Remarks by

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CURRENT MONETARY POLICY

Monetary policy continues to focus on laying the groundwork for reducing long-run inflationary pressures, a necessary prerequisite for sustained economic expansion. Inflation had begun accelerating in early 1979 and by last fall was nearing 14 percent at an annual rate; real final sales also increased quite substantially in the fall quarter. Growth in the monetary aggregates and in bank credit also accelerated and became inconsistent with the targets which the Federal Open Market Committee (FOMC) had established in February and reaffirmed in July. In order to bring growth rates of the aggregates more in line with the established targets, the Federal Reserve on October 6 announced a new anti-inflationary program involving an increase in the discount rate and new marginal reserve requirements. The most significant part of the new package, however, was the announcement that, henceforth, in its efforts to control growth of the monetary aggregates, the Federal Reserve would concentrate on the supply of bank reserves and place less importance on maintaining a narrow range for the federal funds interest rate. As a result of these policy changes, growth in the aggregates slowed sharply in the fourth quarter and the federal funds rate rose markedly.

In February of this year, the Federal Reserve Board sent to the Congress its semi-annual Monetary Policy Report which contained the growth targets for the monetary aggregates in 1980. Those targets represented a further slowing from both the targets and the actual performance over the four quarters of 1979. For example, the target growth of M-1A over the four quarters of 1980 was set at 3½ to 6 percent (mid-point 4-3/4 percent) while the actual growth over 1979 was 5½ percent; for M-2 the 1980 target is 6 to 9 percent (mid-point 7½ percent) compared to an 8-3/4 percent rise over 1979.

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The Board stated in this report that one objective of monetary policy in 1980 was to "impart a sense of long-range stability in policy and in the economic environment." The firm judgment was that in order to achieve this objective it was first necessary to brake the momentum of inflation and of inflationary expectations. Once this had been done, the selected growth targets should provide the base for stable growth over the longer run -- enhancing opportunities for capital formation, for improved productivity performance and for resumption of growth in real personal incomes. Further, curtailment of inflation and a more stable domestic economy should result in a stronger dollar in foreign exchange markets.

At the March FOMC meeting these objectives were reaffirmed and somewhat more specific growth rates -- within the adopted ranges for the year as a whole -- were set for the first half of 1980. The FOMC directed that open market operations be such that M-1A grow at an annual rate of about 4½ percent over the first half, M-1B at 5 percent, and M-2 at about a 7-3/4 percent pace; in short, growth should be at about the mid-point of the target range.

The Federal Reserve Board and the FOMC recognize that concentrating on growth in the aggregates will result in wider swings in the federal funds rate than had hitherto been the case. Accordingly, the FOMC also includes a constraint on the federal funds rate in the directive for short-run open market operations during the inter-meeting period. In March this constraint was established as a range of 13 to 20 percent for the weekly average funds rate. But it is important to understand that, under our new operating procedures, policy does not set a particular federal funds rate or any particular intervention point for Desk activities.

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As inflation continued to accelerate in the early months of this year, it seemed clear that the steps taken last October needed to be reinforced. Even making allowances for the sharp run-up in oil prices and the impact of increases in homeownership cost, the rate of rise in the consumer price index was tending to accelerate. Financial markets were indicating clearly that investors were becoming increasingly concerned about the inflationary outlook. As a result, on March 14 the President announced a broad program of fiscal, energy and credit restraints. Among these new measures was the invocation of the Credit Control Act of 1969 under which the Federal Reserve was authorized to restrain the growth of certain types of consumer credit extended by banks and others. The Board also announced a special credit restraint program, increased the marginal reserve requirements on managed liabilities instituted last October, and established a three percentage point surcharge above the discount rate for large banks resorting to frequent use of the discount window.

The end result of these various monetary policy actions since last October has been a significant slowing in the growth of the monetary aggregates and bank credit and a sharp run-up in interest rates in the period following March 14. During the last few weeks, however, both short- and long-term interest rates have fallen sharply, as loan demand and the monetary aggregates weakened markedly.

For well over a year, a number of economic forecasters have been projecting a recession beginning in the next quarter or two. These projections have had to be revised repeatedly as the economy continued to expand -- mainly on the strength of sustained consumer demand. In fact, consumer spending was maintained even in the face of declining real take home pay. This

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was accomplished by adding to instalment debt at a rapid rate and by reducing personal saving to lows not seen since the Korean War period. In recent weeks, it has become apparent that the consumer has finally begun to cut back and that the economy has indeed entered the long-predicted recession. Although real GNP rose slightly in the first quarter, the underlying data indicate that activity probably peaked in the early months of the year and that real growth has been declining since then.

