

ECONOMICS U\$A

Program #13

“Monetary Policy: How Well Does It Work?”

Learning Objectives

PURPOSE:

To discuss the relationship between the money supply and economic growth and inflation, and to illustrate some of the reason why choosing the correct monetary policy is so difficult.

OBJECTIVES:

1. Interest rates are affected by the supply and demand for money. The money supply is largely controlled by the Federal Reserve. The demand for money is affected by the level of GNP (transactions demand) and the level of interest rates.
2. High interest rates can be due to either an increase in the demand for money or a decrease in the supply of money. Therefore, it is not always possible to determine the proper monetary policy by simply following a money supply rule.
3. The quantity of money necessary to support a given level of GNP can change from year to year. Therefore, it is not always possible to determine the proper monetary policy by simply following a money supply rule.
4. The debate between Keynesians and Monetarists has centered on how money affects the economy and whether the Fed should try to target the growth in the money supply or the level of interest rates.

KEY ECONOMIC CONCEPTS:

demand for money
income velocity of money
accommodative monetary policy
interest rate versus monetary aggregates targets
interest sensitivity of investment, housing and consumer durables

ILLUSTRATIVE EVENTS:

1. the pressure on Burns to increase the money supply to support the recovery in 1975
2. the increase in interest rates in 1978 in spite of a rapidly increasing money supply
3. the rise in interest rates and the recession early in 1980 when the Fed became very restrictive.

Program Transcript
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Annenberg/CPB Project (Logo and Music)

TEASER

BURNS: Oh sure we could do more, we could do a lot more, we could even wreck this country, but we're not going to do it, Senator.

DAVID SCHOUMACHER: In 1975 Fed. Chairman Arthur Burns refused to open the monetary floodgates to fight rising unemployment. Why was he holding back?

Four years later Chairman Paul Volcker set the Fed on a course that would lead to the worse recession since the Great Depression. What could have been worth such a terrible price?

On October 20, 1987 the heartbeat of the financial world nearly fluttered out. What could new Fed Chairman Alan Greenspan do to revive the patient?

During the 1970's and 80's the Federal Reserve adopted long term policies to halt inflation and ease unemployment. What would the Fed do in an economic emergency? Monetary Policy: How Well Does It Work?" That's the question economic analyst Richard Gill and I will investigate on this edition of ECONOMICS USA. I'm David Schoumacher.

(MUSIC PLAYS—OPENING TITLES)

(MONETARY POLICY: HOW WELL DOES IT WORK? Appears on screen)

PART I

DAVID SCHOUMACHER: The Federal Reserve Board is responsible for deciding how much money the economy needs to grow. In the early 1970's the Fed held to a policy of using the money supply to try to keep the economy on course. In times of inflation, the Fed tightened the money supply to squeeze excess dollars out of the economy. In times of recession, it increased the money supply to stimulate growth. But in 1975 the Fed, under the Chairmanship of Arthur Burns, faced a new and troubling

dilemma. Caught between persistent inflation and the growing recession, how did Chairman Burns keep the economy on course?

By late 1974, inflation had become a serious economic problem. Under pressure from rising fuel prices, inflation rose to a staggering 12%. Inflated interest rates had driven up the price of mortgages and brought the building industry to a standstill. Sales of new cars and home appliances plunged.

In September, President Gerald Ford asked Congress to join him in a battle against inflation. “My first priority is to work with you to bring inflation under control. Inflation is domestic enemy number one.”

SCHOUMACHER: The Federal Reserve was also committed to fighting inflation and, under the Chairmanship of Arthur Burns, held to a policy of keeping money tight.

Robert C. Holland served on the Fed’s policy-making Board of Governors.

HOLLAND: “When the Federal Reserve wants to fight inflation, what it does is provide funds...basic funds we call reserves...funds to the banking system...less fast than bank customers are asking for money and credit to finance the kind of spending they’re trying to do in this inflationary period. That means banks have to hold back a bit in terms of the amount they lend. They have to sell some assets, sell some securities to adjust. That puts a little more restraint on borrowers. They don’t get quite as much money. Banks typically charge higher interest rates... Those higher interest rates lead borrowers and investors of all sorts to think a bit more before they decide to make that next expenditure. And in that slow, pervasive, percolating way, sort of a gentle restraining hand is laid on the economy.”

