

The FOMC in 1981: Monetary Control in a Changing Financial Environment

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LAST year marked the second full year of the Federal Reserve's implementation of operating procedures introduced on October 6, 1979. Since then, the Federal Reserve has attempted to achieve better control of the growth of the monetary aggregates by placing more emphasis on controlling the growth of bank reserves and less on controlling short-run movements in the federal funds rate.¹

This past year was a turbulent one for both the economy and the conduct of monetary policy. Real GNP declined markedly in the fourth quarter after increasing rapidly during the first quarter and holding steady during the middle two quarters. The growth rates of the monetary aggregates diverged over the year, with the narrower aggregates growing at a substantially reduced pace compared with the previous year, while the broader aggregates grew somewhat more rapidly than they did the previous year.

The policy of the Federal Open Market Committee (hereafter referred to as Committee or FOMC) in 1981 reflects a commitment to restrain the growth of the monetary aggregates. A number of financial innovations and regulatory changes, however, caused the Committee to change the policy weights placed on the various monetary aggregates. Furthermore, the nationwide introduction of NOW accounts prompted

the FOMC to introduce a new monetary aggregate, shift-adjusted M1B, which it used to specify its policy directives.

This article discusses the FOMC's monetary policy decisions during 1981. The organization is as follows: The financial innovations and regulatory changes of 1981 are reviewed, and the impact of these changes on the growth rates of the various monetary aggregates is discussed. Next, the annual policy objectives of the FOMC for the growth of various monetary aggregates are reviewed, and the actual growth rates for the year are compared with the annual targets. Finally, the short-run policy directives of the FOMC are reviewed.

FINANCIAL DEVELOPMENTS OF 1981

Several financial developments affected the direction of monetary policy in 1981. The most important of these were the nationwide introduction of NOW accounts on January 1, the liberalization of interest rate ceilings on small-savers certificates on August 1, the introduction of tax-exempt All-Savers Certificates on October 1, and the rapid, albeit varied, growth in money market mutual funds (MMMFs).

The Measurement and Use of Shift-Adjusted M1B

The first of these developments resulted in the use of shift-adjusted M1B for policy purposes. The FOMC had anticipated that the introduction of NOW accounts would produce a shift in the public's holding of financial assets, from non-demand deposit

Note: Citations referred to as "Record" are to the "Record of Policy Actions of the Federal Open Market Committee" found in various issues of the *Federal Reserve Bulletin*.

¹For a description of the current operating procedure, see R. Alton Gilbert and Michael Trebing, "The FOMC in 1980: A Year of Reserve Targeting," this *Review* (August/September 1981), pp. 2-22; and Richard W. Lang, "The FOMC in 1979: Introducing Reserve Targeting," this *Review* (March 1980), pp. 2-25.

assets, such as savings deposits, into NOW accounts (see table 1 for the composition of the monetary aggregates).² As a result of this shift, the FOMC anticipated that measured M1B would contain a certain amount of "hidden savings." Furthermore, until complete, this shift would cause the growth rate of measured M1B to overstate the actual growth rate in transactions balances.

Initially, it was estimated that this shift would cause the growth in measured M1B to overstate the growth in transactions balances by 2 to 3 percentage points.³ In anticipation of this development, the Committee stated both its long-run and short-run policy directives in terms of shift-adjusted M1B. Shift-adjusted M1B was obtained by subtracting from measured M1B, the *estimated* increase in other checkable deposits (above some expected normal growth) that came from sources other than demand deposits.⁴

Furthermore, the FOMC anticipated that nearly all of the shift into NOW accounts from sources other than demand deposits would come from sources in-

²For a more detailed discussion of the composition of the monetary aggregates, see R. W. Hafer, "The New Monetary Aggregates," this *Review* (February 1980), pp. 25-31.

³It was assumed that individuals would shift assets primarily out of traditional demand deposits and other interest-earning assets included in M2 into NOW accounts. Thus, the growth rates of M2 and M3 would be unaffected by these shifts. There were two reasons for anticipating shifts out of savings deposits into NOW accounts: First, most NOW accounts had substantial minimum-balance requirements. Thus, it was assumed that individuals would shift part of their savings into NOW accounts to meet these requirements. Second, the New England experience with NOW accounts indicated that about one-third of the flow into ATS and NOW accounts had come from savings deposits. See "Monetary Policy Objectives for 1981" (Board of Governors of the Federal Reserve System, 1981), p. 4-5; and "Monetary Report to the Congress," *Federal Reserve Bulletin* (March 1981), pp. 195-208.

⁴The proportion of the increase in other checkable deposits (OCD) that was estimated to have been shifted from sources other than demand deposits was determined from a number of surveys and a cross-sectional econometric study. It was estimated that the proportion of OCD diverted from sources other than demand deposits was between 20-25 percent in January, and 25-30 percent thereafter. Shift-adjusted M1B was obtained by first estimating the proportion of the *change* in seasonally unadjusted OCD from end of the year 1980, above some trend growth in OCD that came from sources other than demand deposits. The proportion was assumed to be the midpoint of the above ranges. Next, this amount was seasonally adjusted using the seasonal factors for commercial bank savings deposits. This seasonally adjusted amount was then subtracted from seasonally adjusted M1B to obtain seasonally adjusted, shift-adjusted M1B. For more details, see "Recent Revisions in the Money Stock," *Federal Reserve Bulletin* (July 1981), pp. 539-42; and John A. Tatom, "Recent Financial Innovations: Have They Distorted the Meaning of M1?" this *Review* (April 1982), p. 23-35.

Later in the year, it appeared that most of the shift out of

Table 1
Composition of Monetary Aggregates

Component	M1B ¹	M2	M3
Currency	X	X	X
At commercial banks and thrift institutions:			
Demand deposits exclusive of deposits due to foreign commercial banks and official institutions	X	X	X
NOW accounts	X	X	X
ATS accounts	X	X	X
Credit union share draft balances	X	X	X
Overnight RPs		X	X
Savings deposits		X	X
Small time deposits (<\$100,000) ²		X	X
Large time deposits			X
Term RPs			X
Retail RPs (<\$100,000)		X	X
Other:			
Travelers checks of nonbank issuers ³	X	X	X
Overnight Eurodollar deposits of U.S. nonbank residents ⁴		X	X
Money market mutual funds shares ⁵		X	X
Bankers acceptances			X
Commercial paper			X
U.S. savings bonds			X
Liquid Treasury securities			X
M2 consolidation component ⁶		X	X

¹The M1B series has been renamed M1. The M1 series now contains an M1 consolidation component which represents the estimated portion of thrift institution vault cash used to service their other checkable deposit liabilities.

²Includes small-savers certificates and All-Savers certificates.

³Travelers checks were included in the monetary aggregates during the June 1981 revisions. See the Board's H.6 release for June 26, 1981.

⁴Overnight Eurodollars issued by Caribbean branches of member banks.

⁵M2 now excludes "institution only" MMMFs (funds which do not offer accounts to individuals). See the Board's H.6 release for February 5, 1982, for details.

⁶Represents the estimated amount of demand deposits and vault cash held by thrift institutions to service time and savings deposits.

demand and nondemand deposit components of M2 appeared to have taken place during the first four months of the year. As a result of the completion of the major portion of the shift, the Federal Reserve Board discontinued its series on shift-adjusted M1B, effective January 6, 1982. The M1A measure was dropped at the same time.

cluded in M2. This would cause the growth rate of *measured* M1B to increase relative to M2. However, the Committee was uncertain about the extent of the shift and about the ultimate source of the new NOW accounts. Hence, it was uncertain about the appropriate weighting of shift-adjusted M1B and M2 for policy purposes. This uncertainty was exacerbated by the rapid and varied growth of the money market mutual fund component of M2 during the year.⁵

The Elimination of the M1A Target

The shift from non-interest-bearing checking accounts into interest-bearing NOW accounts resulted in a substantial reduction in the growth rate of M1A (currency plus demand deposits at commercial banks). This blurred its meaning, as the proportion of checkable deposits it represented declined markedly after the first of the year. As a result, the Committee eliminated any reference to the M1A measure from its short-run policy objectives and from its tentative long-run policy objectives for 1982.⁶

The Growth in Non-Transactions Balances

It was believed that the liberalization of interest rate ceilings on small-savers certificates and the introduction of tax-exempt All-Savers Certificates would increase the attractiveness of these components of M2 relative to money market assets that are not included in M2. By the middle of 1981, the Committee was concerned that these regulatory changes, especially the introduction of All-Savers Certificates, would produce shifts from money market assets into these components of M2. The Committee believed that these changes might cause a rapid acceleration in the growth rate of M2, especially during the fourth quarter of the year, altering the relative growth rates of M2 and shift-adjusted M1B still further. Thus, these regulatory changes also contributed to the uncertainty about the appropriate weighting of shift-adjusted M1B and M2.

This uncertainty was heightened by the increase in the income velocity of shift-adjusted M1B during

the year.⁷ It was argued that high interest rates had induced the use of new cash management techniques that reduced the demand for traditional transactions balances, thus increasing the income velocity of money. For example, it was argued that since many MMMFs have check-writing privileges, they may themselves be considered transactions balances, or at least close substitutes for the transactions balances included in M1B. If this were true, shift-adjusted M1B would understate the growth in transactions balances of the economy.

ANNUAL TARGETS FOR 1981

The Full Employment and Balance Growth Act of 1978 (also called the Humphrey-Hawkins Act) requires the Board of Governors, each February and July, to transmit to Congress reports on the objectives for growth rate ranges for monetary and credit aggregates over the current calendar year and, in the case of the July report, the objectives for the following calendar year as well. The Committee has chosen to establish ranges from the fourth quarter of the previous year to the fourth quarter of the current year.⁸ While these ranges must be reported to Congress each February and July, the Act provides that the Board and the Committee may reconsider the annual ranges at any time.⁹ The period to which the annual ranges apply, however, may not be changed. The base period (the fourth quarter of the previous year) would remain the same even if the Committee decided to change the desired growth rates of the aggregates for the year.

