6-1967

Current and Recent Monetary Policy

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Some of the problems that now confront monetary policymakers, or that have been faced in the recent past, are the result of long-term adjustments in the economy. Others are a consequence of past fiscal and monetary operations. The theme of this statement is that recent monetary policy operations have been a main cause of the recent inflation and of the decline in industrial production. Policy operations have been both too large and too variable to achieve the fullest use of resources without inflation. Large increases in the quantity of money and in its growth have been followed by large contractions and then by renewed rates of increases of money that are almost certain to increase the rate of inflation in the near future. It is clear that large, frequent adjustments in policy during the past few years did not prevent inflation in 1966, and have not prevented a reduction in industrial production and in the growth rate of total output in 1967.

My theme, however, requires additional discussion. It is not enough to point to the price increases in 1966 and the decline in real g.n.p. in early 1967 to support my argument. Others may claim that these events are the result of "special factors" that operated during the period or that some of them are mainly the
result of fiscal policy. However, it is not necessary to argue that
the government's budget deficit and spending for Vietnam did not
contribute to the inflation in 1966 and will not contribute to
inflation in 1967. Moreover, I do not wish to deny that the budget
deficit and its financing prevented the decline in output from
becoming larger. Fiscal policy changes, however, seem to me to be of
less significance for understanding the recent past or anticipating
the future than the average size and particularly the variability of
changes in the stock of money.

Although some have argued that, at times or under some circum-
stances, the Federal Reserve cannot control the stock of money,
inability to control the stock of money has not been a problem in
recent years. Both the size and variability of recent changes in
money are to a large extent the result of changes in monetary policy.
Changes in the monetary base -- reserves and currency -- and in the
reserve requirement ratios have been the main source of changes in
money. Changes in the monetary base and in the reserve requirement
are, of course, the result of monetary policy decisions. Indeed, for
the purposes of this discussion the distinction between changes in
the stock of money and changes in monetary policy operations are of
consequence primarily if we consider the precise amount or timing of
the changes that have been made, since there is a lag or delay between
the time that monetary base changes and the time that the money stock
changes. The lag between changes in policy and changes in money,
however, is much shorter and much less troublesome than the lags
between changes in money and changes in prices and output that I
discuss below.

The Effects of Recent Monetary Policies

If prices and output responded very quickly to policy changes,
sudden, large changes in the growth rate of money would be reflected,
after a brief lag, in the movements of output and prices. The
Federal Reserve could expect that the effects of the very large decline
in the growth rate of money last spring or of the decline in the
money stock last summer would have quickly and almost fully offset
the very high rate of monetary expansion in 1965, and early 1966,
and would in turn be fully offset by the very high average rate of
monetary expansion from December, 1966, to June, 1967. I say fully
offset because the 2% average rate of growth in money from May, 1966,
to May, 1967, is not very different from the average rate of growth
in money during the post-Korean period and would have produced results
similar to (or not very different from) the average results of these
years, if the variability of policy was of no consequence. The 2% 
average rate of increase in money during the past year or the higher
(3.3%) rate of increase in money from August, 1966, to June, 1967,
have been accompanied by a very expansive fiscal policy. If output
responded very quickly to policy operations, output and industrial
production would now be expanding rapidly as a result of recent
monetary and fiscal policies.

The variability of monetary policy -- the large changes in the
size and direction of policy operations during short periods of time
-- seem to me to be of greater importance for understanding our
present position than the longer-term averages I have just presented.
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The reason is that the economy gradually adjusts to any maintained average rate of change of money. If the maintained average rate of change of money is relatively large, the domestic price index rises and, under fixed exchange rates, gold flows out. If the maintained average rate of change of money is relatively small, prices fall and with fixed exchange rates, gold flows in. The public learns to expect rising, falling or unchanged price level and gradually takes action to protect itself from the consequences of price change. There is abundant evidence that the public learns to expect -- and learns to adjust to -- a given average rate of change of money.

