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Statement by

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before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

June 8, 1984

I am glad to appear before this Subcommittee to present the views of the Federal Reserve Board on the behavior of interest rates this year. My remarks will focus on the principal causes of the recent rise in interest rates and its implications for the overall expansion of the economy. My colleague, Karen Horn, President of the Federal Reserve Bank of Cleveland, will discuss the effects of the increase in interest rates on economic conditions in the Fourth Federal Reserve District.

Interest rates have moved substantially higher this year. Short-term rates have risen about 1 to 1-1/2 percentage points since December. In long-term markets, rate increases on Treasury and corporate bonds have been as large as those on short-term securities. Increases in rates on mortgages have been somewhat more moderate.

A rise in interest rates in an expanding economy is not unusual. As Chart 1 illustrates, interest rates typically increase during periods of economic expansion, when growing demands for money and credit press against limited supplies. Interest rate patterns during the first 1-1/2 years of expansion do differ. Nevertheless, the chart

suggests that the rise in short-term rates during the current expansion has not been exceptional. The increase in long-term rates during the first year and a half of this recovery is, however, quite large relative to the experience of the past 30 years.

What role, if any, has monetary policy played in the rise of interest rates since late last year? The answer is, I believe, a minor one.

During the late spring of 1983, the Federal Reserve did take steps to slow the growth of M1 and M2 from the very high rates that had prevailed in the latter half of 1982 and early 1983. It did so in the context of growing evidence that the economic recovery was robust and that the velocity of money, particularly that of M1, was returning to more normal patterns. In that context, those policy actions were effective in slowing the annual growth rate of M1 to 7-1/4 percent, and the growth rate of M2 to about 8 percent, from the second to the fourth quarter average of last year.

In February, the Federal Reserve announced growth ranges for 1984 of four to eight percent for M1, six to nine percent for M2 and M3, and eight to eleven percent for the debt of domestic nonfinancial borrowers. When these ranges were announced, most observers considered them appropriate to support the nation's economic objective of sustained economic expansion without jeopardizing progress against inflation. That judgment is still, I believe, correct.

From the fourth quarter of last year through the first four weeks of May, M1 increased at around a 7 percent annual rate, about equal to its rate of increase in the second half of last year and in the upper half of the target range for 1984 (Chart 2). From the fourth quarter through April--the latest month for which data are available--M2 had increased at a 6-3/4 percent annual rate, in the lower half of its range and a little slower than in the second half of last year. M3 growth on the other hand, accelerated to a 9-1/2 percent annual rate, above the upper end of its range and above the rate of expansion in the second half of 1983. These patterns of change in the monetary aggregates do not support the contention that monetary restraint has played any substantial role in the rise of interest rates this year.

A more likely source of the upward pressure on interest rates is the explosion that has occurred in demands for credit, generated in the main by the strength of economic expansion. In nominal terms, GNP rose at more than a 10 percent annual rate in the latter half of 1983, and the pace of expansion increased further to almost a 13 percent annual rate in the first quarter of 1984. By late last year, the growth of total credit extended to domestic nonfinancial borrowers was near the upper end of the Federal Reserve's monitoring range, as indicated in Chart 3. The growth rate of such debt has risen still further, to above the upper end of the monitoring range, in the early months of 1984.

Private credit demands typically strengthen as recovery proceeds, and this recovery has been no exception. In the private domestic nonfinancial sectors, the growth of debt has moved progressively upward, from a six percent annual rate in the first quarter of 1983 to nearly 12 percent in the first quarter of 1984. Consumer instalment debt rose at a 17 percent annual rate in the first quarter; mortgage borrowing remained strong, and business credit demand strengthened substantially further. While some business borrowing this year has been to finance takeovers and other

forms of reorganization, underlying business credit demands have also increased--as growing outlays for investment in inventories and plant and equipment have outpaced the internal generation of funds.

