Questions and Answers on Monetary Policy

with Stuart G. Hoffman

Q I understand that the Federal Reserve has intensified its efforts to control the growth of the nation's money supply. Why? What influence does money have on the rate of inflation?

A Let's begin by recognizing that excessive money growth, along with energy-related facts and overly stimulative fiscal policy, contributes heavily to chronic inflation. As I am sure you are well aware, the rate of inflation has accelerated in this country over the past several years. The Consumer Price Index (CPI) rose at a 6½-percent annual rate in 1977, 9 percent in 1978, and 13¼ percent in 1979. Rapid money growth clearly contributed to the acceleration of inflation during that time. To quote Chairman Volcker, ". . . I do believe that moderate, noninflationary growth in money and credit, sustained over a period of time, is an absolute prerequisite for dealing with the inflation that has

Q What rate of money growth for 1980 does the Fed feel is consistent with its goal of reducing the rate of inflation?

A In February 1980, Chairman Volcker reported to Congress the monetary growth target ranges selected by the Federal Open Market Committee (FOMC) for 1980. This process is in accordance with procedures outlined in the Full Employment and Balanced Growth Act (Humphrey-Hawkins Bill) passed by Congress in 1978. The Committee selected an M-1A growth range of 3½ to 6 percent, and M-1B range of 4 to 6½ percent, and an M-2 range of 6 to 9 percent. Recently, the Board of Governors redefined the monetary aggregates. Old M-1—which consisted of currency and traditional bank checking deposits—was redefined to exclude those checking deposits held by foreign commercial banks and official institutions. This new aggregate is referred to as M-1A. The Board also defined another new aggregate—M-1B—which includes M-1A plus

Many readers write or ask us questions on a host of economic topics. They seem most eager for easily understood answers on the mysteries of monetary policy and financial developments. We asked Senior Financial Economist Stuart Hoffman to respond to some typical questions about recent monetary policy.

ravaged the dollar, undermined our economic performance and prospects, and disturbed our society itself."

The inflationary effects of overly rapid money growth are not felt immediately. In fact, evidence suggests that money does not begin to impact prices until nearly one year later and continues to be felt in the following year. This is widely referred to as the "lagged effect" of monetary policy on inflation. Recognizing this important, albeit delayed, causal relationship between excessive money growth and inflation, the Federal Reserve has committed itself to more vigorous efforts to slow the rate of money growth. This should eventually result in a slower rate of price increase.

new checkable deposits, specifically NOW accounts, automatic transfer accounts (ATS), credit union share drafts, and demand deposits at mutual savings banks. This move was designed to remedy the criticism that old M-1 was an obsolete measure of the public's total transactions balances. M-2 was redefined to include M-1B plus savings accounts and small-denomination (under $100,000) time deposits at both banks and thrifts, overnight repurchase agreements (RPs) at banks, overnight Eurodollars, and money market mutual fund shares. These recently announced monetary growth ranges for 1980 are an important clue to how determined the Committee is to keep money growth on a moderate track. I believe that these ranges continue the Fed's efforts in 1979, most forcefully in October, to reduce money growth to a less inflationary rate over time.

"These growth ranges are an important clue to how determined the Committee is to keep money growth on a moderate track."

Q I've heard many people refer to the special FOMC meeting in October 1979 at which several emphatic actions were taken to help reduce inflationary pressures. But I'm still not sure I understand the whole story. What circumstances convinced the Committee that such actions were necessary?

A After slowing in the first quarter of 1979, measures of money growth suddenly accelerated sharply in the second and third quarters, that is, in the six months prior to the Committee's special meeting in early October. In fact, M-1 growth reached 10½ percent at an annual rate and M-2 nearly a 12-percent annual rate during that six-month period. Such rapid growth, if continued, would have resulted in money growth well above the FOMC's targets for 1979. Those targets, adopted in February 1979 in accordance with the Humphrey-Hawkins Act, called for an M-1 target growth range of 3 to 6 percent (adjusted for technical factors) and an M-2 target range of 5 to 8 percent. If money were

---

Q Exactly what did the Federal Reserve do at its special October meeting?

A The Federal Reserve took three actions to help combat inflation. First, it raised the Federal Reserve discount rate from 11 to a record 12 percent. The discount rate is the interest rate that the Federal Reserve charges its member banks for borrowing. Actually, the discount rate is determined by each Federal Reserve Bank's own Board of Directors, subject to approval by the Board of Governors in Washington.

A second action taken by the Board of Governors was to impose marginal reserve requirements on certain types of liabilities (used to finance the rapid growth in bank credit) that were not formerly subject to requirements or that had been subject to lower reserve requirements.

