B_K12
Fredman (3)

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

May 14, 1971

Burns discusses recent rapid growth of money.

The Honorable William Proxmire
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Proxmire:

Your letter of May 3, attaching a reprint of an article by Milton Friedman, asks for comment on the issue of whether the substantial rate of growth in money supply over the past few months is related to "obsolete procedures" in carrying out monetary policy, with too much emphasis being placed on money market conditions and interest rates. I would say that the monetary growth experienced is not the product of a procedural problem, but rather that it reflects fundamental forces in the economy and has to be evaluated in relation to these forces.

The recent rapid growth rates in money, both narrowly defined to include currency and demand deposits (M_1) and more broadly defined to include also time and savings deposits at commercial banks other than large CD's (M_2), may be attributed mainly to two conditioning circumstances. First, particularly with respect to narrowly defined money, the recent rapid growth has reflected the temporary surge in demand for cash balances to accommodate enlarged transactions needs of the public resulting from the post-auto-strike rebound in economic activity. In the fourth quarter of 1970, because of the auto strike, the nation's gross national product valued in current prices rose at less than a 2 per cent annual rate; in the first quarter of 1971, with production recovering from strike-depressed levels, GNP rose at about a 13 per cent annual rate. Over the course of those two quarters, and roughly paralleling the swing in GNP growth rates, rates of increase in M_1 were around 3-1/2 per cent and 9 per cent, respectively.

While temporary variations in transactions demands for cash in the economy were central in explaining M_1 behavior over the past few months, it should also be noted that Treasury cash management practices have been a factor. There was a sizable net transfer of funds from the U.S. Government to private sectors late in the first quarter, indicated by a considerable drop on average in Government deposits from February to March. As often occurs, such net transfers led to a temporary enlargement of cash balances in private hands. Since peaking in early April, the outstanding amount of M_1 has declined on balance, in part reflecting replenishment of the Treasury cash balance.

The second principal explanation for rapid growth in money pertains mainly to M_2. In the early months of 1971, there was a sharp spurt in net inflows of time and savings deposits other than large CD's to banks. For the most part these are consumer-type time and savings deposits. We believe this spurt was largely the result of one-time transfers of savings by consumers out of market instruments, on which yields had dropped sharply during the fall and winter, to time and savings deposits at banks, whose yields had been maintained. According to preliminary estimates contained in the Board's quarterly flow-of-funds accounts, households sold or redeemed, net, about $17-1/2 billion of credit market instruments, principally U.S. Government securities, in the first quarter. In substitution, and reflecting also a continued high rate of net new personal saving, they added about $15 billion to their holdings of time and savings deposits at commercial banks and about $12 billion to deposits at nonbank savings institutions.

Most recently, net inflows to banks of consumer-type time deposits have slowed to more moderate proportions as many banks adjusted their offering rates down and as the amount of savings available for shifting was, in any event, worked off. This has led to a substantial moderation in the growth rate of M_2 following an unusually rapid 18 per cent annual rate of increase over the first quarter as a whole.

To slow down the growth in money--either M_1 or M_2--over the winter period of very rapid growth would have required the Federal Reserve to hold back on the provision of bank reserves. Total reserves of banks rose at about an 11 per cent annual rate in the first quarter, which accommodated--at the interest rates prevailing during the period--the temporary rise in demands for cash and the large shift by consumers in the forms in which their savings are held. If expansion in reserves had been at a slower rate, money market conditions would have been considerably tighter and, more broadly, both short- and long-term interest rates would have been higher than they were. As it turned out, the yield on new high-grade corporate bonds reached a low point in late January and has since risen by over one full per cent. And in short-term markets, Treasury bill rates were at lows in mid-March and have since risen, depending on maturity, by 60 to almost 100 basis points.

During the past several months, then, it has been necessary to weigh behavior of the monetary aggregates against the behavior of interest rates, and to assess them both in relation to the prospects for the strength of economic recovery and in light of the international position of the dollar. The Federal Reserve has not committed itself to a single financial indicator or objective in gauging monetary policy, but seeks instead to relate over-all financial conditions to the specific economic developments and prospects of the time. In the period under review, there were specific explanations for behavior of the aggregates which indicated that the rapid rates of growth would tend to be self-correcting. Moreover, since the economy was in the beginning tender stage of recovery, we judged that there was undue risk that any significant tightening in credit markets--particularly long-term markets--might hamper progress toward the expansion in economic activity and in job opportunities toward which we are all striving.

I hope these comments will prove useful to you. I recognize that there can be room for difference in analyses of the appropriateness of financial developments, even taking account of the economic environment in which they have occurred. The essential point, however, is that the recent rapid growth in the aggregates is not a matter of the procedures used in carrying out open market operations, but must be viewed in relation to credit market conditions generally, to an appraisal of what such conditions would have been if efforts had been made to reduce growth rates under the circumstances of the time, and to one's assessment of current economic conditions and economic prospects. I can assure you that we are watching the behavior of the monetary aggregates carefully, as well as the performance of the money and capital markets, and that we are prepared to move if that behavior should appear to threaten the prospects for orderly economic progress.

Sincerely,

Arthur F. Burns

#184

United States Senate

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

May 3, 1971

Honorable Arthur F. Burns
Board of Governors of the
Federal Reserve System
Washington, D. C. 20551

Dear Mr. Chairman:

I am enclosing a copy of a recent article by Milton Friedman on the Federal Reserve Board's monetary policy over the last few months. Dr. Friedman points out that the money supply, narrowly defined, grew at the rate of 13% a year in the two months from January to March. Also enclosed is a table prepared by the Federal Reserve Bank of St. Louis indicating an annual growth rate of 18.1% from February to April.

The Federal Reserve Board table also indicates that the money supply has been growing at an annual rate of 9.6% from November, 1970 through April, 1971. The St. Louis Federal Reserve Bank figures would thus seem to bear out Dr. Friedman's contentions that the money supply has been expanding at an extremely sharp rate in recent months.

In the article, Dr. Friedman argues that the reason the money supply has been expanding at an excessive rate is due to the obsolete procedures used by the New York Federal Reserve Bank in carrying out monetary policy. Dr. Friedman contends that the New York Fed places too much emphasis on money market conditions and interest rates. I would appreciate your comments on Dr. Friedman's assessment of the reasons for the substantial increase in the growth rate of the money supply over the last few months.

With best wishes, I am

Sincerely,

William Proxmire
U.S.S.

Enclosures