MONETARY POLICY OBJECTIVES FOR 1981

Summary Report
of the
Federal Reserve Board

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Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. Presented by Paul A. Volcker, Chairman, Federal Reserve Board, February 25-26, 1981.

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MONETARY POLICY IN 1981

The Federal Reserve's Objectives for the Growth of Money and Credit

Since the midyear report to Congress last July, events have underscored the importance of the Federal Reserve policy of restraint on the expansion of money and credit and of complementary restraint in federal fiscal policy.

Few today would question the virulence of the inflation that is ailing this economy or the urgency of mounting an effective attack on the forces that are sustaining it. The rapid rise of prices clearly is the single greatest barrier to the achievement of balanced economic growth, high employment, domestic and international financial stability, and sustained prosperity. The need to deal with inflationary trends has become increasingly urgent, for as price increases continue, the public's expectations of inflation become more and more firmly embedded and add further to the stubborn upward momentum of wages and prices.

Persistent monetary discipline is necessary in any effort to restore stability in the general price level. Other areas of policy are also important, but it is essential that monetary policy exert continuing resistance to inflationary forces. The growth of money and credit will have to be slowed to a rate consistent with the long-range growth of the nation's capacity to produce at reasonably stable prices. Realistically, that rate must be approached over a period of years to avoid severe contractionary pressures on output and employment.

The ranges of monetary expansion specified by the Federal Open Market Committee for the year ending in the fourth quarter of 1981 reflect these considerations and imply a significant deceleration of growth in the money aggregates from the rates of 1980 and other recent years. The ranges are:

Ranges of Monetary Growth[1]

	1981	1980 Actual	
M-1A	3 to 5-1/2 percent*	5 percent	(6.3)*
M-1B	3-1/2 to 6 percent*	7.3 percent	(6.7)*
M-2	6 to 9 percent	9.8 percent	
M-3	6-1/2 to 9-1/2 percent	9.9 percent	
Commercial bank credit	6 to 9 percent	7.9 percent	

*1981 ranges for M-1A and M-1B and the numbers in parentheses are adjusted for the estimated impact of shifts into ATS and NOW accounts.

[1]M-1A is currency plus private demand deposits at commercial banks net of deposits due to foreign commercial banks and official institutions.

M-1B is M-1A plus other checkable deposits (i.e., negotiable-order-of-withdrawal accounts, accounts subject to automatic transfer service, credit union share draft balances, and demand deposits at mutual savings banks.)

M-2 is M-1B plus savings and small denomination time deposits at all depository institutions, shares in money market mutual funds, overnight repurchase agreements (RPs) issued by commercial banks, and overnight Eurodollar deposits held by U.S. residents at Caribbean branches of U.S. banks.

M-3 is M-2 plus large time deposits at all depository institutions and term RPs issued by commercial banks and savings and loan associations.

Bank credit is total loans and investments of commercial banks.

Owing to the introduction of NOW accounts on a nationwide basis at the end of 1980, the monetary ranges are stated on a basis that adjusts for the impact of the shift of funds into interest-bearing checkable deposits; this adjustment for the distorting effects of such shifts results in the only meaningful measure of monetary growth. Valid comparison of actual year-to-year growth must also allow for this institutional change.

The ranges for M-1A and M-1B are 1/2 percentage point less than those the Federal Reserve sought in 1980. Growth last year measured after adjustment for the impact of shifts into interest-bearing checkable deposits (the figures shown in parentheses on the table), was close to the upper ends of the stated ranges for the period; therefore, the new ranges are consistent with a deceleration of considerably more than 1/2 percentage point. Because of the movement of funds from demand deposits to NOW accounts, M-1A could contract this year; M-1B could grow more rapidly because of movement of funds into NOW accounts from savings deposits and other assets. The behavior of M-1A and M-1B thus far this year has reflected this pattern, but in an exaggerated degree.

As the next section indicates, estimates of the extent of the prospective shift into NOW accounts must be tentative. The Federal Reserve will monitor the shift into interest-bearing checkable deposits as the year progresses and assess its impact on the expansion of the monetary aggregates. From time to time, the System will report its estimates of the adjusted growth of M-1A and M-1B so that the public and the Congress can better assess the consistency of monetary expansion with objectives stated by the FOMC.

The 1981 range for M-2 is the same as that in 1980; however, the upper end of the range is roughly 3/4 percentage point less than the actual growth recorded in 1980. A reduction in the range does not appear appropriate at this time in light of what is known about the relationships among the various monetary measures. In fact, M-2 growth in 1981 may be in the upper half of its 6 to 9 percent range. Changes in regulatory ceilings have made small time deposits more attractive in comparison to market instruments and money market mutual funds have become more popular.