While an increase in credit usage by private borrowers is normal during an economic expansion, sustained heavy credit demands by the Federal government are not. Historically, the Federal deficit and borrowing have dropped off rapidly in an expansion, as growth in private income leads to higher tax receipts, and Federal spending slows for a variety of income support programs. When Treasury borrowing remains as huge as it is currently, competition between public and private borrowers is bound to intensify.

Both traditional economic theory and common sense suggest that increases in government spending, or reductions in taxes, tend to stimulate the economy, raise total credit demands relative to supplies, and push up interest rates. There is a large body of empirical evidence supporting that view. Econometric models by the dozens have been constructed that find significant effects of fiscal stimulus on the real economy and on interest rates. They include models of a monetarist persuasion, such as the well-known model of the Federal Reserve Bank of St. Louis.

The state of knowledge is not sufficiently advanced to permit precise estimates of the effects of increasing deficits on interest rates. But the magnitudes are apparently not small when fiscal stimulus occurs on the scale we have seen in recent years. Since fiscal 1981, the structural deficit in the Federal budget--that is, the deficit that emerges when Federal receipts and expenditures are adjusted for the cyclical position of the economy--has risen by about $100 billion. Such an increase, according to some econometric models, may have raised interest rates by two percentage points or more, other things equal.

Longer range developments in financial markets have also played a role in the behavior of interest rates during the current recovery. Over the past three decades, and especially over the past five to ten years, innovation and deregulation of U.S. financial markets have increased the mobility of funds from one region of the country to another and from one market to another. They have removed nearly all of the legislative and regulatory impediments to payment of market-related rates of interest to savers. Most importantly, they have led to a breaking down of usury ceilings and other artificial barriers to credit flows that used to play so prominent a role in the rationing of available supplies of credit

among potential borrowers. In the financial world we live in now, the rationing of credit is done primarily by interest rates. As a consequence, interest rates in a period of economic expansion are forced to much higher levels--even after adjustment for inflation--than we were accustomed to seeing in the 1960's and the 1970's.

In this context, the prospect that structural Federal budget deficits might increase substantially further--as they will under current law--has serious implications for long-term interest rates. Potential investors in long-term securities cannot be sure from past experience how high interest rates will have to go to balance supplies and demands for credit at a level appropriate to maintaining a sustainable pace of economic expansion and avoiding a resurgence of inflation. Failure of the Federal government to take prompt and decisive action to reduce structural deficits adds powerfully to their concerns.

Participants in financial markets now widely expect that a downpayment on deficit reduction will be accomplished this year. They are understandably concerned, however, because the amounts of deficit reduction currently being discussed for the near term are so small relative to the size

of the problem. Under current law, the structural deficit will increase by about $25 billion in fiscal 1985. The two bills before the Congress provide for deficit-reducing measures of between $25 and $30 billion in the upcoming fiscal year--that is, about enough to keep the problem from getting worse. Thus, unless the Senate-House conferees adopt stronger measures of deficit reduction for fiscal 1985, the near-term effects of the fiscal downpayment on the economy and on financial markets are likely to be quite small.

Let me turn now to your question regarding the effects of the rise in interest rates on the economy. It seems evident some slowing in the pace of expansion is likely to result from the higher costs of credit, and the sectors most likely to be affected are those--such as housing--in which dependence on credit is heavy and demands are therefore sensitive to rising interest rates. How much the economy will slow is hard to judge at this juncture, given our limited knowledge of the relationship between interest rates and economic activity in today's environment. A considerable moderation from the very rapid pace of real economic growth in the first quarter--nearly nine percent at an annual rate--is necessary if we are to sustain this expansion over time. It seems likely, however, that economic growth will not slow

so much as to prevent further progress in reducing unemployment, because the basic forces of economic expansion are still quite strong.

Quite apart from their effect on overall economic growth, the effects of rising interest rates are very worrisome. High interest rates relative to those abroad have pushed up the value of the dollar in exchange markets, contributing to extraordinarily large deficits in our merchandise trade and current accounts. Higher interest rates add to the already serious problems faced by farmers. Small businesses more generally have only begun to recover from the difficulties they encountered in 1980, 1981, and 1982. Our thrift institutions are still in a weakened condition. Equally worrisome is the effect of rising interest rates on the prospects for managing the external debt-servicing problems of developing countries. Many of these countries, with the advice and assistance of international lending organizations, are attempting to put in place domestic economic policies that will generate both cash and confidence to help them attract capital and meet their obligations. It is of utmost importance to us, as well as to them, that they succeed in this endeavor. A rise in interest rates makes this task more difficult.

