Monetary Targets – Their Contribution to Policy Formation

Remarks by LAWRENCE K. ROOS, President, Federal Reserve Bank of St. Louis Before a Conference on Monetary Targets, The City University, London, England, May 10, 1979

FIRST of all, I want to thank the organizers of this conference for inviting me to participate in these very timely discussions. I can recall no period in recent history when economic issues have weighed as heavily on people's minds as they do now, and it is encouraging to know that so many of you, representing different nations and diverse points of view, are devoting your time and talents to search for a better way to assure the future growth and stability of the economies of the Free World.

In my remarks this afternoon, I shall concentrate on monetary policymaking as it is conducted in the United States with specific attention to monetary aggregate targeting. In so doing, I will first describe the process of monetary policymaking in my country, follow that with a discussion of some of the problems inherent in that process, and finally, offer for your consideration some recommendations for changes which I believe would alleviate at least some of the present causes of economic instability.

From the outset, it is only fair to admit that my viewpoint is neither reflective of the prevailing opinion within the Federal Reserve System nor does it enjoy the enthusiastic support of all opinion-molders within the United States. While this lack of widespread acceptance occasionally generates a degree of frustration for me and my colleagues at the Federal Reserve Bank of St. Louis, it does not diminish our concern that current monetary policymaking practices are not achieving the goals for which they are intended. We are convinced that, in order to minimize the instability that has become characteristic of economic events over the past two decades, we must take a fresh approach to policymaking.

I also want to emphasize that I am fully aware that the recommendations I shall present will not, in themselves, assure the immediate or painless eradication of inflations and recessions. But, if they will at least enable us to eliminate *money-induced* economic fluctuations, we will have accomplished significant progress.

Let's first consider the process by which U.S. monetary policy is currently conducted.

I am sure you are aware that since the development of the Federal funds market, the commercial banking system in the United States in general does not maintain any substantial excess reserves. As a result, substantive increases in deposits and, thus, in money stock can occur only if the Federal Reserve supplies additional reserves to the banking system, either through its open market operations or through a reduction in reserve requirements. Since reserve requirement changes are infrequently used to affect reserve availability, open market operations are in reality our principal tool of money management.

As you know, the Federal Open Market Committee of the Federal Reserve meets ten times each year and at each meeting establishes two primary targets: a range for the Federal funds interest rate and a growth range for the monetary aggregates. These targets are set by a majority vote of the Federal Open Market Committee and a directive is given to the open market trading desk at the Federal Reserve Bank of New York to implement the decisions of the Committee. If market forces threaten to move the Federal funds rate above the upper limit of the Committee's prescribed range, the trading desk, in order to resist the rise in the Federal funds rate, purchases securities in the open market, thereby supplying additional reserves to the banking system. Conversely, if the monetary aggregate growth rates reach the upper limits of their ranges, the desk withdraws reserves by selling

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securities, thereby limiting money expansion and causing upward pressure on the Federal funds rate.

A problem arises when *both* the Federal funds rate and the growth of monetary aggregates simultaneously reach the upper or lower limits of their prescribed ranges. When this happens, the Open Market Desk faces a dilemma of whether to let the Federal funds rate exceed its prescribed limits in order to keep money stock growth within established ranges, or to let money overshoot or undershoot *its* target range in order to meet the prescribed Federal funds target.

Let's examine the published history of the behavior of interest rates and the monetary aggregates in the period since long-term monetary aggregate growth ranges were first announced in 1975. In the forty-seven months in which short-term policy ranges have been set, the Federal funds interest rate has fallen outside of its target ranges only five times; in the same forty-seven periods, M-1 growth has fallen outside of its ranges twenty-three times, essentially 50 percent of the time.

The monetary aggregates (M-1) have tended to exceed their targets during periods of *rising* Federal funds rates, to fall short of their targets during periods of *falling* Federal funds rates, while usually remaining within their targets during periods of *stable* Federal funds rates. For example, from June to December 1976, the Federal funds rate fell from 5.6 percent to 4.5 percent and monetary aggregates fell short of their target ranges three out of seven months. From April to October 1977, when the Federal funds rate rose from 4.7 percent to 6.5 percent, the monetary aggregates exceeded their targets five out of seven months. From October 1977 to March 1978, the Federal funds rate remained fairly stable at approximately 6.6 percent, and monetary aggregates remained within their ranges.

Two conclusions can be drawn from these observations. First, it is clear that in periods of incompatibility between the Federal funds ranges and the monetary aggregates targets, the Federal funds rate has reigned as the primary target in the conduct of monetary policy, and adherence to monetary aggregate ranges has played, at best, only a secondary role. Secondly, the principal thrust of monetary policy has been to stabilize the Federal funds rate and to resist both upward and downward market pressures on interest rates, even if it has meant permitting the growth of monetary aggregates to fall outside of their ranges. Thus, monetary policy in the United States, either by design or by default, has been fashioned to stabilize interest rates, even if it has meant destabilizing money growth.

