Briefing on Forecasts and Alternative Ranges for Money and Debt Growth

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The Committee would appear to face two primary issues regarding the money and credit aggregates and their long-run ranges: first, whether to increase the weight given to the monetary aggregates and, second, whether to adjust the provisional annual ranges selected last July.

As you know, the velocities of the broad monetary aggregates rose appreciably over the early 1990s in a substantial break with their earlier patterns, prompting the Committee to reduce their weight in policy. The upper panel of your first chart updates a scatterplot the staff presented to you last year. The standard measure of M2 opportunity costs is measured on the horizontal axis and the velocity of M2 on the vertical axis. The black dots and fitted line depict the experience during the thirty years ending in 1989, a period of considerable stability in M2 demand.

The subsequent shift in velocity, occurring during the early 1990s, is traced out by the red line. Many of the factors that evidently gave rise to that shift--a historically steep yield curve, deleveraging by households, the contraction of the thrift industry, and unusual restraint on the flow of credit through banks--have long since disappeared. Flows into bond and stock mutual funds, in contrast, have remained quite robust. The increased availability of such funds, large reported capital gains on fund investments over the past few years, and unaggressive bidding for deposits by banks all have encouraged the burgeoning of the mutual fund industry.

Despite the substantial ongoing reallocations of household portfolios associated with the growth of mutual funds, the velocity behavior of M2 over the past ten quarters or so,

shown by the green dots, appears to have stabilized. The green regression line has closely explained velocity since mid-1994. Interestingly, the line has a slope that is virtually identical to the one that prevailed before 1990, indicating that the long-run relationship between opportunity costs and V2 has apparently not changed much. The shorter-run responses, however, may have evolved. Lower transaction costs in shifting funds between M2 instruments and mutual funds, for example, could have sped up the reaction of money growth to interest rate variations.

There are plenty of reasons to be skeptical that the estimated new relationship will prove to be durable. The recent sample period has been brief, the range of variation of short-term opportunity cost limited, and the financial environment uniformly benign. Whether money demand maintains its recent relationship in the face of more pronounced swings in financial asset prices--for example, an appreciable stock market correction--remains to be seen.

Nonetheless, this relationship seems to be the best framework available for analyzing recent M2 growth, and the staff again has employed it in developing its forecast for M2 consistent with the Greenbook outlook, shown in the second column of the table at the bottom. Under that forecast, short-term interest rates and hence opportunity costs are expected to be about flat over 1997. Thus, M2 growth is projected to expand in line with the staff forecast for nominal income, at a 4-1/2 percent rate. Such growth would leave V2, as shown in the upper panel, little changed over 1997 and essentially on the estimated regression line.

The second line of the table indicates that M3 growth, as in 1996, is expected to be somewhat brisker than that of M2, running 6-1/4 percent this year. Although bank and thrift credit is expected to increase at a moderate pace, banks are likely to continue issuing a substantial volume of large time deposits in response to the much lower deposit insurance premiums, which will substitute in part for non-M3 sources of funds. Also, money market mutual funds are expected to continue to grow relatively quickly.

Domestic nonfinancial sector debt, the third line, is seen as expanding 5 percent this year, again a shade above nominal income growth. Although federal debt growth should be relatively modest and household borrowing is likely to slow this year, a growing business financing gap and heavy equity retirements should continue to buoy the expansion of overall debt.

In view of these forecasts, the Bluebook presented two alternative sets of ranges for the Committee's consideration, repeated here in the third and fourth columns. The first alternative comprises the provisional ranges established last July, which are identical to the ranges for 1995 and 1996. The second alternative raises the monetary ranges by one percentage point. With debt growth well centered in the provisional range, the second alternative does not include an increase in the range for that aggregate.

The exhibit on the next page presents a decision tree intended to help the Committee select ranges by considering three relevant issues identified in the boxes. The FOMC's choice may depend first on whether it plans to place more weight on the aggregates--and, in particular, on M2--in the conduct of policy. On the one hand, the recent stability of the demand for M2 may argue for placing a little more weight on that aggregate in policy

deliberations. The recent experience, while brief, has been impressive. Moreover, a monetary aggregate with appropriate stability properties can have significant benefits for policy. Trends in money growth can provide potentially useful information to policymakers, help anchor price movements over the long run, and assist the Federal Reserve in explaining adjustments to the stance of monetary policy. On the other hand, the Committee may well be concerned that the risk of unexpected developments in M2 demand remains substantial. The reliability of M2 has proved disappointing in the past, and the Committee may wish to await additional evidence of its stability to further reduce doubts about its usefulness before taking it more seriously in policy deliberations.

If Committee members concluded that it was not yet time to place more weight on M2, moving down the left branch of the tree, they may then wish to ask whether, nonetheless, increased predictability of the aggregates means that their ranges should be adjusted to better center them on expected outcomes. Faced with a similar situation last year, albeit with a shorter track record of recent good M2 behavior, the FOMC in effect said "no" and elected to retain the relatively low range for M2 growth of 1 to 5 percent. The Committee was concerned that the aggregates remained unpredictable and feared that adjusting the ranges to better encompass rates of growth that seemed most likely to be associated with its expectations for nominal income growth could be misinterpreted as an indication of increased weight on money--or, worse, as a signal of a less resolute anti-inflation policy. The Humphrey-Hawkins reports noted that monetary growth could be near the upper ends of the ranges and emphasized that the ranges served as a benchmark for money growth under conditions of reasonable price stability and historical velocity behavior. Most--but not all--

Committee members believed that this approach met the requirements of the Humphrey-Hawkins Act. Clearly, the Committee could follow the same approach this year. Consistency would seem to argue for maintaining this course unless the FOMC saw conditions as having changed significantly.

Alternatively, some Committee members, while not wanting to put any more weight on the aggregates, might think it appropriate to establish numerical ranges that are better centered on the expected outcomes for the current year. In this case, the Committee, moving diagonally down the "yes" branch in the middle, would need to examine its expectations for the course of policy. If policy will likely need to tighten significantly, money growth would probably come in noticeably below the staff baseline forecast--for example, the Bluebook predicted that M2 growth of about 3-3/4 percent, well within its provisional range, would be associated in 1997 with the "stable inflation scenario." In this case, the FOMC might want to retain the existing, alternative I, ranges. On the other hand, if the Committee was not prepared to prejudge that it would be firming policy this year, this argument would call for raising the ranges to better center them on expected outcomes. While alternative II does not exactly center them, it would move considerably in that direction.

The FOMC would also need to make a similar judgment about the probable course of policy if it did decide to place more weight on the monetary aggregates, moving down the right branch of the tree from the top. Because movements of the aggregates toward the limits of their ranges over the course of the year would raise questions about the stance of policy, the Committee would want to have some assurance that those limits were consistent with what it saw as likely to be appropriate policy. Thus, expectations of tightening during the

year, either with the objective of preventing an upward ratcheting of inflation or with the intent of making progress toward price stability, could be consistent with selection of the lower ranges of alternative I. But a view that substantial policy tightening during the year was not a foregone conclusion might lead policymakers to forecast that appropriate rates of money growth could well turn out to be at or even above the upper limits of the alternative I ranges and that a realignment, as under alternative II, would be most reasonable. Because the alternative II ranges still are not centered on expected outcomes, they might also be seen as consistent with the Committee's determination to reduce inflation over time and its view that there are greater odds that policy would need to tighten to contain an inflationary impulse than to ease in reaction to unexpected weakening in demand-- a view consistent with the Committee's asymmetric directive.