THE NEW FED POLICY

Address by
Lawrence K. Roos
President
Federal Reserve Bank of St. Louis

Before the
Economic Conference on Monetary Policy
Sponsored by
The Federal Reserve Bank of St. Louis and the
Center for the Study of American Business
Washington University
St. Louis, Missouri
October 19, 1979

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

As one of the sponsors of this Conference, it is a special pleasure to welcome all of you to the Federal Reserve Bank of St. Louis. It is a privilege, as well, to have the opportunity of joining you in pondering how we might learn from past experience in planning monetary policy for the future.

In the time allotted me, I would like to share with you some impressions of past policy-making that I, in my four years as president of the Federal Reserve Bank of St. Louis have gained, and to explore with you what I believe we might look forward to in the years ahead.

Looking back in the 1970s, I would be less than candid if I did not admit to some deep feelings of frustration with the way in which monetary policy has been conducted, as well as to a failure to understand how policies which produced such adverse consequences managed to persist for so extended a period. Perhaps the best way to express my feelings is to focus on a few fundamental concepts which have come to dominate my own understanding of the impact of monetary policy on the economy.

First, and foremost, is the concept that inflation is fundamentally a monetary phenomenon. This is an extraordinarily appealing notion to me, if for no other reason than its generality and sheer simplicity. As Beryl Sprinkel recently noted: "It doesn't take a genius to know that if you pump more and more money into the system, you get inflation." Now, I suppose that if Beryl is correct that it truly does not take a genius to understand this, then there is still hope that this concept will come to be widely accepted. Unfortunately, the time lag necessary for acceptance of this appears to exceed, by a considerable margin, the time lags with which changes in money affect prices.

Because the full impact of changes in the rate of growth of money on the inflation rate occurs over a considerable period of time (estimated variously from 3 to 6 years), it is important that monetary policymakers, as well as the general public, clearly understand

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

that the "core" inflation rate, or "underlying" inflation rate, or "basic" inflation rate (to mention just a few of the terms that have been attached to it) is determined by the long-term trend rate of growth in money after adjustments for changes in money demand.

In fact, because long term changes in velocity have, roughly, had equal and offsetting impacts to that for changes in output, the "core" inflation rate is essentially <u>equal</u> to the trend growth in money. Because the trend rate of growth of money has approximated 7 per cent, the current "monetary-induced" rate of inflation is about 7 per cent. To put it somewhat differently, had there been no oil shocks or other exogenous non-monetary induced impacts on prices, we would nevertheless be currently faced with an inflation rate of about 7 per cent due solely to the growth in money that has emerged from past monetary policy decisions.

A careful understanding of the difference between the <u>actual</u> inflation rate and the <u>monetary-induced</u> or core rate of inflation is crucial for the proper conduct of monetary policy. Only the monetary-induced rate of inflation should concern monetary policy-makers; it is the only component of inflation that they can influence. Exogenous "shocks" such as those caused by higher energy prices or crop failures will always contribute to the current measured inflation rate, but their impact is transitory. Attention paid to these exogenous influences on prices must never divert monetary policy-makers from focusing their actions toward controlling, and reducing, the monetary-induced rate of inflation.

A second key concept that has guided my understanding of the impact of monetary policy is that abrupt and substantial changes in the growth of money, if sufficiently prolonged, have dramatic and usually unfortunate consequences for the economy. Unusually rapid growth in money, if sustained for several quarters, while having some positive effects on employment and output for a short time, will ultimately and inevitably increase the monetary-induced rate of inflation. Similarly, unusually slow

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

growth in money, if sustained for several quarters, will result in reduced growth in output and employment--perhaps, even a recession, and ultimately reduce the monetary-induced rate of inflation.

Careful understanding of the short-run consequences of sharp fluctuations in the growth of money is crucial for the proper conduct of monetary policy. To avoid undesirable results such as recession or an over-heating of the economy, monetary policy-makers must avoid policy actions that result in sudden or capricious changes in the growth of money. They should, instead, conduct policy in such a way that changes in the growth of money are systematic and gradual.

A third concept that has guided my understanding is that the growth of money can best be controlled, not by focusing on the behavior of interest rates, but by controlling the growth of the monetary base. Since the Federal Reserve controls the largest component of the monetary base--Federal Reserve Credit--growth of the monetary base is directly and completely in the hands of the Federal Reserve. Similarly, there is considerable evidence that the multiplier linking the monetary base to the money stock is sufficiently stable and predictable to assure a reasonably close relationship between growth of the base and growth of money over all but the shortest-term period. Consequently, the lesson for policy-makers is that, if control of the growth of money is to be a crucial part of monetary policy, desired money growth rates should be linked directly in the policy process to the growth of the monetary base.

Finally, a fourth concept which has enabled me to understand the impact of monetary policy on the economy is that economic markets, especially the financial and foreign exchange markets, are reasonably rational and efficient. Thus, increased rates of money growth tend to produce <u>higher</u> interest rates and to <u>lower</u> the value of the dollar on international exchange markets as soon as the financial market participants, who seem to be well aware of the association between money growth and inflation, come to expect

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

increased future inflation rates. It follows that, while so-called "tighter" monetary policy may immediately produce higher interest rates, the same result occurs with "looser" monetary policy in the longer time span. Interest rate movements per se are unreliable guides to policy. This is especially true when we consider that interest rates, which represent the price of credit, are also affected by a host of non-monetary influences.