The range for M-3 in 1981 is the same as that for 1980, but is, again, below the actual growth experienced last year. The deceleration would reflect the slower expansion specified for M-2, which accounts for more than three-quarters of the broader M-3. Large time deposits at commercial banks — the other major component of M-3 — are likely to expand moderately again this year.

The growth of bank credit is expected to be about the same as in 1980. Household borrowing at banks could increase, especially in the consumer installment area, where credit use last year was severely damped for a time by credit controls. However, nonfinancial firms are expected to rely less heavily on bank borrowing than they did in 1980.

The Impact of Nationwide NOW Accounts on Monetary Growth in 1981

The behavior of M-1A and M-1B will be affected greatly this year by the advent, under the Monetary Control Act of 1980, of nationwide NOW accounts and other interest-bearing checkable deposits. The phenomenon is qualitatively similar to the experience of 1980 — growth in M-1A was depressed and growth in M-1B enhanced by the shift of funds into ATS (automatic transfer service) accounts — but quantitatively the distortions in 1981 will be much greater.

The introduction of a new financial instrument such as the NOW account may result in a broad adjustment in the way the public wants to hold its money. As a practical matter, the major impact is likely to be a shifting of funds from existing nonearning checking deposits and from highly liquid, relatively low yielding savings deposits, into the new accounts. Analyses have indicated that in the past roughly two-thirds of the funds flowing into ATS and NOW accounts have come from demand deposits and about one-third from savings deposits.

Depository institutions have marketed the new accounts aggressively, lining up a sizable number of customers before the end of 1980, and the shifting to the new instruments has occurred much more rapidly than anticipated. Since December 30, the new growth of interest-bearing checkable deposits has totaled more than $22 billion.

The further growth of interest-bearing checkable deposits over the remainder of the year is extremely difficult to forecast. Based on the assumption that total growth this year will be about $40 billion and over the remainder of the year about two-thirds of the growth will come from demand deposits, the range for M-1A from the fourth quarter of 1980 to the fourth quarter of 1981 would be -4-1/2 to -2 percent and for M-1B 6 to 8-1/2 percent.

Planned and Actual Growth of Monetary and Credit Aggregates

(percent changes, fourth quarter to fourth quarter)

M-1 targets and growth before and after shifts into ATS/NOW accounts

	After adjustments for shifts into ATS/NOW accounts		Before adjustments for shift into ATS/NOW accounts	
	M-1A	M-1B	M-1A	M-1B
Planned for 1980	3-1/2 to 6	4 to 6-1/2	2-1/4 to 4-3/4**	4-1/2 to 7**
Actual 1980	6-1/4*	6-3/4*	5	7-1/4
Planned for 1981	3 to 5-1/2	3-1/2 to 6	-4-1/2 to -2***	6 to 8-1/2***

*Reflects current estimates of the impacts on M-1A and M-1B of shifting from demand deposits and other assets into new ATS and NOW accounts not taken into account in 1980 targets. Growth of M-1A is about 1-1/4 percentage points larger than actual recorded data after adding back in shifts out of demand deposits; growth of M-1B is reduced by about 1/2 percentage point after taking out shifts into M-1B from savings accounts and other assets.

**Target adjusted to reflect NOW-ATS account shifts referred to in note above.

***Reflects tentative assumptions regarding impacts of shifts into new ATS and NOW accounts in 1981. Growth of M-1A is assumed to be reduced by roughly 7-1/2 percentage points by transfer from demand balances to NOW-ATS accounts; growth of M-1B is assumed to be increased by 2-1/2 percentage points by transfer from sources outside of M-1. These assumptions will be reviewed from time to time.

THE OUTLOOK FOR THE ECONOMY IN 1981

Near-Term Prospects

The economy entered 1981 on an upward trajectory, extending the recovery in activity from last year's brief but sharp recession. January saw further large gains in retail sales, employment, and industrial production. On the whole, the demand for goods and services has continued to prove more buoyant than most analysts had expected. At the same time, there has been no abatement of inflation.

The persistence of intense inflationary pressures jeopardizes the continuity of economic expansion over the remainder of the year. Unless the rise of prices slows, there can be little hope of an appreciable, sustained easing of interest rates or of a substantial improvement in the balance sheets of various sectors of the economy.

The near-term prospects for prices are not favorable. In the months immediately ahead, the major price indexes likely will reflect rising food prices and the impact of higher OPEC charges and domestic decontrol of energy prices. Increases in the Consumer Price Index, furthermore, will reflect — in a way that exaggerates the true change in the average cost of living — the rise in mortgage interest rates that occurred in the latter part of 1980.