At its February meeting, the Committee agreed on the desirability of reducing the rate of monetary growth, thereby contributing to reducing the in-

⁷See "Record" (July 1981), p. 568. The income velocity of money is given by the ratio of nominal GNP to money. It indicates the number of times each unit of nominal money "turns over" in producing this year's final output.

⁸Prior to 1979, the Committee adopted one-year growth rates each quarter, and the base period for the annual targets announced each quarter was brought forward to the most recent quarter. This method resulted in a problem referred to as "base drift." Growth in aggregates above (below) an annual growth range in a quarter would raise (lower) the base level for calculating the next annual growth path. Specification of annual objectives in terms of calendar year growth rates, which eliminates the base drift problem within a calendar year, does not solve this problem from one calendar year to the next, since new ranges are established from the end of each calendar year.

⁹At its midyear review of the annual ranges, the Committee also established tentative ranges for the monetary aggregates for the next year — measured from the fourth quarter of the current year to the fourth quarter of the following year.

⁵See "Record" (April 1981), p. 314; and "Record" (June 1981), p. 500-01.

⁶The Committee decided to omit reference to M1A from its statement of the short-run policy objectives for 1981 at the March meeting and from its statement of long-run policy directives for 1981-82 at the July meeting. See "Record" (June 1981), p. 500; and "Record" (September 1981), p. 716.

flation rate and providing a basis for economic stability and sustainable growth in GNP.¹⁰ The Committee agreed to specify an annual target range for shift-adjusted M1B that was ½ percentage point below the comparable range for 1980.¹¹ There was less agreement, however, on the specification of the growth rate ranges for the broader monetary aggregates.

Members differed somewhat more in their views concerning the broader monetary aggregates, in part because of uncertainty about the potential effects of interest rate relationships on the behavior of the nontransaction component. Reflecting an expectation that growth of the broader aggregates would increase relative to that of the narrow aggregates adjusted for expansion of NOW accounts, a number of members favored specification of ranges slightly higher than those for 1980. However, most members believed that sufficient allowance for the possibility of relatively stronger growth of the broader aggregates would be made by reiterating the 1980 ranges for them in association with ranges for the narrower aggregates that were 1/2 percentage point lower than those for 1980. In this connection, it was stressed that specification of ranges rather than precise rates for growth over the year inherently provided for some change in relative rates of growth among the monetary aggregates, and that growth of both M2 and M3 might well be in the upper portions of their ranges. Even so, growth of the broader aggregates would be less than actual growth in 1980. One member preferred to focus exclusively on the narrower aggregates, not specifying ranges for the broader aggregates.¹²

At the end of this discussion, the Committee established the same annual target ranges for M2 and M3 as it had established in 1980. Table 2 shows the target growth rates for shift-adjusted M1B, M2 and M3 that the Committee established at its February meeting.¹³ The Committee did not establish annual growth rate ranges for measured M1B. However, it was estimated that a range of 6 to 8½ percent for measured M1B would correspond to the Committee's range for shift-adjusted M1B.¹⁴ Growth rates of the monetary aggregates relative to their long-run ranges are presented in charts 1 and 2.

¹⁰"Record" (April 1981), p. 315.

¹¹There was no shift adjustment to M1B in 1980. Thus, the "comparable range" is the 1980 range for actual M1B.

¹²"Record" (April 1981), p. 315.

¹³"Record" (April 1981), p. 316; and "Monetary Report to Congress," p. 205. An annual target range for M1A was adopted at the February meeting (3-5½ percent). It is not reported here, however, because M1A was dropped for policy considerations later in the year. See footnote 6.

¹⁴"Monetary Report to Congress," p. 207.

Table 2
Planned Growth of Monetary Aggregates for 1981 (percent changes, fourth quarter to fourth quarter)¹

Aggregate	Proposed range for 1981	Actual 1980 growth rate	Actual 1981 growth rate
Shift-adjusted M1B	3.5 - 6.0%	6.6% ²	2.3%
M1B ³	6.0 - 8.5	7.3	5.0
M2	6.0 - 9.0	9.2	9.4
M3	6.5 - 9.5	10.0	11.4

¹Data as revised by Board of Governors in February 1982.

²This growth rate was taken from Board of Governors of the Federal Reserve System, *Monetary Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978* (February 10, 1982), p. 14.

³The Committee did not establish an annual growth rate range for measured M1B for 1981. However, it was estimated that a range of 6-8½ percent would correspond to the Committee's range for shift-adjusted M1B.

Actual Money Growth Rates for 1981

As shown in table 2, the broader monetary aggregates grew at rates above their long-run ranges for the year: M2 grew at a 9.4 percent rate, just above the top of its range, while M3 grew at a 11.4 percent rate, 2 percentage points above the top of its annual range.

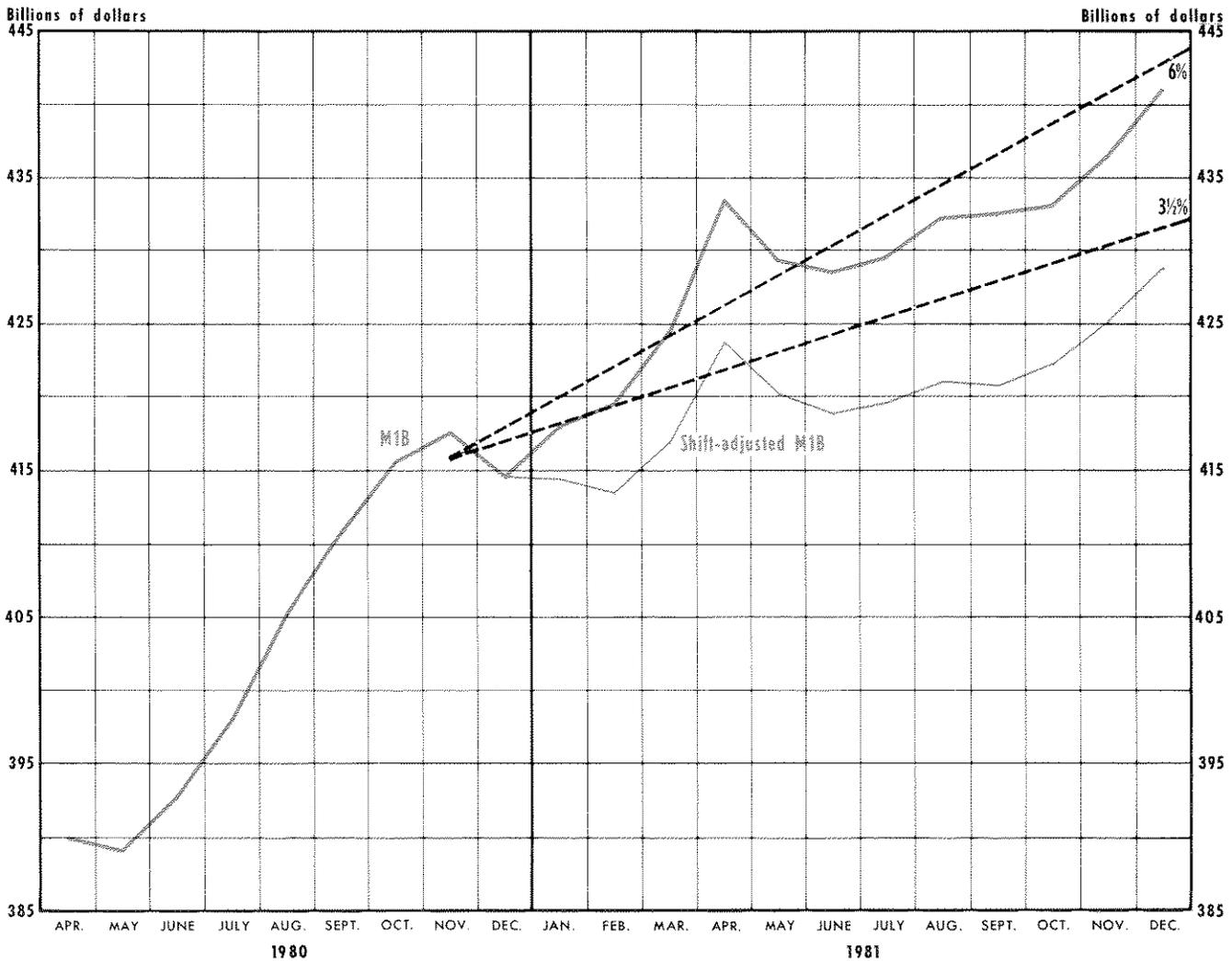
In contrast, the growth rate of shift-adjusted M1B was substantially below its target range for 1981. Shift-adjusted M1B grew at an annual rate of 2.3 percent from the fourth quarter of 1980 to the fourth quarter of 1981, about 1 percentage point below the lower end of its planned growth range.¹⁵

While this shortfall in the growth of shift-adjusted M1B was somewhat larger than the Committee anticipated by mid-year, financial developments during the year led it to accept a slower growth in shift-adjusted M1B as long as the growth in the broader monetary aggregates remained at the upper ends of their ranges.

... in light of its desire to maintain moderate growth in money over the balance of the year, the Committee wished to affirm that growth in M1B near the lower

¹⁵Because there was no shift-adjusted M1B for the fourth quarter of 1980, its growth rate was calculated from the average level of M1B for the fourth quarter of 1980.

Chart 1
M1B, Shift-Adjusted M1B and Growth Objectives for Shift-Adjusted M1B



end of its range would be *acceptable and desirable*. At the same time, the Committee recognized that growth in the broader monetary aggregates might be high in their ranges (*italics added*).¹⁶

Much of the willingness to accept a slower rate of growth in shift-adjusted M1B stemmed from uncertainty about the extent to which financial developments were affecting the relative growth rates of

various monetary aggregates, and the extent to which these developments in turn were affecting the relationship between the aggregates and economic activity. This is most evident in the Committee's discussion of short-run policy directives for 1981.

SHORT-RUN POLICY DIRECTIVES FOR 1981

The announcement of annual target ranges for the monetary aggregates, mandated by the Full Employment and Balanced Growth Act of 1978, is intended to set public guidelines for the FOMC in choosing short-run policy objectives during the year. Committee decisions that influence the *day-to-day*

¹⁶"Record" (September 1981), p. 716. Similar statements appear on numerous occasions in the "Record." For example, "Record" (October 1981), p. 792 and 794; (December 1981), p. 908; and (January 1982), p. 41. Also, see "Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Finance and Urban Affairs," *Federal Reserve Bulletin* (August 1981), p. 615.