The third change decided upon by the Federal Open Market Committee was a change in the operating strategy for influencing money growth that had evolved during the 1970s and was in practice up until October 6. Essentially, the Federal Open Market Committee had been using the Federal funds rate—the overnight interest rate on interbank loans—as a "handle" for influencing money growth. When the funds rate rises, individuals and businesses prefer to hold less money because of the higher opportunity

allowed to continue to grow in excess of the targets, it would have served to further entrench the prevalent inflationary psychology and ultimately fuel the fire of inflation itself. This was clearly unacceptable to the Federal Open Market Committee. Also, the foreign exchange value of the dollar had again come under significant downward pressure during most of the summer, partly in response to the inflationary implication of the accelerated money growth. Additionally, speculative excesses in financial and commodity markets were readily apparent. In these circumstances, the FOMC felt more forceful actions were necessary.

"If money were allowed to continue to grow in excess of the targets, it would have served to further entrench the prevalent inflationary psychology and ultimately fuel the fire of inflation itself."

costs of foregone interest income. Following this strategy, when money growth was excessive, the Committee would raise its Federal funds rate target to retard money growth and vice versa. However, the Committee had always been reluctant to allow the Federal funds rate to rise sharply during a short period of time. A certain amount of interest rate stability had always been a separate objective itself. This often reduced the Committee's ability to hit its short-run money growth targets. Inevitably, when the Committee's twin objectives of money growth and interest rate stability were in conflict, something had to give, and more often than not, it was money growth.

When it became apparent that controlling money through the Fed funds rate was not an effective strategy, the Committee decided to try a different approach. An alternative strategy is to use the supply of bank reserves as the "handle." With the change on October 6, the Committee placed a higher priority on controlling money growth by supplying an appropriate amount of bank reserves. The consequence is that the Committee currently allows the Federal funds rate to vary considerably more than in the past as bank reserve and credit demands dictate.

Q When can we expect the policy moves taken by the Federal Reserve to actually reduce inflationary pressures? How soon can we look for inflation to slow down?

A Most economists distinguish three important lags between monetary policy actions and their effect on economic activity. First, it takes some time before a tight rein on bank reserves reduces money growth. After October 6, though, the "bite" on money growth occurred quite rapidly, with old M-1 and M-2 increasing at only 3- and 6¾-percent annual rates, respectively, in the final three months of 1979. However, at least another quarter of slow money growth is necessary before concluding that a significant trend has been achieved. Second, a slowdown in money, once accomplished, produces a moderation in aggregate economic activity within six to nine months. This is reflected in lower rates of production and a possible rise in unemployment. Third, the slowdown in aggregate demand is ultimately reflected in a declining rate of inflation during the following year. Thus, the initial effect of a "tighter" monetary policy on inflation is negligible but gradually builds up for as long a period as two years.

Q Since 1980 is expected to be a recession year, there are sure to be pressures to accelerate growth in the money supply. How can the public tell if the Fed remains firm to its commitment to pursue more moderate money growth objectives consistent with an eventual decline in the rate of inflation?

A The Fed has often been criticized in the past for implementing "stop and go" policies. However, the moderate money growth targets adopted for 1980, even lower than those for 1979, present a clear "stop" sign for rapid money growth. To find out if the strategy is working, financial analysts and the public can compare actual money growth with the announced monetary guideposts. Since money fluctuates widely from month to month, it's not necessary for M-1A, M-1B, and M-2

So one would not expect any immediate anti-inflationary impact from the procedural changes taken in early October 1979. Indeed, the *initial* reaction may actually be the reverse. The explanation is that a tighter monetary stance initially pushes up interest rates. Businessmen quickly pass the higher interest costs through to prices, while higher home mortgage rates for home buyers enter directly into calculations of the CPI. In fact, inflation has remained uncomfortably high. This is related to the earlier excessive money growth, along with certain special factors, such as continued pass-through to retail levels of oil price increases, unexpected jumps in food prices, and a sharp rise in home mortgage rates.

Even if the Fed's policies continue to reduce money growth, the beneficial effects on inflation will probably not be visible until the latter half of 1980 but should continue to build thereafter.

"The initial effect of a 'tighter' monetary policy on inflation is negligible but gradually builds up for as long a period as two years."

growth to be within the annual target each and every month. But what is important is to watch for whether the money growth fluctuations are averaging out over several months to a rate within the Committee's long-run range. If so, slower money growth will make an important contribution toward reducing inflationary pressures before the end of 1980. Further relief should then come in 1981 and beyond. ER

"To find out if the strategy is working, financial analysts and the public can compare actual money growth with the announced monetary guideposts."