SCHOUMACHER: But the Fed’s “restraining hand” began to have a negative effect when unemployment started to rise in late 1974. By January of ‘75, seven and a half million Americans were out of work.

The pressure was on Washington to act. Representative Henry C. Reuss was Chairman of the House Banking Committee.

REUSS: “Several million men and women were losing their jobs and unemployment... the statistics... shot up to 9%, which was the worst since the “Great Depression”... the worst in 30 years.

SCHOUMACHER: In March, Congressional Banking Committees under Senator William Proxmire and Representative Reuss, began to pressure Arthur Burns and the Fed to relent and allow the money supply to grow more rapidly.

PROXMIRE: “The nation’s money supply has been increasing at an annual rate of only 1.3% since mid-June. And you may call that a middle course, but I consider it a very restrictive course.”

BURNS: “We will not open up the spigot and permit the money supply to increase rapidly because if we did, in our judgment, we would not be helping significantly to relieve unemployment, and we would be, on the other hand, releasing forces that could accelerate what is already a dangerous inflation.”

SCHOUMACHER: Burns predicted that the modest easing that the Fed had permitted would be sufficient to stimulate the economy, due to an increase in the velocity, or turnover, of money.

BURNS: “The high, dynamic variable in the business cycle is not the stock of money, but the rate of turnover of money.”

REUSS: “Velocity is simply the number of times the rate at which a dollar of money turns over, and, of course, if you have a lot of velocity... people spending their dollars before they stop rolling... then you can get by with a net increase of fewer dollars than if the velocity is not all that strong. The hitch is that nobody can tell or project what velocity is going to be and hence we felt... and I think we were right... that you had to be a little less stingy about the money supply itself.”

HOLLAND: “The critics of the issue were saying we need more M1. The long-term analysis shows M1 velocity is stable, or sufficiently stable so the wise course is to keep pushing it out. We said, look, that may have been the average for quite a while, but there are practical reasons why it’s changing. You can see ‘em in the marketplace... you can see it in the bank... you can see it in the offers being made to people... you can see how people and businesses are reacting. We need to recognize that reality.”

BURNS: “Oh sure we could do more, we could do a lot more. We could even wreck this country. But we’re not going to do it, Senator.”

SHOUMACHER: Burns stuck to his guns and kept the money supply growing at a modest rate. By summer, indicators began showing the first signs of a recovery. By fall, the unemployment rate had dropped substantially. But most important for the Fed, the recovery did not lead to new inflation.

By the year’s end, it had fallen to 9%. Arthur Burns had taken a difficult and certainly controversial stand. Caught in the currents of political pressure, he had managed to keep monetary policy on course. Using velocity as a guide, he had succeeded in fostering a recovery without further

fueling inflation. How exactly does this concept called “Velocity” fit into the economic picture? We asked analyst Richard Gill.

(MUSIC PLAYS—COMMENT & ANALYSIS I)

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RICHARD GILL: Economists like terms like “velocity” because they suggest we’re scientists, like physicists. Well, perhaps we aren’t quite that scientific, but we do have our own concept of “velocity,” specifically the “income velocity of money.”

Briefly, “income velocity” tells us how many times a year a dollar circulates through the economy to buy final goods and services.

We measure it by dividing annual money national income by the stock of money in the economy.

Annual money national income equals the average price of a good, P , times the quantity of good produced, Q . This is really our old familiar GNP concept in money terms.

If we now divide money national income by the stock of money, our currency and demand deposits, M , we get velocity, V . Thus, V equals P times Q divided by M .

We can put the M on the other side and get: M times V equals P times Q . This is called the equation of exchange.

Now the economic question facing the monetary authorities, like Arthur Burns, was: What would happen to the economy when you changed the money supply, M ?

Roughly speaking, congressional critics were saying that you needed a bigger increase in M , on the left-hand side, to get a bigger increase in Q —more output, jobs, employment. What Burns was saying was that you could get this bigger increase in Q without such a large increase in the money supply because V , velocity, would also be going up.

