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RECENT FINANCIAL DEVELOPMENTS
AND THE ROLE OF MONETARY POLICY

by

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I appreciate the invitation to meet with you today. Forums such as these are good opportunities to communicate about Federal Reserve monetary policy and the performance of our economy.

The need for a clear public understanding of economic policy is particularly important today in view of the swirl of rapid events of recent weeks that have impacted financial markets and the economy. Among these events, as you know, has been the sharp drop of interest rates in both the money and capital markets, a decline in the commercial bank prime rate to 12 percent, and a commensurate sharp rally in the stock market. All these events have taken place against the backdrop of an economy in which the unemployment rate has risen to above 10 percent, concerns are being expressed about the stability of our international financial system, and news stories have appeared to the effect that the Federal Reserve has "caved-in" in its fight against inflation.

In view of the widespread publicity, speculation, and uncertainty accorded these events recently, I intend to alter the subject of my remarks from what is cited in your program. Instead of discussing the subject of "Quick-fix Economic Solutions", I think it would be eminently more appropriate if I took some time to discuss with you the developments that have occurred in financial markets in recent weeks and to treat in particular the role played by Federal Reserve monetary

policy. In the course of my remarks, I also intend to offer some comments on the current business situation and the economic outlook.

I

In any examination of the current economic situation, I think it is useful to remember that the principal objective of economic policy in the United States during the past three years has been to reduce the rate of inflation. As you recall, it was widely agreed three years ago that unless the accelerating inflationary spiral of the late 1970's was checked, it would threaten to undermine and eventually bring down our entire financial, economic, and political system. As a result of this general view, an anti-inflationary program was put into place—the cornerstones of which were reduced government spending, reduced taxes, and reduced rates of growth in the availability of money and credit.

The Federal Reserve's role in this program was to implement a monetary policy designed to gradually slow the growth rate of money and credit. This facet of the program was extremely critical because it is generally agreed by economists that there is a positive correlation between money growth and inflation over the long run. Thus, to obtain a gradual reduction in the rate of inflation, it was deemed necessary to gradually slow the rate of growth in the money supply.

The record of how the Federal Reserve has performed this role over the past three years is quite clear. Since October 1979, the Federal Reserve has both sought and achieved slower growth rates of money and credit. And, this consistent policy has been highly instrumental in the marked reduction that has occurred in the rate of inflation. Indeed, there is now growing evidence that the inflationary momentum of the late 1970's is in the process of being broken.

This welcome development in the battle against inflation has not been achieved without significant costs. By curtailing the growth rate of money and credit, the growth in the total demand for goods and services in the United States also has been held in check. As a result, the nation's economic growth rate has been much slower than generally desired, which has been reflected by an increase in excess productive capacity and a steady rise in the unemployment rate. And, this situation has been exacerbated by a historically high level of interest rates which prevailed up until about the middle of this year.

Normally, one would have expected that interest rates would have declined earlier this year given the good progress being made against inflation. However, future inflationary expectations were still quite high, in large part because of the extraordinary large deficits being projected for the Federal Government's budget. In other words, the large budget

deficits being projected for many years to come were fueling inflationary expectations, keeping interest rates historically high, and thereby casting a pall over business activity and the economic outlook. Unfortunately, this situation continued to prevail not only through the first half of this year but throughout much of the third quarter as well.

II

Only recently has the gridlock of high interest rates been broken. As you know, we have recently seen a marked drop of interest rates in all sectors of the market. Since there has been no significant change in the posture of fiscal policy and, hence, in the dimensions of future budget deficits, what then has changed to account for the recent decline in interest rates?

In my opinion, four fundamental factors have contributed importantly to the decline in interest rates. These factors are: (1) the continued weakness in the economy; (2) the commensurate reduction in inflationary pressures; (3) the market's growing recognition of these two factors; and (4) the role played by Federal Reserve monetary policy. In the time remaining, I want to touch briefly on each of these factors.

