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OF THE
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TO: Federal Open Market Committee

FROM: Mr. Holland

As you will recall, it was suggested at the May 28 Federal Open Market Committee meeting that copies of Professor Harry Johnson's paper at the recent ABA Conference be distributed to the Committee. A copy of the paper, entitled "Current issues in monetary policy," is enclosed.

Robert C. Holland, Secretary,
Federal Open Market Committee.

Enclosure

CURRENT ISSUES IN MONETARY POLICY

by

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CURRENT ISSUES IN MONETARY POLICY

In inviting me to present a paper here this morning, Beryl Sprinkel asked me to discuss issues of common concern for central bankers, economists, and commercial bankers, and suggested various problems of which you have been informed in the program. At the same time he expressed the hope that I would be "argumentative, provocative, and interesting." A short general paper offered for discussion to such an expert panel could not fail to achieve some of these qualities, albeit perhaps unintentionally; but in order to develop some of the issues as I see them I shall have to transgress to some extent on the subjects dealt with in previous sessions of this Conference.

Let me begin with some intentionally provocative remarks on an essentially political issue, the relation of central banks to their central governments and their position in the structure of government. Monetary historians look back to the 1920's as a sort of high tide of the influence of independent central banking on economic policy. With the Great Depression of 1929-33, however, and the associated collapse of the international monetary system, the Central banks were toppled from power by the Treasuries, and became mere handmaidens in the implementation of cheap money policies. Cheap money policies were aimed initially at curing the depression--which they signally failed to do owing to the customary confusion in central banking circles of historically low interest rates with strongly expansionary monetary policy--then at securing low-cost war finance, and then at holding down interest rates for reasons of public debt management and employment maintenance. With the postwar return to an increasingly liberal trade and payments system based on convertibility of currencies at fixed exchange rates, however, central banks have rapidly been recovering their influence on economic policy. Their return to power has been based on both the need to use monetary policy as a major weapon of balance-of-payments adjustment, and on the need for co-ordination and co-operation among central banks in operating the international monetary system.

The return of the central banks to power in economic policy has, however, had two prices, both of which have stored up trouble and raise issues for the future.

In the first place, and most important, the central banks have had to compromise seriously, albeit reluctantly, with the inflationary consequences of national economic policies aimed at maintaining high levels of domestic employment. This has implied on the one hand prolonged international payments disequilibria associated specifically with the relative overvaluation of the pound and the dollar and relative undervaluation of certain European currencies, and on the other hand a world inflationary trend which has enhanced the problem of prospective shortage of international liquidity to the point of forcing the adoption of the "two-tier" gold price system. While these two problems have helped to increase the power and influence of the central banks, the present international monetary situation is both necessary transitional and potentially highly unstable. Unless the central banks manage, first, to maintain credible progress towards effective replacement of gold by Special Drawing Rights as the basic international reserve, and second, to arrive at an agreed change in the exchange value of the dollar in terms of the major European surplus-country currencies--appreciation of these currencies rather than depreciation of the dollar in terms of the international unit of account would probably entail least international disturbance--there is a fair probability that some crisis will lead the world to return to a system of floating currencies such as prevailed in the 1930's. The resulting relative insulation of domestic employment policy from balance of payments discipline would inevitably reduce the power and influence of the central banks in economic policy. I would myself regard a return to floating rates as more desirable than a continuation of balance of payments policies along present lines, especially for Canada and the United Kingdom but also for the United States; but others, particularly the central bankers, would obviously disagree. I therefore confine myself to stating the issue as I see it.

The second price that has been paid by the central banks for their return to power has been an extension of controls over transactions--both international and domestic--by banks and other financial institutions. To the economists, this trend raises the question of the effects on efficiency in the allocation of resources, both by financial institutions and among financial and other institutions.

