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This is the time when policymakers make public their economic plans for the current year. The President, in his January budget messages, outlines the fiscal game plan of the national administration. The Federal Reserve presents to Congress the monetary policy blueprint for the year. Each of these messages is carefully . . . and sometimes not so carefully . . . analyzed by financial pundits for clues to what may lie ahead for the economy as a whole.

As the President of a Federal Reserve Bank, my special interest lies in the field of monetary policy. As a member of the Federal Open Market Committee, I have a direct voice in the development and implementation of Federal Reserve policy. It is from this perspective that I shall discuss the current direction of monetary policy and hopefully help you to better understand the challenges and opportunities that presently face policymakers.

Just this morning, Paul Volcker, Chairman of the Board of the Federal Reserve, appeared before the House Banking Committee and presented the Fed's planned monetary growth target ranges for 1980. This is the sixth consecutive year for which long-run (that is, 12-month) monetary targets have been publicly announced. The practice began in 1975 with House Concurrent Resolution 133, requesting the Federal Reserve to meet quarterly with appropriate committees of the Congress to detail the Federal Reserve's plans for monetary aggregate growth for the next twelve months. In 1978, Congress passed the Humphrey-Hawkins Act which, among other things, calls for the Federal Reserve semi-annually to present not only its monetary growth targets, but also its general economic forecast regarding prices, employment and output.

Because the rate of growth of the monetary aggregates is such an important determinant of future economic events, such as the rate of inflation, changes in output and movements in interest rates, the Fed Chairman's testimony to Congress is of paramount importance in assessing financial prospects, not only for the current year, but for future years as well. For this reason, it would be well to begin our analysis by focusing on the

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general implications of Chairman Volcker's policy statement; to consider what it implies for the coming decade, and whether the prospects for the successful achievement of the current goals are brighter than in past years when similar announcements were not supported by policy.

To begin, let's consider the meaning and significance of Chairman Volcker's testimony this morning before the House Banking Committee.

Historical evidence clearly demonstrates that the rate of growth of the money stock is what determines the basic rate of inflation. I am carefully differentiating between the basic or monetary-induced rate of inflation and what I shall term the temporary rate of inflation. By temporary, I mean that part of inflation which is caused by short-run factors, such as shortfalls in agricultural output, strikes or large increases in crude oil prices. Exogenous factors such as these can temporarily drive the measured rate of inflation above its basic trend. But the basic rate, the one that persists over long periods of time and consequently the one that generates the public's inflationary expectations, is a purely monetary phenomenon. That basic rate of inflation, as measured by the GNP deflator, is currently estimated to be about 7%, while the temporary rate, currently mainly affected by OPEC actions, is expected to approximate 3% for 1980.

As I have said, the basic rate of inflation is nothing more than the consequence of the rate of long-term monetary growth over the past 3 to 5 years. Our present basic inflation has been in the making for some time; it cannot be reduced significantly overnight or even over the course of one year. Attempts to reduce the basic rate of inflation quickly by sharply reducing the rate of money growth below its long-term trend inevitably lead to recessions or at least prolonged and intensified declines in economic activity. Similarly, sharp increases in money growth above the 5-year trend temporarily stimulate output and employment, but ultimately lead to an acceleration of inflation. Therefore, while monetary policy is the only means of changing the basic rate of inflation, policy changes, if they are to avoid undesirable economic side effects, must be conducted in a

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prudent and gradual manner over a protracted period of time. Monetary policy cannot be successfully used to fine-tune the economy from week to week or quarter to quarter.

The policy goals for money growth for the year 1980, as announced today by Chairman Volcker, are clearly a step in the right direction for reducing inflation in the 1980s. They would reduce money growth below its long-term trend of 7% in a manner that is not so sharp as to cause or contribute to a recession and at the same time start the ball rolling for a reduction of inflation. While a recession might occur in 1980 as a result of certain non-monetary induced factors such as excessive increases in energy prices, monetary policy, if kept within the announced targets, will not contribute to such downward pressures. Although we will probably see no significant reduction in the basic rate of inflation during 1980, the announced targets should bring that basic rate down by at least 1% in 1981. Further declines in money growth in subsequent years could be expected to reduce the basic rate of inflation to zero by the second half of the decade.

