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Statement on Monetary Policy

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Testimony prepared for the Senate Committee on Banking, Housing and Urban Affairs

November 15, 1976

by

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I last had the pleasure of appearing before this committee in February 1975 when the subject for discussion was the Senate Concurrent Resolution on Monetary Policy that soon became House Concurrent Resolution 133. In my statement urging the committee to adopt the resolution, I listed some benefits that I expected to follow adoption. The greatest benefit was expected to be a more stable monetary policy, and I expected that improvement to be achieved only if the Federal Reserve adopted procedures that looked beyond the problems of the money market to the longer-term effects of monetary policy operations.

The resolution has produced some of the expected effects. The Federal Reserve has responded to the resolution by adopting monetary targets for a year in advance and has kept the growth rate of money within the specified range. The growth rate of money has been held in a range consistent with lower inflation, so the rate of inflation has been reduced as the economy recovered from the recession of 1974-75.

The experience of the United States is reinforced by experience abroad. Countries that have announced growth rates of money, or some monetary aggregate -- Germany, Switzerland and the United States -- have recovered from recession with lower rates of inflation than other developed countries. These three countries can look forward to continued recovery and lower inflation if the growth rate of money remains controlled.

Some witnesses who appeared before the committee last May urged a substitution of an interest rate target for a monetary target. Adoption of a target rate of interest has also been suggested by some members of
the Congress as a substitute or a supplement for the monetary target. I would like to comment on these proposals and to recommend against them. Then I will discuss a procedural change to improve operations under the monetary target. Finally, I will discuss some effects of recent policy and recommend a monetary policy for the next year.

An Interest Rate Target?

House Concurrent Resolution 133 expresses the sense of Congress that the Federal Reserve should seek lower long-term interest rates as well as maximum employment and stable prices. Federal Reserve policy has achieved lower interest rates on short and long-term instruments without a specific target for interest rates. At about the time the resolution was passed, the rate of interest on the longest-term bond issued by the Treasury was approximately 8-1/4%. Currently, the same bond yields about 7-3/4% to maturity. The decline in rates on intermediate-term bonds is larger than on long-term bonds. Yields on bonds with five years to maturity have fallen almost one full percentage point during the past eighteen months.

Reduced inflation and anticipations of future inflation are the principal reason that long- and medium-term interest rates have declined. The reduction is a consequence of the lower rate of monetary expansion and the adoption of new budgetary procedures that have permitted savers and investors to believe that recovery can be achieved while the rate of inflation falls.

Those who urge that an interest rate target be adopted usually suggest that the target be a short-run rate of interest. I believe that an interest rate target not only would fail to increase the contribution of monetary
policy to economic stability but such a target would reduce the contribution. There are two related reasons. First, my studies of the conduct of monetary policy under the Federal Reserve Act during the past sixty or more years lead me to conclude that the principal errors of monetary policy have resulted either from an attempt to control the market rate of interest or from the use of market rates of interest as an indicator of current monetary policy. Second, market rates of interest are not easy to predict or to relate to precise levels of inflation and real output.

Recent experience is consistent with the experience over many years. Short-term rates of interest, whether measured by the Federal funds rate on one day loans or the rate on three month Treasury bills, are lower now than was anticipated only a few months ago. The published report of the hearings before this committee last May contains (page 49) estimates of the Federal funds rate made by one of the leading forecasting companies, D.R.I. Their forecast indicates that the Federal funds rate in the current quarter would be 5-3/4% with the rate of monetary expansion at more than 9%. In fact, the rate of monetary expansion is much less than 9% and the Federal funds rate is about 5%, much lower than the forecast.

If the Federal Reserve tried to achieve a 5-3/4% Federal funds rate in this quarter, the rate of monetary expansion would have to be reduced considerably. Monetary policy would be less expansive and would, therefore, contribute less to employment and recovery. The example illustrates the problem of using interest rates as a guide to monetary policy. Critics of monetary aggregates like to point out that there is slippage in the short-run relation between the growth of any monetary aggregate and the growth of output.
They usually fail to note that the relation between money growth and the growth of GNP or other broad measures of output, though far from constant, is considerably more stable than the relation between interest rates and the growth of GNP.

