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# "The Outlook for Monetary Policy"

Preston Martin

Vice Chairman

Board of Governors of the Federal Reserve System

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As Congress and the Administration look toward the convening of the 98th Legislative session and begin to address the budgetary and economic opportunities before them in the 1983 fiscal year, the discussions of economic affairs have become increasingly reflective of uncertainty and restlessness over the prospects for an early and quick resolution to the recession in which we find ourselves today. Indeed, this recession has been of a duration unparalleled by recent economic downturns. It has as its roots decade-long trends of declining productivity and accelerating inflation--the reversal of which has not been without economic hardship and setbacks.

We are beginning to see the first hopeful indications of an improvement in those trends and of the start of economic recovery. We have made real progress in breaking the momentum of the inflation malaise which gripped our society. A reflection of progress on that front has been the decline in interest rates over the last several months. Though interest rates are still at an historically high level, the trend downward is encouraging both as an indication of a change in inflationary expectations within the financial markets as well as in the support that this trend gives to the recovery process.

There seems to be a slowly growing awareness that the disinflationary progress made to date can endure, and that we could see further moderation of the inflationary pressures in the future. Continued success in restoring price and wage stability is an essential part of the foundation for sustainable economic recovery and renewed long-term growth. In that regard I might assure you that the Federal Reserve remains committed to maintaining discipline in monetary and credit growth--a discipline that will contribute to price stability and to soundness in the financial system.

In light of recent financial industry events I would like to take the opportunity today to outline the current objectives of the Federal Reserve's monetary policy and the role that such policies have played in promoting our economic goals. Additionally, I would like to look forward and project what we can reasonably expect to achieve in the near future.

Monetary policy carries a special, specific responsibility in bringing about the disinflationary process. At the same time though, the Federal Reserve accepts its role to promote levels of production and employment through real economic growth. The major objective of our monetary policy has been to create an environment conducive to a sustained recovery in business activity while maintaining the financial market discipline needed to foster price stability--easy enough to enunciate, but complex in implementation as the deposit and savings instruments undergo metamorphosis and evolution.

The implementation of this objective has led us over the years to a pragmatic approach toward the monetary targets. This year, for example, we have accommodated growth around the upper ends of our monetary aggregates target ranges and have shown tolerance of monetary bulges over those ranges from time to time. This pragmatism is a result of the need to orchestrate an economically consistent monetary policy in the face of the rapid and intense changes within the structure of the financial markets brought on by deregulation and technological innovation.

Recent data indicate an increase in the public's desire to hold demand deposits, other checkable deposits, and short-term liquid assets. We have seen the velocity of the M1 and M2 aggregates decline sharply over the last several months. Part of this asset holding behavior on the part of the public probably reflects precautionary motives, part may be a function of uncertainty arising from a multitude of financial alternatives. Part may be utterly transitional, as balances are shifted, say, from all savers certificates to other investments.

As you know, the Federal Reserve has been increasingly focusing on the monetary aggregates as intermediate targets for monetary policy since the early 1970s. We report to Congress and the public twice a year as to specific performance against targets. The use of the aggregates in the execution of monetary policy relies on the established, historical relationships between measures of money, interest rate, prices and economic activity. The Federal Reserve has lots of company in the world's central banks. Of most import for the recent economic environment is the strong correlation between reductions in the growth of the money aggregates and reductions in the rate of inflation.

The emphasis on the monetary aggregates in conducting monetary policy and communicating that policy has worked well over the last several years. However, changes have been occurring and are continuing to occur in financial markets that will greatly distort the relationship of certain monetary aggregates to economic activity. The M1 aggregate is probably the most widely followed of these aggregates and one that will probably experience the highest degree of distortion.

The maturing of $30 to $35 billion in "All Savers Certificates" (ASCs) in October had a significant but unpredictable effect on the transaction accounts contained in

M1. Shifts occurred of maturing ASC balances to M1 accounts that could constitute, for the most part, "parked" funds that may shift to investment instruments sometime in the future. Of course, it is not inconceivable that the liquidity preference of consumers actually has shifted in response to the depth and duration of the recession. Consequently, the precise volume of parked funds, the speed with which these funds will move out to other instruments or to consumption and the extent to which some of these funds will remain as a precautionary part of transaction accounts will only be known--and then uncertainly--through analysis after some time has passed.

The new "money market deposit accounts" mandated by Congress and to become effective this month and next month will also have an impact on the M1 aggregate. It is expected that there will be a sizable shift from checking and NOW accounts to these instruments as well as shifts within the M2 aggregates from money market funds and other investment instruments.

