

The U.S. Economy And Monetary Policy in 1982

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There was an unusually large number of significant economic and financial developments in 1982. The most important developments were the continued weakness of business activity in the United States, further disinflation of prices and wages, the strong performance of the U.S. dollar, the emergence of strains in the domestic financial system, and substantial declines in interest rates. This article examines these developments, discusses the performance of monetary policy in 1982, and comments on the outlook for the economy and monetary policy in 1983.

THE PERFORMANCE OF THE U.S. ECONOMY

The underlying weakness in U.S. economic activity, present since early 1979, continued throughout 1982. At yearend, the recession that began in August 1981 was maintaining its grip on the economy. Real gross national product (GNP) declined during the first three quarters of the year at an annual rate of about 1 percent, compared with a small gain in 1981 and a small decline in 1980.

The pattern of business activity during the year was somewhat uneven. Real GNP dropped

at an annual rate greater than 5 percent in both the fourth quarter of 1981 and the first quarter of 1982. These sharp declines were followed by a small increase in the second quarter of 1982 (Chart 1). The apparent turnaround in real GNP did not mean, however, that the recession ended in the spring of the year. Indeed, final sales—purchases by consumers, homeowners, businesses, and governments of final goods and services—declined in the second quarter, so the rise in output was due to changes in business inventory investment.

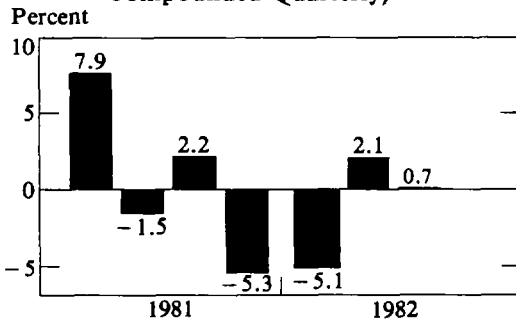
The performance of the economy in the third quarter of the year confirmed that the economy was still in recession. Real GNP was up slightly from the second quarter, but final sales dropped further. Even with the personal income tax cut of July 1, real personal consumption expenditures rose slower in the third quarter than in the first half of 1982. Moreover, adjusted for inflation, purchases of consumer durables declined in the third quarter, business fixed investment continued to fall sharply, as it did throughout 1982, net exports dropped sharply, and state and local government purchases continued their mild downward movement of the past couple of years. Federal government purchases rose sizably in the third quarter and residential construction spending showed a small decline.

As of December 1982, most monthly data on production, sales, income, and employment

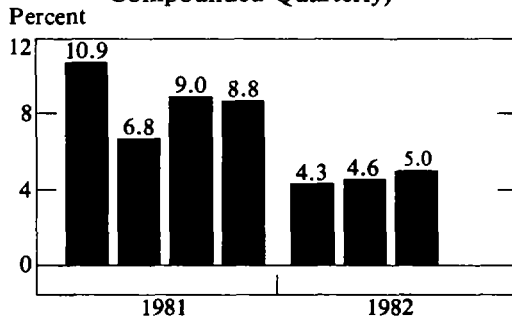
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suggest that the economy continued in recession in the fourth quarter of the year. The composite index of coincident indicators, which summarizes the performance of these four measures, fell in October 1982 for the fifteenth month since it reached its July 1981 peak. Industrial production declined in November for the fourteenth of the last 16 months and brought the index of capacity use in manufacturing to its lowest level since the series was begun in 1948. The overall unemployment rate set another new post-World War II record in November at 10.8 percent of the civilian labor force, which emphasized that the economy has a great deal of slack in the form of unused resources.

Chart 1
CHANGE IN REAL GNP
 (Seasonally Adjusted Annual Rates
 Compounded Quarterly)



CHANGE IN GNP DEFLATOR
 (Seasonally Adjusted Annual Rates
 Compounded Quarterly)



Most of the good news about the performance of the U.S. economy in 1982 lies in the substantial disinflation in prices and wages. This development is closely related to the continued weakness of the economy and to the slack in resource use.

Disinflation shows up clearly in all the major price indexes. The GNP deflator rose at an annual rate of about 4.6 percent through the first three quarters of 1982, after rising more than 9 percent in 1981 (Chart 1). Monthly measures of price change show a similar pattern. The increase in the index of wholesale prices of finished goods (PPI) rose only 3.7 percent from November 1981 to November 1982, compared with a rise of 7.2 percent in the preceding 12 months. The consumer price index (CPI) increased 4.6 percent from November 1981 to November 1982, about half the 9.6 percent increase in the previous year. Producer prices and consumer prices benefited in 1982 from only modest increases in food and energy prices.

