Monetary Aggregates and Monetary Policy in the Twenty-First Century: Discussion

Jerry L. Jordan*

Like Bill Poole's, my associations with both Frank Morris and the issues of this conference go back a long way. In the mid 1960s I was a graduate student and research assistant for Karl Brunner at UCLA when he was host of a couple of conferences called "Targets and Indicators for Monetary Policy." My role at these conferences was to change the tapes on the reel-to-reel tape recorder, then spend weeks transcribing what was said by all the eminent economists who participated.

The issues addressed in those conferences were the same as those subsequently addressed by the FOMC Committee on the Directive. At that time, my association with Frank was not nearly as direct as Poole's. Later, however, I had a couple of opportunities to revisit the topics of reserve and monetary aggregate targets in debates with Frank.

On one occasion in the early 1980s, I was invited to the University of California at Berkeley to discuss monetary policy and inflation with Frank Morris and James Tobin. At one point Professor Tobin said that the Federal Reserve should offer to buy long-term government bonds in the open market at a price that would produce a yield of 4 percent, and the Fed should hold long-term bond yields at the 4 percent rate until full employment was reached. Frank said, "But, Jim, we might wind up buying them all." And Professor Tobin replied, "So?"

On another occasion in 1993, after I had returned to the Federal Reserve and Frank had retired, I was invited by Frank's daughter, Lisa Grobar, a professor of economics in California, to participate in a program with Frank entitled "Searching for a Monetary Policy Target." By that time both Frank and I had concluded that the most serious

*President and Chief Executive Officer, Federal Reserve Bank of Cleveland.

problem for monetary authorities was the absence of a credible commitment to an ultimate objective of price stability. In this discussion of Poole's paper, I will revisit several of the issues we raised in that program.

I agree with Poole that reading the Memorandum of Discussion of 1970 is interesting and important, but I would also recommend that all of you read the Memorandum of Discussion of February 14, 1972. The entire meeting was devoted to discussing the third report of the Committee on the Directive, which I believe was also the final report of that committee. The meeting concluded by recommending an experimental approach to recasting the directive to the Trading Desk. In my remarks this morning, I am also going to highlight a few of the issues raised in that meeting that I think parallel and complement the issues that Poole raises in his paper.

The Debate circa 1993

Before turning back to the recommendations of the Committee on the Directive, I want to take a few minutes to highlight some of the issues Frank and I raised in 1993. I believe the perspective we came to share illustrates what Poole identifies as the strategic outlook that currently pervades FOMC discussions.

In 1993, I reflected back on the 1960s and noted how I had failed to appreciate the context in which the UCLA conferences had been conducted. At the time of the conferences, inflation had been under 2 percent for more than a decade, followed by a couple of years (1964 and 1965) when it jumped into the range of 3 or 4 percent. It was thought then that the problem was only one of choosing the appropriate reserve and money targets and indicators—that is, the levers or handles for monetary policy—that would serve as instruments for formulating and implementing policy. The mindset of the American people at that time, I think, was that *increases* in inflation and interest rates were temporary, destined to go back down, sometime.

Later, after more than two decades of inflation, the mindset of the American people seemed to be that *declines* in inflation and interest rates were temporary. People started to believe that the permanent condition was rising inflation and interest rates.

Coming back to the Fed after some seventeen years, I initially thought the question was "Which M?" The Cleveland Fed staff persistently said to me, "It's the objective, stupid, not the target, that is the real issue!" And, for a while, I kept saying, not only to myself but also to my colleagues, that I thought the objective was quite clear. The staff kept telling me I was naive.

Some years back, I heard about Goodhart's Law.[1] I think Henry Wallich first told me about it and wrote about it. The idea is that once a central bank reveals that it is using a certain variable as an indicator or intermediate target because of some past empirical relationship to a specific objective, that variable ceases to be reliably related to the objective. The analogy was something from physics called the Heisenberg uncertainty principle, which arose after that scientist realized that focusing a high-powered microscope on an electron alters the behavior of the electron. Therefore, you can never see it behaving as it would if it were not being observed. Similarly, once people know the central bank is responding to some operating target, their behavior changes—the people being traders in bond, equity, and foreign exchange markets, as well as real people. Then, because people change their behavior in anticipation of what the central bank is going to do based on these indicators, the outcome is not the same as it otherwise would have been.

I now think that Goodhart's Law is relevant only if monetary policy is not anchored by clear, well-understood objectives, that is, a clear strategy for achieving and maintaining price stability. If everyone understands and acts on the belief that the objective will be achieved, people will not care about the intermediate targets or instrument variables. So, I am going to assert a corollary to Goodhart's Law. That is, if the monetary authorities have as an objective the stable purchasing power of money—and this objective is known and credible, such that the actions of households and businesses reflect this knowledge and belief—then the operating target becomes a secondary issue.

Milton Friedman taught us that having and hitting any monetary growth target was superior to a pure discretionary policy. However, this Friedman dictum is valid in the absence of policy being anchored by a clear objective. I am not so certain that an anchored policy is flawed just because implementation involves discretion. All of the debate about rules versus discretion that we saw in the profession for a couple of decades I now think implied the absence of an unambiguous long-run objective.