You ask, Mr. Chairman, what policies could be followed to foster lower interest rates and sustain economic growth. I doubt that my answer will surprise you. What needs to be done is to act promptly, and decisively, to reduce structural deficits in the Federal budget. Let me note, in this respect, that the fiscal "downpayment" presently under discussion in the Congress is a necessary first step in developing a fiscal policy suited to our needs. But it is only a first step in a larger effort that needs to begin very soon.

Attempts to lower interest rates by speeding up the growth of money and credit would, under present circumstances, be a serious mistake. The economy is growing strongly; total credit demands are extremely large; the Federal budget is badly out of balance; our merchandise trade and current account deficits are enormous; inflation, although not yet accelerating, is still proceeding at an annual rate of four to five percent. If people here and abroad gained the impression that the Federal Reserve had thrown in the towel in its efforts to keep money and credit growing at a reasonable pace, we would be faced, in my judgment, with potentially chaotic conditions in financial markets.

Let me assure you that we in the Federal Reserve have no intention of proceeding on such a course of action. We are supplying enough money and credit to finance a sustainable rate of economic expansion, and we intend to continue doing so. But we do not intend to waste the substantial gains in the battle against inflation that have been won at such enormous cost during the past few years.

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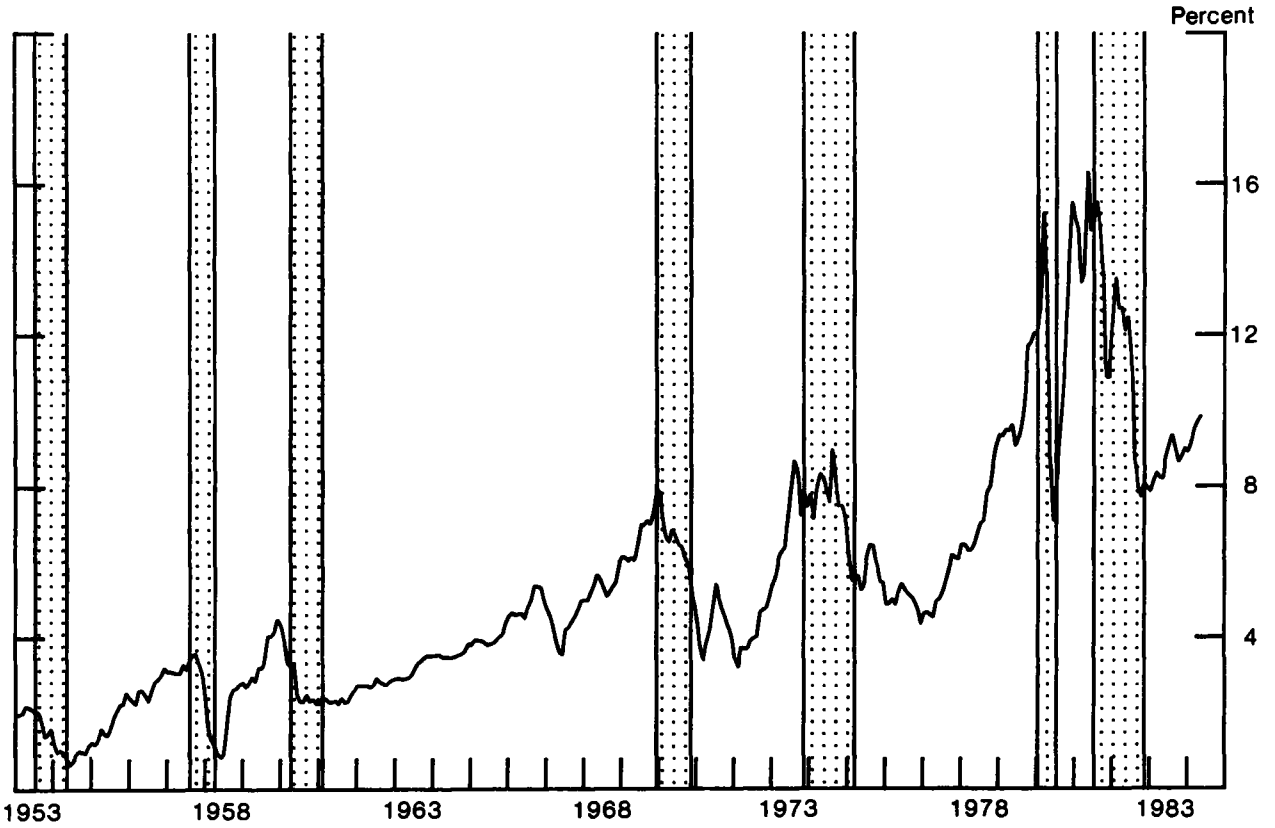
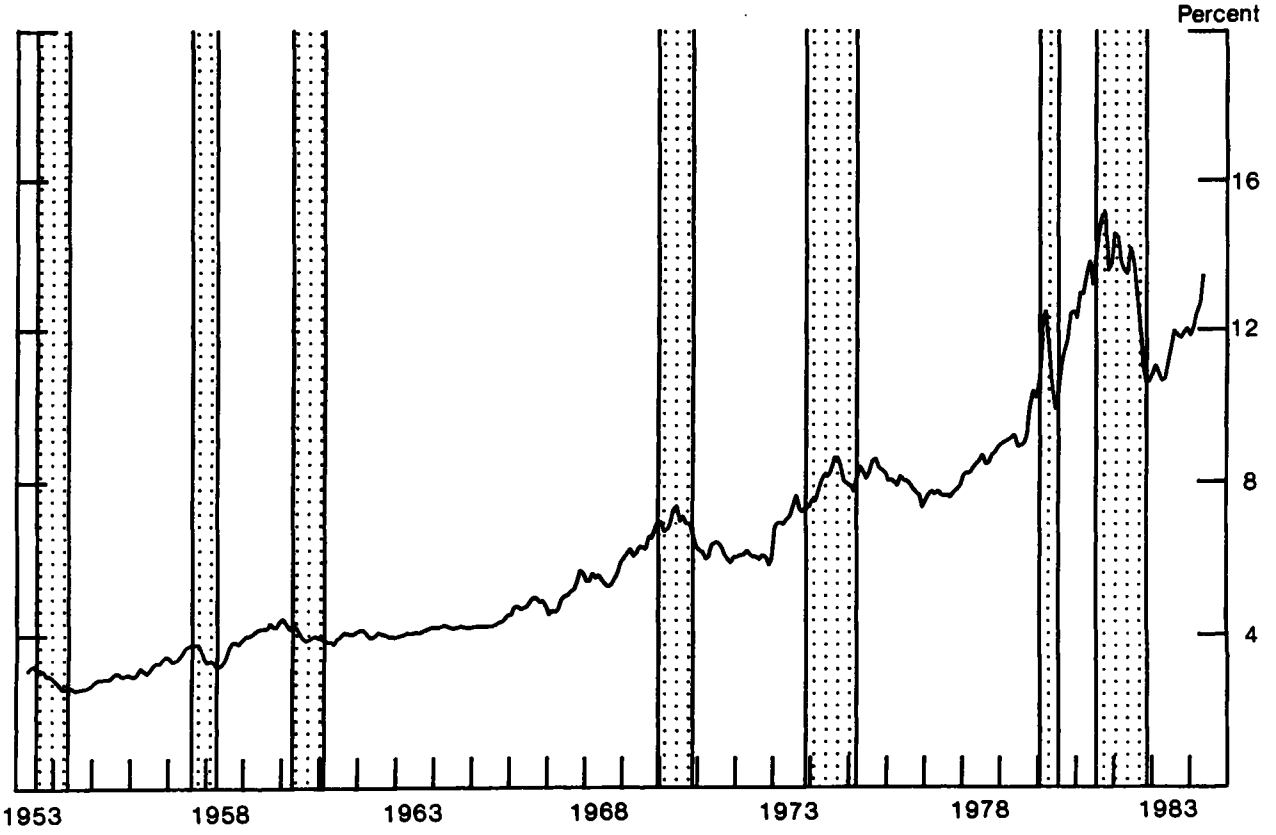
Chart 1

