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Commentary

I PRESUME THAT I WAS ASKED to comment on the papers by Collins and Edwards, and Orphanides, Reid and Small because I spent a good portion of the last six years looking at the "+," that is, on the assets, the desirability of whose inclusion into a broadened monetary aggregate is the subject of these deliberations. It is true that I not only watched stock and bond fund assets, and money market fund assets, but also had some influence on their definition, methods of collection and aggregation, and similar mundane matters. So, when the yield curve steepened a few years ago and, consequently, the flow of retail savings into longer-term debt instruments intensified, those who were uncomfortable with the apparent unresponsiveness of M2 to consecutive reductions in the Fed funds rate frequently used me as a sounding board for all sorts of proposals to redefine this monetary aggregate. In other words, I have been exposed to the alleged problems and proposed solutions before and I am pleased to discuss them once again.

However, since I was asked to specifically comment on the presented papers, and duty comes before pleasure, let me start with the papers and then move on to the broader issue of re-definition of monetary aggregates.

I will begin with the article examining empirical properties of an expanded M2, M2+. The authors of this article, Orphanides, Reid and Small, do an excellent job of examining the stability, indicator properties and, to some extent, controlability of M2+ (that is, M2 plus assets of bond and equity mutual funds) by trying to determine the demand for M2+, including reduced-form relationships that presumably would capture the determinants of supply as well.

To specify the demand for M2+, they correctly recognize the importance of specifying the ex ante return on its close substitutes—real assets such as commodities and durable goods, as well as financial assets such as direct holdings of short-term instruments, bonds and stocks. However, they note the difficulty of measuring such returns. They also note that M2+ would include the capital gains and losses on stock and bond mutual funds, because of the difficulty—I would say impossibility—of removing such ex ante gains and losses from the mutual fund component. Not incidentally, they do not believe such gains and losses should be removed, a subject to which I shall return later.

It is important for me to summarize their conclusions because I will be using them in commenting on the other article. The authors conclude from their analysis, and I agree with their conclusions, that:

1. On stability:

   "...the estimated demand functions are not very stable. Hence, the usefulness of these equations in interpreting and forecasting movements in M2+ may prove to be limited."

2. On indicator properties:

   "In terms of their information content, M2+ and M2 do not appear to have differed significantly." Both overpredicted nominal GDP before and during the last recession.

"... capital gains and losses cause growth of M2+ to be more volatile than that of M2.

Moreover, the capital gains and losses in M2+ may cause movements in the aggregate that neither reflect shifts in the stance of monetary policy nor provide appropriate signals for changes in policy."

3. On controllability:

   The authors do not explicitly examine this aspect but, based on their previous statement just quoted, presumably would agree that M2+ is far less controllable than M2, which itself has not proven to be controllable at all during the period when it was the major monetary aggregate targeted by the Federal Reserve.

On the basis of these conclusions, they doubt that anything would be gained by expanding M2 to include assets of stock and bond mutual funds. I agree completely.

By contrast, the authors of the second paper, Collins and Edwards, still consider M2+ (and its companion, M3+) a worthwhile replacement for M2. They argue that M2+ is less worse than any other proposed replacement, first because the added components, that is, assets of long-term mutual funds, have enough moneyness—their medium-of-exchange and liquidity attributes, and second, because, as intermediation continues to shift wealth from present components of M2 to long-term mutual funds, M2+ should, in fact, grow in value as an indicator of economic activity.

The authors of the paper recognize the potential pitfalls of using M2+. For example, some of the components of M2+ will have to be interpolated from annual data to monthly series in order to net out the institutional assets that would otherwise lead to double counting. Such interpolation drastically reduces the indicator properties of an aggregate for short-term purposes. Even if we leave the interpolation problem aside, the usefulness of M2+ as a long-run indicator also would be limited: For the demand for M2+ to be properly specified, *one would need to specify ex ante returns—a task bordering on the impossible, as the authors of both papers seem to acknowledge.*

The technical issue then appears to be, at least in part, whether the moneyness attributes of the "+" make its components so indistinguishable from the components of M2 proper as to warrant the expansion of M2 despite the deficiencies of the broader measure established by Orphanides, Reid and Small, and pitfalls of using it as recognized by Collins and Edwards. A broader issue is, of course, what would be gained, if anything, by including assets of stock and bond funds into an expanded M2.

So now, as my principal assigned duty is fulfilled, I feel I am entitled to express my other thoughts on this matter. In order not to keep the audience breathless, I shall state at the outset that I disagree with the conclusions of the paper by Collins and Edwards and think that nothing would be gained by introducing yet another, broader monetary aggregate.

First, if the demand for M2+ is neither stable nor more informative than that for M2, as Orphanides, Reid and Small show, then deciding to adopt it because it is less worse than other proposed aggregates is a most unusual criterion for selection. I shall elaborate on this in a moment.

Second, it is fairly easy to show that the added components making up M2+ lack moneyness, contrary to what the authors of the second paper claim. Table 1 gives the turnover of some of the major components of M2 (those in columns one through four, and six and seven of the table; small time deposits, overnight repurchase agreements and overnight Eurodollar deposits were not available) and the turnover of bond and equity funds (the last two columns).

The striking feature of the table is that the turnover rates for the bond and equity funds are so much lower than that for any other financial assets. They are less than 10 percent of that of general-purpose money market funds, and less than 0.07 percent of that of demand deposits outside of New York City banks. Moreover, in contradistinction to demand deposits and even money market funds whose turnover ratios have tended to drift upwards over the nine years portrayed in the table, turnover ratios on bond and equity funds have declined or remained constant. Thus, their relative moneyness, at least as measured by turnover ratios has, in fact, decreased.