This issue merges with the general issue of regulation of banking and financial structure, discussed in an earlier panel; and it becomes more acute as interest rates rise, because the losses imposed on financial institutions by the discriminatory imposition of controls on them tend to vary with the level of interest rates. A particular problem of this kind, which has figured in American and Canadian discussions and more recently in the British Report on Bank Charges, is the effect of controls of various kinds on commercial banks in putting the banks at a competitive disadvantage in relation to near-bank financial intermediaries, thereby promoting the relative growth of the latter. In North America this issue has been discussed largely in terms of commercial equity; in Britain the Report on Bank Charges has raised the more fundamental issue of the prospect of a gradual erosion of the financial sector over which the central bank has traditionally exercised closest control, and a consequent erosion of control itself. In both contexts, the practical man has tended to recommend extension of controls to include the near banks. This solution seems equitable on the surface; but the increase in efficiency obtainable by equalization of competitive conditions among financial institutions may be offset or more than offset by the extension of discrimination against financial institutions generally as compared with non-financial productive enterprises. This may be a particularly important point for the United Kingdom, for two reasons. First, development theorists have been attaching increasing importance to the growth and sophistication of financial intermediation as a causal factor in economic growth. Second, successful competition among advanced industrial nations appears increasingly to depend on the exploitation of human intelligence and organizing ability--including financial organizing ability--rather than on sheer production of commodities. Yet British economic policy seems consistently to idolize manufacturing and to despise services, in many of which Britain has an apparently ineradicable comparative advantage. Incidentally, it is not clear to me how the new British policy of merging the smaller banks will overcome the disadvantages now imposed on British banking by present monetary policy control methods. For its part, the United States has been led by prevailing concepts of proper balance of payments policy into attempting to reverse the trend towards integration of world capital markets that is one of the alleged advantages of a fixed exchange rate system.

This has been a somewhat lengthy discourse on issues arising with respect to the relation of central banks to the economic policy-making structure. I now turn to current theoretical issues relating to the potentialities of monetary policy as an instrument for achieving the major objectives of economic policy. Of course, one really has to think of fiscal and monetary policy as joint instruments, the possibility of combining which in different ways gives added flexibility to the policy-makers--if, that is, institutional arrangements or public opinion allow them to use it. But for brevity it is convenient to confine the discussion as closely as possible to monetary policy alone.

The objectives of economic policy which monetary policy is nowadays expected to serve, or help to serve, include full employment, price stability, economic growth, and balance of payments equilibrium as the four major ones, with a reasonably equitable distribution of income sometimes thrown in for good measure. Sometimes low interest rates are specified as a general objective, though where this objective is asserted it must be as an intermediate step towards the achievement of one or more of the other objectives--equity, growth and full employment being the obvious ones. I shall discuss the issues with respect to these objectives in turn, though not in order.

To begin with, it is not at all clear how monetary policy can affect the equity of the income distribution. There are three major conceivable connections. First, if monetary policy is defined to include control over the terms on which credit is available to particular types of borrowers, it might seem that equity could be served by fixing low charges for borrowers towards whom it is desired to redistribute income. This belief, though commonly held, involves the fallacy of the usury laws (and the minimum wage laws); while those who obtain credit at all obtain it on favorable terms, the supply becomes insufficient for all comers, and has to be rationed, the rationing usually discriminating against those most intended to be helped. Second, inflation is generally assumed to redistribute income away from the rentier groups, and hence tends to be favored by those who view society as divided into meritorious entrepreneurs and parasitic coupon-clippers, and disfavored by those who identify rentiers with old age pensioners. It is true that an inflationary policy imposed unexpectedly on an economy that has made its calculations in terms of a stable value of money and corresponding interest rates on monetary assets will redistribute income and wealth, as will a deflationary policy imposed unexpectedly on a stable or inflating economy. But once inflation has become established and expected to continue, money interest rates get adjusted to it, and the only significant element of income redistribution becomes that between the issues and holders of non-interest-bearing or interest-yield-controlled monetary assets, the incidence of which is both small and difficult to determine. Thirdly, if monetary policy could influence the level of real interest rates, this could affect income distribution, since it is generally assumed that lower real interest rates redistribute income towards the lower--income groups. Monetary policy by itself, however, cannot in theory influence the level of real interest rates, expect transitionally over the cycle; the theory of the fiscal-monetary policy mix suggests that a combination of a tighter budget and a lesser monetary policy could lower real interest rates permanently, but there are theoretical and empirical reasons for doubting how significant this effect would be.

