

DISCUSSION OF DUESENBERY'S PAPER

There is a large gap between monetary theory and the practice of monetary policy, as I've said a number of times. There is a larger gap between discussions of the theory of economic policy and the actual conduct of policy. When economists discuss economic policy, conclusions are very clear. Policy operations should set the market rate equal to the natural rate, provide something called the "optimum stock of money," or in the more esoteric models, move the economy to a so called bliss point.

There may be some tenuous connection between these ideas and the activities that take place at the trading desk or at the meetings of the Open Market Committee, but like Jim Duesenberry, I've read a lot of minutes and sat in when economists were invited to discuss policy, and I haven't seen any close connection between the activities that take place and the framework used to discuss economic policy.

One main reason for the gap is that in the theory of economic policy we always assume that we know not only what has happened, but what is going to happen as a result of any change we make. In the actual conduct of policy, we are usually a good deal more uncertain about the short-term impact of policy actions, even if we have confidence in our ability to predict the long-term effects.

To bridge the gap between theory and practice, Karl and I developed the analysis that Jim Duesenberry used today. Since Jim and I agree on main points, I want to discuss areas of agreement rather than differences and talk about implementation.

Let me begin by agreeing that policy decisions should be made in a way that permits the Committee to give the manager a quantitative target. I know enough about the history of the Federal Reserve to know that this proposal has been discussed many times both within and outside the System. But nothing has been done, so I plan to make some suggestions about the ways in which the conduct of policy can be changed to permit the Committee to give clearer instructions.

One of the first problems that has to be solved is the problem of definition. We are all familiar with the complaint about different definitions of money and monetary aggregates. As Henry Wallich said yesterday, 'There are at least 20 different definitions'. No doubt Henry is guilty of understatement. There are probably more than twenty. But many of the disputes about definitions are not matters of great moment. The most important difference is of recent origin and is a consequence of the substantial rates of growth and decline in commercial bank certificates of deposit resulting from the failure to change Regulation Q. Milton Friedman, the main proponent of a definition that includes time deposits, now agrees that the amount of CD's should not be included in the definition of money. With this change, M_1 and M_2 (minus CDs) move together.

I don't know of any period in which there would be substantial difference in policy as a result of using one rather than the other definition of money as an indicator of monetary policy. There are differences between M_1 and M_2 . For example, the long-term rates of growth are very different. However, there is no sustained period in which people who looked at M_2 minus CDs would have suggested that policy was expansive while people who looked

at M_1 thought policy was contractive. Disagreement about the extent to which policy was expansive or contractive might be larger at times, but again the difference would not be substantial.

Several years ago, while reviewing Cagan's work on money I could not find any period up to 1955 in which an important error or judgement would have resulted from using M_1 rather than M_2 to judge the thrust of monetary policy. Although I prefer M_1 , as you know, I fail to understand why economists harp on difference in definition that are of limited importance for policy.

Let me turn to a second area on which we may reach agreement, the choice between rules and authorities. This choice is more an apparent than a real choice. One reason is that we have to make decisions to implement a monetary rule. Another is the existence of fixed change rates. I believe that the main substantive issue in the rule vs authority debate is the desirable amount of variability in the growth rate of the stock rate of money permitted during a given period. Recent experience has probably taught many people that there are limits to the acceptable or desirable amount of variability. Senator Proxmire's proposal gives wide latitude to discretionary policy but restricts the growth rate of money, narrowly defined, to a range of two to six per cent. The Proxmire proposal avoids the pitfall of forcing sizable deflation on the economy in a peculiar attempt to compensate for inflation, although the lower end of Proxmire's range would permit slight deflation to restore equilibrium. My own preference is for a narrower range. One reason is that I believe it is undesirable to shift from the current positive expected rate of price change to a position in which the prevailing expectation is deflationary. If we could get through the transition from

expected inflation to expected deflation, it might be very desirable to have the return to cash balances from deflation that economic theorists have discussed. But our past experience gives overwhelming evidence that the transition to deflation is very difficult, and I do not want the Federal Reserve to retain the power to choose a policy that forces the price level to fall.

