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1. memo	Beryl Sprinkel to Cabinet Council on Economic Affairs, re Domestic Monetary Policy, 3p	4/24/81	~~P5~~ KB 10/13/00

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THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

April 24, 1981

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: BERYL W. SPRINKEL

SUBJECT: Domestic Monetary Policy

The thrust of the President's tax expenditure and regulatory programs is to stimulate economic growth by increasing incentives to saving, work and investment, while monetary policy intends to reduce the rate of inflation. Slow economic growth and rapid inflation are not distinct problems, however, and cannot be attacked separately. Instead, monetary policy should be considered as an integral part of the economic program and achievement of the monetary goals is crucial for the success of the entire program. It is vital, therefore, that the Administration keep a close watch on the conduct of monetary policy, conveying to the Federal Reserve both support for their goal of long-run monetary control and suggestions for further improvement of their control procedures.

Inflation is a tax that has effects on economic incentives which are as certain as those resulting from more explicit government levies and regulations. The disruptive effects of the hidden tax of inflation and the structure of the government's direct taxes have been mutually reinforcing. Thus, it is crucial that the problem be attacked on both fronts, for failure to reduce inflation would greatly reduce the long-run growth effects of the President's budgetary and regulatory program. The fact is that high inflation and slow economic growth go hand in hand. Reduction of inflation, in turn, requires that the Federal Reserve provide a permanently slow and steady growth of money. This is the overriding issue for current monetary policy.

In this context there are several factors to be considered. First, and foremost, is the requirement that the Federal Reserve move smoothly and persistently to reduce the rate of monetary expansion. This means that the Federal Reserve should have a long-run policy horizon and that they not be distracted by shorter term considerations such as interest rate movements or variations in exchange rates. The ultimate influence of monetary actions on interest rates and exchange rates is through the rate of inflation. Thus, permanent reductions in interest rates and a fundamentally strong dollar can be achieved only through a reduction in the pace of inflation. Therefore, it is important that the Administration emphasize its support for a long-run monetary control and that we will do all in our power to remove short-run obstacles to achievement of the Federal Reserve's goals.

There are many reasons, including weakness in the housing sector and the savings and loan industry, which have, in the past, led the Federal Reserve to be concerned about interest rate movements. In the current economy an obvious issue is the budget deficit and the presumption that it will exert significant pressure on interest rates. Some analysts contend, for example, that Federal borrowing will make it difficult for the Federal Reserve to stick to its monetary targets. Quite simply, however, there is no necessary linkage between budget deficits and the rate of monetary expansion. Money is under the control of the Federal Reserve and Federal borrowing leads to accelerated money growth only when the monetary authorities attempt to counter short-term interest rate pressures.

A second consideration is the manner in which the Federal Reserve moves to slower money growth. The Administration has recommended a gradual approach of reducing money growth over each of the next six years. The reason for such a pattern is that it would minimize the immediate short-term restrictive effects on output and employment resulting from slowing of money growth. A gradual slowing would allow the private sector more flexibility in adjusting to the prospect of slower money growth in the long run.

However, such an approach does carry the danger that inflationary expectations will not adjust as rapidly and thus inflationary pressures would persist somewhat longer. Unless the Federal Reserve is diligent in pursuing its annual targets, it is not clear that a gradual approach to slowing money growth will involve smaller transition costs that would be involved in a more abrupt slowing. In any event, however, the pattern of money growth which is implied by the gradual approach should be considered as a ceiling for the rate of monetary expansion.

Any under-shooting of this long-term target path, such as in the first quarter of this year, should be accepted. No effort should be made to boost money growth in order to make up for such under-shooting and instead the target for the future rate of monetary expansion should be reduced accordingly.

Efforts to compensate for a period of slow money growth with a period of sharply accelerated expansion will result in variations in the rate of monetary expansion which will weaken the credibility of the monetary control policy. This, in turn, would slow the adjustment of inflationary expectations and thereby delay the move to slower inflation. It is for this reason that systematic short-run variability of money growth should be avoided.

The ability of the Federal Reserve to implement such a program depends on two elements: (1) the degree to which the Federal Reserve responds to short-run concerns for interest rate and exchange rate movements and (2) the actual procedures which the Federal Reserve uses to control growth of money. The former were discussed above and the latter involve technical issues, such as the appropriate control variable, the structure of reserve requirements, administration of discount window, and the structure of regulations in financial markets. Given the vital importance of appropriate monetary actions to the ultimate success of the President's economic program, it is prudent that we take every opportunity to advise the Federal Reserve where we believe that control procedures can be improved.

The Federal Reserve has said consistently over the past ten years that they have had a policy of bringing money growth under control. The fact is that they have failed to match action with intent. Imperfections in control procedures have been responsible, in large part, for this failure. Procedures have been tightened recently but there is room for further improvement and the Administration cannot simply ignore these issues, treating them as merely technical factors of internal Federal Reserve operations.

In summary, the Administration and the economy have a large stake in the ability of the Federal Reserve to achieve a permanently slower and less variable rate of monetary expansion. While the Federal Reserve is an independent institution, there is much that the Administration can do to assure the achievement of monetary policy goals. This involves a coordinated and consistent program for the budget, foreign exchange policy, and regulation of the financial industry.