FRBSF WEEKLY LETTER

May 29, 1987

Brave New World I

We are quite supportive of the (Fed's) general strategy and the way they are going about getting money under control.
—*Treasury Undersecretary Beryl Sprinkel, July 1981*

A previous *Letter* ("Transition," April 17, 1987) noted that the "Economic Recovery Program" of the incoming Reagan Administration in 1981 included four principal elements designed to spur economic growth while at the same time wind down inflation. These elements included a cut in tax rates and other tax deductions, a reduced rate of growth in federal spending, a reduced "burden" of regulation, and, in the area of monetary policy, a reduced rate of growth of the money supply. Budget Director David Stockman and Congressman Jack Kemp (R-NY) described the latter as the "critical linchpin" of the incoming Reagan administration's economic program, essential not only to restoration of the Fed's "tattered credibility" but also to the avoidance of an "economic Dunkirk for the GOP."

This *Letter* reviews the political and economic environment surrounding the conduct of monetary policy during the early 1980s, particularly the difficulties created by large federal deficits and a reversal in Administration support.

Let's pretend
In July 1981, the Vice Chairman of the Congressional Joint Economic Committee (JEC), commenting on the Administration's proposed tax cuts, asserted that total tax revenues bolstered by vigorous real (after inflation) growth in the economy (estimated to average about 4.5 percent a year) would rise by about $250 billion notwithstanding a prospective loss of about $500 billion in revenues from tax cuts over the next four years. This growth, he claimed, would surpass a $190 billion rise in expenditures and result in a budget surplus of $7 billion in FY 1985. In the absence of the program, a budget surplus of $122 billion was projected for FY 1985, but the higher surplus figure was unacceptable to the Administration because it would have been accompanied by an increase in the government's share of GNP.

As it turned out, FY 1985 ended with a $212 billion deficit in spite of some $125 billion in new funds from various "revenue enhancements" enacted in 1982-84 to help stem the fiscal fissure. Over the four years, the flow of red ink swelled to $736 billion, doubling the outstanding federal debt in the process.

Restoring "tattered credibility"
In the face of continuing strong inflation and expectations of future inflation, stemming in part from already soaring budget deficits and widespread fears that efforts to control the money supply (and inflation) would be abandoned, the Fed reduced its targets for growth of the monetary aggregates in 1981. Both bank reserves and M1 grew at a significantly slower rate (the latter by 2.5 percent adjusted for shifts from non-M1 sources into NOW accounts, which were authorized nationwide in 1980, and 5 percent, including NOWs), but M2 and M3 exceeded their 1980 growth rates.

Interest rates reached new record highs, including a 20½ percent "prime" and a T-bill rate of just over 16 percent. Inflation, which started the year at an 11 percent annual rate, dropped to a 7 percent rate late in the year when real GNP went into a decline that extended through most of 1982 — the sharpest decline (3.5 percent) of the post-World War II years.

The sharp drop in the rate of inflation indicated to some observers that the Fed's anti-inflation credibility was being restored, but not everyone was pleased with the overall results. Assessments of the economy's — and the Fed's — performance varied widely within and among the House and Senate Banking Committees, the Congressional Joint Economic Committee (JEC), and the Administration, and led to several unsuccessful attempts at "institutional reforms" to subject Federal Reserve policies to closer Congressional supervision.

1982: Intensifying debate
With the economy showing continued weakness in 1982, including rising unemployment (which reached 10.6 percent of the labor force) and

high real interest rates resulting in part from a continuing sharp decline in the rate of inflation (to under four percent by year-end), the debate begun in 1981 over monetary and fiscal policies intensified.

In his testimony to the House and Senate Banking Committees early in the year and again at mid-year, Chairman Volcker explained that the Fed's basic objective was to foster an economic environment conducive to sustained recovery and "reasonable price stability." He also noted that the desire of the public to hold assets in relatively liquid form was contributing to a stronger-than-expected demand for money and to a significant decline in its "velocity" or rate of utilization in spending on production and consumption related activities (a view strongly disputed by the President's Council of Economic Advisors in their February Economic Report to the Congress).

