REGULATION AND THE MONETARY ECONOMY

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James Tobin sees the demise of monetary targeting with glee; I see it with foreboding. The financial innovations underway create serious problems for monetary policy. Deregulation brings many benefits, but we need to protect the effectiveness of monetary policy.

The various financial assets that have transactions capabilities are growing. This reflects the declining costs of handling check clearings. In addition, reserve requirements on checking deposits in traditional depository institutions create an incentive to avoid the requirements by providing transactions services on accounts not subject to reserve requirements. How far this circumvention will go is unclear. Congress could extend reserve requirements to all instruments deemed to have transactions capabilities, though such capabilities become murky on the margin. (If one can write a check on a mutual fund or brokerage account, these are transactions balances. If one first sells a bond to raise a brokerage account, and then writes the check, is the bond deemed a transactions asset? Usually not, but what if the broker automatically sold the bond from a person's account to cover checks that came through the clearing process?)

Alternatively to an extension of reserve requirements to all transactions assets, such assets without reserve requirements could grow at the expense of those with requirements because of the ability of the former to pay a higher return. Whether accounts now offering partial transactions services (through minimum size of checks or maxi-

mum number of checks per month) will ever offer full services and incur the resulting clearing costs is doubtful. Nevertheless, we seem headed for a system with various marginal kinds of transactions balances making the concept of the medium of exchange fuzzy.

If in time a monetary system evolved in which all transactions were made via transfers of marked-to-market mutual fund shares or other assets easily transferable by computer, the Federal Reserve would essentially be out of the money-creating business. Some new kind of monetary control over aggregate demand would have to replace the present Federal Reserve open market operations. One can speculate about how such a system could or should operate, but the answer depends on institutional details that are hard to envision. What would the unit of account be? Would there be instruments with value fixed in terms of the unit of account? By whom would they be issued? What role would or could the government choose to play? Whether the medium of exchange is fixed in terms of the unit of account is important because it determines whether a change in the value of money can occur through a change in the price of money directly or requires a change in the general price level.

The payments system I envision for the near future, however, involves the transfer of present assets, currency, deposits, mutual fund shares, or the like. And these must be owned in advance of purchases. But the issue is, what is held in advance by the public? Through sweep accounts it need not be the asset that is actually transferred, though of course the institution conducting the transfer has to own the assets used in clearings among institutions. These clearings can be handled by a quantity of deposits in banks and the Federal Reserve that is a miniscule fraction of the total of assets that are subject to immediate transfer and therefore that are offering transactions services to the public. There would still exist a monetary base and its multiplier effect on some aggregate of transactions balances. But an obvious problem is that the larger the multiplier the less control the Federal Reserve has over the aggregate transactions balances, both because the multiplier can vary considerably over time and because the multiplier process will take a long time to work through a change in the monetary base.

What will happen to velocity depends on the definition of transactions accounts. For a wide definition of such accounts, their velocity will be lower because many of them held partly for investment purposes will not turn over frequently. The velocity of reserves, such

as the monetary base, on the other hand, will turn over rapidly because a smaller base will be able to service the clearings for a larger volume of transactions. I see these developments as increasing the lag time of open market operations and the variability of the money multiplier.

The advent of interest payments on money through NOW accounts and overnight repurchase agreements (RPs) makes the traditional LM schedule more vertical, because the opportunity cost of holding money vis-à-vis other assets changes less. This stabilizes velocity. At the same time, however, the growth of convenient substitutes for money through sweep accounts increases the substitutability between any specified group of monetary assets and other liquid assets. Hence, any change in a variety of variables that cannot be easily measured and taken into account will produce shifts between assets, represented by shifts in the vertical LM curve. The net effect on the ability to conduct monetary policy is unclear. So far we do not see clear evidence of such shifts, though there have been unpredicted movements in velocity attributable to what appear to be one-time adjustments to specific financial innovations, particularly the payment of interest by new NOW accounts.

