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MONETARY POLICY--THEORY AND PRACTICE

Remarks by
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As a policymaker, I am often asked if policy is too tight or too easy. Recently, M2 has been falling, and is now well below the lower bound of the Federal Open Market Committee's--or FOMC's--2 to 6 percent annual target range. Moreover, M2 grew at only a 2 percent rate during 1992, below our target range of 2.5 to 6.5 percent. Does this indicate that policy is tight?

Maybe not. Although no longer an official target, M1 grew at a 6.6 percent annual rate in the first quarter of 1993, about in line with its five-year trend growth. During the preceding two years, it grew at a double-digit annual rate. Does M1 growth indicate that monetary policy is easy?

The unusual disparity in the behavior of these monetary aggregates is one of the challenges I face in moving from theory to practice. This evening I would like to describe to you the factors I consider when approaching the monetary policymaking process. Then I will comment on the M2 versus M1 debate and conclude with some thoughts on the effectiveness of the FOMC process.

The first factor I consider is the goals of economic policy, which are to maintain high employment and sustainable economic growth and to ensure the stability in the purchasing power of the dollar. Although it was once thought that there was a tradeoff between policies pursuing growth and those

aimed at price stability, we now know that maximum sustainable growth is achieved when price level uncertainty ceases to be a factor in economic decision making. In other words, inflation doesn't stimulate growth.

The United States' experience over the last 25 years supports this position. The acceleration of monetary growth, nominal spending growth and inflation in the 1970s didn't buy added real growth. It fell. Nor did the deceleration of monetary growth, nominal spending growth and inflation slow real growth in the 1980s. It rose relative to the 1970s.

We also see evidence of this internationally. Among developed countries, Germany and Japan have been world leaders in both real growth and price stability over much of the postwar period. Among developing nations, the newly industrializing Asian economies have led the world in growth rates. They too have had low inflation rates.

As these examples illustrate, there is no tradeoff between growth and price stability. Rather, the potential of any economy to grow is determined by real factors such as growth of its labor force, capital investment and increases in productivity. Price level stability is a prerequisite to realizing an economy's potential. It allows decisions to be

based on real price signals and not on inflation-distorted illusions.

The second factor I try to keep in mind when contemplating monetary policy decisions is that in the long run, monetary policy principally affects the general level of prices. Accordingly, policy's most important contribution to maintaining high employment and sustainable economic growth lies in providing a stable price backdrop. Despite evidence to the contrary, there are still some individuals who see 'easier' monetary policy and the risk of higher inflation as an avenue to higher real growth.

Does this suggest, then, that countercyclical monetary policy is inappropriate? Not necessarily. The third factor I consider is that monetary policy actions occur in a dynamic economic environment with many non-policy-related factors influencing economic performance. When recessions occur, monetary policy actions should lay the foundation for recovery by boosting sagging monetary growth. In expansions, the opposite applies. In either case, monetary policy can act as a counterweight to potential swings in monetary growth.

However, these actions should not be pursued to excess. Monetary policy effects are felt only after a considerable lag. What appears to be the appropriate policy today can

prove to be destabilizing in the future. Short-term effects on real growth might not be felt for a year or longer, and the effects may vary depending on the economy's inflationary expectations. Monetary policy effects on inflation are even more drawn out--not being realized on average for about two years, perhaps even longer.

Regardless of monetary policy's potential for stabilizing output growth in the short run, there is considerable risk of overreacting to current economic measures. Preliminary data are often subject to major revisions, and even the best forecasts are uncertain. Thus, short-term fine tuning, whether based on current data or forecasts, in retrospect, can turn out to be destabilizing.

A fourth and final factor I try to keep in mind when determining policy is the need for an indicator that gauges the thrust of monetary policy actions and can determine whether monetary excesses are building up. This indicator must be tied to monetary policy actions--open market operations, changes in reserve requirements and the terms for extending discount window credit. Bank reserves and the adjusted monetary base are empirically closely linked with M1, the narrow monetary aggregate that corresponds most closely with spending. Although no longer an official target of the

FOMC, the trend growth in M1 still provides useful information to monetary policymakers.

Throughout the 1950s, '60s and '70s, M1 growth was a reliable indicator of the thrust of monetary policy actions. The tendency for nominal spending to grow more rapidly than M1 resulted from the upward ratcheting of inflation, inflationary expectations and nominal interest rates during those decades. That steady upward trend in M1 velocity ended in the 1980s. With lower expected inflation and nominal interest rates, M1 velocity has actually been trending down in the 1980s and early '90s. Thus, we no longer target M1.