But then, unfortunately, another problem comes up. Suppose both M and V are increasing, how can we be sure that the effect will be on Q and not mainly on P ? Will we get more Q ... output and jobs... or simply a higher price level, P ?

Will the Fed’s actions bring us prosperity or simply more inflation?

PART II

SCHOUMACHER: By the late 1970's inflation had taken over again, and there was a widespread feeling that the Fed had to exercise restraint on the economy. But how? Up until this period, most economists felt that the best way to cool inflation was to raise interest rates, keeping the price of money high. That would slow down business investment and spending and put inflation back in the box. But others felt it was best to work on the money supply directly, and to focus on the long run rather than the short-run.

In August 1979 Paul Volcker became the new Fed Chairman. What course would he take?

The Fed was already facing enormous criticism, much of it coming from a group of economists called "Monetarists." At the head of the Monetarist attack was economist Milton Friedman.

FRIEDMAN: "In my opinion, given that there is a Federal Reserve, the best way for it to operate would be to set targets for a single monetary aggregate, and stick to those targets, and keep to them as closely as possible. Those targets should be set so as to go from wherever you start to a rate of growth in the money supply which is consistent with zero inflation."

SCHOUMACHER: On October 6, 1979, Paul Volcker announced that the Fed would no longer target interest rates, but would focus instead on targeting the money supply itself, restraining it until inflation was broken. In a speech before the National Press Club, he stressed his determination to stick to this long-term course.

VOLCKER: "Will the Fed stick with it? My short and simple answer to that question is "yes" and I don't intend to qualify...(APPLAUSE)... I don't intend to qualify that answer. But I do want to be clear... clear about what the it is that we intend to stick with. It, in the sense of our October 6th actions, is restraint on the money supply... reducing its growth over time toward levels consistent with price stability."

SCHOUMACHER: Fred Schultz was Vice-Chairman of the Fed Board under Volcker.

SCHULTZ: "The major change was a difference in how monetary policy was going to be carried out. Before that, there had been an effort to try to have relatively slow interest rate changes. That clearly was not doing the job of controlling the economy in this kind of a very volatile, inflationary environment that had appeared in 1979.

And so the change was to go to strict targeting on the money supply alone. The effect of that is... if you're not paying any attention to the price of money, which is what interest rates are, the effect of targeting entirely on the supply is that the price of money is going to change a good deal more."

SCHOUMACHER: By the end of the year, interest rates began to rise, and rise dramatically. By February the prime rate had reached a record 20%. Among the first to feel the squeeze were small businessmen.

BUSINESSMAN: "We understand what the objective of the national government is, what the objective of the Fed is, but we think that what can be a cure for the country's ills can be fatal to the small businessman.

SCHOUMACHER: The Carter administration reacted to the sky-high rates by imposing a limit on the amount of credit banks could offer. Suddenly, the buying spree ended and the Fed was pulled off course. They were forced to expand the money supply to rescue the plummeting economy.

But in late 1980, the situation changed. The election of Ronald Reagan gave Volcker the opportunity to return to his long-term plan. As part of his economic program, Reagan encouraged and supported monetary restraint.

But in 1981, restraint began to take its toll. High interest rates caused a collapse in the building industry. The high cost of consumer loans put auto dealers out of business and auto workers out of jobs. Still, Volcker held to his long-term course.

VOLCKER: "Consolidating and extending the heartening progress of inflation will require a continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint."

SCHOUMACHER: By 1982, the economy had fallen into the deepest recession since the "Great Depression." Even the Reagan Administration was urging the Fed to relent. But Volcker and the Fed Board, determined to bring inflation down, held tight. Finally, in late 1982, the Fed saw inflation drop substantially, and ease the money supply.

REAGAN: "This last week, the Federal Reserve Bank decided to lower its discount rate to 9.5%, the first time this key interest rate has gone below two digits since 1979, and the fifth reduction in just 4 months. This demonstrates the Fed's confidence that inflation and market rates will continue coming down, and it's confidence that we can work together for a healthy, non-inflationary recovery."

SCHOUMACHER: Throughout the recovery that followed, inflation held at 4%. Though inflation had been substantially reduced, the Monetarists criticized the Fed for not adhering to a strict growth rate of the money supply.

