

# Monetary Policy Over the Next Decade

*By Preston Martin*

Life in the American electronic village of today is characterized by an infinite variety of information and by a focus on our immediate problems. There is a virtual obsession with the very short run and with the risk and danger that confront us now. Confidence in our institutions is buffeted by waves of data whose validity is subject to question because of frequent revisions and adjustments. Forecasters and econometric model builders seem to be confounded by subsequent events — the range of error around the consensus forecast has widened so much that it sometimes appears their computers cannot even identify the direction of change. It is thus important to extend our view to a multiyear horizon, to review the more fundamental trends affecting the institu-

tional underpinnings of our economy and financial system. Only in this way can we dispel some degree of the uncertainty about the future and about the appropriate policies to promote long-run stability and growth.

One aspect of the uncertainty is the revolutionary changes in the financial environment. Monetary policy operates through financial markets, which are today constantly in flux. In this country — and lately also in London, Tokyo, and other financial centers — new financial instruments and institutions arise almost monthly. An important part of the central bank's responsibility is to maintain the integrity of the financial system in this rapidly changing landscape. With the internationalization of financial markets in recent years and the integration of the U.S. economy into an interdependent world economy, the concerns of the Federal Reserve and U.S. Treasury also extend to the safety and soundness of the international monetary system. It is not an exaggeration to say that both the domestic and international financial systems are undergoing a transformation.

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In implementing monetary policy, we must be aware that the rules of the game are frequently changing and must adapt our strategy in light of those changes. The difficulties are intensified by the strains on the financial system caused first by a significant acceleration of inflation and then by the necessary financial and nonfinancial adjustments to disinflation, which was not fully anticipated by the markets. In this environment, it is even more tempting to focus on the problems and challenges of the day, postponing consideration of tomorrow's problems. To paraphrase the Scriptures, "Sufficient unto the day is the challenge thereof." Too often we have contented ourselves with such short-run thinking regarding policy alternatives.

I submit that today's world no longer permits that luxury. Thus, let us avail ourselves of this opportunity to step back from the immediate concerns and to take a longer run view of the trends shaping the environment in which monetary policy is conducted. We do so not only to prepare for the future but also to understand the present and appreciate the past. It is in this spirit that I approach a discussion of monetary policy over the next decade.

You will appreciate that the most appropriate starting place is our historical base. What might have been said on long-range monetary policy in 1975? The U.S. and world economies were just emerging from the stagflation following the first oil shock. In part as a response to America's first bout with double-digit inflation combined with a severe recession, Congress had adopted a resolution requiring that the Federal Reserve report its monetary growth objectives. The Federal Reserve first announced money growth targets in the midst of a major shift in money demand. The question then, unlike 1985, was why M1 was growing so slowly. The "Case of the Missing Money" in the mid-1970s in

my view was never solved despite the best efforts of the Sherlock Holmeses and Hercule Poirots of monetary economics.

Slow monetary growth during this period helps explain why Federal Reserve policy seems, in retrospect, to have been overly accommodative in the late 1970s. Some argue that this accommodative policy allowed inflationary pressures to build and the exchange value of the dollar to decline. Of course, many factors other than monetary ones contributed to that inflation. Several developments led to the decline in productivity growth, among other examples.

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The inflation of the 1970s also set the stage for a wave of financial innovation and deregulation. Think how far we have come since 1975. Interest-bearing checking accounts were then confined to New England; thrifts and banks were then more easily distinguishable by the composition of their balance sheets; financial futures and options were not yet prevalent; and despite the severe recession, the financial health of all major sectors seemed not just secure, but rock-solid. Review the economic and financial literature of that day and you find that, when asked to assess the outlook for monetary policy over the next decade, yesterday's experts almost to a man would have expressed a relatively sanguine view. And remember this was a time when policymakers thought the economy could be "fine tuned."