Recent experience is instructive. The money market gives a forecast of future rates of interest every day. In late June 1976, the market forecasts of the rates on Treasury bills for the three months beginning in September 1976 was 5.9%. Three months later, Treasury bills carried a rate of less than 5%, an error of about one percentage point. In late June, the market believed that three month Treasury bills would yield about 6-3/4% in December 1976. Currently the market believes the same bills will yield less than 5%. In a very short period of time, the market has changed its mind considerably.

Recent work on the theory of interest rate changes indicates that on average market forecasts of interest rates are as good as any forecast available. The market reflects the composite opinion of the many skilled professionals who support their judgment by investing large sums. The Federal Reserve could not expect to do better, on average, than the market forecast. Hence, the large errors in recent forecasts of interest rates are indicative of the minimum errors to be expected from Federal Reserve efforts to set interest rate targets instead of money stock targets.

A recent published study by Michael Hamburger and Elliott Platt of the Federal Reserve Bank of New York provides some information on the forecasting ability of market participants. The study shows that, on average, market participants efficiently use available information about the future course of the economy. Yet, on average, their forecasts of future interest rates are no better than the simple forecasts that rates will remain unchanged.
If the Federal Reserve had used interest rate targets in recent months, it seems likely that the errors in monetary policy would have been increased. If interest rates had been held at the June level, the money growth rate would have been lower; or, equivalently, if the Federal Reserve had tried to achieve the November interest rate by monetary expansion, they would have over-estimated the required rate of monetary expansion by a large margin.

The main reason that the error would have occurred in the recent past and can be expected in the future is that the relationship between market rates of interest and rates of monetary growth depends on developments in the credit market and on the anticipations that credit market participants hold about the future. The anticipations are of several kinds; anticipations about the near term growth of the economy, the amounts of saving and investment that will be generated at the anticipated level of income; anticipations of the amounts of borrowing and lending that will occur, and anticipations about the rate of price change likely to occur.

We are not without information about the Federal Reserve's ability to forecast interest rates. During most of its history, the Fed used interest rates as the target of monetary policy, and the practice continues. During these years, the Federal Reserve generally under-estimated the rise in interest rates during periods of economic expansion and under-estimated the fall in interest rates during periods of economic contraction. We know this is so because the growth rate of money has generally been too high during periods of expansion and too low during periods of contraction. Consequently, expansions culminated in inflation and contractions were prolonged and
exacerbated. This is precisely the pattern to be expected if the Federal Reserve replaces money stock targets with interest rate targets.

Since interest rates are difficult to predict, the Federal Reserve would have great difficulty choosing and meeting interest rate targets for a year in advance. The result would be a return to the very short range focus of monetary policy. Instead of directing monetary policy toward the task of stabilizing the economy, we would once again use monetary policy to stabilize the short-term credit market often at the cost of greater fluctuations in prices and output. This was the pattern prior to Resolution 133, and I believe the pattern would be restored if the Congress replaces monetary targets with interest rate targets.

Improving Procedures

Although I favor continued use of a monetary target, I believe that current procedures for setting the target can be improved. At present, the Federal Reserve changes the target growth rate of money each quarter. The reason is that the Federal Reserve has chosen to express the target as an annual growth rate from a moving four quarter base. Each quarter, the Fed announces an upper and lower target rate of growth for the next four quarters.

There are erratic changes in the quarterly rates of growth of money. The Fed must decide each quarter how much of the erratic movement should be removed by raising or lowering the growth rate projected for the next four quarters. If the Fed is cautious about changing the growth rate, as appears to be the case, erratic changes in the base from which the projections are made are built into the money stock.
As an example, I have chosen the month of June 1976 to indicate some of the effects of past decisions. There are four announcements of money growth rates that can be used to project the expected upper and lower values of the money stock for June 1976. I have averaged the upper and lower target to obtain the mid-point or implied target for \( M_1 \) for each of four dates.