The slowdown in price inflation has been reflected in a slowdown in the growth of labor compensation, which, in turn, supports the slowing in inflation. For example, the index of average hourly earnings of production workers in the private nonfarm economy rose at a 5.9 percent annual rate in the first nine months of 1982, after an increase of 8.2 percent in 1981.

THE PERFORMANCE OF THE U.S. DOLLAR

Against the background of a weakening world economy and growing international tensions, the U.S. dollar remained very strong throughout 1982. Except for a few transitory declines, the weighted average of the exchange value of the dollar increased throughout 1982, reaching its highest level in 13 years toward yearend (Chart 2).

Relatively high U.S. interest rates and expectations of continuing high rates contributed to

the strength of the dollar in the first quarter of 1982. Expectations of continuing high U.S. interest rates reflected concerns about the growing U.S. federal budget deficit and the possible reaction of the Federal Reserve to the sharp increase in M1 that occurred in early January. The value of the dollar declined briefly in mid-April as these concerns abated somewhat, but then regained strength after mid-May due to rising U.S. interest rates and the Iran-Iraq and Israel-Lebanon conflicts.

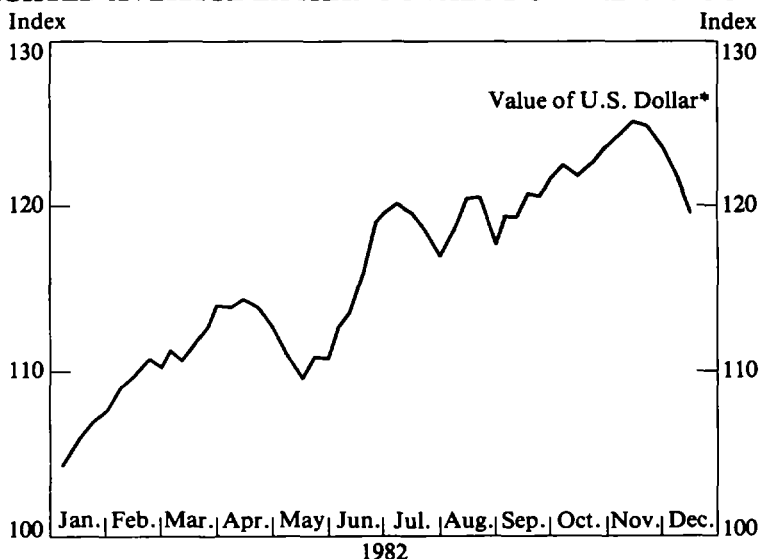
The value of the U.S. dollar increased steadily between late August and mid-November, despite declines in U.S. interest rates. Even with a decline near yearend, the dollar remained stronger at the end of 1982 than at the beginning of the year. The drop in U.S. interest rates was accompanied by a commensurate decline in foreign interest rates and progress against inflation in the United States. Thus, relatively high real U.S. interest rates (rates adjusted for infla-

tion) may have contributed to the strong demand for the dollar. Adding to the strength of the dollar was the further weakening of major European economies, highlighted by the failure of a large industrial company in Germany and a large bank in Italy. Economic crisis in Mexico, the collapse of the Mexican peso, and continued fighting in the Middle East strengthened investors' preference for the dollar as a safe-haven currency.

STRAINS IN THE DOMESTIC FINANCIAL SYSTEM

While the international scene was plagued with economic crises, the United States also had economic and financial difficulties. As noted by Federal Reserve Chairman Paul A. Volcker in his midyear report to Congress, ". . . when inflation cost trends remain entrenched, the process of slowing monetary growth can entail economic and financial stresses. These strains

Chart 2
WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



*Index of weighted-average exchange value of U.S. dollar against currencies of major trading partners. March 1973 = 100. Weights are 1972-76 global trade of each of the 10 countries.

