The Senate Concurrent Resolution on Monetary Policy

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by

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The resolution under consideration is a forward and far-reaching step that, if properly interpreted and applied,will contribute to increased economic stability and lower inflation. Monetary policy must make a greater contribution to the maintenance of full employment and stable prices. The resolution expresses the intent of Congress to exercise, more fully than in the past, the constitutional powers that Congress has delegated to the Federal Reserve System. Equally, the resolution replaces the vague and archaic statement of purpose in the Federal Reserve Act with directions that commit the Congress and the monetary policy of the country to the goals of maximum employment and price stability. These goals have been neglected increasingly in recent years despite affirmations by Presidents, many members of Congress, and the recent chairmen of the Board of Governors of the Federal Reserve System.

Affirmations of intention and broad statements of purpose are not enough. The Committee knows that we currently suffer from the largest peacetime inflation and the most severe postwar recession. Part of our current problem is a result of actions taken by the cartel of oil producing nations known as OPEC, but even if the cartel had not been formed, or were at this instant dissolved, we would experience high inflation and deep recession. Most of the current inflation is a result of the monetary and fiscal policies of the past decade; the severe current recession is to a considerable extent a consequence of the sudden,sharp reversal of monetary policy in the summer of 1974. This reversal brought the annual rate of monetary expansion from about 5.5% in the year ending

June 1974 to less than 1% for the most recent six months, and less than 4% in the year ending January 1975. During the past six months, the Federal Reserve maintained a policy of nearly zero monetary growth. That policy remains in effect. Continuation of the current policy increases the prospects that the recession will be deeper, more severe and longer lasting than is now forseen.

Our present difficulties are not the result of malevolence in the Federal Reserve System. We do not suffer from high, continuing inflation and deep, growing recession by design. Our problems are, to a considerable extent,the result of a systematic, misinterpretation of monetary policy by the Federal Reserve that causes them to swing from excessive expansion to excessive contraction.

Statements of principal spokesmen for the Federal Reserve System, if reported correctly, fail to recognize that current policy is inappropriate under current conditions. I interpret the rapid decline in market interest rates on short-term securities as largely the result of a decline in the demand for credit by businessmen and consumers. The reduced demand for credit is itself a result of the recession and the decline in production, in desired inventory positions and in the financing of durable goods purchases that are part of the road map recession follows as it moves through the economy.

To describe the monetary system as liquid or to describe current monetary policy as appropriate to current circumstances is to repeat one of the principal errors that the Federal Reserve has made throughout its history. That error is the misinterpretation of interest rate changes. A principal corollary is the failure to recognize that changes in interest rates convey inaccurate information about the direction or thrust of current monetary policy. Interest rates and the growth rate of money typically fall in recession and rise in expansion. The recent decline in interest rates is not the result of a more expansive monetary policy but is instead a consequence of the severe recession. Statements describing current monetary policy as "easy" recall the similar statements in the minutes of the Federal Reserve for the years 1930 to 1932. Then, as now, the Federal Reserve systematically misinterpreted its policy, failed to control the growth rate of money, and permitted the recession to worsen.

There are many differences between the current situation and the situation in the 1930's. There is as yet no reason to believe a major depression will recur. There is, however, an unfortunate parallel between the excessively contractive monetary policies of the two periods and the misinterpretation of those policies by spokesmen for the Federal Reserve System.

Three Benefits

There are three principal benefits to be expected if the resolution is adopted. First, the systematic misinterpretation of policy will end. Congress and the public will receive information useful in formulating their plans, information that cannot be obtained reliably in any other way from any other source. Second, the Federal Reserve will be required to plan over a longer horizon. The resolution directs the Federal Reserve to focus its current attention on both inflation and unemployment and the longer-term goals of stable prices and maximum employment. Acceptance of these goals means that monetary policy will be more stabilizing in the future than in the past. I believe the resolution should make clear, however, that maximum employment means the amount of employment consistent with stable prices. Third, the resolution replaces the outmoded statement of purpose in the Federal Reserve Act with a clear statement of Congressional intent that is in accord with the role that monetary policy can be made to take in the future.

