MONETARY POLICY—
THE POSSIBLE AND THE IMPOSSIBLE

Address by
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It is a pleasure and an honor to participate in your program today. In running over in my mind the many possible topics I might try to tackle, I decided that perhaps I should say a few things about Federal Reserve monetary policy. Fed policy, of course, is much in the news these days. But aside from whatever immediate impact the System's actions may be having on conditions in the financial markets at the present moment, it seems to me that this is a good time to talk about monetary policy for a couple of reasons.

First, our country has been in a real economic quandary for some time now. To cite just a few bits of evidence, real GNP grew at a 4.2 percent annual rate in the 1960s, but it grew at only a 3.1 percent rate in the 1970s. Employment, in contrast, grew more rapidly in the 1970s than it did in the 1960s, which means that we experienced some decline in productivity in the 1970s. On top of this, economic activity fluctuated more widely in the 1970s than in the 1950s and the 1960s. We suffered three recessions in the 1970s, and the one that began in 1973 and ended in 1975 was the most severe recession since the 1930s. But the most pervasive and in my view the most dangerous problem we face currently is inflation. In the 1960s prices rose roughly 25 percent; in the 1970s prices rose almost 100 percent. Moreover, as you are all well aware, inflationary expectations have risen rapidly along with actual inflation. These expectations, in turn, have been incorporated into long-term interest rates and have helped propel these rates to unprecedented heights. Many economists believe that monetary policy can help the nation achieve a better economic performance in the 1980s.

The second reason that this is a good time to talk about monetary policy is that the Administration is trying to engineer a substantial shift in both emphasis and direction in the formulation of national economic policy. This shift has important implications for monetary policy.

Accordingly, I want to make four main points this morning, and I'll flag them so that you won't miss them. First, I'll touch lightly on what might be called the traditional post-war view of how monetary policy works. Second, I'll describe how I think this view is changing. Third, I'll share with you my personal view regarding the proper role of monetary policy, and, finally, I'll give you my assessment of the chances that the policies we are now following will contribute to an actual improvement in the nation's economic performance.

Let me move then to my first point: the traditional post-war view of monetary policy. As you all know, there are several competing views about how the Federal Reserve should conduct monetary policy. I think it is fair to say that over the post-war period as a whole, the majority view among those with an interest in public policy has been that the Fed should conduct monetary policy by trying to manage interest rates. Some people have even argued that the Fed should try to conduct monetary policy with the express purpose of keeping interest rates low in order to stimulate borrowing, investment, aggregate demand and economic growth. Others have held the somewhat more moderate view that the System should adjust interest rates up or down as necessary to smooth out swings in the business cycle. In any case, this traditional view of monetary policy has clearly been reflected in the actual conduct of policy over most of the last 25 years.

My second point has to do with recent changes in attitudes toward monetary policy. I think it is increasingly recognized both by professional economists and by the general public that the Federal Reserve cannot control interest rates for any extended period of time, especially in an environment with deeply embedded inflationary expectations such as we face now. If the Fed tries to control interest rates, it inevitably winds up trying to move them away from the levels determined by the natural forces of demand and supply in the financial markets. Attempts to do this, however, set off a chain of reactive forces in the markets that eventually drive rates back towards their original levels and beyond them. To illustrate, if the Fed tries to push rates below market levels, it has to supply additional reserves to the banking system. These added reserves cause the money supply to grow faster. Increased money supply growth, however, raises both actual and anticipated inflation, and this increase in expected inflation puts upward pressure on interest rates as both borrowers and lenders build this revised expectation into nominal rates. As a result, rates eventually move back toward their original levels and then beyond them. In short, efforts to manage interest rates are counterproductive. It seems to me that recent monetary history provides compelling evidence that this is the way the world really works.

Now for my third point. If the Fed cannot effectively manage interest rates with monetary policy, what then can it do? The answer to this question should surprise no one: We can and we should control the rate of growth in the money supply. I reach this conclusion by a fairly simple route. Most of the historical evidence economists have developed suggests that our nation's real output can grow by about 3 percent or so per year. It seems intuitively clear that the means of financing this physical growth should grow at about the same rate if we are to avoid the development of inflationary pressures or recessions. This logic leads me to conclude that the money supply should increase at about 3 percent or so per year over the long run, with an adjustment to reflect the trend rate of growth in the velocity of money.

As you know, the Federal Reserve is now committed to controlling the money supply. The System annually sets targets for the growth of the monetary aggregates in the year ahead in accordance with the Full Employment and Balanced Growth Act of 1978 —the so-called Humphrey-Hawkins Act. The main dispute in this area these days is over the extent to which the Fed, in setting these objectives, should try to anticipate relatively short-run fluctuations in economic activity and offset these anticipated fluctuations with discretionary changes in the rate of growth of the aggregates. I'm increasingly convinced that no one can forecast the business cycle with much confidence, and I don't think anyone understands very well the short-run impact of the growth of the money supply on economic activity. Therefore, I favor reasonably steady, nondiscretionary growth in the money supply in both the short run and the long run with appropriate adjustments for long-run trends in the velocity of money. Under such an approach money would serve as an automatic economic stabilizer, exerting a brake on inflationary pressures and serving as a cushion against recession. My own feeling is that what we now call M-1B (currency, coin, and transactions balances held by the public) is the best of the existing concepts of the money supply to use for this purpose, but the choice of a particular monetary aggregate is a secondary matter. The main thing is to choose one definition of the money supply and then stick to it.