Chart 2
Ranges for M2 and M3 for Period IV/80 to IV/81

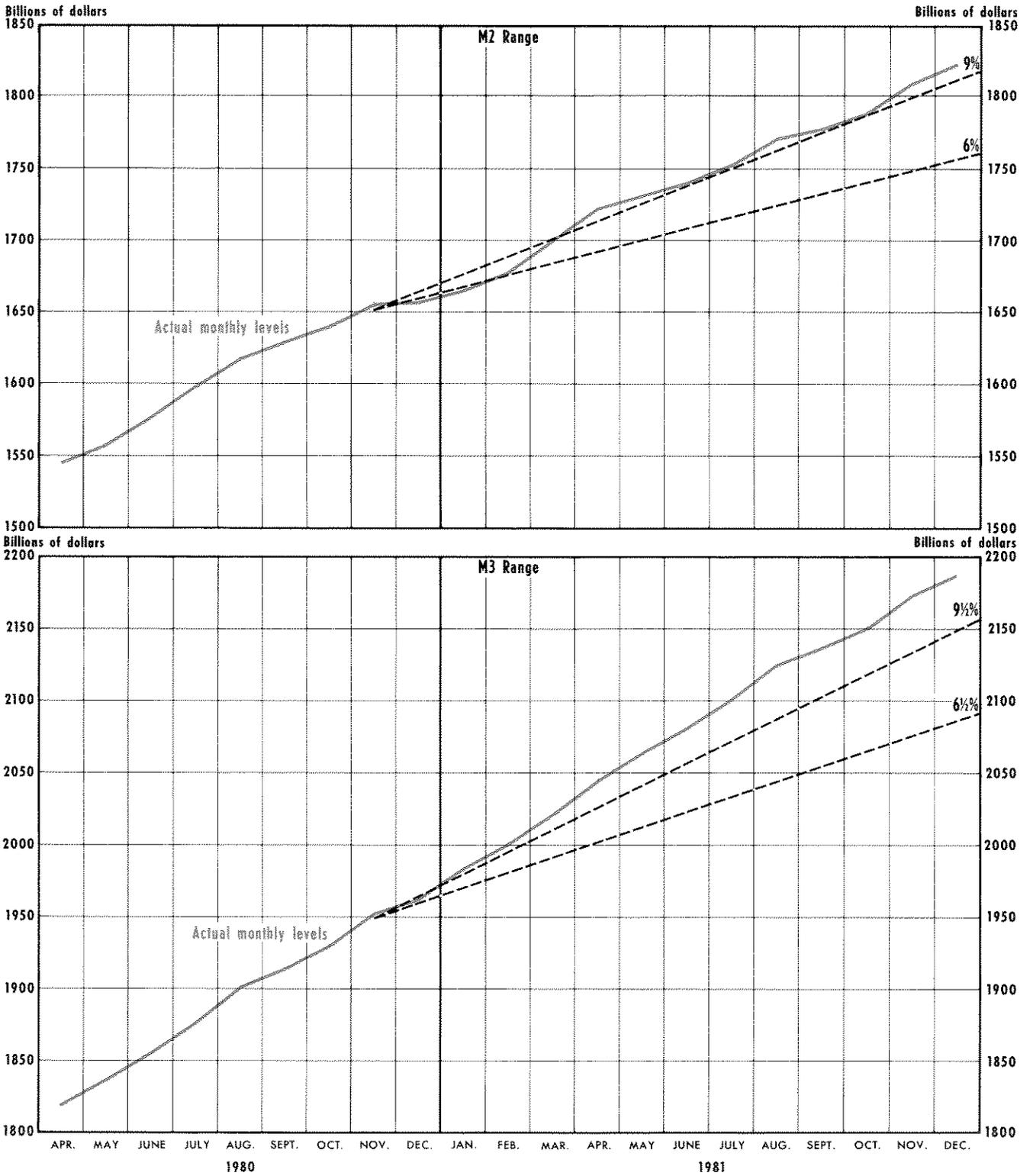
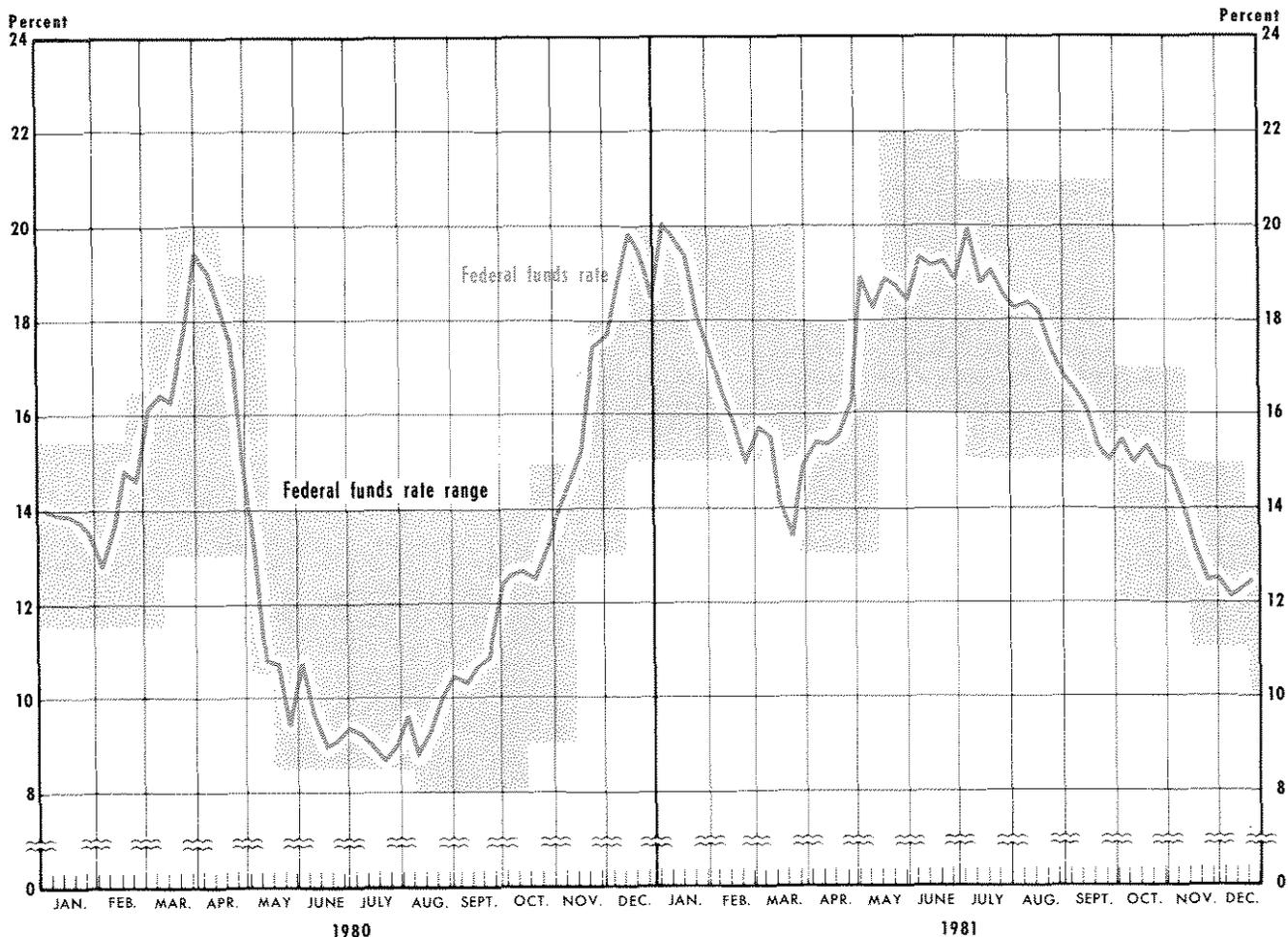


Chart 3
FOMC Ranges for Federal Funds Rate



NOTE: Rates are calculated as weekly averages of effective daily rates. At each meeting the Committee specified a range for the federal funds rate. These ranges are indicated for the first full week during which they were in effect.

implementation of monetary policy, however, are specified in the short-run policy directives. The Committee issues these directives to the Manager of the Open Market Account at the Federal Reserve Bank of New York.

At each meeting in 1981, the Committee specified short-run growth rates for shift-adjusted M1B and M2.¹⁷ It also specified an intermeeting range for the federal funds rate.¹⁸ These ranges and the actual

federal funds rate are presented in chart 3. The growth rates for the monetary aggregates and the ranges for the federal funds rate that the Committee specified during 1981 are presented in table 3. Charts 4 and 5 show the short-run ranges for shift-

¹⁷A short-run growth rate target for M1A was established at the February meeting; however, M1A was dropped from the Committee's short-run objectives at the March meeting. The short-run target range for M1A set at the February meeting was 5-6 percent.

¹⁸If movements of the federal funds rate within the range appear

to be inconsistent with short-run objectives for the monetary aggregates and related reserve paths during the intermeeting period, the manager for Domestic Operations at the Federal Reserve Bank of New York is to promptly notify the Chairman, who in turn decides whether the situation calls for supplementary instructions from the Committee. Two such meetings were called during 1981. Meetings were called on February 24 and May 6; see "Record" (April 1981), p. 318 and "Record" (June 1981), pp. 502-03. The federal funds rate range first appeared as a "trigger mechanism" with the change to reserve targeting procedure on October 6, 1979. See "Record" (December 1979), p. 977.