Most importantly, Volcker added that attempts to lower interest rates by excessive money growth would only re-activate inflationary expectations. Noting that the Congress' mid-year Budget Resolution called for the Federal Reserve to "re-evaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy" (i.e., that monetary policy be more accommodative), he expressed the view that "the risks seem . . . all on the side of a still greater deficit (for FY 1983) than the Congress and Administration had estimated." It was a grimly accurate assessment. Fiscal year 1982 shortly was to close with a $120 billion budget deficit — three times that projected in 1981 by the Administration and by the Congress in its Budget Resolutions, and FY 1983 was to close with a deficit of $208 billion — double the projection.

Back to Dunkirk?
For his part, Treasury Secretary Regan in the spring of 1982 contended that a "restrictive" monetary policy was overwhelming the stimulative efforts of the 1981 Kemp-Roth tax cuts, and Arthur Laffer, a leading "supply-side" advocate, stated that "monetarism hasn't worked out and I don't think it ever will." But Beryl Sprinkel, Undersecretary of the Treasury for Monetary Affairs and a leading monetarist, argued in testimony before the JEC that the money supply was still growing at an "extremely rapid rate" by historical standards, and that if the Fed were to raise its "targets" for the monetary aggregates, it would "lose the credibility it has established over the last year and a half." His assessment was shared by the majority members of the Senate Banking Committee, who also endorsed Sprinkel's view that in the interest of reducing excessive volatility in the money supply, the Fed should focus on control of bank reserves or the monetary base rather than on the broader monetary aggregates (which are determined in part by demand).

In a dissenting view, most of the minority (Democratic) members of the Senate Committee characterized Fed policy as "excessively tight" and called for greater attention to the level of interest rates. However, Senator Proxmire (D-WI) again argued that interest rates were being kept high by fears that the Fed would cave in under pressure to monetize soaring deficits, and added that the Fed offered the "only anti-inflation game in town." In June, the Treasury announced that it had undertaken a study of possible changes to curb the Fed's "independence."

In its August *Monetary Policy Report,* the House Banking Committee asserted that "very high short-term rates, especially in real terms, are a clear sign that monetary policy remains tight by any standard." It questioned the reliability of the monetary aggregates as appropriate policy targets, but also asserted that the Fed's willingness to *exceed* its targets in order to attain an "appropriate" monetary growth "undermined" its credibility. Most of the minority (Republican) members strongly disagreed, noting that key interest rates had fallen by a third over the year, along with a very sharp decline in the rate of inflation. They added that "redundant Sense of the Congress Resolutions (and) conflicting recommendations of the two Banking Committees will only make the Federal Reserve's task more difficult, and sow confusion in the financial markets."

On balance, each of the monetary aggregates increased in excess of their targets in 1982 (M1 substantially so, due in part to the introduction of no-interest-ceiling "Super Nows"; and M2 and M3 slightly so due in part to the introduc-

tion of Money Market Deposit Accounts that also had no interest ceiling). Nevertheless, a number of Congressmen and Senators, variously critical of the Fed for having worked "hand in glove" with the Administration and for being at "cross purposes" with the Administration, submitted several different proposals designed to achieve a better "coordination" of monetary and fiscal policies.

In addition to earlier unsuccessful proposals to impeach the Federal Reserve's Board of Governors and the Federal Open Market Committee (FOMC) — the Fed's monetary policy setting committee, and to repeal the Federal Reserve Act, several measures proposed to restructure the Fed by shortening the terms of Governors, subjecting the System to the appropriations process, making the Fed part of the Treasury, and/or by placing the Treasury Secretary back on the Board of Governors (a position which he held, along with the Comptroller, until removed by the Congress in 1936).