My mid-1970s mythical economist, Kenneth Keynes, almost certainly would have limited his outlook to domestic considerations. Despite concern about the recycling of petro-

dollars through the Eurodollar market, which itself was thought to be somewhat of an aberration, the U.S. economy and financial system were still more or less insulated from their counterparts abroad. Exports and imports were thought to be so negligible that they played a minor role at most in forecasting U.S. economic growth. Ken Keynes invariably included only a few sentences at the end of his forecast alluding to international matters. The record of policy actions of the Federal Open Market Committee in that period reflected this domestic orientation, containing few references to international considerations other than the price of oil.

Then came the shocks and discontinuities of the last decade. Accelerating inflation in the late 1970s led to a runup of gold and other commodity prices and to a decline in the exchange value of the dollar. By the fall of 1979, financial markets were gripped with inflation fever. In response, the Federal Reserve announced a major change in operating procedures and an intensified commitment to monetary control as a means of containing inflation. Soon thereafter, President Carter's announcement of a budget with a "whopping" projected deficit of \$16 billion rekindled the anxiety in financial markets, especially exchange markets. The response was to impose credit controls, treating the symptoms but not the causes of our economic problems.

A more substantial response began in late 1980, when the Federal Reserve embarked on a policy of sustained monetary restraint. Because of uncertainties surrounding the introduction of nationwide NOW accounts in 1981 and the associated redefinition of the monetary aggregates, the effective degree of monetary restraint was difficult to measure. Real interest rates soared, commodity prices plunged, and the U.S. economy suffered through a prolonged recession — all of which contributed to

unprecedented strains in the international financial system, including the severe debt-servicing problems of LDC debtors. On the plus side of the ledger, we achieved our objective of disinflation: monetary restraint contributed to rapid progress in bringing inflation down from 13 percent in 1979 to 4 percent in 1982.

Nor did the turmoil end with the easing of monetary policy beginning in late 1982. The declining interest rates in late 1982 and early 1983 were followed by an unexpectedly rapid fall-off in the velocity of money. At the time, many commentators, including Milton Friedman, predicted that the acceleration of M1 growth in 1982-83 would inevitably lead to a commensurate increase in inflation. Others attributed the rapid M1 growth to the buildup of precautionary balances in NOW accounts, which are generally recognized to have both transactions and savings characteristics. Subsequently, models were developed that helped explain the rapid M1 growth as resulting from heightened interest sensitivity of money demand due to inclusion of NOW accounts in M1. The operative word here is *subsequently*. As one involved in monetary policy decisions at the time, I will concede that the reasons for the shift in the public's demand for liquidity are still subject to analysis and review. Even now, we cannot be sure of the reasons for the atypical behavior of M1 in the 1982-83 period. The important point is that the FOMC's decision to rebase the M1 target for 1983 to accommodate the increased demand for liquidity was vindicated: inflation did not accelerate.

Some thought inclusion of accounts with market-related rates would so reduce the interest sensitivity of money demand that the Federal Reserve would lose control of M1. But the rates on Super NOW's have proven to be sticky, so the interest sensitivity of M1 has

remained high. What effect has the introduction of Super NOW's and money market deposit accounts had on the monetary aggregates? We now have enough experience with the new accounts to be reasonably confident that M1 growth remains very responsive to changes in market interest rates.

Furthermore, the continued progress against inflation led to a downward revision of inflationary expectations that contributed to another major reduction in interest rates over the last year. Even those of us who in 1983 foresaw a slowing of economic growth did not anticipate the full extent to which the accompanying decline in interest rates would stimulate M1 growth and lead to the unprecedented declines in velocity experienced this year. The decision to rebase the M1 target for 1985 was based, in part, on our judgment that rapid M1 growth through the summer would not be inflationary because it resulted from portfolio adjustments due to declining interest rates. After we rebased, M1 growth continued at double-digit rates for reasons not fully understood, leading to another sharp decline in velocity in the third quarter. To the unsolved Case of the Missing Money in the mid-1970s, we now must add an equally puzzling Case of the Missing Velocity in the 1980s.

