

DESPERATELY SEEKING TARGETS--THE MONETARY POLICY DILEMMA

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As some might have observed, the title of my remarks is a takeoff on the movie "Desperately Seeking Susan." Because we have relatively young children, I have the dubious distinction of having seen this movie, which features the rock star Madonna. My associates at the Bank have wondered, given this background, whether I might be proposing to you a new target for monetary policy. To go along with all our M's--M1, M2 and M3--perhaps there should be a Madonna as well. While that might make for an interesting talk, it is best that I not pursue it.

However, there is a parallel between the theme of this movie and what I think will be the ultimate resolution of a dilemma faced by monetary policymakers. The dilemma is this: we are currently operating without any reliable intermediate targets that can be used to determine the impact of monetary policy actions on the economy. The old, tried-and-true targets which worked 25 years ago, 10 years ago, even five years ago, have fallen into disrepair--they simply do not work the way they used to. As a result, for the last several years there has been a search, of sorts, for new targets--a search which, so far, has been unsuccessful. In the movie, there is a search as well, although that one has an ending--a young lady sets out to find the elusive Susan and in the end finds herself.

Now you may feel that the monetary policy dilemma is some technical, even dull, problem that is easily remedied by simply finding some new targets. However, this problem is not just technical, nor is it easy to solve. To see why all of us should be concerned with the search for targets, it might be useful first to discuss the nuts and bolts of monetary policy.

Monetary policy is simply the process through which the Federal Reserve attempts to influence the economy. Everyone agrees pretty much about its goals: maintenance of reasonable growth in the economy and stability of the price level. To do this, the Federal Reserve predominantly uses a technique called open market operations in which it buys and sells government securities on the open market. When it buys securities, it increases bank reserves, enabling banks to make more loans; these, in turn, increase the amount of money and, with it, the amount of spending in the economy. The rise in spending leads initially to an increase in output and, ultimately, to an increase in the price level. When the Federal Reserve sells securities, the opposite results occur.

Now, clearly the monetary policy trick is to provide just enough reserves to keep output growing normally in the short run, but not enough to cause prices to rise substantially over time. If it sounds like that should be easy to do, I want to disabuse you of that notion; it is not easy to maintain the "proper" reserve growth over time. Part of the problem is that a variety of economic circumstances determine what the proper policy should be. Another complicating factor is that monetary policy affects the economy with lags that are often long and variable.

For example, when the Federal Reserve supplies additional reserves to the banks, depending on circumstances, bankers may choose not to make additional loans for a time, or the public may choose to simply hold the additional money and not spend it, or businesses may choose to raise prices rather than output. To complicate matters further, Federal Reserve actions may take months, quarters, even years to fully run their course throughout the economy. Because of these uncertainties, monetary policy-makers need some guide or target that is reasonably related to their policy actions, reasonably related to their goals, and easily observable over time. Basically, they need something that responds rapidly and predictably to open market operations and, at the same time, provides a guide to future economic activity. What they need is a reliable monetary policy target.

Historically, the quantity of money (the amount of currency and checkable deposits in circulation) has been an extremely useful target. For example, whenever the quantity of money rose, prices rose eventually as well. This result occurred whether the money in use was some commodity, like sea shells or gold, or some paper product, like fiat money or checkable deposits.

When interest developed in shorter-run policy targets, in part because of increased political pressure to manage the economy on a shorter-run basis, it turned out that the growth in the quantity of money was useful for certain short-run policy actions as well. Thus, policy-makers developed certain rules of thumb between money growth (the target) and real output and price movements (the goals). In general, the rate of inflation was determined by money growth over the previous four to five

years. Moreover, sharp reductions in money growth produced recessions within two or three quarters.

These relationships were based on our experience over the entire post-World War II period, and the Federal Reserve Bank of St. Louis had a strong hand in developing and propagating these concepts. Much of the empirical research to confirm and support these relationships was produced here, and the policy prescriptions emanating from this Bank earned a "maverick" designation--maverick, I presume, because they challenged old policies, not because they were "off the wall" or incorrect.

Since 1982, however, the relationships between money growth and economic activity have slipped badly. For example, the longer-run growth in money has accelerated over the past five years, reaching an average growth rate of 10 percent in 1986. Inflation, however, has declined steadily over this period, falling to two percent last year. It is obvious that the relationship between money growth and inflation has changed.

It is also clear that we do not know why. It may have come about because interest-bearing accounts are now part of the money supply, or because interest rates have declined substantially, or because stock market gains have increased peoples' wealth, or for other reasons that would increase the public's desire to hold money balances. Unfortunately, none of these developments can fully explain, over the entire period since 1981, the apparent breakdown between money growth and spending or inflation. Moreover, we do not know whether these changes are permanent or only temporary ones. Thus, in essence, monetary policymakers are like pilots flying without a reliable compass. This is not to suggest that policy has been poorly conducted as a result; but it certainly is more difficult to carry out.

