

"MONETARY POLICY: A CASE FOR RULES"

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**Before the
Mississippi Bankers Association
Credit Conference
Jackson, Mississippi
October 4, 1988**

The recent increase in the discount rate has produced various and conflicting reactions. On one hand, there are those who welcomed this action as a preemptive strike against prospective inflation. On the other, there are those who feel that it will produce slower economic growth. Whether one agrees with either--or both--of these views, they clearly demonstrate one thing: there is a widespread public perception that the Federal Reserve affects both our pocketbooks and our standard of living in immediate and powerful ways. Indeed, because the fiscal side of economic policy has, in recent years, focused primarily on ways to reduce the federal deficit, the Fed has come to be viewed as "the only game in town."

When I listen to discussions about the Federal Reserve--whether the subject is "what the Fed is up to" or "what the Fed should be up to"--it frequently concerns me that some fundamental policy issues are being overlooked. For example, it is widely assumed that the Federal Reserve has the ability to move the economy, almost at will; yet, few people seem to ask--and even fewer seem to be able to explain--precisely how this is done. Or, to take another example, it is widely assumed that the Fed is "free" to pursue whatever policy actions it deems necessary. However, few people can explain precisely why the Federal Reserve has this policy "freedom" and even fewer people have questioned whether such total policy freedom is actually desirable. Because I consider these questions to be among the most important policy issues that we face today, I would like to go over them with you in some detail. After doing so, I would like to discuss a proposed constraint on monetary policy actions that, in my opinion, would produce better monetary policy decisions and economic

outcomes. The first issue that we must carefully examine, however, is how the Fed actually influences the economy and how monetary policy decisions are made and implemented.

The chief power of the Federal Reserve, or for that matter, any central bank, lies in its ability to create or destroy the nation's money stock. Of course, the supervisory and regulatory roles of the central bank vis-a-vis financial institutions are also important. However, these latter roles are primarily ancillary ones that complement the fundamental role of the central bank as the creator and destroyer of money.

It is odd, but unfortunately true, that there is considerable confusion over how the Fed actually manages to create or destroy money. As generally defined, the nation's money stock consists of currency and checkable deposits. Checkable deposits are created, of course, by tens of thousands of private depository financial institutions; they add to the stock of money whenever they expand their lending. But these depository institutions can make new loans only if they have adequate reserves. And, of course, it is the Federal Reserve that increases or decreases the supply of reserves to these institutions. Thus, simply by increasing or decreasing the amount of reserves in the financial system, the Fed can regulate the amount of money in the economy. The Federal Reserve does this through its "open market operations"--the purchase or sale of government securities in the open market.

What are the consequences of the Fed's open market transactions? If they result in the creation of more money than people are willing to hold at current income levels, the immediate effect is to increase the rate of growth of spending in the economy. While this faster spending growth is reflected initially in faster real output growth, the inevitable

result is simply higher inflation. The opposite results occur whenever the Federal Reserve supplies less money than people are willing to hold at current income levels. Thus, when we assess the results of Fed actions on the economy, we must be careful to distinguish between the transitory short-run effects on output and employment and the longer-lasting, longer-run effects on inflation.

What else does the Federal Reserve affect besides spending? While it is widely believed that the Fed can control interest rates, there is very little substance to this notion in general. The Federal Reserve sets, and therefore controls directly, the discount rate--the rate at which depository institutions can borrow reserves temporarily from the central bank. The Federal Reserve also can directly influence the federal funds rate--the interest rate at which depository institutions lend and borrow reserves among themselves; it does so by changing the supply of reserves through open market operations. However, the relationship between these rates and financial market interest rates in general is typically quite different from what is generally believed. Interest rates in financial markets, like the prices in any markets, are determined by the net result of all factors that underlie and influence the supply and demand conditions. While Fed actions can influence these supply and demand conditions, they do so in ways that are generally offsetting; consequently, the actual impact of monetary policy actions on interest rates at any point in time is extremely difficult to predict.

