What is Our Monetary Policy?

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What Is Our Monetary Policy?
by Allan H. Meltzer

What is the monetary policy of the United States? No one knows. The Federal Reserve does not know because it does not have a policy that looks ahead more than a few months, and it avoids any attempt to develop one. It announces annual targets but does not adopt procedures capable of achieving them. Part of the administration frets publicly about monetary policy from time to time, but the administration has no authority to develop a monetary policy. The Congress has constitutional responsibility for money, but it is unwilling to require the Federal Reserve to announce and implement a long-term policy. It seems content to let the Federal Reserve announce its objectives at public hearings and then ignore them. Congress neither requires the Federal Reserve to achieve its announced targets nor to explain why there is little relation between what the Federal Reserve says and what it does.

Past history gives little reason to believe that the announcements are a reliable guide to what the Federal Reserve will do. Targets or objectives for money growth have been announced since 1975. They are rarely achieved. Although the Federal Reserve staff has claimed publicly that it can hold money growth within a narrow band around the announced growth rate, the Federal Reserve has not done so. Table 1 shows the difference between past announcements of money growth and reported or actual money growth.

The table suggests that the Federal Reserve has an inflationary bias. The average growth rate of money (M1) -- currency and checking deposits -- is above 7% for the eight year period. Federal Reserve errors are typically positive and average about 2 to 3 percentage points per year. As long as the Federal Reserve behaves as it has, inflation will be a recurring problem. Variable
rates of inflation and periodic efforts to slow inflation will continue to impose an unnecessary burden on the economy.

Table 1
Targets for M₁ Growth 1976-1983

<table>
<thead>
<tr>
<th>Year ending in 4th Quarter</th>
<th>Target Range</th>
<th>Target Mid-point</th>
<th>Actual or Reported</th>
<th>Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>4.5-7.5%</td>
<td>6.0%</td>
<td>5.8%</td>
<td>-0.20%</td>
</tr>
<tr>
<td>1977</td>
<td>4.5-6.5</td>
<td>5.5</td>
<td>7.9</td>
<td>+2.40</td>
</tr>
<tr>
<td>1978</td>
<td>4.0-6.5</td>
<td>5.25</td>
<td>7.2</td>
<td>+1.95</td>
</tr>
<tr>
<td>1979</td>
<td>3.0-6.0</td>
<td>4.5</td>
<td>7.4</td>
<td>+2.90</td>
</tr>
<tr>
<td>1980</td>
<td>4.0-6.5</td>
<td>5.25</td>
<td>7.2</td>
<td>+1.95</td>
</tr>
<tr>
<td>1981</td>
<td>6.0-8.5</td>
<td>7.25</td>
<td>5.1</td>
<td>-2.15</td>
</tr>
<tr>
<td>1982</td>
<td>2.5-5.5</td>
<td>4.0</td>
<td>8.5</td>
<td>+4.50**</td>
</tr>
<tr>
<td>1983</td>
<td>1st half 4-8</td>
<td>6.5*</td>
<td>9.6*</td>
<td>+3.10</td>
</tr>
<tr>
<td></td>
<td>2nd half 5-9</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* 1st half mid-point 6.0, actual 13.8; 2nd half mid-point 7.0, actual 5.4
** target abandoned in October; error for first three quarters is 2.8 at annual rates

Sustained periods of money growth at the average rate of 1982 and 1983, if continued, will bring inflation back to the level of the 1970's. The recession of 1981-2 will have no more than a temporary effect on the rate of inflation. The public will have paid the cost of recession without receiving any durable benefit. The widely noted decline in inflation to less than 4% in 1983 will be followed by higher inflation just as were the relatively low rates of inflation in 1967, 1972 and 1976.
The absence of a policy is costly. No one knows from quarter-to-quarter or year-to-year whether money growth will be adequate to sustain expansion, so excessive that it restores inflation to previous rates or so low that we experience another recession. No one can look ahead with confidence that monetary policy will contribute to stable growth for the next several years or even for the next several quarters.

The jagged pattern of recent money growth has left its mark on the growth of GNP. Chart 1 shows that quarterly changes in the growth rate of the monetary base -- bank reserves and currency -- are followed within a quarter by similar changes in the growth rate of nominal GNP. The monetary base is the amount of money produced by the Federal Reserve. It is completely controllable if the Federal Reserve chooses to do so or is required to do so by law.

