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Statement by

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before the

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of the

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I am pleased to be able to testify before this Subcommittee on the international implications of the Federal Reserve's October 6 measures. The measures represented an added restraint on the availability of credit and a more effective technique of controlling growth of the money supply and related monetary aggregates. These actions are designed to assist in curbing the unacceptable inflation we are experiencing and should bring improvement on both the domestic and the international side of our economy. My assignment here is to discuss the international side. But I am sure you understand fully that the domestic and the international effects are closely interrelated.

As background, I would like to review briefly some of the most important developments in the weeks and months leading up to October 6.

The monetary aggregates, after growing at quite low rates in the fourth quarter of 1978 and the first quarter of this year, began to expand at a very rapid pace in the second and third quarters. Growth of M-1 averaged about 10 percent at an annual rate, and growth of M-2 averaged nearly 12 percent over the course of the latter two quarters. The rapid expansion of the aggregates in the third quarter occurred despite increases in the federal funds rate totaling about 1-1/4 percent over that quarter. Continuation of growth at these rates would have meant that we could not achieve our longer run targets for the growth in the aggregates from the fourth quarter of 1978 to the fourth quarter of 1979. Under the provisions of the Humphrey-Hawkins Act, the Federal Open Market Committee had set these targets in February and reaffirmed them in July.

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At the same time as incoming data revealed a surprising degree of real strength in the economy, consumer prices continued to show monthly increases at a 13 percent annual rate in July and August, while the producer price index increased at nearly a 16 percent annual rate over the third quarter, portending possibly a near-term acceleration rather than a slow-down of consumer price increases.

In the foreign exchange market, the dollar had declined by 5-1/2 percent on a weighted-average basis from mid-June to the beginning of October, despite a substantial appreciation against the Japanese yen. The dollar's real exchange value, that is, the dollar's exchange value adjusted for relative U.S. and foreign inflation rates, had declined by somewhat less. This occurred despite very heavy official purchases of dollars -- particularly at times by U.S. authorities.

Exchange market pressures on the dollar intensified in September; the DM/$ rate, for example, had declined to nearly the October 1978 lows. Because of these developments, exchange market participants were anticipating some sort of policy "package" from the United States. Talk in the market tended to be focused on possibilities for macro-economic policy action, particularly monetary policy action. This reflected the view that the fundamental cause of the dollar's weakness in exchange markets was the severe U.S. inflation rate and that until prospects brightened for bringing inflation under control even augmented U.S. exchange market intervention could do little to help the situation. A sign of the importance that the exchange market attached to action on inflation by the United States was the dollar's sharp advance on October 2 on the news that Chairman Volcker had left the Belgrade meetings early to return to Washington.

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Speculation in the gold markets reached feverish proportions from late August until early October, with the price soaring by $100 per ounce to a high of almost $450 in London trading on October 2. The price was double that prevailing at the beginning of the year. This infection soon spread to other metals markets, and from there to still other commodities. The BLS index of industrial commodity prices rose at an annual rate in excess of 50 percent over the month of September, with metals prices rising faster than the average. These developments in gold and other commodity markets were symptomatic of a general rise in inflationary expectations that tended to feed on themselves.

It was against this background that the Federal Reserve announced on October 6 its package of complementary measures: (1) an increase of one percentage point in the basic discount rate from 11 to 12 percent; (2) the establishment of an 8 percent marginal reserve requirement on further expansion in the managed liabilities of the larger banks -- liabilities that had been actively used to finance the rapid recent expansion in bank credit; and (3) a change in short-run operating procedures, placing more emphasis on the supply of bank reserves and less emphasis on managing the interest rate on overnight federal funds, in order to achieve better control over the growth of the monetary aggregates. This last action was intended, in particular, to provide greater assurance that the growth of the aggregates over the remainder of the year would be consistent with the previously adopted longer run target ranges.

In making the announcement and later in letters addressed to the Federal Reserve member banks and to the branches and agencies of foreign banks, Chairman Volcker made clear that these measures were intended to

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bring about a slowing but not a halt in the flow of credit. He particularly stressed the need for bankers to provide a continuing reasonable flow of credit for small businesses, consumers, home buyers and farmers and pointed out the inadvisability of loans to finance essentially speculative operations in commodities, gold, and foreign exchange markets as well as the inadvisability of unproductive financial loans. To guard against the possibility that lending by foreign banks to U.S. resident borrowers might undermine the restraint exerted by the marginal reserve requirements, Chairman Volcker requested the cooperation of U.S. branches and agencies of these banks as well as their foreign affiliates.

Bank credit and the expansion of the monetary aggregates appear to have slowed significantly since these measures were adopted, although initially these effects were obscured by errors in the data concerning the money supply. In the financial markets, the reaction of interest rates and exchange rates was immediate and sharp.