By instructing the Federal Reserve to control the stock of money, the Congress recognizes a point that is now well established by careful research conducted both within and outside the Federal Reserve System. There is much that is unknown, or in dispute, about the working of a complex, modern, monetary economy. There is, however, a substantial body of research showing that sustained expansion of money produces inflation and that intermittent, sporadic attempts to control inflation by sharp, sudden reductions in the growth of money bring recession.

The members of this committee, and other committees of the Congress, have had difficulty obtaining clear statements of policy from spokesmen for the Federal Reserve System. The measures used to represent the posture of current or past monetary policy differ from period to period and from meeting to meeting.

It is an unfortunate fact, but nevertheless a fact, that the measures used by Federal Reserve spokesmen are subject to shifts that are no less erratic than the policies they purport to describe. Interest rates, reserves, money, credit and ever-changing combinations of financial assets and liabilities are used by the Federal Reserve to describe their actions. To make matters worse, the rates of change of the various assets and liabilities are stated in different ways at different times. Monthly, quarterly and annual growth rates are reported to Congress in so many different ways that it is unlikely that the public, members of Congress or other non-specialists are able to properly judge or interpret the information they are given.

Part of the resolution before the Committee would be unnecessary if the Federal Reserve had reported to the public and the Congress in a more reliable and more consistent way. I believe the resolution should be amended to define money as currency and demand deposits of the public and to specify the precise way in which the growth rate is to be measured. The specific measures of money and of the growth rate of money that are chosen, though important, are less important than the decision to choose one of the widely used measures and to describe policy action in a consistent way.

Recent actions by the central banks of the German Federal Republic and the Swiss Confederation make clear that central banks, concerned about proper policy, and the proper interpretation of policy, have chosen voluntarily to report publicly on their plans. In recent months, the German and Swiss central banks have announced the growth rates of money they expect to maintain during 1975 to achieve their goals of reducing inflation and reducing unemployment.

Reasons for Requiring Control of Money

We will not be rid of our present set of economic problems easily or quickly. The consequences of a decade of inflation will remain with us for some time. The return to full employment at a rate of inflation lower than the average of the past few years requires policies that look ahead years, not months. The return to stable prices, if it is to be achieved at minimum loss of output and employment, requires time and more stabilizing monetary and fiscal policies than we have had in the past or have presently. A rapid reduction in the rate of price change from nearly 12% in 1974 to the lower rate that I expect in 1975 would have occurred in the absence of any monetary contraction. The restrictive monetary policy of the past six months is, I believe, working against the inherited, continuing inflation of 6 or 7% per annum. I applaud the attempt to end inflation but deplore the increase in cost arising from the sudden shift to an anti-inflation policy.

The inflation we now have is the product of more than a decade of rising money growth rates. In Table 1, I have listed the average rates of growth of money -- currency and demand deposits -- for overlapping five year periods. Alongside the growth rates of money, I have listed the average rates of inflation -- shown by the consumer price index -- for identical periods. In column three, I have listed the average growth rates of real output computed in the same way. These data have the advantage of eliminating short-term fluctuations. The long-term movements show through clearly.

The data show that higher average rates of monetary expansion and higher average rates of inflation are closely associated. The average rate of inflation in the U.S. remains between one and two percentage points above the average rate of monetary expansion in each period. There is, however, no evidence that the growth of real output has increased with inflation.

Data for the United Kingdom, cover a wider range of money growth rates and consequently a wider range of average rates of inflation.

Again, there is a clear, strong association between higher rates of money growth and higher rates of inflation. Moreover, reductions in the average rate of monetary growth appear in the British data. The reductions are followed by lower rates of inflation or slower increases in the average rate of inflation. The British data, like the U.S. data, show no evidence that higher rates of inflation are accompanied or followed by higher rates of real growth. The contrary proposition appears better supported.

Spokesmen for the Federal Reserve have often described inflation, or the effects of monetary policy on inflation as new, and totally different from the past. These data demonstrate that such statements are false. Furthermore, I believe the recent period and the longer historical record show that the main lessons of monetary experience are as valid today as in the past.

