

Research Department
Federal Reserve
Bank of
San Francisco

May 16, 1980

Has the Fed Given Up?

The answer is, "Certainly not." Those pundits who have interpreted the steep decline in interest rates as a Federal Reserve surrender to inflation have somehow missed the message of the Fed's October 6 policy shift. (They probably haven't paid any attention either to Milton Friedman's *Newsweek* columns over the past decade or so.) The real story is that the Fed has consistently pursued the same money-growth objectives since last fall. But in the process, interest rates have swung widely in both directions, reflecting (among other things) the Fed's increased emphasis on money growth rather than interest rates in its operating processes.

Without doubt, interest-rate movements have been unprecedented in recent months. Treasury-bill rates, for example, rose from a 10.2-percent average rate last September to a 15.5-percent average rate in the month of March, before dropping to 8.8 percent in early May. And the prime business loan rate, after rising to 13½ percent on the eve of the Fed's October policy action, jumped to 20 percent this April before declining to the present level of 16½ percent. But these massive rate movements, far from indicating monetary-policy shifts, rather have indicated wide shifts in loan demand, as well as slowness by market participants in adjusting to a new market environment.

By improving its control over bank reserves in the past half year, the Federal Reserve has managed to reduce money-supply growth roughly by half. In the two quarters prior to the October 6 policy shift, the M-1B measure of the money supply increased at about an 11-percent annual rate. (M-1B consists of currency, plus bank demand deposits, plus similar check-type deposits at other financial institutions.) In the following two quarters, the growth rate dropped to about a 5½-percent annual rate. Then, in the present quarter to date, the money supply has actually declined. The recent data indicate, not

a worrisome easing of policy, but rather a danger of excessive tightening.

Money growth and inflation

To put this problem in the proper context, we should understand the connection between money growth and inflation, and the reasons why the Federal Reserve shifted its operating techniques last fall to fight inflation more effectively. Most economists agree that over the long run, the fundamental determinant of the rate of inflation is the rate of growth of the money supply. Monetary growth greater than that which is required to meet the needs of trade and finance will ultimately result in higher prices (see chart). However, it takes approximately two years for most of the effects of an increase in the money supply to work their way through the economy to price increases.

Although the relationship is not perfect, there is a general correspondence between the U.S. rate of inflation and U.S. monetary growth two years earlier. This relationship can be expected to hold in the long run, while in the short run, inflation may also be influenced by non-monetary factors such as oil-price shocks, crop failures, and price controls.

Between the first quarter of 1979 and the first quarter of 1980, the price index (deflator) for personal consumption expenditures rose by 10.3 percent. What factors accounted for such a sharp increase? One important factor was the oil-price shock of 1979. Due primarily to OPEC oil-price increases, energy prices in the U.S. rose by almost 40 percent in 1979. This contributed significantly to the past year's rise in the overall price level, and the effects may continue as the energy price increases work their way through to prices of related products. Nonetheless, the oil-price shock has added no more than two percentage points to the inflation rate over the last year. This still leaves us with a high

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underlying rate of inflation, which is explainable in terms of the past history of monetary growth.

Annual money growth averaged about 3 percent in the early 1960's, but averaged over 8 percent between early 1977 and late 1979. What has caused this excessive money growth? And if excessive monetary expansion is the root cause of inflation, why doesn't the Federal Reserve System simply adopt more conservative policies and aim at a slower growth of money and credit?

Excessive growth (I)

After the end of World War II, many countries, including the United States, adopted national economic policies aimed vigorously at full employment. This is understandable in the context of the economic and human ravages of the Great Depression and the Great War. Later on, the full-employment goal was augmented by programs of social welfare and income maintenance. These goals were achieved largely through greatly enlarged government spending programs.

While the programs themselves were popular, an increase in taxes to finance these programs was far less popular, and the result has been chronic large-scale deficit financing. When economic resources are substantially under-utilized, it can be constructive to achieve fiscal and monetary stimulus through well-designed government spending programs, financed through budget deficits and/or an accompanying increased growth of money and credit. However, the U.S. has recorded federal budget deficits in 19 of the last 20 years, irrespective of the stage of the business cycle.

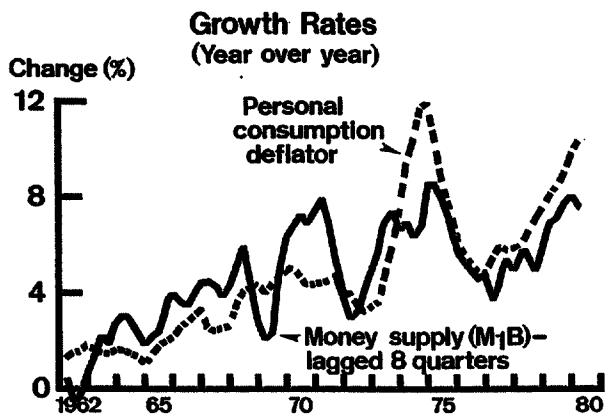
Because of strong public pressures to keep interest rates as low as is consistent with short-term economic growth, and because of the operating procedures which were in place until last October 6, the Fed in the past tended to use newly-created money to purchase a large portion of the bonds floated by the Treasury to finance the deficit. This process—monetizing the deficit—may be explained by the different effects of expansionary monetary and fiscal policy on domestic interest rates.