Aside from these special factors, the basic trend of prices is linked closely to the behavior of unit labor costs, which constitute the largest element in production costs. Poor productivity performance has contributed to rising costs, and wage demands have been sizable. Despite the acceleration in wage increases that has occurred, many workers have failed to keep pace with rising prices in the past few years. This development was virtually inevitable in light of the decline in productivity and the adverse terms-of-trade effects of the tremendous increase in foreign oil prices. So long as those conditions continue, the average worker cannot anticipate a rising living standard, and attempts to make up losses in real income will be reflected in strong cost and price pressures.

The condition of labor markets affects wage decisions. Despite the fact that the overall unemployment rate stands at 7-1/2 percent, scarcities of skilled workers exist in some sectors of the economy. Even where there is slack in labor demand, however, the impact on wages is slow in emerging; wages appear to have a strong momentum rooted in employer and employee expectations of inflation.

Changing Expectations

This expectational momentum must be turned in a favorable direction. To do so will require a firm and credible commitment to monetary and fiscal restraint and the direction of other governmental policies toward fighting inflation. Labor and management must be persuaded that the inflationary process will not be accommodated — that wage and price decisions based on anticipation of rapid inflation will prove inimical to employment and sales volume. Put positively, they must be convinced that moderation of individual wage and price actions will not put them at a relative disadvantage, but will, in fact, produce a better economic environment.

The Federal Reserve's policy of monetary restraint is intended to contribute to the process of breaking the momentum of inflation. Fiscal policy also has a crucial role to play. Cuts in federal taxes have the potential to help invigorate private capital formation and thereby enhance productivity, reduce costs, and pave the way for faster economic growth, but government spending must be held firmly in check at the same time to avoid excess aggregate demand and pressures on credit markets that would impede the financing of private investment.

Economic Projections

Members of the Federal Open Market Committee, in assessing the economic outlook, recognize the possibility of some reduction this year in business and personal income taxes and of initial steps in the longer-range effort toward the slowing of federal expenditure growth. With these as working assumptions, individual members of the Committee have formulated projections for economic performance that fall in the following ranges. Projections of FOMC members for output and inflation encompass those underlying the Administration's recent budget proposal.

Economic Projections for 1981

	Actual 1980	Projected 1981	
		FOMC Members	Administration
Changes, fourth quarter to fourth quarter, percent			
Nominal GNP	9.5	9 to 12	11.0
Real GNP	-0.3	-1-1/2 to 1-1/2	1.4
GNP deflator	9.8	9 to 10-1/2	9.5
Average level in the fourth quarter, percent			
Unemployment rate	7.5	8 to 8-1/2	7.7

1981

8.6

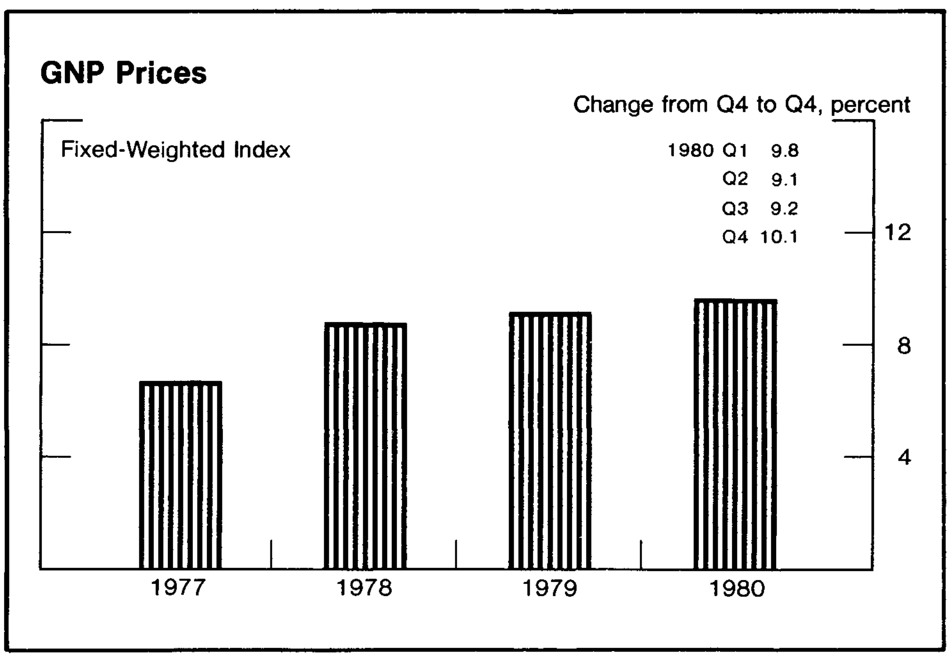
Members of the FOMC see inflation remaining rapid in 1981, although not as rapid throughout the year as early in the period. Because of this and the large budgetary deficits in prospect for the year, continued strong demands for money and credit and relatively high interest rates are anticipated. Against this backdrop, economic activity is likely to show only intermittent strength, and unemployment probably will rise between now and the end of the year.