By the end of the first full week, interest rates on short-term dollar assets had jumped by as much as 1-1/2 percentage points. Prices in stock and bond markets tumbled. In the exchange market, the dollar advanced over 1-1/2 percentage points on a weighted-average basis -- by 2 percentage points against the German mark -- without any central bank intervention support. The gold price did not show any further significant decline, though it had dipped below $400 a few days earlier, and remained very volatile. Other commodity prices dropped back from their early October highs.

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Commentary on the Federal Reserve's actions in the domestic and foreign financial press and by foreign monetary authorities was predominantly favorable, emphasizing that the United States was doing something fundamental about its inflation problem. Some skepticism was expressed, however, as to whether the Federal Reserve would "stick to its guns" in moderating money and credit growth should a widely forecast recession actually materialize. Among exchange market participants, foreign dealers tended to be more skeptical in their comments than American dealers.

By the end of October, conditions in financial markets had become more settled. Short-term rates were somewhat higher, but were generally less variable, except for the federal funds market where the effective daily rate ranged from more than 17-1/2 percent to about 12 percent. Somewhat greater variability in the federal funds rate was, of course, expected in view of our new operating methods. Stock and bond prices, which had declined sharply for about two weeks following the October 6 announcement, regained a moderate portion of their earlier losses and also tended to stabilize.

In the exchange markets, some of the initial skepticism about the Federal Reserve's actions waned, and the dollar advanced even further, despite substantial sales of dollars by a few central banks in support of their currencies. The dollar remained near these higher levels despite the release of trade figures showing a large U.S. deficit for September and an increase in the German Bundesbank's discount rate at the end of October. The dollar was underpinned by the Treasury's announcement of its two new issues of DM-denominated securities in the German capital market.

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By month-end the dollar's weighted-average exchange value was up by 3-3/4 percent from its October 1 level. Gold prices eventually declined to below $380, partly reflecting the announced increase in the size of the Treasury's auction held on November 1. In other commodity markets, prices declined further -- the BLS index was off 3 percent over the month.

Our actions seem to have prevented any further aggravation of inflationary psychology and, at least for now, may have broken its gathering momentum. Over the longer run, the principal effect of the new monetary policy procedures of the Federal Reserve will occur through the impact that these procedures can be expected to have on growth of the money supply and on inflation. If the monetary aggregates are firmly controlled, and if complementary energy, tax, regulatory, and structural policies are followed, inflation should come down over a period of time, and the dollar should maintain its strength. If at the same time the current account moves in the direction of surplus, as now seems likely, this should add further strength. Obviously there are a number of uncertainties in the present situation, including the risk of a major further increase in the price of oil which underscores the importance of an effective energy policy.

In the context of the dollar's exchange value, a greater volatility of the federal funds rate such as may be associated with the new procedures should not have major significance. For one thing, day-to-day fluctuations in the federal funds rate are unlikely to be interpreted as an indication of changes in Federal Reserve policy, as they have tended to be interpreted in the past.

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Second, other short-term interest rates and, particularly, long-term interest rates, need not be expected to follow closely, if at all, the daily fluctuations of the funds rate. Such behavior would reflect both the lesser policy significance attaching to the funds rate and the fact that 90-day rates and, even more, longer term rates tend to reflect the average level of the funds rate over the life of the instrument rather than to follow its daily level. For instance, fluctuations in rates for daily money in London and in Frankfurt do not seem to influence very much the rate for 90-day money, and also do not seem to influence very much the exchange rates of the pound sterling and German mark.

In the third place, the interest rate is only one of several factors bearing upon the exchange market and probably not the most important. Interest rate differentials are more fully exploited by investors and arbitragers when markets are reasonably stable. Interest-bearing investments in a currency must be held for some time, after all, before the expected benefits from a more attractive interest rate accrue.

An example of this can be seen in the behavior of the foreign exchange value of the dollar during the years 1975-77 as contrasted with interest rate developments during that period. The dollar went from a position of weakness early in 1975 to a condition of greater strength during late 1975, almost all of 1976, and the first part of 1977, only to weaken thereafter. U.S. interest rates actually moved inversely, falling, on balance, from mid-1975 through mid-1977, and rising once more beginning in the latter part of 1977. To be sure, U.S. interest rates

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must be viewed in relation to interest rates in foreign countries and in relation, particularly, to rates of inflation. The data do, however, warn against the acceptance of any simple correlation between interest rates and exchange rates.

If our economy should slow down as is widely predicted, it could be appropriate for interest rates to decline as growth in money and credit subsides and inflationary expectations diminish. I do not believe that such a development would be viewed as a source of weakness of the dollar. Inflation and current account developments are more fundamental determinants of the exchange rate than are nominal interest rates. The measures announced by the Federal Reserve on October 6 should assist in the effort to make progress in effectively dealing with these fundamental factors.

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