Table 1
SELECTED INTEREST RATES
(Averages for Periods Indicated)

Period	Bank Prime Loan	3-Month Treasury Bills	Federal Funds	U.S. Govt. 20-Year Bonds	Recently Offered Aaa Utility Bonds
1979	12.7	10.1	11.2	9.3	10.0
1980	15.3	11.4	13.4	11.4	12.7
1981: H1	19.1	14.6	17.2	13.1	14.8
H2	18.7	13.4	15.6	14.3	16.3
1982: H1	16.4	12.6	14.4	14.0	15.6
Q3	14.7	9.3	11.0	12.9	14.6
Oct.	12.5	7.7	9.7	11.0	12.3
Nov.	11.9	8.1	9.2	10.6	11.9

[are] reflected in reduced profits, liquidity problems, and balance sheet pressures”¹

Strains in the domestic financial system were especially evident during 1982. The U.S. government securities market was somewhat unsettled in May and June by the problems of two small securities dealers. Drysdale Government Securities failed to pay accrued interest payments to the original owners of securities it had borrowed. However, acting as an intermediary in the transactions, Chase Manhattan Bank eventually repaid the original owners on behalf of Drysdale. In late May, Marine Midland Bank temporarily discontinued securities clearing operations for Comark, a small government securities dealer, until it felt sure there was no immediate potential for a substantial loss.

While these events disturbed the securities market, there was no major panic, as many had feared. The spread between U.S. Treasury bill yields and private yields widened, as nervous market participants sought higher quality.

¹ “Midyear Report to Congress on Monetary Policy Objectives for 1982,” testimony by Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve System, July 20, 1982.

Also, smaller dealers had some difficulty obtaining financing and were charged a greater risk premium than were larger dealers. Nevertheless, major government securities dealers had no difficulty obtaining financing and no problems were posed for Treasury auctions or Federal Reserve open market operations.

The financial system was under further stress after midyear. The failure of Oklahoma City’s Penn Square National Bank in July increased concerns, and the subsequent failures of Abilene National Bank and Lombard-Wall, a government securities firm, added to the uneasiness. Consequently, the spread between Treasury bill yields and private yields widened even further in September. The economic troubles of Mexico and concomitant collapse of the peso heightened concern in domestic financial markets as a result of the exposure of domestic banks to possible losses on foreign loans. Meanwhile, domestic business failures contributed to concerns about the exposure of banks to potential losses on domestic loans. While the economic and financial strains of 1982 resulted in failures for some private firms, banks, and individual market participants, there were no major disruptions of the financial system as a whole.

INTEREST RATES IN 1982

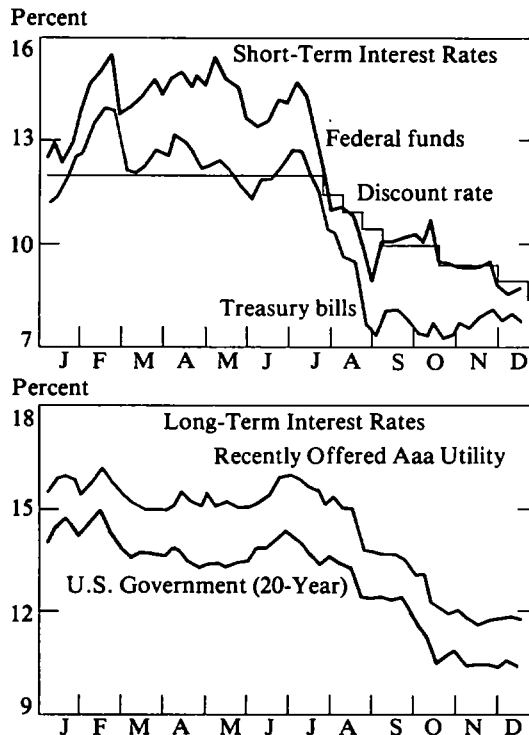
One of the year's most important developments was the significant declines in interest rates after midyear. There was some decline in interest rates in the first half of the year (Table 1). Long-term rates were slightly lower than in the last half of 1981, while short-term rates showed a greater decline. These average declines on a half-year basis show up despite a small runup in all rates early in the year (Chart 3).

Interest rates dropped sharply in July and August and averaged substantially lower in the third quarter than in the first half of the year. Again, the fall was greater in the short-term rates than in long-term rates. The decline in short-term market rates, such as 3-month

Treasury bills and federal funds, was more than three percentage points, while long-term rates, such as 20-year governments and Aaa utilities, dropped about one percentage point. Further declines from third-quarter levels occurred in October and November for most short- and long-term interest rates.

