Forces at Work: The Fed, Money, and Forward Guidance

Modern-day monetary policymaking has shifted focus away from the role of monetary aggregates. But the accepted role of money in the economy is in large part due to the efforts and leadership of Homer Jones and Darryl Francis, president and CEO of the St. Louis Fed from 1966 to 1976. In "Darryl Francis and the Making of Monetary Policy, 1966-1975," David Wheelock and R. W. Hafer document how Francis argued that the main determinant of inflation over medium and longer terms was the Fed's monetary policy. He argued that the main reason for the high and rising inflation was the Fed's misplaced attempt to lower unemployment and that attempting to lower unemployment caused higher inflation, which made unemployment worse over the long haul. Under Francis's leadership, the St. Louis Fed persuaded policymakers in the Fed and in Congress to adopt a monetary policy strategy based on money supply targeting to eliminate the inflation problem.

The reality of monetary targeting was much different from monetarist theory. It turned out that monetary aggregates were difficult to control and attempting to do so caused a significant rise in the volatility of interest rates and inflation. The policy, however, did end 25 years of accelerating inflation and began the long period of declining interest rates that continued into mid-2013. The story of Paul Volcker's monetarist monetary policy reform is told in "The Reform of October 1979: How It Happened and Why," by economists who actively participated in that reform: David Lindsey, Athanasios Orphanides, and Robert Rasche. The decade after the reform was spent trying to understand how to conduct monetary policy analysis in dynamic models in which the central bank used interest rate rules and people behaved rationally in forming expectations and making decisions about consumption, investment, and production. This article discusses the communication problems the Fed experienced when it initiated a fundamental change in the direction of policy.

The next article, "Inflation Targeting in a St. Louis Model of the 21st Century," by Robert G. King and Alex Wolman is the first of the modern New Keynesian models that incorporated both monetarist and Keynesian ideas in a dynamic general equilibrium model with interest rate rules. The focus of this new paradigm, which has taken over as the primary model for conducting policy analysis in central banks, is on modeling the effects of expectations about future monetary policy on current behavior.

The final article in this section, "Announcements and the Role of Policy Guidance," by Carl E. Walsh explores the effects of central bank transparency on economic uncertainty. Walsh asks what happens if the central bank reveals its assessment of future economic activity in a world where the central bank has some inside information but it is not always accurate. The key idea in Walsh's paper is that it is more important for the central bank to be transparent when the underlying quality of its information is better.

Maverick in the Fed system

St. Louis bank preaches that it's quantity of money, not cost, that counts

Darryl R. Francis, president of the Federal Reserve Bank of St. Louis, urged last May that the Open Market Committee tighten the nation's money supply.

The classical architecture, the empty marble halls, the chandeliers all carry the distinctive stamp of the Federal Reserve System—substantial, respectable, discreet. But behind its exterior, the Federal Reserve Bank of St. Louis has become a maverick, questioning both the current monetary policy of the system, and the basic premises on which that policy is based.

The system always has had its family disputes. But two factors make the dissent from St. Louis distinctive and jarring.

- It reflects a fundamental disagreement over how monetary policy works. As the Fed traditionally views it, monetary policy bites mainly through interest rates. But St. Louis leans toward the quantity theory of the Chicago school and its leader, Milton Friedman. This holds that changes in the quantity of money—not the cost of money—are what really count.
- The St. Louis bank, moreover, is perfectly willing to make its dissent known to the world. "We try to do it delicately," says Homer Jones, research vice-president. "We never said that policy was bad—but at times the facts were damaging."

Pamphlets. The facts, as St. Louis sees them, come through a torrent of timely reports on everything from movements of money supply to the impact of the high-employment budget. Jones prides himself on having a more understandable set of monetary statistics—and not merely on the money supply—than even the Fed's board of governors. While most leading monetary economists don't buy his theories, they eagerly subscribe to his numbers.

The St. Louis viewpoint isn't pure Chicago school, but the two do meet

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on a great many points. And this year, as never before, the quantity-theory crowd is having the best of it.

