Research Department
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October 8, 1976

Policy in a Weak Recovery

In a speech last May to the Institutional Investors Institute, Federal Reserve Governor Wallich set forth a useful rule-of-thumb of monetary policy: "When there are disturbances on the side of the real sector, monetary policy should focus on the (monetary) aggregates and allow interest rates to move up or down in order to counter the disturbance. Conversely, when there are disturbances on the monetary side, monetary policy should focus on interest rates in order to avoid transmitting these disturbances to the real sector." His remarks may provide some background for examining the recent "summer lull"—the unexpected slowdown in the expansion pace of the real economy, as exemplified by an apparent lag in GNP growth and by a decline in the leading indicators of future business activity.

Then: monetary disturbance

Actually, Governor Wallich's remarks were made in the context of what was seen at the time as "a disturbance on the monetary side—the less predictable demand for M_1." He was referring to the fact that during late 1974 and 1975, conventional money-demand equations had persistently (and increasingly) overpredicted the amount of money demanded by the public to finance transactions. By the last quarter of 1975, the over-prediction had cumulated to $19 billion—about 6 percent of the actual level of the narrowly defined money supply.

The Federal Open Market Committee responded to this monetary disturbance—the apparent instability in money demand—in a way consistent with Governor Wallich's rule-of-thumb. For example, the Record of Policy Actions for the January 20th meeting stated, "In view of the current uncertainties regarding the behavior of the monetary aggregates, many members advocated that the Committee continue to give greater weight than usual to money-market conditions in the period until the next meeting, and that it specify two-month ranges of tolerance for growth in the monetary aggregates that were wider than usual."

The FOMC thus decided to shift the short-run ranges of tolerance it had previously used for its policy variables. For the M_1 money supply, it widened the range to five percentage points—somewhat greater than the average range of three percentage points it had used in earlier months. But for its interest-rate variable (the Federal-funds rate), it narrowed the range of tolerance to ¾ percentage point, down from the 1-1¼ percentage-point range of the immediately preceding months.

A good deal of recent research has attempted to explain the large errors produced by standard money-demand equations. Enzler, Johnson and Paulus, in a recent article in the *Brookings Papers,* identified several factors which reduced the error but still left a relatively large amount to

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be explained. However, we should note one important point: since the fourth quarter of 1975, the error in the money-demand estimates has become relatively stable, in the sense that it has stopped its upward climb and levelled off. Consequently, for the past three quarters, changes in the demand for money have been in line with their past behavior, in relation to changes in aggregate demand, interest rates and prices.

Now: real disturbance

Today the emphasis has shifted, with more uncertainty in the real sector than in the monetary sector, in the form of the "summer lull." One of the most striking features of the summer lull was the succession of three straight increases in the unemployment rate, to 7.9 percent in August. This was the first time since 1959 that unemployment had risen in such a fashion in the midst of a business expansion—and the 1959 episode was explained by a major steel strike which forced layoffs in other industries. According to the Bureau of Labor Statistics, most of the recent upsurge in the jobless rate reflected an unexpectedly large increase in the civilian labor force, especially in the number of women jobseekers. In August, however, the labor force grew only modestly and still the jobless rate continued to rise.

Another element in the summer lull was the lag in business plant-equipment spending, relative to the pace projected in the preceding survey of business spending plans. This was the fifth consecutive quarter in which actual outlays trailed projections. In addition, new orders for non-defense capital goods fell by a steep 12 percent in August after a seven-month string of increases.

There was some encouraging news as well. Retail sales, which had fallen in July, rose more than 2 percent in August. Capital appropriations, which lead spending plans for plant and equipment, were up substantially in the second quarter. And although the August survey of spending plans indicated little advance over the previous (April) survey, real outlays may be higher than

indicated because of the easing of capital-goods prices between the two survey dates.

Different choice of variables

Given the present concern over the state of the real economy, some importance attaches to the variable that is emphasized in policy deliberations. Past experience indicates (as does our rule-of-thumb) that when aggregate demand is weaker than expected, targeting interest rates closely would tend to keep rates higher than otherwise would have been the case. Such an action in turn would tend to reinforce the weakness in the underlying economy.

Testifying before the House Banking Committee last February, Congressional Budget Director Rivlin presented an argument against emphasizing interest-rate variables rather than monetary-growth variables. "If an unexpected economic weakness were to develop, for example. . .it would have the effect, because of the fall-off in loan demands, of reducing monetary growth and lowering interest rates. Following an interest-rate target at such a time would mean taking steps to raise interest rates back to target levels, and these steps would further reduce demands and hence further weaken the economy.

"Following a monetary target, on the other hand, would mean taking steps to raise the money supply back to its target level, and these steps would tend to strengthen demands and counteract the unexpected economic weakness." In her view, whenever unexpected strength or weakness has occurred during past business cycles, "it seems clear in retrospect that following monetary-growth targets would have promoted economic stability."

Current cyclical indicators suggest that we are now faced with relatively greater uncertainty regarding the real sector than regarding the monetary sector. Although forecasts of both real and monetary variables are subject to error, the future course of real-sector behavior may be the more crucial factor for policymakers to watch.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/22/76	Change from 9/15/76	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	89,747	– 325	+ 3,905	+ 4.55
Loans (gross, adjusted)—total	68,022	– 381	+ 3,693	+ 5.74
Security loans	1,534	– 461	+ 518	+ 50.98
Commercial and industrial	22,033	+ 138	– 719	– 3.16
Real estate	20,760	+ 124	+ 1,120	+ 5.70
Consumer instalment	11,454	– 3	+ 1,223	+ 11.95
U.S. Treasury securities	9,219	+ 43	+ 384	+ 4.35
Other securities	12,506	+ 13	– 172	– 1.36
Deposits (less cash items)—total*	88,743	– 469	+ 2,288	+ 2.65
Demand deposits (adjusted)	25,125	– 511	+ 1,213	+ 5.07
U.S. Government deposits	486	– 139	+ 170	+ 53.80
Time deposits—total*	61,806	+ 511	+ 944	+ 1.55
States and political subdivisions	5,290	– 38	– 549	– 9.40
Savings deposits	27,225	+ 137	+ 6,329	+ 30.29
Other time deposits‡	26,822	+ 359	– 3,421	– 11.31
Large negotiable CD's	11,127	+ 381	– 5,292	– 32.23

Weekly Averages of Daily Figures	Week ended 9/22/76	Week ended 9/15/76	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	– 14	26	35
Borrowings	0	3	19
Net free(+)/Net borrowed (–)	– 14	+ 23	+ 16
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 297	+ 280	+ 981
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 405	+ 1,255	+ 668

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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