

MONETARY POLICY: RECENT CHANGES AND CURRENT CONDITIONS

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ISSUE DEFINITION

Congressional interest in monetary policy has been stimulated by several developments: concern about general economic conditions and inflation control, major legislation enacted in 1980 that deals with the financial system and has implications for the conduct of monetary policy by the Federal Reserve, the significant changes in monetary policy operating procedures initiated by the Federal Reserve in October 1979, and the hearings Congress has held regularly since 1975 to oversee and review the record of Federal Reserve monetary policy.

This issue brief summarizes the current status of monetary conditions and policy. It also describes the process through which Congress oversees monetary policy, the recent changes in the financial system which affect monetary policy, and the October 1979 changes in Federal Reserve operating procedures. Additional references cite congressional documents and other materials which examine current monetary policy developments and CRS documents which review monetary policy since 1979 and analyze various policy issues.

BACKGROUND AND POLICY ANALYSIS

Congressional Oversight of Monetary Policy

Regular congressional oversight on monetary policy began with hearings before the House and Senate banking committees in the spring of 1975. Since January 1979, semi-annual oversight hearings have been held under the guidelines set forth in P.L. 95-523, the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act.

To conform with the provisions of the Humphrey-Hawkins Act, the Federal Reserve reports to the Congress by Feb. 20 and July 20 of each year. These reports review monetary policy, summarize economic conditions, set objectives for the growth of money and credit in the form of 1-year target ranges, and relate the monetary policy objectives to general economic goals set forth each year in the Economic Report of the President. The House and Senate Banking Committees hold hearings to review the Federal Reserve's monetary policy report and subsequently each Committee submits to the Congress a report containing its own views and recommendations on monetary policy.

In establishing its objectives for growth of money and credit, the Act requires the Federal Reserve to consider "past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices." The goals in the Economic Report of the President to which the Federal Reserve is required to relate its objectives include numerical goals for the current and next calendar years for employment and unemployment, production, real income, productivity, and prices.

The 1-year targets for the growth of money and credit are specified as ranges, with upper and lower bounds, and are stated as desired percentage increases in selected monetary and credit aggregates. The targets cover the annual periods from the fourth quarter of one year to the fourth quarter of the next year. Monetary aggregates are measures of the amount of money in

circulation. The most narrow definition of money as set forth by the Federal Reserve, M-1, consists of cash and deposits at depository institutions that are directly available to spend. The broader measures of money such as M-2 and M-3 add groups of assets that, though highly liquid and easily converted into a spendable asset, are not in general directly available to be spent. As such, these assets tend to be used less actively in the payments process. The Federal Reserve reports on a family of monetary aggregates, definitions for which appear in the last section of this issue brief. For credit growth, the Federal Reserve reports on a bank credit measure, bank credit being the sum of funds provided to borrowers by banks.

Changes in the Financial System and the Implications for Monetary Policy

Financial developments in recent years have reduced the relevance of the traditional definitions of money. Therefore, in February 1980, the Federal Reserve announced new official definitions of the money stock, designed to be better measures of the liquid assets available to the public for spending. The organizing principle was to combine similar kinds of monetary assets at each level of aggregation. Since then, changes in the financial system have meant that the Federal Reserve has had to refine the definitions and its measurement methods, and carefully interpret monetary data for monetary policy purposes, taking into account shifts in the financial behavior of the public. Changes can also make it more difficult for observers to monitor or interpret monetary policy. In particular, interpretation of the growth paths of the monetary aggregates must be handled with care.

Many of the definitional changes and difficulties in interpreting trends in growth of monetary aggregates have emanated from changes in the financial behavior of the public as it has adapted to the economic climate of recent years, characterized by inflation and high interest rates. These circumstances have prompted changes in the forms in which the public holds money. Businesses and individuals have economized on cash balances, including traditional types of checking accounts, and have sought out interest-bearing alternatives.

Financial institutions have responded by developing new forms of deposit accounts and financial instruments. For example, in 1980 and 1981, important growth occurred in interest-bearing transaction accounts, permitted by Federal law for all forms of depository institutions, effective Dec. 31, 1980. The Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221), which authorized such accounts, also extends Federal Reserve reserve requirements to transaction accounts and certain other deposit accounts at all depository institutions to provide the Federal Reserve with better monetary control. Formerly, reserve requirements applied only to commercial banks with membership in the Federal Reserve System.

In anticipation of shifts into the newly available interest-bearing transaction accounts, in 1980 and 1981 the Federal Reserve targeted and reported data for two measures of M-1, the most narrow definition of money and the most closely watched indicator of monetary policy: M-1A, which consisted primarily of currency and demand deposits at commercial banks, and M-1B, which consisted of M-1A plus other checkable deposits at all depository institutions. Targets and measurements of growth rates for these aggregates were then adjusted to distinguish between changes with true economic significance which would represent actual or intended changes in the amount of spendable assets available to the public and changes resulting only from shifts into new deposit forms which would not represent a change in the

amount of spendable assets.