REVIEW OF THE ECONOMY AND MONETARY POLICY IN 1980

Economic Performance in 1980

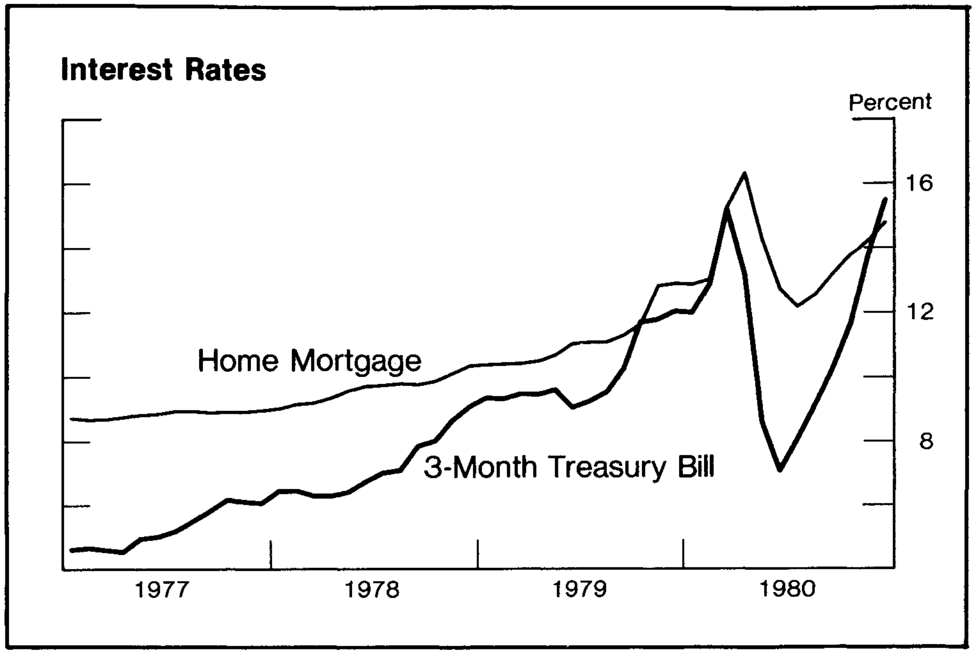
The past year was marked by considerable turbulence in the nation's economy and in credit markets. Output and employment experienced extraordinarily sharp swings as did interest rates and financial flows. The aggregate output of goods and services at the end of 1980 was little changed from the beginning of the year, and with a growing labor force, unemployment was appreciably higher.

Inflation did not abate in 1980, but neither did it gain new momentum. Rather, the increases in most aggregate price indexes were about the same as in 1979. The fixed weight price index for gross national product rose 9-3/4 percent last year, a little more than in 1979, while the consumer price index rose 12-1/2 percent, somewhat less than in 1979.