3-MONTH TREASURY BILL RATE

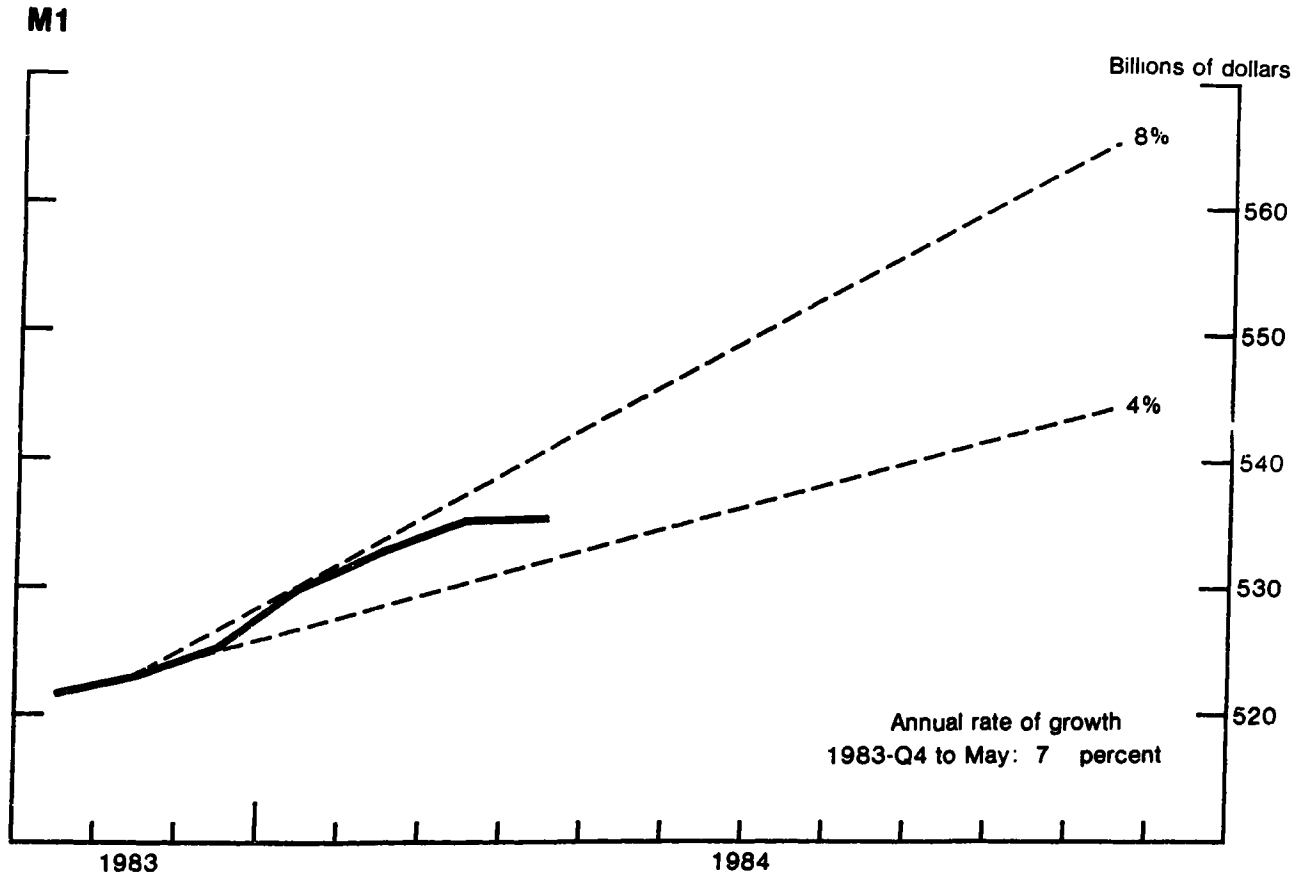


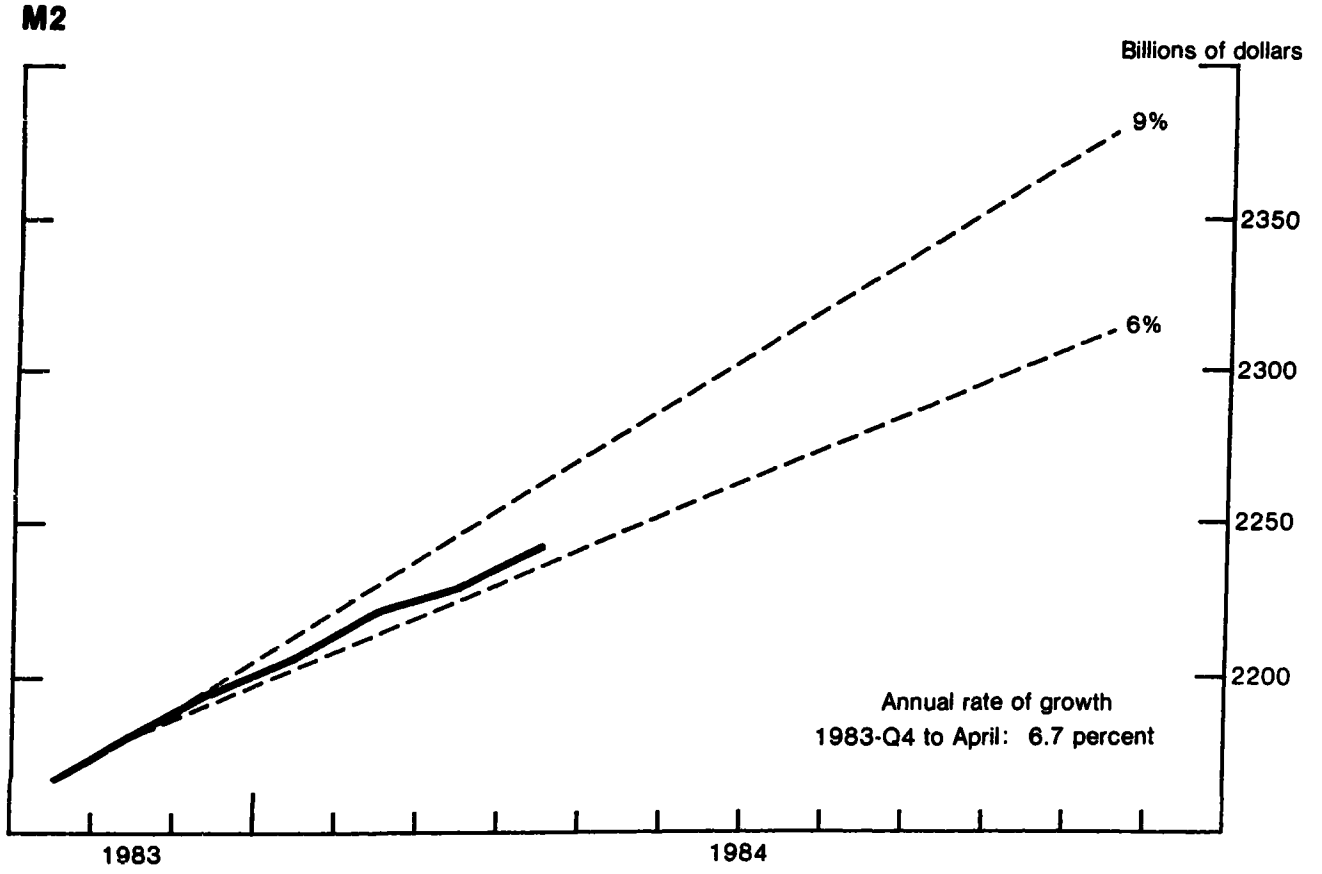
20-YEAR TREASURY BOND RATE



Note Shaded areas represent business cycle recessions.