While such shifts could not be perfectly forecasted or the proportion coming from accounts included in other aggregates estimated precisely, the adjusted targets and measurements were intended to be more meaningful indicators of monetary policy than actual (recorded) data. Adjustments were made for growth in M-1B resulting from shifts into the new forms of transaction accounts from accounts such as savings accounts included only in broader aggregates. Adjustments were made for decreases in M-1A resulting from shifts out of demand deposits into the new forms of interest-bearing transaction accounts. In 1982 the Federal Reserve is targeting and reporting data for a single measure of M-1, equivalent in coverage to M-1B in use in 1980 and 1981. The Federal Reserve has developed historic data series for this current measure of M-1. This decision is based on the assumption that the major structural shifts into interest-bearing transaction accounts have occurred, eliminating further need for "shift adjusted" data.

The substantial growth of money market mutual funds in 1981 can also be attributed to the desire of the public to hold liquid assets in forms that earn interest at near market rates. This development has necessitated careful interpretation of the growth rates of the monetary aggregates as they have been affected both directly and indirectly. For example, the surge in growth of money market mutual funds in 1981 was among the influences increasing the growth of the broader measures of monetary assets beyond the target levels set by the Federal Reserve at the beginning of the year. The liquidity and transaction features of money market mutual funds are also believed to have influenced individuals to economize on cash balances in transaction accounts, thus contributing to the growth of M-1B below target levels in 1981.

The examples above suggest the importance of taking into account changes in financial behavior of the public and institutions in evaluating monetary policy. Changes in financial behavior which may affect the growth of individual monetary aggregates or relationships among the growth rates of the aggregates in 1982 include possible further changes in patterns for holding transactions balances, and possible changes in patterns of personal saving resulting from recent changes in tax law and the continuing deregulation of deposit interest rate ceilings at depository institutions.

New Monetary Control Technique

In October 1979, the Federal Reserve announced a change in the procedure it uses to implement monetary policy. Under the new procedure, monetary policy is focused primarily on the control of reserves at depository institutions. Since depository institutions must hold a designated proportion of their deposits in reserves, the growth of reserves of depository institutions is closely related to the growth of their deposits and therefore the money stock. Under the new reserve control procedure, day-to-day monetary policy operations are designed and implemented to achieve the growth path in bank reserves that is consistent with the desired rate of growth in money.

Previously, Federal Reserve procedures for implementing monetary policy were based primarily on controlling short-term interest rates, particularly the Federal funds rate. (The Federal funds rate is the interest rate a bank pays to borrow reserves from another bank). Under this procedure, the Federal Reserve determined a range for the Federal funds rate that was

estimated to be consistent with the desired rate of money growth; monetary policy operations were then designed and implemented to keep the Federal funds rate within that prescribed range.

This change in operating technique was instituted because it was believed that the Federal Reserve could control monetary growth more precisely with a reserve-control approach. However, interest rates can be expected to vary more and to vary over a wider range under the reserve-control procedure, since the Federal Reserve is no longer deliberately and continuously stabilizing a key interest rate. The Federal Reserve does not ignore market interest rates under the new operating method and can still use its powers to ameliorate fluctuations in interest rates if they move too far out of a desired broad range; but if the Federal Reserve is to maintain control of bank reserves it cannot also offset the various market forces that can cause fluctuations in market interest rates.

Monetary Policy in 1982

At the beginning of 1982, the United States was experiencing a recession, with rising unemployment. This was accompanied by continuing high levels of interest rates and strains in financial markets. At the same time, substantial progress was becoming evident in controlling inflation. It was against this background that the Federal Reserve announced to Congress in February 1982 its monetary and credit targets for the year.

The Federal Reserve's overall goal for monetary policy continues to be to seek a gradual decline in the rate of growth of money and credit to reduce inflation and inflationary expectations. The target range for M-1 has been set at 2.5% to 5.5%. This compares with a target range of 3 1/2% to 6% in 1981 for M-1B adjusted, the equivalent measure in use at that time. While the M-1 target has been decreased, the Federal Reserve would find acceptable actual growth in the upper half of the target range as contrasted with the below target range growth of M-1B adjusted in 1981. Thus, actual growth might be somewhat larger than experienced in 1981. The Federal Reserve has explained that the relatively slow growth of M-1B last year combined with the low base from which M-1 growth is starting this year would allow for growth in the range of 4% without compromising the desired reduction in money growth over time.

The target ranges for M2, M3, and bank credit are unchanged from 1981. While growth in M2 exceeded target range last year, the Federal Reserve would expect growth within the upper half of the target range this year unless further significant institutional changes in financial markets occur. Although for the first quarter of 1982 actual growth was well above target for M-1 and slightly above target for M-2, it was within the target range for M-3.

Target growth ranges for 1982 for the monetary aggregates and bank credit and actual growth rates for the first quarter of 1982 are shown below. Annual data showing the actual growth of the monetary aggregates and bank credit for the four years 1978-1981 is also provided.

Federal Reserve Target Growth Ranges for 1982 and Actual Money
and Credit Growth Rates for the first quarter of 1982
(Seasonally adjusted compound annual growth rates)

	<u>Target Ranges</u>	<u>Actual Growth Rates</u>
	1981: IV	1981: IV
	to 1982: IV	to 1982: I
M-1*	2.5 to 5.5	10.7
M-2	6 to 9	10.0
M-3	6.5 to 9.5	8.9
Bank credit	6 to 9	N.A.

*Formerly M-1B

Source for actual growth rates:

Source for actual growth rates: Calculated from data series of the Board of Governors of the Federal Reserve System, accessed April 1982 from data files of Data Resources, Inc.

Actual Money and Credit Growth Rates, Annual Data, 1978-1981
(Fourth quarter to fourth quarter, percentages)

<u>Actual Growth Rates</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
M-1B*	8.3	7.5	6.6	2.3
M-2	8.3	8.4	9.1	9.4
M-3	11.3	9.8	9.9	11.4
Bank credit	13.3	12.6	8.0	8.8

*Growth rates for 1980 and 1981 adjusted to reflect estimated impacts of shifts into interest-bearing transaction accounts from other assets.

Source for actual growth rates: Board of Governors of the Federal Reserve System. Monetary policy objectives for 1982, summary report of the Federal Reserve Board. February 1982. p 7.

Plans for monetary policy for 1982 have been criticized on various grounds. Some monetarist critics are concerned about the variability in money growth, ranging from rapid expansion to negative growth for certain periods. They argue that the variability in money growth contributes to volatility in interest rates and consequent instability in economic activity. According to this line of reasoning, money growth is erratic because the Federal Reserve does not adhere closely to its reserve control procedures. Such critics believe the Federal Reserve could achieve its money growth targets if it chooses to do so; they also support certain technical changes in operating procedures that they feel would improve short run monetary control. Other critics feel that it is not the fluctuations in money growth but the slow trend in money growth which is at issue. Such critics argue that the monetary growth targets for 1982 are too restrictive to allow for satisfactory economic growth when recovery begins. Their view is that in a recovery situation, restrictive monetary policy will cause interest rates to rise as credit demands increase, thus discouraging further growth.

The Federal Reserve's February 1982 report to Congress includes

projections for economic performance in 1982 expressed by individual members of the Federal Open Market Committee (FOMC), the Federal Reserve body which determines monetary policy, taking into account current economic circumstances and the monetary targets set for 1982. At that time, FOMC members expected inflation to continue to moderate in 1982. They expected real economic activity to accelerate with most growth coming in the second half of the year. At the same time, they expected the recovery to be somewhat restrained due to continuing inflationary pressures, in which case unemployment would still be substantial at year-end.

Among the inflationary pressures of particular concern to the Federal Reserve is the prospect of large budget deficits when the economy is in recovery. Their concern is that while cyclical Treasury borrowing needs can be expected to be financed during a recessionary period without creating upward interest rate pressures due to slack in the demand for credit, heavy Treasury borrowing during a period of economic expansion could put upward pressure on interest rates both by adding to the demand for credit in the financial markets and by heightening inflation expectations. This would contribute to continued financial stress for interest-sensitive areas of the economy such as the housing and auto industries as well as for business investment, all of which have traditionally played vital roles in economic recovery and expansion. According to this view, inflation can be contained by controlling money growth; however, a sound base for lower interest rates and a sustained recovery depends on a mix of Government economic policies.

Financial markets are currently reflecting uncertainties concerning the future course of Government economic policies. Following the recession that began in July 1981, credit demand eased and from September through late November 1981 short-term interest rates dropped sharply, reflecting the fall-off in economic activity. The Federal Reserve discount rate was decreased to 13% effective Nov. 2, 1981 and was decreased another full percentage point to 12% effective Dec. 4, 1981. Since then, short-term run-ups in the money supply have been accompanied by increases in short-term interest rates, apparently reflecting concern that the Federal Reserve would act to restrain money growth. Long-term interest rates have fluctuated downward since October 1981. However, a pent-up demand for long-term credit by businesses which have postponed long-term financing for some time because of high and volatile interest rates, Government financing needs, and uncertainty about the long-term outlook for the economy are all acting to keep a floor under long-term interest rates. Under any conditions, it is likely that significant moderation of interest rates or easing of credit availability will be difficult to achieve in long-term markets due to distortions those markets have experienced in recent years.

Definitions of Money

Current definitions of the monetary aggregates, as determined by the Federal Reserve, are as follows:

M-1 is currency held by the public plus travelers checks, demand deposits at commercial banks, and other checkable deposits at all depository institutions, including NOW (negotiable order of withdrawal) accounts, accounts subject to automatic transfer service, and demand deposits at thrift institutions.

M-2 is M-1 plus savings and small-denomination time deposits (including retail repurchase agreements) at all depository institutions, shares in non-institutional money market mutual funds, overnight repurchase agreements at commercial banks, and overnight Eurodollars held by U.S. residents other than banks at Caribbean branches of member banks.

M-3 is M-2 plus large-denomination time deposits at all depository institutions and large denomination term repurchase agreements at commercial banks and savings and loan associations and shares in institutional money market mutual funds.

The Federal Reserve reports data on a weekly basis for M-1, and on a monthly basis for the other money measures, in its weekly statistical release H.6 (508).

HEARINGS

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