"MONETARY POLICY - A REVIEW OF THE OPTIONS"

Address by
Theodore H. Roberts
President
Federal Reserve Bank of St. Louis

Before the
20th Annual Economic Outlook Conference
of the
Chicago Chapter of the American Statistical Association
and the
Chicago Association of Commerce and Industry
Palmer House
Chicago, Illinois
June 8, 1983

Today I would like to discuss some fundamental issues in monetary policy--issues that are not new but are as relevant today as they have been for decades past. I think it is no longer debatable that an economic recovery is under way and the three-year span of economic stagnation and recession has come to an end.

Yet, public perceptions about the economic order are not sanguine:

projections of an awesome federal deficit overhang financial markets,

the recovery is viewed as fragile with unemployment still much too high,

some perceive real interest rates to be exceptionally high,

and the persistent strong exchange value of the dollar and problems with loans to lesser developed countries threaten international markets.

A great many people are calling upon policymakers--in particular, monetary policymakers--to alleviate these problems. At the same time, people are puzzled because they find it difficult to determine precisely what monetary policy is doing or what it is capable of doing.

I would like to talk to you about the options facing monetary policymakers and their potential for reducing the economic risks facing this Nation. As you know, I am a novice at central banking. I realize that you may wonder how much insight into policymaking I may have gleaned in only four months as the President of the Federal Reserve Bank of St. Louis. Let me reassure you that in my prior incarnation as a commercial banker for nearly 30 years I learned (sometimes in financially excruciating detail) just how much influence monetary policy decisions have on financial markets; in today's world, professional bankers must be reasonably good amateur macroeconomists to survive.

Also, being a newcomer to monetary policy has its advantages. In particular, I can avoid the natural reluctance of policymakers to criticize their own past actions. Since I have no vested interest in past policy alternatives, I hope that I can view them objectively. Finally, from your perspective, there is an additional benefit from listening to a newcomer to monetary policymaking. Someone once noted that the art of central banking consisted, in part, of taking something perfectly understandable and making it hopelessly confusing. I really don't feel that I have acquired that skill in only four months; thus, I hope that what is understandable to me will also be understandable to you.

In order to assess the likely success of the policy options potentially open to the Federal Reserve, we must first clearly understand just what it is that the Federal Reserve <u>can</u> do. Regardless of what policies it may pursue and irrespective of what goals it may wish to attain, the Fed can immediately and directly do just three things. First, it can change reserve requirements. Second, it can change the discount rate. Finally, the Fed can buy and sell securities and foreign currency, thus increasing or decreasing the amount of reserves in the financial system and affecting the supply of money and credit.

It is also important to remember what the Fed cannot do--at least directly or immediately. The Federal Reserve cannot directly control the total supply of credit. There are a host of actual and potential suppliers of credit in financial markets who make decisions independent of Federal Reserve actions. Further, despite common folklore and financial market mythology to the contrary, the Federal Reserve cannot arbitrarily and unilaterally control interest rates. To be sure, its reserve supplying actions influence interest rates via their impact on financial institutions. However, the Fed's direct effect is small and temporary.

Most of the current debate on Federal Reserve policy is not concerned with what the ultimate goals of monetary policy should be. In my opinion, we all agree that policy should seek to achieve sustainable economic expansion and relatively stable prices. The only real question is how to do this. Or, rather, what targets of monetary policy will best indicate the actions necessary to achieve these goals?

The candidates most often mentioned as potential targets for monetary policy are interest rates, commodity prices (usually the price of gold is stressed), foreign exchange rates, credit growth, and the growth of certain monetary aggregates, notably M1 and M2. These are the potential options available for guiding monetary policy to achieve the desired goals.

I shall discuss each of these in turn, but for the sake of brevity let me dispense quickly with the three that are least attainable: control of commodity prices, control of foreign exchange rates, and control of credit growth. I will then concentrate on interest rates and the monetary aggregates.

What about proposals to target on and stabilize some measure of commodity prices? Why not return, in effect, to the "good old days" of the gold standard? The argument in favor of stabilizing the price of gold is well known. The price of gold is presumably quite sensitive to any excess supply or demand for money. The stabilization of the price of gold, it is said, would lead to the "proper" money growth; the money stock would always equal precisely what the public wished to hold and would not induce fluctuations in output or the rate of inflation.