Table 1 shows that the changes in the upper and lower target do not fully reveal the Federal Reserve's intentions with respect to the money stock. The \( 1/2 \% \) reduction in the lower target on January 20, 1976 was in fact a \( 1\% \) reduction in the mid-point of the range for money for June 1976. There can be -- and there are -- changes in the target money stock without any change in the projected growth rates or changes in the growth rates without any change in the projected money stock. A more useful procedure would be to have the Federal Reserve announce the mid-point of the range for the money stock a year in advance. This would remove any tendency to build past errors or erratic movements that have affected the base from which the projections are made. A range around the mid-point would be selected to guard against the anticipation that the Federal Reserve can achieve a specific numerical value. To use the example of Table 1 a target for \( M_1 \) in June 1976 of 307.3 could have been announced in June 1975. Or, preferably, a target average money stock should be announced for the quarter one year ahead. The use of quarterly averages would perhaps reduce some of the emphasis now given to weekly announcements of the money stock.

The June 1975 announcement would have been followed by an October announcement. If the Fed chose to keep the growth rate of money unchanged
the projected money stock would be the mid-point of the range that would be achieved with a constant rate of monetary expansion.

Table 1

<table>
<thead>
<tr>
<th>Date of Announcement</th>
<th>Annual growth rate</th>
<th>Implied Target for $M_1$ mid-point of target</th>
<th>Change in implied annual growth rate lower/upper</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 17, 1975</td>
<td>5% 7.5%</td>
<td>307.3</td>
<td>+ 0.2%</td>
</tr>
<tr>
<td>October 21, 1975</td>
<td>5% 7.5%</td>
<td>308.2</td>
<td>- 1.0%</td>
</tr>
<tr>
<td>January 20, 1976</td>
<td>4.5% 7.5%</td>
<td>305.0</td>
<td></td>
</tr>
<tr>
<td>April 20, 1976</td>
<td>4.5% 7.0%</td>
<td>302.6</td>
<td>- 0.7%</td>
</tr>
</tbody>
</table>

Reported $M_1$ 303.0

Money Growth and Inflation

Looking back over the first 18 months of experience under Resolution 133, there is reason for the committee to be more pleased than disappointed at the outcome. The growth rate of money has been erratic from month to month and, at times, from quarter to quarter, but the annual growth rate has remained relatively stable and has been brought to a less inflationary range. Inflation has been reduced, more than many observers believed likely a year or more ago, and a moderate recovery has been achieved.

The combination of moderate recovery and lower inflation is easier to criticize than to improve upon. Much of the criticism at one time or another voices the complaint of those who prefer faster recovery with higher inflation or slower recovery with zero or lower inflation. Such policies differ from recent policies by deferring solutions to the problem of inflation or the problem of unemployment to some unspecified future.
If we plan to continue reducing inflation as we recover from recession, the choices we face are more tightly constrained than much public discussion suggests. The inflation we face is the result of more than a decade of choosing to stimulate now and solve inflation later. Until recently, each attempt to reduce inflation produced unemployment and was followed by ever more stimulative policies. The result is an entrenched belief that the current policy of gradual reduction in the rate of inflation will not continue but will be replaced by more stimulative policies and followed by higher inflation.

The inflation we now have is mainly the result of maintained monetary expansion. Ending inflation requires lowering the average rate of monetary expansion. Actions that increase the growth rate of money contribute to the rise in prices or set up conditions that must be reversed if inflation is to be ended.

It is the maintained, average rate of monetary expansion that must be lowered if we are to eliminate inflation in this decade. When I testified in February 1975, I prepared a table showing the relation between five year average rates of change in money, prices and output for the years 1964 to 1973. I have brought the chart up to date to illustrate some effects of recent policy.