This point brings us to one aspect of the question of using monetary policy to promote economic growth. This question has frequently been phrased loosely, to define growth merely as a cyclical expansion of output and decrease in unemployment, which expansion is better regarded as a transitory shift in the level of economic activity.

To distinguish an influence on growth from one on unemployment, it is necessary to inquire into sustainable growth rates at a given activity level. Here, the fiscal-monetary policy mix analysis suggests that a tight-budget loose-money mix could increase saving and investment and hence the growth rate. But this too, according to contemporary growth theorists, would be a transitory increase in the rate of growth, though within a far longer perspective than the business cycle, because eventually the rate of growth settles down to a rate determined by the more fundamental forces of technical change and population growth. There are, too, some heretics who maintain that it is not investment that creates growth, but growth that induces investment, growth in the relevant sense being determined by sociological and other forces outside the grasp of monetary policy and perhaps of government policy entirely.

The theory of the fiscal-monetary policy mix is a relatively recent Keynesian invention, developed more in the context of balance-of-payments policy than in that of growth. The more traditional approach to the influence of monetary policy on growth is concerned with the possibility of promoting growth by inflation. The notion that inflation redistributes income from rentiers to entrepreneurs has been used to argue both ways on that question, depending on whether investors or savers are taken to be the dynamic force in capital accumulation; but as pointed out earlier, this notion only holds water for an unexpected inflation, and not for an inflation pursued as a deliberate policy. For deliberate inflationary policies, the concept of inflation as a tax on the holding of cash balances is relevant; and it is certainly conceivable that such a tax could be devoted to increasing investment and hence the growth rate. Apart from the practical difficulties of implementing such a policy, however, it appears that empirically the possibilities of raising the growth rate by this means are slight, especially in a financially developed economy.

As mentioned, contemporary theories of growth indicate that a growing economy will tend to settle down to a steady rate of growth determined by exogenous forces. Very recently, monetary theorists have begun to investigate the influence of alternative policies of long-run growth of the money supply on the level of consumption per head enjoyed in such steady-growth conditions. The nature of the problem and the analysis of it are too complex to be worth presenting here--indeed, at this moment a conference of monetary theorists is meeting on Long Island to thrash out some intricately technical disputes--but it is safe to say that no reliable practical guidance for monetary policy has yet emerged from this technical analysis.

I would be prepared to go further, and assert that our knowledge of the process of economic growth and of what determines the rate of growth is at present too limited and fragmentary to permit a specification of what a growth-oriented monetary policy would look like--much as the policy-makers would like to know the answer. The furthest one could go is to suggest that monetary disturbance cannot be helpful to growth and that therefore the policy-makers should seek to manage monetary policy as to avoid such disturbances and their effects on the public's expectations about the future.

I must and will be brief on the subject of monetary policy and the balance of payments, since this has already been discussed in this conference. I would suggest, first, that so far as it is relevant recent American and British experience has disproved the feasibility of attempting to improve the balance of payments by "twisting" the term structure of interest rates. This experience has also cast serious doubt on the relevance and reliability of the theory of fiscal-monetary policy mix as a guide to balance of payments policy. And above all it has cast doubt on the effectiveness of controls over outward capital movements as a means of improving the overall balance of payments. The explanation can be expressed very simply in the phrase, "the fungibility of money."

More fundamentally, recent balance of payments experience raises in the international field a question which in the domestic field was for a while hotly disputed, "does money matter?" The present consensus, at least among North American economists, is that domestically money does matter. But internationally, in the analysis and determination of balance of payments policy, the implicit consensus seems to be that it does not. I refer not merely to the fact that both national policy-makers confronted with deficits and other national policy-makers urging them to take action to correct the situation have persistently based their prescriptions on the assumption that a balance-of-payments disequilibrium, which is a net international monetary flow, can be corrected by surgery applied to particular types of payment flows--a very naive arithmetic approach indeed. I refer more importantly to the fact that much of the intellectual apparatus of expert analysis of balance of payments problems and policies--multipliers, feed-back ratios, elasticities of international demand--makes no explicit reference to national monetary policies as a casual factor in the generation of international monetary flows. This procedure ignores a long historical tradition of monetary analysis of international disequilibrium and adjustment. The question is whether the contemporary practice is justified in so doing, or whether the difficulties of operating the international monetary system stem in part from disregard of the monetary factor. So far as I know, no solid research has been done on this issue, though it has been raised. An interesting test of the issues will be whether the devaluation of sterling will have the successful results predicted for it by contemporary estimating techniques.

