# Conduct of U.S. Monetary Policy: Recent Problems and Issues

*by Roger Guffey*

From my perspective as president of the Federal Reserve Bank of Kansas City during the past four years, and my association with the System in the previous decade, there is no doubt in my mind that the most serious problem facing monetary policy today—both in the United States and abroad—is the chronic inflationary environment that is now gripping the economies of the entire free world. As a consequence of this inflationary environment, the normal flow of financial savings into productive investment has been seriously reduced, economic growth and job opportunities have diminished, and the stability of the international monetary system has been periodically threatened. In sharp contrast to the period of the 1930s, when chronic unemployment was the No. 1 economic problem, chronic inflation is clearly the No. 1 economic problem of our day.

As a central banker, I find this situation to be highly disturbing. After all, it is generally agreed that the most fundamental task and responsibility of a central bank is to provide for the continued soundness and stability of its nation's currency, both domestically and internationally. If this is true, however, it must be concluded that central bankers have not been as effective as they should be in coping with the inflationary problem.

In trying to rationalize this uncomfortable conclusion, it is very easy to come up with numerous nonmonetary causes of the inflation spiral. In the United States, for example, it is often claimed that a large part of the inflation is due to exogenous or uncontrollable shocks to the economic system—such as the worldwide crop failures and devaluations that occurred in the early 1970s, and the sizable oil price increases of recent years. It is also argued that the regulatory burden of government has become so pervasive as to discourage innovation and new investment which, in turn, have contributed to a slowdown in productivity and an upward ratcheting in unit labor costs.

On a more fundamental level it is said that, beginning in the mid-1960s, there was a marked upward shift in the demand for government services on a broad social level. And, as part of that shift, there was a renewed emphasis placed on government policies designed to attain full employment—even at the cost of incurring an increase in the degree of inflation. The net effect of this shift in the role and emphasis of governmental policies was to impart an inflationary bias to the economy

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which, it is claimed, the Federal Reserve, as a public institution, found difficult to resist in its entirety.

## THE MONEY-PRICE LINK

While these and other nonmonetary explanations of inflation have varying degrees of appeal, it is, nonetheless, difficult to ignore the basic long-run relationship between money and prices. As most economists agree, an expansion of money and credit in excess of the long-run output potential of an economy will invariably lead to a rise in the overall price level. This relationship is not new, of course, but its importance has become incrreasingly emphasized by central bankers in the conduct of monetary policy. In the United States, as you may know, the Federal Reserve has publicly announced its desired growth rates of money and credit for the year ahead since 1975. These targeted growth rates have been almost steadily lowered out of a desire to gradually reduce the rate of inflation.

Despite these good intentions, however, the actual growth rates of money and credit have tended to be in excess of our established targets, especially during the past half year. I can assure you that these excesses in money growth, both this year and last year, were neither intended nor desired by any member of the Federal Open Market Committee (FOMC). Rather, I believe these excesses were the direct consequence of the inflationary spiral itself, which distorted and obscured the very informational variables through which we have traditionally conducted monetary policy.

One informational variable that central bankers have traditionally utilized is the level of nominal interest rates. As a general rule, rising interest rates are taken as a sign of restraint. Also, high and rising interest rates are deemed consistent with trying to curb the demand for money growth. In times of rampant inflation, however, interest rates become a very poor guide for policy and a very poor instrument for controlling money growth. That is because an inflationary premium tends to be incorporated into interest rates, which makes it extremely difficult to know what, if any, restraint is being applied by a high level of interest rates. Needless to say, this problem became quite apparent in the United States over the past half year when-despite higher interest rates— money growth accelerated rapidly.

Other informational variables that have been distorted by the inflation spiral are the various concepts of money itself. With interest rates rising due to inflation, there has been an immense change in the practices of financial intermediaries and a virtual explosion in the development of near-money substitutes. As a result, many of the traditional measures of money no longer provide the same informational content as they did in the past; nor do they serve as a reliable guide as to what policy should be. Without a doubt, some of the rapid growth in money in the United States this year can be traced to difficulties in properly interpreting the data on the monetary aggregates. A resolution of these difficulties, I should note, is now being intensively examined by the Federal Reserve.

These and other factors have led to a marked increase in the growth rates of money and credit in the United States over the past half year. And, commensurate with this growth in money, inflationary pressures have accelerated and an inflationary psychology has become more widespread. As a reaction to these developments, the U.S. dollar came under very strong downward pressure in exchange markets this fall, the price of gold soared above $400 an ounce, and speculative activity increased sharply in other commodity markets. Quite clearly, there became a dire need for much more forceful measures of monetary restraint.

On the evening of October 6, the Federal Reserve announced a series of forceful and complementary actions designed to curb the growth of money and dampen the forces of inflation. These actions included: (1) an increase in our discount rate, (2) an imposition of marginal reserve requirements on managed liabilities of member banks, and (3) a change in the procedure by which we conduct monetary policy. Under the new procedure, less emphasis is now being placed on interest rates as a means of controlling money and greater emphasis placed on the supply of bank reserves.