If the government sells bonds to pay for an increase in the Federal deficit (expansionary fiscal policy), this will increase the supply of bonds available to the public, and will put upward pressure on interest rates. On the other hand, if the Fed increases the supply of money (expansionary monetary policy) by buying bonds on the open market, this will reduce the supply of bonds available to the public, and will put downward pressure (at least in the short run) on interest rates.

Higher interest rates impact heavily on businesses, farmers, homebuilders and state-and-local government units. To avoid such problems, the Fed sometimes has had a tendency to buy all of the additional bonds sold by the Treasury, leaving no change in the supply of bonds available to the public, and no immediate change in interest rates. Thus, in times of large increases in Federal deficits, such as in the Vietnam War era, the Fed has tended to monetize the deficit and thus increase the supply of money beyond what it otherwise would have been.

Excessive growth (II)

Secondly, high money growth has occurred because of uncertainty regarding the effects of monetary policy. Expanding money growth increases production in the short run, but increases the inflation rate in the long run. Similarly, while a deceleration in money growth leads to an eventual decline in the inflation rate, the immediate effects are negative—an increase in unemployment and a reduction in real output. While the central bank has a responsibility to strive for



non-inflationary economic growth, it also has a responsibility to avoid policies which produce sub-normal growth and excessive unused resources.

Because of the uncertainties of economic forecasting, however, there is almost always a large "gray area" in the range of appropriate monetary policy, no matter how clear the proper policy may appear in retrospect to economic historians. Because of such uncertainties, and because the short-run effects of policy are sometimes weighted more heavily than the long-run effects, there is often a tendency to err on the side of monetary ease. The result frequently is a favorable short-run impact on employment and output, but a worsening of the inflation rate in the long run.

Excessive growth (III)

The third reason for the high monetary growth of the last decade has to do with the operating procedures of the Federal Reserve—the way in which money was injected into the economy—prior to October 6, 1979. Under that procedure, the Fed's policy-making committee, the Federal Open Market Committee (FOMC), chose an appropriate rate of money growth, and then chose a short-term interest-rate target (the Federal funds rate) which appeared to be consistent with the targeted rate of money growth. If the Fed funds rate rose above the chosen rate, the Fed would purchase securities with newly created money, putting downward pressure on short-term interest rates. Similarly, if the Fed funds rate fell below the chosen rate, the Fed would sell securities, thus withdrawing money from the system and pushing rates back up.

This procedure created problems, however, because of the FOMC's reluctance, in practice, to change its targeted interest rate. Interest rates can be affected by factors other than monetary policy, so that a policy which tries to fight such changes will result in monetary growth different from intended. During a cyclical expansion, for example, interest rates tend to rise for reasons not

directly related to current monetary policy, such as increases in private-sector investment demand and increases in inflation expectations. The Fed consequently would feel forced to buy additional securities, thus increasing the supply of money, in order to keep interest rates at their targeted level.

The old operating procedures, coupled with reluctance to change the short-term interest rate, thus led to a procyclical monetary policy. In other words, we experienced an overexpansion of the money supply during economic booms, and underexpansion of the money supply during economic slowdowns. And since most years in the past two decades have been expansion years, this situation has led to a net overexpansion of the money supply.

The new operating procedures should avoid these problems. As we've seen, the Fed now allows short-term interest rates to fluctuate much more than before, and concentrates instead on controlling directly the amount of reserves in the banking system. Because banks hold a fairly stable amount of reserves relative to total deposits, this new procedure should improve monetary control and prevent some of the excesses which occurred in the past. Indeed, these procedures seem to be working, as was noted at the outset.

Looking ahead, it is apparent that the problem of inflation will not be solved overnight, because it has built up over a number of years. The Federal Reserve is determined to reduce, gradually yet consistently, the rate of growth of the money supply. Despite the time required to make this policy completely effective, it is the necessary solution for bringing down the rate of inflation in this country.

Stephen Zeldes

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding 4/30/80	Change from 4/23/80	Change from year ago	
			Dollar	Percent
Large Commercial Banks				
Loans (gross, adjusted) and investments*	138,394	+ 39	+ 12,885	+ 10.3
Loans (gross, adjusted) — total#	116,690	+ 127	+ 14,037	+ 13.7
Commercial and industrial	33,749	+ 52	+ 2,949	+ 9.6
Real estate	46,079	+ 116	+ 9,095	+ 24.6
Loans to individuals	24,314	- 105	+ 2,616	+ 12.1
Securities loans	1,123	+ 122	- 447	- 28.5
U.S. Treasury securities*	6,391	- 150	- 1,346	- 17.4
Other securities*	15,313	+ 62	+ 194	+ 1.3
Demand deposits — total#	43,921	+ 670	+ 1,175	+ 2.7
Demand deposits — adjusted	31,085	-1,141	+ 406	+ 1.3
Savings deposits — total	25,904	- 318	- 3,838	- 12.9
Time deposits — total#	64,517	+ 588	+ 14,703	+ 29.5
Individuals, part. & corp.	55,610	+ 541	+ 15,128	+ 37.4
(Large negotiable CD's)	23,225	+ 441	+ 6,164	+ 36.1
Weekly Averages of Daily Figures	Week ended 4/30/80	Week ended 4/23/80	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	331	479		10
Borrowings	88	148		224
Net free reserves (+)/Net borrowed(-)	243	331		- 214

* Excludes trading account securities.

Includes items not shown separately.

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