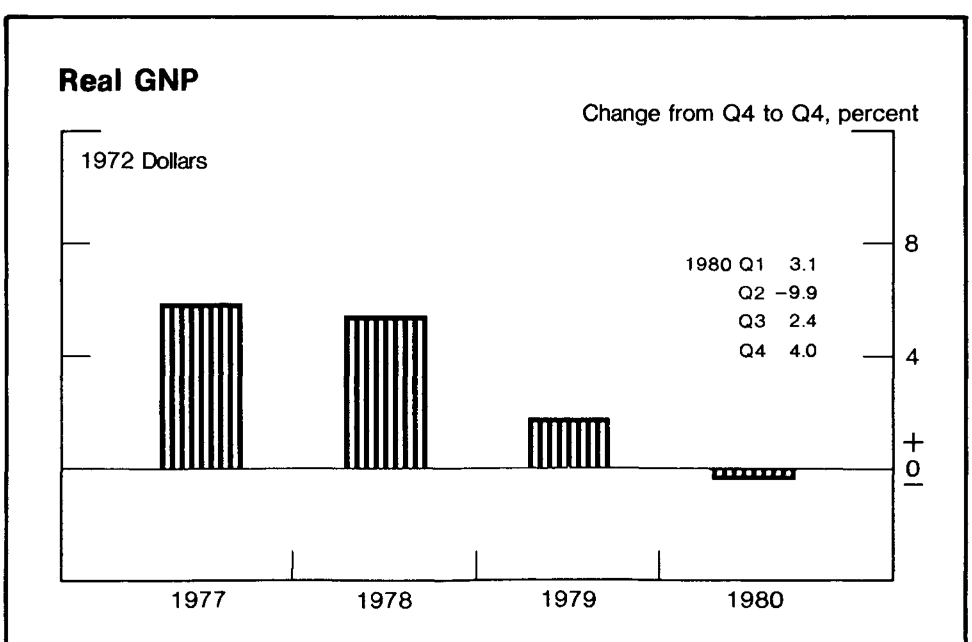


Developments Over the Year

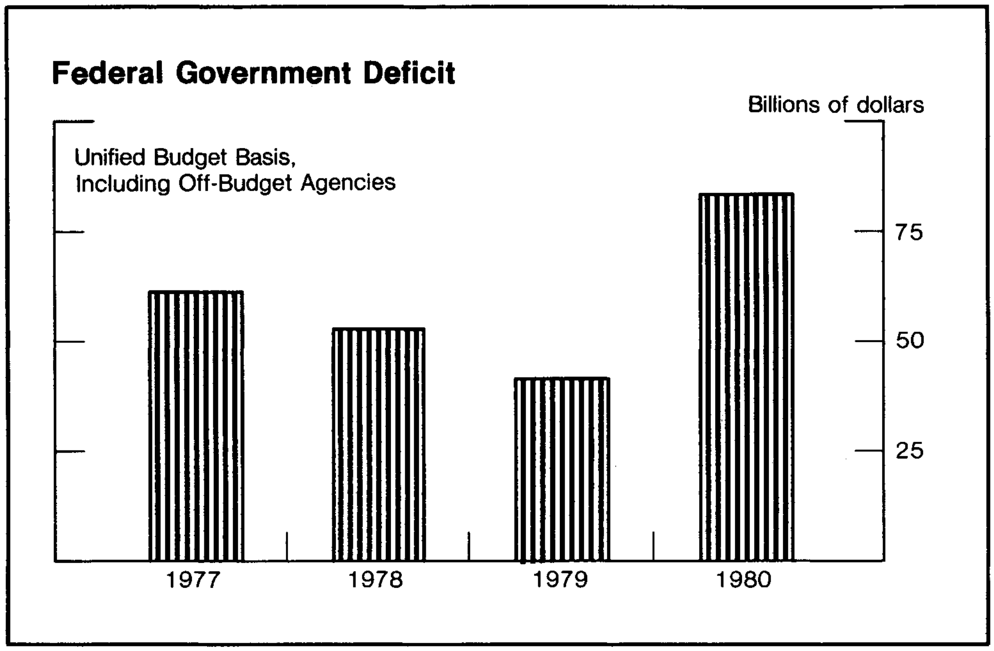
During the opening months of 1980, the late-1979 boost in imported oil prices combined with other factors to aggravate inflationary expectations. These expectations increased the upward pressures on interest rates associated with the Federal Reserve's efforts to contain the growth of money and credit. In March, President Carter announced an anti-inflation program that included use by the Federal Reserve of special restraints on credit growth, under the powers of the Credit Control Act of 1969.



The tightening of credit markets and the psychological impact on consumers of the credit restraint program contributed to the sharpness of the economic decline in the first half of the year — the largest of the postwar period. With the slump in activity came a pronounced weakening of demands for money and credit and a steep decline in interest rates which, coupled with removal of the special credit restraints, in turn was instrumental in bringing about an early and unexpectedly strong rebound in economic activity in the second half of the year. Real GNP was restored almost to its year-end 1979 level. During this period of recovery, the public's demands on financial markets intensified and interest rates rose as the System attempted to hold monetary expansion within bounds.