Nominal interest rates, such as those shown in Table 1, include an inflation premium that reflects the expected rate of inflation. A "real" interest rate that adjusts for the inflation premium in the nominal rate can be calculated by subtracting an estimated expected rate of inflation from the nominal interest rate. Even adjusted for inflation, as measured by the GNP deflator, interest rates were very high in 1981. The real prime rate, for example, averaged over 10 percent for the year, nearly twice the average

Chart 3
SELECTED INTEREST RATES IN 1982



1982

Table 2
NOMINAL AND REAL PRIME RATE
 (Averages for Periods Indicated)

Date	Nominal	Real
1979	12.7	4.7
1980	15.3	5.5
1981: H1	19.1	10.5
H2	18.7	10.1
1982: H1	16.4	12.0
Q3	14.7	10.1
Q4	12.0	7.0

Note: The real prime rate is defined in this table as the nominal prime rate minus the rate of inflation as measured by the change in the GNP implicit price deflator. The table assumes that the change in the GNP deflator for the fourth quarter of 1982 will be 5.0 percent, the same as for the third quarter.

real prime rate in 1980 (Table 2). The real prime rate increased in the first half of 1982 as inflation declined more than nominal interest rates. But the sharp declines in interest rates in the third quarter, along with a slight increase in the inflation rate, brought a substantial reduction in the average real prime rate for the third quarter of 1982. With the nominal prime rate estimated to average around 12 percent in the fourth quarter of inflation rate expected to be about the same as the 5 percent reported for the third quarter, the real prime rate declined further in the fourth quarter to an estimated 7 percent.

Several factors combined to lower nominal interest rates in 1982 and sharply lower rates after midyear. Real economic activity continued very weak, putting downward pressure on interest rates. Substantial disinflation of prices lessened the demand for money and reduced inflationary expectations, which reduced the inflation premium in interest rates.

The effect of federal budget deficits on interest rates is less clear. The unified budget deficit was about \$110 billion for fiscal 1982,

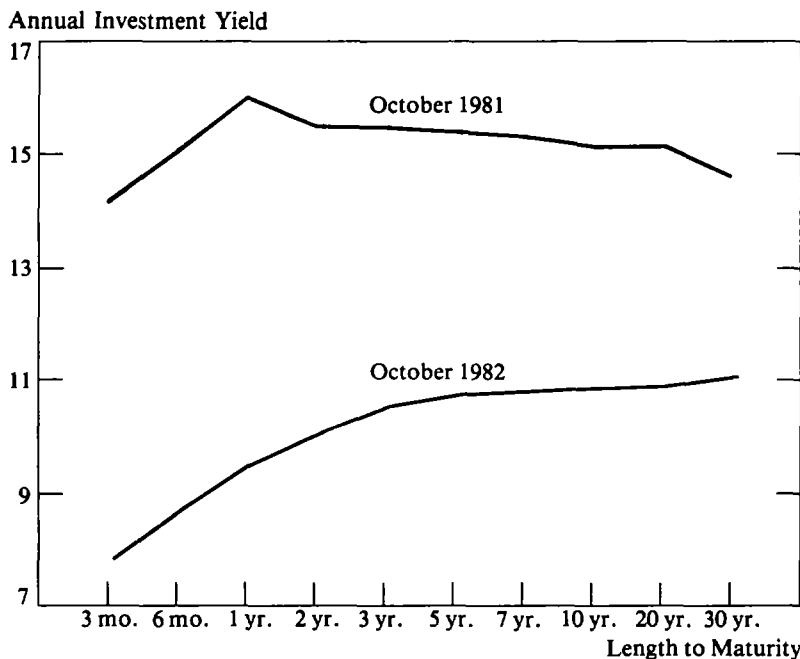
and projections show it substantially higher for fiscal year 1983. By leading to large credit demands by the Treasury, such deficits tend to put upward pressure on interest rates. However, because of the tax increase in 1982 and a perceived commitment to slowing in federal spending, the public and financial markets may have a perception of progress on the deficit problem. Such a view may have mitigated the upward pressure on interest rates. Yet, more progress in reducing the deficit would almost certainly have meant even lower interest rates in 1982, and the expectation of larger deficits in the future remains a factor in keeping rates high.

Aside from the decline in the general level of interest rates, there were two other noteworthy interest-rate developments in 1982. One was a significant change in the shape of the interest rate yield curve. Another was a marked widening in the spread between interest rates on private and public debt instruments as market uncertainty increased.

The interest rate yield curve is used to compare market rates of interest at various lengths of maturity. The curve is a smooth line drawn through several values observed at a particular time. Chart 4 shows two yield curves, one for October 1981 and one for October 1982. In October 1981, Treasury interest rates rose with increasing maturities up to one year and then declined as maturities lengthened beyond a year. The upward-sloping portion of the curve suggests that investors had a strong desire for liquidity, while the downward-sloping portion reflects market expectations for declining interest rates over the longer horizon.