[Insert Chart 1 about here]

Chart 1 does not suggest that Federal Reserve action is the only determinant of GNP growth. GNP growth is influenced by many other factors. The chart shows, however, that for the past three years every peak or trough in base growth has been followed within one quarter by a local peak or trough in GNP growth.

Federal Reserve spokesmen have told Congress and the public that money growth has little relation to GNP. They have offered explanations of the reasons why this is so. But they have given no evidence. Chart 1 suggests, contrary to these claims, that the relation has become closer in one respect. The lag between growth of the monetary base and the growth of GNP appears to be shorter than in the past and more consistent. All recent turning points in base growth have been followed within a quarter by turning points.
in GNP growth. The magnitude of the relative changes in base and GNP growth vary, however, so quantitative forecasts of quarterly GNP growth based on this relation are no more reliable than other forecasts of quarterly GNP growth.

Chart 1 shows that the excessive variability introduced by destabilizing actions of the Federal Reserve has increased the variability of the economy. Increased variability raises the risk that the economy bears, raises the rate of interest, lowers investment in long-term capital and increases interest payments on the government debt. Estimates prepared for the Treasury Department suggest that the increased variability of unanticipated changes in money growth raised short-term interest rates in 1980 to 1982 by three percentage points. Variability declined in 1983, so the risk premium in short-term rates is now smaller than in the previous three years. But, the risk premium remains higher than in the sixties or seventies reflecting heightened uncertainty about future money growth.

My calculations suggest that the excessive variability of money growth raised short-term rates in 1983 by 2 to 2-1/2 percentage points and kept long-term rates more than one percentage point above the level they would have reached if variability returned to the level of the 1970's.

Spokesmen for the Federal Reserve and some administrative officials try to explain the present levels of interest rates by referring to budget deficits. I do not know a single study showing a relation between deficits and interest rates for the United States. The Congress should ask for evidence to support these claims.

I have commented on the problems posed by persistent deficits in previous hearings and elsewhere, in the past, so I will summarize two main points here.
First, a principal problem with our fiscal policy is not the deficit per se. It is the high rate of consumption spending encouraged by government and sustained by government transfer payments and spending for defense. These programs shift resources from investment toward consumption. Second, deficits become inflationary and raise market rates of interest when they are financed by the Federal Reserve. No one knows how much of the deficit the Federal Reserve will finance because, as I have said, the Federal Reserve does not have a policy. But if the Federal Reserve continues to attempt to control interest rates, they will, from time to time, finance part of the deficit by inflating.

The deficit is not the only excuse offered by the Federal Reserve. Some, including presidents of two of the Federal Reserve banks, blame deregulation of the financial industry for the variability of money growth and current and past levels of interest rates. Such statements are difficult to reconcile with research by the staff of the Federal Reserve Bank of San Francisco and the staff of the Board of Governors, the latter published in the May 1983 Federal Reserve Bulletin, showing that M1 has not been much affected by the introduction of the new types of deposit accounts.

The main cause of monetary variability is not deregulation or deficits. It is the failure to have a stable, non-inflationary monetary policy. No one should expect to restore stable growth with low inflation until the Federal Reserve adopts a policy and develops procedures that achieve the policy it adopts. Congress has constitutional authority for monetary policy. It should not permit the Federal Reserve to operate as it has.

Hearings such as this are not an effective procedure for imposing monetary discipline. The comparison of announcements made at past hearings with actual
policy, in Table 1 above, shows little relation between words and deeds. What point is there to having the Federal Reserve announce plans or intentions that bear little relation to what they do?

I believe the Congress must find a more effective procedure for monitoring the performance of its agent, the Federal Reserve. Congress should require the Federal Reserve to set a target for monetary growth. If they miss the targets by more than one percentage point, the chairman and all members of the Board of Governors should be required to offer their resignations to the President of the United States, who appoints them, with an explanation of the reason for the discrepancy. The President would have the right to accept the explanation, and with it the responsibility for the result of the policy, or accept the resignations.

This proposal removes a principal obstacle to more stable, more reliable monetary policy -- the absence of accountability. It ends the separation of authority and responsibility and gives an incentive to the Federal Reserve to improve its performance. Without improved performance, we will continue to pay the costs imposed by variable and uncertain monetary actions and the absence of a coherent monetary policy.