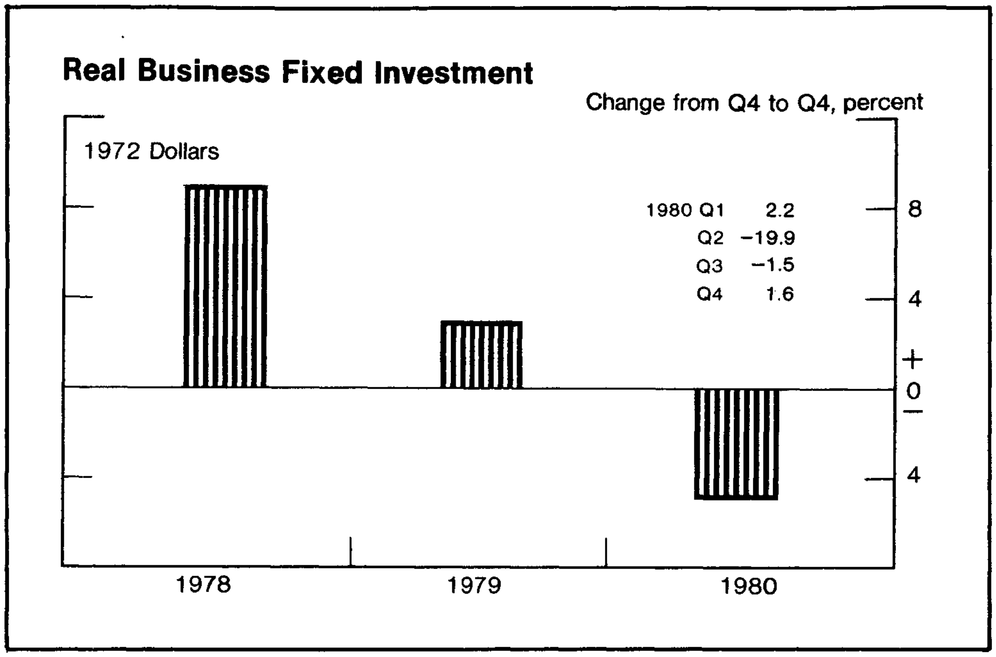
The financial pressures on the private sector of the economy last year were intensified by the competition of the federal government for the limited supply of credit. The federal deficit (unified basis, including off-budget agencies) grew from $41 billion in calendar year 1979 to $83 billion in calendar year 1980.



In 1980, as in most periods of financial tension, purchases that involved longer-term investments of large sums were hardest hit. Residential construction especially was squeezed by high interest rates and, particularly in the first half of the year, by reduced credit availability.

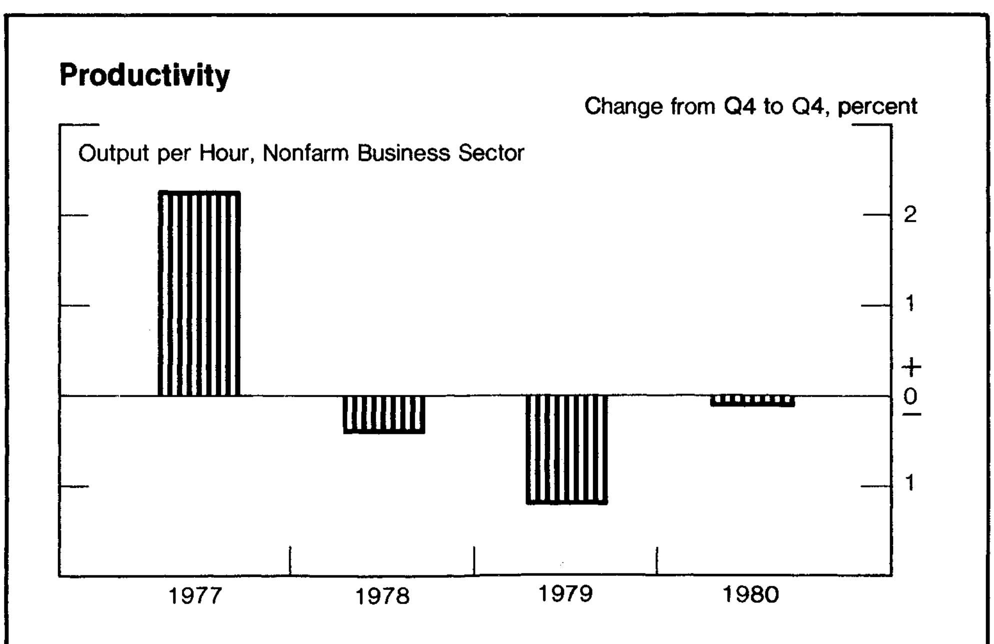
Credit conditions also played a role in damping personal consumption expenditures in 1980 — particularly outlays on big-ticket durable goods. However, consumers already had been faced with budget strains caused by relatively rapid increases in the prices of such basic necessities as food and energy; many families had sought to maintain customary consumption patterns by borrowing. Automobile purchases, which tend to be deferable in the short run, bore the brunt of the subsequent consumer retrenchment.

Business firms, like households, entered 1980 in a weakened financial condition. A combination of deteriorating balance sheets, a high cost of capital, and slackening demands for final products resulted in a 5 percent drop in real business fixed investment during 1980. Businesses kept a tight rein on inventories, as a result of the high cost of carrying stocks.



