



MONETARY POLICY...A BETTER WAY

Address by
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I am very pleased to have this opportunity to address your distinguished group. The New York Society of Security Analysts has a well-deserved reputation as a national forum for timely economic discussion, and it is a distinct privilege to appear before you.

I realize that the Federal Reserve Bank of St. Louis is eyed with suspicion in certain quarters because it has long been considered a breeding ground for that controversial school of professional economic thought known as "monetarism." I am also aware that a distinguished newspaper, in a recent article, referred to me as a gadfly and a maverick within the hallowed halls of monetary policymaking.

Well, I think a few disclaimers and clarifications are in order. First, I am not a professional economist, and when I came to work for the Fed three years ago I hardly knew the difference between a monetarist and Keynesian. And I am neither a professional dissenter nor one who relishes swimming against the current simply for the sake of the added exercise.

More accurately, I am a concerned citizen who believes that accelerating and continuing inflation poses a serious threat to the economic, social and political well-being of our Nation. And, as a participant in our Nation's monetary policymaking activities, I am convinced that responsible monetary policy can play a crucial role in reducing inflation and restoring stability to our economy.

In a world beset by shortages of one kind or another, there is no shortage of theories about the causes and cures of inflation. Seldom a day passes without anguished expressions of concern about inflation and endless prescriptions for remedial action. We are rapidly reaching the point, however, where conversation and theories are no longer going to be enough. While past U. S. economic history is replete with periods of inflation that lasted one or two years and then subsided, we have never experienced a persistent, accelerating inflation with the scope and perseverance of that which we are currently encountering.

The wise men of economics and the Washington pundits blame our present inflation

on all kinds of perceived villains. Some point to rising food prices, failing to note that in recent years we have had periods of rising food prices as well as periods of falling food prices. . . and inflation has persisted through both. Some say rising oil prices are the cause of inflation, yet inflation had its roots in the late sixties and early seventies when oil prices were stable. Some attribute inflation to the declining value of the dollar in foreign exchange markets, a questionable theory in view of the fact that inflation began to accelerate at a time when the value of the dollar was static, and has steadily increased under free-exchange market conditions when the value of the dollar has both risen and fallen. It is time we stopped fooling ourselves by blaming inflation on spurious scapegoats which merely divert the public's attention from the truth.

There is only one underlying cause for our current inflation, and that is the excessive growth rate of our money supply which has out-distanced our production of goods and services, and has thus bid up the cost of everything. Since 1960, money supply, broadly defined, has skyrocketed 130% while real GNP has risen less than 80%.

It wasn't always so. From 1958 until the mid-60s, when we began printing millions of extra dollars to finance both butter and guns, our money supply rose at an average 2.7% annually, while inflation registered an inconsequential 1.7%. We're not alone in that experience. Most Western industrial nations experienced moderate money growth during the 1960s and correspondingly moderate inflation until they accelerated their money supply growth. In Belgium, for example, a 3.8% late-1960s inflation rate paralleled a 3.5% increase in the nation's money supply, while the early 1970s saw both measures growing at a 10.7% clip. The United Kingdom, which quadrupled its money supply growth rate from the late 1960s to early 1970s, saw inflation jump from 4.3% to 14.9% during the same period. In France, the 4.6% inflation rate and 5.3% monetary growth rate of the sixties grew into 11.6% inflation and 12.1% expansion in the money supply during the first half of this decade. Likewise, Germany, the Netherlands, Switzerland, Canada . . . the evidence is undeniable.

Why, then, despite overwhelming evidence here and abroad that money growth

causes inflation, do we continue to tolerate money growth in excess of the rate of growth of goods and services? Is it because of some malicious intent on the part of monetary policymakers? Is it because political pressure groups consciously favor inflationary monetary policies? Is it because money growth has a life of its own and cannot be controlled?

My response to all of these questions is an unequivocal "no." In my opinion, the cause lies in the process by which monetary policy has been conducted in recent years. Our present inflation, as well as most past periods of deflation, is the direct result of having concentrated on fine-tuning interest rates instead of controlling the growth of the money supply. It is a procedural problem and as such is capable of being easily and expeditiously corrected.

Let's examine the process by which monetary policy is conducted.

I am sure you are aware that since the development of the Federal funds market, the commercial banking system in general does not maintain any substantial excess reserves. It follows, then, that any substantive increases in deposits . . . and thus in money stock. . . can occur only if the Federal Reserve supplies additional reserves, either through its open market operations or through a reduction in reserve requirements. Since reserve requirement changes are infrequently used to affect reserve availability, open market operations remain the primary tool of money management.

