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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

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I appreciate this opportunity to discuss with you today the current stance of monetary policy and some problems for the future. Before responding to certain questions directed to me about monetary policy in your letters of October 18 and November 17, Mr. Chairman, I should first emphasize that the basic thrust and goals of our policy are unchanged since I testified before the Congress on July 20. The precise means by which we move toward our goals must take account of all the stream of evidence we have on the behavior of (and distortions in) the various monetary aggregates, the economy, prices, interest rates, and the like. But we remain convinced that lasting recovery and growth must be sought in a framework of continuing progress toward price stability -- and that the process of money and credit creation must remain appropriately restrained if we are to deal effectively with inflationary dangers.

For that reason, we must continue to set forth targets for growth in money and credit and to judge the provision of bank reserves -- our most important operating instrument -- in the light of the trend in the growth of these aggregates. This process necessarily involves continuing judgments about just what growth in those magnitudes is appropriate in the short and longer run, matters affected by institutional change as well as by more fundamental economic factors.

As you are aware, the current job of developing and implementing monetary policy has been complicated by regulatory decisions as well as by recent developments in the economy and in our financial markets. We have, as a consequence, (1) made some technical modification in our operating procedures to cope with obvious distortions in some of the monetary data -- particularly M1 -- and (2) accommodated growth in the various M's at rates somewhat above the targeted ranges. The first of those decisions was essentially technical. The latter decision is entirely consistent with the view I expressed in testifying before the Banking Committees in July that the Federal Open Market Committee would tolerate "growth somewhat above the targeted ranges . . . for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money."

Unfortunately, the difficulties and complexities of the economic world in which we live do not permit us the luxury of describing policy in terms of a simple, unchanging numerical rule. For instance, the economic significance of any particular statistic we label "money" can change over time -- partly because the statistical definition of "money" is itself arbitrary and the components of the money supply have differing degrees of use as a medium of exchange and liquidity. That doesn't make much difference in a relatively stable economic, financial, and institutional environment, but, at times of rapid change, like the present, it can matter a great deal.

We also have to take account of varying lags -- never known with precision -- between actions today and their consequences later. We have to try to disentangle the temporary and cyclical from more persistent trends in relationships among different measures of money and inflation and economic activity. And we have to evaluate the significance of developments abroad as well as at home, as reflected in trade accounts and the exchange rate, and of strains in the financial structure itself.

As this suggests, the economic environment in which we set policy -- or policy itself -- cannot be condensed into a simple, one-dimensional statement. Perhaps the essence of the problem and our approach can be better captured by a few "yes-but" phrases.

(1) Yes, we have broken the inflationary momentum -- but continuing vigilance and effort will be essential to continue progress toward price stability.

As you know, the broad price indices this year have been running at about half or less of the peak levels reached two or three years ago. As part of this disinflationary process, growth in worker compensation in nominal terms has declined to the 6 to 7 percent area -- but that slower growth in nominal income has been consistent with higher real wages as inflation has moderated.

Price and cost trends in particular sectors of the economy are mixed -- reflecting in part lags in the process of disinflation, the effects of long wage contracts, international and exchange rate developments, and the immediate effects of

recession on some prices -- most particularly commodities. But there is, it seems to me, strong reason to believe that the progress toward price stability can be maintained -- albeit at a slower rate -- as the economy recovers. For a time, unemployment and excess capacity should restrain costs and prices and, of more lasting significance, productivity growth should improve from the poor performance of most recent years. Taken together, restraint on nominal wage increases and productivity growth should moderate the increase in unit labor costs, which account for about two-thirds of all costs. Real incomes can rise as inflation slows, paving the way for further progress toward stability.

To be sure, as the economy grows, some factors holding down prices over the past year or two will dissipate or be reversed. But large new "price shocks" in the energy or food areas appear unlikely in the foreseeable future, suggesting that a declining trend in the rise of unit labor costs should be the most fundamental factor defining the price trend.

That analysis would not hold, however, if excessive growth in money and credit over time came again to feed first the expectation, and then the reality, of renewed inflation. Too much has been "invested" in turning the inflationary momentum to lose sight of the necessity of carrying through. There are clear implications, as I will elaborate in a moment, for fiscal as well as monetary policy.