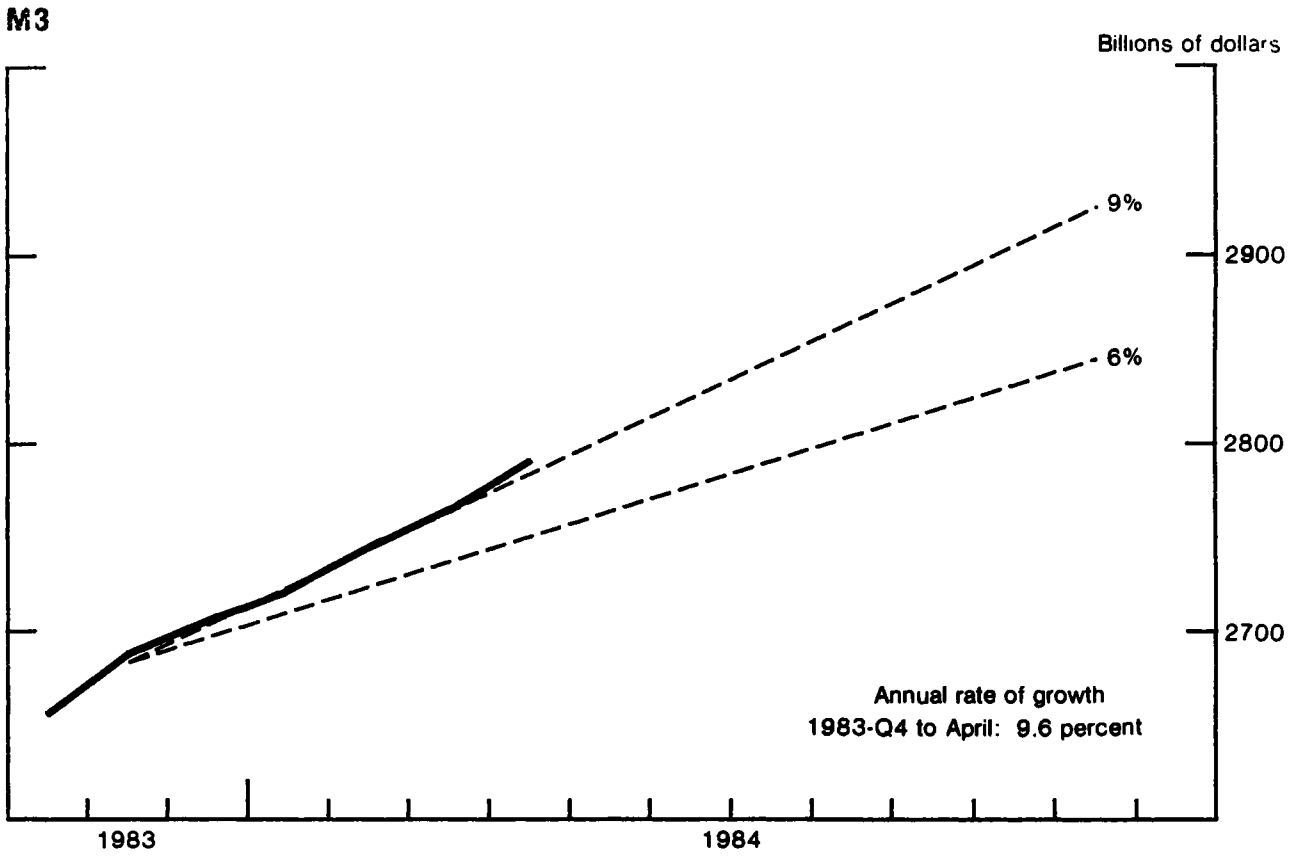
Chart 2



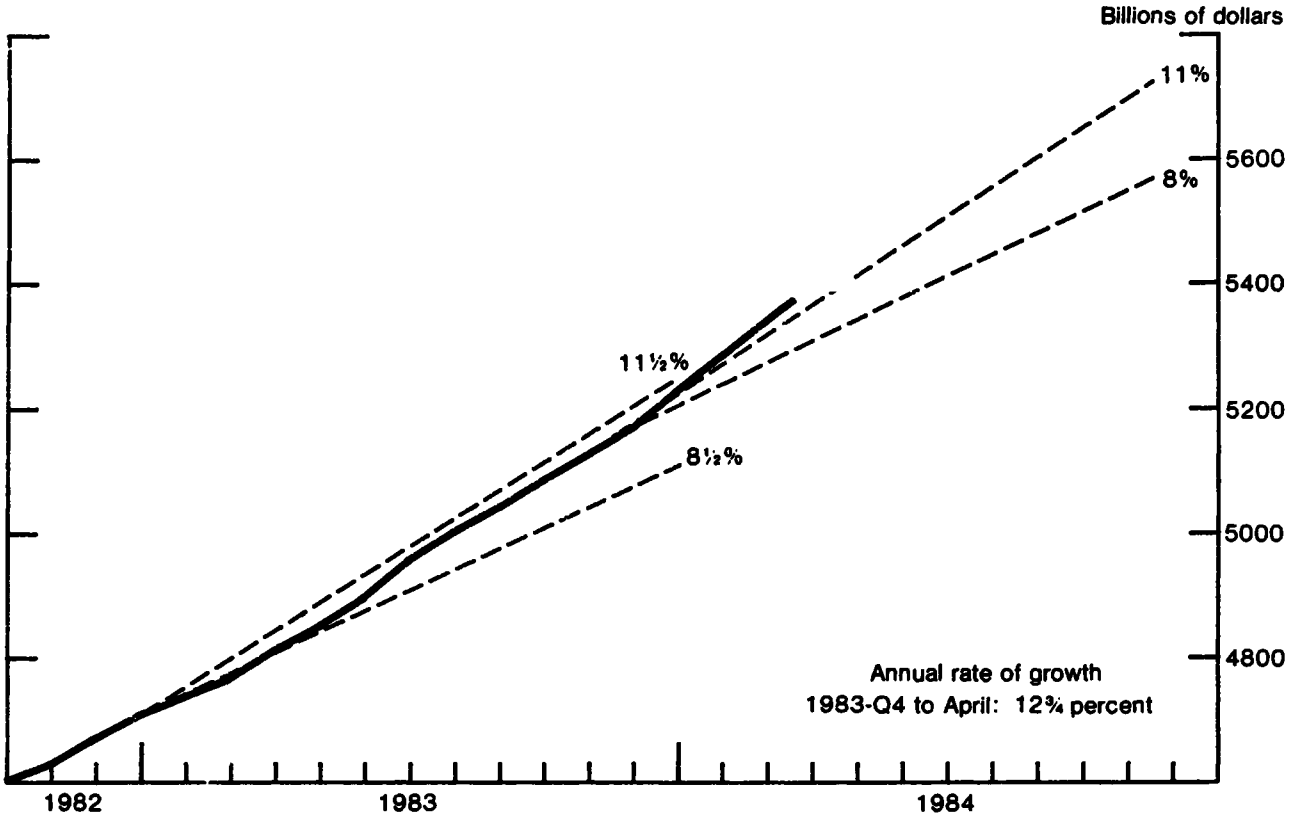


Note: M1 for May is based on data through May 28.

Chart 2A



DOMESTIC NONFINANCIAL DEBT



Note Domestic nonfinancial debt for April 1984 is estimated

GROWTH IN DOMESTIC NONFINANCIAL DEBT
(Seasonally adjusted annual rates, percent)

	Total	Federal Government	Private
1983-Q1	9.0	19.5	6.2
Q2	12.2	25.9	8.4
Q3	10.1	15.2	8.6
Q4	11.4	10.1	11.8
1984-Q1	12.3	14.2	11.8