

For release on delivery
10:00 A.M., E.S.T.
Thursday, February 24, 1983

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

February 24, 1983

I appreciate the opportunity to appear before this Committee today to discuss the current economic and budgetary situation and the Federal Reserve's goals for monetary policy. Last week I presented to the Banking Committees the specific numerical targets for the growth of money and credit in 1983 set by the Federal Open Market Committee (FOMC). This morning I will focus on the broad issues confronting monetary policy and their relationship to other aspects of domestic and international economic policy.

Current Economic Conditions

Recessionary forces were ebbing at the end of 1982, and activity has turned upward in several sectors. Moreover, we have made impressive progress against inflation over the past year, and the underlying trends of inflation point at least toward consolidating that progress in 1983, and more likely toward further improvement. Thus, the opportunity presents itself for an orderly recovery in business activity that will bring with it the increases in job opportunities and real income that we all desire. The challenge is to see the present signs of incipient recovery evolve into a long-lasting non-inflationary expansion.

A key element in the improved outlook is the change in financial market conditions over the past year. Short-term interest rates are now as much as 10 percentage points below their earlier peaks, while long-term rates are down about 4 to 5 percentage points. Reflecting these developments, activity has been improving in the credit-sensitive sectors of the economy.

The most notable turnaround has been in the housing market. Production and sales of new single-family homes have now risen substantially over the depressed levels of late 1981 and the first half of 1982. With personal debts relative to income lower than in several years and with liquid assets rising, activity in consumer markets also has shown some signs of improvement. Auto sales, in particular, have responded to the lower interest rates offered under special programs as well as to improvements in design and pricing policies that have made domestically produced autos more competitive and more attractive to consumers. Moreover, consumer purchases of other "big-ticket" items also appear to be improving.

As is usually the case, the inventory cycle has played a large role in the recession, and will determine the speed and shape of recovery in its early stages. Businesses made vigorous efforts to control the accumulation of unwanted stocks early in the recession and again in the final months of 1982 when recovery failed to develop, as had been widely anticipated, earlier in the year. Inventories generally are now back to the levels of early 1981. Consequently, if final sales continue to strengthen, increases in production could be more than proportionate

For the time being, with excess capacity large and profits depressed, business investment in new plant and equipment is likely to continue to fall. Some delay in the recovery of capital spending is not out of line with previous cyclical experience, as many firms initially intensify the use of existing capital rather than invest in new plant and equipment.

Nonetheless, there are some encouraging signs in this sector. In particular, new orders for capital goods have firmed in recent months. Moreover, lower costs for long-term borrowing and equity financing have allowed firms to begin restoring their balance sheets to more liquid conditions -- thereby putting the business sector on a sounder footing for expansion.

The U.S. economy has become increasingly integrated into the world economy over the years. In contrast to most earlier recessions, exports dropped sharply in 1982, reflecting both the recessionary tendencies in the rest of the world and substantial appreciation of the dollar in 1981 and much of 1982. The sluggishness of business activity abroad is a major reason that recovery here is likely to be significantly less rapid than after most previous recessions.

The Outlook for Inflation and Interest Rates

The outlook for a sustained expansion of economic activity depends in major part on the success of monetary and fiscal policies in fostering confidence in our ability to make continuing progress against inflation in the years ahead. Interest rates and inflation rates frequently do not bear a close relationship to each other for short time periods -- and those periods can sometimes extend over several years. Over time, however, there are strong analytic reasons to expect a closer relationship because borrowers and lenders alike are interested in real returns -- that is, in assessing the costs or returns of investments after allowance for changing prices. What counts, in that respect, is

expected prices, which we cannot measure directly. To the extent that substantial doubts exist that the progress against inflation may not be maintained, interest rates currently -- particularly long-term rates -- will remain higher than otherwise necessary. That situation is further aggravated, as I will discuss in a few minutes, by the prospect of outsized federal budget deficits in future years. To the extent interest rates are an obstacle to sustained, well-balanced recovery and to improved economic performance generally, we must deal with these doubts and concerns.

Looking back, the gains in the fight against inflation are striking. All broad measures of prices rose less than 5 percent last year, the slowest rate of increase in a decade. To be sure, part of the improvement reflected unusually favorable food and energy price developments as well as abnormally low commodity prices, the effects of the sharp appreciation of the dollar, and more generally, the cyclical weakness of the economy.