Table 3
FOMC Operating Ranges — 1981

Short-Run Operating Ranges					
Date of meeting	Federal funds rate range	Periods to which monetary growth paths apply ¹	M1A	Shift-adjusted M1B	M2
February 2-3, 1981 ^a	15-20%	December-March	5-6%	5-6%	about 8%
February 24 ^b	(no change)	(intermeeting conference)	reaffirmed	February 2-3 ranges	
March 31 ^c	13-18	March-June	—	5½ or somewhat less	about 10½
May 6		(intermeeting conference)	reaffirmed	March 31 ranges	
May 18	16-22	April-June	—	3 or lower	about 6
July 6-7 ^d	15-21	June-September	—	7	remains around the upper limit of its range for the year
August 18 ^e	15-21	June-September	—	7	remains around the upper limit of its range for the year
October 5-6 ^f	12-17	September-December	—	7	around 10 or slightly higher
November 17	11-15	October-December	—	about 7	about 11
December 21-22 ^g	10-14	November-March 82	—	around 4-5 ²	around 9-10
Long-Run Operating Ranges					
Date of meeting	Target period	M1A	Shift-adjusted M1B	M2	M3
February 2-3, 1981 ^h	IV/1980-IV/1981	3 - 5.5%	3.5 - 6%	6 - 9%	6.5 - 9.5%
July 6-7	(reaffirmed above ranges)				

¹Growth objectives specified by the Committee over quarterly periods are interpreted in terms of monthly data.

²This range is for non-shift-adjusted M1B.

adjusted M1B and M2 based on first-published data. First-published data give a more accurate representation of the Committee's short-run policy decisions based on information available at the time. Revised data for shift-adjusted M1B are lower relative to its annual ranges than first-published data. Revised data for M2 are substantially higher relative to its annual ranges than first-published data.¹⁹

The Committee's short-run policy directives

¹⁹To see this, compare charts 1 and 4, and charts 2 and 5. The data for M2 in chart 5 is higher than the M2 data as of the February 1982 revisions. Much of this difference is due to the redefinition of M2 to include retail RPs (those issued in amounts of less than \$100,000) and to exclude "institution only" MMMFs (funds which do not offer accounts to individuals). See the Board's H.6 release of February 5, 1982, for details.

followed three phases and are reflected by the general movement of the monetary aggregates during the year. During the first phase, the Committee's objective was to achieve a gradual acceleration in the growth of shift-adjusted M1B within its annual range, after it fell below the lower end of its range in January. During the second phase, the Committee gave greater weight to keeping the growth of M2 around the top of or within its annual range, while permitting growth in shift-adjusted M1B to fall substantially below the lower bound of its range. In the final phase, the Committee once again desired more rapid growth in shift-adjusted M1B, while accepting a somewhat larger departure of M2 above the upper limit of its annual range. Growth rates of shift-adjusted M1B, measured M1B, M2 and the adjusted monetary base corresponding to these phases are presented in table 4.

Table 3 (continued)

Footnotes — Dissents to FOMC Actions

^aMrs. Teeters dissented from this action because she believed that the specifications adopted for monetary growth over the first quarter were unduly restrictive. She preferred specification of higher rates for monetary growth over the first quarter, consistent with the ranges adopted for monetary growth over the whole year, in association with a lower intermeeting range for the federal funds rate.

Mr. Wallich dissented from this action because he preferred to set a higher range for the federal funds rate in order to help avoid a repetition of the sharp drop in interest that had occurred in the second quarter of 1980.

^bMr. Roos dissented from this action because he believed that it would tend to prolong unduly the shortfall in growth of M1A and M1B from the Committee's ranges for the year. In the circumstances, he preferred to reduce the lower limit of the intermeeting range for the federal funds rate in order to encourage a more prompt pickup in growth of narrowly defined monetary aggregates.

^cMr. Wallich dissented from this action because he favored specification of lower monetary growth rates from the period from March to June than those adopted at this meeting along with a higher intermeeting range for the federal funds rate. In light of the recent strength of economic activity, he believed policy had not been as restrictive as supposed, in part because money market mutual funds and other sources of liquidity had contributed to an increase in the velocity of M1B, and that continuation of excessive strength in activity posed the greater danger for the period ahead.

^dMr. Partee dissented from this action because in the light of weakening in economic activity, he preferred to give more emphasis to reducing the risk of a cumulative shortfall in growth of M1B. Accordingly, he favored specification of a somewhat higher objective for growth of M1B over the period of June to September, and without additional weight assigned to the potential for more rapid growth of M2. In his view, the short-run behavior of M2 was subject to great uncertainty because of both the volatile influence of money market mutual funds and the recent DiDC actions authorizing certain deposit instruments to be offered at competitive interest rates beginning August 1.

^eMr. Partee dissented from this action because, as at the previous meeting, he preferred to give more emphasis to reducing the risk of a cumulative decline in the growth of M1B in light of the indications of weakening in economic activity. Accordingly, he favored specification of a somewhat higher objective for growth of M1B over the period from June to September, and without the additional weight assigned to the potential for more rapid growth in M2. In his view, the short-run behavior of M2 was subject to great uncertainty because of the volatile influence of money market mutual funds, the liberalization of deposit rate ceilings on small saver certificates beginning August 1, and the introduction of tax-exempt "all savers" certificates beginning October 1.

^fMr. Wallich dissented from this action because he favored specification of somewhat lower rates for growth in the monetary aggregates over the last three months of 1981 than those adopted at this meeting and was willing to accept a greater shortfall in growth of M1B from the Committee's range for over the year. In his opinion, much of the shortfall was attributable to a decline in the public's desire to hold transaction balances of the types included in M1B and to the growth of other asset forms, especially money market mutual funds, that to some extent serve as transaction balances. He was also concerned that the public might perceive fairly rapid monetary growth over the balance of the year as a relaxation of the System's policy of restraint, especially if such growth were to be accompanied by sizable decreases in interest rates.

^gMr. Solomon dissented from this action because he felt it was particularly important at the beginning of an annual target period that the Committee not formulate its directive in terms that conveyed an unrealistic sense of precision. In his view, the directive language referring to the November-to-March growth rates in M1 and M2 did seem to convey such a sense.

Mr. Boykin dissented from this action because he favored specification of somewhat lower rates for growth in the monetary aggregates from November to March. For M2 in particular, he stressed the desirability of specifying a rate no higher than the range of 6 to 9 percent that had earlier been tentatively adopted for growth over 1982, with a view to avoiding a possible interpretation that the Committee had implicitly raised its objective before completion of the current review of the growth ranges for 1982.

^hMr. Wallich dissented from this action because he thought the ranges adopted for growth of M1A and M1B were too high. He believed that somewhat lower ranges would provide adequate monetary growth in 1981, because he expected a further downward shift in money demand and also because growth of the monetary aggregates over the past year generally had exceeded the specified ranges.

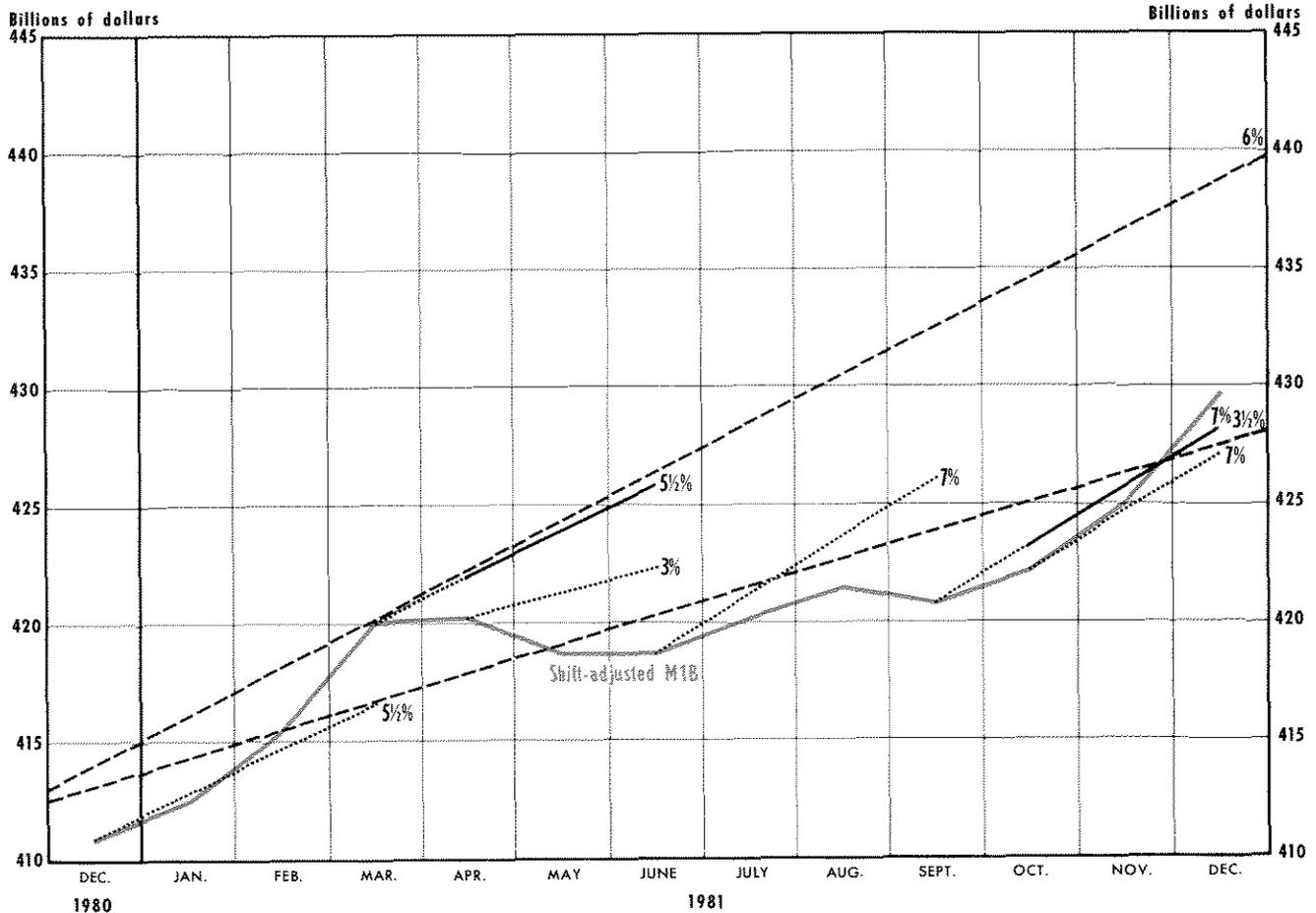
Meetings in February and March

The first phase encompasses the FOMC's first two meetings in February and March. In determining short-run policy objectives at the February meeting, the Committee took special note of the fact that the growth of shift-adjusted M1B, from the fourth quarter of 1980 to January 1981, had fallen below the lower end of its annual range. It was generally agreed that open market operations, before the March meet-

ing, should be directed toward a *gradual* restoration of the growth in shift-adjusted M1B to a rate consistent with its annual range. While there was disagreement over the acceptable amount of growth during the intermeeting period, it was agreed that the gradual approach lessened the danger of misinterpreting policy intentions.