The procyclical effect of this bias toward interest rate stabilization has contributed materially to the host of economic ills that have plagued our nations — accelerated inflation, deepened recessions, incompatible monetary growth among nations, exchange rate volatility, domestic and international trade restrictions, and, in all probability, lower economic growth than would otherwise have occurred. Because interest rate stabilization has had these undesirable effects, it is only natural to question why, after all that has happened, we continue to use, defend, and protect interest rate targeting as a preferred method of policymaking? There are several contributing factors.

The first — and perhaps the most troublesome because it represents a crucial analytical error on the part of monetary policymakers — is a failure to distinguish between the economic consequences arising from changes in people's demand for *money* and those created by changes in *credit* markets. Changes in money market conditions and changes in credit market conditions have substantially different economic effects and require fundamentally different monetary policy responses. Interest rate stabilization is a justifiable monetary policy response to changes in money demand but leads to significant procyclical consequences when used to resist changes in the credit market.

To illustrate what I mean, let's examine the effects of changes in the demand for money. People — households and businesses — tend to hold a certain amount of money in cash or similar liquid assets for their present spending needs and for protection against unforeseen future needs. The amount of such assets they desire to hold varies from time to time. A fundamental goal of monetary policy should be to provide enough money to satisfy people's money demand. If individuals and businesses want to hold more money, it is the responsibility of the central bank to supply the necessary amount of money to satisfy that desire. If they want to reduce their money holdings, the money supply should be reduced.

Consider how interest rate stabilization fits into this money demand equation. If individuals and businesses decide for one reason or another to increase their holdings of cash balances, they can do so either by reducing their spending or by selling off other assets. In either case, the normal result is an increase in interest rates, a decline in demand for newly-produced goods and services, a decline in output, and

a decline in prices. Assuming that the legitimate goal of monetary policy is to achieve stability of output and prices, the correct policy response to *increases* in money demand is to supply more money to the economy. This, in turn, has the effect of exerting downward pressure on interest rates and preventing decreases in output and prices. Thus, interest rate stabilization is justifiable when it is used as a response to changes in the demand for money.

Interest rate stabilization, however, is *not* an appropriate response to increases in the demand for *credit.* If individuals or businesses resort to borrowing in order to expand their current spending, the results are significantly different from those I have previously discussed in connection with changes in money demand. Increased borrowing causes interest rates to rise. However, neither output nor the price level is necessarily affected by such increased borrowing, as any increased spending by borrowers is offset by reduced spending on the part of lenders. Since credit demand tends to rise in periods of economic expansion and fall in times of contraction, monetary policy geared toward increasing the money supply to resist increases in interest rates emanating from rising credit demand merely adds to the underlying growth of spending. Conversely, reducing the money supply to resist reductions in interest rates during periods of *decreasing* credit demand results inevitably in aggravating the downward movement of output and prices. Thus, efforts by monetary policymakers to stabilize interest rates in the face of fluctuations in credit demand have the effect of accentuating rather than stabilizing changes in output and prices.

Much of the inflation we are presently experiencing can be attributed to monetary policy directed toward the stabilization of interest rates in times of rising credit demand. This, in turn, has reflected a failure on the part of policymakers to differentiate between the economic consequences of money market disturbances and those created by changes in credit markets.

A second factor contributing to continued concentration on interest rate stabilization is a fundamental misconception of exactly what monetary policy can and cannot accomplish. Regardless of its goals and purposes, monetary policy as practiced in free market economies can directly affect only one variable, the rate of growth of the money stock. And it is the rate of growth of this variable that affects economic activity and price levels throughout the economy.

Monetary policymakers frequently go astray whenever they assume that their policy actions can affect only one specific market without affecting all markets. Interest rate stabilization often carries with it the temptation to try to affect particular markets by manipulating interest rates. If, for example, policymakers assume that certain markets such as housing, credit, or the international exchange market are bellwethers of economic activity, interest rate manipulation might seemingly offer a legitimate way to affect one or more of those markets. What they sometimes fail to take into consideration is that any attempt to use monetary policy to stabilize unemployment in a particular market will have the effect of destabilizing other markets and will lead to an increase in the general price level. Furthermore, policy aimed at stabilizing financial markets in order to prevent interest rates from falling causes contraction in output and employment. Unfortunately, even after it becomes apparent that such manipulation causes detrimental results in other sectors of the economy, parochial pressures often persist.