The yield curve for October 1982 is not only considerably lower, reflecting the overall lower level of interest rates, but also has a significantly different shape. This type of yield curve is referred to as an upward-sloping yield curve because the interest rate increases with the

Chart 4
YIELD CURVES FOR TREASURY SECURITIES



length to maturity. An upward-sloping yield curve, which has historically been considered typical, can reflect one or both of two factors—increased premiums paid to induce investors to hold securities longer (in other words, a demand on the part of investors for liquidity) and market expectations of future increases in interest rates.² The emergence in 1982 of a positively sloped yield curve is viewed by many as a welcome return to more normal interest rate relationships.

With regard to the second development, the spread between interest rates on private and public debt instruments is often seen as in-

² This is because an investor expecting short-term interest rates to increase would not purchase a long-term security unless its rate exceeded the current short-term rate. He would have to earn (at least) the average of the expected short-term rates in order to invest in a long-term security.

dicating the riskiness of private instruments. While U.S. government securities are generally considered risk free, debt instruments of private companies are not risk free because private corporations can default. As a result of this risk, investors must be paid a premium over the risk-free interest rate to hold private debt. As the perceived risk of the private debt rises, so does this premium.

The emergence of strains in the domestic financial system in 1982 was reflected in an increase in the spread between the 3-month commercial paper rate and the 3-month Treasury bill rate. In response to the incidents in May and June involving government securities dealers, the spread had risen by July to 1.6 percentage points, compared with only 0.8 percentage points in January. The spread declined slightly in August, as market concerns seemed to abate briefly. Then, in late August

and September, market tension mounted as international problems prompted fears of sizable losses by U.S. banks on foreign loans and continued weakness in domestic business heightened concerns. As a result, the spread soared to 2.4 percentage points in September. The spread then declined to 1.5 percentage points in October, reflecting a marked decline in market concerns. Further declines in this spread may be expected as economic and financial conditions improve and investors perceive the resulting reduction in riskiness in the private sector.

MONETARY TARGETS AND MONETARY GROWTH IN 1982

As required by the Full Employment and Balanced Growth Act of 1978, the Federal Reserve reported to the Congress in early 1982 on its targets for growth in money and credit. That report showed that, at the February 1982 meeting, the Federal Open Market Committee (FOMC) reaffirmed the target ranges tentatively set in July 1981. The 1982 growth rate range was set at 2.5 to 5.5 percent for M1—the narrowly defined money supply consisting of currency held by the public, travelers' checks, and transactions deposits at banks and other depository institutions. Transactions deposits include demand deposits and other checkable deposits (OCD's), such as NOW accounts. Target growth rate ranges for M2 and M3—more broadly defined aggregates including M1 and such other assets as savings deposits, time deposits, and shares in money market mutual funds (MMMMF's)—were set at 6 to 9 percent for M2 and 6.5 to 9.5 percent for M3. Bank credit growth was targeted at 6 to 9 percent. In July 1982, the FOMC reaffirmed these 1982 targets for monetary and credit growth.

Through November, all the 1982 growth rates for these monetary aggregates were running above the upper end of the target ranges

(Table 3). Growth of M1 at 8.7 percent was well above the upper end of its range of 2.5 to 5.5 percent. Growth in M2 of 9.9 percent and growth in M3 of 10.5 percent slightly exceeded the upper limits of their ranges. M1 grew considerably more rapidly in 1982 than in 1981 and somewhat more rapidly than in 1980. On the other hand, M2's growth rate in 1982 was only slightly greater than in the previous two years, while M3 grew less rapidly in 1982 than in 1981 and only slightly more rapidly than in 1980.

Much of the growth in M1 in 1982 was accounted for by very rapid growth in OCD's. From the fourth quarter of 1981 through November 1982, OCD's, the only component of M1 that pays interest, increased \$26.1 billion, compared with a total rise in M1 of \$37.9 billion. During that time OCD's increased as a share of M1 from 17.0 percent to 21.2 percent. In contrast, demand deposits, the

Table 3
GROWTH RATES OF MONEY SUPPLY
(Percent Change at Annual Rates)

Period	M1*	M2	M3
1980	7.3	9.2	10.0
1981	2.3	9.5	11.4
1982: First 11 Months†	8.7	9.9	10.5
1982: Target Range	2½-5½	6-9	6½-9½
1982: Q1	10.4	9.8	8.7
Q2	3.3	9.5	10.7
Q3	3.5	9.7	12.1
Sept.	14.0	5.0	3.9
Oct.	20.3	8.2	9.1
Nov.	16.1	11.2	8.9

Note: Annual rates of growth are based on quarterly average data.