In accepting the gradual approach toward encouraging rates of monetary growth consistent with the ranges adopted for 1981, several members com-

Chart 4
Short-Term and Long-Term Growth Objectives for Shift-Adjusted M1B
Based on First-Published Data



NOTE: Long dashed lines represent the long-term growth objectives for shift-adjusted M1B for the period IV/80-IV/81. Short dashed lines represent the current short-term growth objectives for shift-adjusted M1B. All growth objectives treated as simple annual rates of change. Data are "first-published" numbers from the Board's H-6 release. These data may differ significantly from the data revised as of February 1982.

mented on the danger of potentially confusing interpretations of policy intentions and also of possible instability in financial markets. It was observed, for example, that efforts to raise monetary growth promptly toward the longer-run paths could have the undesirable consequences of encouraging first relatively rapid growth and then an abrupt deceleration. A few members also suggested that the gradual approach to making up the shortfall would be acceptable provided that it proved to be compatible with relative stability or some easing in money market pressures.²⁰

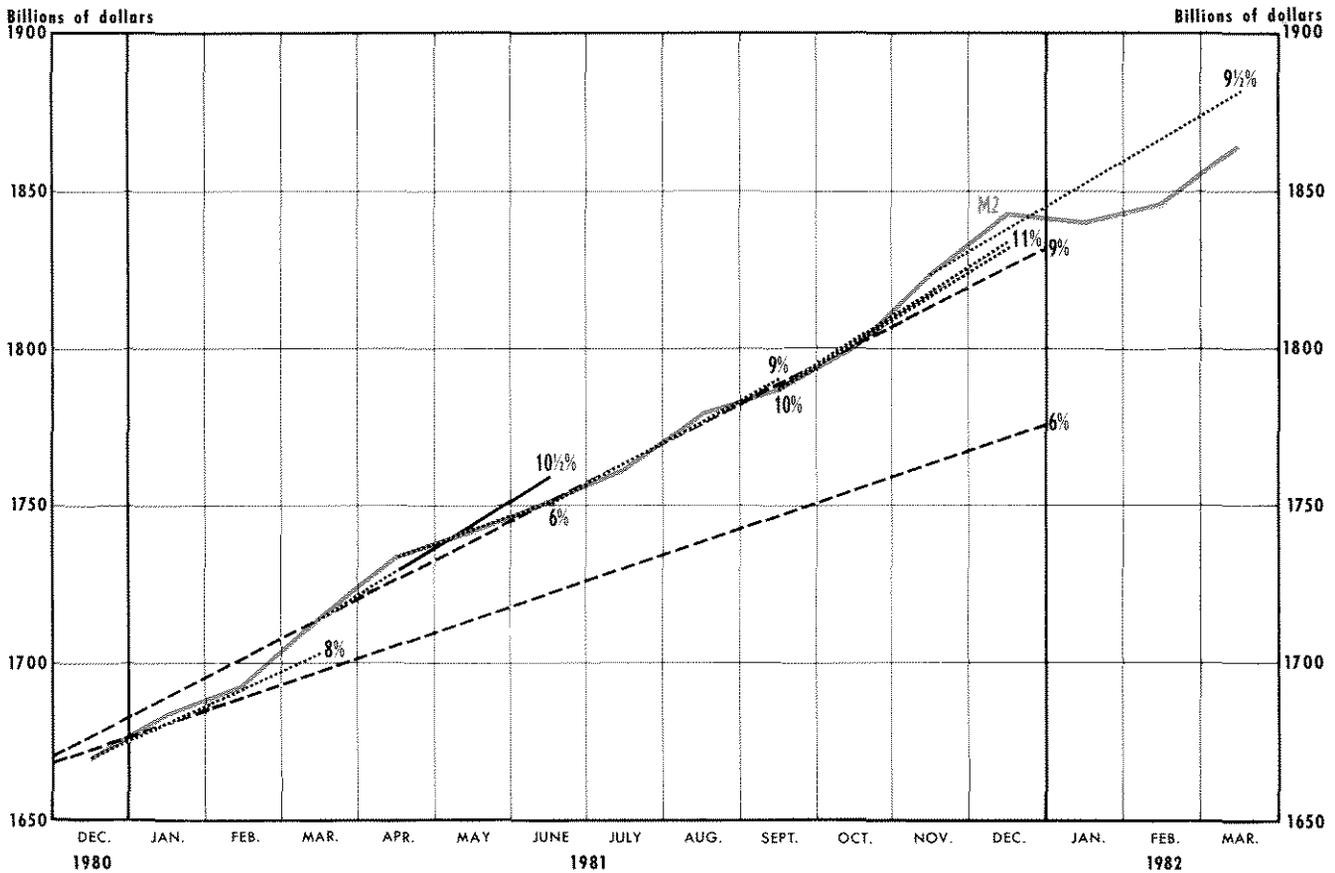
At the March meeting, it was noted that the growth of shift-adjusted M1B had expanded substantially during the first two weeks in March, but remained at a level below the bottom end of its annual range. It was also reported that the growth of M2 had ap-

parently accelerated considerably in March, spurred on by a record expansion in money market mutual funds that had more than offset the weakness in small savings and time deposits. It was argued that the weakness in the growth of shift-adjusted M1B might be a misleading indicator of the growth of transactions balances, since a part of the rapidly growing money market mutual funds might themselves be considered transactions balances. As a result of this discussion, the Committee decided to give *more weight than before to M2* in interpreting its short-run policy directives.²¹

²⁰"Record" (April 1981), pp. 316-17.

²¹"Record" (June 1981), pp. 500-01. Many MMMFs have check-writing privileges. However, most require checks to be written in amounts of \$500 or more. For an analytical argument why MMMF deposits should not be considered money, see R. W. Hafer, "Much Ado about M2," this *Review* (October 1981), pp. 13-18.

Chart 5
Short-Term and Long-Term Growth Objective for M2 Based on First-Published Data



NOTE: Long dashed lines represent the long-term growth objectives for M2 for the period IV/80-IV/81. Short dashed lines represent the current short-term growth objectives for M2. All growth objectives treated as simple annual rates of change. Data are "first-published" numbers from the Board's H-6 release. These data may differ significantly from the data revised as of February 1982.

The Committee established a short-run growth rate for shift-adjusted M1B for the period March to June of "5½ percent or somewhat less," and for M2 of "about 10½ percent," some 2½ percentage points above the range established in February.²²

If achieved, these short-run growth rates would have resulted in a level of shift-adjusted M1B at the upper bound of its annual target and of M2 above the upper bound of its annual target, as illustrated in charts 4 and 5. Thus, the Committee raised the short-run target growth rate for M2 and simultaneously gave more weight to M2 in evaluating the behavior of the monetary aggregates.

²²The disparity in the changes in these rate ranges for shift-adjusted M1B and M2 is even more pronounced when "base drift is taken into consideration." On March 31, shift-adjusted M1B was at a level below the lower end of its annual range, while M2 was above the upper end of its annual range.

Table 4
Growth Rates of Monetary Aggregates and Adjusted Monetary Base for 1981¹

Period	Adjusted monetary base	M1B	Shift-adjusted M1B	M2
1/1981 - 5/1981	7.0%	8.1%	4.1%	12.0%
5/1981 - 9/1981	2.3	1.4	4	7.9
9/1981 - 12/1981	5.7	9.0	7.6	9.9

¹Data revised by Board of Governors, February 1982.

Meetings in May through August

The second phase of short-run policy directives encompasses the May through August meetings. Its beginning is marked by a reversal of the policy of gradually accelerating growth of shift-adjusted M1B, which was characteristic of the February and March meetings. At the May meeting, the Committee noted that the growth of the monetary aggregates had been very rapid during March and April. The Board staff told the Committee that the growth of shift-adjusted M1B during May and June would have to be negligible if the growth rates specified in March were to be achieved.²³ However, the staff's analysis indicated that the growth of M2 in the coming months would be less rapid, reflecting a slowing in the growth of savings and small-denomination time deposits and a weakness in the growth of MMMFs. It was reported that the broader monetary aggregates might move back toward the tops of their annual target ranges.

The Committee took particular note of the continuing strength of economic activity in the first quarter, the rise in income velocity of M1B, which it believed posed the risk of pressure for further expansion of money and credit later in the year, and the continuing strength of inflation expectations in deciding to reduce the growth of the monetary aggregates rather quickly.²⁴ The Committee voted for a substantial deceleration in the growth of the monetary aggregates. The target rates of growth of shift-adjusted M1B and M2 were reduced to "3 percent or lower" and "about 6 percent," respectively, for the two-month period from April to June.

By the July meeting, the Committee noted that the rapid deceleration in the growth rates of the monetary aggregates that it had voted for in May had materialized. It was reported that the growth rate of M2 was reduced to about 5 percent for the May and June periods and that shift-adjusted M1B declined at annual rates of 5 percent in May and 10½ percent in June, following a growth rate of almost 17 percent in April. This brought the growth rate of shift-adjusted M1B to about 2¼ percent from the fourth quarter of 1980 to the second quarter of 1981, over

1 percentage point below the lower end of the annual range.²⁵ At the same time, it was noted that the shortfall in the rate of growth of shift-adjusted M1B was accompanied by an unusually large increase in its income velocity. The significance of the relative growth of shift-adjusted M1B and M2 was considered once again.