As you know, the Federal Open Market Committee meets monthly and gives the trading desk at the New York Fed two primary targets to achieve. These are a Federal funds interest rate range and a growth range for the monetary aggregates (known as M-1 and M-2). If market forces threaten to move the Federal funds rate above the upper limit of its range, the desk, in order to curb the rise in the Fed funds rate, buys securities, thereby supplying additional reserves to the banking system. Conversely, if the monetary aggregates reach the upper limits of their ranges, the desk withdraws reserves by selling securities, thereby limiting money expansion and causing an upward pressure on the Federal funds rate. But what should be done when both the Federal funds rate and the

monetary aggregate simultaneously reach the upper limits of their prescribed ranges? Should the Open Market Desk let the Federal funds rate exceed the limits established by policy in order to keep money stock growth within established limits? Or should it let money overshoot its target range in order to meet the prescribed Federal funds target? A real dilemma occurs when the interest rate targets and monetary aggregate ranges are incompatible. Let's see what has happened in the past when this situation has occurred.

A review of the published history of interest rate and monetary aggregate behavior in the period since long-term monetary aggregate growth ranges were first announced is enlightening:

In the 46 periods in which short-term policy ranges have been set, the Federal funds interest rate fell outside of its target ranges only five times; in the same periods, M-1 growth fell outside of its ranges 22 times, or nearly 50% of the time.

M-1 tended to exceed its targets during periods of rising Federal funds rates and to fall short of its targets during periods of falling Federal funds rates, while usually remaining within its targets during periods of stable Federal funds rates. For example, during the two-year period ending in mid-1974, when loan demand grew at an annual rate of 19.1%, the Federal funds rate increased from 4.5 to 11.9% and bank reserves were supplied at an 8% rate. But in the next year and a half, when loan demand flattened and the Federal funds rate dropped from 12.9 to 5.2%, reserves were supplied at only a 4.7% annual rate.

Two conclusions can be drawn from these observations. First, it is evident that in periods of incompatibility, the Federal funds rate reigns as the primary target in the conduct of monetary policy while adherence to monetary aggregate ranges is secondary. Secondly, the principal thrust of monetary policy has been to stabilize the Federal funds rate and to resist both upward and downward market pressures, even if by doing so the aggregates fell outside of their ranges. Monetary policy, either by design or by default, has been fashioned to stabilize interest rates, even if it has meant destabilizing money growth.

While my remarks have emphasized the inflationary impact of interest rate stabilization, it is crucial that we recognize that such policy can have the opposite effect. A decrease in credit demand normally would lead to a decrease in the Federal funds rate. If this rate is prevented from declining with market forces, there is a resultant contraction of bank reserves and consequently a contraction of money stock with attendant negative impact on the economy.

Why is there such a preoccupation with the stabilization of interest rates? There are essentially four points of view which support primary targeting on interest rates.

First, there are those who believe that interest rates represent the price of money, rather than the price of credit. They interpret changes in interest rates to reflect changes in people's demand to hold dollars. They rationalize that when money demand increases, people tend to hold . . . rather than to invest or spend . . . their dollars. This is the "cookie jar" theory . . . that people will sock away dollars in their cookie jars rather than spend them. Thus, they reason, when interest rates rise, it is necessary to supply additional money in order to maintain current levels of spending while at the same time satisfying people's desires to fill the "cookie jar."

I disagree with this point of view. I believe that interest rate changes mainly reflect variations in the desire of people to borrow in order to spend. When people are in a mood to spend, they seek additional credit, and this credit demand translates into higher interest rates. Under inflationary conditions, it is patently obvious that credit demand for spending dominates any desire to save for a rainy day. The "buy-it-now-because-it-will-only-cost-more-tomorrow" syndrome has become an accepted part of our culture, a by-product of inflationary anticipation. As Leonard Silk noted recently in the New York Times, it is as though people's perception has changed from mild insecurity over rising prices to a sharp fear that money is losing its value . . . if not as precipitously as in Germany half a century ago, then at least over the long run. Monetary policy designed to stabilize interest rates in the face of such heavy credit demand leads inevitably to expansion of the money supply and increased inflationary pressures.

Another argument for primary emphasis on stabilizing interest rates is that a rise in interest rates serves to discourage borrowing, thus precipitating recessions by reducing consumption and investment. After all, critics note, the stock market regularly reacts nervously when investors sense that higher interest rates are in the wind, because they interpret such signals as foretelling an eventual recession. Practitioners of this school of thought believe that any increase in interest rates should be resisted in order to avoid recession and increased unemployment.

This argument again ignores the true causes of increases in interest rates. If interest rates rise because the Central Bank, through its open market operations, withdraws money and thus limits credit, yes, borrowing will decline, and economic contraction may take place. But if interest rates go up because people want to borrow more, total borrowing and spending will continue to rise, regardless of higher interest rates.

A third argument for stabilizing interest rates centers around the contention that targeting on monetary aggregates instead of the Fed funds rate would lead to intolerable fluctuations in interest rates and produce "disorderly conditions" in financial markets.

