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Statement by

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Board of Governors of the Federal Reserve System

before the

Domestic Monetary Policy Subcommittee

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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It is a pleasure for me to be here today to testify on Joint Resolution 365. The issues involved are of vital interest and concern to the Board of Governors, and my colleagues and I appreciate the opportunity to convey our views.

Let me emphasize at the outset that the Federal Reserve Board agrees fully with the objective of achieving a lasting reduction in interest rates. Lower interest rates would serve to improve conditions in credit-dependent sectors of the economy such as housing, agriculture, and small business and would relieve earnings pressures on numerous financial institutions, particularly thrift institutions. Interest rates have declined sharply over the past two months, as private credit demands have weakened along with reduced economic activity. But they remain high by historical standards. The fundamental reasons for this are the persistence of inflationary expectations along with large Federal financing requirements. I would hope that recent improvements in price performance will begin to erode inflationary expectations, but so long as borrowers believe that they will be able, through inflation, to pay off loans with shrunken dollars, they will have a strong incentive to borrow. And so long as lenders see inflation in their future, they will require an "inflation premium" that compensates for the erosion of purchasing power.

Monetary policy is designed to achieve a gradual reduction in monetary growth rates that will curb inflation over time. Reduced monetary expansion is essential if the fight against inflation is to be successful. As inflation and inflationary expectations subside, conditions for sustainable economic recovery should be established. If the Federal Reserve were to attempt

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to reduce interest rates by pouring reserves into the banking system and promoting a sharp surge in money growth, short-term interest rates might decline further, but this decline would be only temporary. The excessive monetary stimulus would intensify price pressures in the economy. Inflationary expectations would worsen and long-term interest rates, which are of major importance for investment activity and homebuilding, would undoubtedly rise. Thus, the end result of an overly expansionary monetary policy would be higher, not lower, interest rates.

I would like to turn now to the specific provisions of the Joint Resolution. The first of these provisions calls for reconsideration of current economic policies "so as to bring interest rates down rapidly enough to effect an early, complete recovery from the recession and to prevent a resurgence of high interest rates in future years." It is our view that what we take to be the basic purpose of this provision--a sustainable economic recovery without the excessively high interest rates we all want to avoid--can be achieved only if inflation is brought under control. That will require a steady monetary policy, but also and importantly, disciplined fiscal policies and moderation of wage and price behavior on the part of business and labor.

The Joint Resolution also calls for "an aggressive campaign designed to encourage banks to cease providing loans or lines of credit for unproductive takeovers and speculative purposes so as to increase the supply of credit for productive purposes." We assume that this means use of "moral suasion" rather than authority that might be involved through Presidential activation of the Credit Control Act of 1969.

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The Board of Governors is fully sympathetic with the objective of encouraging the most productive use of credit and understands the concerns that prompted this provision of the Joint Resolution. Nonetheless, we have serious reservations about the provision. It raises fundamental issues regarding the definition of "unproductive" and "speculative" credit. For example, we should be wary of categorizing given uses of credit--such as the financing of corporate takeovers--as necessarily undesirable. A given takeover may be "productive" in the sense that it may strengthen management, generate resources for increased investment in improved facilities, produce economies of integration or scale, and especially in the case of smaller enterprises, provide for orderly transfer of ownership from one generation to another.

On a more technical level I would point out that the several highly publicized merger deals this year have in reality had quite limited impacts on credit markets. The credit flows involved in actually consummated transactions have been considerably smaller than suggested by the aggregation of credit lines that were arranged, including those by unsuccessful bidders. Moreover, mergers generally involve only a transfer of ownership of existing assets and do not tend to absorb the real savings in the economy. Stockholders who sell out obtain funds that are available for reinvestment or for loan repayments, thereby recycling these funds into credit markets.

I do not want to suggest that we should be complacent about takeover loans. They may in some cases be a cause for concern and they should be given close scrutiny. Moreover, they can have a somewhat inhibiting effect on short-run

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flows of credit. In committing themselves to a large volume of takeover loans, banks may restrict for a time their lending to other potential borrowers, but any such effects should normally be quite small and of short duration.