Potentially more important, however, trends of underlying costs are now moving lower, and those trends should be sustainable as the economy recovers its upward momentum. One element suggesting optimism is the recent behavior of productivity. After languishing in the late 1970s and early 1980s, labor productivity turned up last year, somewhat unusual in the midst of recession. Beyond those statistics, which at this point can only be suggestive of a changing trend, there is increasing evidence of efforts by both workers and management under the pressures of competition and recession to increase efficiency and reduce "break-even"

points. The fruits of those efforts should be more apparent during recovery. If combined with continuing moderation in nominal wages, the result should be long-lasting reductions in cost pressures and expansion of real incomes. Increases in nominal wages slowed to the 6 percent range last year, and seem to be rising at a slower pace than that now. That slowing of nominal wage increases has been fully consistent with rising real wages for those working because price increases have come down more rapidly than wages. With real wages rising, one source of pressure for aggressive wage bargaining should subside.

Clearly, the more restrained wage increases last year were directly related to the pressures in the labor market. Employment fell throughout 1982. Although layoffs were concentrated in the industrial sector of the economy, even the service-producing sector -- the primary source of employment growth in recent years -- experienced declining payrolls. The extent of these employment cutbacks was reflected in sharp increases in the unemployment rate. While the January drop in joblessness was encouraging, current unemployment rates are still obviously high, and may decline only slowly.

Success in dealing with inflation cannot be based on an economy that stays in recession, with unacceptable levels of unemployment. But we will need to maintain moderation in wage settlements and pricing policies as the economy expands. The favorable near-term outlook in that respect is reinforced by

the current softness in the price of one of our most important raw materials -- oil. But sustained improvement will depend on a sense of conviction that government policy will remain alert and forceful in dealing with inflationary threats as the economy expands. That is the same environment in which interest rates can decline, and stay lower, helping to support a recovery in investment and sustained growth.

International Considerations

Other industrialized countries have been attempting to deal with some of the same basic problems that we have been facing. Most of them have been fighting stubborn inflationary pressures. Subnormal economic performance has been pervasive, and unemployment of labor and the underutilization of other resources have risen to levels unprecedented in the postwar period.

The sluggishness of activity in the advanced industrial economies has affected the volume of exports of developing countries and contributed to substantial declines in commodity prices. Those factors, in turn, have made it more difficult for some heavily indebted developing countries to deal with those debt burdens. Growing recognition of the potential strains on the international banking system -- after a decade of rapid growth in lending to developing countries -- was precipitated in part by interruptions in debt service by Mexico last summer.

One danger has been that lending banks would attempt to protect their individual positions by rapidly retreating from new lending. But borrowers who have built up large debts over a period of years are not in a position to repay suddenly. An uncoordinated attempt to force such repayment would undercut the stability of the borrowers, the lenders, and the international financial system alike. We could not fully insulate our domestic banking and credit system -- and our own economy -- from such developments. Consequently, we have the strongest kind of self-interest in measures to contain and deal with the threat.

Management of that situation has required, and will continue to require, the active cooperation of borrowing countries, banks, central banks and treasuries of leading countries, and international financial institutions. The International Monetary Fund has a special, and indispensable, role to play. In that connection, I believe it is essential that the Congress approve enlarging the resources of the IMF at an early date so that it can, with some assurance, proceed in the knowledge that its resources will be adequate to meet its responsibilities. As you know, that action will require budgetary authorization and appropriation, even though the operations of the IMF do not significantly affect net budget outlays or the deficit.

Monetary Policy in 1983

There was a time not so long ago when the American public felt confident -- in retrospect overly confident --

about the ability of government to keep the economy on a stable growth path. Since the mid-1960s, long years of accelerating inflation and rising unemployment, instability in financial markets and the economy, and concern about continual budget deficits have eroded that confidence. We can restore it -- not in the earlier sense that a high degree of "fine tuning" is thought to be feasible, but in the sense that government can encourage a sense of price and financial stability and a fundamental environment for growth.

In one important sense -- dealing with inflation -- we have come a long way in the past two years, even though a good deal of skepticism remains and we must not assume the battle is over. That effort has been accompanied by strains and tensions in financial markets at home and abroad, extraordinarily high interest rates, and, of course, a serious recession. But now we can also begin to see prospects for recovery and more settled conditions in financial markets. Changes in the fiscal structure adopted in recent years should, in time, help encourage investment and savings.

But there are also obstacles that must be removed if we are to capitalize on the progress that has been made and to make the happier vision a reality. Both monetary and fiscal policy will have large and complementary roles to play in dealing with those obstacles and providing a solid base for renewed confidence.

The role of monetary policy is to build on the progress against inflation while providing enough money and liquidity to meet the needs of recovery.