While I do not wish to suggest that the long-term average rate of monetary expansion is unimportant, the average rate of monetary expansion during the past year or two does not explain the sequence of inflation, falling output and renewed inflation that we have experienced or can expect in the future. The variability of monetary policy is far more important for understanding this sequence of events.

A main reason that the variability of monetary policy is troublesome is that prices and output respond to policy changes only after a variable lag. There are several reasons why we should expect the lag between policy action and its effect to be variable, and I will mention only a few. First, monetary policy does not operate according to a computer program spreading its effect from one sector to another in a regular pattern. It works by changing the demand, prices and production of particular commodities, by altering individual decisions about the relative merits of present and future consumption
and business decisions about production. Second, the length of the
lag depends in part on the path taken by the changes in spending
induced by the increased or decreased quantity of money. More
importantly, the length of time required before changes in money
affect the price level depends on the past rate of expansion in the
economy, the current and past growth rate of the capital stock, and
the previous rate of price change. Once the public expects prices
to rise, the effect of the increase in demand induced by monetary
expansion affects the price level more quickly. Furthermore, the
length of the lag depends on the variability of policy. A very large
change in policy causes individuals and firms to revise expectations
and to generate new money more quickly.

When the rate of monetary expansion accelerated in the fall
of 1965 and the winter of 1966, the inflationary effect of the
high rate of change of money increased. The sudden reversal of policy
during the summer of 1966, reduced the growth rate of money from a
6 or 7% annual rate of increase to a two or three percent annual
rate of decline. This sudden change, as always, affected demand and
output and reduced the rate of change in prices. The suddenness of
the contraction in money meant that output and prices responded more
quickly to the change in the direction of policy.

Unfortunately, policy again changed direction suddenly in
December, 1966, and the rate of monetary expansion increased greatly.
The current rate of monetary expansion will revive and increase the
expectation of inflation. Recent changes in short- and long-term
interest rates and in union demands for contract terms suggest that these expectations are now becoming a part of long-term contracts.

Let me make clear that I do not question that, in principle there are combinations of fiscal and monetary change that can -- through a series of frequent and careful adjustments -- increase industrial production and real g.n.p. while preventing inflation and reducing expectations of future inflation. Recent practice suggests, however, that we have not found that combination of policy changes. I doubt that we have sufficient understanding of the short-term effects of policy operations to find such combinations in the near future.

Policy for 1967 - 68

My argument leads me to suggest that recent rates of growth of money and the variability of monetary policy have created more problems than they have solved. Expectations of inflation have been revived, inflation has occurred and output has declined. In my view, the variability of monetary policy has contributed substantially to this sequence of events.

A find, on the other hand, few if any benefits to match the problems that have been posed. Little benefit to the economy resulted from the increased rate of expansion in money during the winter of 1966, or the winter and spring of 1967. At best, policy during the winter and spring of 1966 postponed until summer part of the rise in interest rates required to prevent inflation.
To the extent that the delay permitted expectations of price change to be formed, it caused interest rates to be higher and thus raised the size of the reduction in money required to reduce long-term rates to a desired level and to eliminate the expectation of inflation. Moreover, monetary policy in early 1966 moved the economy farther away from balance of payments adjustment at the present rate of exchange. The sharp decline in money during the summer and fall and the renewal of a high rate of monetary growth in the winter also raised the cost of adjustment without adding comparable benefits.

At present, the decline in output appears to have slowed, and there are signs of increased demand by the private sector. I expect the increased demand to be accompanied by rising prices; in fact, I expect prices to rise even if output rises only slowly in the latter part of the year.

If the Federal Reserve again responds to rising prices by reducing the quantity of money, the sequence of events that I have described will be repeated. The decline in money will first induce a decline in output and only later will reduce the rate of inflation to zero. To avoid or at least reduce the size of the decline in output while reducing the rate of inflation, monetary policy must provide a less variable rate of change of money. Past experience suggests that if an approximately three percent rate of growth of the monetary base is maintained for the next six to twelve months, real output will rise and the expectation of inflation will decay gradually. This is the policy I recommend as most appropriate for achieving full use of resources without inflation.