Another provision of the Joint Resolution urges "efforts to ensure that thrift institutions, the housing industry, small business, farmers, consumers, and homebuyers have access to the least expensive possible credit." A few months ago our staff completed a study for the Senate Banking Committee which concluded, not surprisingly, that adverse credit conditions had played a role in curtailing activity in housing, automobiles, and agriculture, and apparently many small businesses as well. Actually, as the study also makes clear, we have to be cautious about blaming high interest rates for all the problems that some sectors of the economy are experiencing. In many instances a major part of the difficulty appears to lie elsewhere, including excessive price increases in the past and failures to remain fully competitive. Nonetheless, high interest rates have certainly exacerbated problems and have had an uneven impact on different sectors of the economy.

Access of selected sectors to credit on the least expensive terms possible cannot be achieved by credit-control-type approaches in today's highly competitive national and international financial markets. Inequities, administrative nightmares, and distortions in credit flows would be the principal result. Allocation of credit on the least expensive terms possible is most effectively performed by a freely functioning and competitive market. Last year's experience with credit controls, although they were imposed under exceptional circumstances and were in effect only for a brief period, emphasizes that

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they lose their effectiveness and become increasingly inequitable as the financial system devises ways to circumvent them.

Pressures in credit-sensitive sectors can be relieved efficiently and effectively only by achieving and sustaining a lower level of interest rates generally. This depends on bringing inflation under control. This process would be accelerated, and sectors of the credit market relieved, if Federal fiscal deficits were held down. In current inflationary circumstances heavy borrowings by the Federal government tend to hold up interest rates and absorb savings that would otherwise be channeled to private borrowers.

The Joint Resolution also asks for studies "on innovative techniques for managing the money supply and credit resources in times of tight credit so as to meet urgent national needs." As many Committee members know, the Federal Open Market Committee adopted new operating procedures about two years ago that were designed to improve the System's control over the growth of the monetary aggregates. Those operating procedures, and certain alternatives, were reviewed by our staff in a comprehensive study that was completed earlier this year. Copies of the two-volume staff study were supplied to Congressional Committees. In addition to this study, we of course have our procedures, as they involve all the instruments of policy, under continuing review. Against this background, and given current economic developments, I would question whether a major new study of the type contemplated in the resolution is needed.

The Joint Resolution calls on the Federal Reserve to "reconsider its tentative decision to reduce the targets for monetary growth for 1982." The contemplated reduction applies to only one of the targeted measures of

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money, namely, narrowly defined money or M1-B; no changes from this year's ranges were proposed for the broader measures of money, including M2 and M3. For a number of reasons, including the explosive growth in money market mutual funds that may substitute in part for M1-B type accounts, growth of M1-B this year has fallen short of our target range, while expansion in the broader monetary aggregates has been close to or above the upper limits of their respective target ranges.

In keeping with the Joint Resolution and its own past practice, the Federal Open Market Committee has planned a full review of the tentative 1982 ranges at a meeting scheduled for early February and a final decision regarding those ranges will be made at that time. By early February the Committee will have had an opportunity to analyze the Administration's new budget proposals and will, of course, be in a position to evaluate the latest economic and financial developments. I cannot predict the outcome of that review, but I can assure you that it will be thorough.

As a final provision, the Joint Resolution states that "the President shall select individuals for nomination to vacancies on the Board of Governors ...so that this Nation's agricultural and commercial interests, including housing and small businesses, will no longer be underrepresented." The selection of new Board members is, of course, the prerogative of the President subject to confirmation by the U.S. Senate. In my view, it would be helpful at this time for a new Board member to have a broad business or financial background and to possess administrative skills. I can see positive benefits in diversity of backgrounds and regional representation on the Board, provided a member does

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not undertake to represent the narrow interests of a particular group, industry or region.

In conclusion, I want to reiterate that my colleagues and I on the Board of Governors are sympathetic with the basic objectives of the Joint Resolution to lower interest rates and achieve a balanced distribution of the Nation's credit resources. However, we would question the need for the resolution at this time. It runs the risk of being interpreted as calling for monetary policy to back off from its anti-inflationary stance and of regenerating what I hope are diminishing inflationary expectations. I believe it is critically important that the economic recovery following the present downturn in economic activity be on a sustainable basis with inflation continuing to unwind.

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