Unfortunately, there are innumerable events that could raise the world price of gold: political crises overseas, industrial innovations, and changes in inflationary expectations anywhere in the world. The Fed's response under gold price targeting would be to contract the money stock; the result would be a decline in economic activity, even though there would have been no inflationary pressures in the U.S. Of course, over the very long term, we might find that prices would be stable. But I doubt that we, or any other country, would subject our economies to systematic and frequent fluctuations in output, employment and prices in the shorter run to achieve price stability over a century.

A similar option is to stabilize exchange rates. If such stabilization implies that all countries will permanently fix their rates of inflation at some pre-agreed level, it could work. But I doubt that such an agreement is politically enforceable. If, on the other hand, stabilization of exchange rates means that the U.S. will conduct its monetary policy in a manner which will simply keep the value of the dollar constant against other currencies, then we are, once again, subjecting our economy to every economic policy decision abroad. I doubt, again, that such policy would be palatable to our society.

The third potential option for monetary policy targeting is some measure of total credit. Those who advocate focusing monetary policy actions on the basis of credit growth targets do so primarily because there is a fairly close relationship between the growth of credit and the growth of GNP. Perhaps the biggest problem with using credit growth targets for monetary policy is that the Federal Reserve, in the absence of statutory credit controls, cannot exert close control over total credit growth. As a result, attempting to determine the proper policy response to differences between credit growth and some established target is subject to considerable error. Targets that can not be controlled closely are simply not useful for policy purposes.

The fourth option is interest rate targeting. Intuitively, interest rate targeting and interest rate stabilization appear both reasonable and achievable actions for the Federal Reserve to pursue. If interest rates were solely determined by the interaction of the supply and demand for money, interest rate stabilization would be the perfect target for monetary actions. Any increase in the demand for money would be immediately manifested as an increase in interest rates. The Fed would prevent interest rates from rising by supplying the additional money that the public desires, thus avoiding an economic contraction. Conversely, should a decrease in demand for money cause interest rates to fall, the Fed would simply contract the money stock and prevent an increase in the price level.

Unfortunately, there are three strikes against interest rate stabilization: a theoretical one, an empirical one, and a political one. First, interest rates are not determined by the supply and demand for money alone; they are primarily determined by the supply and demand for credit. Thus, when credit demands increase, interest rate stabilization leads to monetary actions that increase both credit and money even though the demand for money is unchanged. The net result is that changes in credit demands will produce procyclical movements in money growth, exacerbating the swings in output, prices and interest rates. That is strike one.

Empirically, we have tried interest rate stabilization, in one form or another, from the late 1960s to the end of the 1970s; its legacy was accelerating inflation. Within these 15 years, inflation rose from near zero to double digits. That's strike two.

Finally, there are the political ramifications of interest rate targeting. If the monetary authority is explicitly targeting on interest rates, political pressures will invariably arise to pressure the monetary authority to <u>reduce</u> rates, regardless of the longer-run consequences of such actions. Recent Congressional bills that seek to add interest rate targets to monetary deliberations are a good example of this kind of pressure. Interest rate targets inevitably invite increased political interference and preoccupation with short-run considerations at the expense of long-run goals. And that, in my opinion, is the third strike against interest rate targeting.

The fifth option is targeting on money growth. This procedure presumes that the demand for money is relatively stable; not in the sense of being unchanged, but in the sense that it is predictable. If this were not the case, then significant and unexpected increases in the desire to hold larger money balances would result in recessions, and unforseeable decreases in money demand would produce inflation.

Those who advocate monetary growth targeting assert that money demand <u>is</u> relatively stable because of two pieces of evidence. First, over extended time periods, there is a close relationship between money growth and inflation. To cite just one example of the long-run similarities: from 1954 to 1966, the average annual rate of growth in M1, the narrow money stock, was 2.5 percent and the average annual inflation rate was 2.2 percent. Since 1966, money growth has averaged 6.4 percent per year and inflation has averaged 6.5 percent per year. Current studies support the assertion that sustained changes in money growth will produce similar changes in prices after a lag of about three years or so. This evidence suggests that current monetary growth targets are not particularly helpful for influencing current prices; they do, however, give you a good idea of the direction and magnitude of price movements some time into the future--provided that actual money growth is in line with the targets.