The slackening of domestic aggregate demand worked to hold down imports; at the same time, U.S. exports rose appreciably in real terms and the U.S. current account moved into sizable surplus in the second half of the year; the contrast with developments in other major industrial countries contributed to a substantial appreciation of the dollar relative to continental European currencies over the year.

Employment traced a path similar to that of output in 1980 — that is, down substantially in the first half and up substantially in the second, with little net change. Labor productivity — output per hour worked — showed no gain for the year.



The index of average hourly earnings for production and nonsupervisory personnel increased 9-1/2 percent in 1980 compared with 8 percent in 1979, even in the face of a weakening in labor demand that moved the unemployment rate from 6 to 7-1/2 percent.

Difficulty of Overcoming Inflation

The behavior of the economy demonstrated rather vividly the difficulties of overcoming a deeply entrenched inflation and, particularly, the stresses that arise when necessary monetary restraint is not adequately supported by other public policy instruments.

The Federal Reserve shaped its policy for 1980 with the objective of reining in inflationary forces so that decision-makers in both the public and private sectors could look forward over the longer run to a restoration of reasonable price stability. The basic premise of the System's policy is broadly accepted: inflation can persist over a long period only if it is accommodated by monetary expansion. The System has committed itself to hold monetary growth to rates that fall short of such accommodation but that are not so restrictive as to impose unduly harsh short-run adjustment costs on the economy. Rates of monetary expansion specified by the Federal Open Market Committee last February implied a substantial degree of restraint on the growth of nominal GNP — that is, the combined result of inflation and real growth.

The Growth of Money and Credit in 1980

Measured from the fourth quarter of 1979 to the fourth quarter of 1980, the growth ranges set by the Federal Open Market Committee (and the actual growth) in 1980 were as follows:

Monetary Growth 1980

	1980 Ranges	1980 Actual	
M-1A	3-1/2 to 6 percent*	5 percent	(6.3)*
M-1B	4 to 6-1/2 percent*	7.3 percent	(6.7)*
M-2	6 to 9 percent	9.8 percent	
M-3	6-1/2 to 9-1/2 percent	9.9 percent	
Bank credit	6 to 9 percent	7.9 percent	

*1981 ranges for M-1A and M-1B and the numbers in parentheses are adjusted for the estimated impact of shifts into ATS and NOW accounts.

Developments Over the Year

The monetary and credit aggregates grew quite rapidly in the opening part of the year. Then, as economic activity began to fall rapidly, the growth of money and credit slowed markedly. Indeed, the narrow monetary aggregates, M-1A and M-1B, which are measures of the public's transactions balances, actually contracted significantly in the second quarter. This decline, occurring as it did at the same time that interest rates were falling sharply, was considerably greater than would have been expected on the basis of historical relationships among money, income, and interest rates. Bank credit meanwhile contracted slightly.

At midyear, when the FOMC reassessed the monetary growth ranges for 1980, there were few, if any, signs of the then incipient economic recovery. In these circumstances, the Committee reaffirmed the ranges for money and bank credit that it had adopted in February.

Over the second half of the year, however, the monetary aggregates and bank credit grew very rapidly. There was a surprisingly swift and strong turnaround in economic activity. Simultaneously, the public's demand for money retraced much of the evident downward shift of the first half. Both of these developments may have been associated with the phasing out of the extraordinary credit restraint program at the end of the second quarter which, in retrospect, seems to have played a greater role than was apparent at midyear.

Although the Federal Reserve resisted the accelerating growth in money and credit — and did succeed in bringing about a deceleration in the latter months of the year — the growth of the monetary aggregates on a fourth quarter to fourth quarter basis in 1980 was generally near or a bit above the upper ends of the ranges announced by the System. Bank credit growth was within the range specified by the FOMC.

Growth of Money and Bank Credit

(percentage changes)

	M-1A	M-1B	M-2	M-3	Bank Credit
Fourth quarter to fourth quarter					
1978	7.4 (7.9)	8.2 (8.0)	8.4	11.3	13.3
1979	5.0 (6.7)	7.7 (6.8)	9.0	9.8	12.3
1980	5.0 (6.3)	7.3 (6.7)	9.8	9.9	7.9
December to December					
1978	7.1 (7.8)	8.2 (7.9)	8.3	11.2	13.6
1979	5.2 (6.6)	7.5 (6.8)	8.9	9.4	11.5
1980	4.1 (5.2)	6.5 (5.8)	9.7	10.3	8.9
Annual average to annual average					
1978	7.7 (8.0)	8.2 (8.0)	8.9	11.7	12.3
1979	5.2 (6.8)	7.8 (7.0)	8.9	10.3	13.4
1980	4.6 (5.6)	6.4 (5.9)	9.1	8.6	8.3

Note: Numbers in parentheses are adjusted for the estimated impact of shifting to ATS and NOW accounts from other assets, and should give a better indication of the underlying trend of monetary expansion.