The Fed has followed an easy-money line since late 1966—but interest rates have soared recently to their highest levels in years. To Friedman and his followers that is because the Fed has erred in permitting the money supply (defined by Friedman as currency plus demand and time deposits) to grow too rapidly. In this view, when the supply of money grows too rapidly, high interest rates are inevitable.

Discord. Fed policymakers disagree violently. They blame the rise in rates on such factors as the Treasury's huge cash needs and Wall Street's dread of tight money to come. However, Fed officials are unable to offer much evidence that today's sky-high rates have held down demand for credit, and Friedman is attracting new converts.

As early as last May, Darryl R. Francis, president of the St. Louis bank, parted company with his fellows on the Fed's policy-setting Open Market Committee and urged a turn toward tight money—a step the committee has yet to take.

Developments like these make for a certain amount of tension between Washington and St. Louis—most of it low-key as befits the solemnity of a central bank, but some of it rather intense. For instance, the St. Louis Fed has annoyed many in Washington with the rather critical reviews of monetary policy published in the past three years. And last year, for a time, the St. Louis Fed even issued its own figures on the money supply as an alternative to official figures coming from Washington.

Independent path. "The real disservice they do," says one Washington Fed official, "is to convince people that you only have to look at the money supply to determine Fed policy. That simply isn't true, but it is difficult to refute."

Even so, Fed Chairman William McC. Martin, Jr., whose own career began with the St. Louis bank, prides himself on tolerating dissent within the Fed system. "He has resisted all efforts to clamp down on Homer," says one of his aides.

I. Merchandiser

Between the material his people pour out and the monetary theory line he follows, Homer Jones has attracted wide attention.

An 18-year veteran of the Fed—10 years in Washington and eight in St. Louis—Jones has a substantial following outside the Federal Reserve System, something that is rare

Vice-Presidents Homer Jones (left) and Leonall C. Andersen of the St. Louis bank believe money supply should have a greater role in setting Fed policy.

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among regional bank economists. There are economists more highly regarded within the system than Jones. ("He's strong on numbers, weak on basic research," says one Fed aide in Washington.) But none can match the contacts Jones has outside the Fed—including a goodly number within the academic community.

Source. Little of the material that flows out of the St. Louis bank originates there; most of it is prepared initially by Washington. "Most of what we do," concedes Jones, "is a rehash."

Jones and his people take the basic material pumped out of Washington, then rework and polish it, and put it into highly readable form. As one Fed aide in Washington observes "Homer has the most merchantable stuff coming out of the system today."

Probably the St. Louis bank's best-known product is a weekly 12-page chart-book called U. S. Financial Data that shows in both chart and tabular form movements in the money supply and its components, in bank reserves, business loans, and interest rates. Many of the series feature annual rates of change over the preceding 3, 6, 9, and 12 months. Readers can quickly catch up on trends on virtually every financial indicator of importance.

More reports. The St. Louis bank has other publications—including monthly data on economic and monetary trends, quarterlies on gross national product, the federal budget, and the balance of payments.

A lot of the bank's material is presented in "triangular" form—comparable rate-of-change charts—that are easy to follow. The computer techniques for these triangles was developed in Washington, but they were whipped into shape for public consumption by Jones.

Of course, the public is only a secondary beneficiary of this material. By and large, it is worked out for what Jones views as his primary chore: preparing his bank's president for the periodic Open Market Committee meetings in Washington. It is at these gatherings, held every three or four weeks and attended by every Fed governor and regional bank president, that monetary policy is forged. "Voting in these meetings," says Jones, "is the most important thing a regional president does."

Open door. No clear-cut areas have been defined in which regional research people are supposed to work, although the assumption generally has been that Washington would concentrate on national matters with the regional banks working

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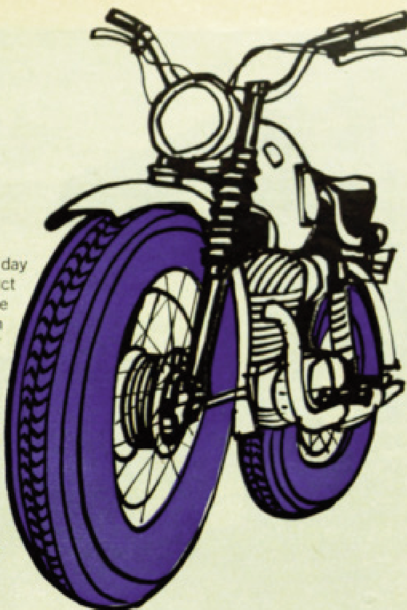

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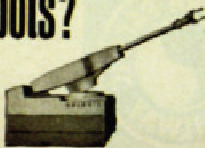

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on regional matters. "It is a weakness for a regional bank to concentrate on national matters," says one Fed governor. "We have a fine staff in Washington. Where our people can fall flattest is on regional research."

