FOR RELEASE ON DELIVERY
Thursday OCTOBER 11, 1979
11:45 A.M. EDT

THE CURRENT THRUST OF FED POLICY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Seventh Institutional Investor Bond Conference

New York City

Thursday, October 11, 1979

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

THE CURRENT THRUST OF FED POLICY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Seventh Institutional Investor Bond Conference

New York City

Thursday, October 11, 1979

Summary

1. Strategy of monetary policy must shift from traditional leaning against whatever wind blows to one of greater long-run steadiness in bringing down the growth of the money supply.

2. The expected improvement in our current account should lend strength to the dollar.

3. The rapid expansion of the Euromarkets affects domestic monetary policy, needs to be watched carefully, and should be brought into better harmony with domestic monetary expansion.

4. The new open market procedures adopted by the Federal Reserve over the weekend should make possible a greater steadiness that is required in the effort to bring down inflation.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I am glad to have this opportunity of speaking to the Seventh Institutional Investor Bond Conference on the subject of "The Current Thrust of Fed Policy." I shall address myself to its domestic as well as international aspects and shall finish up with some comments on the Federal Reserve's new open market procedures.

The Changing Environment

Monetary policy has never been easy. There was a time, nevertheless, when it was relatively simple. The standard prescription was to smooth out the business cycle. When the economy began to turn down, monetary policy was eased. The criterion usually applied to a central bank's performance was how well it "caught" the top and how quickly it shifted from restraint to ease. Once the low point of the cycle had been passed, a lessening of ease was in order. The general principle was that of leaning against the wind.

Even with this simple prescription, mistakes occurred. The most serious mistake, incurred repeatedly, was to start restraint too late. Waiting to tighten until you saw "the whites of their eyes" meant that some inflation was allowed to occur that was not wrung out in the subsequent downturn. Excessive stimulative fiscal policies contributed to building in a mounting rate of inflation. In successively leaning against the winds of unemployment, inflation, and again unemployment, we kept switching targets until we had ratcheted ourselves up to very high levels of both inflation and unemployment.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Today the problems of monetary policy are more complex. I can enumerate only a few. We now must contemplate the possibility of rising unemployment and high inflation occurring simultaneously. We may find ourselves moving into that situation from a cyclical peak now. Fiscal policy has remained stimulative, with an effective deficit -- when in reality we are at full employment -- of the order of $40 billion, even though the Administration and Congress have made commendable efforts to bring that deficit down from much higher earlier levels. More near-term but nevertheless important considerations are that the monetary aggregates have been very strong for some months and that interest rates have been at best barely positive in real terms. These are some of the factors that must be taken into account in assessing the thrust of monetary policy. I shall revert to this aspect presently.

More generally, the traditional policy of leaning against whatever wind blows is no longer appropriate to problems of our day. The wind now seems to be blowing from all sides. Greater steadiness is needed. In particular, we need steadiness in reducing the growth of the monetary aggregates in order to wind down the inflation.

The International Side

International contingencies also are bound to play an important role in monetary policy. The United States is not alone in the world, although it has sometimes acted almost as if it were. We are increasingly dependent on international economic ties, having moved, in not many years, from a level of imports of goods and services of about 3 percent to one presently of about 10 percent of GNP. The dollar is no longer fixed but

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

floats, and we have learned that our economy and the rest of the world are best served by a strong dollar. We know also that the value of the dollar will ultimately be determined by market forces, especially the current account, interest rates, and inflation. These factors, which today I see positioned to lend growing strength to the dollar, are in their turn influenced by monetary policy. Thus, in the international area, we again find monetary policy confronted with some very basic issues.

In looking at the interaction between the United States and the outside world at this particular point in time, we observe that cyclical patterns are running in opposite directions. The United States seems to be facing a moderate recession, recovery from which may be slow. In the interest of reducing inflation, the recovery certainly should not be hectic. The rest of the world is on the average expanding, especially Germany and Japan, the most important economics aside from the United States. We look to this expansion of the world to have a twofold effect on our own economy: In combination with our own recession, it should help us to end the deficit in our current account and hopefully to bring that account into substantial surplus, thus lending support to the dollar. Second, a rising trend of exports should provide some of the impulse toward recovery that the domestic economy may be slower than usual in providing. This aspect, too, will be important for monetary policy to watch.