Where Things Went Wrong

Poole cited the work we did at the St. Louis Fed as one motivating factor for the creation of the Committee on the Directive. A lot of what we did at St. Louis, including my own writing at that time, assumed the context of demand management. Think about the implied message—that the role of monetary policy is to *manage* demand or spending. That clearly is wrong. It gave a lot of people the idea that an activist discretionary

[1] See Goodhart, C.A.E., *Monetary Theory and Practice: The U.K. Experience*, Macmillan, London, 1984, p. 96.

monetary policy could be used to hit certain objectives in terms of output growth, the rate of inflation, levels of employment, the unemployment rate, and so on. And people had the idea that it was appropriate to use monetary policy to pursue "countercyclical stabilization policy" to offset either real shock effects or shocks emanating from the government sector. Right up to the present we still hear references to the idea that monetary policy must be adjusted based on what happens on the fiscal side, or what happens to oil prices.

While I now think that most of the discussion about activist monetary policies is nonsense, it did derive from the work that I and others were involved in, back in the 1960s and 1970s. We should not have allowed the emphasis of our work to appear to suggest that monetary targeting was about creating alternative levers for monetary authorities to push and pull to achieve some sort of unspecified and frequently changing objectives. What we failed to make clear was a crucial underlying premise of monetarism—the Hayekian principle[2] that a market economy, based on private property and using prices to allocate resources, is inherently resilient and naturally gravitates toward full use of its productive resources in the absence of various types of shocks emanating from the government sector.

The Debate circa 1972

Let me now turn back to the FOMC debate regarding the third report of the Committee on the Directive in February of 1972. Committee members and Federal Reserve Board staff covered the full range of opinions of the economics profession at the time regarding both the desirability and the effectiveness of incorporating reserves and monetary targeting in policy decisions. Some expressed considerable confidence that the relationship between various monetary aggregates and nominal spending or inflation was sufficiently reliable that the issue in achieving the desired outcome was finding and adopting operating instruments, or "handles," as they chose to refer to them. Others did not see the merits of incorporating monetary aggregates in the decision process, either because they did not believe the respective money velocities were sufficiently predictable, or because they did not believe that operating instruments were available for achieving desired growth rates of the aggregates, or sometimes both.

---

[2] Hayek explains how markets coordinate the optimal utilization of resources in "The Use of Knowledge in Society," *The American Economic Review XXXV*, No. 4, September 1945, pp. 510-30. A summary of his arguments against the Keynesian notion of equilibrium unemployment can be found in his book *A Tiger by the Tail*, The Institute for Economic Affairs, London, 1971.

Even some who seemed to think that reserve targeting could achieve desired money growth rates—and that money growth rates were sufficiently related to nominal income or inflation to be relied on—questioned whether the byproduct of interest rate fluctuations would be acceptable. Some wanted to have a reserve target with a proviso that interest rate fluctuations would be contained within an acceptable band, while others wanted to have an interest rate target with a proviso that reserve growth or money growth would be within an acceptable band. An irony is that some who opposed reserve targeting in 1972, on the grounds that it would be accompanied by unacceptable interest rate fluctuations, supported reserve targeting later, in 1979, precisely because it was expected that large and desirable changes in interest rates would occur.

During the 1972 debate, Frank Morris argued that the reason the Committee on the Directive recommended adopting reserve targeting as a way of achieving desired monetary growth rates was to avoid the kind of mistakes that had been made under a money market condition strategy. His arguments then are still valid more than a quarter century later. Specifically, he said:

> The FOMC had been very slow to react to signals that it was supplying reserves much more rapidly or slowly than economic conditions warranted. Perhaps the best example was in the second half of 1968 when, in an effort to resist rising interest rates, the Fed had supplied more reserves than any member would have thought desirable at that time. If the Committee continued to employ a money market strategy, it was highly likely to repeat that mistake in 1972, since interest rates probably would come under upward pressure as the economy expanded. By focusing on money market conditions, the Committee would again tend to resist the rise, supplying excessive reserves in the process and not recognizing that fact until well after the damage had been done.

Note that Morris's argument does not involve a direct link between interest rates and economic objectives. Rather, it was a concern about appropriate reserve growth—or what some might call central bank liquidity, others base money.

Over the next decade, the M1 velocity (really the variance around the trend of the M1 velocity) was quite reliable, leading to the belief that if the central bank conducted monetary policy (open market operations) so as to hit an M1 target, it also would achieve a desired nominal GDP growth. So, part of the legislation in 1980 moved the financial system toward what were called uniform and universal reserve requirements—reserve requirements only on transactions liabilities and the *same* reserve ratio on all transactions liabilities at all institutions, so that as balances bounced around from a credit union to a savings and loan to a bank and from a big bank to a little bank, and so on, they would not release and absorb reserves in an erratic way, causing noise in the multiplier. Along about

that time, or maybe shortly after—some people say it was the 1982 Garn/St Germain legislation—M1 got dethroned. While an effort was made to improve the monetary control side, the connection to something we cared about seemed to break down as the velocity of M1 started to become much more interest elastic.

By the time Frank and I had our debate in 1993, it was pretty clear to most people that the prior statistical relationships could no longer be relied upon. The link between open market operations and money growth was not so reliable as once thought. The link between measures of money and the rate of inflation or nominal income growth also was changing.

Some Concluding Thoughts

It is quite obvious that monetary targeting is not a *sufficient* condition for a satisfactory monetary policy. Whether or not it is a *necessary* condition is still debatable. I do think that having a clear objective (strategy) for monetary policy is necessary. I am still waiting for people to persuade me that it is, or is not, sufficient. Poole cautions us that we ignore money at our own peril. I strongly concur in that belief. Not targeting money is one thing, ignoring it altogether is another matter. I think the use of a "proviso clause" in the directive in the 1970s served the FOMC very well. It may again in the future.