If it were only understood that monetary policy is a powerful tool in the stabilization of general economic activity and the price level, but is a weak and very costly tool for the stabilization of individual economic sectors and markets, perhaps the bias toward interest rate control would abate. A great improvement in the effectiveness of monetary policy could be expected if policymakers were to recognize that decisions to increase or decrease the growth of money stock can provide an environment in which free markets can function efficiently, but that their effect on particular transactions is minimal.

A third reason for interest rate stabilization is the benefit it offers government. Whether we agree or disagree with the spending and revenue policies of our governments, interest rate stabilization by a central bank removes an important budgetary constraint on government. As we know, expenditures by government must be financed either by raising taxes or by deficit spending. In a democracy, increases in taxes are ultimately subject to review by the citizenry at the polling booth. Budget deficits financed by the private sector necessarily entail an increase in interest rates to induce the public to hold more government debt and are, thus, open to public scrutiny. It is only when a central bank stabilizes interest rates that government expenditures can be increased in a seemingly "painless" and relatively hidden manner without a tax increase or a rise in interest rates. To be sure, transfer of wealth still occurs through subsequent inflation but only with a lag of a couple of years and without clear public recognition of what induced the

inflation. Thus, interest rate stabilization makes possible increased government spending *without* public awareness and *without* voter approval. While I am not suggesting that this practice is consciously being employed at present, it does represent a powerful incentive for government to encourage interest rate stabilization.

In closing, let me summarize the points I have tried to make. I have described the mechanics of U.S. monetary policymaking and implementation. I have shown how establishing multiple targets for the Federal funds interest rate and the monetary aggregates has frequently resulted in incompatability, with the Federal funds rate usually emerging as the dominant target. I have suggested that, in recent years, monetary policy in the United States and elsewhere has been directed toward interest rate stabilization. Whenever that has occurred, whether in the United States or in other nations, it has led to destabilization of economic activity and accelerated inflation.

I have identified what I perceive to be some of the more important reasons for continued adherence to disproven policies: the confusion between money demand and the credit market; an unwillingness to admit that monetary policy is a very poor and very costly means of manipulating individual markets; and the fact that interest rate stabilization relieves government of important budgetary constraints. All of these are powerful social and political factors and it is not surprising that changes in the manner of conducting monetary policy are hard to come by.

I am convinced that there is a better way to accomplish the goals of monetary policy. That better way is to control the growth of the money stock so that it is consistent with the potential growth of output and with a predetermined — preferably zero — rate of inflation. In order to achieve this goal, however, it will be necessary to abandon interest rate targeting and to announce publicly what our monetary policy goals are and what mechanism will be used to achieve them. Only if we are prepared to take these steps can we realistically hope that monetary policy will become a stabilizing rather than a disruptive force.

I know that these proposals are not new and that contrary arguments persist against the feasibility of controlling the growth of money. Critics continue to assert that money stock growth cannot be measured with precision and thus cannot be controlled. My response to that argument is that a policy of explicitly controlling the growth of money has not been given a fair chance in the United States; in other economies that have made the effort, it has worked well. A second and more serious criticism is that, if money demand changes do indeed occur, a steady growth of money stock would lead to instability in economic activity. Empirical evidence clearly indicates that, over periods of a year or more, income velocity changes very slowly and predictably. In the very few instances when sudden changes in money demand have occurred, such as the one induced by the OPEC shock in 1973 and 1974, or those induced by institutional changes, they have been of temporary duration and were readily recognizable. Should exogenous changes occur, the rate of money growth can be temporarily changed to meet specific situations, and such changes should be announced publicly and the rationale behind them explained. A third frequently directed argument against a constant rate of money growth is that, if labor unions demand wage increases or businesses set prices in excess of the rate of growth of productivity, unemployment would result. This, I think, emphasizes the critical importance of central bank credibility. If it becomes clear that monetary authorities are going to adhere to their announced money growth targets, I doubt that businesses or unions would risk the loss of sales or employment that would accompany exorbitant wage or price demands.

I would stress that we can no longer enjoy the luxury of procrastination. We cannot be content merely to debate and theorize as to the best methods of conducting monetary policy. The time has come to learn from our past policy errors.

Interest rate stabilization as a means of seeking economic stability has had its day in court and its results have certainly been less than satisfactory. We are still experiencing persistent and accelerating inflation, and we again face the grim prospect of recession. If we respond as we have in the past, if we persist in repeating past errors, we will have failed in our responsibilities as monetary policymakers. We must be prepared to try new methods which offer the potential for success. Targeting on interest rates at the expense of stabilizing the growth of the money supply has brought us the situation we face today. If we feel that there is a better way — and I firmly believe there is — I suggest that we move ahead without further delay.