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TO IMMEDIATE F C O
TELEGRAM NUMBER 3320 OF 12 OCTOBER
INFO PARIS, BONN, TOKYO, OTTAWA, UKREP BRUSSELS.
INFO SAVING ALL C.G.'S U.S.A.

read in full.

A SHIFT IN US MONETARY POLICY?

not

SUMMARY

1. FINANCIAL MARKETS AND COMMENTATORS HERE HAVE INTERPRETED THE OUTCOME OF LAST WEEK'S MEETING OF THE FEDERAL RESERVE'S MAIN POLICY COMMITTEE (THE FEDERAL OPEN MARKET COMMITTEE), AND THE REDUCTION IN FEDERAL RESERVE BOARD'S DISCOUNT RATE FROM 10 PER CENT TO 9 1/2 PER CENT, AS A SIGNIFICANT RELAXATION IN US MONETARY POLICY, AT LEAST IN THE SHORT RUN. HOWEVER, OPINION IS DIVIDED ON THE IMPORTANCE OF THE CHANGE FOR THE MEDIUM TERM. CHAIRMAN VOLCKER, IN A SPEECH LAST SATURDAY, SAID THAT NO CHANGE IN THE BASIC THRUST OF POLICY HAS BEEN MADE, BUT THAT TECHNICAL FACTORS MADE IT APPROPRIATE TO ATTACH 'MUCH LESS THAN USUAL WEIGHT' TO THE MAIN MONETARY AGGREGAT M1 IN THE PERIOD AHEAD AND TO MOVE TO A WIDER RANGE OF INDICATORS, ESPECIALLY M2 AND M3, IN JUDGING THE STANCE OF MONETARY POLICY. IT APPEARS TO MANY COMMENTATORS AS IF THE FED, AT LEAST IN THE WEEKS RUNNING UP TO THE 2 NOVEMBER CONGRESSIONAL ELECTIONS, AND PERHAPS UNTIL AN ECONOMIC RECOVERY GETS UNDER WAY, WILL CHOOSE TO ERR ON THE SIDE OF ACCOMMODATING UPWARD MOVEMENTS IN THE MONETARY AGGREGATES RATHER THAN RISK A SIGNIFICANT REVERSAL OF THE RECENT DECLINES IN INTEREST RATES.

DETAIL

2. DURING HIS ANNUAL HUMPHREY-HAWKINS TESTIMONY TO CONGRESS LAST JULY, CHAIRMAN VOLCKER SAID THAT MONETARY GROWTH 'SOMEWHAT ABOVE THE TARGETED RANGES WOULD BE TOLERATED FOR A TIME IN CIRCUMSTANCES IN WHICH IT APPEARED THAT PRECAUTIONARY OR LIQUIDITY MOTIVATIONS, DURING A TIME OF ECONOMIC UNCERTAINTY OR TURBULENCE, WERE LEADING TO STRONGER THAN ANTICIPATED DEMANDS FOR MONEY''. SUBSEQUENTLY, THE MAIN MONETARY AGGREGATE M1 ROSE ABOVE ITS TARGET RANGE, AND THERE WAS A GENERAL DECLINE IN INTEREST RATES, ESPECIALLY IN SHORT-TERM MARKET RATES. THERE HAS RECENTLY BEEN SPECULATION ABOUT WHETHER AND WHEN THE FED WOULD ADOPT A MORE RESTRICTIVE STANCE TO BRING MONETARY GROWTH IN LINE WITH THE TARGET RANGES.

