Monetary Policy and The Business Cycle

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One of the important policy issues we face today is the linkage between monetary policy and the business cycle. This issue is of relevance from an economic point of view, but I assure you it is also relevant from a political point of view. From the beginning of President Reagan's administration, our preferred operational monetary guide has been very simple. We want stable and moderate monetary growth. Although our objective has not been fully achieved, we continue to judge monetary performance against that standard and we continue to believe it represents the best, risk-minimizing strategy. I would like to briefly give you the arguments in favor of that proposed strategy.

We do not believe that fine tuning of monetary—or for that matter fiscal—policy can work. There are inevitable lags that are likely to turn efforts at fine tuning the macroeconomy into unintended destabilizing forces. There is, for example, the observation lag. With uncertainty about contemporaneous economic activity—when the economic data provide mixed signals as they so often do—we cannot expect to judge with any degree of precision what the appropriate policies are for responding to emerging or expected economic conditions.

There is also an execution lag. The execution lag need not be long in monetary policy, because policymakers consist of a small group that meets regularly. But in the fiscal policy area policy debates can go on literally for years, making it very difficult to act in a timely fashion. Finally, there is the impact lag. The macroeconomic effects of a policy change are not immediate and, in fact, some of the short-run effects may be exactly the opposite of the long-run effects. For

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these reasons, I have long held that the fine tuning of policy will not work and is as likely as not to be destabilizing by inducing a stop-go pattern to economic performance and the business cycle.

There is a fairly consistent lead-lag relationship between monetary change and the business cycle. Although this relationship is debatable, the evidence of the direction of change between money growth and nominal economic activity appears overwhelming. One does not have to argue that money is the only causal factor in business cycles, and I would not, but the evidence certainly suggests that maintaining stable money will avoid reinforcing other inherent, cyclical initiators. Stable and moderate monetary policy would at least not contribute to or reinforce cyclical fluctuations, and therefore would be better than what we typically have experienced.

Why does this administration propose moderate money growth? Well, the answer is pretty obvious. I think that of all the hypotheses proposed in economics, the one that may have been most widely tested is the relation between money growth and inflation. Disagreements about how soon and how much will always occur, but there are very few economists who would argue that the growth of monetary aggregates has no bearing on the subsequent rate of inflation.

If our objective is to achieve price-level stability, then it does indeed matter whether we maintain moderate money growth. I assure you that the President's goal of achieving and maintaining price-level stability remains very firm, and I do my best to reinforce his position.

Some say, well what's wrong with inflation? Inflation always looks relatively attractive or harmless when it is low. But we have all learned how difficult it is to maintain just a low inflation rate. And as inflation escalates, it becomes less and less attractive and more and more harmful. Inflation distorts the structure of prices and profits and causes resources to be misallocated, in addition to causing an arbitrary redistribution of income.

Because of the lack of complete price flexibility, inflation tends to distort relative prices, thereby sending out the wrong production and consumption signals. Furthermore, when the government defines certain rules—such as tax codes—in monetary terms, inflation causes very serious distortions in the economy. It can erode productive incentives and encourage major efforts to avoid taxes. I would argue that it unfairly redistributes income and asset values; certainly the poor do not do well in a period of inflation nor do the holders of fixed-rate financial assets. Inflation promotes nonproductive activity, causes considerable effort to be put to use to adjust portfolios, and creates incentives for speculation. Regardless of how profitable or useful these activities may be to an individual operating in an inflationary environment, all such activities are a waste of society's economic resources, compared to an environment of price stability which would render these activities unnecessary. Therefore, inflation essentially limits potential real growth and impedes the improvement of living standards. It also contributes to volatile exchange rates around the world, thereby changing signals between tradeable and non-tradeable goods and services. This, of course, inflicts costly adjustments on societies.

Of course, inflation inevitably brings pressures to disinflate with all the political pains and the very real economic costs that occur. I know them only too well. In conclusion I believe achieving stable and moderate monetary growth will go a long way toward improving the performance of the economy. It will not, of course, solve all of our economic problems.

From my view, I would welcome the day when the topic of this conference—"Money, Politics, and the Business Cycle"—would become obsolete. Not because there is no relation between money, politics, and the business cycle; there is. But I would welcome the day when we quit trying to use monetary policy to fine tune the economy and, most important, when we quit expecting the Federal Reserve to do so. The fundamental relation between money, growth and economic activity will always be with us, but I look forward to the possibility that we will eventually recognize the limitations of monetary policy and cease expecting the Fed to iron out every wrinkle that develops in the economy. Then we could concentrate on society's real economic problems, undistorted by monetary disturbances. Money would then, indeed, be neutral.