The M1 Target and Disinflation Policy

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ECONOMIC COMMENTARY

To regulate the nation's money supply, the Federal Reserve System sets target ranges for three measures of money, which are designated M1, M2, and M3. Although there are three different monetary targets, academic researchers focus on the M1 measure, which is announced on a weekly basis. Researchers find it most useful in academic policy debates because the Federal Reserve can use M1 as a target in the future.

Currently, the FOMC has apparently chosen to place more emphasis on indicators of real economic activity rather than on deviations of M1 from target. Thus far, the outcome has justified this approach. However, as long as there is uncertainty about velocity, there is a chance that above-target M1 growth will lead to more inflation. While more uncertainty about velocity naturally leads to a less aggressive reaction to a deviation of M1 from target, the long-run goal of price stability requires some reaction to reduce the probability that more difficult corrections will be needed in the future.

Money Demand and Gradual Disinflation

The idea that the Federal Reserve's economic policy should be designed to eliminate inflation gradually is based on the presumption that it would cost more to eliminate inflation all at once. Observers have suggested that the transition to a permanently lower expected inflation rate would be associated with the transition to a permanently lower inflation rate, and could be associated with the transition to a permanently lower expected inflation rate. This is achieved when the transition to price stability is complete, the ratio of real balances to real income should be higher, and the growth rate of money should be lower than the growth rate of nominal income.

The Federal Reserve targets M1 because it affects the Federal Reserve's high priority on ending inflation has played an important role in the Federal Reserve's monetary policy. A gradual change in money growth, designed to slow and reverse inflation, should not only reduce the growth rate of money relative to income. A fundamental change away from a policy of accelerating inflation would lower the growth rate of money relative to income. The resulting disinflation policy will affect the public's demand for M1.

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1. The Federal Reserve maintains targets for M1, M2, and M3. See the Federal Reserve Bulletin, any recent issue, for definitions of these measures. M1 includes bank failures and checks written on demand deposits, including those in NOW and Money Market Deposit Accounts. M2 includes M1, plus household savings assets. M3 includes M2 plus institutional savings assets.

2. The term real denotes constant dollar amounts. Real magnitudes are measured in terms of goods and services, and nominal magnitudes are measured in terms of dollars.

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The quantity of money demanded (due to the successful application of a disinflation policy) could be to allow a temporary rise in the money growth rate? Failure to allow more rapid money growth under these conditions could result in a real money deficit and disinflation than originally planned.

However, the gradual approach to disinflation is facilitated by the short-term volatility in money growth and other variables tends to obscure the gradual changes in the long-run trends for these variables. Previous attempts to eliminate inflation gradually have not been successful. Judging makers allowed to react too late for reasons unrelated to the disinflation goal. Consequently, the public continues to view the Federal Reserve will once again deviate from its disinflation policy.

To accurately predict future inflation, one must be able to sort the temporary factors from the permanent factors that drive demand for real money balances. Hence, the uncertainty about Federal Reserve policy is one of the major challenges for those who monitor information about M1 growth to predict inflation. On the one hand, a successful disinflation policy that is applied gradually should lead to a permanent upward shift in the public's demand for money relative to income.

In recent years, money has grown faster than the price level because the quantity of real money balances demanded has increased, with the result that the short-run rate of inflation has been below the long-run rate of inflation. However, in a high inflation period, people may be willing to hold this higher level of money balances at a higher rate of interest to stabilize around zero. If inflation rises, we can expect people to reduce their money balances. This would be associated with a period in which the price level grew faster than the demand for money—a result of rapid money growth.

In the Execution of Policy. What explains the difference? In each of the first four years, M1 grew above the target range only twice—in 1976 and again in the first half of 1977. In both cases, inflation rose from 4.7 percent in 1976 to 8.2 percent in 1979. After October 1979, inflation fell from 10.2 percent in 1980 to 3.0 percent in 1981, just fast enough to exceed the M1 target led to inflation before 1980, but were associated with disinflation afterwards.

Failure to allow more rapid money growth in February 1985 could be interpreted as the FOMC's judgment that the rapid M1 growth early in the year was not inflationary. This judgment could have been based on observations that the foreign exchange value of the dollar had appreciately rapidly, that inflation-sensitive prices (commodities, real estate, etc.) were not signaling future inflation, and that supply-side cost pressures (wages and energy costs) did not seem to be building. This judgment has been vindicated since subsequent economic reports, which show nominal GDP growth averaged 5 percent in the first half of 1985, a rate that is 2.5 percent higher than a base below the original projection made when the M1 target range was chosen.