What conclusions can we draw from our experience over the last decade for monetary policy in the next decade? One is that monetary and reserve aggregate targets serve a useful purpose in the fight against inflation. Focusing on financial quantities rather than on interest rates imposes discipline on monetary policy. Central bankers are cautious by nature — they hesitate to change their policy stance until it becomes clearly necessary to do so. When the stance of policy is characterized mainly by the level of short-term interest rates, this cautious tendency can lead to artificially high or low interest rate objectives,

especially when financial change and other shocks confuse the signals from incoming data. By the time it becomes clear that a policy change is necessary, it may be too late. In contrast, monetary targets by their very nature focus attention on the long-run objective of price stability, leaving interest rates to be determined by market forces.

Nevertheless, our experience indicates that rigidly adhering to monetary targets would also be unwise, especially in a rapidly changing financial environment. What would have happened, for example, if we had pursued policies that allowed interest rates to rise in late 1982? How important was achieving our M1 target in the midst of a severe recession and of Act I in the international debt crisis? We didn't take that unnecessary risk, and subsequent developments have, in my view, vindicated our decision then to relax the degree of restraint.

I am frank to admit that a great deal of uncertainty is likely to persist regarding what the monetary aggregates are telling us until we have a great deal more evidence on how the new array of deposits and certificates will be

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utilized. How will financial institutions compete for deregulated deposits? What forms of deposits will be available? What preferences will depositors themselves demonstrate? The incomplete answers to these questions at this time do not support the monetarist proposal that monetary growth be the exclusive, or at least the preeminent, guide for the conduct of monetary policy over the next decade. It may be that the aggregates in some future period will be reliably enough related to our goal

variable to warrant renewed emphasis on monetary growth in policy implementation. Meanwhile, the information content from the monetary aggregates will be useful but not decisive in the conduct of monetary policy.

Then what other alternatives are available as policy guides? A number of concepts have been put forward for alternative monetary policy targets or objectives, with a strong undercurrent of a desire for the Federal Reserve to conduct monetary policy according to some simple "rule." If a single, reliable indicator could be found, such a rule would have the advantages of being easily understood by the public and readily used by Congress in holding the Federal Reserve accountable. A rule might even be an anchor that could reduce uncertainty about future price levels. Let me go through several of the possibilities; but I will tell you in advance that each has serious drawbacks. The eclectic approach is likely in the end to be preferable to any of the proposed rules.

One proposal would orient policy to the growth of total debt. As changes in the public's asset preferences began to distort the monetary aggregates, it was suggested by some that we turn our attention to the liability side of the public's balance sheet and focus on a credit aggregate. Research from Federal Reserve staff and from leading academics suggested that the ratio of GNP to total credit — a counterpart to the velocity or turnover rate of money — had been virtually constant over long periods. The FOMC did establish an annual range for total credit beginning in 1983, but characterized it as a monitoring range in part because of uncertainty about the durability of the relationship.

That skepticism seems to have been justified. Since 1981, the historical relationship between debt and GNP has broken down. Expansion of debt has vastly outpaced that of

GNP; the "velocity" of debt has plummeted. One reason, of course, is the explosive growth of government budget deficits in recent years and the associated inflow of capital from abroad. Private debt has also grown unusually rapidly during this expansion. One could argue that the debt to GNP relationship will return to normal after the unprecedented budget deficits and capital inflows diminish. However, it is precisely when you are navigating turbulent waters that you rely most on your rudder. Variables that are predictable only in normal times are not, in my judgment, strong candidates for monetary policy targets.

Another proposal is to target nominal income or nominal GNP growth directly. In the absence of external shocks, inflation cannot get out of hand if nominal income growth is kept near the economy's long-run growth potential. The main problem I see with this approach is that it promises more than can be delivered. Nominal income growth is not sufficiently controllable over horizons of a year or less to be a reliable criterion for the public or the Congress to judge monetary policy. Many other factors, including fiscal policy, affect nominal income. Moreover, the noninflationary growth rate of nominal income is uncertain because there is so little consensus today on the long-run "trend line" growth in potential output. On a pragmatic level, the FOMC members' projections for real growth, the unemployment rate, and inflation are even now sometimes misinterpreted as goals rather than forecasts. Such an approach would put the Federal Reserve in the position of attempting to fine tune policy to achieve short-run values for real economic outcomes, objectives for which monetary policy is particularly ill-suited. Remember Milton Friedman's caveat that fine tuning is an example of the "best being the enemy of the good." In the real world environment in which policy decisions

are made; I fear that nominal income targets, far from helping us contain inflation, would make controlling inflation even more difficult and would thus impair efforts to achieve sustainable real growth.