The temporary rate of inflation which, as noted earlier, is expected to be about 3% in 1980, is beyond the control of monetary policy. It is possible, of course, that future energy price increases will be smaller than currently estimated. If this were the case, the temporary rate of inflation would decline and that would bring down the total rate of inflation proportionately. But the basic monetary-induced inflation rate during the 1980s will be reduced only if the announced monetary policy goals are achieved.

You may recall that money growth targets as announced in the past have been repeatedly exceeded . . . a process which ultimately produced our current inflation. Why should one be more confident now that these goals will be attained? The reason that I am more confident is that the new monetary policy implementation procedures that were instituted on October 6, 1979, provide the necessary framework for controlling money stock growth.

As you remember, the Federal Reserve announced last October that it would place more emphasis on controlling bank reserves rather than on stabilizing the federal funds

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rate, as it had done in the past. While this shift in emphasis might seem trivial . . . other than, perhaps, for making the federal funds rate slightly more volatile and thus your interest rate predictions more difficult . . . it is actually of tremendous importance from the point of view of controlling the growth of the money stock. Please remember that for years, despite the best intentions of policymakers, money growth was procyclical and, on average, expansionary . . . exactly the opposite of what was needed. The record shows that such erratic results are a direct consequence of the emphasis that was placed on interest rate stabilization. It should have come as no surprise that in periods of economic expansion borrowings tended to increase and upward pressure was placed on interest rates. When the Fed tried to stabilize those rates, it could do so only by injecting additional bank reserves into the credit markets, thus fueling the growth of the money stock and inflation. In periods of contracting economic activity, stabilization of interest rates could be achieved only by contracting the money stock, and this placed additional downward pressures on output and employment. Over the long pull, persistently rising federal budget deficits, coupled with a desire to fine-tune certain individual markets such as housing, resulted in attempts to prevent a secular rise in interest rates. The end result was the accelerating long-term growth of money and the resulting increase in inflation.

Targeting on bank reserves avoids contradictions inherent in interest rate stabilization. Reserve targeting establishes a desired growth of the money stock and a consistent growth of bank reserves. It permits changes in the federal funds rate within a wide band and enables financial markets to adjust to those changes freely. As a consequence, the growth of bank reserves and money stock is not as likely to occur in as erratic a pattern as was the case under federal funds stabilization. Nor is there a temptation to fine-tune various sectors of the economy, since the control of bank reserves does not lend itself to allocation of credit to selected markets. The emphasis on reserve targeting removes the unplanned element of money growth and the consequent unplanned rate of inflation.

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For these reasons I believe that the announced money growth ranges for 1980 are far more credible than they were in the past. I also believe that if the aggregate ranges are reduced gradually over the next five years, we are in an excellent position to eliminate the basic rate of inflation entirely.

I am frequently asked the question, "Do you really believe that the Fed will adhere to its new practices, or, as has so often happened in the past, will it yield to the pressures of the moment and return to the discredited practices of the past?" While people are generally supportive of the new Fed procedures, many are still skeptical as to the will and ability of the Fed to follow through on its good intentions.

My response to this type of questioning is a strong, "Yes, I believe we will stick to our new game plan." I base this belief on my personal knowledge of Paul Volcker as being a courageous and determined Chairman who has succeeded in gaining unanimous support of the members of the Federal Open Market Committee for the new program. Secondly, anyone who objectively reviews the track record of interest rate stabilization will recognize that it was that policy which led to the present intolerable inflation we are experiencing. If the Federal Reserve is to maintain its credibility, it must adhere to its new direction of policy, as anything else would be viewed as a retreat into mistakes of the past. For these reasons, there is no doubt in my mind of the Fed's determination to persist on its present course.