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3. AT LAST WEEK'S FEDERAL OPEN MARKET COMMITTEE (FOMC) MEETING, A DECISION APPARENTLY WAS TAKEN TO CONTINUE TO IMPLEMENT MONETARY POLICY IN LINE WITH VOLCKER'S JULY STATEMENT, DESPITE RECENT MONETARY GROWTH ABOVE THE TARGET RANGES. THE EFFECT OF THE LEAKS FOLLOWING THE MEETING WAS TO CONTRIBUTE TO A FURTHER DECLINE IN INTEREST RATES. INTEREST RATES ON 3-MONTH TREASURY BILLS ARE NOW ABOUT 8 PER CENT AND ON LONG-TERM TREASURY BONDS LESS THAN 11 PER CENT. THE BANKS' PRIME RATES WERE REDUCED LAST WEEK FROM 13 1/2 PER CENT TO 13 PER CENT. THERE HAS BEEN A DRAMATIC UPSWING IN THE EQUITY MARKETS, AND THE DOW-JONES INDUSTRIAL AVERAGE ON THE NEW YORK STOCK EXCHANGE HAS RISEN ABOVE 1000. CHAIRMAN VOLCKER HAS BEEN ABLE TO EXPLAIN THE REDUCTION IN THE FED'S DISCOUNT RATE LAST FRIDAY FROM 10 PER CENT TO 9 1/2 PER CENT AS 'MAINTAINING AN APPROPRIATE ALIGNMENT WITH SHORT-TERM MARKET RATES'. AT LEAST SOME PART OF THE DECLINE IN MARKET RATES WAS ITSELF BECAUSE OF MARKET SPECULATION ABOUT THE OUTCOME OF TUESDAY'S FOMC MEETING.

4. AS WELL AS THE DECLINE IN US INFLATION: THERE WERE TWO TECHNICAL REASONS FOR THE FOMC DECISION THAT WERE CITED BY VOLCKER IN HIS SPEECH TO THE BUSINESS COUNCIL AT HOT SPRINGS ON 9 OCTOBER (EXCERPTS FROM THE SPEECH ARE CONTAINED IN MIFT). FIRST, THE MATURATION OF DOLLARS 31 BILLION IN "ALL SAVERS" CERTIFICATES ISSUED BY THE SAVINGS AND LOANS ASSOCIATIONS LAST YEAR, A LARGE PART OF THE PROCEEDS FOR WHICH WILL TEND ARTIFICIALLY TO INCREASE THE GROWTH OF M1. SECOND, THE INTRODUCTION IN A COUPLE OF MONTHS' TIME OF MONEY MARKET-TYPE DEPOSITS AT BANKS AND SAVINGS AND LOANS ASSOCIATIONS, WHICH WILL ALSO HAVE A DISTORTING EFFECT (ALTHOUGH WHETHER THIS WILL INCREASE OR DECREASE M1 IS UNKNOWN).

5. COMMENTATORS HERE HAVE WIDELY INTERPRETED THE FOMC DECISION AS GOING BEYOND A TECHNICAL ADJUSTMENT. THEY POINT OUT THAT SOME FED GOVERNORS, INCLUDING VOLCKER, HAVE REPEATEDLY VOICED THEIR CONCERN ABOUT THE CONTINUING SOFTNESS OF THE US ECONOMY, THE FINANCIAL WEAKNESS OF US COMPANIES AND FINANCIAL INSTITUTIONS, AND THE POTENTIAL INSTABILITY OF THE WORLD FINANCIAL SYSTEM. THE IMMINENCE OF THE CONGRESSIONAL ELECTIONS ON 2 NOVEMBER IS ALSO ADDUCED AS A FACTOR WHICH MIGHT HAVE MADE THE FOMC DECIDE TO ERR ON THE SIDE OF ACCOMMODATION RATHER THAN TIGHTNESS IN THE COMING WEEKS.

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6. SOME COMMENTATORS APPEAR TO EXAGGERATE THE CHANGE. THERE IS NO INDICATION THAT THE FED HAS DEPARTED FROM THE POLICY INTRODUCED IN OCTOBER 1979 OF TARGETING THE MONETARY AGGREGATES RATHER THAN INTEREST RATES. NOR DOES IT SEEM TO BE ENGAGED IN AN AGGRESSIVE CAMPAIGN TO BRING DOWN INTEREST RATES AT ALL COSTS. BUT THE FED MAY FIND IT DIFFICULT TO REVERSE ITS RELAXED STANCE UNTIL THERE ARE MORE DEFINITE INDICATIONS OF AN UPTURN IN THE US ECONOMY. ITS MONETARY STANCE WILL PROBABLY CONTINUE TO EVOLVE IN THE LIGHT OF DEVELOPMENTS IN THE ECONOMY AND FINANCIAL MARKETS.

7. F C O PLEASE PASS TO BOTTRILL (TREASURY), AND WATSON (BANK OF ENGLAND).

WRIGHT

[ADVANCED AS REQUESTED]

MONETARY
NAD
ERD
NEWSD

COPIES TO:-
MR BOTTRILL - TREASURY
MR WATSON - B/ENGLAND