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"Remarks on Monetary Policy"

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The fall political season has generated discussions of economic affairs that seem to have increasingly highlighted conflict and disagreement. Despite the election year rhetoric, I believe that there has solidified a basic consensus on what the economic goals of our nation should be, though certainly not what highway will lead us to their attainment. There may have been a strengthening of the resolve to reestablish a path of sustainable economic growth--one in which rising incomes and productivity will generate increased savings and spending and create desperately needed employment. I believe there is a developing belief derived from over a decade of experience that economic recovery can be achieved without reigniting the inflationary spiral.

From the private sector we have seen the scattered cooperative efforts by management and labor to reduce costs and increase productivity. The Department of Labor reported last week that major union contract agreements reached during the first nine months of this year provided for first-year wage increases of just 3.8 percent (excluding possible COLA increases). In 1979-80 when the same unions bargained last, the negotiated increase was 8.3 percent (again excluding COLAs). At the same time, we have begun to see some improvement in the aggregate measures of productivity. After declining throughout most of 1981, productivity has increased in each of the last three

quarters--rising at a 1.7 percent annual rate. Combined with the slowing of compensation increases, this improvement in productivity performance has led to a pronounced deceleration in the trend of unit labor costs--a fundamental determinant of the underlying rate of inflation. Union militancy has certainly not evaporated. However, continued advances in productivity and reductions in unit labor costs could create the base for future price stability and economic growth and are essential if American industry is to create jobs to employ a growing labor force and compete successfully in markets which are increasingly international in scope.

From the government sector we have seen an initial step toward fiscal policies that can create a less negative economic environment. Last year's tax bill still provides incentives for private sector investment. The recent progress on the fiscal side is encouraging but much more needs to be done. Federal deficits, now projected by some analysts to be well in excess of \$150 billion in coming fiscal years will place tremendous pressures on the financial markets when recovery becomes substantial. Of total funds raised in credit markets next year, the amount to be borrowed under federal auspices--including government-related agencies and guaranteed loans--will be at peacetime high. Crowding out threatens to abort any recovery. The Congress will have some immediate opportunities before it as it comes back for

its post-election session. Let us not fall prey to total cynicism--after all, Congress acted to increase revenues in an even-numbered year.

The actions by both the private and public decision-makers in response to the disinflationary process has not been without its economic setbacks, though. We have experienced the unfortunate transition costs of reversing a momentum of wage and price advances that have built up and become ingrained in our economy since the late 1960's. The unemployment rate has risen past the 10% mark. Balance sheets, both in the financial and nonfinancial business sectors have been severely strained in past years as reduced profits and cash flows have forced firms to turn to the credit markets at times when real borrowing costs were at historically high levels. Understandably, short-term credit was overused. Bond issuance at \$6.0 and \$7.0 billion per month and stock issuance at \$2-plus billion are welcome indicators of reliquification of the corporate sector. Industrial activity as measured by percent of capacity utilization is at its lowest level since 1975. Yet employment in "services" continued to rise during the recession.

Nevertheless, we have made real progress in breaking the momentum of the inflationary malaise which gripped our society. There seems to be a slowly growing awareness that the disinflationary progress made to date can endure, and that we could see further moderation of the inflationary

pressures in the future. Continued success in restoring price and wage stability is an essential part of the foundation for sustainable economic recovery and renewed long-term growth. In that regard I might assure you of the Federal Reserve's continued commitment to maintaining a discipline in monetary and credit growth--one that will contribute to price stability and to soundness in the financial system.

In light of recent events I would like to take the opportunity today to outline the current objectives of the Federal Reserve's monetary policy and the role that such policies have played in promoting our economic goals. Additionally, I would like to look forward and project what we can reasonably expect to achieve in the near future.

Monetary policy carries a special, specific responsibility in bringing about the disinflationary process. At the same time though, the Federal Reserve accepts its role to promote levels of production and employment through real economic growth. The major objective of our monetary policy has been to create an environment conducive to a sustained recovery in business activity while maintaining the financial market discipline needed to foster price stability. Easy enough to enunciate, but complex in implementation as the deposit and savings instruments undergo metamorphosis and evolution.

The implementation of this objective has led us over the years to a "pragmatic" approach toward maintaining the monetary targets. This year, for example, we have accommodated growth around the upper ends of our monetary aggregates target ranges and have shown tolerance of monetary bulges over those ranges from time to time. This pragmatism is a result of the need to orchestrate and economically consistent monetary policy in the face of the rapid and intense changes within the structure of the financial markets brought on by deregulation and technological innovation. Recent data indicate the public's desire to hold demand deposits, other checkable deposits, and short-term liquid assets. Part of the motivation is precautionary, part may be a function of uncertainty arising from a multitude of alternatives. Part may be utterly transitional, as balances are shifted, say, from all savers certificates to the stock market.