I may add that the turnover ratio has in its numerator the sum of debits, that is, it includes exchanges out of these funds. These in most

Table 1

Turnover of Deposits, MMMFs and Bond & Equity Funds, 1984-92

	Deposits at commercial banks				MMMFs		Bond & equity funds		
	Demand deposits NYC banks	Demand deposits other banks	OCDs	Savings	Institution	Broker/ dealer	General purpose	Bond/ income	Equity
1984	1,843	269	15.8	5.0	4.2	3.0	2.2	0.4	0.3
1985	2,169	302	16.7	4.5	5.0	3.5	2.5	0.3	0.4
1986	2,461	327	16.8	3.0	4.6	3.4	2.9	0.3	0.5
1987	2,671	357	13.8	3.1	4.6	3.7	3.0	0.5	0.6
1988	2,897	333	13.2	2.9	4.6	3.5	2.4	0.3	0.5
1989	3,421	408	15.2	3.0	4.5	3.6	2.4	0.3	0.4
1990	3,820	465	16.5	6.2*	4.3	3.2	2.2	0.3	0.4
1991	4,271	448	16.2	5.3*	4.8	3.2	2.3	0.3	0.4
1992	4,798	436	14.4	4.7*	6.9	3.6	2.7	0.3	0.3

*Includes money market deposit accounts at banks for these years.

SOURCES: Federal Reserve Bulletin (various issues) and Investment Company Institute

cases represent changes in asset composition of a shareholder's overall portfolio rather than debit to a checking account or a money market fund which has for its counterpart acquisition of, say, a new suit. Excluding exchanges out (that is, redemption exchanges) from debits would make the already low turnover ratios for long-term funds considerably lower. In any event, the low turnover of bond and equity funds indicates that they probably have far less to do with the types of transactions that might influence GDP over the span of time normally adopted in framing monetary policy. In fact, it seems plausible that a switch of, say $1,000, from my money market fund or bank account to a bond or stock fund, suggests a decision to move a potential near-term $1,000 purchase into the future, quite possibly beyond the relevant time frame. Consequently, it seems to me that, contrary to the claims of Collins and Edwards, very little, if any, moneyness resides in the bond and equity components of M2+. I think that the extremely low transaction cost of converting these assets into cash creates this illusion of moneyness.

Third, adopting M2+ because it might *eventually* have better indicator properties and would, at least, in the meantime, envelop close substitutes for M2 assets, leads me to ask where will the broadening end? Milton Friedman recognized many years ago that the definition of money was as much an empirical as a theoretical matter, but deciding where to draw the line is not easy and, under current law, the Federal Reserve must decide where to draw it. Now, I don't want to get into a largely doctrinal argument over the wisdom of the requirement to set targets for monetary aggregates. However, because financial institutions are able and willing to grant credit lines collateralized by all types of assets, it does seem to me that *broadening the definition to envelop close substitutes has as its feasible upper limit all of household wealth if not all of national wealth.* I can get liquidity out of my home equity by simply opening my desk drawer, grasping my pen and writing out the amount I wish to spend. Moreover, I don't have to fear the tax consequences of my decision because I don't have to compute and report any of the capital gain on my home at the time I wrote the check. By contrast, if I were to write a check on my bond fund this would be a capital transaction requiring relatively complex computations of my cost basis for reporting short- or long-term capital gains. In this sense, a home equity line of credit has greater moneyness than a stock or bond fund. Thus, rather than stopping with including bond and equity mutual funds, shouldn't we go all the way and include home equity, margin credit, other lines of credit, including signature loans and, eventually, as our experience with financial innovation suggests, any assets that can be sold or borrowed against?[1]

This third comment brings me to a question that has been too easily dismissed by Collins and Edwards. Has the definition of money gone in the wrong direction? It seems to me that is a conclusion a reasonable person could draw from the experience of the past several decades as the Federal Reserve tended to broaden the definition of money. Despite the view of the authors that the Federal Reserve now would be reluctant to backtrack towards narrow measures of money, it is my humble opinion that the movement has been indeed in the wrong direction.

Although we all understand that monetary aggregates are not the ultimate objectives of policy—sustained growth and low inflation are really the measures by which the Federal Reserve policies will be judged—I have always been struck by the fact that the Federal Open Market Committee (FOMC) has typically used various components of bank reserves as internal guides for its open market operations even as it was proceeding in evolutionary steps from narrow to broad definitions of money when communicating its objectives to the public.

Of course, I don't want to give the impression that the links between narrow aggregates like reserves or the monetary base and the ultimate policy objectives are any more precise than the links between broader aggregates and those objectives. Nevertheless, the place of such narrow aggregates in the interplay of policy, ultimate objectives and information variables (such as commodity prices, interest rates, yield curves and exchange rates) has been more "enduring" in the conduct of monetary policy than any of the publically targeted monetary aggregates.

To summarize both papers, I agree with Orphanides and others and disagree for the same reasons with Collins and Edwards that adding M2+ to the monetary zoo would not make monetary policy more effective in achieving its ultimate objectives or make the Fed's stance more transparent to the Congress and the public.

I have tried to put the work of the two papers in the larger context of either being prepared to draw the line at total wealth rather than repeatedly drawing the line, erasing it, and redrawing it again and again at arbitrary segments of the wealth spectrum or, on the other hand, of moving back towards narrower aggregates which the Federal Reserve uses and can control. To me the choice is obvious.

[1] I can understand the tendency to resort to broader definitions if the desire is to incorporate wealth effects into the formation of monetary policy. However, such effects tend to have little explanatory power from quarter to quarter, or from year to year, in explaining movements in aggregate demand, production, employment and especially inflation. Furthermore, if this were the case, all assets that can easily be liquified would have to be included into such a wealth-effect-capturing aggregate.