# Quick-Fix Economics: A Look at the Issues

*By Roger Guffey*

The need for a clear public understanding of economic policy is more critical than ever in the face of continuing debates about the nation's basic strategy for wringing out inflation and bringing about sustainable economic growth. The cornerstones of this strategy, as you know, are reduced taxes, reduced government spending, reduced regulation, and slower growth in money and credit. In my judgement, this program is generally on track. Taxes are being reduced, regulations are being pared, and growth in the supply of money and credit is being reduced by the Federal Reserve.

However, our current economic concerns reflect the fact that a major element of the program—reduced government spending—has not been fully implemented. As a result, large budget deficits are now being projected for years to come. These deficits, in turn, are fueling inflationary expectations, keeping interest rates high, and thereby casting a pall over the economic outlook.

In periods of economic weakness, such as we are now experiencing, there are always calls for quick-fix economic solutions and proposals for tinkering with economic policy procedures or market forces.

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In evaluating quick-fix solutions for reducing high interest rates, we must remember that the Federal Reserve has adopted and is adhering to a policy of reducing the growth of money over time to a rate consistent with sustainable noninflationary economic growth. It is well accepted that moderate growth in money and credit translates into a reduced pace of inflation. And, in my judgement, the Federal Reserve's long-run targets are absolutely appropriate and consistent with the nation's overall economic strategy. The record is quite clear. The Federal Reserve has established its credibility by achieving slower growth in money over time and, by doing so, has contributed importantly to a welcome reduction in the rate of inflation.

Despite this credible record of Federal Reserve monetary policy, proposals for quick fixes to bring down interest rates continue to be heard. Some of these proposals are, indeed, very beguiling.

One proposal receiving attention these days is a suggestion that the Federal Reserve be made a part of the U.S. Treasury. Such a change would bring the Federal Reserve under the control of the administration, making it easier, some believe, to "coordinate" the tools of monetary and fiscal policy and, therefore, to meet our nation's desired economic goals.

There is no question that the Federal Reserve is a public institution and that it must be responsive to political input in the broad sense. We in the Federal Reserve recognize that the central bank must take into account both the wishes and the long-run best interests of the American public. Our steady anti-inflation course of recent years is evidence, I believe, of that accountability.

But the proposals to fold the Federal Reserve into the Treasury are not, in my view, consistent with this broader interpretation of political responsiveness. Rather, these proposals would subject the monetary policy process to the short-run influences of political expediency. Moreover, mechanisms are already in place—through the Full Employment and Balanced Growth Act—to require the Federal Reserve to establish periodic monetary targets and then report to Congress on progress toward meeting those targets.

When Congress designed the Federal Reserve System and delegated to it the responsibility for managing the money supply, the central bank's independence was clearly established. Congress has observed an independent Federal Reserve for nearly 70 years and has continued to reaffirm the separation of monetary policy implementation from partisan politics. The reason for doing so is abundantly clear. World economic history is full of lessons of what happens when politicians become involved in managing money. Inevitably too much money is created. This is followed by rampant inflation and a deterioration of the nation's economic and political framework.

Therefore, we should be particularly wary of attempts to weaken the independence and the resolve of the central bank to keep monetary policy on a proper course no matter how the winds of political expediency may blow at a given time.

Most rational observers would agree that tampering with Federal Reserve independence is fundamentally unwise. But other ideas are being proposed which appear to be less far-reaching in impact. These proposals make specific suggestions about how the Federal Reserve should *conduct* monetary policy. The most vocal ideas come from some of those whom I view as extreme monetarists, who believe that the growth of money should and can be controlled with absolute precision, with predictable economic growth and stability the natural result.

It's true that because of the link between money and economic activity, the Federal Reserve has adopted procedures and is currently formulating policy within a generalized monetarist framework, such as by using the monetary targeting approach. And the adoption of this targeting approach has helped the Federal Reserve contribute importantly to the declining inflation rate. Nevertheless, our monetarist critics continue to be unhappy. If only the Federal Reserve would smooth out short-run money growth, they say, interest rates would then come down. Or, they say, if the Federal Reserve would focus on just one measure of money, erratic money growth behavior would then be avoided. Let's look at these two issues.

First, what about the proposition that the Federal Reserve should closely control the short-run growth of money? If this were done, it is contended, the money growth path would be smooth, uncertainty would vanish, and interest rates would fall.

In my view, however, the Federal Reserve simply cannot control the monetary growth rate precisely on a weekly, monthly, or even a quarterly basis. Most of the nation's money stock consists of deposits at depository institutions, and the public's use of these deposits are not and should not be controlled by the Federal Reserve. We do have the ability to influence the money supply over the longer term by affecting the volume of reserves available, which in turn, influences the lending and investing activities of depository institutions.

Furthermore, and more important to the issue, the Federal Reserve has no control over the public's demand for money, which we know to be quite volatile in the short run. This volatility frequently causes wide short-run swings in the growth rate of money. Thus, the Federal Reserve can do little about short-run swings in money growth, and no tinkering with monetary control procedures will allow the Federal Reserve to closely control the weekly, monthly, or quarterly growth rate of money. I should also note that those who advocate procedures for greater short-run control completely ignore or discount the greater interest rate volatility that would accompany such procedures.

Next, what about the proposal that erratic short-term money growth could be avoided if the Federal Reserve would simply focus on one definition of money? In my view, such tunnel vision would be risky, primarily because of the rapid financial innovation now taking place.

