The Role of Money in Economic Policy

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Published In
Controlling monetary aggregates: Proceedings of the Monetary Conference, held on Nantucket Island.
The Role of Money in Economic Policy

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Prepared for the Nantucket Monetary Conference
June 9, 1969

There is no single answer to the question implied by the title of this session. The role of money in economic policy depends now, as it always has, on three closely related aspects of the environment within which policy operates. The three aspects are: the prevailing international arrangements, the domestic framework within which monetary policy operations are conducted, and the amount of information about the economic system that is reliably possessed.

I discuss each of the three briefly. If I had more time, I would direct attention to the third and most neglected of the three aspects.

The main points to be made about international arrangements are that the tasks of monetary policy depend on whether trading policies are more rather than less liberal and on whether adjustments to balance of payments surpluses or deficits are made by changing exchange rates or through some other means. Where trade policy is liberal, there is a presumption that tariffs or other restrictions will not be used as the main corrective for balance of payments deficits, so more of the adjustment to imbalances must be made by adjusting the exchange rate or the rate of inflation. Where the maintenance of a fixed exchange rate system is accepted as an end or social goal by the governments of major trading countries, changes in exchange rates -- whether of the periodic or freely fluctuating variety --
are foresworn. The long-run policies of the countries adhering to the fixed exchange rate system must be directed toward maintaining a uniform rate of inflation in each of the trading countries, and short-run policies can deviate from long-run policies only to the extent that countries are willing to lend or to tolerate a redistribution of reserves.

By accepting the fixed exchange rate system, a country gives up a considerable part of its freedom of action with respect to monetary policy and in principle accepts responsibility for maintaining a rate of inflation equal to the rate of inflation in other trading countries. In practice, governments have been reluctant to change exchange rates but even more reluctant to pursue policies designed to maintain the rate of inflation consistent with prevailing exchange rates. Instead, governments have searched in recent years for combinations of monetary and fiscal policies, or for supplements to these policies, that would hold down the rate of inflation or hide its effects, the supplements most often taking the form of restrictions on trade of capital movements or indirect controls of prices and wages by means of guidelines, guideposts or incomes policies. Without analyzing the details of each experience, it seems reasonable to conclude from the evidence we have that neither guideposts nor incomes policies have produced any substantial reduction in rates of inflation. For the past twenty years, GATT rules, a laudable commitment to liberal trade policies and fear of retaliation have limited the extent to which governments have been able to impose trade restrictions. Controls on capital movements, however,
are more readily accepted by the governments of both capital exporting
and capital importing countries, and in recent years such controls have
helped deficit countries and particularly the United States to maintain
a higher rate of inflation than is consistent with the current exchange
rate and dollar price of gold. For the U.S., the longer-term effect of
this policy has been to increase imports relative to exports and shift
the balance of trade from surplus toward deficit. This was not a necessary
consequence of the policy. The time that was purchased by imposing
restrictions on capital movements could have been used to reduce the
rate of inflation and maintain the exchange rate. Although I do not
believe that the use of capital controls is justified by a policy
of reducing the rate of inflation, the combination is certainly more
desirable than the policies we have followed.

My present purpose is not to offer a critique of past policies but
to discuss the broad framework within which monetary policy decisions are
made. I mention the failures of past policies to end inflation and
achieve equilibrium in the balance of payments because consideration of
these failures adds considerably to our understanding of that framework.
In my judgment, two closely related reasons help to explain why the rate
of inflation was not reduced after capital restrictions were introduced.

One reason is that the institutional setting within which monetary
policy operates has become increasingly complex. Regulations affecting
the reserve requirement ratios for time deposits, the computation of
excess reserves, and the rates payable on time deposits have become considerably more complicated in recent years. The proposed change in borrowing arrangements for member banks adds to the complexity. These arrangements make it more difficult for policymakers to judge the effects of their own past actions. Since knowledge of past actions and their anticipated effects is a prerequisite for rational policy decisions, it is hard to justify either the new or many of the old regulations. To cite one example, the failure to raise Regulation Q rates -- alleged to be part of the Federal Reserve's current anti-inflationary policy -- has the effect of raising demand deposits and increasing the narrowly defined money stock. The Federal Reserve can, of course, offset the effect on money by reducing the growth rate of the monetary base. My point is not that the Federal Reserve cannot stop inflation but that a policy action that is believed to be of considerable importance for controlling inflation has the opposite effect.

A second, related but more important reason for the failure to slow inflation in recent years is the reliance on an inappropriate indicator to measure the current thrust of monetary policy. The inappropriate indicator is, of course, the market rate of interest and the misinterpretation is that high or rising market interest rates are considered restrictive and low or falling rates are considered expansive. Use of an unreliable indicator -- more than any other single fact -- explains the misinterpretation of the effect of policy actions throughout monetary
While there are several very different reasons underlying the mistaken belief that levels or changes in market rates of interest are primarily the result of monetary policy, the principal source of the error is the neglect of the effect on interest rates of changes in borrowing and in desired holdings of securities -- effects that occur on the credit, not the money, market.

An open market purchase expands the monetary base and lowers market interest rates. The rise in the base increases the nominal stocks of money and bank credit. If these were entire effects of monetary policy, high growth rates of money and low market interest rates would occur together during periods of economic expansion. However, market interest rates generally rise in periods of economic expansion and fall in recession, opposite to the movement predicted by those that rely on interest rates as indicators.

A main reason that interest rates, economic activity and the growth rate of money generally rise and fall together is that expansive monetary policies increase the desired amount of borrowing by consumers and business, and the increased borrowing reverses the initial effect of monetary policy on interest rates. The rise in interest rates during periods of expansion results principally from the decisions of consumers and business that are carried out on the credit -- not the money -- market.

This position, rejected by many economists and by the Federal Reserve through most of its history, has now been accepted by its principal spokesman. Let me quote from Chairman Martin's statement of March 25 to the Senate Banking Committee:
"I do not mean to argue that the interest rate developments of recent years have had no relation to monetary policy. We know that, in the short-run, expansive monetary policies tend to reduce interest rates and restrictive monetary policies to raise them. But in the long-run, in a full-employment economy, expansive monetary policies foster greater inflation, and encourage borrowers to make even larger demands on the credit markets... Over the long-run, therefore, expansive monetary policies may not lower interest rates; in fact, they may raise them appreciably. This is the clear lesson of history that has been reconfirmed by the experience of the past several years."

With that statement, I believe Chairman Martin abandoned the framework that has guided Federal Reserve policy through most of its history and that has been responsible for most of the major errors in policy.

The role assigned to monetary policy depends on the amount of information reliably possessed. If policy decisions are based on a better validated, clearer understanding of the monetary process in the future, discretionary monetary policy can be used to provide more stability than it has in the past. On the other hand, if increasingly complex regulations increase the amount of knowledge required for rational decisions, the best policy may continue to be a policy of relatively infrequent change in the growth rate of money.