As you might imagine, there have been numerous proposals to choose a different target of monetary policy actions. Among the alternatives offered have been the price of gold, some interest rate or other, and the foreign-exchange value of the dollar. Unfortunately, there are substantial problems associated with using any of these as policy targets.

If the price of gold is to be used successfully as a target for monetary actions, then an increase in gold prices must mean an increase in economic activity and inflation; a fall in gold prices must signal the opposite. Presumably, if the price of gold is rising, monetary actions should be "tighter" and, if gold prices are falling, monetary policy actions should be "looser." In fact, this actually occurred in the days of yore when the U.S. was on a gold standard.

This clearly will not work any more. Apart from the difficulty of deciding precisely what the "normal" or non-inflationary price of gold should be, using the price of gold to determine policy actions would subject our economy to unnecessary and undesirable shocks. As an example, suppose that major gold producers (such as the Soviet Union or South Africa) reduce their gold production and, in response, gold prices rise. If we respond by tightening monetary policy, we will simply produce a recession. Indeed, every international action that could affect the price of gold would dictate changes in policy that might be detrimental to the U.S. economy.

If not gold prices, what about using interest rates to guide policy? Here again, we face major problems. First, because the interest rate is the price of credit, there is a serious question about the appropriate monetary response to changes in interest rates. In particular, there is an automatic built-in bias associated with setting interest rate

targets. Any increase in credit demand causes interest rates to rise. If monetary authorities respond to higher interest rates with "looser" policy, the general result would be increased economic activity and even further increases in the demand for credit. Sooner or later, inflation accelerates, producing even higher interest rates. This is precisely what happened in the 1970s when interest rate targeting was actually used. And, of course, a decrease in credit demands, which initially produces downward pressure on interest rates and tighter policy actions, can easily set off a recessionary cycle.

Well, what about the exchange rate as a target? Why not stabilize the price of the dollar internationally? Doing this assumes that, if the value of the dollar falls from some predetermined level, there are too many dollars in the foreign exchange market, and monetary authorities should tighten policy to reduce the supply of dollars. This process, of course, will slow down economic growth. If the value of the dollar rises, presumably opposite actions are taken, and inflationary pressures will arise. In short, targeting on the international value of the dollar will, in many cases, destabilize the domestic economy.

As a matter of fact, we are facing this very dilemma at the present time. Many people are demanding action now to prevent the dollar from depreciating further. One way to do this would be to reduce the supply of dollars to world markets. But this reduction in the U.S. money stock would have domestic effects as well--slower growth of the U.S. economy is one of them. Thus, the policy question that we must answer is: How much risk of recession are we willing to bear to stabilize the dollar's exchange rate in the short run?

Occasionally, perhaps in despair, there are proposals that we should be pragmatic, eclectic even, and use multiple targets. Now, words like "pragmatic" and "eclectic" have a nice reasonable sound to them. However, what should we do when one target indicates an economic expansion and another suggests an economic contraction? Would you be comfortable flying in an airplane with a pragmatic and eclectic pilot who uses several inconsistent and conflicting guidance systems? This is essentially what the economy faces when eclectic policy targets are used.

The pursuit of eclectic policy produces other problems as well. Chief among these are the political pressures to achieve short-term objectives at the expense of long-run economic stability. These pressures become harder to resist when policymakers themselves are confused about what their targets should be. And, of course, these pressures increase when policymakers appear to be jumping back and forth among alternative targets--which is precisely the appearance produced by eclectic targeting.

In denying the use of gold prices, interest rates or exchange rates as possible monetary targets, I am not suggesting that their behavior should be ignored by monetary policymakers. At times, their behavior, actual or expected, has appropriately constrained policy actions. However, what must be emphasized is that these variables are prices determined in various markets. Most of the factors that influence these prices are beyond the control of the central bank. Just as important, there is no stable, long-term relationship between these prices per se and long-run economic performance.

The one thing that the central bank can control, however, is the supply of money. At the present time, we do not understand why the relationship of money to economic activity has shifted. But, I suspect,

just as in "Desperately Seeking Susan," having looked for Susan in the form of gold prices, interest rates, exchange rates and the like, we will "find" ourselves. Our efforts at the St. Louis Reserve bank continue to be directed towards understanding the impact of money on the economy. We need to understand why the money/income and money/price relationships broke down in the 1980's. We also need to search for a narrow monetary aggregate that we can control and that bears a close relationship to our economic goals. Without such a target, policy becomes more vulnerable to short-run political pressures. Even worse, it is prone to excesses in either direction, imposing cycles of inflation and recession on the economy no matter how capable or well-intentioned policymakers are. And so, with good reason and much vigor, we will continue desperately seeking targets.