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Remarks by

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It's a pleasure to be with you today. I would like to share some of my thoughts concerning present economic conditions and our monetary policy objectives. As participants in the positive economic events of the last several months, many of you have been direct witnesses to the economic recovery that now seems to be firmly in place. The growth in GNP for the fourth quarter appears to be continuing at a strong, though somewhat moderated pace from its second and third quarter expansion. An "in-bounds" deceleration in GNP at this point in the expansion phase follows the pattern common to past cyclical patterns and seems to have provided some relief to financial market fears of an overheated economic rebound.

Rate declines in long-term markets have been somewhat less than those of short-term rates since mid-August. Coupled with the unusually large advance in long rates in relation to the increases in short-term rates over the early summer, this seems to suggest the emergence of upward revisions in expectations of future real interest rates--revisions that are more related to prospective rather than present market conditions.

In my view, it would be a mistake to confuse the probability with inevitability of federal mega-deficits exceeding $200 billion over the next several years. The electorate will be heard from next year. It is conceivable that public debate could raise voter awareness that the tax burden continues to impede expansion; that higher Social Security taxes, higher state and local levies, and bracket creep have offset marginal rate reductions in his, the voter's, federal taxes. Contemplate for an uncomfortable moment the impact the pre-1981 tax structure would have had on this recovery. Putting it another way, fiscal policy has contributed to the recovery and today's expansion in part because the tax burden has not been increased for the first time in decades.

Deficits have always had to be financed in recovery and expansion periods--in the first year of the 1976 recovery, capital markets handled a $74 billion deficit, an additional $54 billion in the second (1977), and $59 billion in the third (1978). However, the contrast of those deficits with deficit projections for the 1984-87 fiscal years is striking. How strong will a 1985 expansion year be if the deficit that year is running at $200 billion, approximately 3.4 times that which characterized 1978? A word of caution is appropriate here. Our economy and our society are so changed and changing that the best economic models are of very finite usefulness for long-range forecasting. What is the range of error around the first Congressional Budget Resolution forecast of a $175 billion deficit in 1986? You have reviewed the models and you know how raising the real growth assumption rate from 4% to 5% would reduce that figure.

Nevertheless, however cloudy the prospects are in reality, the specter of continuing mega-deficits, as well as the present deficit are causing problems. Out-year mega-deficits tend to create doubts as to the prospects for the success of economic policy--to some, the very capacity of economic policy--to contain inflationary pressures over the long run. Even if pessimism should be unwarranted, it constitutes an unsettling influence on financial markets and the potential for upward, expectational shifts in interest rates. My point is that it would be wise to levy a discount against the more extremes of doubts that responsible fiscal policy may take place.

Perhaps a more fundamental concern, however, arises from the assessment of the prospects for structural damage to the economy due to the long-term effects of even baseline federal spending increases as projected. Realization of these projections would mean that demands for capital investment and reinvestment developing from rising capacity utilization rates would be damped by the appropriation of those resources by public sector consumption. The adverse implications for future productivity and economic growth are obvious. This would threaten to impede the accomplishment of the enormous task before us in rebuilding and expanding both domestic and export industrial and services capacities.

Another consequence of our present mega-deficits and the strong upward pressure they have put on "real" rates of interest has been the propensity of those rates for contributing to the large inflow of foreign capital we have experienced. This has helped to keep the foreign exchange value of the dollar so high, that it damages our ability to compete in world trade and results in international political tensions and calls for self-destructive protectionism. That is a market result that cannot be dealt with artificially. And it is difficult to see a return to more typical levels of interest rates under current fiscal projections, barring any unexpected slowdown in economic activity.

The Federal Reserve, through its monetary policy alone, cannot resolve such economic imbalances. It can only aim to affect aggregate demand within reasonable bounds through its influence on money and credit expansion. The discipline of monetary targeting served us well in turning back the "ninth wave" inflationary tide of 1978-1981, and a determined effort to keep growth in money and credit within bounds remains the key operational task of monetary policy.

But as the record will attest, achieving a sustained, noninflationary recovery has not proved to be easy in the past. Today, the difficulty of engineering growth with some restraint in the face of strong federal spending stimulus is compounded by the problems of determining the appropriate rate of monetary expansion to achieve this task in an environment of rapid change in the financial industry and markets.

As you are well aware, we have now embarked on a period in which profit-motivated private financial innovation is combining with the progressive easing of traditional regulatory restraints to produce a dramatically altered financial structure within our economy. Full-page advertisements and a drumbeat of electronic reminders surround the urban saver. The difficulties this revolution presents us not only tax our powers of analysis and judgment, but may also tend to sow confusion and misapprehension in the minds of those seeking to gauge Federal Reserve policy and intentions.

A relatively straight-forward example of how the implementation of monetary policy is complicated by structural change is provided by the authorization of money market deposits last December. In addition to substantially altering the composition of M-2, shrinking the money market funds, savings, and small time deposit components, this popular instrument also siphoned funds from non-monetary sources, boosting M-2 growth.

As a result, there was a brief period when M-2 could not meaningfully be related to any target ranges. As you know, we dealt with this problem by selecting the February-March period as the base from which to measure this year's M-2 growth, rather than the fourth quarter last year. The target growth range for M-2 was also raised by a percentage point to allow for shifts from nonmonetary assets into MMDAs after March. Such an experience can understandably cause confusion. On the face of it, "forgiving" a period of rapid M-2 growth and raising its target range are both expansionary moves. Under the circumstances, we do not believe this to have been the case.

A subtler problem raised by money market deposits is to what extent the behavior of M-2 has been altered with its composition. Most likely, it has become less amenable to Federal Reserve control, as its attractiveness versus competing instruments will now be harder to influence. Even after arriving at a good estimate of how M-2 should now behave, we face a potential problem in explaining to financial markets why, for example, it may be appropriate to seek to return M-2 more slowly than before from any departure from target ranges if we are to avoid undue wrenching of the markets.