It is reasonable to assume that fluctuations in the funds rate would probably increase if monetary policy were to cease its concentration on interest rate stabilization. However, there is no historical evidence to suggest that such fluctuations would be disruptive, damaging, or excessive. Indeed, there is every reason to believe that a free-market approach to interest rates would encourage more careful money management. Now, I do not doubt that there are bond traders who take some comfort in knowing that interest rates will not exceed the boundaries of the stated target range. I'm sure, however, that, after a short period of adjustment, these experts would conform to the new environment. I can see no reason why financial markets are not as well equipped to anticipate interest rate changes resulting from free-market forces as they are to guess the intentions of the Federal Open Market Committee in its monthly deliberations. Adjustments to increased risk occur as a matter of course in other financial markets, without major disruptions in these markets. There are many markets which are not tightly

controlled and which are not suffering for this status, and there are others where former controls have been relaxed or eliminated altogether without leading to panic or chaos. When a flexible international exchange rate superceded a fixed rate in 1973, pandemonium did not ensue; when farm supports were reduced in 1973, agriculture certainly did not wither away. Why should we have so little faith in the ability of our financial markets to adjust, especially if the new policy were clearly enunciated and announced well in advance of implementation?

The fourth argument against targeting primarily on monetary aggregates is based on a skepticism as to whether the money stock can in reality be effectively controlled. This concern, if based on recent experience, has no legitimacy, because the unpredictability of aggregate behavior in recent years has resulted from the practice of targeting primarily on Fed funds. The relationship between the monetary base, which is precisely controllable and measurable by the Fed, and the money stock is predictable. Monetary aggregate control is feasible and practicable if annual or even semi-annual targets are set and adhered to. Such control is not possible if intervention is attempted on a daily or weekly basis in response to movements within the financial markets.

In order to enhance our ability to resist excessive inflation in times of strong credit demand and to avoid the recessionary consequences of abrupt reductions in the money supply, I propose the following changes in our conduct of monetary policy:

1. We should abandon the stabilization of interest rates as the primary goal of monetary policy and move gradually toward a freely-fluctuating Federal funds market.
2. We should concentrate instead on establishing and adhering to long-term money supply growth rates that are consistent with national economic policy.
3. As the most effective available means of controlling monetary growth, monetary policymakers should target on the monetary base, which is the source of money creation.

I realize there are those who will argue that permitting interest rates to move in response to market forces after years of controls would adversely affect our financial trading mechanism. Others would concede that monetary aggregates should be controlled . .

but feel that this should be done by varying the Federal funds rate.

The first concern, if it is perceived by the financial community as a valid one, can be minimized by a gradual widening of the FOMC ranges for Fed funds rates as a means of moving in a deliberate fashion toward a freely-fluctuating market.

I cannot agree that the most effective method of controlling the monetary aggregates is through varying the Federal funds rate. A more effective method is to target on the monetary base, that is, bank reserves and currency in the hands of the public. The monetary base is controllable by the central bank and is predictably related to monetary aggregates. Targeting on the base would eliminate the temptation to indulge in "fine-tuning" which, in turn, destabilizes monetary control.

At this point in time, we have an unprecedented opportunity to institute some of these changes. It is significant to note that Section 108 of the Humphrey-Hawkins Act requires the Federal Reserve to report semi-annually to the Joint Economic Committee of Congress in order to outline the Fed's planned expansion of monetary aggregates consistent with the President's economic plans . . . and to report why past growth targets have or have not been met. These requirements make control of monetary aggregates part and parcel of the economic policy of this Nation and call for policies that will seek to maintain the aggregates within agreed-upon ranges.

In closing, let me emphasize that I am not suggesting that monetary policy ever be conducted in a mechanical, inflexible manner. We must remain sensitive to social, political, and economic practicalities, and we must be prepared to make adjustments in monetary policy as required by national and world conditions.

Ours is a constantly changing world, and monetary policy must be flexible and adaptable to match changing conditions. What I am suggesting is that changes in policy be made for clear, specified reasons, and not be the result of a belief that there must be an immediate reflexive reaction to every movement in the economy, however slight.

Sixteen months ago, Business Week noted, correctly, I think, that "the Fed cannot entirely ignore interest rates, but it can let them fluctuate within a considerable range without damaging the economy." I fear we do not have another 16 months in which to debate and theorize. My remarks today have been offered because I view our efforts to reduce inflation and to avoid a recession as deadly serious business. The future course of this Nation . . . and the rest of the free world . . . could well depend upon our action or inaction within the coming weeks and months. We have capabilities to make important inroads on inflation, not next year, but now. It can be done if we are prepared to change what needs changing and retain what merits retention, based on solid experience rather than doctrinaire thinking.

In the field of monetary policymaking, targeting on interest rates at the expense of stabilizing the growth of the money supply has brought us to the situation we face today. If we are satisfied with the present condition of the U. S. economy and with our ability to adapt to ever-increasing inflation in the future, let us continue to function as we have in the past. If we think we can do better . . . and I firmly believe we can . . . I suggest that now is the time to act!