The shortfall in growth of shift-adjusted M1B in the first half of the year followed relatively rapid growth in the latter part of 1980; and it was accompanied by an usually rapid rise in the income velocity of money, as nominal GNP expanded strongly. In partial explanation, extraordinarily high interest rates in combination with the introduction of NOW accounts on a nationwide basis apparently provided a greater stimulus to intensive management of cash balances than that normally associated with an increase in interest rates. In the period ahead, M1B might behave somewhat differently from earlier measures of transaction balances, because of the sizable volume of deposits earning interest and because of the greater weight of household balances in the total. The behavior of M2 was likely to be affected to some extent by two recent decisions of the Depository Institutions Deregulation Committee (DIDC), effective August 1: one removed rate caps on the 2½-year small saver certificate, enabling the rate to fluctuate with the yield on 2½-year Treasury securities at all levels; and the other eliminated ceilings altogether on small time deposits with initial maturities of four years or more. The rapid growth of money market funds appeared to influence the growth of both M1 and M2, in opposite directions, but the magnitude of the effects was difficult to judge.²⁶

At the conclusion of this discussion, the Committee decided to foster the growth of shift-adjusted M1B over the third quarter that would be fast enough to push the growth of this aggregate toward the lower end of its annual range. Accordingly, the Committee adopted the following short-run policy directive.

In the short run the Committee seeks behavior of reserve aggregates consistent with growth of M1B from June to September at an annual rate of 7 percent after allowance for the impact of flows into NOW accounts (resulting in growth at an annual rate of about 2 percent from the average in the second quarter to the average in the third quarter), *provided that growth of M2 remains around the upper limit of, or moves within, its range for the year* (italics added).²⁷

The Committee established a growth rate for shift-adjusted M1B that, if achieved, would result in a level of shift-adjusted M1B just above the lower end of its annual range. This policy directive was reaf-

²³"Record" (July 1981), p. 568.

²⁴The Committee anticipated that the large bulge in the income velocity of M1B would reverse itself later in the year, resulting in a significant increase in the demand for M1B and a correspondingly large increase in the level of M1B later. See "Record" (July 1981), p. 568; "Record" (June 1981), p. 500; and "Record" (September 1981), p. 715.

²⁵"Record" (September 1981), p. 713.

²⁶Ibid., p. 715.

²⁷Ibid., p. 718.

firmed at the August meeting.²⁸ However, even this growth path was conditional on the M2 proviso, that is, on M2 remaining about or moving within its annual growth rate range.

By the August meeting, the Committee was concerned that new legislative and regulatory changes were likely to alter the relative growth paths of shift-adjusted M1B and M2 still further. In particular, it expressed uncertainty about the effect of the liberalization of interest rate ceilings on small-savers certificates and the then-pending introduction of tax-exempt All-Savers Certificates.²⁹ It was thought that these developments, especially the All-Savers Certificates, might contribute to a marked acceleration in the growth of M2 during the fourth quarter of the year.³⁰ Several Committee members expressed concern about relying too much on M2 in view of the potential sources of distortion. At the end of this discussion, the Committee reiterated the short-run objectives it had agreed upon at its July meeting.

Meetings in October through December

At the October meeting, the Committee took particular note of the widening divergence in the behavior of shift-adjusted M1B and the broader monetary aggregates. It continued to express uncertainty about the impact of the recent legislative and regulatory changes on the relative growth paths of the monetary aggregates. Moreover, it noted that the public's desire to hold transactions balances in forms included in M1B apparently had declined. This was evidenced by the unusually high level of M1B velocity, given interest rate levels. While the Committee generally agreed to seek more rapid growth in shift-adjusted M1B, it disagreed about how much more growth was appropriate and how the aggregates should be weighted.

Committee members agreed on the desirability of continuing to seek more rapid growth in M1B over the remaining three months of 1981, while taking account of the relative strength of the broader aggregates. The observation was made that a pickup in

growth of M1B now would reduce the risks of cumulative contraction in activity, which could well be followed by an excessively rapid recovery and expansion.

At the same time, many members expressed the view that very rapid growth of M1B over the few remaining months of the year would contribute to instability and would interfere with achievement of longer-term economic goals. Specifically, such growth most likely would dissipate the gains already made in moderating inflation, exacerbate inflationary expectations, and induce a rebound in interest rates after no more than a temporary decline. Moreover, rapid growth in M1B would significantly increase the risk that the broader monetary aggregates would exceed their ranges for growth over the year by sizable margins, which was a source of concern in light of the uncertainties about the interpretation of the various monetary aggregates in the current circumstances.³¹

At the end of this discussion, the Committee decided to give approximately equal weight to shift-adjusted M1B and M2 in developing short-run policy directives, and voted for more rapid growth in M2. This marked the beginning of the third phase in policy. The growth rate for M2 was established at "10 percent or slightly higher," at least 1 percentage point above the rate established by the M2 proviso of the previous two meetings. In contrast, the Committee established a growth rate of 7 percent for shift-adjusted M1B for the fourth quarter of 1981, the same short-run growth rate it had established for the third quarter.

By the November meeting, the Committee acknowledged that the downward drift in economic activity, which it had noted at the previous meeting, had developed into a recession. It also acknowledged that there was a modest shortfall in the growth of shift-adjusted M1B from the 7 percent rate that the Committee had established in October. Committee members continued to agree on the desirability of seeking somewhat more rapid growth in shift-adjusted M1B and reaffirmed their October growth path for the narrower aggregate. The growth path for M2, however, was increased to "around 11 percent," despite the fact that M2 was above the upper end of its annual range. Furthermore, it was understood that a faster growth of shift-adjusted M1B than specified in the short-run objective was acceptable.

It was understood that somewhat more rapid growth of M1B, consistent with the objective for

²⁸"Record" (October 1981), p. 794.

²⁹See "Record" (October 1981), p. 792. The Depository Institutions Deregulation Committee (DIDC) removed the interest rate "caps" on 30-month small-savers certificates effective August 1, 1981. The interest rate ceilings on small-savers certificates was allowed to fluctuate with the rate on 30-month Treasury securities. Prior to August 1, the caps were 11.75 percent for commercial banks and 12.00 percent for thrift institutions. The DIDC also approved the introduction of tax-exempt All-Savers Certificates effective October 1, 1981.

³⁰"Record" (October 1981), pp. 792-93.

³¹"Record" (December 1981), pp. 908-09.

growth over the fourth quarter adopted at the previous meeting, would be accepted in the event that transaction demands for money proved to be stronger than anticipated; it was also understood that moderate shortfalls from the growth path would not be unacceptable, particularly if broader aggregates continued to expand rapidly.³²

At the December meeting, the Committee noted that the growth of both shift-adjusted M1B and M2 had accelerated during November, reflecting the growth of other checkable deposits and the non-transactions components of M2. The Committee continued to express uncertainty about the interpretation of the monetary aggregates.

In the near-term pursuit of the fundamental objective of fostering the financial conditions that would help to reduce inflation and promote recovery in economic activity on a sustainable basis, the Committee continued to face considerable uncertainty about the interpretation of the behavior of the monetary aggregates. Growth of other checkable deposits (OCD) had picked up sharply in November and early December. (Such deposits include NOW accounts and ATS accounts at banks and thrift institutions and credit union share draft accounts.) Moreover, the surge in OCD was accompanied by a renewal of flows into savings deposits at commercial banks and continuation of substantial flows into money market mutual funds, which raised growth of M2 in November to the highest rate so far in 1981. Given the volatility of the behavior of the monetary aggregates in the short run, it seemed that the recent spurt might have resulted partly from an expansion of highly liquid precautionary balances at a time of considerable uncertainty about near-term economic and financial conditions, as well as a response to the lower level of market interest rates in earlier weeks.³³

After considerable discussion over the appropriate growth rates for the aggregates, the Committee decided to set target ranges for the period November 1981 to March 1982 of "4 to 5 percent" for M1 (previously measured M1B) and "around 9 to 10 percent" for M2. If achieved, this growth of M2 would produce a level of M2 in March 1982 above a

projection of the 11 percent growth rate that the FOMC had voted for at the November meeting. Thus, the apparent reduction in the desired growth rate of M2 is really more expansive when "benchmarked" at the November level of M2 (see chart 5).

CONCLUSIONS

During 1981, the Federal Reserve achieved a substantial reduction in the rate of growth of M1B (both shift-adjusted and unadjusted). In fact, shift-adjusted M1B grew at a rate substantially below the lower bound of its target range for the year. In contrast, the growth rates of the broader monetary aggregates were more rapid than a year earlier.

Monetary policy decisions in 1981 reflect the Committee's commitment to restrain the growth of the monetary aggregates. However, uncertainty about the effect of financial developments on the growth rates of shift-adjusted M1B and M2 and on the relationship between these aggregates and economic activity led to uncertainty about which aggregate is most important to control. As a result, the FOMC twice changed its weighting of shift-adjusted M1B and M2 for the purpose of implementing its short-run policy directives. During most of the year, the Committee allowed shift-adjusted M1B to grow below the bottom of its annual target range when M2 grew within or at the top of its range. In the fourth quarter of the year, M2 was permitted to exceed the top of its annual range when the Committee increased the priority for a faster growth of the narrower aggregate in response to declining economic activity.

Thus, it appears that the most significant question for monetary policymakers in 1981 was which monetary aggregate to control in a financial environment marked by innovation and regulatory change. The impact of such developments on the growth rates of the monetary aggregates, and the relationship between the aggregates and economic performance will undoubtedly be significant policy issues in 1982.

³²"Record" (January 1982), p. 42.

³³"Record" (February 1982), p. 108.

Appendix: Summary of Discussion at Committee Meetings

February 2-3 Meeting

In their discussion of the economic outlook and situation during this meeting, Committee members disagreed on the expected path of real output and unemployment for 1981. However, all members anticipated a somewhat higher inflation rate for 1981.

At this meeting, the Committee completed a review of the long-term growth rates of the monetary aggregates for the period from the fourth quarter of 1980 to the fourth quarter of 1981, as mandated by the Full Employment and Balanced Growth Act of 1978. This discussion began at the December 1980 meeting. Members of the Committee agreed that, in light of their long-standing goals of contributing to a reduction in inflation and providing a basis for the restoration of economic stability and growth in real output, a further reduction in the ranges for monetary growth was appropriate. However, there was concern that the impact of the nationwide introduction of NOW accounts on December 31, 1980, as authorized under the Monetary Control Act of 1980, had changed the relationships among the measured growth rates of the monetary aggregates.

