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INFLATION AND THE FEDERAL RESERVE

Remarks of

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## INFLATION AND THE FEDERAL RESERVE

Current discussion of the various economic and social forces underlying today's inflation have produced little in the way of a consensus as to what ought to be done to bring it to an end or to moderate its severity. As no one cause can be signaled out, no single remedy is likely to be adequate and all have obnoxious features. We flinch, as well we might, at public policies eventuating in rising unemployment, declining real output and lower real wages. The question is more and more frequently being asked: "Are such sacrifices really necessary?" Some would say that we are "hanging the wrong man."

These doubts and questions have to be weighed against a deterioration in the condition of a large and growing sector of our population--the retirees--who are relatively defenseless against inflation. Their incomes are not indexed, or only partially so, by law or employment practices so their living standard declines as certainly as if it were affected by a work-week cutback or intermittent layoffs.

Our citizenry is impatient to know when inflation will abate and how long before the evidence will become apparent to all that the public purgative actually works. Citizens wonder why trusted advisors have not been able to offer less painful and more certain remedies or why there is so little they have to say, or why what is said is so non-responsive or tautological. Fortunately, they have been spared Cassandras and Messiahs in these troubled times.

A major policy dilemma which confronts us is that inflation today is a worldwide phenomenon, out-of-hand both in the major industrial countries of the world as well as in the less developed nations. This fact alone suggests that a good share of our inflation is not something we brought on ourselves by inappropriate domestic public and private economic policies, but is a result of external forces. Granted that no country is entirely innocent of contributing to these forces, it still is highly unlikely that worldwide inflation happened as a result of over-stimulative internal policies adopted more or less simultaneously, though in varying degrees, throughout the countries of the world. Nor is it likely that the U.S. exported in 1973-74 a domestically produced inflation. In significant measure, subduing inflation is a world problem.

The economies of the world have enough in common to provide a basis for a double-digit inflation. The most obvious characteristic is the worldwide market for energy, industrial raw materials and food. Supply constraints on these resources and their products introduced by cartel arrangements and adverse weather have had a considerable influence on the worldwide inflation of 1974. While the worst of the inflationary effects generated by those developments appears to have passed, still further price increases are in prospect as a result of changes they have already placed in train. The basic remedies for price disturbances of this type lie in accelerating the development of better technologies for energy and raw materials production and altering consumption patterns which will make for more efficient use of the world's natural resources.

Another inflationary factor affecting many nations and possibly having a worldwide impact has been the shift away from fixed exchange rates and subsequent devaluations. Uncertainties about the future of the world's monetary system and unfamiliarity with a floating exchange rate environment undoubtedly raised the carrying and indirect costs of international transactions. One might conceptualize international financial developments in terms of what has happened to worldwide monetary and credit aggregates. Unfortunately, we do not have world aggregates to match our domestic  $M_1$ ,  $M_2$  or credit series. At this point we can only speculate as to what they might have shown had they been available in 1973 and 1974. I cannot conceive that the growth in international money aggregates lagged in these years and evidence that they grew explosively would not be surprising.

In calling your attention to the worldwide aspects of inflation at the outset of my remarks today, I do not intend to suggest that we can afford to enervate our resolution to adopt structural, fiscal and monetary measures to deal with the domestic aspects of inflation. Our inflation has internal as well as external roots and whether the internal roots relate to structural deficiencies or excessive aggregate demand, we must persevere in remedial measures for a sufficient time to achieve reasonable price stability.

The purpose of my remarks today is to describe how our monetary efforts to deal with inflation should be measured. This issue may seem operational in character and narrow in significance but it

is vital to our ability to achieve a satisfactory monetary performance in times such as we face today.

The present-day way of looking at monetary action is through the monetary aggregates and, especially, the narrowly defined money supply. While the concept of monetary aggregates has a long history in academic circles, acceptance in banking, business and investment communities is fairly recent. In the sixties monetary action was seen through its impact on credit flows and interest rate levels. In the fifties monetary decisions were attuned to the "tone and feel" of the market, a phrase intended to convey the psychology and expectations of participants in financial markets.

