The Federal Reserve Bank of St. Louis

Thomas C. Melzer
President

Post Office Box 442
St. Louis, Missouri 63166

314 444 8301

**STRICTLY CONFIDENTIAL (FR)**
**CLASS I - FOMC**

**PLEASE FAX IMMEDIATELY**

May 10, 1988

To: Mr. Normand R.V. Bernard
Special Assistant to the Board
Division of Monetary Affairs
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

From: Thomas C. Melzer

Total pages: 5

**STRICTLY CONFIDENTIAL (FR)**
**CLASS I - FOMC**

May 10, 1988

To: Federal Open Market Committee

From: Thomas C. Melzer

As you know, Chairman Greenspan plans to include a discussion of the monetary base at the May 17, 1988 meeting. Attached are some additional comments on the proposed adoption of a monetary base growth constraint, together with a copy of the original proposal.

Attachment

May 10, 1988

# COMMENTS ON THE PROPOSED ADOPTION OF A MONETARY BASE GROWTH CONSTRAINT

Immediately after the February 9-10, 1988 FOMC meeting, a proposal for the adoption of a monetary base growth constraint was discussed by the Committee on an informal basis (see attached copy of the original proposal). Several issues arose during and after that discussion which warrant further comment.

First, it should be emphasized that the proposal is for a broad constraint on the long-term direction of monetary policy, not another monetary aggregate target. A monetary target suggests a degree of precision not implied by a constraint. Under a targeting procedure, the FOMC sets both long-run and short-run objectives for the aggregate and operates between meetings in a way that is consistent with those objectives. In contrast, the FOMC can conduct policy under the proposed constraint exactly as it does now, without attempting to hit some specific monetary base target during the inter-meeting period. The Desk would merely monitor base growth to see if the constraint were in danger of being violated. Only a threatened violation would require some action.

Second, in view of the current operating procedure, such a constraint seems very much in order. While it is not explicitly a method of interest rate stabilization, the borrowings targeting procedure used presently is a reasonable proxy for such a regime. In the long run, this approach can

have destabilizing effects, either because emerging interest rate pressures are masked or because policymakers are reluctant to move interest rates fast enough or far enough. The proposed base constraint would permit interest rate stabilization up to a point; however, it also would ensure that the undesirable long-term effects of such stabilization do not materialize. This counter-balancing role of the constraint would be quite consistent with the history of past System operating procedures.

Third, although some might argue that existing M2 or M3 aggregate ranges act as constraints, the relationship between these aggregates and Desk operations has been so loose that their movements have been largely ignored. In contrast, the monetary base can be measured on a timely basis and can be substantially and effectively controlled by Desk operations. Accordingly, the credibility of the base would be much greater.

Fourth, a major issue concerning the use of the monetary base constraint is the effect of currency on the behavior of base growth. In work conducted at the St. Louis Bank, it has been shown that, during most periods since 1970 (and especially in the 1980s), when base growth violated the proposed five percent to nine percent growth band, this often was due to unusually rapid growth of total reserves and not to currency growth. This work also showed that, while currency comprises a relatively large proportion of the base, most of the variability in base growth is attributable to changes in total reserves, not to currency growth.

Finally, there is some concern that the proposed constraint would contribute to increased short-term interest rate volatility. Because the proposal is for a constraint and not a target, there would, of course, be no effect on interest rates so long as base growth remained within the band. The difficulty of modeling this approach has led to inconclusive results in some simulations of its effect on interest rate volatility. In an experiment conducted at the St. Louis Bank, however, currency and borrowings were set at their historical levels and a counterfactual path for nonborrowed reserves was calculated that kept base growth within the proposed five percent to nine percent range. An econometric model was then simulated using the counterfactual path for nonborrowed reserves. In this simulation, there was no increase in the volatility of interest rates during the 1980s.

In conclusion, the adoption of the proposed constraint on the growth of the monetary base would help reduce wide swings in policy that might otherwise occur. Use of the base growth constraint also would forestall some of the external pressures that have been, and undoubtedly will continue to be, brought to bear on the Federal Reserve. And, of equal importance, the proposed constraint would provide financial markets with a clear indication of the FOMC's steadfastness with respect to its long-run policy direction and goals, thereby considerably reducing financial market uncertainty.