

I appreciate ~~the~~^{because} invitation to meet with the Society of Financial Analysts today. I welcome such forums as opportunities to communicate about the Federal Reserve's policy role ~~and~~^{its' PAST} performance and to discuss the appropriate course ~~of~~^{FOR} monetary policy in a difficult economic environment. - *Brief Some Remarks.*

Economic problems dominate our daily headlines, reflecting public concern about the state of the economy. Inflation, recession, unemployment, the federal budget deficit, and interest rates compete for attention. In addition, financial markets react to economic news and appear confused at times about the direction of economic policies. I bring no ready solutions for these problems, but I hope to clarify ~~any~~^{some} confusion you may have about the stance of the Federal Reserve. Moreover, I intend to give you my view *of what I believe to be an* appropriate monetary policy for the period ahead.

As a point of departure, it ~~is~~^{maybe} important to remind you that the Federal Reserve's stated goal in recent years has been to achieve a gradual reduction over time in the growth ~~of~~^{of} money and credit at rates consistent with a lessening ~~of~~^{OF} inflation and a sustainable pace of economic activity. *In my view,* This goal was reinforced by the public mandate voiced in the national elections of 1980 which called for a redirection of our national economic policies.

In my judgment, good progress was made toward those goals in 1981. Over the year, the Federal Reserve was able to reduce the growth in M1-B—the narrow monetary aggregate—to 2.2 per cent. This slowing of money growth, from as high as 7.5 per cent in 1979, contributed to solid anti-inflation progress in 1981. That

The Success of my meeting here today will depend largely on you - I intend to make brief remarks and then turn to a question and answer session

progress was emphasized in the announcement last week that the Consumer Price Index grew at only 8.9 per cent ~~in 1981~~. ^{LAST YEAR} The first year since 1978 that the CPI had been below 10 per cent.

It's true, of course, that when the reduced supply of money and credit clashed with high credit demands in 1981, interest rates soared to historic peaks. But with reduced inflationary expectations and a softening in business activity in recent months, many interest rates have trended downward. Another important effect of reduced inflationary expectations by the public has been a moderation in wage demands. Such moderation is a welcome prelude to further progress toward price stability.

But what about the period ahead? What can you expect from monetary policy? As you know, twice each year the Federal Reserve establishes target ranges for growth in the various monetary aggregates, then reports on these targets to Congress. Paul Volcker will be discussing the specific targets for 1982 with Congress in mid-February. Without, of course, revealing the details of Chairman Volcker's ^{testimony to} ~~testimony to~~ Congress, I want to ^{emphasis} ~~emphasize~~ the Federal Reserve's ^{continued} ~~commitment~~ to the fight against inflation. In my view, the Federal Reserve's adherence to a policy of gradual reduction in money growth is appropriate and essential. In fact, the Federal Reserve has tentatively indicated its intentions to lower further in 1982 the growth range target for M1, the narrowest money aggregate,

which includes primarily cash and checkbook money. Thus, I believe the public should harbor no doubts about our resolve to pursue ^{an} ~~our~~ anti-inflationary monetary course.

It is obvious, however, that the Federal Reserve's commitment faces some difficult problems in 1982. These problems involve not only issues of policy implementation, but problems of communication and public understanding, as well. I want to touch on three of these issues today—in hopes of improving your understanding of monetary policy actions, ^{which have been or maybe be} taken by the Federal Reserve.

First, from our point of view, a most perplexing issue is the credit market's unfortunate obsession with short-run swings in monetary growth. Because of the inherent volatility in the short-run growth rates of the monetary aggregates, the Federal Reserve and others have constantly warned of the futility of gauging monetary policy from week-to-week swings, or even month-to-month movements in the monetary aggregates. For instances, we know the weekly seasonal adjustments for the monetary aggregates are notoriously poor. A recent example is the widely discussed January 6 bulge in money growth, which in part reflects the application of these seasonal factors, but ^{the timing of the} also ~~large~~ Social Security payments at yearend, as well as a number of other unknown factors.

Some administration officials have contended that the recent bulge in money growth has "unnerved the financial

Quote

as I am sure you are aware,

equivocate

so much

markets" by raising questions about the Federal Reserve's determination to maintain the moderate money growth needed to slow inflation and bring down interest rates. These officials have suggested that recent money growth will hinder the administration's economic recovery program. However, I believe that the underlying concern of the financial markets is not related to recent short-run money growth, but rather to the prospective impact of ^{the continuing} large Federal deficits. That is why, in my judgment, we are not seeing any significant reduction in long-term interest rates. (As recently as two months ago, I should note, administration ^{officials} ~~officers~~ were asserting that the ^{money} ~~monetary~~ growth sought and achieved by the Fed in 1981 was hampering progress toward the administration's goals by worsening the recession.)

it seems

Clearly, the lesson to be learned is that financial market participants should watch trends in money growth over the longer-run perspective and not the blips and bulges in the money supply in the short run.