The use of the monetary aggregates is the result of attempts to be more precise with respect to quantities of monetary input in relationship to the perception of the lagged effect of such inputs on the economy. The belief is that some aggregate exists or will be found which is a more reliable measure of monetary input needed for a desired effect on the economy than is some observed change in the level of interest rates or a shift in financial market psychology. The increased popularity of aggregates relative to interest rates follows in some degree from the fact that inflation has obscured the meaning that any particular level of interest rates may have for stimulation or suppression of investment opportunities.

But there is an uncomfortable fact about our experience with monetary aggregates too. In my view, none of those in use has performed under actual circumstances consistently or according to expectations.

At times a change in the level of interest rates or even the qualitative judgment on market psychology--the old-fashioned "tone and feel" of the market--may provide a more reliable method of measuring monetary inputs. Thus, while I believe the aggregates have the promise of providing a superior operating technique in the future, given present-day knowledge and expertise they frequently should have a lesser role in conditioning our judgment than other indicia of monetary input.

While there are a large number of monetary aggregate variables, they can be categorized as money, credit, or liquidity types. Money is coin, currency and demand deposits. Money is ultimate liquidity in concept, but since it includes demand deposit compensating balances which are not liquid because they, by agreement, cannot be spent, there is an ambiguity in its definition.

Liquidity aggregates include the elements of monetary aggregates--coin, currency and demand deposits--and, in addition, saving and time deposits at depository institutions and, in still broader definition, short-dated marketable paper. Credit aggregates have been neglected in recent years although the Federal Reserve continues to make available the bank credit proxy, often a useful series, as well as the flow of funds accounts which show the total flow of credit in the economy by major types and component sources. Still another measure of monetary influence, usually overlooked, would include in the liquid assets available to spending units their capacity to obtain credit under established lines or commitments.

Among these families of aggregates available for guidance in gauging monetary inputs, I find the broader concepts of existing and available liquidity sources to be more useful than narrow measures,  $M_1$  and its close variants. The reasons I would give for that judgment are primarily institutional and operational.

In the United States money ( $M_1$ ) is coming to be treated by its holders not as a stock, but as a flow of credits and debits. These flows do not exactly coincide but their mismatching is being bridged by a variety of ways of deferring debits and converting assets into money, i.e., by drawing on other liquidity resources. Thus, vendor credit, bank and non-bank credit cards, instalment contracts, float, bank overdraft arrangements make it convenient for businesses and individuals to time the payment of bills out of a flow of credits and reduce the size of their average money holdings. We are also seeing the liquidity earlier held in demand deposits being transferred to savings accounts, time certificates of deposit and other asset forms--all of which are capable, if necessary, of being converted into money on short notice to meet expenditure flows. As this process becomes more and more pervasive, the money held by consumers, businesses, and governments is tending to become just the amount of coin, currency and demand deposits needed to carry on a day's transactions.

It is well known, for example, that corporate treasurers, as a class, target zero balances in their demand deposit accounts allowing for the fact, of course, that they must maintain an amount sufficient to compensate their bank for the cost of banking services

including credit accommodation provided to them. Their stock of "money", so far as  $M_1$  is concerned, is not fixed by some desired liquidity position but by agreement and convention, an important consideration in light of the fact that corporate deposits account for about 60 per cent of the total of demand deposits. Indeed, when in the course of increasing monetary constraint the raising of compensating balances occurs, the demand deposit component of  $M_1$  also rises absorbing reserves to the degree of the differential between reserve requirements on demand and time deposits or no reserves at all. Thus, a spurt in the growth in  $M_1$  at such a time could be an indication of considerable tightness, not ease as is popularly supposed.

Corporations are not the only sector in the economy that has been shifting its demand balances into interest-earning status-- individuals, governments and non-profit institutions are doing likewise. Some banks today offer these groups instant liquidity in a savings account with a 5 per cent return and link this account to a checking account in a bank for money transfer services.

All kinds of thrift institutions--savings and loan associations, mutual savings banks and credit unions--are showing increasing interest in offering money transfer services out of savings accounts. These services may turn out to be "payable-through" drafts or third party credits, i.e., transfers from one to another account in the same institution. In either event the service is competitive with that offered by a demand deposit and the savings balance has the features



of bank deposit money. Even if savings accounts are not directly used for money transfers, they now and increasingly will serve as a back-up and spill-over liquidity reservoir for checking accounts.