Consumer retrenchment has been evident in the recent declines in retail sales -- both adjusted and unadjusted for inflation. In fact, sales at general merchandise, furniture and apparel stores plunged over 5 percent in the last two months; and sales at all retail stores other than auto dealers and building materials stores, but including food stores and gasoline stations, are fractionally below their January peak. Sales of automobiles, particularly of domestic makes, have plummetted in recent months -- reaching a 5-year low in April. Here the problem seems to be a combination of rapidly rising gas prices -- a 97 percent annual rate of rise between December and March -- high price tags, declining real earnings and tighter credit conditions. Measures of consumer confidence and consumer sentiment have plunged in recent months -- indeed, one index was at a 25 year low -- while at the same time consumer expectations of rapid inflation remained quite high.

Recent surveys of business spending plans for new plant and equipment in 1980 indicate about a 12.5 percent increase over 1979; however, much, if not all, of this rise seems likely to be eaten up by inflation. Finished capital equipment prices rose at over a 13¼ percent annual rate over the first quarter -- resulting in little real addition to capital stocks this year. Recent reports of a sharp rise in new orders for capital goods upon examination

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reveal that much of the increase was in orders for new aircraft and spare parts rather than in machinery and other capital equipment. Businessmen remain cautious with respect to their inventory policies -- especially in view of the high interest costs involved in carrying stocks. However, a very sharp decline in demand could result in an involuntary rise in such stocks, thus intensifying recessionary forces.

Of course, one of the most conspicuous signs of a recession is the housing industry. The very rapid increase in mortgage interest rates in recent months has resulted in a precipitous drop in new housing starts -- in March starts of single family houses were close to a record low for the post-war period. New permits are also down sharply and employment in the construction industry has dropped appreciably in the last two months.

Fiscal policy has also turned more restrictive in recent quarters and, indeed, the President has submitted to Congress a revised budget which shows a surplus for fiscal year 1981. By one measure, the net swing toward restrictiveness in fiscal policy has been about $40 billion over the last couple of years. Just as Federal spending on many programs is being curtailed so also are many State and local governments cutting back on their plans. Highway construction is being reduced as a result of loss of Federal matching funds. States and localities are also finding it difficult to float bond issues with high coupon rates; in many instances they have bumped up against legal ceilings and must wait until rates are lowered or the ceilings lifted.

Employment opportunities are beginning to dry up in many industries -- especially automobiles and related products such as tires and steel. Initial claims for unemployment insurance, a weekly barometer, have risen by 200,000 workers

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in just the last 8 weeks to the highest level since June, 1975. At least eleven states have now reached unemployment rates high enough to make claimants eligible for extended benefits. The overall unemployment rate rose to 7 percent in April from 6.2 percent in March, the sharpest one-month rise since January, 1975 and the highest rate in over three years. At the same time, the average manufacturing work week has fallen three-quarters of an hour since January to about 39½ hours and overtime hours have also dropped quite sharply.

Total industrial production has shown virtually no growth over the past five months; actually, the level in March 1980 was just slightly below that in January 1979. However, this total includes a decline of 1-3/4 percent in consumer goods and an increase of 3½ percent in business and defense equipment. And, in recent months, even this latter component has ceased to grow. Apart from autos, there have been large drops recently in output of other big-ticket consumer items, power and transportation equipment for business and of materials -- especially those associated with consumer durables and with the construction industry. Utilization of manufacturing capacity has fallen over the past year and is currently at the lowest point in almost two years.

Despite the sharp slowing in demand in recent months; there has been no appreciable slowing of inflation. Even when energy and food prices are taken out, the CPI still rose at the same rate in March as the average of the preceding seven months -- about a 14½ percent annual rate. Increases in overall producer prices have slowed only slightly since the sharp jumps in January but continue rapid; however, excluding food and energy prices there has been considerable slowing in these prices. It remains to be seen, though, how soon this development will begin to appear in consumer prices.

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As is now widely understood, the current recession and high inflation present particularly difficult problems for economic policymakers, notably of a kind not easily resolved by the traditional wisdom. This seems especially so for those responsible for the formulation of monetary policy.

For example, growth of the monetary aggregates was slower than expected in March and, on the basis of available data, will be sharply negative in April. The reasons for this sluggishness in the aggregates are not known at this time, and, therefore, it is not clear whether it will be only temporary or the result of a sudden and perhaps longer-term reduction in overall demand in the economy. If it is the latter, our dilemma is obvious.

With the aggregates registering growth substantially below their target ranges, we could, of course, increase reserves by an amount sufficient to bring them within the announced ranges. However, the increment in reserves necessary to achieve this could imply a federal funds rate that is far lower than seems prudent under current conditions.

Such a provision of reserves would run the risk of creating too much liquidity too soon. Moreover, it might be interpreted by market analysts as indicating an abrupt shift by the Federal Reserve towards monetary ease, possibly thereby encouraging inflationary expectations.

