



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

December 13, 1982

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

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The memorandum, "Options for Intermediate Targets and Implications for Operating Procedures of Deposit Rate Deregulation," distributed December 10, 1982, contains a few typographical errors, and page 3 is missing from a number of copies. Attached are page 3 and corrected copies of pages 25 and 31.

Attachments

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PART I

Monetary and credit aggregates appear to encompass the measures that are most relevant for consideration as intermediate targets representing monetary policy and as guides for open market operations. Other potential targets, such as interest rates and GNP, have major drawbacks.

Announcement of interest rate targets or even interest rate expectations seems clearly counterproductive for a central bank. Such an announcement is unrealistic because it assumes more knowledge of the underlying strength or weakness of the economy, credit demands, and expectations than the central bank (or anyone) can have; the appropriate rates would have to be subject to continuous change as circumstances inevitably alter, undermining the central bank's credibility as it becomes necessary to adjust announced targets; the policy process would tend to be politicized; and markets would be distorted, with the prospect of undesired economic outcomes, in the degree that the central bank's rate "announcement" is itself a dominant factor in establishing market rate levels.

We also assume that the Federal Reserve should not announce a target for GNP, though it should, as it does, give expectations (within a range) of GNP outcomes thought generally consistent with whatever intermediate policy targets are chosen. A GNP target would make the central bank appear to be more powerful than it in fact is, and take on more responsibilities than it is capable of performing. Moreover, establishment of a GNP target would evidently raise difficult questions about the target's relation to goals set by the Administration.

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Even if the demand for M1 remains relatively stable under interest rate deregulation, other problems could detract from the usefulness of M1 as an intermediate target. These problems concern possible permanent changes in the responsiveness of M1 to movements in the general level of market rates of interest. The significance of this depends importantly on how sensitively depository institutions adjust their offer rates on checkable deposits in response to movements in market yields. As depository institutions adjust deposit rates to changes in market rates, the spread between them will vary much less than do market rates. Since it is this spread that affects the public's demand for M1, given changes in market rates will be associated with smaller changes in M1 than in the past, even recognizing that the existence of the proportional reserve requirement "tax" allows the size of the spread in basis points between market rates and "own" rates to vary positively, to at least some extent, with the level of market rates.

With variations in the level of market interest rates having a smaller effect on M1, movements in the aggregate might well be determined primarily by changes in income and prices. This might mean that M1 would be more closely associated with movements in income and prices making it a better intermediate target. It might also mean, however, that M1 would no longer be a leading indicator of these ultimate goals of policy. The loss of these "structural" lags could detract from the usefulness of M1 as an intermediate target.

A lower responsiveness of M1 to market interest rates also could involve monetary control problems. With a flexible own rate of return on M1, it may take larger changes in market rates to bring M1 back to its target once deviations occur. Thus a given degree of precision in short-run monetary control may involve more substantial interest rate volatility than

estimates mean that the interest elasticity of M2 is now only about 1/3 that of M1 over a month and about two-fifths that of M1 over the long run. It should be noted, moreover, that to the extent that the MMDA draws funds both out of M1 and out of instruments not included in either M1 or M2, the proportion of M2 represented by the nontransaction component should rise. Thus the responsiveness of M2 to a given change in market rates should decline further. Furthermore, introduction of a super NOW account will reduce the interest elasticity of M1, and hence further reduce that of M2 as well. Another econometric method provides additional evidence that the interest elasticity of M2 has already fallen sharply since the introduction of money market certificates in mid-1978.^{1/}

Controllability. The interest elasticity estimates are instructive, despite the uncertainty that surrounds them and despite the fact that they have to be modified in the future. They suggest that, even though quite sharp jumps in interest rates would be needed to offset fully a surge in M1 demand over a month, the interest rate impact of countering an equal percentage jump in the demand for M2 would be about three times greater.^{2/} Even over a year's time, interest rates would have to move about 2-1/2 times as much to offset a change in the demand for M2 compared to the same percent change in M1 demand, abstracting from feedback effects on income.

^{1/} This long run elasticity of M2 has been estimated to be -0.3 during 1960 through mid-1978 and -0.06 during mid-1978 through 1981. See John P. Judd and John L. Scadding, "Financial Change and Monetary Targeting in the United States," Federal Reserve Bank of San Francisco memorandum, November 1982.

^{2/} As discussed more fully below, the monthly percentage variation in M2 around its trend has averaged only three-fifths that of M1. Thus, rigidly holding M2 on a target path month-by-month would on average imply about 1-1/2 to 2 times more monthly volatility of short-term interest rates than would doing so with M1.