



MONETARY POLICY IN 1980 . . . A DISAPPOINTING YEAR

**Address by
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It is a pleasure, once again, to have the opportunity to address this distinguished assemblage. Meetings of the New York Society of Securities Analysts have a well-deserved reputation as a forum for the discussion of vital economic issues, and I consider it an honor and privilege to have been invited to a repeat performance before you.

When I previously appeared here on February 5, 1979, I gave a talk entitled "Monetary Policy . . . A Better Way." In that speech I was sharply critical of the manner in which monetary policy was then being conducted, and I made specific reference to how interest rate stabilization stood as a major obstacle in the way of reducing inflation. I suggested that consistent monetary restraint offered a much better means of dealing with inflation than continued efforts to fine-tune interest rates.

As you may recall, on October 6, 1979, some ten months after I spoke to you, the Federal Reserve announced a significant change in the manner in which it intended to conduct monetary policy. It announced that henceforth it would focus greater emphasis on controlling the monetary aggregates and less on constraining movements in interest rates.

I remind you of this in no way to imply that the Fed's change of heart was a direct consequence of the irresistible logic of my 1979 speech. Nor do I infer that my colleagues at the Fed suddenly "saw the light" and, in a moment of blinding inspiration, rushed to embrace the monetarist precepts of Milton Friedman. Rather, the Federal Reserve found itself compelled to change its procedures simply because it was increasingly apparent that the old methods of policymaking had proved ineffective in combating inflation, and that something better was needed if financial disaster was to be averted.

In order to appreciate the seriousness of the situation leading up to the October pronouncement, I would ask you to think back for a moment to that particular period of time. By the end of September 1979, interest rates were rapidly rising and the foreign exchange value of the dollar was plummeting. In both 1977 and 1978, money growth had exceeded the Federal Reserve's intended targets, and, in the six months immediately

preceding October 1979, money had grown at an annual rate in excess of 10%. It had become obvious that, unless some significant actions were taken, monetary growth in 1979 would exceed the Federal Reserve's target ranges for the third year in a row. Against this backdrop there was widespread concern over the Fed's seeming inability to control the situation, and financial markets were reflecting a need for a change in the methods by which monetary policy was being conducted. Chairman Volcker's pronouncement on October 6, 1979, that henceforth the Federal Reserve would emphasize control of money and credit, offered such a change.

Initially the new thrust of policy showed real promise. Growth of M1B (the money stock measure consisting of currency and transactions balances) slowed abruptly in the fourth quarter of 1979 to an annual rate of 3.2% and, for the first time in three years, the Federal Reserve found itself able to report that money growth had remained within its announced annual target ranges. As we entered 1980, hopes were high that the Fed's new procedures were working.

Then something went wrong. Instead of more stable monetary growth, fluctuations in M1B became more pronounced than at any other time in the past two decades. Interest rate movements became equally erratic. Financial markets were dazed by interest rates that rocketed to all-time highs by the end of March, plunged precipitously in the second quarter of the year, and by year-end shot up again to record high levels.

The general pattern of money growth and interest rate movements throughout 1980, although perhaps somewhat more exaggerated in its ups and downs, was not unlike what typically had occurred in the past. As the economy slowed, interest rates and money growth declined; when the economy accelerated, interest rates and money growth increased. It is no wonder that, by year-end, "Fed watchers" were beginning to question whether anything had really changed.

This afternoon, I should like to examine how such wildly erratic growth in money could have been the product of a policy, the primary purpose of which was to concentrate

on controlling money growth.

I believe that we would all agree that the fundamental mission of monetary policy must be to reduce inflation in a manner that does not have a destabilizing effect on the economy. It is important to consider just how well the Federal Reserve's new program met this test. Did it indeed contribute to a reduction in inflation? Did it promote greater economic and financial stability?

First, consider its impact on inflation. To have any meaningful effect on reducing inflation, money growth must be reduced and held below its long-run trend rate of growth. This did not occur in 1980. The trend rate of growth of M1B in the five-year period from the end of 1974 to the end of 1979 was 7%. From the fourth quarter of 1979 to the fourth quarter of 1980 . . . the first year of the Fed's new procedures . . . M1B grew 7.3%. This was above the growth rate of money over the past five years and certainly does not reflect the reduction necessary to achieve significant progress against inflation.

Furthermore, although M1B growth was targeted to grow at between 4% and 6-1/2% in 1980, its growth last year actually exceeded the announced target range by nearly one percentage point. And that overshoot would have been considerably greater had money growth in December not dropped to a -8% annual rate. Based on that record, it is difficult to conclude that monetary policy in 1980 contributed in any meaningful way to the reduction of inflation.