In terms of the economy, there is no question that the consensus view early this year was that an economic recovery would occur soon after the midyear tax decrease. As the third quarter unfolded, however, it became increasingly obvious that

the hoped-for recovery was not materializing. The expected pickup in consumer spending due to the midyear tax cut was clearly not coming on stream. Instead, consumers were retrenching in their spending behavior and building up their precautionary money balances. Moreover, the boost in consumer income expected to flow from the tax cut was largely offset by the loss of consumer income stemming from the higher level of unemployment. As a result, the weakness in consumer spending, particularly for durable goods such as autos, has continued to spread.

Reflecting the weakness of consumer spending, businesses have been accumulating unwanted inventories. In turn, business orders for new durable goods have remained soft, business spending plans for new plant and equipment have weakened sharply, and the demand for labor has dropped in both the goods and service industries.

The net picture that emerges from these developments is that the economy is now being viewed as being much weaker than was earlier anticipated. Specifically, it is now expected that real GNP in the third quarter will show little or no growth and that a recovery in the fourth quarter is by no means assured. The implication for financial markets from this reassessment is that the demand for credit will be commensurately weaker, too.

News on the international economy presents a similar

picture. Most industrialized countries are now experiencing a downturn in business activity with no near-term recovery in sight. The unemployment rate in the EEC countries is now averaging about 10 percent and it's up to 12 percent in Canada. The situation is even more bleak in the lesser-developed countries—many of whom are having debt-structure problems. These problems have developed mainly because of the disinflationary process underway in the world economy. Moreover, the softness of business activity in the industrialized countries has hurt the exports of many of these underdeveloped countries, which has made it difficult for them to obtain the foreign exchange reserves necessary to meet their debt obligations. This situation has been exacerbated by the high value of the dollar in foreign exchange markets as well as the high level of interest rates internationally. While the debt-restructuring problem has been most publicized in the case of Mexico, similar problems exist for a number of other countries such as Bolivia, Argentina, Brazil, Chile, Poland, and Yugoslavia.

Against this background of a weakening domestic and international economy—all of which portend a softening in the demand for credit from the private sector—it also has become obvious that inflationary pressures are easing rapidly, too. This factor also is expected to contribute to the softening in the demand for credit.

The third factor accounting for the recent decline of

interest rates is the market's recognition of these two fundamental factors I've just mentioned. That is, the market has just recently come to realize that the economy is much weaker than was generally expected and that progress on inflation is proceeding more rapidly than expected. The combination of these fundamental forces, therefore, has set in train the natural process in which market interest rates have declined in both the money and capital markets.

The fourth factor has to do with the role of Federal Reserve monetary policy. As I've indicated, the conduct of monetary policy has been geared to slowing the growth rates of money and credit. Given this framework for policy, the financial markets have come to expect that whenever money growth begins to exceed the Fed's established target for money growth, monetary policy tends to become less accommodative.

Throughout this year, however, we have tried to make clear that monetary policy in 1982 was going to be less mechanical and more flexible than it had been in the preceding two years. In fact, we have publicly indicated on numerous occasions that we were not going to react immediately to every little bulge and dip in the money supply behavior. Moreover, we have indicated that we would be willing to tolerate the growth of money somewhat above the targeted ranges in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty, were

leading to stronger than anticipated demands for money.

Nonetheless, in early October, the financial markets were expecting that the Fed might be forced to tighten monetary policy because the money supply was coming in above its targeted range. This expectation was running counter to the fundamental forces at work, all of which suggested that interest rates should be easing over this time frame.

It was in this environment, therefore, that Chairman Paul Volcker—speaking in behalf of the FOMC—recently indicated that we would be placing less weight than usual on movements in the M1 definition of money over the period ahead. The reason for this change in emphasis in how we operate monetary policy was simply that over the next few months the M1 definition of money is likely to be highly distorted by a number of developments—all of which will make M1 a very unreliable guide for monetary policy. One development is the maturing in early October of about \$31 billion of all-savers certificates. To the extent that these certificates are not rolled over and the proceeds temporarily parked in demand deposits prior to being invested elsewhere, there is likely to be a large bulge in M1. The other development concerns the recent legislative authorization of a new money market account for banks and thrifts that would be directly competitive with MMMF's. This account, which is to be implemented within about 60 days, could result in funds

shifting out of demand deposits which could cause a very large reduction in M1 balances.