It had been anticipated that shifts into NOW accounts would significantly reduce the growth in M1A and enhance the growth of M1B. However, the experience during the first few weeks in January revealed much larger shifts than anticipated. It was generally concluded that estimates of the impact of such shifts on the measured growth rates of the two monetary aggregates could be only tentative due to the size of and uncertainty about the ultimate source of the funds. Nevertheless, the Committee, abstracting from the NOW account effects, specified ranges for M1A and M1B, one-half percentage point below the 1980 ranges. While the members differed somewhat more in their views about the growth rates for the broader monetary aggregates, the Committee

ultimately decided to maintain the 1980 long-term growth rates for M2 and M3 and commercial bank credit in 1981.

Considering the objectives for monetary growth for the intermeeting period, the Committee took particular note of the fact that both M1A and M1B had fallen below their 1981 growth paths during the December-January period. It was generally agreed that open market operations should be directed toward a gradual restoration of the growth in M1A and M1B, adjusted for NOW account effects. Almost all members were willing to accept the continuation of relatively slow growth in relation to the ranges for 1981, at least through March, in recognition that it would generally compensate for the rapid growth during the fourth quarter of 1980, which carried growth for the year slightly above the upper bounds of the ranges.

Thus, the Committee decided to seek growth rates in M1A and M1B that would gradually bring these aggregates within their annual target ranges, with the provision that the Chairman would be notified if a range for the federal funds rate of 15 to 20 percent appeared to be inconsistent with the monetary and related reserve paths.

Late in February, data on M1A and M1B, after adjusting for NOW account shifts, indicated these aggregates were growing at rates well below those consistent with the policy directive. Simultaneously, the growth in M2 and M3 was stronger than anticipated. Also, the federal funds rate had declined to around the 15 percent level. As a result of a telephone conference on February 24, the Committee adopted the following modification to its earlier policy directive:

In light of the relatively strong growth of M2 and M3 and the substantial easing recently in money market conditions, as well as uncertainties about the interpretation of the behavior of M1, the Committee on February 24 agreed to accept some shortfall in growth of M1A and M1B from the specified rates in the domestic policy directive adopted on February 3 as consistent with developments in the aggregates generally and the objectives for the year.¹

Note: Citations to "Record of Policy Actions of the Federal Open Market Committee" are referred to as "Record." Money growth rates referred to in this appendix are taken from published minutes of the Committee's meetings for 1981 and, therefore, may not correspond to more recent benchmark revisions. The data reflect information available to the Committee at the time of the meetings.

¹"Record" (April 1981), p. 318.

Organization of the Committee in 1981

The Federal Open Market Committee (FOMC) consists of 12 members: the seven members of the Federal Reserve Board of Governors and five of the 12 Federal Reserve Bank presidents. The Chairman of the Board of Governors is, by tradition, also chairman of the Committee. The president of the New York Federal Reserve Bank is, also by tradition, its vice chairman. All Federal Reserve Bank presidents attend Committee meetings and present their views, but only those presidents who are members of the Committee may cast votes. Four memberships rotate among Bank presidents and are held for one-year terms beginning March 1 of each year. The president of the New York Federal Reserve Bank is a permanent voting member of the Committee.

Members of the Board of Governors at the beginning of 1981 included Chairman Paul A. Volcker, Frederick H. Schultz, Henry C. Wallich, J. Charles Partee, Nancy H. Teeters, Emmett J. Rice and Lyle E. Gramley. The following presidents served on the Committee during January and February 1981: Roger Guffey (Kansas City), Frank E. Morris (Boston), Lawrence K. Roos (St. Louis) and Willis J. Winn (Cleveland). The Committee was reorganized in March and the four rotating positions were filled by: Edward G. Boehne (Philadelphia), Robert H. Boykin (Dallas), E. Gerald Corrigan (Minneapolis), Silas Keehn (Chicago).¹

The Committee met eight times during 1981 to discuss, among other things, economic trends and to decide upon the future course of open market operations.² As in previous years, however, telephone or telegram consultations were held occasionally between scheduled meetings. During each regularly scheduled meeting, a directive was issued to the Federal Reserve Bank of New York. Each directive contained a short review of economic developments, the general economic goals sought by the Committee, and instructions to the Manager of the System Open Market Account at the New York Bank for the conduct of open market operations. These instructions were stated in terms of short-term rates of growth of M1A, shift-adjusted M1B and M2 that were considered to be consistent with desired longer-run growth rates of the monetary aggregates.³ The Committee also specified intermeeting ranges for the federal funds rate. These ranges provide a mechanism for initiating consultations between meetings whenever it appears that fluctuations within the specified range is proving inconsistent with the objectives for the behavior of the monetary aggregates.

The Account Manager has the major responsibility for formulating plans regarding the timing, types and amount of daily buying and selling of securities in fulfilling the Committee's directive. Each morning the Manager and his staff plan the open market operations for that day. This plan is developed on the basis of the Committee's directive and the latest developments affecting money and credit market conditions, growth of the monetary aggregates and bank reserve condi-

tions. The Manager then informs staff members of the Board of Governors and one voting president about present market conditions and open market operations that he proposes to execute that day. Other members of the Committee are informed of the daily plan by wire.

The directives issued by the Committee and a summary of the reasons for the Committee actions are published in the "Record of Policy Actions of the Federal Open Market Committee." The "Record" for each meeting is released a few days after the following Committee meeting. Soon after its release, the "Record" appears in the *Federal Reserve Bulletin*. In addition, "Records" for the entire year are published in the *Annual Report of the Board of Governors*. The "Record" for each meeting during 1981 included:

- 1) A staff summary of recent economic developments — such as changes in prices, employment, industrial production, and components of the national income accounts — and projections of general price, output, and employment developments for the year ahead;
- 2) A summary of recent international financial developments and the U.S. foreign trade balance;
- 3) A summary of recent credit market conditions and recent interest rate movements;
- 4) A summary of open market operations, growth of monetary aggregates and bank reserves, and money market conditions since the previous meeting;
- 5) A summary of the Committee's discussion of current and prospective economic and financial conditions and of current policy considerations, including money market conditions and the movement of monetary aggregates;
- 6) Conclusions of the Committee;
- 7) A policy directive issued by the Committee to the Federal Reserve Bank of New York;
- 8) A list of the members' voting positions and any dissenting comments;
- 9) A description of any actions and consultations that may have occurred between the regularly scheduled meetings.

¹Mr. Keehn took office as President of the Chicago Bank on July 1, 1981 and subsequently became a voting member of the FOMC. From March to June, Mr. Winn voted as an alternate member.

²No formal meetings were held in January, April, June or September of 1981.

³At the March 31 meeting of the Committee, short-term growth objectives for M1A were discontinued.

March 31 Meeting

The Committee's discussion of policy for the immediate future focused on two interrelated issues: the desired rate of growth of narrowly defined money, and the appropriate weight for M2 in implementing policy. It was suggested that the slow rate of growth of M1B during the early months of the year might be a misleading indicator of the growth rate of transactions balances over this period. It was argued that some part of money market mutual funds might be regarded as transactions balances. Thus, the rapid growth in these funds might indicate a faster growth in transactions balances than the growth rate of measured M1B would show.

The Committee also noted that shifts into money market accounts would probably continue to distort the growth of M1B to an unpredictable extent. Thus, the Committee agreed to the following change in procedure:

In evaluating the behavior of the aggregates, it was agreed that greater weight than before would be given to the behavior of M2.²

On May 6, the Committee held a telephone conference. Available data showed a sharp increase in the rate of growth of M1B, pushing it to about the midpoint of the 3½ to 6 percent range established for 1981. The growth of M2 had decelerated slightly in April; however, it continued to expand at a relatively rapid rate. Simultaneously, it was reported that the reserves supplied through open market operations declined substantially, putting strong pressure on banks' reserve positions. As a result, borrowings from the Federal Reserve increased sharply in late April and early May, the federal funds rate increased from 13 to 14 percent and the surcharge was increased from 3 to 4 percent, effective May 5. Due to the short time before the next regularly scheduled meeting on May 18, the Committee agreed to maintain the short-run objectives for monetary growth established at the March 31 meeting.

May 18 Meeting

The staff projections presented at this meeting indicated that the sharp upturn in real GNP that occurred in the first quarter of the year would moderate over the rest of 1981. However, a number of Committee members expressed the opinion that the expansion in economic activity over the remainder of the year was likely to exceed earlier expecta-

tions. It was generally agreed that there was a need to reduce the growth rates of the monetary aggregates quickly in order to maintain a posture of monetary restraint.

In considering objectives for monetary growth over the remainder of the quarter, the members in general agreed that a posture of restraint needed to be maintained. They generally agreed with the view that it was particularly important to reduce growth of the monetary aggregates rather quickly, and initial differences in views concerning the precise specifications for monetary growth were relatively narrow. In the discussion a number of points were emphasized. The indications of continuing strength in economic activity combined with the recent exceptional rise in the income velocity of money posed the risk of pressure for excessive expansion in money and credit as the year developed. Growth of the broader monetary aggregates was already somewhat high relative to the Committee's ranges for the year. The indications of some slowing of the rise in the consumer price index did not appear to reflect as yet any clear relaxation of underlying inflationary pressures, and emphasis was placed on the importance of conveying a clear sense of restraint at a critical time with respect to inflation and inflationary expectations.³

Thus, the Committee reduced the short-run growth rate ranges rather sharply from the levels established at the March 31 meeting.

In the short run the Committee seeks behavior of reserve aggregates consistent with a substantial deceleration of growth in M1B from April to June to an annual rate of 3 percent or lower, after allowance for the impact of flows into NOW accounts, and with growth in M2 at an annual rate of about 6 percent. The shortfall in growth of M1B from the two-month rate specified above would be acceptable, in light of the rapid growth in April and the objective adopted by the Committee on March 31 for growth from March to June at an annual rate of 5½ percent or somewhat less.⁴

July 6-7 Meeting

In accordance with the provisions of the Full Employment and Balanced Growth Act of 1978, the Committee reconsidered its long-term growth ranges for the monetary aggregates from the fourth quarter 1980 to the fourth quarter 1981 and gave preliminary consideration to its long-run ranges for the fourth quarter 1981 to the fourth quarter 1982. It cited the recent unexpected strength in the economy and the need to reduce the rate of inflation as the primary considerations that influenced its choice of long-run ranges.