Even in the absence of large structural changes such as the authorization of a new account, my colleagues and I have known that we must not concentrate too rigidly on particular quantitative targets, because the relationships between various measures of money and the ultimate goals of economic policy--output, employment, price level--have always contained a large element of the unpredictable, particularly on a shorter term but even on a quarter-to-quarter basis. Thus, the Federal Reserve has not and does not pursue a policy that could be regarded as "mechanical monetarism."

Our flexible approach has led to other important changes in the past year. We found it necessary, in light of institutional developments, to reduce the emphasis placed on the basic money stock measure, M-1, to that of a "monitoring" rather than a target range, and to assign a greater weight to the broader aggregates.

In the past, M-1 was viewed as a reasonably good measure of "transactions" balances in the economy. As such, it has been regarded as a key monetary measure because of the assumed relation between nominal economic activity and the volume of transactions balances the public wishes to hold.

Unfortunately, the concept of transaction balances has become fuzzier in recent years as high nominal interest rates gave impetus to the development of highly liquid interest-bearing instruments which serve as both savings and transactions vehicles. This process culminated with the authorization of NOW accounts in 1981 and of Super NOWs this past January. This major change in the composition of M-1--it is currently about one-fourth NOW or Super NOW accounts--has most likely fundamentally changed its longer run behavior, and recent velocity behavior has been highly unusual. In retrospect, it seems that M-1 probably has had a greater interest rates sensitivity at a time of much lower inflation. This helps to explain why M-1 grew so fast and its velocity declined in late 1982 and early 1983.

The logic behind this is not difficult to understand. Keep in mind that, although short-term market interest rates--traditionally viewed as a measure of the opportunity cost of holding currency or demand deposits--fell by 4 to 5 percentage points during the second half of last year, from about 13 percent to around the 8 percent range, the decline in the opportunity cost of holding NOW accounts was much more dramatic, at least in percentage terms, dropping from about 7-1/2 percentage points to about 3 percentage points. And, although market rates rose in 1983, the effect on the opportunity cost of holding NOWs was lessened by the introduction of Super NOWs in January. Rates on Super NOWs have been kept in quite close alignment with money market rates.

This theoretical explanation is consistent with the fact that one-half of the 14 percent annual growth in M-1 from last September to June was due to a 40 percent expansion in its NOW/Super NOW component. The demand deposit component, by contrast, rose at less than a 6 percent annual rate, and this was likely boosted by rate-related increases in compensating balance requirements.

These observations suggest that the rapid growth of M-1 over the past year has a considerably less disturbing implication for the future course of the economy than might otherwise be the case. It is our view that an attempt to hold M-1 growth down more severely in 1982-1983 would have resulted in a significantly tighter monetary stance than would have been appropriate for recovery and expansion.

The skeptic might respond that nominal GNP accelerated sharply in the second quarter just as a monetarist looking at M-1 behavior would have predicted. This, unfortunately, is an argument that is not likely ever to be settled satisfactorily. I would suggest that there is a serious risk of spurious correlation here. It is quite possible that last year's decline in interest rates resulted in both an acceleration of M-1 and a pickup in GNP growth. The monetarists anticipated the strong second and third quarter GNP increments. However, "monetarist" models--such as the famous one developed by the FRB of St. Louis--which link GNP growth directly to money growth, in fact would have predicted a faster and stronger resurgence in GNP growth than actually occurred--which is another way of recognizing that velocity has been unusually low.

Despite the various difficulties of interpretation I have discussed, we continue to believe that monetary targeting is useful and of course we are pleased and strengthened in our convictions that each of the aggregates is now within its target or monitoring range. We do not believe it is wise to ignore any relevant information, and watch each of the monetary aggregates closely for whatever they can tell us.

I would like to conclude my remarks with some brief additional observations about financial matters. First, as you are well aware, interest rate volatility has increased, although it has been less severe this year. In the very short run, increased volatility is partly related to the Federal Reserve's switch to a reserves-based operating procedure in late 1979.

It is important to note, however, that interest rates have also become more volatile in a cyclical context. There are probably two main factors at work here. The first is interest rate deregulation. The absence of non-price rationing effects such as those associated with Regulation Q in previous periods of monetary restraint makes it likely that interest rate swings must be somewhat greater to achieve the same degree of resistance to departures of the economy from any particular growth path. Secondly, owing to the extraordinary shocks that the economy has received in recent years, and to the extent to which inflation expectations had become entrenched in economic decision making, the degree of monetary restraint necessary to turn back inflation has been greater than would otherwise have been the case. As a result, the economy itself has become more volatile, and this feeds back to interest rate behavior.

While we may hope and strive for a calmer, more stable economic environment in which the practices of the past can once again be safely followed, for now our markets need to adapt to the environment as it is. This can be seen taking place in the adjustments being made by our financial institutions. Commercial banks have put more emphasis on floating rate loans, for example. Similarly, thrift institutions have reduced the maturities of their mortgages, offered floating rate mortgages, and relied more on mortgage banking and other services for income. These adjustments by the financial industry are positive and can only help toward making the financial structure more resilient to cyclical change.

The changes underway today promise an expansion of financial services available to the public, an enhancement of their accessibility, and greater competition for the consumer's business. In order to fulfill this promise, complex issues of control, equity, and regulation must be addressed. We hope that review of these issues results in a modernized legal and regulatory framework that recognizes the unique role depositories play, that is flexible enough to adapt smoothly to innovation but, at the same time, that is regulated and supervised so as to preserve the safety and soundness necessary to the stability of our financial markets.