# DISCUSSION OF THE LEVY AND MELTZER PAPERS

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What did the experience of the last half of the 1960s and the decade of the 1970s teach us about the effects of monetary policy actions? It did not teach us anything "new." It only gave us another set of empirical observations to support the long-standing proposition that a maintained excessive growth of money will generate an acceleration in inflation and will raise inflationary expectations. The policy actions that engineered the move from price stability in the first half of the 1960s to a 6 percent rate of maintained inflation by 1973 were an accelerated rate of purchase of government securities by the Federal Reserve which resulted in a faster growth of monetary base and bank reserves and, hence, a rise in the trend growth of money from 1-2 percent to 6 percent.

Prior to the mid-1960s there already existed a very large amount of evidence that this would be the expected result of these types of policy actions. Indeed, one does not have to use highly sophisticated methods of analysis to come to this conclusion. Simply a close look at the data should be enough to convince most people of this strong relationship between the growth of money and inflation.

The experience since 1973 has reminded us that price theory can be useful in analyzing macroeconomic developments. Severe supply

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shocks raise the level of prices and, hence, contribute to the measured rate of inflation. However, as 1975-1976 illustrate, these effects do not result in sustained inflation.

Both Meltzer and Levy point out that sustained inflation is a monetary phenomenon. They differ with respect to whether monetary actions are the "fundamental" cause of inflation. Meltzer puts the blame for inflation and its acceleration directly at the door of the Federal Reserve. He rejects the assertion that the Vietnam War, deficits, and government spending of the mid-1960s were the origin of inflation or were the motivating force causing the Fed to expand money. I agree with Meltzer that the Fed must accept the blame for starting and maintaining inflation. The money stock grew at steadily more rapid rates because the Fed allowed it to do so by providing the necessary bank reserves. If the Fed had not supplied more reserves, money growth would not have accelerated and, hence, inflation would not have accelerated. The Fed can make excuses about why it followed such a policy, but the fact remains that it did follow such a policy.

Levy raises the interesting question of why policy moved from one that underwrote price stability to one that underwrote accelerating inflation. His conclusion is that, in the mid-1960s, there were major political and social changes that led to greater social activism on the part of the government (such as a shift toward increased "nonproductive" transfer payments and regulation) that reduced productivity and set off the inflationary spiral. I would interpret his conclusion as meaning the Federal Reserve was caught up in this process and essentially pulled along the path it followed by forces over which it had no control.

There is a growing body of evidence supporting the idea that the factors Levy discusses operated to lower potential real output growth. However, if these factors had not been accompanied by a surge in monetary expansion, there is considerable doubt we would have had the acceleration in inflation that we experienced.

This still leaves open the question of why, despite repeated statements of policy intent to halt inflation, the Federal Reserve allowed its policy actions to feed inflation. If the Fed had actually planned an acceleration in inflation, it could not have followed a program that was better grounded in theory and supported by empirical evidence. I have difficulty accepting the explanation that the Federal Reserve was simply pulled along by the tide of expansionary sentiment. To some extent, that may have been the case. Especially, one can point to the repeated failure of certain members of Congress to accept the interest rate consequences of their deficit spending. However, the basic cause of the high and rising interest rates that have characterized the last 15 years has been the inflation generated by Federal Reserve actions and the resulting rise in inflationary expectations.

I would ascribe the failure of monetary policy to achieve its objective of stable overall prices to a failure to accept and remain committed to a few very basic principles. These are: (1) the primary job of a central bank is to prevent an acceleration in the basic rate of inflation and monetary policy cannot fine tune real output; (2) excessive money growth means an acceleration in inflation; (3) money grows at a sustained, faster rate only when the central bank provides more monetary base; (4) if there is a surge in government demand for credit or private demands for credit or a surge in measured inflation, short-term

interest rates will rise and Federal Reserve attempts to prevent this rise will only ensure that interest rates remain at these higher levels; (5) the Federal Reserve can control the trend growth of money; and (6) although in theory, money growth can be controlled by operating on the federal funds rate, in practice this is a very unsatisfactory procedure. If the Federal Reserve had remained committed to these six basic principles, it seems very unlikely that monetary policy would have followed the path that characterized the last 15 years.

Of the above six principles, the last two have been the hardest for the Federal Reserve to accept: ability to control money and the flaws in a federal funds target. More than anything else, these two items have contributed to the failure to achieve policy objectives. Too often the question of "can the Fed control money?" has gotten mixed up with the question of "should the Fed control money?" If the central bank can control the growth of the monetary base, it can control the supply of money. This should be a lesson that is learned in an introductory money and banking course. During the past 15 years the Federal Reserve has tried to control the federal funds rate, not growth of monetary base and bank reserves. Hence, the Federal Reserve has not "controlled" money.

This is why the most important aspect of the policy actions announced by the Fed's Open Market Committee on October 6, 1979, was the part announcing a change in operating procedures. Primary emphasis was shifted from the federal funds rate to growth of a reserve aggregate. If the Federal Reserve remains committed to this change, monetary actions may start to match the intent of monetary policy.

It is much easier to analyze how we got into our current predicament than it is to state how to get out of it. Obviously, to lower the trend rate of inflation, the growth rates of the monetary base and money must be reduced. However, the objective of monetary policy is not just to slow inflation, but to do so with a minimum loss of real output. As other papers at this conference have emphasized, there is a great deal of uncertainty about the effects of alternative "slowing" policies on real output and employment as well as their short-term effects on the financial markets. Traditional macroeconomic models usually assign a fairly large and prolonged real output effect to anti-inflationary monetary policy. However, as Taylor points out in his paper, recent developments in economic theory raise serious questions about implications of traditional models.

Despite our uncertainty about the exact magnitude of the effects on real output, it is becoming generally accepted that the less the degree of uncertainty about the path of monetary actions the less effect these actions will have on real output and the larger and quicker their effect on inflation. Meltzer discusses this issue under the heading of the "basic inference problem." He shows that, if transitory changes in the growth of money are frequent, it is optimal to observe a relatively long series of observations before concluding that a permanent change has occurred. The past behavior of the Federal Reserve with respect to the growth of money has made this a good rule to follow. The Federal Reserve has announced monetary targets and then repeatedly failed to hit these targets. The Federal Reserve has announced major policy actions designed to slow money growth, as it did in November 1978, and then actually substantially reduced money growth for five months.

However, this was apparently only a transitory change in money growth, as the last six months have completely reversed the pattern of slow money growth.

Hopefully, one lesson that the Federal Reserve has learned is that it must make its policy announcements credible to the public. Credible means taking actions, and maintaining those actions that are consistent with its stated policy intent. Also, when the Federal Reserve makes a major change in its method of implementing policy, it should clearly explain this new procedure. The immediate case in point is the October 6 announcement of a move toward a reserve targeting procedure. To minimize disturbances in financial markets and to have a maximum effect on inflationary expectations, the Federal Reserve should clearly explain the new rules of the game. How much more short-run flexibility does the Fed plan to allow in the federal funds rate? Exactly which reserve aggregate is going to be the new target? What is the Federal Reserve's growth target for this reserve aggregate? How is the Federal Reserve going to project the relationship between the reserve aggregate and money? An improved monetary policy for the 1980s must include answers to these questions.