Some analysts argue that the Federal Reserve should target an index of commodity prices, which are thought to be a good leading indicator of the general price levels. One reason monetary policy cannot stabilize the aggregate price level in the short run is that many wages and prices are administered rather than market determined. Most labor contracts, for example, set wages for two or three years. Because of these institutional rigidities, monetary policy affects prices of goods and services only after a substantial lag. In contrast, commodity prices are set by supply and demand forces in the markets and thus could be quickly affected by monetary policy actions. Some advocate using an index of commodity prices as a short-run proxy for the overall price level, claiming also that stabilizing commodity prices would reduce cyclical fluctuations.

I have reviewed extensive empirical evidence on the properties of commodity price indices in the 1970s, ranging from prices on raw materials to prices of goods headed for the shelves, and including the Federal Reserve's own commodity price index. One conclusion from my review is that various commodity price measures do provide information useful in understanding inflationary — or deflationary — forces. Surges in food or energy prices, for example, can be significant as precursors to an increase in the overall inflation rate. However, none of these price indices for commodity baskets consistently leads the general price level. Consider the past few years' experience — consumer prices have increased at a moderate and nearly constant rate even though commodity prices first

increased sharply and then deflated almost as sharply. Statistical evidence over longer periods confirms that commodity prices are not closely enough related to either overall inflation or economic growth to serve as a simple price rule for monetary policy. And the relation of commodity prices to general inflation and economic performance is likely to be even more tenuous in the future as the U.S. economy moves increasingly from an agricultural-manufacturing-extractive industrial base to an information-finance-service orientation. A commodity price rule just does not seem practical. Can commodity prices nonetheless provide useful information for monetary policy? Of course they can.

Literally two decades of inflation have stimulated many to turn to the idea of a return of major trading nations to a gold standard. Under the previous gold standard, the participating countries attempted to fix the prices of their currencies in terms of a specified amount of gold. Led by the Bank of England, the central banks of the leading countries at least part of the time followed the rules of the game — they adjusted the rates of growth or contraction of their domestic money supplies and the adjustment of price levels to external gold flows. The game was centered on the Bank of England's "field." The 1870 to 1914 period was the heyday for the gold standard. However, even then some countries did not follow the agreed-on rules of financial behavior, often "sterilizing" gold flows so that the domestic money supply would not be contracted or expanded thereby.

Would the leadership in one of today's political economies long permit gold to be freely exported and imported in a manner that would significantly affect domestic prices, investment, and consumption as did the Bank of England in the 19th century? Would a specific price for gold be maintained if that price

were associated with actual deflation, falling prices, in an economy? Obviously not. However, it is not possible simply to dismiss gold as a possible anchor to a modern monetary system by citing inflationary or deflationary trends that occurred in gold standard countries prior to World War I or during managed gold standards in the 1920s. Likewise, it is not practical to disregard the information arising out of changes in gold prices in today's markets. One cannot ignore changes in the attitude of investors and speculators toward the hold-

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ing of gold. It is much more difficult, however, to argue for complete and sole reliance on gold or any other single commodity for the guidance of monetary and other stabilization policies.

A fourth alternative target for monetary policy is the exchange value of the dollar. The proposal to base monetary policy on a targeted exchange rate has obviously arisen because of the extreme volatility and misalignment of the dollar in recent years. Furthermore, exchange rates are given high priority by other central banks in Europe and Japan. It is argued by some that monetary policy should remove the uncertainty of volatile exchange rates and the large trade deficits resulting from a "overvalued" dollar by pegging the exchange value of the dollar. Indeed, the dollar exchange rate has recently been characterized by Otmar Emminger, former President of the Deutsche Bundesbank, as "the most important price in the world economy."