Again, we are faced with the gap between theory and practice. The choice of an optimal growth rate of money is of limited value if we cannot implement the choice. Until we learn a good deal more about designing policies that permit smooth transitions from where we are to where we want to be the transition will remain an obstacle.

Another obstacle is the constraint imposed on the day to day conduct of policy as a result of historical developments and particularly the background and preferences of men chosen as members of Board or as managers of the open market account. One example is the concern for money market events as measured by free reserves and short-term interest rates. This concern restricts the choice of a target to measures that are available daily and that have a reasonably close connection to the actions that the manager takes in the money market. The reason is that the manager wants to observe what he has done and does not know how to operate without a target he can observe--however inaccurately--on a daily basis.

As Brunner and I have indicated elsewhere, the monetary base can be controlled effectively with the information now collected at the trading desk in New York. In fact, the manager can control the base more accurately than he can control movements of free reserves or the other money market indicators he now uses. By controlling the base, the manager controls the rate of

monetary expansion sufficiently well to maintain the rate within a narrow range. If we can get the Federal Reserve to give up a part of its concern for the money market, we can bridge part of the gap between theory and practice and can improve the conduct of monetary policy.

I propose, as a first step that we reverse the present system, moving away from the use of free reserves, interest rates, or money market targets that are achieved subject to a proviso clause, as in the announced policy of the Open Market Committee for the last several years. Instead, let the former proviso clause become the target. State the target as a growth rate of the quantity of money or of the monetary base or as an absolute change in the base (we can translate from one to the other). Set a range of fluctuations in interest rates as the new proviso clause. In this way, we move away from an approach based on money market or credit market conditions toward an approach based on control of money as a means of affecting economic activity and prices. By gradually widening the range of acceptable fluctuations in interest rates, we take additional steps away from the money market conception toward a system that is far more consistent with monetary theory. In this way we start to bridge the gap between theory and policy operations.

An additional step, that Jim suggests several times in his paper, is to describe policy in quantitative terms. Anyone who has read the history of Federal Reserve policy knows that the manager is generally given vague, qualitative directions so that there is no clear way for the committee to decide whether he carries out the policy that the majority of the committee favored. One committee member may think he has; another is sure he has not.

Even those who agree on descriptive phraseology don't always have the same results in mind.

Until recently there has been little concern about measuring what the manager has done or auditing his performance. Matters have improved slightly in recent years, and there is now a clearer idea about what the manager is directed to do. My suggestion that the Federal Reserve accept the monetary base as a target of policy and relegate fluctuations in interest rates to the proviso clause permits the Committee to describe desired policy in quantitative terms. Once that is done, the Committee can audit the Manager's performance. Furthermore, the committee can move toward a more stabilizing policy by reducing the range of acceptable deviations between desired and actual policy.

By specifying a range within which interest rates are permitted to fluctuate, we pay attention to the historical concern of central bankers for day-to-day or week-to-week changes in interest rates. However, we do not allow concern for fluctuations in interest rates to interfere with the longer-range goals of monetary policy such as employment and price stability. In making this suggestion I want to distinguish two types of fluctuations in interest rates. One is the daily or weekly change that will be a subject of the proviso clause. The other is the change in interest rates that occurs during cycles. There is no reason that I know for expecting the use of money as a policy target to increase the size of cyclical fluctuations in interest rates.

Although there is considerable evidence that exchanging the positions of money and interest rates in the proviso clause and as target of monetary policy would increase the contribution of monetary policy to economic stability,

there are a number of changes in arrangements that would further improve the operating characteristics of the revised system. Some of the changes I am about to propose can be made by the Federal Reserve without seeking new legislative authority. Others require an act of Congress and are therefore difficult to accomplish. Since I have neither the time nor the knowledge to provide a complete list of desired changes, I am content to mention a few that come to mind.

First, one restriction that has little present economic justification is the maintenance of different reserve requirements for banks of different classes. Differences in requirement ratio are based on historical, not current, conditions. By eliminating differences in requirements, the Federal Reserve moves toward a less complex set of institutional arrangements and thus improves its own ability to predict the effect of its actions.