In judging the new policy against the objective of achieving stability in financial markets, we again see something less than satisfactory performance. The incredibly erratic gyrations in the growth of money last year reflect anything but stability. Money growth staggered and stumbled like a drunk on Saturday night, falling at -13% in April, spurting to +24% in August, and then dropping at -8% in December. These excessive gyrations, and the associated erratic behavior of interest rates, led to increased uncertainty as to the intended course of monetary policy and resulted in severe instability in financial

Thus, from the standpoint both of reducing inflation as well as achieving financial stability, the first year of the Fed's new program was disappointing.

There are two critical questions that must be answered: "What went wrong?" and, "What can be done to avoid similar problems in the future?" First of all, I want to make clear that I am in no way suggesting any lack of good intent on the part of policymakers. The problem was one of procedure, not purpose. And it was not a matter of having set incorrect annual targets for money growth. The experience of 1980 provides a perfect example of what happens when policy changes are not accompanied by technical and procedural changes necessary to make them work. It is the same as if a football team, in the middle of a losing season, changes its offensive strategy, but neglects to replace its old playbook. Changing monetary policy from stabilizing interest rates to focusing more directly on controlling the aggregates called for certain changes in practices and procedures. The Fed's reluctance to change its operating techniques to a sufficient extent was, in my opinion, the primary cause of the poor results of 1980.

To avoid a repetition of the problems experienced in 1980, and to enhance the Fed's ability to achieve its 1981 monetary growth targets, I propose the following changes in the conduct of monetary policy.

1. The Federal Reserve should use either total reserves or the adjusted monetary base, instead of nonborrowed reserves, to control money growth. The most direct and effective means of controlling money growth would be to control the growth of reserves that constrain monetary expansion. The Fed's present procedure of choosing a nonborrowed reserve growth path, and assuming a certain level of future commercial bank borrowing from the Fed's discount window, unnecessarily complicates its ability to hit its targets. This is because of the difficulty inherent in accurately predicting the future level of bank borrowing. Not only is the practice of targeting on nonborrowed reserves cumbersome, it is also based on the erroneous assumption that banks somehow respond differently to changes in borrowed reserves than to changes in nonborrowed reserves. This assumption is clearly

incorrect; it is the quantity of total reserves, regardless of their source, that determines money growth. Consequently, a total reserve or monetary base target would be distinctly preferable to the present targeting procedure.

2. The Federal Reserve should revert to contemporaneous reserve accounting.

The Federal Reserve currently uses lagged reserve accounting to determine the required reserves that financial institutions must hold against their deposit liabilities. Any current week's required reserves are based on deposits held two weeks previously. As a result, banks tend to create new loans and deposits without knowing what reserves will be available to them at settlement time two weeks hence. Under the present practice of lagged reserve accounting, the monetary authorities have tended to accommodate these loans and deposits by subsequently providing necessary required reserves. Effective monetary control requires that reserves serve as a constraint on future money growth, rather than an accommodation of lending actions already taken by banks. A return to contemporaneous reserve accounting would strengthen the impact of monetary policy.

3. The Federal Reserve should "float" the discount rate so that it will conform more closely to movements in market interest rates. This change is

especially important under a nonborrowed reserve targeting procedure. The extent to which financial institutions choose to borrow from the Federal Reserve to meet reserve requirements is directly related to the relationship between the discount rate and interest rates in financial markets. Failure to move the discount rate often enough and by large enough amounts increases the difficulty for policymakers to accurately estimate and thereby control the extent of commercial bank use of the discount window.

One objection to floating the discount rate has been a belief that the Federal Reserve would lose the "announcement effect" on financial markets

that discount rate changes are alleged to have generated in the past. This objection is irrelevant. Experience has shown that financial markets respond primarily to published money numbers and the extent of their deviations from announced targets, rather than the so-called "announcement effect" of changes in the discount rate.

4. The Federal Reserve should target on a single monetary aggregate, preferably on M1B. Currently the Federal Reserve announces target ranges for a variety of aggregates: M1A, M1B, M2, M3, and commercial bank credit. This multiplicity of targets is confusing to policymakers and the public alike. This is especially true when some aggregates are within, while others are outside of their announced target ranges. It is simply not true that all of the aggregates are "equal" with respect to their impact on the economy. Research conducted at the Federal Reserve Bank of St. Louis shows that M1B, when compared to the other monetary aggregates, is more closely controllable by the Federal Reserve and is more closely related to aggregate demand and inflation than other aggregates.

