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Statement by

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of the

Committee on Banking, Finance and Urban Affairs

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I am pleased to appear before this Committee today to present the views of the Federal Reserve Board with respect to recent monetary developments. As I understand it, the purpose of this hearing is to provide an updating of the recent monetary oversight hearings of your parent Committee, at which Chairman Burns appeared. My remarks therefore will supplement his, and I think it would be appropriate to include a copy of the Chairman's testimony on that occasion as an attachment to my much briefer statement.

As Chairman Burns indicated at the July 29 hearings, the FOMC at its July meeting adopted new longer-run growth ranges for the monetary aggregates that it expected to be appropriate to the needs of the economy over the coming year. These growth rate ranges were 4--6-1/2 per cent for M_1 (defined to include currency and demand deposits at banks), 7--9-1/2 per cent for M_2 (which is M_1 plus savings and time deposits--except for large negotiable CD's--at the banks), and 8-1/2--11 per cent for M_3 (which is M_2 plus deposits at the thrift institutions). The Chairman also noted that implicit in these projections for monetary growth was the expectation that the velocity of M_1 would continue to increase at a faster rate than it had during comparable periods of previous business-cycle expansions, and that, because of heightened uncertainty as to the relationship between rates of monetary expansion and the performance of the economy, the Federal Reserve would continue to maintain a posture of vigilance and flexibility in the period ahead.

The fact is that the pace of monetary expansion now appears to have been unusually rapid during recent months. This is especially true of the narrowly defined money supply, where the increase over the past 6 months--from February to August--is indicated to have been at an annual rate of 9.1 per cent. This rate of expansion, of course, is well above the FOMC's stated longer-run range of projections. Broader measures of the money supply, on the other hand, have grown at rates only a little above the upper end of the Committee's projected ranges. During the past 6 months, M_2 and M_3 have increased at annual rates of 9.9 per cent and 11.3 per cent, respectively. I might note that over longer time periods--the past year, for example--growth in M_1 has been more moderate while the increases in M_2 and M_3 have been somewhat higher than those I have just cited. And over all of the period of economic recovery, dating from the first quarter of 1975, the expansion in the narrow money supply has averaged just over 6 per cent per annum.

As the recent expansion in the monetary aggregates tended to run above the FOMC's expectations, System operations have been directed toward holding down on the provision of bank reserves needed to support the larger monetary totals. Just as in any other market, the more limited availability of reserve supplies relative to demands has meant that prices--in this case, interest rates--have gone up on day-to-day bank borrowings (Federal funds) and other very short-term sources of financing. The rate paid on Federal funds, for example, is up about 1-1/2 percentage points from the lows prevailing early

this year, with almost all of the rise taking place during and after the April and July run ups in the narrow money supply. Other short-term market interest rates also have been affected, but longer-term interest rates, which are of much greater significance to the economy, have not increased on balance despite the firming since April in short-term market conditions.

Some would argue that the Federal Reserve should have responded more forcefully to the April and July bulges in the money supply. Indeed, a few would say that the reserves necessary to support the deposit expansion simply should not have been provided, letting financial markets and the economy suffer whatever consequences might result. But the FOMC continues to believe that the wiser course is to limit the speed with which money market conditions are adjusted to changing monetary growth rates. We believe this partly because the monetary aggregates--particularly M_1 --have proved to be inherently unstable in the short run. Bulges of a month or two in duration are often reversed subsequently, as was the case in the spring and summer of 1975 and again in 1976. Prudence in our actions is dictated also by the fact that the relationship between the various measures of monetary growth and the performance of the economy is loose and unreliable, since it is subject to rather abrupt shifts as the result of changing financial practices and economic conditions.

In the current situation, for example, there are a number of ambiguities for which we do not yet have the answers. Until

there is more information, it seems to me that one should be very cautious about prescribing a policy of stern monetary restraint.

First, the excessive growth in the narrow money supply this year has been concentrated in just two one-month periods--April and July. We do not have a good explanation for these bulges. It may be that they reflect in part a shift in the seasonal pattern of money demand. If so, it is entirely possible that a period of adjustment in money growth could lie ahead, just as it has in the latter part of other recent years.

Second, the abnormal expansion that has occurred over the past 6 months has been concentrated in the narrow money supply, while the growth in broader monetary measures--though substantial--has been much closer to our expectations. One reason for this development may be that the accelerated pace at which other forms of deposit and liquid asset instruments were being substituted for bank checking account balances has now slowed, at least temporarily. That would modify the meaning of the changed relative growth rates of the various monetary aggregates, in terms of probable impact on future economic performance, since it would simply reflect a shift in holder preference from one form of deposit to another.

Third, the behavior of the economy this spring and summer, though generally satisfactory, does not suggest that a major new boom is in process of developing. Indeed, both the growth in real activity and the pace of inflation have slowed somewhat in recent months, following acceleration earlier in the year. This has been true also abroad, where most developed countries to date have shown

only rather sluggish recoveries. Nor has there been a rush of business borrowing at the banks, though credit demands in general have been well sustained. Thus the current economic data do not suggest that businesses and households are building up cash balances with a view to increasing abruptly their rate of expenditure. Since sizable unused resources still exist in this and other economies, moreover, there is no immediate need to restrain excessive expansion, and there should be time to check any speculative surge in spending and investment that might develop.

I can assure you that the Federal Reserve has been concerned about the recently accelerated growth in the narrow money supply, and that we are monitoring this development closely. And I want to emphasize that we have by no means given up on our views as to the ranges of growth for the family of monetary aggregates that are appropriate in the longer run to the needs of the economy. The recent tendency toward excess has proceeded in fits and starts, however, and we cannot yet be sure how durable--or meaningful--these increases are likely to be. Our efforts to restrain the monetary expansion must therefore be judicious. With the unemployment rate nationally still hovering around 7 per cent, we would not want to contribute to conditions in credit markets that might imperil the prospects for sustained economic recovery.

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