A second proposed step is the elimination of changes in reserve requirement ratios. The most recent change in reserve requirements illustrates the defects of reserve requirement ratios as policy instruments. At a time when there were about \$130 million worth of excess reserves in the banking system, there is no rationale for a policy that requires banks to shift \$650 million from excess to required reserves? There was no way in which the banks could affect their excess reserves during the two weeks in which they were expected to meet the requirement other than by borrowing from a Federal Reserve or inducing the public to give up currency. The banks were forced to borrow, and there is now about \$1 billion of additional borrowing. As in past periods, the borrowing remained in the System so that the banking system was able to expand the stocks of money and credit. The main effect of the reserve requirement change, as so often in the past, is on the profits

of the banks. This is a rather indirect way to reduce bank expansion and hard to justify when there are more direct methods available.

A third step, a similar step, is suggested for very similar reasons. The System ought to remove reserve requirements for Treasury deposits so that the movement of Treasury balances between banks and the Federal Reserve would not cause swings in the money supply. There is nothing that the banks can do to attract Treasury deposits; removing the reserve requirement cannot lead banks to bid for Treasury deposits in any effective way. With taxes and expenditures given, or set by congressional policy, the Treasury alone decides where it wishes to keep its balances and when the balances are going to be withdrawn. Removing the reserve requirement ratio is a step in the direction of institutional simplification and has the desirable side effect of removing the need for defensive operations by the Federal Reserve.

A fourth step, one that is being discussed at the moment, is to put borrowing arrangements on a more rational basis. A very cumbersome proposal has been produced by the System. The proposal requires judgements about the purpose that brings the borrowing bank to the Federal Reserve bank, the size of the seasonal swing in deposits at the borrowing bank, etc. These are matters that are of no concern to the Federal Reserve when acting as a lender of last resort. A much simpler borrowing arrangement has been proposed many times in the past. The banks should be allowed to borrow at a penalty rate.

Fifth and currently the most important change of all, is to remove the ceiling rate on time deposits. Regulation Q is a mischievous device that confuses the Open Market Committee. The confusion arises because of the neglect of differences between nominal and real interest rates. Regulation Q rates are nominal rates. Banks find numerous ways to circumvent the

regulations. They offer additional services to depositors; they sell participations in loans; they change the required size of compensating balances. These and other adjustments permit the banks to offset part of the effect of Regulation Q. More importantly the change in market rates relative to Regulation Q ceiling rates causes a change in the stock of money, narrowly defined, relative to the stock of money defined to include term deposits, and changes the relationship between money and credit. Regulation Q is a main cause of diverging growth rates of monetary aggregates during cycles. The divergence in growth rates misleads the Federal Reserve and others and contributes to the uncertainty about the direction of monetary policy.

My second group of proposed changes includes those that are more difficult to obtain. Though no less important, I discuss these proposals more briefly. The first is important for the development of a rational world monetary system. We need a mechanism for adjusting to payment imbalances that reduces the domestic instability caused by the imbalances. A second source of instability that should be removed is the practice of the home finance industry of holding short-term liabilities and long-term assets. One of the lessons of monetary history that has been repeated most frequently is that this practice leads to insolvency. Fear of forcing insolvency on an important segment of the financial industry inhibits the central bank from taking action.

My solution to the problem is relatively simple. Both the banking system and the home finance industry should be open to entry. Banks should be permitted to acquire savings and loan associations, and savings and loans should be permitted to acquire banks. Recent legislative proposals that threaten to stop this process are undesirable. Finally, let me close with

an economist's favorite recommendation. The payment of interest on demand deposits should be permitted. Permitting interest payments would reduce the size of shifts between time and demand account when rates change, and would improve economic welfare. Once again, we take a step toward reducing the gap between theory and practice.

Each of you may not accept my list of priorities or my solutions. I hope you will agree, however, that by removing some of the restrictions we have imposed on the operation of the monetary system, we can develop a system that more flexibly adjusts. Recent changes have made institutional arrangement increasingly complex, have made monetary policies more difficult to design and interpret and have increased the gap between theory and practice.