(2) Yes, exceptional demands for liquidity can reasonably be accommodated in a period of recession, high unemployment, and excess capacity -- but guidelines for restrained money and credit growth remain relevant to insure against renewed inflation.

A variety of specific and general evidence strongly suggests that the desire to hold cash and other highly liquid assets, relative to income, has increased this year. Much of the more rapid increase in M1 has been in interest-bearing NOW accounts, which did not exist a few years ago but which provide the basic elements of a savings, as well as transaction, account. With market interest rates falling, those accounts have been relatively more attractive on interest rate grounds alone, and they are a convenient means of storing liquidity at a time of economic and financial uncertainty. At the same time, the broader aggregates appear to reflect some of the same liquidity motivations, as well as the stronger savings growth in the wake of the tax cut.

Most broadly, we can now observe, over a period of more than a year, a distinct decline in "velocity" -- that is, the relationship between the GNP and monetary aggregates. The velocity decline for M1, which is likely to amount to about 3% from the fourth quarter of 1981 to the fourth quarter of 1982, stands in sharp contrast to the average yearly rise in velocity of 3-4% over the past decade; it will be the first significant

decline in velocity in about 30 years. M2 and M3 velocities -- which had been relatively trendless earlier -- have also declined significantly. While some tendency toward slower velocity is not unusual in the midst of recession, the magnitude and persistence of the movement in 1982 is indicative of a pronounced tendency to hold more liquid assets relative to current income. Without some accommodation of that preference, monetary policy at the present time would be substantially more restraining in its effect on the economy than intended when the targets for the various aggregates were originally set out earlier this year.

At the same time, policy must take into account the probability that the demands for liquidity will, in whole or in major part, prove temporary, and that an excessive rise in money or other liquid assets could feed inflationary forces later. Elements of judgment are inevitably involved in sorting out these considerations -- judgments resting on analysis of the economy, interest rates, and other factors. But broad guidelines for assessing the appropriate growth on the basis of historical experience will surely remain relevant and appropriate.

In that connection, I must note the implications of the future Federal budgetary position. To put the point briefly, the prospect of huge continuing budgetary deficits, <u>even as the economy recovers</u>, carries with it the threat of either excessive liquidity creation and inflation in future years, or a "crowding-out" of other borrowers as monetary growth is restrained in the

face of the Treasury financing needs, or a combination of both. The problems flowing from the future deficits are simply not amenable to solution by monetary policy. Moreover, the concern engendered in the marketplace works in the direction of higher interest rates today than would otherwise be the case, contrary to the needs of recovery. I know something of how difficult it is to achieve further budgetary savings, but I must emphasize again how important it is to see the deficit reduced as the economy recovers. The fact is those looming deficits are a major hazard in sustaining recovery.

(3) Yes, lower interest rates are critically important in supporting the economy and encouraging recovery -- but we also want to be able to maintain lower interest rates over time.

Since early summer, short-term interest rates have generally declined by five to six percentage points, and mortgage and most other long-term rates have dropped by three to four percentage points. While consumer loan rates administered by banks and other financial institutions have lagged, they are also now moving lower. There are clear signs of a rise in home sales and building in response to these interest rate declines, and other sectors of the economy are benefiting as well.

We have also had experience in recent years of sharp increases in interest rates curtailing economic activity at times when recovery was incomplete and unemployment high. Sudden large fluctuations in interest rates contribute to

other economic and financial distortions as well. And no doubt the fact that many interest rates remain historically high, relative to the current rate of inflation, reflects continuing skepticism over prospects for carrying through the fight on inflation.

In this situation, the Federal Reserve has welcomed the declines in interest rates both because of the support they offer economic activity and because they seem to reflect a sense that the inflationary trend has changed. However, we do not believe that progress toward lower interest rates should -- or for long in practice can -- be "forced" at the expense of excessive credit and money creation. To attempt to do so would simply risk the revival of inflationary forces; renewed expectations of inflation would soon be reflected in the longer-term credit markets, damaging prospects for the long-lasting expansion we all want.