*M1 is equivalent to M1-B in 1980 and M1-B adjusted for deposit shifts into NOW accounts in 1981.

†Fourth quarter 1981 through November 1982.

Table 4
**GROWTH RATES OF NOMINAL GNP,
M1, AND VELOCITY OF M1**

Period	GNP	M1	M1 Velocity
1979	9.7	7.4	2.1
1980	9.4	7.3	2.0
1981	9.6	2.3	7.2
1982: First 3 Quarters*	3.8	5.8	-1.9

Note: Annual rates of growth are based on quarterly average data. M1 is equivalent to M1-B in 1979 and 1980 and M1-B adjusted for deposit shifts into NOW accounts in 1981.

*Annualized percent change from fourth quarter 1981 to third quarter 1982.

largest component of the narrowly defined money supply, declined as a percent of M1, dropping from 54.0 percent in the fourth quarter of 1981 to 50.1 percent in November 1982. Of the components of M2, the fastest growing in 1982 were OCD's, MMMF's, and small denomination time deposits, although the latter declined in October due to the maturing of a large volume of all savers certificates. The decline in demand deposits in 1982 and the sharp increase in OCD's, MMMF's, and small denomination time deposits reflect the increasing tendency for depositors to keep their money balances in accounts that pay the highest return.

The rapid growth in M1 in 1982 is especially noteworthy. In light of the weakness in economic activity throughout the year and the concomitant disinflation, this rapid growth in M1 did not reflect a growing need for money to finance economic transactions. Indeed, during the first three quarters of 1982, M1 grew faster than nominal GNP. Thus, there was a decline in the velocity of money, or its rate of turnover (Table 4). This decline in velocity was in sharp contrast to the unusual increase in velocity in 1981, when, although M1 growth was quite

moderate, turnover was rapid enough to support fairly rapid growth in nominal GNP. In contrast, with declining velocity during the first three quarters of 1982, considerable growth in M1 was associated with a slowing in nominal GNP growth.

It is not surprising that M1 velocity declined in 1982. Slower turnover of money is not unusual in a recession. However, the magnitude and persistence of the 1982 decline are unusual. Indeed, Chairman Volcker described it as the first significant drop in velocity in about 30 years.³

Velocity can ordinarily be explained by historical demand relationships in which the desire to hold money depends on interest rates, prices, and real income. From time to time, however, other factors interfere with the normal relationships, making velocity unpredictable. Interest rate declines, sluggish real economic growth, and price disinflation do not by themselves explain the significant decline in velocity in 1982. It is necessary to look beyond these conventional elements of explanation of money demand. It seems quite plausible that, in a time of concern and uncertainty about business and financial conditions, individuals were seeking to hold precautionary balances in as liquid a form as possible while still earning a return. As most of 1982's M1 growth was in interest-bearing OCD's—transactions accounts with some of the characteristics of savings deposits—these accounts apparently meet the precautionary demand for liquidity.

In view of the continued rapid growth in M1 in October and November, along with the continued sluggish economy, M1 is likely to have grown faster than nominal GNP in the fourth quarter of 1982—although December's M1

³ Statement of Chairman Volcker to Joint Economic Committee, November 24, 1982.

growth could be slowed by transfers from M1 balances into the new money market deposit instrument introduced at midmonth. Thus, the downward trend in velocity may be extended another quarter. A significant part of the rapid October-November growth in M1 was due to the maturing of all savers certificates, and some of these funds were transferred into demand deposits and OCD's. Nevertheless, apart from the effect of the all savers certificates, velocity probably would have declined in the fourth quarter or increased only slightly.

MONETARY POLICY IN 1982

As 1982 opened, the Federal Reserve remained committed to restraining growth in money and credit so as to bring continuing downward pressure on the inflation rate. The FOMC, therefore, set targets for 1982 aimed at slowing money growth over time to a pace consistent with reasonably stable prices and the needs of an economy growing in line with its productive potential. As noted earlier, the FOMC set target growth ranges for 1982 and reaffirmed the ranges at its July meeting.