Monetary Policy and the Euromarkets

Increasing international interdependence is significant for monetary policy for still another set of reasons. A new financial system has come into existence abroad, in the form of the Eurocurrency market,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

that has implications for U.S. monetary policy. About 75 percent of the total Eurocurrency market is in U.S. dollars, and about 35 percent of this dollar component flows through the foreign branches of U.S. banks. After allowing for interbank liabilities and for liabilities to nonbanks outside the United States, there remains an amount that, at the end of 1978, may be very roughly estimated at $50 billion which to all intents and purposes should be viewed as part of the U.S. money supply. Compared to U.S. M-1, this $50 billion was not quite 15 percent. Compared to U.S. M-4, it was close to 6 percent. But the Eurodollar market has been growing very fast, at a rate of about 20-25 percent per year. At such a rate, it would double in 3-4 years. Thus, in evaluating the stance of U.S. monetary policy, the Eurodollar market is a factor that must be reckoned with. If we ignore it, the rate of growth of the total dollar supply, combining the U.S. and the Euromarket, would be rising faster than we think. While at present the difference is still moderate, it will not remain so if the market continues to expand.

By taking into account this monetary expansion in the Euromarket in setting its domestic money supply targets, the Federal Reserve could, of course, adjust the domestic targets so as to keep the combined amount of domestic and Euromoney on the right track. But as the Eurodollar market grows, the Federal Reserve would have to bear down increasingly hard on the domestic supply of money and credit in order to offset the expansion of Eurodollars. This would work a hardship on our domestic economy and particularly on U.S. borrowers who did not have access to the Euromarket.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Euromarket expands more rapidly than the U.S. domestic supply of money and bank credit because it enjoys a competitive superiority. In large part, although not entirely, that superiority derives from the absence of reserve requirements in the Euromarket. Free of that burden, the Euromarket can pay more for deposits and charge less for loans than U.S. banks do domestically. Moreover, by outbidding U.S. domestic seekers of funds, the market can attract a virtually unlimited supply of funds.

What is needed is a means of establishing some degree of equality of competition between the Eurodollar market and the U.S. market. One such means would be to impose reserve requirements on the Eurodollar market. Another would be to remove reserve requirements on similar deposits at home, but that would limit the Federal Reserve's options in the conduct of monetary policy.

A third possibility would be to limit the expansion of the Euromarket by imposing prudential controls on its banks, such as a capital-assets ratio. In recent months, the Federal Reserve together with foreign central banks and the Bank for International Settlements (BIS) has been studying the possibility of such measures to control the Euromarket. The institutions and legal powers of major countries differ, and it may not be easy to achieve a uniform solution in the near future. Some combination of different techniques, each country using one most appropriate to it, may be feasible.

These potential measures, in addition to their importance for monetary policy, have some bearing on the bond market and may, therefore, have a special interest for this audience. Restraint on the expansion of Eurobank credit can be expected to increase the flow of credit through

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the world's bond markets -- Eurobonds, Yankee bonds, and all of the rest. This would not imply a nullification of the objective pursued by those measures. Their purpose, after all, is not to deny credit to the world, but to even up competitive conditions between the Euro- and domestic banking systems. If an incidental result should be a shift, probably very partial only, of credit demand to the bond market, this could be viewed as a form of funding, substituting less liquid assets in the hands of investors for more liquid assets, and to that extent not inflationary.

Recent Federal Reserve Actions

I would now like to turn to the mechanics of the new procedures adopted by the Federal Open Market Committee for the conduct of open market operations. As you know, this was one of the three actions adopted over the weekend, the other two being unanimous decisions by the Federal Reserve Board to raise the discount rate from 11 to 12 percent and to impose marginal reserve requirements of 8 percent on managed liabilities, including reserves on Federal funds and RPs on which previously there had been no reserve requirements.

In the past, the Federal Reserve has pursued its money supply target using the Federal funds rate as a tool. That is to say, it established a funds rate designed to produce whatever growth rate of the monetary aggregates the Federal Reserve wanted. At different rates of interest, different amounts of money are demanded. Working with the Federal funds rate, which in turn is linked with other money market rates, the Federal Reserve has been able, over time, to influence the money supply from the demand side.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The alternative approach now chosen is to influence the monetary aggregates from the supply side. To do this, the Federal Reserve must calculate the volume of reserves needed to support the desired volume and growth of M-1 and M-2. It must take into account the demand for Federal Reserve liabilities for other uses, such as reserve requirements on managed liabilities, as well as currency. The link between reserves and the monetary aggregates is the so-called money multiplier. Given a reasonably good estimate of reserve needs and of the factors determining reserve availability aside from Federal Reserve open market operations, the Federal Reserve can influence the money supply directly by controlling reserves, from the supply side as it were.

This approach reduces the emphasis on the Federal funds rate that was inherent in the funds rate procedure of controlling the money supply. The funds rate was merely an instrument in that process. Nevertheless, because it was widely watched, and because other short-term interest rates seemed to be closely linked to it, it tended to acquire more than purely instrumental importance. The importance assigned by the market to the Federal funds rate tended to inhibit the Federal Reserve's willingness to let it fluctuate in pursuit of money supply targets.