I have included the British data not only to show that the steady, long-term rate of inflation here lags only a few percentage points behind the British inflation rate but also to show that the policies that some now advocate -- 8%, 10%, or 12% rates of monetary expansion -- would produce a higher average growth rate of money and would be followed by a higher average rate of inflation. The prospects for higher inflation in 1976, 1977 and later years depend very much on how much money is issued to finance the large budget deficit in 1975. We have before us, as an example, the miserable performance of the British economy and the failure of stop and go policies there to maintain full employment and stable prices.

TABLE 1

Money, Prices and Output

United States and United Kingdom

Five Year Average Rates of Change
(in percent)

Five Years Ending	United States Money	United States Inflation	United States Real Growth	United Kingdom Money	United Kingdom Inflation	United Kingdom Real Growth
1964	2.2%	1.3%	4.1%	2.8%	2.8%	3.8%
1965	3.1	1.3	4.8	3.4	3.5	3.4
1966	3.6	1.6	5.8	3.0	3.6	3.1
1967	3.9	2.0	5.0	3.6	3.3	3.2
1968	4.7	2.6	5.1	3.7	3.8	3.0
1969	5.2	3.4	4.5	3.1	4.3	2.3
1970	5.2	4.2	3.2	4.2	4.6	2.2
1971	5.7	4.5	2.5	7.2	5.7	2.1
1972	6.2	4.6	3.3	8.4	6.6	2.2
1973	6.3	5.0	3.5	8.7	7.5	2.7

Some Suggested Changes in the Resolution

One of the most prevalent myths of our time is that we can treat the problem of recession now and the problem of inflation later. Policies based on this incorrect presumption have produced higher rates of inflation and slower growth of capital stocks in Britain and the United States.

We will not achieve full employment, more stable growth, and stable prices unless we stop shifting from one set of concerns to another. In place of stop and go, we must have policies that treat both the problem of recession and the problem of inflation. This requires monetary and fiscal policies to be directed toward both goals. The resolution you have before you begins to recognize this important truth.

However, the resolution leaves to the Federal Reserve the power to choose the growth rate of money. I believe that this continued grant of discretion by the Congress is much too great. The resolution should be amended to specify the range of 2% to 4% as the appropriate range within which the annual growth rate of money -- measured as the percentage change of currency and demand deposits from the same month in the preceding year -- should be kept. Experience in the recent and more distant past indicates that once full employment and stable prices are achieved, the Federal Reserve will retain ample flexibility but will lack the power and discretion to produce a major depression or a sustained inflation.

Congress has recently established new procedures for controlling the budget. This step cannot prevent inflation or depression unless it is accompanied by some action that prevents the financing of budget deficits by excessive monetary expansion and prevents future budget surpluses from being accompanied by sharp contraction in the growth rate of money.

The concurrent resolution should be amended to include a statement of the rate of long-term money growth that Congress regards as appropriate, and by a restriction on the maximum and minimum growth rates of money during the current recession and the period of adjustment to long-term stability. I recommend that the annual growth rate of money from March 1974 to March 1975 be brought to the 5-1/2% range recommended by the Shadow Open Market Committee, a group of business and academic economists. To reach the 5-1/2% annual growth rate requires a $290 billion stock of money, currency and demand deposits, at the end of March and based on available data an $8.5 billion increase from the average for the four weeks ending February 5 to the average for the four weeks ending March 28. This large increase should be accompanied by a clear unequivocal statement that the Federal Reserve intends to maintain a 5% to 6% rate of monetary expansion for the rest of the year. Monetary expansion should gradually be reduced toward the long-term growth rate of approximately 3% that is consistent with stable prices and full use of resources.

Furthermore, Congress should require the Federal Reserve to establish procedures that will improve control of money. These include the simplification of reserve requirements and the elimination of regulation Q.

Congress cannot and should not direct monetary policy. But, Congress has responsibility for setting guidelines that provide much needed stability of prices and the growth of output and income. Sixty years of experience with the Federal Reserve System has shown, repeatedly, that the broad grant of discretionary power has brought instability. I believe it is time for Congress to change the rules. I support the resolution and urge that it be strengthened in the ways I have suggested.