Suppose, simply as an economic experiment, that the Federal Reserve were to lower the discount rate and use open market purchases of government securities to reduce the federal funds rate with massive injections of reserves. Would market interest rates rise or fall following this

policy action? While many people might guess that market interest rates would also decline, historically that answer is wrong. The increased spending and higher inflation expectations following this action tend to push up interest rates, including, eventually, the federal funds rate as well. Thus, the Fed's influence on the behavior of market interest rates is often precisely the reverse of that generally believed by the public.

Federal Reserve policy actions can also influence the exchange rate; again, however, with somewhat different results than might be usually expected. Because the exchange rate is simply the price of the dollar in terms of various foreign currencies, the more dollars that are created and supplied to these markets, the lower will be their value. The opposite result, of course, occurs when the money stock is reduced. While the Fed can influence the value of the dollar, the volumes of imports and exports are not necessarily influenced by such movements. For example, massive creation of dollars intended to reduce the trade deficit might lower the value of the dollar and, other things the same, make our goods cheaper in international markets. At the same time, however, our domestic spending levels and inflation rate would rise, resulting in higher imports. In the end, the higher domestic inflation eliminates the advantage created by the falling exchange rate, and the trade deficit is not reduced.

Thus, it is quite clear what a central bank can or cannot do: it can temporarily influence real economic activity and permanently influence the rate of inflation. The rate of inflation, in turn, can influence nominal interest rates and nominal exchange rates--that is, those rates we observe in markets. What the central bank cannot do is to exert any long-run influence on economic growth or real interest rates or real

exchange rates. Thus, when we consider what might be the proper goal for central banks, the most obvious one would be to supply that amount of reserves which neither adds to inflationary pressures nor slows output growth. In other words, central banks, like doctors, should "do no harm."

As you might suspect, the question that arises now is "what techniques or procedures can help central banks 'do good'?" In a growing economy, reserves are supplied on a daily basis. The full influence of these reserves on the economy, as we noted earlier, shows up only after a considerable period of time has passed--often as long as one, two or even three years. What can be used to determine whether more or less reserves should be supplied now?

In the past, a variety of alternative institutions and targets was used to help resolve this difficult policy problem. Under the gold standard and the post-World War II Bretton Woods system, the respective institutions provided constraints on the quantity of reserves that could be supplied by the Fed.

From the mid-1970s until late 1982, the Federal Reserve utilized varying forms of monetary targeting. The chief advantage to monetary targeting was that the growth of the money stock, which can be measured on a weekly basis, was a good indicator of future inflation and of short-run fluctuations in output. Thus, reserves could be supplied daily, their impact on money growth could be measured weekly, and money growth targets consistent with noninflationary economic growth could be achieved. Since 1982, however, for reasons that still remain unclear, the relationship between money growth and inflation or economic activity has become considerably less reliable; as a result, the Federal Reserve has placed less emphasis on monetary targeting.

A variety of alternative targets has been suggested over the past few years to replace the monetary targeting procedure that was formerly used. These alternatives are primarily targets that focus on specific prices: for example, interest rates, exchange rates or commodity prices. These measures are presumed to be useful chiefly because they are available daily and are influenced, at least temporarily, by Federal Reserve actions. Unfortunately, both past experience and the analysis we have just discussed tell us that targeting on price variables, even only for the short run, can, and often will, prevent us from achieving our long-run economic goals.

Consider, for example, the problems associated with using the behavior of interest rates to guide policy actions. Because interest rates can rise for a variety of reasons, the appropriate policy response depends fundamentally on why they rose. If interest rates are rising because the public expects higher inflation, the appropriate policy action might be to "tighten" monetary policy to choke off the impending inflationary conditions. On the other hand, if interest rates are rising because the public's demand for money has increased for reasons unrelated to expected inflation, the appropriate action might be to "loosen" policy in order to provide the larger desired money stock.

It is very easy to see the movement in interest rates; it is very difficult, however, to determine why they are moving or how much they should move. As a result, policymakers will inevitably make mistakes both in the direction that policy should move, as well as in the magnitude of the policy response called for; past episodes of interest rate targeting provide ample evidence of these unfortunate policy errors.