In implementing monetary policy in 1982, the FOMC was faced with a consistent tendency for the money and credit measures to exceed their target ranges, despite the recession. Except briefly in July and August, this was especially true for M1, which rose sharply in January and remained at above-target levels throughout the first half of the year despite small declines in May and June. From the fourth quarter of 1981 through June, M1's growth rate was 5.8 percent, 0.3 percentage points above the upper limit of the 1982 target range. M2's first half growth rate of 9.5 percent was 0.5 percentage points above its target range.

M1 declined again in July, briefly placing its year-to-date growth rate within the target range. In August, however, M1 began four

months of rapid growth. By November its year-to-date growth rate was 8.7 percent, 3.2 percentage points above the upper limit of its target range, considerably more than at midyear. For M2, the year-to-date growth rate that month was 9.9 percent, 0.9 percentage points above the upper limit of its target range and only slightly more than in June.

Despite the persistence of above-target growth in M1 in the first half of 1982, the Federal Reserve took no overtly restrictive policy action during the period, as the basic discount rate remained at 12 percent. However, the Federal Reserve did not supply sufficient nonborrowing reserves to fully accommodate the above-target growth, so that short-term interest rates came under upward pressure from time to time and were somewhat higher at the end of June 1982 than at yearend 1981.

Nevertheless, the discount rate was reduced in four steps in July and August, from 12 to 10 percent (Table 5). These discount rate actions, taken following the May-July decline in M1 that brought it back within the target range, were in line with declines in market interest rates that occurred during the period. Despite the return of M1 to above-target growth after August, the discount rate was

Table 5
THE DISCOUNT RATE IN 1982
(In Percent Per Year)

<u>Date</u>	<u>Discount Rate</u>
January 1*	12
July 20	11½
August 2	11
August 16	10½
August 27	10
October 12	9½
November 22	9
December 15	8½

*The discount rate was set at 12 percent on December 4, 1981.

again reduced in October to 9.5 percent, in November to 9 percent, and a further drop to 8.5 percent occurred in December.

In retrospect, the moderate policy response to above-target M1 growth in the first half of 1982 and the easing in the latter part of the year in the face of continued above-target growth reflect the Federal Reserve's progressive deemphasis in 1982 of M1 targets and performance. At its March meeting, for example, the FOMC decided that M1 deviations from target during the coming period should be evaluated partly in light of M2 behavior. This decision was based in part on most of the large first-quarter increase in M1 being in OCD's—which suggested a desire by individuals to hold more precautionary liquid balances.⁴ The approach to M1 adopted in March was reiterated in May, as outlined in the FOMC's Record of Policy Actions for the May 18 meeting:

Given the uncertainties relating to the public's demand for liquid balances, notably NOW accounts, most members continued to believe that the behavior of M1 should be evaluated partly in light of the behavior of M2 over the weeks ahead. Thus, for example, somewhat more rapid growth of M1 might be accepted if it appeared to be associated with a continuing desire by the public to build up liquid balances and with growth of M2 near its specified rate.⁵

⁴ "Record of Policy Actions of the FOMC, Meeting Held on March 29-30, 1982," Federal Reserve Press Release, May 21, 1982.

⁵ "Record of Policy Actions of the FOMC, Meeting Held on May 18, 1982," Federal Reserve Press Release, July 2, 1982, p. 9

The midyear meeting of the FOMC included further discussion of the role of M1 in implementing monetary policy. Again, it was noted that the growth in M1 was concentrated in OCD's, which made OCD's a larger part of the total, and, in turn, made M1 more sensitive to changes in the public's desire to hold very liquid assets. For this reason, the FOMC—while deciding that the money growth targets for 1982, which had been established earlier in the year, were still appropriate—concluded that M1 growth somewhat above the top of its range would be acceptable. As Chairman Volcker said in his testimony to Congress in July,

... growth somewhat above the targeted ranges would be tolerated for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money.⁶

The FOMC's deemphasis of M1 in 1982 became more pronounced at its October meeting where the directive to the Manager of the Open Market Account specified short-run growth paths for M2 and M3 from September to December, but none for M1. Commenting on the role of M1 in a speech after the October meeting, Chairman Volcker said:

We face over the next few months, not just the possibility but the virtually certainty of distortions—distortions growing out of legislation and regulation—in the M1 number Both the 'ups' and 'downs' in M1 reflecting these

⁶ Volcker testimony, p. 9

regulatory changes will be artificial and virtually meaningless in gauging underlying trends in 'money' and liquidity In the circumstances, I do not believe that, in actual implementation of monetary policy, we have any alternative but to attach much less than usual weight to movements in M1, over the period immediately ahead.⁷

The distortions the Chairman referred to derive from two factors. One is the maturing of all savers certificates and the movement of those funds into other investments, maybe after being parked temporarily in transactions accounts. The other distortion derives from the introduction of the new money market deposit by banks and thrift institutions and the uncertainty of the public's response to it.