The second piece of evidence that is frequently cited is that in the shorter span of time, such as two quarters, substantial contractions and expansions of money growth produce changes in output in the same direction. Thus, whether we are concerned with the long-run impact on the rate of inflation, or the short-run impact on economic activity, monetary growth has been a historically good predictor of GNP growth. This supports the contention that the demand for money is relatively stable.

Another piece of evidence supporting monetary aggregate targeting is that there is a fairly close relationship, over periods of six months or longer, between changes in reserves or the monetary base and changes in M1. Thus, as opposed to what we observe with respect to credit growth, M1 growth can be controlled by the Federal Reserve.

This option, however, has developed a rather bad reputation over the past several years. It is asserted, argued and advertised that from October 1979 until approximately July 1982, it was precisely this option that was implemented by the Federal Reserve System. The results were abominable: we have had two recessions in three years, interest rates skyrocketed in 1980 and 1981, before declining in 1982, high inflation persisted through 1981 before plunging in 1982, and total output of goods and services for this whole period did not grow at all. Hardly a picture of stability or economic growth.

Ironically, upon closer examination, this period provides additional support for monetary aggregate targeting. During this period, money growth was neither stable nor generally within its target ranges. Consider the actual pattern of monetary growth from the fourth quarter of 1979 to the present: 1.5 percent for the first two quarters, 13.3 percent for the next, 7.1 percent during the next, 3.2 percent in the second half of 1981, 11 percent in the first quarter of 1982 and 4.7 percent in the subsequent two quarters. In line with the evidence that I have cited earlier, given these fluctuations in money growth, I would have expected the instability that has occurred.

What conclusion can be drawn from the five principal alternatives currently being suggested for monetary policy deliberations? First, none of them will produce a perfect world. Regardless of which is chosen, we will still incur short-run fluctuations in output, employment, prices, and interest rates--and certainly some of these fluctuations, like those associated with the 1973 and 1979 OPEC oil shocks, will be unpleasant. No monetary policy and no unique system of targeting can eliminate all shocks to the economy.

But it seems to me that the choice of an option must be made on the basis of which one minimizes the systematic shocks to the economy. Control of some commodity price or exchange rate will necessarily produce short-run fluctuations in output and price level. Targeting on a credit aggregate, to the best of our knowledge, is an almost impossible task: we have no reasonable levers to pull. Stabilization of interest rates, given growing credit demands and political proclivity for always lower interest rates, will be procyclical and will systematically raise the rate of inflation. I must, therefore, choose monetary aggregate targeting as the best of available choices. It has no attributes of systematic fluctuation, it is controllable with reasonable accuracy, and it seems to be well related to our goal--stable growth of GNP.

In case you may think that this discussion is some theoretical or dogmatic exercise, let me assure you that this choice of targeting options is real and current. At this time there are several proposals in Congress, and I am certain that many others will crop up again and again, which specify targets to be used in monetary policy. While I do not believe that legislated targets are at all desirable, a wrong prescription can subject all of us to an economic future that may not be acceptable to any of us.

We are now certain that a recovery is underway. There has been a decline in the rate of inflation. There has been a substantial decline in interest rates, and unemployment is beginning to edge down. But what we do now will determine whether these gains can be sustained or whether we will embark on the same roller coaster that has characterized our economic performance of the past 20 years. I am not naive enough to believe that choosing a monetary aggregate target will solve all our ills. But if one looks at history, if one looks at empirical evidence, all other alternatives have failed. Given persistent and growing political pressure to satisfy various sectors of our economy, given the uncertainties that these pressures produce, we must have some rules that govern our economic policies.

We cannot rely anymore on "playing it by ear"--there are too many players that call the tune. And if there is one rule that I would like to see tried, it is the rule that allows for a stable growth of our nation's money stock--a rule that in my opinion has not been tried and, despite opinions to the contrary, a rule whose time has come.