For these and other reasons, we felt it would not be appropriate to conduct monetary policy in a manner geared tightly to movements in the M1 money supply. Instead, we'll be looking at a variety of other factors, including the broader definitions of money—which are not as likely to be affected by these distortions—as well as the behavior of financial markets, the economy, and interest rates.

The market reaction to this Fed position on the money supply has been quite positive. The immediate implication was the market perception that the Fed would not seek tighter credit conditions just because of a technical bulge in M1. As a result of this perception, the fundamental forces at work in the market have been allowed to operate and interest rates have come down of their natural accord. In recognition of this drop in market interest rates, the Fed recently cut the discount rate from 10 to 9 1/2 percent. This action has encouraged a further decline of market rates. Personally, I'm delighted to see the recent decline of interest rates because I believe a lower level of rates is both a necessary and desirable condition if we are to see an eventual recovery in business activity.

Before commenting further on the economic outlook, I want to emphasize that, contrary to some beliefs, the recent

Fed position on M1 does not represent any change in the basic thrust of Fed monetary policy. The Federal Reserve has decidedly not caved-in in its long-term commitment to restore price stability. We are as committed as ever before to the process of continuing to moderate inflation in the months and years ahead because we believe that process is a necessary and vital ingredient to achieving further reductions in interest rates and a sustainable expansion over a longer period of time.

III

In terms of the outlook for the economy, I am presently quite optimistic about our long-term prospects. I believe we've come an enormous distance in our difficult travels to correct the inflationary distortion of the past decade. However, we are still faced with some very difficult near-term obstacles as our economy goes through the disinflationary process.

There is no doubt, for example, that our economy is now wallowing along near the low point of the business cycle. And, it is quite evident that strains are developing in the financial structure both domestically and internationally. I believe that many of these problems can and will be overcome. The financial strains, while potentially very serious, can and will be managed. Moreover, given the fundamental corrective forces now at work in the economy, I believe some modest resumption of business activity is now in prospect in the near term.

Essential to achieving a sustainable business expansion in 1983 and beyond are two important factors. The first is that significant and meaningful steps still need to be taken to restore the credibility of the Federal Government's fiscal policy. The large budgetary deficits in prospect for years to come are still a major unresolved obstacle to further reductions in interest rates, lower inflation, and a strong resumption of business activity.

The second factor is that the Federal Reserve will need to be able to retain its credibility in the eyes of the public as an institution concerned about inflation, monetary discipline, and financial integrity. Quite clearly, these financial conditions are a necessary ingredient to a healthy and growing economic system. We in the Federal Reserve believe that monetary policy has been conducted consistent with these objectives and in the long-run best interests of the American people. To be able to continue to conduct policy in such a fashion, though, requires that the Federal Reserve be allowed to remain sufficiently flexible within the current framework for public accountability.

I cite this factor about the Federal Reserve because a number of legislative proposals have come forward recently that would, in my judgment, serve to politicize the monetary policy process. Some of these proposals, for example, would fold the Federal Reserve into the U.S. Treasury or put the

Secretary of the Treasury as a voting member of the FOMC. While I'm sure all these proposals are well intentioned, I think we should all be particularly wary of attempts to weaken the independence and the resolve of the Federal Reserve to keep monetary policy on a proper course no matter how the winds of political expediency may blow at a given time.

While the independence of the Federal Reserve has long proven to be a wise and appropriate institutional arrangement in the United States, I think it will be particularly so in the period ahead. As I've indicated, a major unresolved obstacle to a resumption of a sustainable and noninflationary economic recovery are the large projected deficits of the Federal Government. Therefore, any legislative changes designed to politicize the conduct of monetary policy will only serve to nourish public expectations that the government debt will be monetized by the Federal Reserve. And this, in turn, will inevitably serve to fuel the fires of the inflationary process once again.

With these important caveats in mind, I want to again stress that I believe there is a strong economic future ahead of us. I am confident that the recovery will occur soon and that an extended period of economic growth is out there waiting to begin. There is no reason we cannot achieve this potential if we have sufficient patience, if we act firmly to achieve an accord over the deficit issue, and if the Federal Reserve

continues to conduct monetary policy in a prudent manner responsive to the needs of the economy. I can assure you that the Federal Reserve will do its part—as we always have—in this important national endeavor.