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cc USA, Dec 79
US Monetary Policy

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

14th December 1979

Dear Michael,

You asked for a brief on recent US monetary policy for the Prime Minister's meeting in the United States with the Chairman of the US Federal Reserve System. This is attached, along with a copy of Mr. Volcker's statement on 13th November before the relevant Sub-committees of the House Committee on Banking, Finance and Urban Affairs.

I am copying this to Martin Vile in the Cabinet Office.

Yours ever,

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US MONETARY MEASURES

Background

1. For much of 1979, policy makers in the US laboured under the belief that a recession was just around the corner. Therefore they were reluctant to push interest rates, already considered high, even higher for fear of intensifying it. A consistent picture seemed to be emerging in the first and second quarters when output advanced only slowly and then declined and the monetary aggregates appeared to be moving near the bottom of the target ranges.

2. By the late summer this picture had been shattered. It was obvious that the second quarter was affected by special factors such as the gasoline shortage and that the economy still had a great deal of strength left in it. Bank credit grew very rapidly; inflation was continuing to accelerate; output in the third quarter more than recovered the fall in the second; the dollar was weak. Most worrying of all, the climate of expectations was deteriorating rapidly. Speculative activity was appearing in commodity markets, not least gold; consumers instead of, as expected, drawing their horns in were buying now and paying later. The most widely watched price index, the CPI, was increasing at around 13 to 14 per cent.

3. In these circumstances, the Fed and, Mr Volcker in particular, decided that decisive action was needed to break this process. Mr Volcker has said "there was in early October no conflict or meaningful trade-off between domestic and international objectives. Nor was there any real trade-off between inflation and employment".

The Measures

4. On 6 October, a comprehensive package of measures was introduced:

a) The discount rate was increased by 1 per cent to 12 per cent.

b) Establishment of an 8 per cent reserve requirement on increases in "managed liabilities" above the level reached at the end of September or $100 million whichever is the larger. Managed liabilities include large certificates of deposit, eurodollar borrowings, repurchase agreements and borrowings from banks outside the Fed system. It was increases of these funds which were considered to have financed the rapid expansion in bank credit.

c) A change in the method used to conduct monetary policy. Though the existing monetary targets were not revised, in achieving them greater emphasis would be placed in day to day operations on the supply of bank reserves and less emphasis on confining short term fluctuations in the Fed funds rate (ie the rate of interest in the interbank market where banks trade surplus reserves to banks whose position is short).

5. The package was very favourably received, both at home and abroad and Mr Volcher was widely praised for having seized the initiative and made a clean break with the gradualist policies of his predecessor, Mr Miller.

Commentary

6. Most attention has been attracted by 4(b). Under the old system, the Fed set every two months a range for the Fed funds rate which it thought consistent with the monetary target. However, it had become apparent that in times of rising inflationary expectations an interest rate objective was a faulty compass as rising interest rates could variously be interpretted as a sign of increasing monetary tightness or an increase in demand due to rising expectations. In practice the Fed found itself supplying reserves to the banks and so permitting a rapid expansion of the money supply.

7. Under the new system, the Fed still takes as its starting point a target growth of the monetary aggregates but instead of calculating the interest rate which is thought to be consistent with it and operating on that, the Fed calculates the required growth in bank reserves and through its open market operations seeks to supply the desired amount of reserves.

8. When this was announced, some observers claimed that the Fed had adopted a fully fledged system of monetary base control, in which interest rates were left to find their own level. This is however, an exaggeration. The Fed is still concerned about the development of interest rates but is now prepared to accept a much wider variation. A range of 4 percentage points (from 11½ to 15½ per cent) was to be permitted, which compared with the range of 1½ points typically set before. If it becomes apparent that the objectives for reserves cannot be achieved even within the expanded range for interest rates, the Fed will reconsider the position. The key phrase is then "change of emphasis".

9. One advantage claimed for the new system is that the emphasis on reserves could be expected to produce a shift towards easier conditions in money markets more promptly whenever the demand for money and credit abated significantly in response to a weakening in economic activity.

Subsequent developments

10. The Fed has expressed satisfaction with subsequent developments. The monetary aggregates have grown more slowly and interest rates have fluctuated within the desired range. After rising very sharply immediately after announcement, bank prime rates have even eased a little. There has been a decline in speculative activity and the dollar has remained reasonably firm even in the face of uncertainties about Iran.

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11. The development of the economy remains as confusing as ever. Output was expected to fall in the fourth quarter but is still growing; and there is no easing in the rate of inflation.

Prospects

12. Although most observers still expect a fall in output in the first half of 1980, with a recovery perhaps towards the end of the year, there is little consensus on the severity of the recession. Similarly there is little agreement on how long interest rates will remain high. There are few however who doubt Mr Volcker's determination to continue present policies until there is an easing of inflation.

13. Attached is a copy of a statement by Mr Volcker to the House Banking Committee. It sets out very clearly his views on a number of issues.

HM Treasury
14 December 1979