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Statement by

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I am pleased to participate in these hearings on monetary policy and its effects on the economy. During the past year, aided by the implementation of House Concurrent Resolution 133, a constructive dialogue has developed between the Federal Reserve and Congress on the course of monetary policy. I am hopeful that this morning's session, which I understand to be exploratory and educational in nature, will help further our mutual understanding of the issues involved. I would like to begin with some brief comments on the monetary policy process, based on my experience over the years working in this area, and then I shall be happy to respond to any questions the members of the Committee may have.

Although economists differ in their theoretical approaches to the channels through which monetary policy works, there is little or no disagreement in the profession that monetary conditions have a profound impact on the performance of the economy. One view is that monetary policy influences economic events primarily by changing the stock of liquidity--particularly, the supply of money and near-money substitutes--and thereby the willingness of consumers and businesses to spend and invest out of these more, or less, ample balances. Another view is that the influence of monetary policy stems mainly from its effects on the money and capital markets; by affecting the cost and availability of credit, policy actions will tend to encourage more, or less, consumption and investment based on the use of credit.

In fact, these theoretical approaches are not contradictory. They both find that an expansive monetary policy will tend to encourage more spending while a restrictive policy will tend to restrain it. But

they do approach the process from different vantage points, and the quantitative measures they suggest we look to in monitoring the conduct of monetary policy differ sharply. The liquidity approach emphasizes the rates of growth in the various measures of the money supply--M_1, M_2, M_3, and still broader definitions encompassing successively larger proportions of what might be considered to be the public's total stock of liquid financial assets. The credit approach to monetary policy, on the other hand, emphasizes changes in the flows of credit through banks, other financial institutions, and the securities markets, as well as changes in the terms--including interest rates--on which such credit is made available. This difference in measurement technique, I believe, gives rise to much of the confusion and disagreement in the evaluations of current monetary policy that one often encounters in the press and elsewhere.

The fact is that observed monetary measures, regardless of current policy intent, will always reflect also the interaction over time of monetary policy with underlying conditions in the economy. Output, employment and prices are affected directly by powerful forces apart from monetary policy, such as governmental tax and spending policies, the attitudes and spending proclivities of businessmen and consumers, the wage increases being obtained by labor and the pricing policies of business firms, the availability of foodstuffs, energy supplies and essential industrial raw materials, and economic conditions and developing trends

abroad. In these circumstances, whether interest rates are comparatively high or low, or whether the demand for credit is strong or weak, will depend on many factors other than the rate at which the Federal Reserve is providing reserves to the banking system--the basic policy instrument at its disposal. Indeed, even the observed pace of expansion in the various measures of money supply may reflect short-run variations in the public's demand for such balances or longer-run changes in liquidity preference in response to technological innovations in financial management, the level and trend of interest rates, and present and prospective rates of inflation.

It is important also to recognize that the impact of changes in monetary policy on various aspects of the economy tend to be reflected with differing time lags. If financial conditions tighten, for example, the effects are likely to appear much more promptly in securities market values, and hence on such wealth-sensitive variables as consumer purchases of durable goods, than in business fixed capital outlays, which require long lead times from planning to fruition. Similarly, the effects of a change in financial conditions will be more pronounced in markets that are heavily dependent on the use of credit--such as for housing and other large investments--than in markets where demand is financed mainly by current income flows, such as for consumer soft goods and services. Ultimately, of course, these areas of the economy too will be affected by induced changes in the income flows themselves.

There is one further timing aspect that requires especially careful evaluation in the formulation and conduct of monetary policy. As I have already noted, the economic influence of monetary conditions--whether measured in aggregate or financial market terms--will be to encourage either faster or slower expansion in spending, depending on whether such conditions are easing or tightening. But this effect on the nominal GNP does not distinguish between real activity and inflation. In my view, a shift in monetary policy can be expected to affect real activity, as demands for goods and labor tend to be augmented or restricted, before it reflects itself in the rate of inflation. This is because it ordinarily takes some time for business and labor to adjust wage and price policies to changing market conditions. The time lag involved, and the intensity of the inflationary effect, will depend on the initial state of the economy and the sensitivity of expectations. But the inflationary effects will sooner or later develop, and this argues strongly against a policy course that calls for large injections of liquidity into the economic system as a temporary panacea. In theory, it might be possible to withdraw the excess liquidity in time, before the inflationary forces begin importantly to work. But in practice this will likely be very difficult--if not impossible--to do.