The recent growth of money market funds, cash sweep accounts, and other new financial techniques is a troubling issue for monetary policy at the present time. Innovation is having an important impact on the public's demand for money balances, complicating our understanding of what constitutes money and, as a result, the relationship of money to economic activity.

For example, financial innovation has led to some reduction in the public's demand for traditional transaction balances. This shift affected the closely watched M1 measure of money in 1981 and is probably continuing this year. For other, not fully understood reasons, M1 has been surprisingly strong this year, making interpretation of its behavior more difficult. The broader measures of money have also been difficult to interpret, because of financial innovation. For example, M2 has been affected by the public's shifts to money market funds and other funds included in this broad measure. In view of these problems of interpretation, it seems clear to me that it would be a mistake for the Federal Reserve to focus on only one of the current measures of the money supply.

Thus, the Federal Reserve must retain its flexibility in the face of financial innovation. If the monetary aggregates are made less reliable guides by innovation, then the risk of errant policy can only be compounded by limiting the Federal Reserve's flexibility to watch various aggregates.

Some of our monetarist friends have put forward other proposals of a technical nature. For example, they suggest that imposing a system of contemporaneous reserve requirements on depository institutions would improve our short-run monetary control. A companion proposal calls for the Federal Reserve to adopt a penalty discount rate. Our research indicates that a penalty rate would help monetary control *only* if contemporaneous reserve accounting were implemented. And if we did implement CRA, such procedures would be costly for financial institutions to implement and, our research shows, would produce little meaningful benefit in achieving firmer monetary control. More importantly, these two changes would likely increase interest rate volatility substantially, and lead to undesirable disruptions in the financial and real sectors of the economy.

Aside from these proposals by monetarists, others who are concerned about high interest rates have suggested that the Federal Reserve simply take action to increase the money supply now. After all, their argument goes, an increased supply surely will bring down the price. While the appeal of this view is understandable, I believe that an attempt to increase the money supply beyond the current targets would be dangerous and ill-advised given the current environment.

To understand why such a simple proposal would be ill-advised, it is useful to examine why interest rates are so high in the current environment. We all know, for example, that interest rates should fall as economic activity declines. Unfortunately, downward pressure on rates because of economic weakness is being largely offset by other factors—primarily the public's perception of the effects of very large federal budget deficits. These large deficits remain the most important factor, in my judgement, in explaining the persistence of high interest rates. Because budget deficits must be financed by borrowing in the nation's capital markets, this heavy demand is helping keep rates high. Many investors also apparently believe that the large projected deficits will lead to a renewal of strong inflationary pressures and sharply higher interest rates as soon as the economy recovers from the recession. It is obvious to me that because of these uncertainties, investors are reluctant to make long-term commitments. By avoiding the bond markets and staying short, investor psychology is contributing to the high levels of interest rates.

However, assume for a moment that the Federal Reserve did take action to increase the supply of money and credit. What would be likely to happen? First, there might, indeed, be some temporary reductions in short-term interest rates. But as concerns about a rekindling of inflation spread, lenders would seek to protect themselves against inflation by incorporating a higher inflation premium into their rates. Because of these inflationary fears, long-term rates would not move down, but would likely move even higher. As a result, users of long-term credit, such as housing and the corporate business sector, would be left high and dry. And corporations would continue to find it difficult to restructure their balance sheets.

Thus, in my judgement, interest rates can only be brought down by a resolution of the federal budget stalemate. So long as that impasse persists, any Federal Reserve action to add monetary fuel to the economy will have a perverse effect. Furthermore, lower interest rates will not result from the application of monetary gimmickry or by taking away the independence of the Federal Reserve. In fact, such proposals do a disservice because they divert the attention of policymakers and the public through claims that simplistic solutions are at hand for complex problems.

While there are no easy solutions to our near-term economic problems, I think it is a mistake to be a gloomy pessimist. Despite our problems, I reject the notion that a 1930s-style economic depression is in the wings. Rather, I see economic recovery beginning about midyear, spurred by increases in consumer spending. With continued progress on the inflation front, consumers will be in a more confident mood when the midyear tax cut takes effect. Their spending will encourage business to build inventories, and the process of recovery should be under way.

Whether the recovery is robust or modest in 1982 will depend largely upon the course of interest rates. Continued high rates will dampen recovery, while lower rates will have a more positive effect. As I have noted, the key to lower rates and the trigger for renewed economic growth is to resolve the stalemate over fiscal policy by making significant reductions in the projected budget deficits. Reduced deficit projections will restore investor and consumer confidence that the nation is willing to deal with its problems. In addition, less deficit financing will tend to relieve pressure in financial markets and reinforce downward influences on interest rates coming from moderating inflation.

Looking beyond the economic problems of 1982, I am optimistic. The nation's broad economic strategy, which incorporates deregulation and incentives for savings, investment, and productivity, shows real potential as a path to a bright economic future. From my perspective, the Federal Reserve's commitment to a monetary policy which seeks to foster noninflationary economic growth fits perfectly with these other objectives.

There is a strong economic future ahead of us. I am confident that the recovery will occur and that an extended period of economic growth is out there waiting to begin. There is no reason we cannot achieve this potential if we have patience, if we act firmly now to achieve an accord over the deficit issue, and if we resist the tempting sirens of economic quick-fix solutions.