Turning to your explicit questions, Mr. Chairman, against this general background, I believe most policy-making officials in the Federal Reserve share the general view that economic recovery will be evident throughout 1983, but at a moderate rate of speed -- probably slower than during previous post-recession years. Unambiguous evidence that the recovery is already underway is still absent, although encouraging signs are evident in some rise in housing, in the improved liquidity and wealth and reduced debt positions of consumers, and in surveys reporting that attitudes and orders may be stabilizing

or improving. The Federal deficit, while fraught with danger for the future, is of course providing massive support for incomes at present.

What is crucially important -- particularly in the light of the experience of recent years -- is that we set the stage for an expansion that can be sustained over a long period, bringing with it strong gains in productivity and investment and lasting improvement in employment. I have already emphasized the importance of progress toward price stability to that outlook, and the evidence that, with disciplined monetary and fiscal policies, we can sustain that progress.

So far as the specific questions about monetary policy in your October 18 letter are concerned, we have not, as you know, set any new monetary targets for 1982. Current trends do indicate that the various M's will end the year above the upper end of the target ranges, probably by 1/2 to 1% for M2 and M3 and more for M1 given the current distortions. Bank credit will be close to the mid-point of its range. As I indicated at the start, the "overshoots," in the context of today's economic and financial conditions, are consistent with the approach stated in my July testimony.

No decision has been taken to change the tentative targets for 1983. That matter will, of course, be under intensive scrutiny over the next two months, and the targets will be announced in February.

For the time being, we are placing much less emphasis than usual on M1. That decision was precipitated in early October entirely by the likelihood that the data would be grossly distorted in that month by the maturity of a large volume of All-Savers Certificates, part of the proceeds of which might be expected to, at least temporarily, be placed in checking accounts included in M1.

In about three weeks, the introduction of a new ceiling-less account at financial institutions -- highly liquid and carrying significant transaction capabilities -- is likely to distort further M1 data. Judging by comments at the last Depository Institutions Deregulation Committee meeting, that account could rapidly be followed by a decision to approve a ceiling-less account with full transaction capabilities. These new accounts could have a large, but quite unpredictable, influence on M1 for a number of months ahead as funds are re-allocated among various accounts. Moreover, the introduction of market-rate transaction accounts will very likely result in a different relationship and trend of M1 relative to GNP over time. Increasing confidence in the stability of prices and a trend toward lower market interest rates might also affect the desire to hold money over time.

Obviously, some judgments on those matters will be necessary in setting a target for M1 in 1983 and in deciding upon the degree of weight to be attached to changes in M1 in our operations. Those problems should appropriately be

described as "technical" rather than "policy" in the sense that we will need to continue to be concerned with the rate of growth over time of the monetary aggregates, including transactions balances.

The decisions taken in early October do point to greater emphasis on M2 (and M3) in planning the operational reserve path during this transitional period. The link between reserves and M2 is looser and more uncertain than in the case of M1, in large part because reserve requirements on accounts included in M2, apart from transactions balances, are very low or non-existent. (Transactions balances are about 17 percent of M2.) Therefore once a reserve path is set, deviations of M2 from a targeted growth range may not, more or less automatically, be reflected in as substantial changes in pressures on bank reserve positions or in money markets as is the case with M1. Consequently, "discretionary" judgments may be necessary more frequently in altering a reserve path than when that reserve path is focused more heavily on M1. In that technical sense, the operational approach has necessarily been modified.

In sum, the broad framework of monetary targeting has been retained, but greater emphasis is for the time being placed on the broader aggregates. The specific operating technique that had been closely related to M1 has, by force of circumstances, been conformed to that emphasis. Obviously, entirely apart from questions of economic doctrine and contending approaches to monetary control, so long as M1 is

subjected to strong institutional distortions our techniques must be adapted to take account of that fact.