The complexity of the relationship between monetary policy and the economy, and the need to move cautiously in modulating financial conditions as economic circumstances and investor and saver attitudes change, indicate clearly the importance of flexibility in the conduct of monetary policy. House Concurrent Resolution 133 fully recognizes this

need. Under this Resolution, the Board reports quarterly on economic and financial developments, and specifies the current expectations of the Federal Open Market Committee for the probable growth rate ranges in a variety of monetary aggregates, alternately before the House and Senate Banking Committees. This procedure is one that permits frequent re-evaluations and adjustments in current monetary policy aims to the economy's changing needs, which I believe to be a highly desirable attribute. Quarterly accounting for the stewardship of monetary policy also implicitly recognizes the difficulty of projecting economic developments very far into the future with any high degree of confidence--an assessment with which, on the basis of experience, I heartily concur.

In the Congressional deliberations leading to the present wording of House Concurrent Resolution 133, and in further discussions since then, a recurring issue has been the question of whether monetary policy intentions should be specified in terms of interest rates as well as monetary aggregates. The Resolution does of course require that the Board specify 12-month growth ranges for the various monetary aggregates, and it provides ample leeway for adjustment of such ranges as conditions change. In my view, this approach is far preferable to any attempt to specify interest rate objectives.

While it is theoretically possible to specify the course of monetary policy in terms of interest rate levels as well as the monetary aggregates, it must be recognized that interest rates are particularly exposed to the influence of many variables external to the scope of monetary policy, and that there is thus a large risk of specification

error. The announcement of interest rate intentions or expectations could lead borrowers and lenders to believe that the Federal Reserve could--and in practice would--guarantee particular levels of interest rates. But the System does not have the power to do so, for interest rates are influenced not only by the interaction of demands for credit with the available supply of funds, but also by the strength of the economy and the public's willingness to defer current consumption in order to save for the future. Interest rates are also importantly affected by the expectations of both borrowers and lenders about the rate of inflation.

If the Federal Reserve did nevertheless attempt to maintain selected interest rates at some predetermined level, the effort could well lead to inappropriate rates of growth in bank reserves and the money stock. If interest rates came under upward pressure because of rising demands for funds, for example, System efforts to prevent interest rate increases would inevitably generate more rapid monetary expansion, thereby feeding new inflationary pressures. If, on the other hand, interest rates came under downward pressure because of slackening business activity and declining demands for funds, System efforts to prevent the decline in rates would inevitably retard monetary growth rates, quite possibly exacerbating the recessionary problem.

Thus, any serious effort to specify monetary policy aims in terms of interest rate intentions or expectations could well prove inconsistent with stated objectives for growth rates in the monetary aggregates. Of course, the central bank might attempt to hold to the interest rate objectives, regardless of the performance of the monetary

aggregates. But even in this extreme case the result would very likely be self-defeating as lenders and borrowers moved to protect themselves against the prospect of accelerating inflation or deepening recession, foreshadowed by what might be very high or very low monetary growth rates. Needless to say, these effects would be quite perverse from the standpoint of economic stabilization.

In closing, I would like to stress that monetary policy alone cannot be expected to deal with all of the nation's economic problems. Fiscal policy has a powerful influence on the course of economic activity, and outsized deficits can and do contribute to inflation. Monopolistic behavior with respect to the setting of wages or prices lies outside the scope of monetary policy, and strongly influences the character of the inflationary bias also. Restrictive trade practices, whether imposed by private power or government regulation, serve to limit productivity and raise costs to the same end. It will require the effort of all the elements of our complex society if healthy economic growth is to be sustained, unemployment reduced to appropriately low levels, and inflation brought under control.

Mr. Chairman, at your request, I have tried to be brief in my treatment of a very complicated topic. It may be that I have raised more questions than I have answered. But I will be glad to respond to questions that Committee members may have.