So far the results are encouraging. In the short period of 4-1/2 months since the October announcement, the Fed has been successful in getting money growth into its target range as announced in February of last year. Notwithstanding recent expressions of concern by certain financial analysts that the Fed has lost its resolve to control monetary growth, there is no evidence that this is the case. Growth of the relevant monetary aggregates has been reduced to one-half the pre-October rate, and the growth of the monetary base has slowed to a pace that is consistent with announced targets for monetary expansion. Even more heartening is the fact that political pressures to accelerate

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money growth have been almost nonexistent, in spite of predictions that a recession is imminent, and I must compliment our political leaders for exhibiting such restraint. But we are not yet entirely out of the woods. It is possible that pressures will be exerted for the Federal Reserve to permit money growth to stray from its announced targets. Such pressures might arise from misinterpretations of the true nature of the policy being pursued, or from renewed sentiments to revert to interest rate stabilization and fine-tuning . . . despite the sad history of such attempts over the past twenty years.

First, let me elaborate on what I mean by possible misinterpretations of the nature of the new Fed procedures. Suppose that for a short period of a month or two the money stock were to grow more slowly than what might be viewed as consistent with the rate at which bank reserves were growing. If that were the case and if short-run changes in money growth were viewed as a reliable policy indicator, there could be calls for expansion of the growth of bank reserves in order to increase the growth of the money stock. If such expansion were to occur, it could seriously disrupt the long-range direction of monetary policy. It is a fundamental misinterpretation to view money growth for any period less than six months as a meaningful indicator. The growth of the money stock may, for any of a number of reasons, deviate from the reserve growth path in the short run, and yet be perfectly consistent with reserve growth and planned growth of money over a longer span of time. Short-term deviations should not be taken as a reason for changes in fundamental policy.

Or suppose that a slowdown in the economy were to reduce the demand for credit, and interest rates were to decline. If foreign exchange traders who are inclined to view interest rates as indicators of monetary policy, were to misinterpret a decline in interest rates as a signal of an "easing" of monetary policy which could be expected to lead to an increase in the future rate of inflation, the value of the dollar on international markets could be expected to fall. This, in turn, could bring pressures to contract reserve growth which, in turn, could cause a disturbing decline in output and employment.

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Or suppose that you, as financial analysts, misinterpret an increase in the federal funds rate resulting from an increase in credit demand as a sign of "tighter" monetary policy which, in turn, could be expected to lead to higher interest rates. Your response would be to try to unload your interest-bearing assets, thus driving interest rates higher and inducing pressure for an increase in bank reserve growth. Even though monetary policy had not in fact changed, misinterpretations such as these could generate pressure on the Fed to tilt its policy towards "ease" and would produce the same unfortunate results as the excessively expansive policies of the past.

So much for the danger of misinterpretation by market participants of what Fed policy is trying to achieve. There is also the possibility that the public might expect too much too soon in the way of results from reserve targeting. Under the best of conditions, reductions in the rate of money growth are not reflected in lower prices for 1-1/2 to 2 years. In the absence of a discernible reduction in inflation this year, if mortgage rates were to remain high and residential construction activity were to slow substantially, there might well be pressures to accelerate money growth. The same can be expected if a much-heralded recession materializes and is more severe than anticipated. What will be overlooked is that high mortgage rates are mainly the result of excessive money growth of the past, and the recession, if it materializes, is mainly the result of energy price increases and the consequent decline in productivity. There is no way in the world by which an increase in the growth of money stock can lead to a reduction in energy prices or increased productivity. It could, however, and indeed would generate higher rates of inflation in the future.

In short, misinterpretations, impatience, and political pressures by various groups might all work to subvert the only viable monetary policy tool that we have left in our arsenal to reduce the basic rate of inflation.

I hope that these pressures remain weak, and I hope that we can successfully resist them. This ultimately is the choice that the public must make, for the Federal Reserve

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System is not insulated from the wishes of the people. By our October actions, we have taken important steps towards eliminating the inflation cancer that threatens economic systems all over the world. Let us not abandon this treatment, for it is the only way to restore the economic stability and strength so essential to the future prosperity of our people.

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