If the view I have just described is correct, however, why do central banks often try to stabilize interest rates, at least in the short run? The obvious answer is that there are always political and social pressures for stable or, better yet, lower interest rates--and these pressures are directed squarely at the central bank. In many countries, the central bank has succumbed to such pressures; in every case, the result has been excessive inflation and economic instability.

We have been much more fortunate in this country. The law establishing the Federal Reserve provided for a central bank independent of the political process. Of course, laws can be changed; in fact, there have been a number of proposed bills that, if passed, would have substantially reduced the Fed's independence. Perhaps more importantly, however, the Federal Reserve has been able to maintain its de facto independence in the past by occasionally citing the constraints imposed by the Bretton Woods agreement or by its monetary targeting procedure. Unfortunately, at the present time, there are no constraints in place that can serve to deflect the political and social pressures that the Fed faces; pressures which, for the most part, tend to focus on short-term results at the expense of longer-term price stability and economic growth.

So far, and I stress the term "so far," the Federal Reserve has had considerable freedom to determine and pursue its own monetary policy decisions. However, the very absence of some rule or constraint could actually jeopardize its continued independence. Furthermore, without some procedure that links its day-to-day actions affecting total reserves with its long run economic goals, the Fed can stumble unwittingly into making policy errors.

I believe that what is needed at this time is a reasonable monetary policy constraint--one that would rein in the potential sharp, stop-and-go policy reversals that have typified monetary policy actions in the past whenever short-run considerations won out over longer-run goals. The trick is to find a viable compromise between some rigid monetary policy rule, on the one hand, and the kind of complete policy discretion, on the other, that inevitably invites political pressures and endangers long-run policy independence.

Does such a potential "soft" constraint on monetary policy exist? I believe that it does. I would like to see the Federal Reserve adopt limits on the quarterly growth of the monetary base. Under current circumstances, if quarterly growth of the base were required to be no less than 5 nor more than 9 percent, at annual rates, we could retain day-to-day policy discretion and still achieve our long-run policy goals.

Why choose a monetary base constraint? There are really two good reasons for doing so. First, the monetary base consists of reserves of depository institutions and currency in the hands of the public. Because these are liabilities of the central bank, the base can be controlled with relative precision. Second, because changes in the base produce changes in loans and the money stock, achieving our long-term goals of stable inflation and stable output growth is closely related to how monetary base grows.

What are the advantages of such a policy constraint? First, and perhaps foremost, it assures that policy errors cannot persist over time; it would reduce the likelihood of substantial accelerations in inflation and sharp slowdowns in short-run economic growth, outcomes that we know are unacceptable. It would also limit the fluctuations in longer-term

interest rates and exchange rates by reducing uncertainty about future policy actions. At the same time, the adoption of fairly wide growth bands retains the day-to-day flexibility and discretion necessary to respond to financial market pressures; it even allows for day-to-day policy smoothing of interest rates and exchange rates if this were deemed desirable. Finally, because it would result in a constraint that could be violated only with public justification, it would limit the political pressures that can be exerted on the central bank--and thus, enhance its independence.

What are the disadvantages of a monetary base growth constraint? The four percentage point growth range I have suggested is wide enough to still permit substantial variation in inflation rates and interest rates. However, until the prior relationship between money growth and economic activity re-emerges, this is a possibility that is unavoidable. Moreover, whenever the constraints become binding, we may observe some larger fluctuations in short-term interest rates for a while. Fortunately, these short-term rates are not the ones that affect economic activity in the long run.

The most important features of such a constraint, however, are that it establishes a rule which constrains total discretion, produces some accountability, and tends to reduce economic volatility. If we want to maintain free markets and freedom of economic choice, we must achieve price stability over the long run. This requires that we have an independent central bank. To retain that independence, however, we cannot exercise total discretion; we must be accountable for our actions. The constraint that I propose will accomplish these ends.