An alternative operating approach suggested by some of supplying and withdrawing reserves with the intent of achieving a particular interest rate target would suffer from several fundamental defects.*

- The body of theory or practice does not provide a sufficiently clear basis for relating the level of a particular interest rate to our ultimate objectives of growth and price stability.
- The implication that the Federal Reserve could in fact achieve and maintain a particular level of relevant interest rates in a changing economic and financial environment is not warranted.
- The very concept and measurement of a "real" interest rate, as called for in some proposals, is a matter of substantial ambiguity.
- As a practical matter, attempts to target and fix interest rates would make more rigid and tend to politicize the entire process of monetary policy.

*That was not, as sometimes mistakenly thought, the operating approach used prior to October 1979. Then, reserves were provided with the aim of achieving and maintaining a particular Federal funds rate thought to be consistent with targets for the monetary aggregates. The Federal funds rate was a means to achieving a monetary target and in principle was to be handled flexibly. In practice, among other difficulties, there appeared to be a reluctance to permit rates to vary rapidly enough to maintain control of the aggregates.

> In current circumstances, with huge budget deficits looming, a requirement that the Federal Reserve set explicit interest rate targets is bound to be interpreted as inflationary, and the rekindling of inflationary expectations will work against our objective.

I realize the several legislative proposals addressed to targeting interest rates would, on their face, seem to call for interest rates as only one of several targets. But interest rates would certainly be the most obvious and sensitive target, and those targets would be difficult to change. Other evidence for a need to "tighten" or "ease" would be subordinated, if not ignored.

As we approach the target-setting process for 1983, our objectives will -- indeed as required by law -- continue to be quantified in terms of growth in relevant money and credit aggregates. We will have to decide how much weight to place on M1 and other aggregates during a transitional period, assuming new accounts continue to distort the data. In reaching and implementing those decisions, the members of the FOMC necessarily rely upon their own analysis of the current and prospective course of business activity; the interrelationships among the aggregates, economic activity, and interest rates; and the implications of monetary growth for inflation. In other words, the process is not a simple mechanical one, and it seems to me capable of incorporating -- within a general framework of monetary discipline -- the elements of needed flexibility. We will also, as part of that process, review whether technical adjustments

in procedures for establishing and changing the reserve paths are appropriate. I will be reporting our conclusions to the Congress in February.

Mr. Chairman, you have suggested that our monetary targets might reasonably be specified as a single number, with a range above and below. At times we have debated within the FOMC the wisdom of such an approach (or setting forth a single target number without a range). My own feeling has been, and remains, that a single number, with or without a range, would convey a specious sense of precision, with the result of greater pressure to meet a more or less arbitrary number to maintain "credibility," even if developments during the year tend to indicate some element of flexibility is appropriate in pursuit of the targets.

To me, our present practice of setting forth a range is preferable. Where appropriate, we can and should suggest the probability of being in the upper or lower portion of the range, or suggest what conditions could evolve in which something other than the mid-points (or even an over or undershoot) would be appropriate. That approach seems to me to provide more information -- and more realism -- than a single number and is broadly consistent with present practice.

For similar reasons, I believe we need to measure and target a variety of aggregates because, in a swiftly changing economic environment, any single target can be misleading. In that connection, I believe an indication of total credit flows broadly consistent with the monetary targets could be helpful. As you know, we now provide such estimates for bank credit alone.

Given the limits of forecasting and analysis, and the volatility of the data, I would question the usefulness of further sectoral estimates. Even with respect to total credit flows, there is considerable looseness in relationships to economic activity for periods as long as a year -- and still more for shorter periods. The theoretical framework relating credit flows to other variables such as the GNP or inflation is less fully developed than in the case of monetary aggregates, and credit flows are less directly amenable to control. The enormous flows across international borders pose large conceptual and statistical problems. Our credit data are typically less complete and up-to-date than monetary data.

However, so long as those difficulties and limitations are recognized -- and some of them are relevant with respect to the monetary aggregates as well -- I share the view that analysis of credit flows can contribute to policy formulation. To assist in that process, I will propose to the FOMC that estimates of the expected behavior of a broad credit aggregate be set forth alongside the monetary targets in our next report.