In some respects, the line is a narrow one, and can't be determined with mathematical precision. But in approaching our policy decisions, two things are clear. First, renewed inflation -- or policies that seem likely to lead to that result -- is neither a satisfactory nor a practical option. The sensitivity of the public and the markets to signs of renewed inflation are all too likely to produce precisely the reactions in financial markets -- and in wage bargaining and pricing policies -- that would soon weaken or abort recovery. The result would be a replay of the past decade or worse.

Second, the problems for monetary policy in meeting the needs of the economy are vastly complicated by the present prospect that huge federal deficits will preempt so much of our credit and savings as a recovery proceeds. I spoke a moment ago of the "narrow path" for monetary policy, but I must also emphasize there is no path that can resolve the economic and financial effects of excessive deficits in a growing economy. The present budgetary outlook -- until corrected -- can only maintain skepticism about future prices and interest rates, narrowing the flexibility for monetary policy now.

I reported in detail on the specifics of monetary policy with respect to our various monetary and credit aggregates last week, and that material has been made available to you with this

statement. I would only note now that the relationships between money and economic activity did not follow "normal" cyclical and trend patterns last year, partly because of the introduction of new deposit accounts but also because of broader economic reasons. Demands for money and liquidity appeared to be enlarged by the uncertainty of individuals and businesses about the economy and financial developments. There is also the possibility that the combination of declining inflation, lower market interest rates, and the increasingly common practice of paying interest on transactions accounts may have a lasting impact on trends in "velocity," and therefore on the appropriate supply of money over time.

Looking through all the complications and taking account of institutional distortions, our targets for money and credit growth in 1983 are similar to those in 1982. Because actual growth last year generally exceeded the target ranges, the effective growth this year should be less than in 1982. Based on present evidence and allowing to some degree for usual cyclical patterns, that amount of liquidity should be fully consistent with the anticipated growth in the economy and sustaining the progress against inflation -- consistent, in fact, with the kind of projections you have from the Administration and the Congressional Budget Office. In a context of declining inflation, the monetary targets themselves are not inconsistent with further reductions in interest rates -- but I must add that other factors, including the budget deficit, impinge strongly on interest rate levels.

The variety of monetary indicators we use and the rapidity of institutional change are potentially confusing. In the circumstances, there is an understandable yearning by some to encompass all policy considerations in a simple, relatively rigid rule. But I know of no such rule reliably suited to our present circumstances. Elements of judgment seem to me inevitable in interpreting the data, and the targets will need to be judged and reviewed at suitable intervals in the light of developments with respect to economic activity and prices and conditions in the domestic and international financial markets. At the same time, the targets do provide a needed discipline, and we mean to be within them over relevant spans of time. They will be changed only if evidence for change is strongly persuasive.

We do take as a point of departure in our judgments the critical importance of maintaining the momentum against inflation. In fact, most members of the Federal Open Market Committee believe that, taking the broader price indices, the inflation outcome in 1983 is likely to be better than projected by either the Administration or the Congressional Budget Office. The recent developments with respect to oil prices only reinforce that outlook. Given the supply of money and credit, such an inflation outlook implies lower interest rates than otherwise and more room for real growth.

The Federal Budget and Monetary Policy

The most obvious obstacle to sustained recovery is the prospect of huge federal deficits even as the economy expands. In the last fiscal year, the federal deficit was a record \$111 billion. The President's new budget report projects a deficit in the current fiscal year nearly double last year's figure and further growth into the foreseeable future in the absence of determined action to alter that outlook.

The members of this Committee, of course, are well aware of the enormity of these projected deficits, but there may be a danger that numbers in the \$200 billion plus range have been cited so frequently as to make them seem almost comfortable and familiar. No matter how readily \$200 billion slips off the tongue, the hard fact remains that deficits of that magnitude would preempt an unprecedented share of our net savings, keep "real" interest rates high, and divert funds from the investment and the housing we need and want.

To be sure, a substantial part of the current deficit -- projected at about 6½ percent of the GNP -- reflects the impact of the recession on the budget. Slack economic activity and higher unemployment have cut deeply into revenues and boosted outlays for unemployment benefits and other automatic stabilizers. At a time when investment is weak and private credit demands have slackened, these cyclically induced deficits have helped support spendable income and buoy the economy. They have not, in the midst of deep recession, been inconsistent with declines in interest rates -- but interest rates have, as you know, remained high relative to the current rate of inflation.