As you know, the Federal Reserve has been increasingly focusing on the monetary aggregates as intermediate targets for monetary policy since the early 1970's. We report to Congress and the public twice a year as to specific performance against targets. The use of the aggregates in the execution of monetary policy relies on the established, historical relationships between measures of money, interest rate, prices and

economic activity. The Federal Reserve has lots of company in the world's central banks. Of most import for the recent economic environment is the strong correlation between reductions in the growth of the money aggregates and reductions in the rate of inflation.

In late 1979 we changed our implementation procedures to place greater emphasis in the pursuit of monetary targets and on the control of the reserve base and much less on short-term interest rates. The employment of the reserve base, or more specifically, the level of nonborrowed reserves as a day-to-day operating target has allowed us to attain a better degree of control of monetary growth since that time. Over the last three years the pursuit of monetary policy goals based on these procedures has importantly contributed to the inflation rate being substantially reduced.

The emphasis on the monetary aggregates in conducting monetary policy and communicating that policy has worked well over the last several years. However, as you know, changes have and are occurring in financial markets over the next few months that will greatly distort the relationship of certain monetary aggregates to economic activity. The M1 aggregate is probably the most widely followed of these aggregates and one that will probably experience the highest degree of distortion.

The maturing of \$30 to \$35 billion in "All Savers Certificates" (ASCs) over the last several weeks has had a significant but unpredictable effect on the transaction accounts contained in M1. Over the last several weeks shifts have occurred of maturing ASC balances to M1 accounts that could constitute, for the most part, "parked" funds that may shift to investment instruments sometime in the future. Of course, it is not inconceivable that the liquidity preference of consumers actually has shifted in response to the depth and duration of the recession. However, the precise volume of parked funds, the speed with which these funds will move out to other instruments or to consumption and the extent to which some of these funds will remain as a precautionary part of transaction accounts will only be known through analysis and after some short-time interval.

The new "money market fund type" deposit account mandated by Congress for implementation next month will also have an impact on the M1 aggregate. It is expected that there will be a sizable shift from checking and NOW accounts to this instrument as well as shifts within the M2 aggregates from money market funds and other investment instruments. To the extent that the characteristics of the new instrument have not been decided, its market effect cannot be predicted with confidence.

In large part the effect that economic events and savings and deposit instruments will have on M1 obviously render this measure virtually meaningless in gauging economic and monetary trends for the short run. Rather than attempting to counteract the movements in the M1 aggregate over the next months we will be focusing less on the M1 aggregate and relying more on broader measures of money and credit available to us in our formulation of monetary policy.

The change in procedures does not represent an unprecedented break from past practices. As I stated earlier, in response to the great financial market changes during the past few years, we have adopted a flexible approach toward implementing our operational targets. M1 superseded M1B last year. The NOW account required adjustments. This flexibility--the willingness to look at all of the available information and to alter the monetary growth objectives in light of current judgments--is fundamental to the practical monetary-oriented targeting approach pursued by the System.

Within this framework the shift in emphasis from M1 to other intermediate targets does not portend a shift in the basic thrust of policy. We consider the opportunities presented in the financial marketplace over the next several months to necessitate a change in our technical operating procedures, but we do not envision it causing a reassessment

of policy direction--nor do we project the need for a primary policy shift for any other economic or financial disturbances at this time.

The deemphasis of M1 as an intermediate target may cause some problems for those who--contrary to our long-standing advice--have come to rely on that single variable to interpret broader economic conditions. I would caution against using such a basis for business or economic forecasting at any time, but I think that this caveat would be especially applicable over the next several months.

We will be pursuing a monetary policy over time to maintain the progress toward price stability. The human and economic "costs" of disinflation have already been incurred. The benefits of disinflation are within our grasp. It is clear that we cannot afford to return to an environment in which prices are rising at double-digit rates and inflationary expectations are distorting business decisions, ballooning interest rates and destroying the work ethic. Nor should we slacken the pace of deregulation to avoid complications within narrow limits of implementing monetary policy. The banking system must have the instruments to compete in an increasingly open market.

We are living through a period of collision between a long recessionary downthrust and a market driven shift of resources into new economic structures and configurations. The transition from inflationary expectations to a disinflation tinged with uncertainty is the background of policy making. Under these circumstances it is most important that monetary policy be implemented with consistency and continuity. To do less is to surrender the gains so hardly won and to miss the opportunities of an economic renaissance.