The chart compares the moving average rate of growth of money (currency and demand deposits) to the moving average rate of inflation, measured by the rate of change of the consumer price index, and the average rate of growth of real GNP.
### Table 2

Money, Prices and Growth in the United States: Five Year Average Rates of Change

<table>
<thead>
<tr>
<th>Five Years Ending</th>
<th>Money</th>
<th>Inflation</th>
<th>Real Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>2.2%</td>
<td>1.3%</td>
<td>3.8%</td>
</tr>
<tr>
<td>1965</td>
<td>3.1%</td>
<td>1.3%</td>
<td>3.4%</td>
</tr>
<tr>
<td>1966</td>
<td>3.6%</td>
<td>1.6%</td>
<td>3.1%</td>
</tr>
<tr>
<td>1967</td>
<td>3.9%</td>
<td>2.0%</td>
<td>3.2%</td>
</tr>
<tr>
<td>1968</td>
<td>4.7%</td>
<td>2.6%</td>
<td>3.0%</td>
</tr>
<tr>
<td>1969</td>
<td>5.2%</td>
<td>3.4%</td>
<td>2.3%</td>
</tr>
<tr>
<td>1970</td>
<td>5.2%</td>
<td>4.2%</td>
<td>2.2%</td>
</tr>
<tr>
<td>1971</td>
<td>5.7%</td>
<td>4.5%</td>
<td>2.1%</td>
</tr>
<tr>
<td>1972</td>
<td>6.2%</td>
<td>4.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td>1973</td>
<td>6.3%</td>
<td>5.0%</td>
<td>2.7%</td>
</tr>
<tr>
<td>1974</td>
<td>6.1%</td>
<td></td>
<td>2.4%</td>
</tr>
<tr>
<td>1975</td>
<td>6.1%</td>
<td>5.8%*</td>
<td>2.0%</td>
</tr>
<tr>
<td>1976**</td>
<td>5.8%</td>
<td>6.2%</td>
<td>2.5%</td>
</tr>
<tr>
<td>1977***</td>
<td>4.8%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* including 1974 rate of price change is 6.6 in 1974, 6.9 in 1975 and 7.2 in 1976

** based on preliminary data ending in August (prices), 3rd quarter real output and September (money)

*** assuming 4% money growth

There has been much talk about shifts in the demand for money, changes in types of deposits and other structural and institutional changes. Table 2 makes clear that none of these changes has greatly changed the relation between inflation and money growth. The moving average rate of inflation is most often within one to two percentage points of the moving average rate.
of inflation. When the money stock accelerates, the difference between maintained growth of money and inflation widens; when the money stock decelerates, the difference between the growth rates falls.

We are now completing the third year in which the growth rate of money has been held between 4% and 5%. The rate of inflation is now lower than during the last several years. Continuation of moderate monetary policy will bring continued reduction in the rate of inflation.

The cost of ending inflation is the loss of output from recession and the relatively low rate of economic expansion in the past year. Many of those costs are in the past. Many of the benefits lie ahead of us in the lower rate of inflation that can be achieved by further reductions in the growth of money.

I believe that desirable monetary policy for the next year would bring the stock of money -- currency and demand deposits -- to an average of $320 billion in the third quarter of 1977, approximately 4-1/4% above the level reached in the third quarter 1976. In the absence of a substantial increase in oil prices or other shocks, we can expect the rate of price change to continue to fall as the economy recovers.

When we compare the recent performance of economies that have controlled money and reduced inflation to economies that chose to "go for growth" through inflation, there can be little about which policies succeeded and which policies failed. Germany, Switzerland and the U.S. have moderate recoveries and lower inflation. Britain and Italy have high inflation and lower growth. Delay has most likely increased the cost of returning to full employment without inflation for them; moderate policies and reduced anticipation of inflation has lowered the costs for us.
This committee has contributed to improved policy through hearings that focus attention on plans for monetary policy and by insisting on the importance of money growth targets. I hope that the constructive role will continue in the next session, that Resolution 133 will be renewed and made permanent, and that the committee will, as in its Third Report on the Conduct of Monetary Policy, continue to favor "moderation that does not cause the public to expect a return of sharply higher inflation."