

SOME THOUGHTS FOR THE FED-WATCHERS

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A few days ago, when I was in the process of considering topics that I might discuss with you here today, my attention was drawn to an article that appeared in the financial section of the Kansas City Star. The headline of the article, in big bold letters, read as follows: "Wall Street Analysts Turn Attention to the Fed." The thrust of the article, as you might guess, was that financial analysts were waiting to see whether the Federal Reserve—at the regular monthly Federal Open Market Committee meeting—would decide to change the direction of monetary policy.

Last Tuesday I attended that FOMC meeting in Washington. Also attending were the eleven other presidents of Federal Reserve Banks together with the seven members of the Board of Governors, including the Chairman, Arthur Burns. At that meeting, we discussed the current and prospective economic conditions in the United States; and then, on the basis of that discussion, arrived at a consensus agreement as to what the nation's monetary policy position should be in the period ahead.

As you know, I can not disclose to you here today the monetary policy decision that was agreed upon by the Open Market Committee. That decision will be made fully public in about thirty days. However, I would like to share with you my personal views on how our nation's economy is progressing, the condition of our money and capital markets, as well as on some other financially related topics that may be of particular interest to you.

In terms of the economy, there has been a distinct pause this summer—as you know—in the strong upward pace of the recovery that began early last year. This pause in business activity can be almost entirely traceable to a slowing down in spending by consumers at the retail level. And, as usually happens when retail sales weaken, there has been a ripple effect throughout the rest of the economy. Businessmen found their inventories rising and, in turn, cut back on their orders for more goods. As a result, production gains have been sluggish this summer and the unemployment rate has remained undesirably high.

It is natural, therefore, that a number of people have expressed concern that the economic recovery may have lost its steam. In my opinion, however, the economic pause this summer was not to be unexpected and is nothing to become overly alarmed about. In this regard, the pickup in retail sales that has been reported recently strongly suggests that the recovery is still on solid ground. Moreover, in every business expansion since World War II, the first year of recovery has always been exceptionally strong—similar to what we have seen in the past year. On the other hand, the second year of recovery has always been much slower. What we are seeing, then, it seems to me, is very typical of past business expansions during the second year of recovery. The pause in activity this summer, in other words, was merely a signal that the economy was shifting gears—from one of being in overdrive last year to a ³lower and hopefully more sustainable pace in the period ahead.

As far as credit markets are concerned, the recent moderate pace of the expansion has clearly had a beneficial effect. Interest rates, both long-term and short-term, have come down somewhat over the past few months. An easing of interest rates during any period of a business expansion is, of course, an unusual event. Therefore, a

legitimate question to ask is: Why have we seen this particular pattern in interest rates?

A major factor accounting for the easing or downward trend of interest rates has been the reduction in inflationary expectations by the investing public. Since we've moved from a period of double-digit inflation to a rate of about 5 to 6 per cent this year, the inflationary premium built into interest rates—particularly long-term rates—has been substantially reduced. In my opinion, if we continue to make substantial progress in reducing the rate of price inflation, we are very likely to see further reductions in long-term interest rates.

Another important factor causing interest rates to ease recently is that the demand for credit has not been overly large. While the U. S. Treasury has borrowed heavily, the private sector—reflecting the lull in business activity this summer—has not been a large borrower. For some time, as you know, business loans at commercial banks have been very weak. It was gratifying to me, therefore, to see that most major commercial banks recently reduced their prime lending rate from 7 per cent to 6 3/4 per cent. With the greatly improved financial condition of our banking system over the past year, commercial banks are now in a much better position to expand their loan portfolio than before.

An additional factor underlying the unusual behavior of interest rates is that the Federal Reserve has been supplying a sufficient amount of money to finance the ongoing recovery. We have been cautious, of course, not to supply an excessive amount of money. We are fully aware that an excessive expansion of money and credit would only rekindle and intensify inflationary expectations which, in turn, might sow the seeds of another recession. Consequently, the Federal Reserve has been reluctant to just open the "tap" and let money flow out in greater abundance. Our policy, in other words, has been to foster a moder-

ate growth rate of money and credit and one which we believe is consistent with encouraging the economic recovery while gradually reducing the rate of price inflation.

