospects. Whether our response was early enough and forceful enough to contain inflation in future years remains to be seen. I believe, however, that if we had had a reliable intermediate policy guide, the policy response might have been more timely and the financial and foreign exchange market responses less severe.

Accordingly, I would argue that rather than burying monetarism, we should redouble our efforts to understand what happened in the 1980's and to come up with an appropriate monetary aggregate that is reasonably related to our goals. This is not meant to suggest that discretion should be totally removed from policymaking. However, we should strive to find a reliable intermediate policy guide that constrains discretionary deviations from persisting too long. In other words,

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discretionary short-run policy actions should not affect long-term policy targets, and deviations from these targets should be offset in the long-run. Failure to do so can easily subject monetary policy to short-run political dictates that probably have little to do with the long-term economic welfare of this nation.

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