The DIDC, as you are aware, has just this week authorized a "Super Now Account"--an even more transaction-oriented MMDA applicable to individuals, to become effective January 5. The effects on deposit flows, and therefore the impact on monetary policy, of this further deregulation cannot yet be predicted.

Nor do we know with any certainty the effects on deposit flows of another decision made by the DIDC, lowering the minimum deposit for the six-month money market certificate, the 91-day certificate and the seven-to-thirty-one day certificate to $2,500, from their previous levels of $10,000, $7,500 and $20,000 respectively.

In large part the effects that economic events and these on-rushing changes in savings and deposit instruments are going to have on M1 obviously render this measure of the money supply virtually meaningless in the short run for gauging economic and monetary trends. Rather than attempting to counteract movements in the M1 aggregate over the next months we will be focusing much less on the M1 aggregate and relying more on broader measures of money and credit available to us in our formulation of monetary policy.

The change in procedures does not represent an unprecedented break from past practices. As I stated earlier, in response to the great financial market changes during the past few years, we have adopted a flexible approach toward implementing our operational targets. The NOW accounts required adjustments, as did the ATS accounts. This flexibility--the willingness to look at all of the available information and to alter the mechanics of our monetary growth targets in light of current judgments--is fundamental to the pragmatic monetary-oriented targeting approach pursued by the System.

Within this framework the shift in emphasis from M1 to other intermediate targets does not portend a shift in the basic thrust of policy. We believe that the opportunities presented in the financial marketplace over the next several months necessitate a change in our technical operating procedures, but we do not believe this calls for a reassessment of policy direction--nor do we project the need for a primary policy shift for any other economic or financial disturbances at this time.

Within the current swiftly changing economic and financial environment targeting on a single aggregate can be misleading. This means that we should rely instead on the measurement of a multitude of broader money and economic activity indicators. The deemphasis of M1 as an intermediate target may cause some problems for those who--contrary to our long-standing advice--have come to rely on that single variable to interpret broader economic conditions. I would caution against using such a basis for business or economic forecasting at any time, but I think that this caveat would be especially applicable over the next several months.

There has been much recent discussion concerning the feasibility of utilizing as alternative operating targets such indicators as total credit flows and interest rate forecasts. I might assure you, as a general response to these proposals, that our implementation of monetary policy has never been a mechanical process of "crunching the numbers." The monetary aggregate operating targets are developed and judged only in light of an analysis of numerous economic activity, interest rates, and financial market indicators and are a reflection of our judgment concerning these factors and the indications they provide as to economic growth and price stability.

There are substantial technical as well as philosophical problems associated with the use of interest rates as intermediate targets that suggest fundamental, dangerous flaws. The expectations of future economic activity and inflation are directly related to forecasted movements inthe interest rates in today's financial marketplace. The contrary effects of market expectations raise questions about the assumption that monetary policy based on an interest rate forecast can promote economic growth and price stability. In addition, there are questions as to whether monetary policy can control interest rates in quite the way some people seem to presume. Finally, implementing monetary policy through interest rate targets becomes potentially more politically vulnerable, and is a process that in the face of a lack of constraint from the fiscal side of the government sector runs the danger of leading us back to runaway inflation.

The analysis of total credit flows broadly consistent with monetary targets can contribute to policy formation, but there are difficulties and limitations there too. The relationship between credit flows and economic activity in the short run is not tightly correlated. From an operational standpoint, there is the problem of considerable time lags in compiling and computing the relevant data. There are the questions of the effect of large credit flows across international borders to be answered. And there are limitations as to the control that monetary policy would have on credit flows. However, recognizing these limitations, the behavior of total credit flows may provide an additional indicator useful in conducting monetary policy.

In conclusion, we are currently in a period of enormous economic and financial institution change. This change has necessitated various technical adjustments in our monetary policy implementation. We view these as temporary adjustments and remain committed to pursuing a monetary policy over time to maintain the progress toward price stability.

The human and economic "costs" of disinflation have already been incurred. We do not want them to linger nor do we want them to recur. The benefits of disinflation are within our grasp. It is clear that we cannot afford to return to an environment in which prices are rising at double-digit rates and inflation expectations are distorting business decisions, ballooning interest rates and imperiling the stability and productivity of our economy. Nor should we slacken the pace of deregulation to avoid complications, within narrow limits, of implementing monetary policy. The banking system must have the instruments to compete in an increasingly open market.

We are living through a period of collision between a long recessionary downthrust and a market driven shift of resources into new economic structures and configurations. The transition from inflation expectations to a disinflation tinged with uncertainty is the current background of policy making. Under these circumstances it is most important that monetary policy be implemented with consistency and continuity. To do less is to surrender the gains so hardly won, to prolong the suffering caused by this transition and to miss the opportunities of an economic renaissance.