Today, the FOMC sets target ranges for M2, an aggregate whose long-run growth rate about equals that of nominal spending. Because real economic growth is largely independent of nominal spending in the long run, accelerations or decelerations in M2 growth have roughly matched accelerations or decelerations in inflation over extended periods. Historical evidence confirms this proposition.

Nonetheless, M2 has limitations as a monetary target. Because only one-fourth of M2 consists of deposits that are subject to reserve requirements, it is difficult for the Fed to control. This problem has been demonstrated over the last two years as M2 growth has slowed despite extraordinary

efforts to stimulate it, including seven cuts in the discount rate and aggressive Fed open market securities purchases that pushed bank reserve and M1 growth to double-digit rates.

With M2 growth continuing to slow and nominal GDP growth rates rising rapidly, one might have questions about the use of M2 that go beyond whether it can be controlled. The long-run stability of M2 velocity may have changed. M2 velocity is currently near its all-time high and has been increasing rapidly for more than a year. Moreover, this rapid rise in M2 velocity has been accompanied by significant decreases in interest rates--a factor that often had increased demand for M2 balances and slowed growth in M2 velocity. Consequently, many economists are concerned that the relationship between M2 and nominal spending growth may have shifted, just as M1 velocity apparently did in the early 1980s.

There are a number of factors that might account for slow M2 growth even as nominal spending growth continues. Some should have only a temporary effect on M2 velocity. Sluggish credit demand, for example, has caused depository institutions not to bid as aggressively for funds. In addition, households have shifted away from low-yielding M2-type deposits to higher interest-paying capital market assets.

Other factors may permanently reduce the demand for M2 balances and raise the level of M2 velocity. They include the increased cost of funds for banks resulting from higher deposit insurance fees and the increased regulatory burden. In any event, it may be some time before we regain confidence in what any particular rate of M2 growth implies for future nominal spending.

So where does this leave us? M2 has lost its luster as an indicator and is not readily controllable by the Federal Reserve. Therefore, there probably is no single indicator that can gauge the thrust of monetary policy actions and their ultimate effect on spending growth and inflation. You might say, I remain the proverbial "doubting Thomas" with respect to any single, simplistic measure of monetary policy. This brings me back to M1 and why I continue to follow its behavior. It indeed reflects monetary policy actions and, when viewed over a long time period, provides some indication of the impact of policy on the economy.

Experiences in the 1980s and early '90s provide a good example. The sharp rise in real growth that began during the second quarter of 1983 was preceded by a rapid increase in M1 growth during the summer of 1982. The decline of inflation that began in the early 1980s was reversed in 1987, following

a rise in M1 growth two years earlier. The 1990-91 recession followed on the heels of a year of negative M1 growth. The current downward trend in inflation began in 1990 following three years of substantial decreases in M1 growth. Finally, data for the first four months of 1993 suggest that this decline has been interrupted, at least temporarily, following double-digit M1 growth over the last two years. Accordingly, though I would not advocate targeting M1, I certainly would not ignore its behavior over time.

To conclude, I would like to explain how the monetary policymaking process, itself, creates an environment conducive to sound decision making despite uncertainties about the behavior of monetary aggregates. The nation benefits greatly from the Federal Reserve's collective policymaking process, which allows differences in both geographic and policy perspectives to be reflected.

As you know, the FOMC is comprised of the seven members of the Board of Governors and five of the 12 regional Reserve Bank presidents. Although not all 12 Reserve Bank presidents vote on policy at one time, we attend and actively participate in FOMC meetings. Because the Board and each Reserve Bank have independent economic research staffs, a broad spectrum of views is represented. The Reserve Bank presidents also bring

to the meetings specific information on what is actually happening in their districts. Accordingly, the decisions that emerge from FOMC meetings are the result of thorough analysis and thoughtful deliberations.

In the end, policy must be judged by the results it produces. Monetary policy has been reasonably successful over the last decade--a long period of moderate growth during which inflation was significantly reduced. This achievement came during a time of unusually large federal budget deficits and complicated international and financial market developments. Though set back by the recession and the unexpectedly slow recovery, a foundation has been laid for a sustainable, low-inflationary expansion in the 1990s. No one can know what the future holds, but if we can hold the line on inflation, the real economy will be on firm footing for genuine progress in the years ahead.