CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee and Nonvoting Presidents

DATE: February 1, 1982

FROM: John J. Balles, President Federal Reserve Bank of San Francisco

SUBJECT: Long-Run Monetary Growth Ranges for 1982.

Summary of Recommendations

I would like to recommend a modification of the long-run ranges for M1, M2, and M3 from those tentatively selected by the Committee in July, 1981. For M1 I would recommend reducing the range ½ percent across the board from the 1981 range, rather than lowering the bottom of the range by more than the top of the range. Thus the 1982 range would be 3 - 5½ percent. For M2 and M3, I would recommend increasing the range by 1 percent and 1½ percent, respectively, from 1981, rather than leaving it unchanged. My reasons for these recommendations are given below.

Changing the M1 Range

The reason behind the July decision to reduce the bottom of the 1982 M1 range by 1 percent and the top of the range by ½ percent from the 1981 range was the expectation of a further reduction in the demand for money in 1982. I supported that decision in July. It was reasonable on the basis of the information we then had regarding both the demand for money and the expected strength in the economy through the end of 1982.

The information we have now, in my opinion, suggests a modification of that decision. The reduction in the demand for money appears to have slowed or even stopped temporarily in the last quarter of 1981. We also know now that the economy has been weaker in the last half of 1981, and is expected to be weaker in 1982, than we believed in July, 1981.

While it is possible for the demand for M1 to resume its decline in 1982, we must balance that risk against the risk that the economy will be weaker than currently expected. Either development could lead to low growth in M1 in 1982. While we would want to accommodate any reduced demand for money, we should resist low money growth associated with a weaker than expected economy.

Last July the greater risk appeared to be a continued reduced money demand in 1982. Currently, the greater risk appears to me to be an unexpectedly weak economy. This change in the balance of risks suggests that we should resist weak growth in M1 in 1982. Therefore, instead of a 2½ percent bottom to the 1982 range, I would recommend a 3 percent bottom, while adopting 5½ percent as the top of the range.

An M1 range of 3 - 5½ percent for 1982 would have several advantages:

1. It would continue the gradual reduction in the M1 range we have been following in recent years, as part of a longer-run anti-inflation policy. Specifically, both the top, bottom, and midpoint

($4\frac{1}{4}$ percent) of the proposed range would show a one-half percentage point decline from the 1981 range. Therefore, such a range should not undermine the credibility of our anti-inflation policy. Moreover, the $4\frac{1}{4}$ percent midpoint, if achieved, would also represent a meaningful reduction from the actual 5 percent growth in M1-B (non-shift adjusted) in 1981 (fourth quarter to fourth quarter).

2. It would help us in our relations with Congressional and other critics who would see a full 1 percent reduction in the lower boundary to $2\frac{1}{2}$ percent as compounding the current problems of high interest rates and the recession.

Changing the Ranges of M2 and M3

The nature of the assets comprising the M2 and M3 aggregates has changed dramatically in recent years. As recently as December 1978, assets yielding market rates of interest comprised only 8 percent of M2 and 21 percent of M3. By December 1981, these proportions had risen to 45 percent and 54 percent, respectively. This significant change in the composition of the broader aggregates means that their income and interest rate elasticities may have changed, so that the historical relations between them and M1 may also have changed.

As a result, the differential between the M1 target and the targets for M2 and M3 that are compatible with it may have changed. This point is illustrated by what happened to the aggregates in 1981. The FOMC targets were 3.5-6 percent for M1-B, 6-9 percent for M2 and 6.5-9.5 percent for M3. The rates of growth actually achieved were 5.0 percent[1/], 9.4 percent, and 11.3 percent, respectively. These results suggest that the differentials between the target bands for the narrow and broader aggregates were set too low and need to be widened. I am suggesting 7-10 percent for M2 and 8-11 percent for M3. Although the mid-points of the proposed ranges (8.5 percent and 9.5 percent, respectively) are higher than last year's (7.5 percent and 8 percent, respectively), they are lower than the actual growth rates in 1981.

The recommended ranges for M2 and M3 are summarized below, along with the recommended range for M1, for comparative purposes.

	M1	M2	M3
1981 Range	3½ - 6 %	6 - 9 %	6½ - 9½ %
1981 Actual	5 1/ %	9.4 %	11.3 %
1982 Range:			
July '81 Tentative	2½ - 5½ %	6 - 9 %	6½ - 9½ %
Feb. '82 Recommended	3 - 5½ %	7 - 10 %	8 - 11 %

There are several advantages to these recommended ranges for M2 and M3:

1. Forecasts of continued high interest rates in 1982 imply further inflows of interest-sensitive funds into M2 and M3.

2. Greater consistency between the broader aggregates and M1 will reduce public confusion regarding the course of monetary policy by avoiding having M1 around the bottom and M2 and M3 around the top of their ranges.

3. Improved credibility with financial markets and the public when they realize that the Federal Reserve sets more realistic and thus more achievable targets.

1/ Shift adjusted M1-B increased only 2.3 percent in 1981. On this basis the spread between M1 and M2 is even wider than reported in the text. However, the downward shift in M1 demand in 1981 would overstate the size of the spread expected to occur in 1982. The non-shift adjusted M1 growth reported in the text is, according to the San Francisco money market model, a reasonable approximation for both the effect of the NOW adjustment and the demand for money adjustment.