As the economy recovers, the cyclical portion of the deficit will recede. But as things now stand the deficit itself will not. Higher revenues from economic growth and reduced spending for unemployment compensation will be offset by -- and possibly more than offset by -- growth in other spending programs and the effects of earlier tax changes. In other words, through the mid- and late-1980s, a huge imbalance would remain even if the economy were operating at much lower levels of unemployment -- and assuming inflation remains under control.

All that is familiar to you -- and it is equally familiar to the financial markets, where the prospect of a major structural imbalance in the government's finances has an impact on current interest rates. It is not just the direct demand for funds to finance the Treasury that is of concern but the fear that ballooning federal borrowing needs will, in effect, bring extraordinary pressure on the Federal Reserve to monetize the deficits, with implications for inflation itself, for inflation expectations, and for inflation premiums in nominal interest rates. One implication is that, to the extent the budget deficit appears to be intractable, the burden placed on monetary policy to demonstrate the government's resolve to follow a non-inflationary course is intensified. The converse is equally true: meaningful action to demonstrate the government's economic discipline on the fiscal side would reinforce confidence that monetary policy over the years ahead can do its job in maintaining a course consistent with price stability without intolerable market pressures.

It is tempting for some to suggest that the budget problem and its consequences for the performance of the economy could be solved by monetary policy. But excessive money creation to meet the needs of the government would only reinforce and validate the fears of renewed inflation, and sooner or later, higher interest rates. In the end, excessive monetary growth would put us in an even more unsatisfactory situation, with still more deeply ingrained inflation expectations and greater skepticism about the ability of our nation to manage its economic affairs. Nothing real would be gained for long, and hard-won ground in the battle against inflation would be lost.

In concept, any inflationary impact from the budget can be contained by appropriate monetary policy. But the harsh implications of excessive deficits for other credit-dependent sectors of the economy would clearly remain.

I don't want to suggest there is a simple trade-off, as sometimes suggested, between future budget policy and current monetary policy. Reducing the threat of those large structural deficits stretching out to the end of the decade in and of itself should have favorable effects on current interest rates and in damping concerns about future increases. In that real sense, budgetary virtue will provide its own tangible reward.

But those benefits would ultimately be lost if monetary policy were to abandon its continuing and necessary concern with restoring reasonable price stability. That point remains central.

What can be said is that a better fiscal outlook, with all it implies, would certainly provide a better environment in the financial markets today, reduce concern about future inflation and an early rebound in interest rates, and moderate preoccupations that the Federal Reserve itself might somehow be forced to retreat from its basic anti-inflationary course. As things stand, with monetary policy assumed to be the only bulwark against renewed inflation and a high degree of sensitivity to the past failures in efforts to contain inflation, every twist and turn in the monetary aggregates or short-term policy actions interpreted as "easing" is closely scrutinized as a sign or symbol of intentions over a longer period. Clear progress in dealing with the budget could, in that sense, somewhat enhance our operating flexibility, so long as we succeed in reinforcing the basic point that the effort to sustain the progress against inflation is intact.

As you know better than I, the process to cut down those future deficits must start now, and with energy and force. Basic budget trends take time to change, but the knowledge that they will be changed will affect markets now. The amounts involved are large, but certainly not beyond our capacity.

It is obviously beyond my competence, or the province of the Federal Reserve, to deal with all the particular priorities that must be balanced. The Administration has set forth its program in that respect. The general order of magnitude seems to me appropriate, although some of the measures proposed would, in my judgment, be more effective if brought forward in time.

Others have proposed different specifics, and I am sure they will receive consideration.

From the standpoint of general economic policy, the more that can be done in restraining expenditures the better. You, of course, have to reconcile that with other priorities, and the basic point is that the sheer arithmetic of the problem does suggest that changes will be necessary over a broad range of programs -- both on the spending and revenue side. I believe recognition of that fact is becoming increasingly widespread both in and out of Washington.

Your Committee is in the critical position of converting that wide consensus on generalities into a specific program, and I have some idea how difficult that is. But I also have some idea how important it is to our future.

Conclusion

I need not dwell on the fact that we are negotiating a most difficult period in our nation's economic history. But I also believe we are in the process of laying the base for more vigorous, and lasting, non-inflationary growth. In looking to the rest of the decade and beyond, there are, in my view, strong forces at work that should lead to a kind of self-reinforcing process of growth, greater price stability, higher real income and profits and declining unemployment. But there are obstacles to that prospect. Monetary and fiscal policies alike need to be directed, and work in concert, toward removing those obstacles and achieving that bright promise.

* * * * *