Finally, with my preceding remarks as background, let me say a little about present and prospective policy. I'll divide this part of my discussion into two subparts. First, why have we at the Fed sometimes failed to achieve our policy objectives in recent years? Second, what efforts are we making to improve the techniques we use in conducting policy and what results can be expected from these efforts?

Why has our performance at the Fed fallen short of what we wanted to achieve? I think there are several reasons. First, it seems to me that some economists and some policymakers have been excessively pessimistic regarding the relative costs and benefits of reducing the long-run rate of growth in the money supply. There seems to be a relatively widespread belief in some circles that one cannot affect the rate of inflation significantly in a short period of time without inducing a severe recession. This view can be summed up in the rule of thumb, derived from conventional econometric models, that one must give up 10 percent of the potential growth in gross national product in any year in order to achieve a 1 percent reduction in the rate of inflation. Two of our economists at the Richmond Fed, Roy Webb and Tom Humphrey, applied that rule to the German hyperinflation of the early 1920s. They estimated that, according to this rule, it would have taken a 50 percent GNP gap maintained over 600 centuries to eliminate the 300,000 percent inflation rate witnessed in Germany from mid-1922 through late 1923. Actually, as you know, the German inflation was virtually eliminated in early 1924 at an estimated loss of only 10 percent of potential GNP. Now this example is probably not entirely fair since by early 1924 the German public knew that the German government was serious about dealing with inflation, whereas the American public was never completely confident that policy was on an unambiguously anti-inflationary course during the period on which many of our econometric models are based. But the example does underline the truth that a serious commitment to monetary control can help reduce inflation in a short period of time without imposing unacceptable social costs in terms of lost output. Incidentally, I think that the precise speed with which we reduce the rate of expansion in the money supply is less important than removing all doubts about our ability to hit our monetary targets and our firm intention to do so.

A second and perhaps more important reason why I believe we have not achieved better results with monetary policy in recent years is what might be called bad engineering. There is absolutely no doubt in my mind that the System's policy objectives have been reasonable and attainable. Our execution of policy, however, has not been as effective as we in the Fed would have liked it to be. In particular, we have been hampered by some institutional flaws in the apparatus that we use to control the growth of the money supply. In addition, I think that some of our procedures have had some shortcomings.

Let me explain what I mean by engineering flaws. As many of you undoubtedly know, prior to October 6, 1979, the Fed tried to govern the rate of growth of the money supply by controlling the Federal funds rate. Specifically, we tried to determine the level of the Federal funds rate that was consistent with our objectives for the growth of the monetary aggregates, and then we supplied the quantity of reserves necessary to hit that level of the funds rate. But we were fooled repeatedly because we simply did not have the empirical information we needed to select a pattern of Federal funds rates that would produce the desired growth in the money supply consistently over time.

Since that date we have been trying to control the money supply by controlling the supply of reserves—specifically, the supply of nonborrowed reserves. This procedural change was important and was, in my judgment, definitely a step in the right direction. As I indicated a moment ago, however, our execution hasn't always been as effective as might be hoped. I would make several observations in this regard. First, the new procedure implied that we would have to allow more short-run movement in the Federal funds rate than in the past. Although we have certainly let the rate move more freely than in years past, it seems clear in retrospect that we have not allowed it to vary as flexibly as required to hold the growth of the money supply under control. Second, I do not think we have always adjusted our nonborrowed reserves targets as quickly and strongly as we should have. Third, the discount rate weapon has not been used as aggressively as it might have been to supplement the other tools for controlling money growth. Fourth, at times we have tended—often mistakenly as it has turned out—to assume that short-run movements of the money supply away from their target paths would be self-reversing. Last year, for example, we did not react very quickly to the weakening in the growth of M-1B in March, and we certainly did not respond nearly strongly enough to the upsurge of growth that began in June. Finally, our system of lagged reserve accounting creates technical difficulties under our new control procedures that were not present when we were trying to control the money supply using the Federal funds rate as the operating instrument.

Fortunately, there is a definite realization within the System that these engineering problems exist, and we are taking actions to correct them. In recent months we have loosened the constraint on movements in the Federal funds rate, and at some point in the future I hope that this constraint will be eliminated altogether. Further, we are currently adjusting our nonborrowed reserve instrument much more rapidly than earlier, and there is also a possibility that the discount rate will be used more actively in the future as a tool for monetary control. Finally, I think there is a good chance that we may soon move over to some form of contemporaneous reserve accounting. I recognize that there are some disadvantages to contemporaneous accounting both from your standpoint in the banking industry and from our standpoint operationally at the Fed. Nonetheless, it seems increasingly clear that some shift back toward contemporaneous accounting—with some modifications to the old pre-1968 system to make it more palatable to you—would reinforce our efforts to control monetary growth more effectively.

Taking all of these considerations into account, I am rather optimistic. I don't want to suggest that the conduct of monetary policy has been perfect so far in 1981, but on balance I think it represents an improvement over events in 1980. I've been either watching or participating in Federal Open Market

Committee meetings for a long time, and I've never seen the Committee more serious about hitting its long-run targets for money growth. So I think we are on the right road, and if we can hold to our course, I believe that most people will probably be surprised by the speed with which inflation can be brought under control. Since I consider inflation the root cause of most of our other economic problems, I believe that any progress we make on the inflation front will yield lower unemployment, higher productivity and growth, a stronger balance of payments, and lower interest rates. The trick now will be to hold firm, even if we run into some stormy economic weather in the months immediately ahead. I can assure you that we in the Federal Reserve will hold firm, and I believe strongly that the nation will reap the benefits of these policies sooner than most people seem to expect.