In summary, in conducting monetary policy in 1982, the Federal Reserve was faced with a consistent tendency for the monetary aggregates, especially M1, to grow faster than the established target ranges. Under a rigid application of the monetary control procedures used in recent years, the Federal Reserve, in an effort to slow monetary growth in order to help reduce inflation, would have responded to above-target monetary growth with restrictive policy actions, such as increases in the discount rate. However, the discount rate remained unchanged during the first half of 1982, although the Federal Reserve did not supply sufficient nonborrowed reserves to fully accommodate the above-target M1 growth. Moreover, the discount rate declined during the last half of the year.

⁷ *Informal Talk to Business Council* at Hot Springs, Virginia, October 9, 1982, pp. 3-4.

The apparent departure from previously employed procedures reflects the progressive deemphasis of M1 as a guide to monetary policy actions in 1982. The deemphasis during the first half of the year reflected the FOMC's assessment that, as the above-target growth in M1 was due to an increase in demand for liquidity, it did not represent excessive monetary growth that would add to inflationary pressures. Later in the year, the deemphasis on M1 also reflected the FOMC's recognition that special factors—maturing all savers certificates and the new deposit instrument—had distorted the behavior of M1, making it an unreliable guide to monetary policymaking.

In deemphasizing M1 in 1982, the Federal Reserve placed relatively greater weight on the behavior of M2. This aggregate was affected less than M1 by greater liquidity demands and special factors and grew more in line with its target range in 1982 than did M1. Also, in taking specific policy actions in 1982, the Federal Reserve considered a number of factors, such as the progress being made in reducing inflation, the continued weak economy, and developments in domestic financial and foreign exchange markets. As Chairman Volcker said in connection with the October decline in the discount rate:

. . . as is usually the case, the change was, in an immediate sense, designed to maintain an appropriate alignment with short-term market rates. It was, of course, also taken against a background of continued sluggishness in business activity, the exceptional recent strength of the dollar on the exchange markets, and indications of strong demands for liquidity in some markets⁸

⁸ *Talk to Business Council*, p. 1.

The Chairman added that neither the 1982 declines in the discount rate nor the reduced emphasis on M1 represented a change in the basic anti-inflationary thrust of the Federal Reserve's monetary policy.

THE ECONOMY AND MONETARY POLICY IN 1983

While 1982 has been a year of recession and strain for the U.S. economy, it has also been a year in which the stage has been set for sustainable—albeit modest—expansion in the future. The elements primarily responsible for providing the environment in which expansion can be sustained are continuing disinflation and recently lower interest rates.

This view remains well founded in spite of mixed signals regarding business activity as 1982 ends. The long-awaited, mainly consumer-led recovery is still not in evidence, although enough strength is expected to pull the economy onto a path of moderate growth. Increasing consumer purchases will be supported by modest growth in housing and some further strength in federal purchases. Countervailing these sources of modest economic strength will be continued weakness in business capital spending, net exports, and purchases by state and local governments. All in all, growth in real GNP in 1983 may not be too different from the long-run trend of 3 to 4 percent.

Two corollaries follow from such an out-

look, with its implications for a great deal of continued slack in the economy. With real growth near the economy's long-run trend rate, few inroads can be expected soon into the high rate of unemployment or the low rate of industrial utilization. At the same time, continued slack in the economy during a modest expansion promises to keep downward pressure on inflation.

The task of monetary policy in 1983 will be to provide money and credit to the economy sufficient to support the expected moderate expansion in business activity, while consistent with the expected further decline in inflation. In July 1982, the FOMC tentatively extended the 1982 growth rate ranges for monetary aggregates into 1983. These tentative ranges will be reconsidered at the meeting in February.

One of the major issues facing the Federal Reserve in 1983 will be the role of M1 in monetary policymaking. Whether M1 remains a reliable guide for the conduct of policy—and to what extent—will need to be given serious consideration. Also to be considered are the role and relative importance of M2 and other policy guides, such as broader measures of money and credit and interest rates. In resolving these issues, the Federal Reserve will seek to employ policy guides that are best suited under the conditions existing in 1983 to achieving the goals of sustainable economic growth and continued disinflation.