5. The Federal Open Market Committee's short-term money growth targets must be consistently related to its long-term target. At each meeting of the FOMC, short-run targets for money growth over subsequent months are chosen. Too often in the past, these short-term growth targets have not been consistent with the Federal Reserve's announced long-term target ranges. Consequently, as was the case last year, money growth from month to month may be within the short-term growth ranges, but at variance with the long-term targets. For example, the short-term target established at the May meeting of the FOMC sought an M1B level of \$393.6 billion in June, while the midpoint of the long-term range called for \$396.5 billion. Similarly, at the October meeting, the short-term goal was \$414.7 billion for December, and the level consistent with long-term ranges would have been \$406.7 billion. Such deviations from long-term path necessitate

severe adjustments late in the year, as actually occurred in 1979 and 1980. By explicitly linking the short-term money growth targets to the long-term ones, the FOMC would eliminate unnecessarily drastic swings in money growth and would assure more stable financial market conditions during the year.

6. The Federal Reserve should eliminate all constraints on the federal funds rate. This change is, perhaps, the most crucial of all. Although the present federal funds rate ranges are considerably broader than the ones that were used prior to October 1979, they still, on occasion, frustrate the achievement of money growth targets. This is especially true whenever the federal funds rate approaches the upper or lower bounds of its targeted range.

Unfortunately, a reluctance to totally eliminate federal funds rate constraint stems, in large part, from a widespread belief that the Federal Reserve can, and therefore should, control interest rates. This belief is totally false and, as far as I know, unsupported by any serious evidence whatsoever. Federal Reserve actions affecting the growth of the money stock do influence interest rate movements, but usually in the exact opposite direction to that espoused by common mythology.

The market interest rate is the price of credit and is determined by supply and demand for credit. Federal Reserve actions influence both the supply and demand sides of the credit markets. "Looser" monetary policy may temporarily increase the supply of credit. However, at the same time it permanently increases the demand for credit as the inflationary consequences of the Federal Reserve's expansionary actions are quickly recognized by the public, particularly under present conditions when inflationary expectations are so important. "Loose" or "easy" monetary policy increases money growth, enhances inflationary expectations, and thereby raises interest rates. "Tight" policy reduces money growth, reduces inflationary expectations, and reduces interest rates. This association between money supply changes and interest rates is well documented. In 1980, even over periods as short as one week, published changes in money stock

figures were directly correlated with changes in interest rates. Yet, the public is still inundated with the economic and political nonsense that the Fed's tight policies are responsible for high interest rates and that only monetary ease will bring rates down.

There is another widely-held argument put forth by the advocates of interest rate stabilization. It is based on a belief that stability in money growth necessarily means instability in interest rates. This questionable reasoning supports sentiment for the Federal Reserve to revert to smoothing the movement of interest rates, even if this means that money growth would be destabilized. I find this argument to be without merit. Last year's erratic interest rate behavior was a reflection of the erratic pattern of money growth and the market's increasing uncertainty as to the direction of policy. More stable growth of money and the achievement of the Fed's publicly-announced monetary growth targets would stabilize rather than destabilize interest rates and would remove much of the uncertainty affecting financial market conditions.

I believe that U. S. monetary policymakers have learned a considerable amount in the past two years. In 1979, we learned that a fundamental change in implementing monetary policy was called for. The rising rate of inflation and the rising level of interest rates over the past fifteen years demonstrated the fallacy inherent in conducting monetary policy through the control of interest rates.

In 1980, we learned that good intentions alone will not suffice and that basic changes in Federal Reserve operating procedures are necessary to achieve monetary stability.

As we gather here today, we have an unprecedented opportunity for economic progress. We have a foundation of support for economic reform such as has not existed for some time. The American public has presented policymakers with a mandate to overhaul the Nation's economic machinery from top to bottom. We have a national Administration that is dedicated to urgently-needed fiscal and regulatory reforms. The Federal Reserve System through its Chairman has expressed its intention to supplement fiscal

reforms with a monetary policy directed toward reducing inflation in a stable and orderly manner.

The necessary elements are in place for effecting major changes in the course of economic events which, if successful, can have a profound beneficial effect for many years to come. But the task will not be a simple one. To succeed, all economic systems, fiscal and monetary alike, must be set on "Go." A failure in any single aspect of the effort can doom the prospect for success of the entire mission.

Monetary policy is but one part . . . albeit an important one . . . of the process of restoring stability and growth to our economy. The ability of monetary policy to achieve its objectives, especially in the critical year 1981, is of special importance, not only for the achievement of our Nation's economic revitalization, but also for the maintenance of the Federal Reserve's credibility.

Today, I have suggested certain changes in the way the Federal Reserve conducts monetary policy. Those changes are essential for the success of the Fed's effort to control monetary growth. Fortunately, they would be relatively simple to implement.

Whether they are put into effect will require the support of many diverse groups. Participants in financial markets must be prepared to accept short-term movements in interest rates. Economists must be willing to test new techniques of monetary policy-making. And the Federal Reserve must be innovative and ingenious in choosing those operating techniques most likely to assure the attainment of the System's monetary targets.

I hope that you will agree that the climate for economic progress has never been better. Let us make certain that we do not let this important opportunity slip through our fingers.