"HENCEFORTH VOLCKER WILL WATCH ALL THE GAUGES ON THE DASHBOARD"

Speech by B. M. Todd, Jr.
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I am going to discuss three things with you today: 1) what has changed in our monetary policy, 2) why it changed, and 3) how we began to see signs earlier this year that significant change in monetarism was in store for us.

With 10.1% unemployment reported for September, by that dismal statistic alone it is clear Reaganomics has not been working. But then neither is Trudeau-economics, Thatcher-economics, Mitterrand-economics, Schmidt-economics, or any other economics one might care to mention. The plain fact is we are experiencing a world-wide recession. There isn't a government on the face of the earth doing any better than we are. Many are doing far worse. Somehow this seems to have escaped the media's attention.

The test of economic policy is not whether it is working in the sense of providing an immediate solution to our difficulties, but whether it is positioning the economy for a healthy recovery once natural forces of recovery take hold. But there is no set of governmental policies that can painlessly convert a world recession into a national prosperity.

We have had more success in bringing down the rate of inflation than anyone expected. It has been running at a 4.8% rate so far this year, well below the 12% rate of 1980. It is unlikely to exceed a 5% or 6% rate over the next twelve months. While Reagan has not done as much as we would like to slow the growth of government spending he has done somewhat better on this score than governments of Western Europe. He has accompanied this with welcome tax cuts which, even after their recent, and probably foolish modification, will stimulate the private sector once recovery is under way.

The most controversial area of economic policy has been monetary policy...the focusing by the Federal Reserve on money supply to the exclusion of other vital indicators.

The Fed's objective is to provide a dollar that holds its value over time so that people who make contracts in dollars don't suffer windfall losses or gains because of unexpected changes in its value. The most important way they have for controlling the value of the dollar is to buy or sell government securities with dollars. How do they do this? They have only three options to guide their open market purchases or sales.

First, they can target the quantity of some measure of money, which we've come to call monetarism. This was the dominant guide of policy for the last three years.

Second, they can target the price of credit, buying or selling bonds to keep interest rates within a specified range. This was the dominant guide to policy from August, 1971 to October 6, 1979.

Or third, they could target the value of money itself in terms of real goods. From 1792 until August, 1971 the banking system in the United States used gold as a proxy for the value of all real goods, buying or selling bonds to maintain the value of the paper currency in terms of gold. Theoretically, other proxies for gold, such as a market basket of commodities, could be targeted in keeping within this price rule.

We don't believe that either Keynesians, Monetarists or Supply-Siders have all the answers. Each has something to contribute to policy. We have learned from painful experience not to look at only one instrument on the dashboard (i.e. monetary aggregates).

What is the new monetary policy? Well, Mr. Volcker has a genius for ambiguity. It is inherently somewhat vague. Once the precise formula of monetarism was abandoned policy will have to take its bearings by more than one indicator. Bob Bartley, editor of the Wall Street Journal, said in an editorial: "How can anyone judge whether Chairman Volcker is suspending M-1 but retaining an anti-inflationary stance, or instead is succumbing to temptations to inflate for political reasons? To judge whether the Fed is stabilizing the price level you watch the movement of prices."

He goes on to point out that to stay ahead of the game you have to watch the most sensitive prices such as commodities and precious metals. Bartley suggests that we watch gold.

I believe monetary policy will take its bearings from several indicators, including real interest rates, the relative strength of the dollar in international currency markets, the price of commodities (including gold), and GNP. Art Laffer suggests we watch the Dow Jones Spot Commodity Index for a clue to possible Federal Reserve response. For the Fed to chart its course by these signs will not be easy. We can expect monetary policy will occasionally drift off course - but it should only be temporary and correction should not be too difficult.

News was leaked to the markets on October 6 that the Federal Reserve's policy making Open Market committee had, on the previous day, decided to make a "temporary policy adjustment". Then on Saturday, October 9, in a speech to the Business Roundtable in Hot Springs, Volcker publicly revealed the "temporary" obsolescence of the M-1 measure of money. Volcker said: "The inflationary momentum that has gripped the economy in the 1960's and 1970's has been broken". He said that the Fed no longer had any alternative but to attach much less than the usual weight to movements in M-1 which, since October, 1979, has been the world's most closely watched economic indicator. Volcker had initiated the monetarist approach three years ago in response to a collapsing dollar and a soaring inflation rate.

Volcker has now, in effect, said he has proved his anti-inflation determination. From now on the markets must trust him to carry on the good fight the way he thinks is most appropriate without expecting him to hold too closely to the arbitrary constraints of publicly announced money supply targets.

We were given clues earlier this year that Volcker was going to be giving greater weight to his own professional judgment in the conduct of monetary policy. For example, in the Sunday, July 4, issue of the New York Times in an article entitled: "The Troubled Fed Seeks a New Way", Volcker said: "There inevitably is a critical need for judgment in the conduct of monetary policy".