Review of Operating Procedure Adopted in October 1979

Open market operations are the major tool of monetary control. Prior to October 1979, the basic approach employed by the System was to supply or absorb reserves through open market operations with an eye to holding short-term interest rates — most immediately, the federal funds rate — within a relatively narrow — but changing — band thought consistent with the desired growth of the money stock. But in 1979, particularly as inflation accelerated and expectations became a more significant and volatile factor affecting economic and financial behavior, predicting the public's desired money holdings at given levels of nominal interest rates became exceedingly difficult. As a consequence, in October, the Federal Open Market Committee altered its technique of monetary control, substituting the volume of bank reserves for interest rates as the day-to-day guide in conducting open market operations.

Reserves Targeting

Under the approach adopted in October 1979, the FOMC sets short-run targets for monetary expansion, as it did previously. The staff then calculates corresponding paths for various reserve aggregates. A path for total reserves is calculated based on the expected relationship between reserves and the money stock — the so-called reserves-money multiplier — recognizing that the relationship is variable. A path for nonborrowed reserves then is calculated by making an allowance for the portion of total reserves expected to be provided through borrowings at the discount window. Adjustments to the path may be made if and as the aggregates deviate from the short-run targets.

Conclusions on Effectiveness of New Procedures

In an effort to assess the efficacy of the new reserves-oriented operating procedure in achieving the objectives of policy, Federal Reserve staff examined the 1980 experience in detail. The staff's conclusions are summarized below:

(1) 1980 was a year of extreme variability in money and nominal interest rates. In the case of variability in money, comparisons with past years are complicated by the fact that monetary data for those periods have been considerably smoothed as additional information has been obtained on changes in seasonal patterns. If the 1980 figures are compared with the initial figures for earlier years, the difference in monetary variability is substantially reduced.

(2) Much of the variability in money and interest rates since October 1979 was attributable to an unusual combination of economic circumstances and not to the new operating procedures *per se.* The imposition and subsequent removal of credit controls, especially, appears to have had a major impact.

(3) There was little evidence that alternative operating techniques would improve short-run monetary control. Indeed, econometric model simulations indicate that, under present institutional arrangements, there would be greater slippage between total reserves or the monetary base and money than between nonborrowed reserves and money.

(4) It appears clear that efforts to severely limit deviations in money from its longer-run growth path would require acceptance of much more variable short-term interest rates.

(5) Short-run variability in the monetary aggregates does not appear to involve significant impacts on the behavior of the economy. Weekly and monthly changes in the monetary aggregates are inherently quite "noisy". Available models suggest that, because of the long response lags involved, sizable quarterly (or even semi-annual) fluctuations in monetary growth — if offsetting — do not leave an appreciable imprint on movements in output and prices.

(6) The federal funds rate has been more variable since October 1979, as would be expected with use of a reserves operating target, but in addition very short-run fluctuations in other market rates also have been larger in magnitude and have exhibited higher correlations than previously with movements in the federal funds rate. The reasons for this closer correlation between the federal funds and other rates in the very short-run are not entirely clear, and it is not certain that such a pattern will prevail in the future. In any event, there are few signs that the resulting variability has imposed appreciable costs in terms of reduced efficiency of financial markets or of increased costs of capital in the period analyzed by the study.

Fundamentally, the research suggests that the basic operating procedure represents a sound approach to attaining the longer-run objectives set for the monetary aggregates. However, the Federal Open Market Committee and the Board of Governors will be considering modifications that might reduce slippages between reserves and money, without unduly increasing the risk of an unnecessarily heightened variability of interest rates. These include the possibility of quicker adjustment of nonborrowed reserve paths or of the discount rate. In addition, the Board has already indicated its inclination to switch from the present system of lagged reserve accounting to a system in which required reserves are posted essentially contemporaneously with deposits and will continue to study the technical feasibility of such a system.

The Committee has continued to set broad ranges of tolerance for money market interest rates—generally specified in terms of the federal funds rate. These ranges, however, should not be viewed as rigid constraints on the Open Market Desk in its pursuit of reserve paths set to achieve targeted rates of monetary growth. They have not, in practice, served as true constraints in the period since October 1979, as the Committee typically has altered the ranges when they have become binding. But, in a world of uncertainty about economic and financial relationships, the interest rate ranges have served as a useful triggering mechanism for discussion of the implications of current developments for policy.

A copy of the full Report to Congress may be obtained from Publications Services, Board of Governors, Washington, D.C. 20551.