I do strongly resist the idea of the Federal Reserve as an institution forecasting interest rates. No institution or individual is capable of judging accurately the myriad of forces working on market interest rates over time. Expectational elements play a strong role -- fundamentally expectations about the course of economic activity and inflation, but also, in the short run, expectations of Federal Reserve action. We could not

escape the fact that a central bank forecast of interest rates would be itself a market factor. To some degree, therefore, in looking to interest rates and other market developments for information bearing on our policy decisions, we would be looking into a mirror. Moreover, the temptation would always be present to breech the thin line between a forecast and a desire or policy intention, with the result that operational policy decisions could be distorted.

While it seems to me inappropriate for a central bank to regularly forecast interest rates, analysis of key factors influencing credit conditions and prices can be helpful at times. On occasion, we have provided such analysis in the past. My concern about the outlook for fiscal policy is rooted in major part in such analysis because the direction of impact on interest rates seems to me unambiguous. I have also, on a number of occasions, indicated that the recent and even current level of interest rates appears extraordinarily high, provided, as I believe, we continue to make progress on the inflation front. Perhaps, in our semi-annual reporting, we can more explicitly call attention to major factors likely to influence short or long-term interest rates and the significance for various sectors of the economy. But I do not believe interest rate forecasting would be desirable or long sustainable, and would in fact be damaging to the policy process.

Finally, Mr. Chairman, you have requested a "single composite forecast" of the major economic variables by FOMC members. As you are well aware, our present practice is to set forth a range of forecasts of individual FOMC members of the nominal and real GNP, prices, and unemployment. The fact is we have no single "Federal Reserve" forecast, and there is no mechanism, within a Committee or Board structure, to force agreement on such a forecast by individual members bringing different views, typically backed by separate staff analysis, to the table. A simple average -- possibly supported by no one -- seems to me artificial. The process of attempting to force a consensus would certainly dilute the product.

I would put the point positively. A range of forecasts by individual FOMC members more accurately conveys the range of uncertainty and contingencies that must surround any forecast. The seeming neatness and coherence of a single forecast too often obscures the reality that a variety of outcomes is possible; the very essence of the policy problem is to assess risks and probabilities -- what can go wrong as well as what can go right. A point forecast would likely be treated more reverently than it would deserve, and could even distort policy judgments in misguided efforts to "hit" a forecast.

I can understand your concern that a range of forecasts may be misleading if strongly influenced by "outlying" opinions rather than reflecting a more even dispersion of views. For that reason, I would be glad to explore with the Open Market

Committee a procedure by which we indicated the "central tendency" of members' views -- assuming such a central tendency exists -- as well as indicating the range of opinions. Conversely, if the forecasts were evenly distributed within the range, we could so indicate. I believe that approach would meet the objectives you seek in a realistic and helpful manner.

In concluding this already long testimony, let me say that we share the common goals of achieving, in the words of the Employment Act of 1946 and the Humphrey Hawkins Act of 1978, "Maximum employment, production, and purchasing power" and "full employment . . . (and) reasonable price stability." Those objectives have eluded us for too many years. We meet again today in particularly difficult circumstances, and there is a sense of frustration and uncertainty among many.

But I also happen to believe we have come a long way toward laying the base for economic growth and stability; economic recovery should characterize 1983, and that recovery can mark the beginning of a long period of stable growth.

Obviously there are obstacles -- interest rates are still too high; inflation is down but not out; there are strains in our financial system; we face budget deficits that are far too high; we are tempted to turn inwards or backwards for quick solutions that ultimately can not work. But it is also plainly within our capacity to deal with those threats -- provided only that we have a strong base of understanding among

us, that we resolve to act where action is necessary, and that we have the patience and wisdom to refrain from actions that can only be destructive.

You are leaving the Congress after 28 years, Mr. Chairman. Through that time, you have consistently provided constructive leadership to the effort to raise the level of economic discussion in general -- and of the dialogue between the Congress and the Federal Reserve in particular. I happen to believe strongly in the independence that the Congress has provided the Federal Reserve through the years -- but also in the need for close and continuing communication with the Congress and the Administration. I presume that this is the last time I will appear before you personally in this forum, but the dialogue will continue to benefit from your efforts, your initiative, and your sense of commitment in more ways than you may realize.

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