But, comments Jones, "regional work doesn't have much to do with a central bank or monetary policy." And while the St. Louis bank does some regional research, it does less than most other regional banks.

President Darryl Francis has spent his entire career in the area covered by the St. Louis bank—parts of Missouri, Illinois, Indiana, Kentucky, Tennessee, Mississippi, and all of Arkansas. He meets frequently with local businessmen and bankers and has, according to a Fed official in Washington, "one of the best grassroots senses there is." Even so, Francis agrees that "the major responsibility of the system still is monetary management. I don't see that regional development justifies the major efforts here."

Homework. Francis works hard to prepare for an Open Market Committee meeting. He meets daily with Jones and has a full blown session with his research staff a week before the gathering. The final days before a meeting are spent digesting material prepared in Washington and the data worked up by Jones.

His last recorded vote was for restraint last May. ("You can see the implications of Homer in that dissent," says a Fed Washington official.) But then, Francis missed a couple of meetings because of illness and he won't say how he would have voted. His own view, though, is that the Fed faces much the same sort of inflationary pressures it faced in 1965, "only more so."

II. Heart of the matter

Neither Jones nor his No. 1 aide, Leonall C. Andersen, who does the annual review of Fed policy, pledge anything like absolute allegiance to the Chicago school. What they do say, however, is that the money supply is vitally important and that Fed policymakers should pay more attention to it when they are setting policy.

"So far as I know," says Jones, "the money supply comes closest to saying something. We feel a change in Fed policy shows up rapidly in the money supply. There is no lag there at all."

Separate road. Obviously, Jones and Andersen part company with Friedman on many points. For instance, they are sufficiently wedded to the Fed to balk at any suggestion that its role be reduced to nothing more than keeping the money supply growing at a set rate—a role that Friedman (and as of this year the Joint Economic Committee) urges the Fed to play. "We see a great role for discretionary money policy," says Jones.

Nor do the two men accept Friedman's inclusion of time deposits in his definition of money supply—something that troubles many other quantity-theory people. Currency and demand deposits—the traditional components of money supply—clearly count as money. But a bank time deposit is only one of many "near-money" instruments that the public can choose to hold in lieu of cash. (Others would be Treasury bills, commercial paper, short-term municipal bonds, and in some cases savings-and-loan shares and savings deposits in banks.)

Approach. In fact, Jones and Andersen, in trying to link money supply and Fed policy, even ignore currency. As they see it, the demand deposit component is the one area of money supply where the Fed's influence is pervasive. This "reserves available" approach, says Andersen, "focuses primarily on the factors intervening between open market transactions and changes in the member bank demand-deposit component of money."

Andersen wouldn't have the Fed worry about money supply alone. But, he says, "The Federal Reserve System could control with a high degree of precision movements in the money stock. The Fed ought to be influencing demand deposits."

That isn't quite what Friedman demands, but it comes close enough to unsettle many in Washington.

Washington still insists that money supply is of little use as a money tool, if only because the numbers are too hard to read. Government deposits, for example, aren't counted in any money supply series, and demand deposits that were built up prior to a tax date simply vanish when the money flows into the treasury, making for wild gyrations in money stock figures.

Last year, St. Louis attempted to smooth out the peaks and valleys in the money supply series with a new seasonal adjustment. Washington, though, objected, cautioning the regional Fed against offering the public "59 different sets of numbers" and the St. Louis series was withdrawn. Washington did respond somewhat to demands for less erratic money supply figures with a new series called the "bank credit proxy," that includes government deposits at member banks. **End**

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