The response to these actions has been both dramatic and widespread. Short-term interest rates in the United States have increased sharply, as the sizable demand for credit is now being limited by the available supply of credit. Also, the value of the dollar has improved in the foreign exchange markets and much of the speculative froth has gone out of the commodity markets. In short, the actions we took have thus far been well received and supported by both the financial community and the general public.

Of the three policy actions taken, the one receiving the most attention has been our shift to a new operating procedure to control the money supply. In some quarters, there has been considerable euphoria about this shift in procedure. Some people, for example, have hailed it as a complete victory for the monetarist school of thought and even as the ultimate solution to our monetary problems. Needless to say, many of these assessments have tended to go too far.

Without a doubt, recent events have demonstrated clearly the need for a change in our operating procedure. Pegging an interest rate to achieve our money supply targets was just not producing the intended results. Therefore, 1 am very much in favor of the change to the new operating procedure, which emphasizes bank reserves, and I enthusiastically support it.

It should be well understood, however, that a reserve-targeting procedure in the United States is not a simple, risk-free technique. On a very basic level, the new procedure does not assure that our targeted growth rate of money will, in fact, be appropriate for the economy. Nor does it resolve the problem of determining which concept of money the Federal Reserve should try to control. Answers to these questions will still require considerable analysis and flexibility in policy operations.

## POTENTIAL SLIPPAGES

On a more technical level, we fully recognize that there can be potential slippages between the growth rate of bank reserves and the growth rate of the money supply. These slippages might occur for two reasons. First. our ability to control bank reserves may not be overly precise, especially in the short run. And, second, there may be variability in the multiplier relationship between bank reserves and the month supply. The latter is very likely to be true in the very large and diffuse banking system that exists in the United States. A further consideration is that it is not reasonable to expect the Federal Reserve to ignore entirely ongoing developments in the money and capital markets or in the foreign exchange markets just to rigidly pursue a reserve-targeting procedure.

These considerations suggest, it seems to me, that not too much too soon should be expected from our shift to a new operating procedure. Many basic conceptual and technical problems still remain unresolved. Moreover, precise control of the money supply is just not likely to be achieved, especially over a short period of time. Thus, an evaluation of this new technique can only be made in an objective manner after it has been in effect for a longer period of time.

Despite these words of caution about our new procedure to control the money supply, I want

to emphasize that the new technique — along with our other recent actions--offers great promise in our battle against inflation. While it is true that the U.S. economy may experience a temporary period of adjustment, our recent actions were taken with longer run objectives in mind. To the extent we can reduce the growth rate of money to moderate proportions, it is very likely that inflationary expectations will be diminished, the high level of interest rates will subside, and confidence in the purchasing power of the dollar will be restored.

I am sufficiently realistic, however, to believe that our battle against inflation has only just begun. Indeed, even though the actions we have taken have been both dramatic and forceful, it is rather simplistic to view our change to a new operating procedure as the sole solution of the problem of inflation. The inflationary bias of our economy — and the economies of other countries, too — is a very deep-rooted problem. It is lodged in the basic political and philosophic thought that has influenced our economic system during the past two decades. Thus, the battle against inflation promises to be very long and arduous.

## PRINCIPLES FOR POLICY

As an absolute prerequisite for our battle against inflation to be successful, I believe central bankers must do a much more effective job than we have in the past. In short, we can no longer be unwilling participants in the inflationary process. To assure that we will be more effective, I believe our policies must be guided by the following principles.

1. Emphasis should be given to a firm and restrictive monetary policy stance. By itself, a better technique to control money is no assurance that the right growth rate of money will, infact, be sought. What is required to correct inflation is a significantly lower expansion of money and credit.
2. The implementation of a restrictive monetary policy must be highly credible in the eyes of the public. In any venture, it is self-defeating to promise more than is delivered. So, too, in central banking. Thus, to be credible, an anti-inflationary policy must actually achieve a significantly lower growth rate of money and credit.
3. Finally, and perhaps most importantly, restrictive monetary policies must be followed in a consistent manner. All too often, restrictive policies are put into place only for a very short period of time at the peak of the business cycle — when fighting inflation is a popular cause. For the rest of the business cycle, however, these policies are often quickly abandoned — in both the downturn and in the subsequent upturn. The net result is that policies have an expansionary bias most of the time, which does much to explain the persistence of the inflationary problem. Therefore, it follows that an effective monetary policy will need to adopt a restrictive stance consistently throughout the business cycle.

The adherence to these principles of monetary management, I believe, will enable us to achieve significant progress in curbing our chronic inflationary problem. The task ahead, however, promises to be both long and difficult and severely challenging. Nonetheless, recent anti-inflationary actions taken by the Federal Reserve should serve to forcefully underscore our desire to rise up and meet that challenge successfully. If is my fervent hope that we, as well as other central banks, will vigorously pursue this course. By so doing, we can clearly demonstrate the economic leadership that is vitally needed to restore price stability and economic vitality to the nations of the free world.

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