The remaining three objectives of full employment, price stability, and low interest rates can be taken together, since they raise the same theoretical issue. Since the 1950's, it has become customary to formulate the problem of attaining full employment with price stability in terms of choosing the optimal trade-off between the rate of inflation and the rate of unemployment, and implementing that choice by appropriate economic policy, the optimal choice involving some unemployment and some inflation. It has recently been pointed out by Milton Friedman and E. H. Phelps, however, that the trade-off curve cannot be assumed to stay still in these circumstances. The rate of money wage and price increase associated with a given label of unemployment reflects expectations of workers and employers about the future course of the value of money, and will adjust to experienced inflation. Hence, to arrive at an unemployment rate below that consistent with price stability, the authorities must inflate at an increasing rate because they achieve the decrease in unemployment only by falsifying expectations about the value of money. To put the point another way, there is a "natural" level of unemployment, determined by the institutions of the labor market, towards which the economy will tend to gravitate unless continually frustrated by monetary policy--not a permanent trade-off between the inflation and unemployment rates.

The same logic applies to the possibility of controlling nominal interest rates. The economy will tend to be characterized by a level of real interest rates--returns on capital investment--determined by the stage of capital accumulation and so forth. The level of money interest rates over the long run will tend to equal the real interest rate plus the expected rate of inflation, as a consequence of market processes of asset choice. If the monetary authority attempts, starting from a condition of price stability, to reduce the level of money interest rates by open market expansion, it can succeed in the short run, but only by generating inflation which in the longer run will be reflected in a rise in money interest rates, and vice versa. This is the explanation of the tendency of money interest rates to fall in depressions and rise in loans, exemplified by recent monetary history in the United States--a tendency which central banks frequently and wrongly interpret as evidence that their policies have been stabilizing the economy.

The central theoretical proposition here is that monetary policy in the longer run can determine monetary magnitudes--the price level and the rate of inflation--but not real magnitudes such as the rate of unemployment and the real rate of interest. (There are some possible exceptions implicit in my earlier discussion). The crucial practical issue, however, is how long a run it takes for the theoretical proposition to prevail. The evidence on this is mixed. As mentioned, under contemporary circumstances expectations of inflation seem to follow experience fairly quickly, so far as interest rates are concerned, though historically the lags appear to have been of the order of twenty years or longer. With respect to wage-rate change and unemployment, the empirical trade-off relationship appears to be stable enough for policy operations within the normal perspective of policy-making. One might, however, argue that in a broad way Britain's balance-of-payments difficulties can in part be attributed to the building into the trade-off relationship of the inflationary expectations generated by the consequences of past full employment policy. The slowness of adjustment of expectations raises another issue important for monetary policy-makers in both the domestic and the international contexts: once inflationary expectations have become fairly established, and it then becomes necessary to break them, what is the best means of doing so and how quickly can it be made to work? Incomes policy, the contemporary alternative to facing that question, in my judgment offers little hope of avoiding the issue.

Having surveyed the issues with respect to how far monetary policy can contribute to achieving desired objectives of economic policy, I turn in concluding the paper to somewhat more technical issues in the actual conduct of monetary policy.