The process of economizing on demand deposits is a gradual one and the consequent erosion of demand balances included in  $M_1$  means that this aggregate's significance also has been gradually eroded. This can be observed by taking a longer look at the rates of growth in  $M_1$ , GNP, money use (debits) and rates of money turnover.

In the past ten years  $M_1$  has grown at an annual rate, compounded monthly, of 5.6 per cent while GNP in current dollars grew at an 8.3 per cent rate in current dollars and 3.2 per cent in constant dollars. In the same period, transactions (debits to demand deposits of individuals, partnerships, corporations and State and local governments) in 233 of the nation's SMSA's grew at an annual rate of nearly 17 per cent.

Obviously, if money balances had not been used much more efficiently in 1974 than in 1964 there would need to have been a very much larger growth in  $M_1$  or a much smaller volume of transactions relative to GNP. Transactions (based on banking data from the 233 SMSA's) were 16 times larger than GNP in 1974 and 7.5 times larger in 1964.<sup>1/</sup>

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<sup>1/</sup> These transactions obviously do not include those made with coin or currency or flowing through banks outside of the metropolitan areas covered in the Federal Reserve series on bank debits. The aggregate of demand deposits in the 233 centers is about \$175 billion compared to \$215 billion of deposits in the nation's money supply series.

The money turnover which accommodated the growth in transactions relative to GNP during this period has risen, according to the partial data available on turnover, at annual rates, compounded monthly, of 11.2 per cent for 233 SMSA's, 13.8 per cent for New York, 11.7 for six other leading financial centers, and 8.4 per cent for all other SMSA's.

The comparative rates of growth for these money and transactions magnitudes clearly reveal two major trends in our economy having a major bearing on the nature of  $M_1$ --first, the large increase in money transactions relative to total GNP and, second, the enormous increase in the efficiency of demand deposits in effecting money transfers. A final statistic will emphasize this latter point. In New York today a demand deposit has an average life, measured in banking days of .75 days; in six other financial centers that life stretches out to 2 days. In the other 226 SMSA's, where purely financial transfers do not have a dominant role, the average life is 3.7 days.

An end to the upward trend in the efficiency of money for transactions has been predicted for many years but the evidence--statistical, institutional and in money mores--has failed entirely thus far to support that expectation. To seek improved monetary control by reliance on a variable,  $M_1$ , whose characteristics and significance is undergoing rapid change, involves unknown exposures. In my opinion, the concept of the narrowly defined money supply is

becoming less and less appropriate even as a proxy for monetary action. Furthermore, optimal growth rates assigned to it based on past experience, by ignoring varying rates of change in its efficiency, additionally jeopardize users of  $M_1$  as a guideline be they policy makers or the public.

There are other significant defects in  $M_1$  as a measure of monetary action, particularly in the short run. Most of these have been thoroughly aired by technicians. These include the problem of estimating non-member bank deposits between quarterly call dates, the difficulty of excluding non-applicable debits from items in the process of collection or due-from balances, and the question of whether or not the deposits of the Federal Government and of foreigners should be included in the money supply. Steps have been taken or are in process to remedy these deficiencies, so far as practicable.

In addressing the subject of inflation and the Federal Reserve, I would, in summary, emphasize the importance of using monetary measures to cope with domestic sources of inflation. How the inputs of monetary action should be gauged is a vital and controversial issue on which several alternatives are available. In my opinion, given our present state of knowledge, an eclectic approach is necessary. In devoting most of my attention to the growing shortcomings of  $M_1$ , I would hope to divert some attention and dependence away from that magnitude and particularly from the assignment of arbitrary target rates to its growth based on historical experience.

I would hope that more attention would be given to the behavior of alternative aggregates--the broader based liquidity series, the bank credit proxy and the flow of funds accounts. The process of financing expenditures through the use of liquid assets and the drawing down of credit lines and other sources of funds and how these sources impact consumers, business, and financial institutions themselves are all useful ingredients to understanding our problem. All should command our attention in finding our way back to reasonable price stability.