FRIEDMAN: “In my opinion, the actions of the Federal Reserve have added to the uncertainty, have added to the instability of the economy rather than reduced it. And, let me emphasize, stable monetary growth is not a guarantee of stable economy. It’s a guarantee that you will not have disturbing elements introduced by the operation of monetary policy. It’s a way, as it were, to keep the Federal Reserve from doing mischief, and not a way to produce nirvana.”

SCHULTZ: “The idea of “monetarism” is that there is a stable relationship between money and the gross national product. Well, we’ve seen that that’s not the case. Furthermore, if you were to be very precise in your targeting and just stayed on that target-path day to day, interest rates would fluctuate enormously, and that wouldn’t be good for the economy.

So we took a pretty “Monetarist” approach in October of 1979 because it called for extreme measures. But, as you’ve seen, since then that position has been ameliorated. Now does that mean that money doesn’t count? Of course not, money is very important, but I think this strict “Monetarist” approach is not workable over a long period of time, but it was necessary when we did it.”

SCHOUMACHER: Focusing on the money supply appears to have worked, but the cost was high. Chronic inflation, which had plagued the economy for more than a decade, was reduced and contained, but at the price of forcing the economy through two deep recessions. Why was the Fed willing to pay such a high price in its battle against inflation? We asked economic analyst Richard Gill.

(MUSIC PLAYS—COMMENT & ANALYSIS)

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RICHARD GILL: Basically, they were willing to pay this high price because they saw no alternative. What happened in the late 1970s and early 1980s, in the field of monetary policy, can be read either (A) as a confession of failure or (B) an expression of hope.

The failure side was an admission that monetary policy, whether focused on interest rates or the money supply, couldn’t do much to avoid short-term difficulties in the economy.

And the recession of the early 1980s was serious. People lost jobs. Basic industries faltered. And Volcker's policy was often cited as responsible.

But the policy was also an expression of hope. It said, in effect, let's shift our attention to the longer run. We may be able to do something to wring inflationary pressures out of the economy over a period of years.

In terms of our equation of exchange, it was admitted that in the short-run V and Q might jump around all over the place, but that, in the long-run, you could control prices (P) by keeping at least a somewhat firmer hand on the money supply throttle.

Failure and hope, the latter justified by what did in fact happen to the rate of inflation. It did fall and, in many ways, more sharply than anyone might have predicted.

So then, has hope won out? Perhaps. Though we discovered in the 1980's that there are times when the short run has to take precedence over the long run. October 1987 gave us a dramatic case in point.

PART III

SCHOUMACHER: 1929. The plunging stock market causes a panic. The Federal Reserve clamps down on the money supply, stifling the economy. Banks starved for ready cash—liquidity—fail by the thousands. Businesses close. Soon 18 million Americans are unemployed, hopeless, and hungry.

This is Wall Street today. Buying and selling by computer, trusting Congress and the Federal Reserve to prevent a repetition of 1929. After many years of experimentation, Wall Street and the nation have learned that a long-term, consistent monetary policy is good medicine to keep the economy healthy. But in 1987 the question remained unanswered: what could monetary policy do in an economic emergency?

REAGAN: I have a statement for you. Paul Volcker has advised me of his decision not to accept a third term as a member and Chairman of the Federal Reserve Board. I accepted Mr. Volcker's decision with great reluctance and regret.

It is my intention to nominate Dr. Alan Greenspan to a four-year term as Chairman for the Federal Reserve.

SCHOUMACHER: On his first day in office Chairman Greenspan revealed his wish list.

GREENSPAN: A dollar, which is always stable, interest rates which stay low, and employment which stays high.

SCHOUMACHER: His first action as Chairman of the Board of Governors was to reaffirm Volcker's tight money policy, a long-range strategy that most economists believed was crucial to maintaining orderly economic growth. But if there was one sector of the economy that was far from orderly in 1987, it was the stock market.

Greenspan feared a collapse, but what could the Fed do? Securities Analyst Roger Kubarych:

KUBARYCH: When Chairman Greenspan came in office in August, one of the finest things he did was to launch a series of studies, call them war games if you like, that did include both the Board and Staff in Washington, members of the Board and the New York Fed, on a number of possible scenarios for market disruption, financial market disruption.

