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Prime Minister (2)

21 September 1982

ALAN WALTERS

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UNITED STATES MONETARY POLICY

Conclusions

In view of all the press speculation that monetary policy has changed and become more expansive, I thought that I ought to carry out a brief analysis and put press comment in its place. My conclusions are:

(a) Since 1979, US monetary policy has been carried out consistently with the objective of getting inflation down from 10-12% to less than 5% by 1984, and this policy is still being pursued.

(b) The effects which one would expect of this policy of reduced monetary growth have been broadly those which the United States has experienced, namely a reduction in growth rate, an increase in unemployment and an appreciation of the dollar against the mark and the yen.

(c) Recent expansion of the rate of growth of M1 is not inconsistent with the counter-inflation strategy, just as our expansion from March 1981 was consistent with the MTFS.

(d) Although the Fed has been criticised by Friedman, Brunner and others for allowing the monetary growth rate to "yo-yo", this has not affected the basic thrust of the counter-monetary strategy, but it may have added to real interest rates. (As we know from our experience, considerable monthly or even quarterly instability in the growth rates is inseparable from a mechanism whereby the Authorities control interest rates rather than the reserve requirements of the banking system.)

Recent Monetary Growth

In Figure 1 I have plotted the actual growth of the money supply compared with that required for a smooth disinflationary path from over the five year period to the end of 1984. This assumes the

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trend rate of growth of velocity of 3% per annum, and anticipates that there will be a 5% growth rate of GNP by the end of the period (this is roughly the same as 3% inflation). As you can see from the diagram, the stock of money supply is still below the trend path. (Rather like ours during this past year.) There is some room for expanding at a faster rate in order to bring the money supply back onto its appropriate path.

There is an even more compelling reason for allowing more relaxed monetary growth. I have assumed in the diagram that velocity increases 3% a year. But over the winter of 1981/82 there was in fact a sharp fall in velocity. It is difficult to present a convincing reason for this fall; I conjecture that it was associated with the perceived threats to various fringe financial institutions and the flight to quality. If this is the case, then the fall is unlikely to persist, and is likely to be reversed in the course of time. Meanwhile, however, it does provide a good argument for Volcker expanding the money supply to get back on course and, indeed, a reasonable argument for an interim overshoot. It is vitally important, however, for the Fed to carry conviction that it will stick to the disinflationary path. More overt toughness than is statistically necessary may be needed to carry conviction. Last Friday's money supply figures and the recent behaviour of the Federal Funds rates suggest that the Fed realises still that it has not won the confidence battle.

Erratic Money Growth and Economic Activity

Granted the average rate of growth of the money supply has been right over the past 2½ years, there has, however, been very considerable criticism that the erratic rate of growth from year to year, and especially the slow-down in the third and fourth quarters of 1981, have contributed considerably to the slump in economic activity which we have seen in the United States from the winter of 1981/82 onwards. (We followed more or less the same policy and saw the same broad effect. You will no doubt recall the difficulty we had in changing our monetary stance, in particular interest rates, from November 1981 onwards.) These oscillations in monetary growth are inevitably part and parcel of the mechanism of monetary control - through interest rate variations instead of through reserve or base money. I am sure Friedman is right in believing that a lot of the oscillations in demand are

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generated by the underlying oscillations in monetary growth; and that the money supply will be stabilised only when we get onto a monetary base system.

Friedman also confirmed that the reaction of US economic activity to a change in monetary growth now takes place after a lag of only three months compared with 6-9 months some years ago. We have seen some signs of a shortening of the lag in the UK - but it is difficult to quantify it yet.

Future United States Interest Rates and Inflation

In conversation today, Friedman said he feared that both interest rates and inflation in the United States would not proceed on their downward course. He believes that inflation will stabilise over the next year or two at about 8%, and that interest rates will be correspondingly round about 10-11%. I was not convinced on the arguments he gave in support of this claim. But I have learned that one dismisses Friedman's arguments at one's peril, so I asked him if he would send me the statistical support for his predictions. For my own part I believe that the American inflation rate is heading, albeit unsteadily, downwards and that interest rates will fall along with it. This depends crucially, however, on the Government convincing markets that the Federal spending programmes are under control. The members of the new economics team say that the President will tackle this in earnest after the November elections. The unthinkables - such as cutting eligibility and indexing of Social Security - will then be pursued. Of course this may be the usual pap fed to markets to bolster confidence, but in this case I suspect that they are right.

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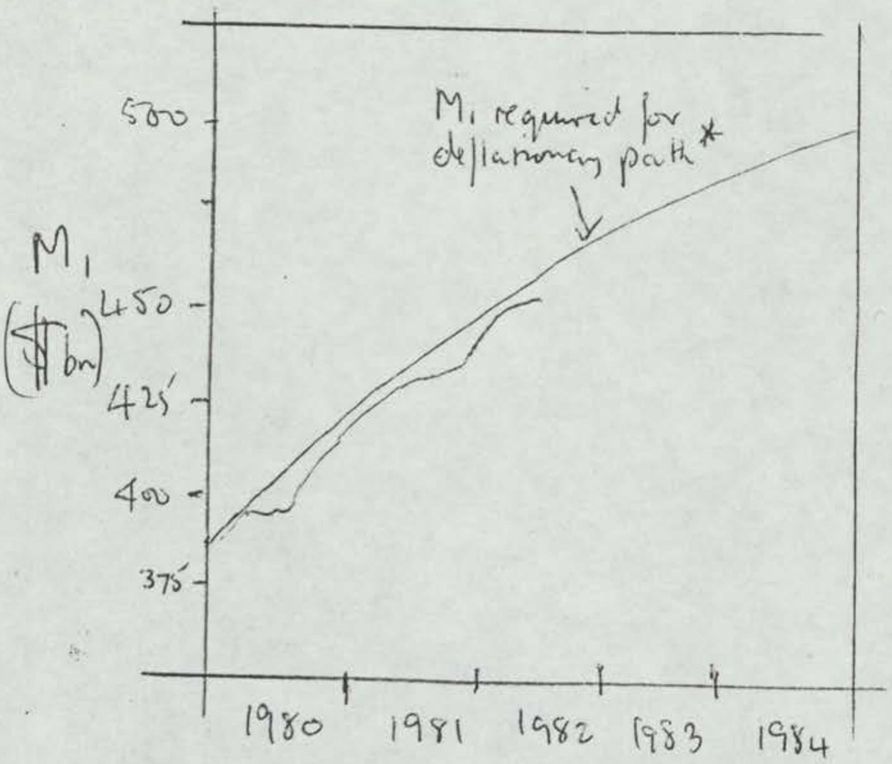
Fig 1 M₁ (bn of $)



* Assuming a 3% trend in Velocity

Fig 2 Velocity (ie M₁/GNP)