Under the new procedure, the funds rate becomes a by-product of the supply of reserves. When the volume of reserves and the money supply are what the market demands, the funds rate will tend to be stable. But when the reserves and money provided exceed or fall short of what the market demands, the funds rate will tend to move to clear the market. Under the reserve procedure of controlling the money supply, therefore, it will be necessary to allow wider fluctuations, within broad limits, of the funds rate.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A certain jumpiness of the funds rate need not be seriously destabilizing to other short-term rates. The rate for daily money, after all, does not determine the rate for 90-day money, such as typical Treasury bills, CDs, and commercial paper, unless the market believes that the level of the funds rate indicates the monetary authority's wishes with respect to these other rates. The rate for any 90-day paper should be the average of the expected daily rate. It is only in this indirect sense that arbitraging between Federal funds and other short-term instruments will transmit the effect of the funds rate to other short-term rates.

For this reason, more or less random fluctuations in the funds rate should not affect international financial flows and the exchange rate of the dollar. There are rates for daily money in other countries, for instance Germany and England, which fluctuate quite widely at times, but these rates do not seem to be regarded as particularly important by the exchange markets. As a very few of you may remember, there was a call money rate in Wall Street before the Great Depression, but its function was very limited.

Any bounciness in the funds rate that may result from the new procedures will be mitigated also by the operation of the discount window. Under the new procedures, member bank reserve needs will no longer be automatically accommodated by the open market desk within a narrow range of funds rate movements. The funds rate, rather than reserves, will be the flexible element that balances demand and supply in the market for Federal funds. But banks can adjust their reserve position by recourse to the discount window as well as by borrowing in the Federal funds market.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The discount window will thus implement to an enhanced degree its traditional role of alleviating minor pressures in the financial markets.

The discount rate, under these circumstances, acquires somewhat greater importance under the new procedures. Since the volume of member bank borrowing from the Federal Reserve tends to rise fairly predictably with the spread of the funds rate over the discount rate, a flexible management of the discount rate, within the general framework of existing policies regarding the administration of the discount window, will be employed in order to discourage excessive member bank borrowing. The discount window, therefore, will serve as an element of adjustment but not as a loophole from reserve control.

Finally, the operations of the market itself will tend to smooth out funds rate movements. Banks and others will try to anticipate fluctuations, and in doing so and arbitraging among short-term assets of different maturities will tend to cut off peaks and troughs in the more volatile rates.

As I have already indicated, the new procedure is expected to permit a firmer approach to the control of the monetary aggregates, provided the Federal Reserve is reasonably successful in estimating the money multiplier and the market factors impinging upon the supply of reserves. This is a powerful reason for adopting the new procedure at this time, when the monetary aggregates have been very strong for several months at the prevailing level of the Federal funds rate. Continuation of monetary growth at recent rates would cause the Federal Reserve to overshoot the monetary targets it set and reported to the Congress. Such growth would clearly be excessive in terms of our basic economic objectives.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

There is a more theoretical reason, moreover, why a reserve strategy may have advantages under present conditions over a Federal funds strategy. Policymakers must take into account at all times the fact that both the economy and the demand for money may exhibit instability. The choice of a money-control strategy depends on which of the two instabilities appears to predominate at any particular time. In case of an instability of the demand for money, a funds-rate strategy is preferable. It automatically offsets variations in the demand for money and prevents any inappropriate changes in interest rates that would otherwise result. This was the case, for instance, last fall and winter. There occurred a downward shift in the demand for money relative to GNP. By staying with a funds rate strategy, the Federal Reserve prevented this decline in the demand for money from lowering interest rates at an inappropriate time and so exacerbating the inflation.

By the spring of this year, the downward shift in the demand for money had come to an end. Since then, continued strong inflation combined with a higher level of economic activity has increased the demand for money. A funds-rate strategy would be in danger of accommodating this increased money demand unless the funds rate were raised sufficiently to keep the money supply on track. Accommodation of an increased demand for money, in other words, would accommodate inflation. A reserve strategy serves to keep the money supply on track, allowing the funds rate to rise if necessary, thus offering resistance to inflation.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

This analysis indicates that the optimum strategy depends on circumstances. Changing circumstances, as the Federal Reserve's recent action shows, can determine changes in strategy. What should not change are the objectives of monetary policy in their broadest sense, at the present time especially the need to bring down inflation. In the past, our policies have suffered from frequent switches among economic objectives. What is most needed at this time is steadiness in the pursuit of objectives, implemented by whatever strategy promises to be the most effective.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis