Monetary policy objectives for 1982

Pursuant to the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act), the Board of Governors is required to report to the Congress twice each year its annual targets for the growth of money and credit and how achievement of these targets relates to the administration's economic goals. The following article consists of a summary of the midyear report plus the testimony of Federal Reserve Board Chairman Paul A. Volcker before the Congress in July of this year.

Monetary policy in 1982 and 1983

There is a clear need today to promote higher levels of production and employment in our economy. The objective of Federal Reserve policy is to create an environment conducive to sustained recovery in business activity while maintaining the financial discipline needed to restore reasonable price stability.

The growth of money and credit in 1982

The annual targets for the monetary aggregates reported to Congress in February were chosen to be consistent with continued restraint on the growth of money and credit in order to exert sustained downward pressure on inflation. At the same time, these targets were expected to result in sufficient money growth to support an upturn in economic activity.

At its July meeting, the Federal Open Market Committee concluded that a change in the previously announced targets was not warranted at this time. Because of the tendency for the demand for money to run strong on average in the first half, and also responding to a congressional budget resolution, careful consideration was given to the question of whether some raising of the targets was in order. However, the available evidence did not suggest that a large increase in the ranges was justified; and a small change in the ranges would have represented a degree of "fine tuning" that appeared inconsistent with the degree of uncertainty currently surrounding the precise relationship of money to other economic variables. However, the Committee concluded, based on current evidence, that growth this year around the top of the ranges for the various aggregates would be acceptable.

The Committee also agreed that possible shifts in the demand for liquidity might require more than ordinary elements of flexibility and judgment in assessing appropriate needs for money in the months ahead. In the near term, measured growth of the aggregates may be affected by the income tax reductions that occurred on July 1, cost-of-living increases in social security benefits, and by the ongoing difficulties of accurately accounting for seasonal movements in the money stock. But more fundamentally, it is unclear to what degree businesses and households will continue to wish to hold unusually large precautionary liquid balances. To the extent the evidence suggests that relatively strong precautionary demands for money persist, growth of the aggregates somewhat above their targeted ranges would be tolerated for a time and still would be consistent with the FOMC's general policy thrust.

Ranges of monetary growth 1982[1]

	1982 planned QIV'81-QIV'82	1982 actual QIV'81-QII'82	1982 actual QIV'81-June '82	1981 QIV levels*
M1	2½ to 5½ percent	6.8 percent	5.6 percent	436.7
M2	6 to 9 percent	9.7 percent	9.4 percent	1807.4
M3	6½ to 9½ percent	9.8 percent	9.7 percent	2171.3
Commercial bank credit[2]	6 to 9 percent	8.3 percent	8.0 percent	1323.1

*Billions of dollars, seasonally adjusted.

[1]M1 is the sum of currency held by the public, plus travelers' checks, plus demand deposits, plus other checkable deposits (i.e., negotiable order of withdrawal (NOW) accounts, automatic transfer service (ATS) accounts, and credit union share draft accounts.)

M2 is M1 plus savings and small denomination time deposits, plus shares in money market mutual funds (other than those restricted to institutional investors), plus overnight repurchase agreements and Eurodollars.

M3 is M2 plus large time deposits at all depository institutions, large denomination term repurchase agreements, and shares in money market mutual funds restricted to institutional investors.

Bank credit is total loans and investments of commercial banks.

[2]Because of the introduction of International Banking Facilities (IBFs), the bank credit data beginning in December 1981 are not comparable to earlier data. Thus, the target for 1982 was stated in terms of growth from the average level of December 1981 and January 1982 (shown in the last column) to the average level in the fourth quarter of 1982, so that the initial shift of assets to IBFs that occurred at the end of the year would not have a major impact on the pattern of growth. Actual growth rates for bank credit are calculated from the December-January base.

The policy of firm restraint on monetary growth has contributed importantly to the recent progress toward reducing inflation. But when inflationary cost trends remain entrenched, the process of slowing monetary growth can entail economic and financial stresses. These strains—reflected in reduced profits, liquidity problems, and balance sheet pressures—place particular hardships on industries that depend heavily on credit markets such as construction, business equipment, and consumer durables.

Unfortunately, these stresses cannot be easily remedied through faster money growth. The immediate effect might be lower interest rates, especially in short-term markets. In time, however, such an attempt would founder, embedding inflation and expectations of inflation even more deeply into the nation's economic system. The present and prospective pressures on financial markets urgently need to be eased not by relaxing discipline on money growth, but by the adoption of policies that will ensure a lower and declining federal deficit. Moreover, a return to financial health will require the adoption of more prudent credit practices on the part of private borrowers and lenders alike.

Tentative ranges for 1983

Looking ahead to 1983 and beyond, the FOMC remains committed to restraining money growth in order to achieve sustained noninflationary economic expansion. At its July meeting, the FOMC felt that the ranges now in effect could remain as preliminary targets for 1983. Because the monetary aggregates in 1982 will likely be close to the upper ends of their ranges, or perhaps even somewhat above them, the preliminary 1983 targets are fully consistent with a reduction in the actual growth of money in 1983.

Tentative ranges of monetary growth 1983
(Based on QIV'82 to QIV'83)

M1	2½ to 5½ percent
M2	6 to 9 percent
M3	6½ to 9½ percent
Commercial bank credit	6 to 9 percent

In light of the unusual uncertainty surrounding the economic, financial, and budgetary outlook, the FOMC stressed the tentative nature of its 1983 targets. On the one hand, experience strongly suggests that, with economic activity on an upward trend, precautionary motives for holding liquid balances should begin to fade, contributing to a rapid rise in the velocity of money. Moreover, regulatory actions by the Depository Institutions Deregulation Committee that increase the competitive appeal of deposit instruments—as well as the more widespread use of innovative cash management techniques, such as "sweep" accounts—also could reduce the demand for money relative to income and interest rates. On the other hand, the long upward trend in the velocity of money since the 1950s took place in an environment of rising inflation and higher nominal interest rates that provided incentives for economizing on money holdings; as these incentives recede, the attractiveness of cash holdings may be enhanced and more money may be held relative to the level of business activity.

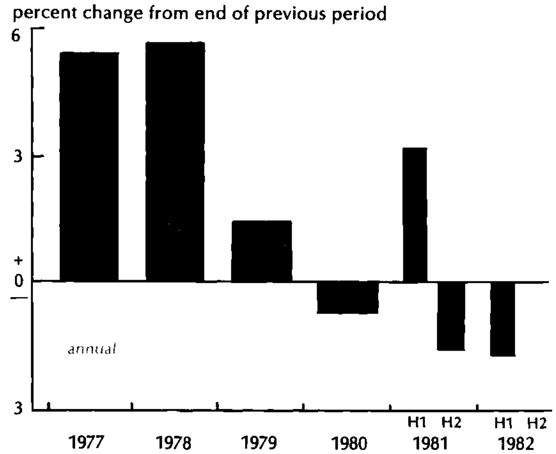
The outlook for the economy

The economy at midyear appears to have leveled off following sizable declines last fall and winter. Consumption has strengthened, with retail sales up significantly in the second quarter. New and existing home sales have continued to fluctuate at depressed levels, but housing starts nonetheless have edged upward. In the business sector, substantial progress has been made in working off excess inventories, and the rate of liquidation appears to have declined. On the negative side, however, plant and equipment spending, which typically lags an upturn in overall activity, is still depressed. The trend in export demand also continues to be a drag on the economy reflecting the dollar's strength and weak economic activity abroad.

An evaluation of the balance of economic forces indicates that an upturn in economic activity is highly likely in the second half of 1982. Monetary growth along the lines targeted by the FOMC should accommodate this expansion in real GNP, given the increases in velocity that typically occur early in a cyclical recovery, and absent an appreciable resurgence of inflation. The 10 percent cut in income tax rates that went into effect July 1 is boosting disposable personal income and

Real GNP

percent change from end of previous period



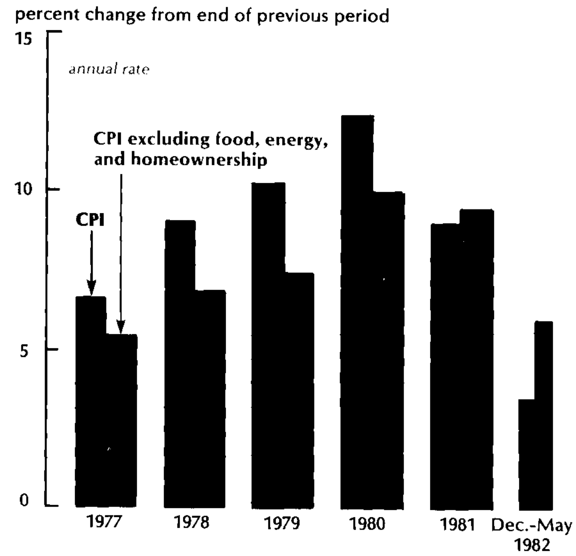
should reinforce the growth in consumer spending. Given the improved inventory situation, any sizable increase in consumer spending should, in turn, be reflected in new orders and a pickup in production. The continuing rise in defense spending and the associated private investment outlays needed for the production of defense equipment will be another element supporting real GNP growth. During its initial phase, the expansion is likely to be more heavily concentrated in consumer spending than in past business cycles; current pressures in financial markets and liquidity strains may inhibit the recovery in residential and business investment.

The excellent price performance so far this year has been helped by slack demand and exceptionally favorable energy and food supply developments. For that reason, the recorded rate of inflation may be higher in the second half of the year. However, prospects appear excellent for continuing the downtrend in the underlying rate of inflation. There has been significant progress in slowing the rise in labor compensation, and improvement in underlying cost pressures should continue over the balance of the year. Unit labor costs also are likely to be held down by a cyclical rebound in productivity growth as output recovers. Moreover, lower inflation will contribute to smaller cost-of-living wage adjustments, which will moderate cost pressures further.

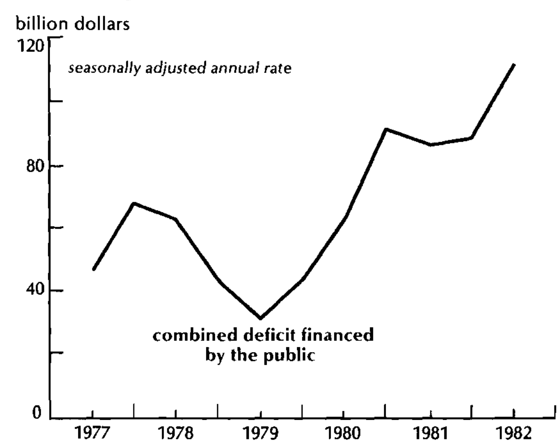
A critical factor influencing the composition and strength of the expansion in economic activity over the next year and a half will be the extent to which pressures in financial markets moderate. This, in turn, depends importantly on the progress made in further reducing inflationary pressures. A decrease in inflation would take pressure off financial markets in two ways. First, slower inflation will lead to a reduced growth in transactions demands for money, given any particular level of real activity. Second, further progress in curbing inflation will help lower long-term interest rates by reducing the inflation premium contained in nominal interest rates.

Another crucial influence on financial markets and thus on the nature of the expansion in 1983 will be the federal budgetary decisions that are made in coming months. The budget resolution that was recently passed by the House and Senate is a constructive first step in reducing budget deficits as the economy recovers, but appropriation and revenue legislation is needed to implement this resolution. How the budget process un-

Consumer prices



Federal government borrowing



FOMC members' economic projections

		Actual* 1981	Projected 1982	1983
Changes, fourth quarter to fourth quarter, percent	Nominal GNP	9.6	5½ to 7½	7 to 9½
	Real GNP	0.7	½ to 1½	2½ to 4
	GNP Deflator	8.9	4¾ to 6	4 to 5¾
Average level in the fourth quarter, percent	Unemployment rate	8.3	9 to 9¾	8½ to 9½

*Based on revised GNP data that were published after the full Humphrey-Hawkins report was submitted.

folds will determine future credit demands by the federal government and thus the extent to which deficits will preempt the net savings generated by the private economy. A strong program of budget restraint would minimize pressures in financial markets and thereby enhance the prospects for a more vigorous recovery in homebuilding, business fixed investment, and other credit-dependent sectors.

In assessing the economic outlook, the individual members of the FOMC have made projections for economic performance that generally fall within the ranges in the table above. In addition to the monetary targets discussed above, these projections assume that the federal budget will be put on a course that over time will result in significant reductions in the federal deficit.

Looking ahead, the Committee members, like the administration and the Congress, foresee continued economic expansion in 1983, but currently anticipate a less rapid rate of price increase and somewhat slower real growth than the assumptions underlying the budget. The monetary targets tentatively set for 1983—which will be reviewed early next year—would imply, under the budgetary assumptions, relatively rapid growth in velocity.