Other proposals, strongly opposed by Senators Garn (R-UT) and Proxmire, would have mandated the Fed to raise its monetary targets to specified levels, and, in spite of what many observers believed was a hard "lesson" of the 1970s, to target interest rates rather than the monetary aggregates.

For example, the "Balanced Monetary Policy Act of 1982" (co-sponsored by 30 Senators) mandated the Fed to set yearly targets for positive *real* short-term interest rates consistent with "historical levels" (which levels and which short-term rates were not specified). A similar bill sponsored by 60 House Democrats would have required the Fed to establish targets for long-term interest rates as well as for the monetary and credit aggregates, and required the President to express his position on every vote of the FOMC. A similarly named "Balanced Monetary Policy and Price Stability Act" submitted by Congressman Kemp directed the Fed, in a complete reversal of Kemp's 1980 position, to *abandon* its concentration on the money supply and to target lower interest rates with the objective of moving towards "price stability." In 1982, Kemp also called for Chairman Volcker's resignation.

None of the bills moved.

In October 1982, Chairman Volcker announced that the rapid expansion of interest-bearing accounts was significantly distorting the traditional relationship of M1 with interest rates, income, and spending, and that, partly because of the effects of the new accounts on "velocity" (GNP/M1, which had reversed its secular climb and dropped by almost 5 percent in 1982), less focus henceforth would be placed on M1 and more on the broader "aggregates" (M2, etc.). At the same time, monetary control procedures would be shifted from a focus on nonborrowed reserves to one on borrowed reserves in an effort to reduce the "unsettling" impact on interest rates of changes in money demand believed to be related more to portfolio adjustments than to underlying changes in GNP. Some observers interpreted the move as a reversion to *de facto* interest rate targeting at the potential cost of reduced control over the money supply.

In December, a "Sense of the Congress" resolution passed that called on the Fed to stimulate an economic recovery. At the insistence of Senators Garn and Proxmire, it also postulated "due regard for controlling inflation so as not to . . . drive interest rates upward." In fact, in the fall of 1982, the economy had begun a recovery that would prove to be the longest peacetime expansion on record. As events also were to prove, monetary and fiscal policies would be the subjects of continuing and — with some shift in various Congressional and Administration perspectives — frequently heated debate. A future *Letter* will discuss developments affecting the economy and the course of the Great Debate since 1982.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/6/87	Change from 4/29/87	Change from 5/7/86 Dollar	Change from 5/7/86 Percent[7]
Loans, Leases and Investments[1] [2]	204,826	115	973	0.4
Loans and Leases[1] [6]	182,236	– 503	– 2,680	– 1.4
Commercial and Industrial	53,565	– 253	– 102	– 0.1
Real estate	67,770	48	1,390	2.0
Loans to Individuals	37,200	18	– 3,517	– 8.6
Leases	5,413	0	– 232	– 4.1
U.S. Treasury and Agency Securities[2]	15,282	565	4,210	38.0
Other Securities[2]	7,309	54	– 556	– 7.0
Total Deposits	206,174	– 1,110	3,082	1.5
Demand Deposits	53,537	– 244	3,494	6.9
Demand Deposits Adjusted[3]	49,119	– 512	14,442	41.6
Other Transaction Balances[4]	19,561	– 17	3,651	22.9
Total Non-Transaction Balances[6]	133,076	– 848	– 4,063	– 2.9
Money Market Deposit Accounts—Total	44,650	– 462	– 1,203	– 2.6
Time Deposits in Amounts of $100,000 or more	31,391	– 576	– 5,637	– 15.2
Other Liabilities for Borrowed Money[5]	23,245	1,226	– 4,309	– 15.6

Two Week Averages of Daily Figures	Period ended 5/4/87	Period ended 4/20/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	19	89
Borrowings	104	72
Net free reserves (+)/Net borrowed(–)	– 84	17

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change