The proposal to peg the value of the dollar fails to cut through the confusion between real and nominal exchange rates, however. The

real exchange rate, the market exchange rate adjusted for differences in price levels across countries, is a major determinant of our trade balance. It reflects the price of our exports relative to the price of our imports — what economists call the terms of trade. What is true for real interest rates and other real economic variables also applies to real exchange rates: monetary policy has only a temporary effect. Therefore, if the Federal Reserve could materially affect market (nominal) exchange rates, the result might not solve our long-run trade imbalance, which depends on fundamental economic factors: consumer preferences, productivity, and saving propensities.

Should the Federal Reserve adjust monetary growth to peg the dollar exchange rate for a prolonged period? Should we gear our monetary policy to adjusting the U.S. inflation rate to inflation rates in the economies of our trading partners? In the context of the past several years, with strong upward pressure on the dollar, this would have meant that the Federal Reserve would have been forced to boost the U.S. money supply, tending to generate more inflation in this country in order to keep nominal exchange rates constant.

How could central banks avoid the trap of exchange rate pegging causing worldwide inflation? It has been proposed that major industrial countries coordinate monetary policies to keep the world money supply, and therefore the world price level, constant. This, it seems to me, is a way of simulating a worldwide gold standard with the dollar, rather than gold, as the international medium of exchange. What would be the probable consequences? Under certain shocks that cause changes in real exchange rates, the United States could be forced to follow a deflationary monetary policy to maintain worldwide price stability. Given the stickiness of wages and prices, deflation in this country could have

severe adverse consequences on domestic output and employment. The Federal Reserve could thus run a real risk of a recession to keep the nominal exchange value of the dollar constant. Our "political economy" would hardly tolerate such a risk.

The problems with a pure exchange rate target would, of course, be alleviated if there were better balance of fiscal policies across countries. Unlike monetary policy, fiscal policy can affect real exchange rates over an extended period. Our experience over the last several years has been one of expansionary fiscal policy in the United States and contractionary fiscal policies in most other developed countries. The accompanying appreciation of the dollar exchange rate suggests to me that a coordination of monetary policies across countries could be overwhelmed by a divergence of fiscal policies. The sluggish world economy stridently calls for greater global balance in the mix of both monetary and fiscal policies. This, it seems to me, is the challenge for economic policy in the next decade.

The September G-5 agreement is a useful first step. Especially if the G-5 and the subsequent IMF-World Bank meetings in Seoul are followed by government spending reductions in this country and less restrictive budgetary policies in some other countries, these developments could begin to meet this challenge.

The message I want to leave with you today, though, is to confirm that the Federal Reserve can be expected to contribute to the progress being made in solving the world's economic problems. However, there is no magic computer software program or simple rule — not monetary or credit targets, not nominal GNP targets, not commodity price

targets, not exchange rate targets — that will solve the problems resulting from fundamental internal and external imbalances caused by real economic factors. We can and will contribute to continued progress toward price stability and growth within an environment of stability in the domestic and international financial systems.

In my view, that objective can best be achieved by continuing the eclectic approach to monetary policy that has characterized our actions since 1982. *Of course* we should use the information from exchange rates and commodity prices, including the prices of precious metals. But we must continue to place primary emphasis on domestic economic and financial developments in the conduct of monetary policy.

Some argue that such an eclectic approach does not allow appropriate accountability to Congress and the American people. I disagree. We can and should be held accountable for the *results*, not just the tactics. In judging monetary policy over the next decade, you should ask yourselves the following questions: has monetary policy prevented reacceleration of inflation to the ruinous rates of the 1970s? Has it also fostered the greatest degree of financial stability feasible under the circumstances? And finally, has the Federal Reserve cooperated in efforts to provide greater balance of policies, both domestically and internationally? In short, has the Federal Reserve contributed to a climate for sustained growth in output and employment both here and abroad?

I hope that your answers to all of these questions will be in the affirmative in 1995. Only then will we know the extent of the contribution monetary policy has made to prosperity in what promises to be a most difficult decade to come.