A second problem of communication and public understanding for the Federal Reserve in 1982 is related to the reliability of the money supply as an indicator of monetary policy. In 1981, it became increasingly apparent that financial innovation is having an important impact on the public's demand for money balances. While the impact is not yet fully understood, we do know that financial innovation is complicating our understanding

of what actually constitutes money and how money relates to economic activity.

As we all realize, financial innovation accelerated in 1981 primarily because of ^{investment} incentives provided by high interest rates. New financial instruments and techniques have been brought on by shifts in the asset preferences of the public. Most notably, these include NOW accounts, money market mutual funds, repurchase agreements of various kinds, and the new "cash sweep" accounts.

While NOW accounts are not recent innovations, their growth accelerated rapidly when they became available nationwide on January 1 last year. Likewise, money market-type mutual funds were available before last year, but they, too, have grown rapidly to more than \$180 billion. In addition, repurchase agreements—once confined to sophisticated wholesale money market participants—have become available even for the general public, through the so-called retail RP's.

A more recent innovation is the "cash sweep" account for businesses and individuals. "Sweep" accounts allow funds to move automatically between conventional transactions accounts and investment accounts—such as money market funds or RP's—paying market-related rates. But, what are the implications of these financial innovations? ??

One impact is the apparent reduction in the public's demand for conventional transaction balances. This impact

for Monetary Policy Makers

which affects the closely watched M1 measure of money occurred in 1981 and we expect it to continue in 1982. A related impact is the public's shift of funds from open market instruments to money market funds and other instruments included in the broader monetary measures. As these shifts occur, the broader measures of money will tend to grow more rapidly than otherwise.

A clear implication of these developments is that the Federal Reserve will find it increasingly difficult to rely solely on the monetary aggregates as a guide for monetary policy. The reliability of the aggregates is indeed a significant issue which deserves additional study. At the present time, however, the growing unreliability of the monetary aggregates underscores the need for the Federal Reserve to remain flexible in its approach to implementing monetary policy in 1982. The impacts of financial innovation on the monetary measures ^{in my judgment} emphasize how ^{merely} irresponsible it would be for the Federal Reserve to commit to a fixed rate of monetary growth, as some observers continue to suggest.

Thus far, I have identified two of the problems which may complicate the ability of the Federal Reserve to pursue its stated course in the period ahead. Both are related to the monetary aggregates we use as targets and as benchmarks for monetary policy. The third problem is related to the Federal Government's fiscal policy decisions and the impact of those decisions on federal budgetary deficits.

formulation

As I noted earlier, the public mandate from the 1980 election signaled a clear agreement on national economic goals. As a result, the new administration and the Federal Reserve, with ~~with~~ ^{BROAD} public support, have been able to move in a direction that we in the Federal Reserve have long advocated.

The federal tax cut package and the unprecedented spending cuts enacted in 1981 gave ample evidence that fiscal policy was firmly on the side of reduced federal outlays and in favor of incentives for private saving and investment. Despite this positive start, it has become clear that the huge tax reductions, together with increased defense spending, will now require further action to prevent the budget deficit from rising even higher.

I would ^{hope and} urge fiscal policymakers, ^{the Administration and Congress} to draw strength from the public mandate of 1980 and hold firm to the direction they have undertaken. In my judgment, inconsistent fiscal policies which fail to restrain spending and reduce the deficits will contribute to expectations of higher inflation and, in turn, will worsen conditions in credit markets.

Problems for the Federal Reserve in the face of large federal deficits are obvious. Steadfast pursuit of more moderate monetary growth when large deficits must be financed could well lead to higher interest rates which, in turn, could jeopardize ^{the} an economic recovery. On the other hand, Federal Reserve accommodation of federal deficits will only lead to higher inflation. So the ~~truth~~ truth, now, as always, is

FUNDAMENTAL

As a result, I look forward to the President's speech tonight.

that the Federal Reserve should not be asked to carry the anti-inflation battle alone. ~~But~~ ^{and up till now} this time around, ~~I, [redacted],~~ ^{have been} hopeful that the momentum of the public mandate will merge with the resolve of economic policymakers to produce the discipline required.

In summary, the nation's economic policies are on a proper course, in my judgment. From the Federal Reserve's perspective, that course must be maintained in 1982. The problems of formulating, implementing, and communicating monetary policy, which we have discussed today, are troublesome, but they will ~~not~~ ^{I have referred to} alter the commitment of the Federal Reserve. ^{indeed} ^{not in my judgment,}

From my perspective, I am convinced that the monetary policy goals of the Federal Reserve are appropriate. This policy is the proper one to bring down inflation. The goal of restoring price stability is absolutely correct. Its success is the only way I know to set the stage for a sustainable economic expansion. ~~With your continued help and support, we will achieve this goal.~~