One of the important issues is the general one of quantification of monetary policy, one which has become increasingly important as monetary policy has assumed more and more of the burden of economic control and as scientific research on monetary policy, both by academic and by central bank economists, has progressed. Ideally, the policy-makers should have at their disposal a complete econometric model of the economy, on the basis of which they could determine exactly what actions their objectives required and introduce appropriate policy changes which could be accurately described both as to direction and as to magnitude. There would then be no ambiguity about what the policy-makers were trying to do; and if they did not succeed, experience could be checked to determine the source of failure and the means of improving subsequent performance. But practice falls far short of the ideal; and the monetary authorities, as well as those who analyze their actions journalistically or academically, are frequently to be found describing policy actions in terms of changes in monetary variables intermediate to the ultimate macroeconomic variables on which policy is seeking to operate, and moveover in terms of a shifting choice of variables not all of which can possibly tell the same story. Thus movements in interest rates of various kinds, in total bank credit or in bank loans, in the money supply (variously defined), in the cash base provided by the central bank, in bank cash reserves, or in "free" bank reserves, have variously been used to describe and measure changes in monetary policy. But these variables are under the control of the central bank to widely varying degrees: Interest rates, for example, are influenced both by real forces and by price expectations, while free reserves are determined in part by commercial bank decisions.

From the point of view of relevant quantification, it would be desirable to measure monetary policy by some variable closely under the central bank's control, such as total money supply on the cash base of the system. On the other hand, the quantitative measure of monetary policy selected should obviously be a monetary variable that influences the ultimate macro-economic variables incorporating policy objectives as directly as possible. Here we encounter the division in contemporary monetary theory between the Keynesians and the quantity theorists. The Keynesian tradition, in common with the dominant tradition of central bank thinking, concentrates on interest rates as the monetary variable that in the short run controls spending, and especially investment spending. The quantity theory, on the other hand, stresses the quantity of money as the monetary variable that controls spending. Which approach is the more correct is an empirical issue still being hotly disputed. But it is relevant to the quantification issue to observe that empirical researchers have had very mixed luck in verifying the hypothesized influence of interest rates on investment, let alone consumption, expenditure, whereas Friedman and Meisenman have had remarkable success in predicting changes in consumption expenditure, in both nominal and real terms, from changes in the money supply.

A second operational issue regarding monetary policy relates to the presence of lags in the influence of monetary policy on the economy and especially the probability that these lags are fairly long and variable. Such lags, if not well understood and allowed for in the conduct of policy, could result in monetary policy being destabilizing instead of stabilizing. The empirical evidence on this point is in fact not too faltering to national monetary policy-makers generally. Some economists have gone so far as to argue that the difficulties of efficient policy-making are such that discretionary monetary management should be replaced by a fixed rule of monetary expansion at a rate determined by the normal growth of demand for money. Apart from the human resistance to such a proposal, and some doubt about how well it would work in practice, the proposal is open to the objection that it implicitly presupposes a floating exchange rate system. However, there is sense in the milder suggestion that central banks should normally seek to approximate a steady rate of monetary expansion of this kind, and even more in the proposition that lags in the effects of monetary policy make it undesirable to change monetary policy as sharply as has been characteristic of recent years.

This argument from the existence of lags in economic response to monetary policy changes against sudden and sharp changes in monetary policy relates to the influence of policy on economic activity. Another argument to the same effect, resting on the existence of lags in a rather different sense, and pertaining to the financial sector, has become apparent in recent years and was sharply dramatized by the "credit crunch" and "financial disintermediation crisis" of 1966. Financial intermediation introduces a lag between the impact of higher interest rates on payments of interest on liabilities and receipts of earnings on assets, which may be positive or negative and depends on the asset and liability structures of the particular intermediaries concerned. Intermediaries normally try to protect themselves against too adverse an impact of likely increases in rate levels by appropriate choice of asset-liability structure, but can be seriously threatened by faster and larger increases in rates than they have been used to, especially if subject to regulation preventing competition for liabilities by rate changes. Unfortunately, under contemporary conditions monetary policy is occasionally forced to make abnormally large and sharp changes. This raises the issue of whether the disturbing effects on the stability of financial institutions should be counteracted by more regulations, aimed at preventing normal competitive adjustments, or by less regulation, supplemented by the development of new types of rediscount operations designed to bail out institutions in trouble.

I have attempted in this paper to survey the major contemporary issues in monetary policy as I see them, in some cases proposing answers and in others raising questions. I hope that my panelists have been suitably provoked into giving us the benefit of their own views and experience on these and other questions.