²"Record" (June 1981), p. 501.

³"Record" (July 1981), p. 568.

⁴Ibid., p. 569.

In the Committee's discussion of the longer-run ranges, the members were in agreement on the need to maintain a policy of restraint. However, continuation of the increase in velocity of M1B at the rate of the first half seemed unlikely, and thus the public's demand for narrowly defined money would probably pick up in the second half. Moreover, a significantly more rapid increase in narrowly defined money would be necessary to reach the Committee's objective for the year. At the same time, it was observed that the present situation provided a critical opportunity to sustain the signs of progress in reducing the rate of inflation, an opportunity that could be lost if monetary growth in the months ahead became too rapid. Even if rapid monetary expansion should lower interest rates, which was debatable, such effects would likely be temporary, and latent demands for goods and services would be released at the potential cost of a still more difficult period of high interest rates and financial strains later. The point was made that lasting declines in nominal interest rates and a solid base for sustained growth would depend on convincing progress in reducing inflation.⁵

In reaffirming the fourth quarter 1980 to fourth quarter 1981 growth rate ranges for the monetary aggregates established during the February meeting, the Committee expected that the growth in M1B for the year would be near the lower end of its annual range, while growth in the broader monetary aggregates might be high in their ranges.⁶

In the Committee's discussions of policy for the short run, it argued for faster growth in M1B, that would permit third-quarter growth in this aggregate toward the lower end of its range for the year.

However, the Committee wanted to be cautious, avoiding too rapid a rebound in M1B. It was argued that too rapid expansion in M1B would need to be sharply reduced later and might tend to raise the growth in M2 above the upper end of its target range for the year. Thus, the Committee introduced the following M2 proviso into its domestic policy directive.

In the short run the Committee seeks behavior of reserve aggregates consistent with growth of M1B from June to September at an annual rate of 7 percent after allowance for the impact of flows into NOW accounts (resulting in growth at an annual rate of about 2 percent from the average in the second quarter to the average in the third quarter), *provided that growth of M2 remains around the upper limit of, or moves within, its range for the year* (italics added).⁷

⁵"Record" (September 1981), pp. 715-16.

⁶Ibid., p. 716.

⁷Ibid., p. 718.

August 18 Meeting

In discussion of policy for the immediate future, the Committee engaged in a lengthy discussion of the impact of financial developments on the growth paths of the monetary aggregates. In particular, the impact of recent legislation and regulatory developments on the growth rate of M2 was questioned.

Among the uncertainties in question were the further impact on M2 of the liberalization of interest rate ceilings on small saver certificates, the continuing attractiveness of money market mutual funds, and the extent to which payments to stockholders as a result of recent merger activities were being invested in nontransaction-type accounts included in M2. Even more difficult to assess was the impact of the introduction of tax exempt "all saver" certificates on October 1, 1981; those certificates could well contribute to a marked acceleration in M2 growth during the fourth quarter, but in the interim measured M2 might be artificially lowered to the extent that funds earmarked for investment in these new instruments were being temporarily accumulated in repurchase agreements with October 1 maturities.⁸

The view was expressed that, because of the increasing difficulty in interpreting the performance of the monetary aggregates, one might argue that more weight should be given to interest rates in evaluating monetary policy. However, it was argued that an attempt to stabilize or reduce interest rates might be counterproductive if it forced excessive monetary expansion and then encouraged inflation expectations. Some members of the Committee had expressed the belief that there were signs that inflation expectations were beginning to abate. Several members expressed concern about placing too much emphasis on M2, given the potential sources of distortion of this aggregate. Nevertheless, the Committee's short-run domestic policy directive contained an M2 proviso.

In the short run the Committee continues to seek behavior of reserve aggregates consistent with growth of M1B from June to September at an annual rate of 7 percent after allowance for the impact of flows into NOW accounts (resulting in growth at an annual rate of about 2 percent from the average in the second quarter to the average in the third quarter), *provided that growth of M2 remains around the upper limit of, or moves within its range for the year* (italics added).⁹

⁸"Record" (October 1981), p. 792.

⁹Ibid., p. 794.

Much of the discussion at this meeting centered on concerns over the appropriate weighting of the monetary aggregates given their divergent growth paths. This discussion followed along lines similar to the August meeting. It was decided that equal weight would be given to movements in M1B and M2. The M2 proviso, which had first appeared in July domestic policy directive, did not appear in the policy directive for this meeting.

The Committee recognized that the behavior of that aggregate would be affected by the recent regulatory and legislative changes, particularly the public's response to the availability of the all savers certificate. In developing related reserve paths, approximately equal weight would be given to the movements in M1B and M2. It was understood that if these objectives were realized, growth of M1B from the fourth quarter of 1980 to the fourth quarter of 1981 would remain below the Committee's range for the year, while growth of M2 would equal or slightly exceed the upper end of its range.¹⁰

There was a general consensus that real GNP was drifting downward and would likely continue to follow this general path into mid-1982. It was noted that a more rapid expansion of M1B growth would reduce the risk of a cumulative contraction in real economic activity. However, many Committee members expressed concern that too rapid expansion of M1B over the remaining months of the year might exacerbate inflation expectations, thus dissipating gains in moderating inflation made so far during the year. It was feared that this would cause interest rates to rise after no more than a temporary decline.

November 17 Meeting

There was a general consensus among Committee members that the downward drift noted at the October meeting had developed into a recession. The weakness in the economy had begun to spread and intensify. However, it was thought that the scheduled reductions in federal income taxes, the projected increase in expenditures for national defense and falling interest rates would generate an upturn in economic activity sometime in mid-1982.

At the same time, the Committee remained concerned that inflationary tendencies remained strong. It was emphasized that inflation expectations would have a significant impact on long-term inter-

est rates and, thus, the ability of the economy to sustain a recovery. Thus, the Committee decided to pursue a somewhat more rapid growth of M1B provided the broader aggregates did not expand too rapidly.

Committee members continued to agree on the desirability of seeking somewhat more rapid growth in M1B, while taking account of the relative strength of the broader monetary aggregates. At the same time, however, questions were raised about how aggressively more rapid growth in M1B should be pursued in the short period before the end of the year. The view was expressed that objectives for growth of M1B over that interval should take account of the desirability of a smooth transition to the targets for monetary growth tentatively established for 1982 as well as the relatively rapid growth in the broader aggregates. While recognizing the variability of demands for money over the short run, many members thought that an aggressive effort to stimulate M1B growth over November and December at a pace sufficiently rapid to compensate for the shortfall in October would interfere with achievement of longer-term economic goals and would risk overly rapid expansion of money and credit in later months, particularly if the effort were accompanied by the precipitous decline in short-term interest rates to levels that might not be sustainable. Such a decline in short-term rates could exacerbate inflationary expectations and abort a desirable downtrend in bond yields and mortgage interest rates. . . . It was understood that somewhat more rapid growth of M1B, consistent with the objective for growth over the fourth quarter adopted at the previous meeting, would be accepted in the event that transaction demands for money proved to be stronger than anticipated; it was also understood that moderate shortfalls from the growth path would not be unacceptable, particularly if broader aggregates continued to expand rapidly.¹¹

The range for the federal funds rate was narrowed to 4 percentage points, 11 to 15 percent.

December 21-22 Meeting

In the Committee's discussion of the economic situation and outlook, the consensus was that real GNP was declining substantially in the current quarter. It was observed that the risk of further significant contraction in the automobile and housing industries appeared small. Furthermore, it was noted that the already legislated income tax reductions were likely to contribute to an upturn in economic activity by the middle of 1982.

With respect to the monetary aggregates, it was noted that shift-adjusted M1B had expanded in

¹⁰"Record" (December 1981), p. 909.

¹¹"Record" (January 1982), p. 41-42.

November and early December to levels somewhat above the levels established at the previous meeting. Nevertheless, the growth of shift-adjusted M1B from the fourth quarter of 1980 to the fourth quarter of 1981 was about 2 percent, about 1½ percentage points below the lower end of the annual range. Growth in M2 for November was at the highest rate thus far in 1981, reflecting a surge in its non-transactions component in addition to the recent strength in M1B. Growth over the year was estimated at about 9½ percent, somewhat above the upper bound of its annual range.

In discussing the near-term policy objectives, the Committee noted that its fundamental objective is to foster financial conditions that would help reduce inflation and promote economic recovery on a sustainable basis. However, the Committee continued to face considerable uncertainty about the interpretation of the behavior of monetary aggregates and, therefore, the desired growth rate.

Growth of other checkable deposits (OCD) had picked up sharply in November and early December. (Such deposits include NOW accounts and ATS accounts at banks and thrift institutions and credit union share draft accounts.) Moreover, the surge in OCD was accompanied by a renewal of flows into savings deposits at commercial banks and continuation of substantial flows into money market mutual

funds, which raised growth of M2 in November to the highest rate so far in 1981. Given the volatility of the behavior of the monetary aggregates in the short run, it seemed that the recent spurt might have resulted partly from an expansion of highly liquid precautionary balances at a time of considerable uncertainty about near-term economic and financial conditions, as well as a response to the lower level of market interest rates in earlier weeks.

Some members stressed the desirability of specifying growth rates for both M1 and M2 for the four-month period that would be within the ranges that had been tentatively adopted for 1982, partly with a view to avoid any possible misunderstanding of the Committee's objectives in the period before completion of the review of its growth ranges for 1982. Other members stressed the importance of avoiding an abrupt deceleration of monetary growth in the first quarter of 1982, particularly if accompanied by upward interest rate pressures, because such developments might well hamper recovery in economic activity. A number of members were willing to accept relatively rapid growth in the period ahead, to the extent that it reflected a continuation of the recent behavior of other checkable deposits and this might reflect expansion in its sizable savings component.¹²

At the conclusion of this discussion, the Committee established growth rates for M1 and M2 of 4 to 5 percent and "around 9 to 10 percent," respectively.

¹²"Record" (February 1982), p. 108.

