federal government means higher interest rates. Historically, excessive money supply growth has triggered increases in inflation and interest rates. But, these are long-run effects.

It is not so clear what would happen in the short run if the Federal Reserve tries to accommodate more government borrowing with higher money supply growth. In the short run, it may be possible to reduce interest rates slightly with higher targets for the monetary aggregates. Whether this strategy would work and for how long depend, in part, on the sophistication of participants in the market for long-term securities. If market participants believed that excessive money growth would lead to further inflation, they would almost certainly bid up long-term rates and drive borrowers into the short-term market, which would drive up short-term rates. The impact of increased money supply growth on short-term interest rates would be offset by inflationary expectations. The net impact on interest rates in the short run is ambiguous. The net effect in the long run is clear: interest rates would be higher.

Summary

The Federal Reserve sets monetary targets based on its desire to achieve sustainable economic growth and gradual disinflation. Monetary targets are set low enough to reduce inflation and interest rates in the long run. Large budget deficits must be financed in credit markets, because the Federal Reserve cannot buy large amounts of government debt without creating excess money growth. To lower interest rates, the budget deficit must be reduced, and money supply growth must be limited to a non-inflationary rate.

The Monetary Targets in 1984

by William T. Gavin

Every February, the Chairman of the Federal Reserve Board of Governors reports to Congress on the economy and presents objectives for monetary policy for the coming year. The chairman's reports are required by the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins). In July, the chairman reviews the current year's objectives and presents tentative objectives for the next year. These objectives are stated as annual target ranges for growth in the supply of money and credit. As Chairman Paul A. Volcker stated in his February 1984 report, "The ranges for 1984 are intended to be consistent with the basic policy objective of achieving long-lasting economic expansion in a context of continuing control of inflationary pressures."1

Not many years ago, economists believed policymakers had to accept trade-offs between unemployment and inflation. Today, most economists agree that the trade-off—if it exists at all—is only a short-run phenomenon. The experience of the last 20 years suggests that more inflation leads to more uncertainty and less efficiency in the economy. Current Federal Reserve policy is based, in part, on the premise that the best way to increase potential real output and reduce unemployment over the long haul is to eliminate inflation. As Chairman Volcker stated, "In a real sense, the greatest contribution that the Federal Reserve itself can make to our lasting prosperity is to foster the expectation—and the reality—that we can sustain the hard-won gains against inflation and build upon them."2

The 1984 Targets

In his recent testimony, Chairman Volcker presented targets consistent with a continuation of the Federal Reserve strategy of gradual reduction of growth in the supply of money and credit. The targets for 1984 were set 0.5 percent to 1 percent below the target ranges for 1983 (see table 1). The 1984 target range for M-1 is 4 percent to 8 percent. This current target is 1 percent below the 5 percent to 9 percent range chosen for the second half of 1983 and the same

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July growth would have signaled the economy did not recover in 1982. The sustained and rapid growth of the primary status it held between the broader M-2 and M-3 aggregates. While M-1 subsequently was re-established in 1982, March 1982, placing more emphasis on the demand side. Other things being equal, more borrowing by the federal government is only one source of funds on the demand side. The FOMC has reduced the M-2 target growth range by a full percentage point from the target range established in 1982. The target range, 6 percent to 9 percent, is 0.5 percent downward shift in the velocity growth; if velocity growth were the only one source of funds on the demand side. The FOMC introduced a monitoring range for domestic nonfinancial sector debt. Actual growth for this credit aggregate was 10.5 percent in 1983—in the top half of the 8.5 percent to 11.5 percent range. This experimental target range has been set at 8 percent to 11 percent for 1984. 

Gradual Disinflation

If the real world were as regular and predictable as the world presented in econometric models, the Federal Reserve could reduce target ranges and actual monetary growth in a predictable way from one year to the next. While the target ranges and actual monetary growth have not been reduced smoothly and gradually each year, the Federal Reserve has come close to achieving this objective for effective money growth, effective being the amount of money growth plus or minus unexpected changes in velocity. Each year the targets are chosen based on an implicit assumption about velocity. To see how the Federal Reserve has achieved reductions in effective money growth, we can compare the deviations of actual M-1 growth from the pre-announced targets with the unexpected developments in velocity.

3. For an exhaustive study of the effects of deregulation on the opportunity cost of holding transactions balances, see Flint Brayton et al., "Alternative Money Demand Specifications and Recent Growth in M-1," Manuscript (Board of Governors of the Federal Reserve System, May 23, 1983).


4. It should be emphasized that the FOMC did not necessarily follow this procedure.

5. See "Monetary Policy Report to the Congress."