Innovations in the financial and payments system since the 1960s have thus strengthened the case against monetary growth rules. The velocity of all the monetary aggregates has exhibited shifts in the 1970s and early 1980s that were unpredictable based on the standard equations that fit so well from 1953 at the time of the Treasury–Federal Reserve Accord to the mid-1970s. These shifts may be due to the removal of deposit rate ceilings and may not be repeated, and even if they are, constant monetary growth would provide a guarantee against severe inflation and would create certainty in monetary policy. Nevertheless, the innovations underway and prospects for the future make the outcome of constant monetary growth uncertain and would produce fluctuations in aggregate demand that are no longer considered acceptable. The old debate over whether rules or discretion would in fact provide a better outcome continues, but modern developments have created a fear of financial disturbances that give a preference to discretionary powers to deal with unknown contingencies. No monetary policy procedure will ever be able, for political reasons, to shed this ultimate degree of discretionary control.

The expanding boundary of money has given rise to proposals to target more definable aggregate, going out to total debt in one direction and into the monetary base in the other direction. I am skeptical that such aggregates would provide an improved stability in their relation to aggregate expenditures. The idea behind the ancient quantity theory of money was that the medium of exchange was special among the totality of financial assets in that its role in the financial system was fairly stable and that therefore it had a predictable relationship to aggregate expenditures. If that relationship proves too weak to serve as a guide for monetary policy, I find it unlikely that any other aggregate will do better. Indeed, total debt is plagued by shifts between debt and equity financing, and the monetary base is plagued by changes in the reserves behind transactions balances. If some transactions balances have reserve requirements and others don't, the base multiplier will be unstable.

All this means that the monetary authorities need discretion to adjust to changing monetary relationships. Does that also mean there should be no constraints on the discretion of the authorities?

These days the financial markets hang on every word—even every gesture—emanating from Paul Volcker. The market wants to know what the Fed is up to and the Fed is not telling all. I can understand that the Fed authorities are reluctant to commit themselves to a line of action when they are unsure how conditions are changing and that they want the flexibility to adjust to ongoing developments. But I see little benefit and considerable disadvantage in the public's ignorance of Fed intentions. Proponents of discretion go too far in dismissing the uncertainty of monetary policy as of no importance.

If a monetary rule is not feasible, there is still a case for constraints on the discretion of monetary policy. I submit the following modest proposal to improve the situation, designed to satisfy the minimum positions of the major camps in the monetary debate. Instead of saying "Trust us to do the right thing," the Fed would lay out its intentions somewhat as follows:

> The board, though subject to some differences of opinion, adopts a consensus view that x percent growth in nominal GNP over the next four quarters is a feasible path to take us toward a long-run desired path of price stability and maximum sustainable real growth. The board looks for nominal GNP growth of x percent to provide y percent growth in real GNP and p percent growth in prices (the best it believes attainable for the present). Nominal GNP growth

> may in fact divide differently between real growth and inflation, but unless the division departs strongly from the latter expectation, the nominal GNP path looks to be best nevertheless. To attain the nominal GNP growth path of x percent over the next four quarters (which is the policy objective) the board believes that growth in M1 of m percent over the next two quarters is most likely to be appropriate. Unless conditions change and the M1 target has to be altered, the board will shoot for m percent growth over the two quarters as a whole, not necessarily month by month. If the evidence suggests a different target for M1 or a different objective for GNP, the change will be announced.
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> It is to be understood that the preceding growth rates are point estimates and actual outcomes could differ by normal standard deviations of epsilon percentage points without indicating a change of policy.

This may look a lot like what the Fed in effect does and says now, but there are major differences. The above sets out a guideline on how monetary policy will be conducted and how it could be changed if conditions vary. It allows observers to see how closely policy is meeting the guidelines and to judge the outcome of policy. It prevents the Fed from hiding behind obscurities. To be sure, it will probably reduce the flexibility of policy (since the Fed would hesitate to announce changes too often) and delay desirable adjustments to changing conditions. It does seem to me, however, to relieve the debate over discretion versus rules of extraneous issues and to pinpoint the fundamental question: Would a more consistent pursuit of an announced target for monetary policy improve the overall outcome compared with a more flexible procedure of rolling with every economic shock? I leave open the question of *how* flexible policy should be in responding to short-run shocks, which of course is crucial to the debate of discretion versus rules. What I stress here is the issue of accountability and, more important, of foreknowledge of monetary policy.