Two months later, on September 19, in another article in the New York Times entitled: "A Talk With Paul Volcker", he talked about a higher rate of money growth being more appropriate during a weak economic setting than during a period of robust activity. He was saying in these articles that stronger money growth was called for due to the weak economy, that the Fed had won credibility as an inflation fighter, that he had to change psychology, and that it was difficult to do with everyone watching money supply.

The benefits of this new policy should be steadier - and lower interest rates as the Fed and the money markets desist from their multi-billion dollar poker game over the week's money supply figures.

At mid-year it was clear that the Fed was moving into uncharted waters in its efforts to set a sound course for future monetary policy. In the past few years they had fought almost single-handedly to bring inflation below double digit rates. In that effort they succeeded, all the while warding off barbs hurled at them by critics, but in mid-1982, after two years of high interest rates, the economy was virtually stagnant, caught in a squeeze between high rates, falling inflation and weak sales. Bankruptcy figures were soaring. Investment plans were being shelved. Millions of workers were laid off with scant prospect of quick return to the payroll.

Looking back to mid-year with inflation now down to 6% why were Treasuries still yielding 14%? It was fear of the future, because of the enormous budget deficits of between $100 billion and $150 billion being proposed by Reagan, not just as a result of the recession but as far as the eye could see in the future. Wall Street was convinced that the Fed and its monetary targets were the only bulwark against a renewed upsurge of inflation. Investors felt that rates might not fall very sharply until Reagan did something about his budget deficits, irrespective of what monetary course the Fed might follow. For if the Fed relaxed its grip while the fiscal picture remained as inflationary as ever, markets would panic at prospects of another inflationary upsurge, recalling lessons we'd all learned in the late seventies.

It was this concern about market psychology, rather than any deep faith in pure monetarist doctrine, that accounted for Volcker's refusal, until early October, to contemplate the abandonment of its monetary targets. The Fed has been concerned about the impact of high rates on the economy. Their own economists had expected a visible recovery would have been in progress by now.

As signs of recovery failed to materialize the pressure to do something about rates has grown. It has come from some of the Fed's own governors, the presidents of the Reserve banks throughout the country, and from private bankers, alarmed by the state of their own balance sheets, and the state of loans to hard-pressed industrial companies and underdeveloped countries. There were three bills before Congress proposing changes in monetary policy.

Most of this year such pressure was counterbalanced from both the Reagan Administration's public pronouncements and some influential Wall Street economists who remain convinced monetarists. They feared that for the Fed to raise its monetary targets would be seen as a retreat from the fight against inflation.

With the recession continuing into mid-summer the markets became increasingly convinced no significant recovery was in sight. The hopeful side of the market's concern, however, was that investors started having second thoughts about the expected clash between huge borrowing requirements caused by the deficits on the one hand and the investment needs of private industry and consumers on the other.

It was against this background of change in perceptions that Volcker took the first public steps toward redefinition of monetary policy culminating in his October 9 announcement that M-1 would now be downgraded as an operational target.

The fact that this announcement was followed by one of the biggest booms in the history of the New York stock and bond markets refuted the doctrine that markets would panic at the slightest sign of deviation from the monetarists' straight and narrow. Returns on both bond and stock markets since mid-year have exceeded 25%.

There may be a new philosophy at the Fed but it would be rash to assume that Volcker will suddenly become a soft touch, just because he has publicly confessed what many always believed - that he was never a doctrinaire monetarist.

Reagan's supply side tax incentives could not possibly work amid this monetary chaos. We had one foot on the gas (tax cuts), and one on the brake (monetary policy). No wonder the engine overheated (high interst rates).

But if, after the November elections, we find that the temporary holiday from monetarism was indeed just that, then the Fed's intervention will unwind the gains of recent weeks and abort recovery. The degree of exuberance of the market suggests Wall Street believes it may be permanent.

What about the current economic environment? November may well mark the beginning of a mild economic upturn. Industries sensitive to the business cycle such as autos, steel, and housing are operating at such low rates a pickup is almost inevitable if a depression is to be avoided (4 1/2 million cars, 40% operating rate in steel, one million housing starts). The sharp drop in interest rates suggests that sales of homes, cars and other big ticket items should begin to show signs of a pickup within the next month or two. An upturn in household expenditures is especially important because only the consumer can provide thrust for our recovery, particularly since falling exports, especially to lesser developed countries, as well as OPEC, are exerting a powerful downward pull on the world economy. I agree with those forecasts which call for a decline in real GNP this year of about 1 1/2% and a recovery next year of about 2 1/2% or 3%.

In my opinion the Fed's change of monetary policy on October 5th means that until further notice we are in a bull market for long term financial assets, both bonds and stocks. The United States will now reflate and Europe will follow us. We are finally getting the break in interest rates many of us had expected earlier. In 1983 we finally get a tax cut. Most of the previous cuts were offset by bracket creep and higher social security taxes.

In summary, the Fed will be taking a more pragmatic approach toward monetary policy, emphasizing quality more than quantity of money. We believe it is a more sensible policy and will lead to much greater confidence in the financial markets which, in turn, will lead to a sustainable economic recovery. This at last has positive implications for good stock and bond markets over the next few years......at last!