SCHOUMACHER: On October 19, 1987 Greenspan got an unwelcome opportunity to test his plans. The market fell 508 points, more than five times greater than the 1929 drop which precipitated the Great Depression. Many investors faced total financial ruin.

KUBARYCH: There was a clear picture of an impending problem of monumental proportion so... it was a fascination. It was like watching a car accident that was happening right on your block.

SCHOUMACHER: The business of buying and selling stocks is based on confidence. By Tuesday morning, October 20, confidence had fled. What were people afraid of? We asked Economic Forecaster Nariman Behraves.

BEHRAVESH SYNC: The specter of a 1929-style depression loomed very large for the markets and for the Federal Reserve. I think the kind of scenarios that the Fed was most worried about was that people had borrowed a lot to finance purchasing stock as the stock market rose. As it crashed a lot of those loans were called in. And the Fed was worried that there would be a lot of bankruptcies—personal bankruptcies, corporate bankruptcies. As those occurred a lot of people would be laid off. The unemployment rate would rise, and you'd have a full-scale recession, and maybe even a depression, on your hands.

SCHOUMACHER: A bank run seemed imminent. Banks needed liquidity immediately. How would the nation's central banker respond? What the Fed did was two-fold. It supplied liquidity through ordinary market operations and through the use of the discount window—very standard

techniques of supplying liquidity. But under the guidance of Chairman Greenspan, they also sought to reduce the demand for liquidity. In other words to use, what you might call, tender persuasion, to convince people that they needn't go seeking liquidity, bidding for liquidity, it would be there.

In 1929 the Fed tightened the money supply. This time Greenspan did the opposite. The Fed's message was: whatever you need, we'll give you.

Greenspan had said the magic words, but was anyone listening? On Tuesday morning the market continued its dive—plunging 225 points. By noon the market was approaching complete meltdown. Buying was at a virtual standstill. Then, buy orders began trickling in like water upon parched land. The buying trend accelerated. Wednesday morning the world awoke to headlines touting the largest rally in the big Board's history.

Monetary Policy works in mysterious ways little understood outside the economic community. But on Tuesday, October 20, 1987, Alan Greenspan demonstrated both the power and the flexibility of the Federal Reserve. His willingness to turn his back on long-term tight money policies and pump cash into a desperate economy helped save the stock market and quite possibly the economy. We asked analyst Richard Gill what this emergency intervention has to do with the demands we place on monetary policy.

(MUSIC PLAYS—COMMENT & ANALYSIS)

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RICHARD GILL: Well, perhaps the basic thing it shows is that, although it might be nice to focus on keeping things steady in the long run, there are times when human judgement and discretion are crucial.

The fall in the stock market in October of 1987 was real. The dangers of a profound effect on the economy, equally real. Numerous commentators observed that the parallels to 1929 were ominous. Even the upturn in the market in late 1987 had had its parallel in the 1920's, only to be followed by a further collapse and the greatest depression of all times.

But it didn't happen. And one reason was that theories of long-run steadiness gave way immediately to an appreciation of the crisis. Did we need more money? More liquidity? "We would have it" the Fed told us quickly and unequivocally. "Forget general rules. Handle the crisis first"—which leaves us where?

Perhaps better off in economic fact than in economic theory. Cruise control is great in automobiles on the open highway. But when the traffic gets hot

and heavy there is, alas, no substitute for human judgement. Hopefully, good judgement.

SCHOUMACHER Closing Standup:

SCHOUMACHER: Monetary policy was an effective factor in holding down inflation in the booming '90s. The federal reserve was also successful in limiting the damage from various crises to hit the U.S. Economy, including the financial crisis after the Russian debt default of 1998 and the terrorist attack of September 11th. In both instances the Fed flooded the banking system with liquidity to make sure U.S. financial markets did not freeze up. It's hard to say how well monetary policy will work in the future, but for the past 20 years monetary policy has called the tune. For ECONOMICS U\$A, I'm David Schoumacher.

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Closing Credits