In carrying out this policy we have by necessity paid close attention to the growth rates in the monetary aggregates, which include various definitions of the money supply. Because of this approach to policy, it has become quite fashionable among various groups of so-called "Fed watchers," including a number of financial analysts, to pay extraordinary attention to every little wiggle in the money supply series—even on a weekly basis. I would like to comment briefly on that particular brand of Fed watching.

The apparent rationale for watching weekly movements in the money supply is that one might detect from these movements what the Fed is going to do. For example, if the money supply jumps up in one week, then the Fed—so the argument goes—will tighten up its policy the following week. Alternatively, if the money supply falls, the Fed is expected to ease its policy the next week.

It seems appropriate to me that the "Fed watchers" and particularly those who watch the "Fed watchers" should understand that in conducting monetary policy the Federal Reserve does not try to play "catch up" with weekly changes in the money supply. The reason we don't play such a game is that we know the money supply is going to bounce around from week to week by a considerable amount due to technical factors alone. And, it's going to do that regardless of what actions we take to prevent such movements.

Accordingly, we formulate our monetary policy in a manner that recognizes and allows for the short-run variability of money. Specifically, as some of you may know, we set our short-run, 2-month targets for money in terms of a desired range. And, the ranges we choose often tend to be quite wide. For example, our short-run targeted growth rates for money might vary from 4 to 8 per cent on an annual basis. Such a wide

range obviously allows for considerable variation in the week-to-week movements in the money supply. The wide range also ensures that we don't overreact to these short-run movements. In other words, the wide ranges keep us from playing the game of "catch up" with weekly changes in money supply.

The FOMC also has adopted another procedure to ensure that we don't conduct policy by overreacting to short-run developments. Each quarter the committee establishes our targeted rates of growth in money for the year ahead based on an intensive review of past events and a projection for the future course of the economy. These long-range targets, I should mention, also are announced publicly a few days after they are agreed upon by the Committee. Therefore, we utilize both short- and long-run targets to help keep us on our chosen course. For these reasons, I think it should be clear that we are not very likely to alter our monetary policy position on the basis of weekly changes in the money supply—as some of the so-called Fed watchers would have you believe.

A final point I would like to cover is: How do we know we have chosen the correct rates of growth for money and credit in the period ahead? Quite obviously, we have no way of knowing for certain we have made the right choice until after the fact. However, we do make an intensive effort to arrive at an intelligent and economically sound decision, and one that is compatible with our national goals of economic growth, full employment, and reasonable price stability.

In arriving at our policy decisions, we seek advice and opinion from a broad range of sources. Each quarter, Chairman Burns consults with Congress in a public forum on our announced monetary targets for the year ahead. Through these consultations, we receive the views of the elected congressional representatives. We also meet with the general public in countless sessions—such as this meeting today—to discuss

monetary policy issues. Also, each president of the twelve Federal Reserve District Banks receives advice and information from his Bank's board of directors, who are selected to represent various segments of the area's business, financial, and economic community. In this way, the president of each Bank is able to bring to the FOMC meeting an understanding of both the regional and national economic conditions that would be painfully lacking if the decision process were conducted solely by governmental officials in Washington.

Another important aspect of the monetary policy process is the independence of the Federal Reserve. That is, the current structure of the System is also well suited to remove policy decisions from the day to day political arena. The principle of independence within government has been a basic provision of the Federal Reserve Act since its passage in 1913. Moreover, if this traditional independence of the Federal Reserve were to be circumscribed, as some would have it, it is doubtful that our decisions on money creation could remain free of political partisanship, as they are now.

In brief, the decisional process of the FOMC, as I've seen it, is an exceptionally good one. Because of it, the Federal Reserve has formulated and pursued a monetary policy during the past year or so of economic recovery that I believe to have been entirely appropriate. We have sought and, in my judgment, have achieved a moderate growth in money and credit in a manner that is consistent with rising output and a slowing in the forces of inflation.

For the longer range outlook, I believe our economy has the potential to continue to grow at a balanced and healthy pace for an extended period of time into the future. However, it will be the task of policymakers to carefully avoid an overly expansionary monetary policy that might reignite the powerful forces of inflation. If we are successful and I am confident that we will be, it is unlikely that the Federal Reserve will succumb to that temptation.