On the other hand, if reserves are not increased sufficiently to bring the aggregates within the established target ranges, we would then be acquiescing toward a more restrictive posture than intended -- doing so as the economy moves into recession. A more restrictive monetary policy in combination with a tight fiscal policy obviously runs the risk of deepening and prolonging the recession. In such circumstances there is no obvious policy prescription, no riskless course to follow.

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I do not know at this point how the FOMC will handle this problem if it becomes acute as a consequence of protracted sluggishness in money growth. In my view, the Federal Reserve should try very hard to achieve its targets for the monetary aggregates over relatively short periods of time. I would be prepared to see the federal funds rate continue around the low end of the currently established range and perhaps even somewhat lower. However, I would be disturbed to see a precipitous decline in the funds rate to a level markedly below the present range. Moreover, I would be concerned about a rapid build-up of liquidity that might prove necessary to push money growth up to targeted rates, as the economy weakens. Therefore, should the increase of liquidity threaten to become excessive, I would be willing to accept a rate of money growth that is below target for the near-term with the expectation that it would be made up for gradually during a later longer-term period.

Regardless of the approach taken by the FOMC it is important for observers to understand that the Federal Reserve is not abandoning its policy of monetary restraint because interest rates fall. Since the change in operating procedure on October 6 from trying to control the federal funds rate to controlling reserves, it is no longer valid to view changes in interest rates as signalling a change in policy. With money supply growth set at anti-inflationary levels, a decline in interest rates reflects a decline in demand for money, not a shift away from a policy of monetary restraint. Any significant change in policy must now be found in the longer-run trends of the monetary aggregates. Of course, the Board and the FOMC are constantly monitoring developments in the real economy as well as in financial markets. Also, monetary growth targets will undergo close scrutiny and reevaluation in July when the Board must submit another Policy Report to Congress. In my

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judgment, however, any change in Federal Reserve policy away from monetary restraint is most unlikely and, I repeat, if the economy is weak this may be associated with declining interest rates although it reflects an unchanged monetary policy.

Should the recession we are entering prove deeper and persist longer than presently expected, we may face the familiar question of the proper mix of monetary and fiscal policies. It is my hope that this downturn will be shallow and short enough to allow us to get through it without moving away from both restrictive fiscal and monetary policies. But, if it is determined that some sort of stimulus to the economy is necessary to combat a recession accompanied by continued inflation, should it come on the fiscal or monetary side? Some analysts have urged that a tight fiscal policy be maintained while following a "flexible" monetary policy -- meaning a relaxation of the current policy of restraint on growth of money and credit. Because inflationary pressures have often been attributed to government deficit spending financed by the Federal Reserve, such a prescription might have considerable political appeal. From my point of view, we would be better served at the appropriate juncture to take the opposite approach: continued monetary restraint by adhering to established targets for the aggregates while allowing some limited relaxation of fiscal policy.

Experience has shown that providing the stimulus from the monetary side during a recession too frequently results in the creation of excess liquidity. This process tends to complicate the task of controlling inflation during the ensuing expansionary phase of the cycle, as it may take too long a time for excess liquidity to work its way out of the economic system.

The effort to reduce and eventually wring inflation out of the economy may take several years during which money growth is steadily reduced

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to the point where it bears the proper relationship to real economic growth. To run the risk of creating excess liquidity during the next economic cycle might needlessly impede and delay the orderly process of laying the basis for non-inflationary economic growth.

I am aware, as you are, that in the past fiscal policy has not proven to be a highly flexible, short-run, countercyclical tool. The lags in shaping and enacting tax or spending changes are long and often difficult to reverse. I am also aware that actions which have the short-run effect of increasing the Federal deficit can be misinterpreted both here and abroad as reflecting a lack of will in fighting inflation. But, I believe that a carefully focused program providing a measured fiscal stimulus is possible and likely to be effective. It would be necessary, I think, that all aspects of such a program be aimed at creating incentives for increasing producitivity -- such as tax reductions for business tied to investment outlays and income maintenance programs tied to training and skills enhancement. Stimulus packages of the latter kind have the advantage not only of being compatible with long-term economic objectives -- and which must eventually be addressed in any case -- but may be phased out when no longer needed without having long lasting undesirable effects.

I will resist the temptation to end this discussion with a sermon. I could try to make points on the subject of the "credibility" and "resolve" of the Federal Reserve and why we deserve better understanding from the press and the public -- but I won't. I will simply say that we are all responsible people at the Fed who have to make decisions from time to time on the basis of limited -- and often later revised -- information. I can assure you that we will apply our best judgments to the difficult issues we will surely face in the coming months.

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