Now none of the above concepts is especially complex and certainly none is likely to be either new or controversial to most of you. However, they do provide an analytical framework for assessing the likely results of monetary policy actions. It is this basis of analysis that has led to my frustration in viewing what has happened over the past four years. No one, who believes as I do that the most significant component of inflation is monetary, could have failed to have been concerned with growth in money that accelerated from 5 per cent over the period from I/73 to III/76 to 8 per cent from III/76 to III/78, guaranteeing a significant increase in the core rate of inflation. No one, who believes as I do that drastic changes in the growth of money produce undesirable economic consequences, could have failed to be concerned when the money stock, having grown at the rate of 8 per cent for two years, suddenly dropped to a less than 2 per cent growth for the period from September 1978 to May 1979, virtually assuring a major economic slowdown. And, certainly, no one, who believes as I do that financial markets are rational and efficient, could fail to be disturbed by the current expressions of concern with alleged "tightness" of monetary policy, as judged by the "high" levels of nominal interest rates. Money growth at rates approaching 10 per cent and an inflation rate of close to 10 per cent are certainly not reflections of tightness. Certainly the financial and foreign exchange market participants have not been fooled; witness the behavior of interest rates and the value of the dollar over the last few months.

But my frustration is not confined only to the unfortunate consequences of past monetary policy actions. It also lies with the monetary policy-making process itself that produced the results we have observed throughout the 1970s. Time and time again,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I have observed the achievement of the Federal Reserve's interest rate target while money growth was permitted to wander at will outside its "desired" target ranges. As I noted in an earlier discussion in London last June, the monthly "betting odds" during the past four and a half years have been only about 1 in 2 that M1 would remain inside its target range. Moreover, there is little doubt that the conduct of monetary policy, by focusing on stabilization of interest rates, has produced a procyclical pattern in the growth in money. That pattern has tended to exacerbate the impact of cyclical movements and exogenous shocks on the economy.

But, again, none of this is especially new to you. Many of you have contributed over the past decade to studies critical of both the monetary policy-making process and policy consequences. I, too, have been convinced, both by the economic arguments to which I have been exposed, and by a first-hand view of the disappointing results of the policies pursued, that only a major change in the formulation of monetary policy--away from concentrating on stabilization of interest rates and towards focusing on the monetary base--would enhance the prospects of successfully achieving the results we desire from monetary policy.

The announcement by Chairman Volcker on Saturday, October 7, that the Federal Reserve is changing its procedures of monetary policy-making to place more emphasis on controlling growth of the reserve aggregates while permitting interest rates to fluctuate freely, represents a giant step in correcting past mistakes. There is no doubt in my mind that if this new approach is effectively implemented in the upcoming months and years, we can achieve control over the growth of money and, consequently, control over the "basic" rate of inflation. Similarly, we can avoid the adverse real sector impacts that have resulted from unintended drastic short-run fluctuations in the growth of money around its longer-run trend rate of growth. Finally, once the financial market participants are convinced that we have indeed seized control over the growth of money and intend to bring about the gradual reduction in money growth necessary to reduce the core inflation

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

rate, I believe that we will see an end to the surges in interest rates and declines in the value of the dollar which have proved so troubling in the past.

Thus, as you may have inferred from my comments, I am enthusiastic and encouraged about the change in the policy-making process that has occurred. However, my euphoria is restrained by a realization that several problems still remain if this change in policy is to produce the hoped-for results. To assure maximum effect from the Fed's new policy the following steps must be taken:

(1) Instead of placing sole emphasis on controlling the growth of non-borrowed reserves, policy-makers should focus also on growth in the monetary base and total reserves. There are just too many slips twixt growth in non-borrowed reserves and growth in money.

(2) Policy emphasis must be firmly and fundamentally redirected from concern about movements in the Federal funds rate to concentration on growth in the monetary base and, hence, the money stock. The substance of policy must go beyond merely widening the permissible range of movements in the Federal funds rate. For if widened Fed funds rate constraints remain even remotely binding, monetary control cannot succeed.

(3) The new procedure must be given adequate time to prove itself. The success of the new monetary control procedure cannot be reasonably evaluated by observing money stock behavior over a short time span. Not even the most ardent academic advocate of base targeting asserts that precise money control is possible over a period of six months or less. At the very least, a one year testing period is necessary for any comparison between previous methods and the current one. Moreover, no one should expect inflation to dissipate in a matter of months. Inflation has been generated over a period of 15 years and cannot be eliminated overnight. It would be tragic if this new approach to policy-making were to be tried and abandoned after a short time because of false

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

expectations.

(4) Finally, and perhaps most importantly in the short run, the procedures for implementation of the new policy, the rules of the game, must be clearly enunciated to the public. As we have observed during the first week after announcement of the new approach, the lack of clearly articulated rules produced a near panic in financial markets. There is no reason to shroud policy in secrecy and to keep markets guessing. While surprises might have had some value in policies directed toward money market stabilization, surprises are counterproductive when monetary aggregates become the target.

Above all, the attention of policy-makers must be focused on the longer-run impacts of policy. Unfortunately, as Arthur Burns noted in his Per Jacobsson Lecture, the "anguish of central banking" has often come from the short-term political pressures on monetary authorities--pressures to which, for-bad-and-for-worse, the monetary authorities have all too often succumbed.

What is needed more than ever before is a steady hand on the tiller of monetary policy. Not only will the Fed's new policy be subjected to critical analysis by those who traditionally have doubted the feasibility of monetary control; the very credibility of this country's central bank is at stake. I trust that we will have the wisdom to implement our policy effectively, the open-mindedness to judge our progress fairly and the courage to resist whatever pressures might arise to retreat from the historic step we have taken.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis