

FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1981

HEARINGS
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
NINETY-SEVENTH CONGRESS
FIRST SESSION
ON
OVERSIGHT ON MONETARY POLICY REPORT TO CONGRESS
PURSUANT TO PUBLIC LAW 95-523

FEBRUARY 25 AND MARCH 4, 1981

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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1981

WEDNESDAY, FEBRUARY 25, 1981

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m., in room 5302, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Tower, Heinz, Lugar, Williams, Proxmire, and Riegle.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The committee will come to order.

We are happy to have you with us today to receive your testimony.

During the past year the Federal Reserve has been pursuing a generally restrictive monetary policy. Unfortunately, with the downturn—even with the downturn last year, inflation continued to build up. Although the Fed attempted to implement a consistent policy, the monetary aggregates fluctuated rapidly. Economic activity rose and fell quickly, partly due to the unfortunate use of credit controls last spring.

I have been one who has generally supported the Fed's efforts to maintain control of growth in the money supply. As you and I have discussed many times, Mr. Chairman, I have always said that it had to be a team effort, and although I've expressed my disagreement regarding the technical management of the money aggregates, the monetary supply, nevertheless, I have also made the point many, many times, it would make no difference who the Federal Reserve Board Chairman was, whether it was you, or if we brought back Arthur Burns or anyone else, as long as this Congress in the management of fiscal policy spends \$50 to \$60 billion a year more than we take in. The Fed has to monetize that debt. You have no choice, but to monetize it, when we spend that much more. So I just want to express to you how strongly I feel that if the budget and the deficits are not reduced, the Fed's policies will cause more problems than they solve.

So it has to be a coordinated effort. I for one will do everything I can to support President Reagan's plans, not only his budget cuts, but his tax cuts. I feel very strongly that budget cuts alone are not sufficient, that we will never, and I repeat never be able to balance the budget with expenditure cuts alone, unless we relieve the tax burden on the American people and provide more money for investment capital, for increased jobs in the private section.

Again, I just want to stress how strongly I feel the necessity for not only restrictive monetary policy, but that we have a restrictive fiscal policy as well. I think the Congress will make a very, very grave mistake, if they do not generally support the President's program, if we do not get control of the budget and reduce Federal spending as a percentage of gross national product. And I think those in both parties, Republicans and Democrats alike, will pay the price at the polls, unless the economy is brought under control.

You have also heard me express many, many times, my feelings about the importance of the independence of the Federal Reserve. And I still feel that way very strongly; however, it must be a coordinated effort on both fiscal and monetary policy, if we ever hope to be sitting here across these tables talking about reasonable interest rates, reasonable inflation rates.

So I pledge my support on the fiscal side to do everything that I can to bring the budget under control. Senator Tower, do you have any comments before we hear Chairman Volcker?

Senator TOWER. I would rather hear from the oracle first and then probably comment during the questioning period.

The Chairman. Go right ahead, Mr. Chairman.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I don't consider myself an oracle, Senator Tower.

Thank you, Mr. Chairman, you will find a good deal of common ground in the statement I am about to read.

I am pleased to be here this morning to discuss with you the Monetary Policy Report of the Board of Governors which review economic and financial developments over the past year and sets forth appropriate ranges for growth of money and credit for 1981. Because I have already reviewed recent developments with the committee, my emphasis this morning will be on the present and future concerns of monetary policy. In that connection, I would like to touch first on some more technical considerations of Federal Reserve operating techniques.

TECHNICAL OPERATING TECHNIQUES

As you well know, 1980 was a tumultuous year for the economy and financial markets. While most measures of the monetary and credit aggregates grew at or very close to our target ranges for the year as a whole, there was considerable volatility from month to month or quarter to quarter. Moreover, interest rates moved through a sharp cycle, and had considerable instability over shorter timespans.

In the light of these developments, I initiated in September a detailed study by Federal Reserve staff of the operating techniques adopted by the Federal Open Market Committee in October 1979, looking among other things, to the question of whether the particular techniques we employed contributed importantly to the observed volatility. Those techniques, as described in our report, place emphasis in the short run on following a path of nonborrowed reserves.

The study drew upon the substantial body of staff expertise both at the Board of Governors and at the regional Federal Reserve

banks, thus bringing to bear a variety of viewpoints and analytic approaches. The Open Market Committee has had some discussion of the findings, and we are now at a point where the work can be made available to interested outside experts. To assure full review, Board staff will be arranging "seminars," as appropriate, with economists having a close interest in these matters, and I would hope that your staff and the staff elsewhere on the Hill could participate in some of those seminars, Mr. Chairman.

Among the important questions at issue is whether alternative techniques would promise significantly better shortrun control over the monetary and credit aggregates, and whether such techniques would imply more interest rate instability.

We also examined again the significance for the economy and for basic policy objectives of monthly, quarterly, or longer deviations of monetary growth from established target ranges.

For the convenience of the committee and others, I have listed in this text some of the technical findings that may be of more general interest. I won't read all of this material, Mr. Chairman, now, but I would note point one confirms what you already know, and I think you and Senator Proxmire have written to us about the amount of volatility and noise in weekly figures and, indeed, in the monthly figures. The weekly data may fluctuate as much as \$3 billion without really having any significance other than randomness. More importantly, perhaps, we did not find in this study that alternative approaches to Reserve targeting would increase the preciseness of monetary control. Indeed, we believe the present technique really offers more potential in that connection. And whatever technique is used, you will have to expect in the current institutional setting, very substantial deviations in the monthly money supply measures, say, one-third of the time, the econometric evidence is the change from the target will be as much as 8 to 10 percent. It would exceed 8 to 10 percent deviation from the target one-third of the time, even if we pursue the target perfectly, in terms of reserves.

The third point simply makes a point that we have made before, that there is a tradeoff between following a stable money supply and interest rate stability. The more stable one makes the money supply in many conditions, the more short-term volatility you will have in interest rates. The major fluctuations in interest rates last year were reflected—were a result of changes in the economy and the credit control program, we believe, rather than a technique per se.

And finally, we do not believe that money supply fluctuations of the sort we had last year of a quarter or even longer, according to the study, have any profound effect on the general costs of economic activity or on inflation.

In analyzing the results of the study, and given the basic intent to control monetary and credit growth within target ranges over a period of time, the Open Market Committee continues to believe present operating techniques are broadly appropriate. Assuming the present institutional structure, alternative reserve control approaches do not appear to promise more short-term precision.

We do, however, have under consideration possible modifications and improvements. Without going into technical detail, such mat-

ters as more frequent adjustment of the discount rate, more forceful adjustments in the "path" for nonborrowed reserves when the money supply is "off course," and a return to contemporaneous reserve accounting are being actively reviewed.

In each case, the possible advantages in terms of closer control of the monetary aggregates need to be weighed against other considerations, including contributing to unnecessary short-run interest rate volatility.

As a personal observation, I would emphasize that swings in the money and credit aggregates over a month, a quarter, or even longer should not be disturbing and indeed may in some situations be desirable, provided there is understanding and confidence in our intentions over more significant periods of time.

A major part of the rationale of present, or other reserve based techniques, is to assure better monetary control over time. I believe, but cannot "prove," that the money supply in 1980 was held under closer control than if our operating emphasis had remained on interest rates.

I hope 1980 was instructive in demonstrating that we do take the targets seriously, both as a means of communicating our intentions to the public and in disciplining ourselves.

TARGETS FOR 1981

In that light, I would like to turn to the targets for 1981. Those targets were set with the intention of achieving further reduction in the growth of money and credit, returning such growth over time to amounts consistent with the capacity of the economy to grow at stable prices.

Against the background of the strong inflationary momentum in the economy, the targets are frankly designed to be restrictive. They do imply restraint on the potential growth of the nominal GNP. If inflation continues unabated or rises, real activity is likely to be squeezed. As inflation begins noticeably to abate, the stage will be set for stronger real growth.

Monetary policy is, of course, designed to encourage that disinflationary process. But the success of the policy, and the extent to which it can be achieved without great pressure on interest rates and stress on financial markets that have already been heavily strained, will also depend upon other public policies and private attitudes and behavior.

Abstracting from the impact of shifts into NOW accounts and other interest-bearing transaction accounts, growth ranges for the narrower monetary aggregates—M-1A and M-1B—have been reduced by one-half percent to 3-5½ percent and 3½-6 percent, respectively. Growth last year from the fourth quarter 1979 average to the fourth quarter 1980 average when adjusted for shifts into NOW accounts approximated 6¼ percent and 6¾ percent, just about at the top of the target range.

When I cite those figures, Mr. Chairman, they are adjusted. I just want to emphasize that the shift into NOW accounts, those are not the figures recorded in the published data. They are given in the footnote and there is a table at the end of this statement which reconciles the targets before and after switches into NOW accounts.

It is potentially confusing, and I think the table might be worth some careful study by those interested. The substance is that the ranges have been reduced by a half and we came in at the top end of the range, essentially, last year, so that the implication is the reduction this year could be more than the half percent reduction in the range, because we don't aim at the top end of the range.

The committee did not change the targets for M-2 or M-3. In the case of M-2, the upper end of the range was exceeded by about $\frac{3}{4}$ percent in 1980, and there seems to have been some tendency recently for M-2, which includes new forms of market-rate savings instruments and the popular money market mutual funds, to grow more rapidly relative to the narrow aggregates.

In the past few years, M-2 growth has been much closer to the growth of nominal GNP than has M-1 growth. Should those conditions prevail in 1981, actual results in that case may well lie in the upper part of the range indicated.

M-3, which includes instruments such as certificates of deposit used by banks to finance marginal loan growth, is influenced, as is bank credit itself, by the amount of financing channeled through the banking system as opposed to the open market. Changes in those aggregates must be assessed in that light.

I must emphasize that both M-1 series, as actually reported, are currently distorted by the shift into interest-bearing transaction accounts. Those shifts were particularly large in January, when for the first time depository institutions in all parts of the country were permitted to offer such accounts. As the year progresses, we anticipate the distortion will diminish, as has already been the case in February. However, any estimate of the shifts into NOW-type accounts for 1981 as a whole, and the source of those funds, must be tentative.

Survey results and other data available to us suggest perhaps 80 percent of the initial shifts during January into NOW and related accounts were from demand deposits included in M-1A, thus "artificially" depressing that statistic. The remaining 20 percent was apparently shifted from savings accounts or other investment instruments "artificially" increasing M-1B.

More recent data suggest the proportion shifting from demand deposits, while still preponderant, may be slowly falling. Making allowance for these shifts, M-1A and M-1B through mid-February of this year have remained near the December average level. At intervals, we plan to publish further estimates of the shifts in accounts and their implications for assessing actual growth relative to the targets. But I cannot emphasize too strongly the need for caution in interpreting published data over the next few months.

Once these shifts are largely completed, we plan publication of a single M-1 series.

In that connection, I must note that the behavior of an M-1 series containing a large element of interest-bearing deposits, with characteristics of savings as well as transactions accounts, is likely to alter relationships between M-1 and other economic variables. For that and other reasons, the significance of trends in any monetary aggregate even over long periods of time must be analyzed carefully, and, if necessary, appropriate adjustment in targets made.

Those technical considerations should not obscure the basic thrust of our policy posture. Our intent is not to accommodate inflationary forces; rather we mean to exert continuing restraint on growth in money and credit to squeeze out inflationary pressures. That posture should be reflected in further deceleration in the monetary aggregates in the years ahead, and is an essential ingredient in any effective policy to restore price stability.

During 1980, despite the pressures arising from sharply higher oil prices and the strong momentum of large wage settlements and other factors, inflation did not increase. But the hard fact is we as a nation have not yet decisively turned back the tide of inflation. In my judgment, until we do so prospects for strong and sustained economic growth will remain dim. In that connection, forecasts by both the administration and members of the Open Market Committee anticipate continuing economic difficulties and high inflation during 1981.

I have emphasized on a number of occasions that we now have a rare opportunity to deal with our economic malaise in a forceful, coordinated way. As things stand, the tax burden is rising; yet, in principle the need for tax reduction—tax reduction aimed to the maximum extent at incentives to invest, to save, and to work—has come to be widely recognized.

Regulatory and other governmental policies have tended to increase costs excessively and damage the flexibility of the economy; but realization of the need to redress the balance of costs and benefits is now widespread.

Despite efforts to cut back from time to time, Government spending has gained a momentum of its own; now the possibility of attacking the problem head on presents itself.

We are all conscious of the high level of interest rates and strains in our financial system. Yet there is widespread understanding of the need for monetary restraint.

The new administration is clearly aware of these realities and has set forth a program of action. It has seized the initiative in moving from opportunity to practical policy.

I know that the case is sometimes made that monetary policy can alone deal with the inflation side of the equation. But not in the real world—not if other policies pull in other directions, feeding inflationary expectations, propelling the cost and wage structure upward, and placing enormous burdens on financial markets with large budgetary deficits into the indefinite future.

That is why it seems to me so critical—if monetary policy is to do its job without unduly straining the financial fabric—that the Federal budget be brought into balance at the earliest practical time.

That objective cannot be achieved in a sluggish economy. Moreover, tax reduction—emphasizing incentives—is important to help lay the base for renewed growth and productivity.

For those reasons the linchpin of any effective economic program today seems to be early, and by past standards massive, progress in cutting back the upward surge of expenditures, on and off budget.

We know the crucial importance of restraint on money and credit growth. When I am asked about the need for consistency among all the elements of economic policy—a policy that can effec-

tively deal with inflation and lay the groundwork for growth—I must emphasize the need to combine that monetary restraint with spending control. Cutting spending may appear to be the most painful part of the job—but I am convinced that the pain for all of us will ultimately be much greater if it is not accomplished.

Thank you, Mr. Chairman.

[The complete statement of Chairman Volcker and a copy of the Monetary Policy Report to the Congress begin at p. 42.]

The CHAIRMAN. Thank you very much, Chairman Volcker.

Before asking any questions, I would like to refer back to our hearings in January when we discussed some of the technical aspects of handling the money supply, specifically the nonborrowed and borrowed reserves and contemporaneous reserve accounting.

I would like to express my appreciation to you for being willing to look at contemporaneous reserve accounting, a market rate on the discount rate, and faster adjustments for increases of the borrowed reserves.

I hope that we will have further reports on your progress in looking at those, but I do appreciate your willingness to at least consider some of those recommendations from the January hearing.

Mr. VOLCKER. Sheer mass may not produce accuracy, Mr. Chairman, but the studies we have undertaken on this subject are being placed in the public domain, and I think it would be a good idea if, as I suggested earlier, the staff of your committee and others who are interested take a look at this material and discuss it with us and see what conclusions they draw from some of this technical work.

The CHAIRMAN. We would appreciate it if we could have access to your studies. I am not sure I wanted to precipitate, when I asked those questions in January, that mass of paperwork.

Mr. VOLCKER. This started before January. we are not that quick.

POTENTIAL CONFUSION OF MONETARY POLICY

The CHAIRMAN. Chairman Volcker, it is interesting to note in January, the first NOW account month, total traditionally defined demand deposits by banks fell by \$30 billion while NOW and ATS accounts in banks and thrifts increased by \$20 billion.

The other major financial aspect category to increase during this period was money market mutual funds which increased over \$7 billion.

During the past few months we have also noted a substantial reduction in savings deposits of banks, S. & L.'s, and mutual savings banks, while time certificates at these institutions have increased dramatically.

This all adds up to what we all know is very rapidly rising cost for financial institutions, and potential for confusion in the administration of monetary policy by the Fed.

We have an administration that is now advocating stimulating economic development and at the same time advocates monetary restraint, request rates of growth. As you can see, a possible conflict exists here. Do you feel, as a basis for this, the Fed should continue the restraint? Or should they readily fund the hoped for growth in the economy?

Mr. VOLCKER. I don't think we are going to get growth in the economy for any period of time, Mr. Chairman, if we don't get a handle on inflation. And, of course, the monetary policy objective is important in connection with getting a handle on inflation. So I don't see any ultimate conflict between the objective of growth, dealing with inflation, and the kind of monetary restraint we have set forward.

That does not mean that in the short run everything is necessarily going to go perfectly smoothly or that we can just sit back and assume that inflation is going to disappear without doing anything about it.

In the past year there has been considerable pressure in financial markets, as you indicated, and I don't have any instant remedy for that. I don't think there is an instant remedy so long as the inflation forces remain so strong. But I think we can make progress on inflation, and as we begin making progress on inflation I think expectations can change and subsequent progress can come more rapidly. In that way you begin laying the stage for sustained growth; I don't know any other way to do it.

The CHAIRMAN. Monday, February 23, in the Wall Street Journal, both governors of the Fed, Schultz and Wallich and Henry Kaufman all said they felt President Reagan's spending cuts were too small. Demand for credit will keep interest rates high throughout the year.

Do you agree that the President's spending recommendations are too small?

Mr. VOLCKER. The President has made recommendations for spending cuts that are more massive than anything we have seen before. I think that is appropriate and I support that effort with all the ardor that I can bring to bear.

I would note in that connection that even in the President's program as presented—\$41 billion of gross spending cuts, which, of course, are partly offset by increases in defense spending—large as those spending cuts are, in historic context they are only a kind of down payment on what his program calls for in subsequent years. This is a first stage, and I think it is important, certainly against the background of the tax program.

It is also being recommended that those spending cuts be pressed. They are the linchpin of the program, as I see it; they are vital to make the whole thing work.

Commenting on the program generally, I would say that the risk is in the direction of not doing enough on spending cuts rather than on doing too much. I see no risk of overdoing the spending side of this equation. The more that can be done, the safer and more effective the total program will be. What I have in mind in saying that is essentially the point that you made initially, Mr. Chairman; that it will then become easier for us to maintain the restraint on money and credit growth that is necessary without unduly straining the financial markets. You can't do too much on the spending side. In that sense, the risk is in not doing enough.

The CHAIRMAN. I would agree with you completely. Would you agree with me, then, that the \$41 billion is a minimum? And obviously it is up to Congress. The President will not back off. But it is now in our court. And what I fear is that I hear some of the

reports from some of my colleagues, both in the Senate and in the House, that they are going to fight this cut or that cut, and I hear projections about well, he will probably get \$30 billion of it.

I would suggest then that if the higher interest rates continue with high inflation, the blame can be laid properly where it belongs, with the Congress of the United States which has the authority over fiscal policy and the spending policy.

Mr. VOLCKER. I believe these cuts are a minimum. When you reduce the expenditure cuts it raises more questions about the other parts of the program.

The CHAIRMAN. I wish Congress would go the other direction and one up the President and go beyond the \$41 billion. They might be absolutely staggered in the future and what it did for the economy and what it did for their reelection prospects. For the first time in their public careers maybe cutting the budget might be the thing that would guarantee their election, because I do think the American people are a lot smarter than some of we politicians give them credit for.

I am hopeful that the Congress will recognize the difficulties this country is in and not look for scapegoats, particularly blame everything on the Fed. Look at our own house and make certain that at least those \$41 billion of cuts are made, if not more, or the economy will pay the consequences.

Also at issue is the relationship between the White House and the Fed. And the Fed, of course, is legally independent of political influence. I have outlined how strongly I feel that there must be a coordinated policy.

What is your opinion of what the appropriate relationship between the Fed and the administration should be?

Mr. VOLCKER. My view, of course, is that we are an independent agency. Congress has delegated its authority in the monetary area to the Federal Reserve, and we are responsible for reaching judgments that we think are appropriate. In that process, I am a very strong believer in maintaining communications as open as possible with the administration, so that we understand their thinking and they understand our thinking. But when the day is done we have to make our own judgments. I hope to maintain that kind of relationship with the administration.

I might say the administration made a broad statement about its assumption about reduction of money and credit over a 5-year period or longer in connection with the President's program. That statement is broadly compatible with what we have been saying consistently ever since I have been here.

TAX CUTS

The CHAIRMAN. In previous testimony you have stated that you felt the spending cuts must be coincident with or should precede tax cuts. You have also expressed a preference for business rather than personal tax cuts in the early going. How do you feel about the present tax cut recommendations, the ratio between business tax cuts and personal tax cuts? And if you disagree, how would you recommend that they be restructured?

Mr. VOLCKER. It is true that in the past I have put somewhat greater emphasis on tax cuts pointed more toward the problem of business investment and savings.

The general point that should be made, first of all, is that the emphasis should be on incentives—incentives for investment, incentives for savings, incentives for work. How you best apply that point in practice is a matter, I suppose, of some judgment. Technical disagreement may arise.

The administration has certainly emphasized the point of concentrating on incentives. They have structured the program in a way that puts more of the reduction on the individual side of the equation, which perhaps relates to some statements I made some time ago.

That is a matter of judgment. I can see a different kind of emphasis, but that question is secondary to the importance of shaping the package with maximum impact on incentives in all these directions.

That leads you to the viewpoint that has been taken, properly, to put in a second priority some tax changes that don't seem to me to have incentive effects, but still lose revenue. They may serve other purposes, but they don't serve incentive purposes.

The CHAIRMAN. Thank you, Mr. Chairman. My time has expired. Senator Proxmire?

Senator PROXMIRE. Thank you, Mr. Chairman. Mr. Chairman, first I would like to say I am sorry I was a little late. But I certainly join you in your opening statement.

I am told you made a strong statement in favor of requesting the Chairman of the Federal Reserve Board to continue a policy of monetary restraint, monetary conservatism. I think that's absolutely essential. The Fed, I think, has been the only game in town fighting inflation. Some people don't agree that you have been, but I think you have. I hope you will continue it, Mr. Chairman.

I also want to tell the chairman how enthusiastically I share his view that your position will be impossible unless we have a much more restrained fiscal policy.

I would like to ask you, Mr. Chairman, Chairman Volcker, what we can do besides what you are doing, or trying to do, in holding down the rate of increase in the supply of money. What the President has done in recommending sharp budget cuts—is there anything else we can do to bring down this cruel high interest rate that is the cutting edge of inflation?

BRINGING INTEREST RATES DOWN

Frankly, the big reaction I get from my constituents continuously is what they are concerned about more than anything else are high interest rates. It's very hard for the farmer, for the small businessman, impossible for the homebuilder, devastating the automobile industry. And I think it's a big factor in retarding economic growth and recovery and in causing unemployment.

What, if anything, can we do in addition to the kind of conservative policy that Chairman Garn has outlined?

Mr. VOLCKER. I know you understand, Senator Proxmire, that our policy is not to have high interest rates per se. We are restraining money and credit in an inflationary environment with heavy

demands for credit. The result tends to be high interest rates, particularly when the economy is expanding, and it has been expanding.

I think I can just say flatly that the only way that interest rates are going to be brought down and stay down over a period of time is to get the inflation rate down.

In the shorter run, interest rates are affected by many other factors, including the strength of business activity and the strength of credit demands at the time. If the economy slows down, presumably interest rates will go down, but that's not a very happy result. You would then have a slowdown in the economy, and that's not a very effective policy.

The critical dimension that you can influence is the one you have mentioned, fiscal policy. The other question that is raised from time to time is, as you well know: Can you control the credit expansion through some kind of direct control?

We went a little distance in that direction for a time last year. I think that period shows some of the real problems that arise from an attempt to intervene directly.

Senator PROXMIRE. Let me ask you another aspect of this, however. Past administrations, Republican and Democratic, have emphasized much more than this administration seems about to emphasize, other anti-inflation strategies, including vigorous antitrust enforcement, including championing free trade.

At this table at my left is the distinguished Senator from Michigan. On my right is the distinguished Senator from Pennsylvania. Autos and steel are concerned about imports, and properly so.

On the other hand, the only kind of competition we have with steel, price competition, is imported steel. By far the most vigorous kind of competition we have in the automobile industry is with imported automobiles.

It seems to me that this, too, can be used as an effective anti-inflation strategy, and then finally, it seems to me that this administration has indicated—Chairman Weidenbaum appeared before this committee a short time ago, Chairman of the Council of Economic Advisors, and indicated complete indifference toward jawboning by the President.

Maybe that's right. Other Presidents have engaged in this with success, have jowboned, down inflationary wage and price increases. This administration won't do that. This administration shows no interest in tax based incomes policy which some eminent economists, including your colleague, Dr. Wallich, have championed.

LIMITED ANTI-INFLATION FIGHT

It seems to me it's a very narrow, limited anti-inflation fight, confined very largely to a fiscal policy which may or may not work out—particularly in view of the fact that they also propose deep tax cuts.

Mr. VOLCKER. Let me make several comments. First of all, it is not my understanding of the administration's intent—certainly they can speak for themselves on this point—to ignore what I loosely think of as the regulatory side and the trading side of the equation.

I think it's terribly important to maintain open markets. If we closed our markets when we have competitive problems, we would be sending exactly the opposite of an anti-inflation signal to the American public: that prices will go up, rather than down, for the very reasons that you suggest.

Many governmental policies built up through the years and reflected in the regulatory process, in labor markets, and in other policies tend to ratchet up costs and put a floor under the price level. I hope—and really expect—that some of those policies will be reexamined. I think that is very important.

Wage-price guidelines or tax-based incomes policies have often looked attractive in concept, and I understand that, because they appear to offer some way of speeding the process or avoiding some of the conflicts that otherwise arise.

Apart from all the other difficulties in terms of the rigidities that those policies imply and the difficulty of keeping them in place for any period of time, my difficulty is that I have not seen any very successful demonstration of those policies in practice.

I don't think we have had any practical evidence that those policies are terribly useful over any particular period of time. The great danger is that they are looked upon as a crutch. They are not going to work if these other basic things aren't done. And I think there is an insidious—

Senator PROXMIRE. Recognizing they won't work, if the other things aren't being done, can't they be used for supplement? You know, we don't have a perfect competitive system. And unless you have some recognition that the President has that bully pulpit, he ought to use it.

Mr. VOLCKER. So far as the jawboning side is concerned, it seems to me the point ought to be made—and it ought to be made over and over again—that to the extent private behavior on wages and prices moves ahead in a way that is out of step with bringing inflation down or out of step with the competitive position of a particular industry, problems are going to be created, and it is going to be harder to bring down the total inflation rate. The responsibility ought to be put where it lies in those cases: if people are moving way ahead of what the overall economic indications justify in terms of wage settlements or pricing policies, then they will get into competitive trouble. Then we've got a problem. The country has a problem. Those industries have a problem. And I think that that point ought to be made that there is a responsibility and a connection here.

Senator PROXMIRE. You wrote me on January 8 in response to a letter I wrote you, and you seemed to indicate—it's hard for me to imply anything but that you would be vigorously and forcefully against passage of anything like the Kemp-Roth tax cut.

Now, here's why, here's what you said, and I quote:

"It is critical that tax cuts be conditioned on the maintenance of budgetary discipline. Budget deficit now estimated for fiscal year 1981 and the trend of Government spending, taking account of our national security and other needs, clearly places limits on the amount of tax reduction that would be prudent at this time.

"Consequently tax reduction without the budgetary discipline necessary to achieve budgetary balance at more satisfactory levels of economic activity could be clearly productive."

A very strong, clear statement. It seems to me you would put a much higher value on reducing the deficit and moving toward a balanced budget than you would substantial personal tax reduction; is that right?

Mr. VOLCKER. I don't think it's inconsistent to move toward a balanced budget and have some tax reduction. We are not going to balance the budget in an atmosphere of high-level unemployment.

Senator PROXMIRE. You're calling for business tax reduction.

Mr. VOLCKER. The way I look at this, I would do all the spending reduction you can do; I don't think you can do too much, as I said earlier, from the standpoint of general economic policy.

Then I would see how much room that left for tax reduction consistent with returning to a balanced budget, as soon as possible, in reasonably favorable economic conditions. That's the way I would measure the size of the tax cut.

The administration, as I understand it, has not only proposed this immediate package of tax cuts and of spending cuts, but there is some followon that has to come very promptly afterwards.

Senator PROXMIRE. And immediate tax cuts and the followon tax cuts?

Mr. VOLCKER. They put both of those together, and they do come up with a narrowly balanced budget, in reasonably favorable economic conditions. The concept follows—I think, what I was suggesting in that letter.

The question is whether that will be achieved, and whether those proportions are right.

BALANCED BUDGET BY 1984

Senator PROXMIRE. The balanced budget, as I understand it, is 1984. Has the Fed staff examined economic model now used by the OMB to project a balanced budget in 1984, and if so, can you give us whether or not that indicates we'll have a balanced budget in 1984, under the most reasonable and realistic assumptions as to growth et cetera?

Mr. VOLCKER. I'm sure we haven't examined that particular model. The way I would go about it is, in projecting a balanced budget—or whether or not one can reach a balanced budget in the years ahead—I would have to make some assumptions about economic activity. When you are looking for a balanced budget—let's look beyond a balanced budget to a surplus—I think you do have to make some assumption about reasonably favorable economic background.

That's not saying it will be attained just because you forecast it, but I think it is a reasonable benchmark for measuring what you are doing on fiscal policy. You know if the economy is performing poorly, unemployment compensation, for instance, will be exceptionally high, higher than it normally would be; revenues will be depressed merely by the fact that the economy is running at a lower level. So I do think you have to measure these things against a reasonable assumption—let's call it an "assumption" rather than a "forecast" at that stage—about economic activity.

Senator PROXMIRE. Mr. Chairman, my time is up. I am not going to ask another question, but it would be very helpful for the record if the chairman would have the Fed staff take a look at this scenario and see what assumptions would have to be made to get a balanced budget.

Mr. VOLCKER. We have made some preliminary calculations of that sort, looking toward 1983, actually, and just making an "assumption" and not a forecast about the condition of the economy. You have to come up with spending cuts in the full magnitude that have been proposed—again, not just the \$41 billion, but the followon cuts—to have a fair chance of a balanced budget with a tax program of the size that's being proposed. Again, this is an assumption, not a forecast.

Senator Tower?

DEFENSE SPENDING AND INFLATION

Senator Tower. Mr. Chairman, do you have any assessment as to whether defense spending has a greater or lesser impact on inflationary pressures than certain types of domestic spending, such as transfer payments and categorical grants and aid?

Mr. VOLCKER. The point is often made, Senator, that defense spending, by its nature, producing goods that are put on the shelf, so far as the economy is concerned—and they may be terribly important in terms of the national interest but they don't provide satisfaction for consumer wants—can have a more inflationary impact, I suppose, then even in transfer payments. They don't produce anything either, when they are made, but they may at the secondary stage give rise to production that satisfies consumption.

I think another factor that has to be looked at in a rapid expansion of the defense program is whether you don't create bottlenecks, shortages of capacity, other factors that put pressure on prices in particular sectors of the economy.

I do think there are problems from the inflation standpoint in rapid increases in defense spending. That doesn't, obviously, mean that you don't do defense spending as a matter of priority if the country needs it.

Senator TOWER. What if most of your increase goes in contractual authority, rather than actual outlays?

Mr. VOLCKER. I would think it would depended upon the rate of speed and the condition of the particular industries that have to supply the defense goods. I am not particularly expert in just what exists in that area now, but the problem could arise of so congesting a relatively depleted defense production capability that it would do aggravate cost pressures in that particular sector. But I simply have not reviewed the situation closely enough to make any good judgment as to what the dangers are in this particular situation.

Senator TOWER. What about areas where production line may be underutilized?

Mr. VOLCKER. Then it's much easier. That problem wouldn't arise.

Senator TOWER. Looking at the international situation, why has the dollar risen so well lately against other hard currencies, and against gold?

Mr. VOLCKER. I would like to think there is a recognition that ultimately the kind of policies that we and others are pursuing will assure a better future for American policy generally, and particularly for inflation. Obviously in the short run, the dollar has been affected by a relatively high level of interest rates. The fact is that our current account position is in relatively good shape—compared to other industrialized countries in quite good shape. Our exports have been doing quite well, and I think there is increasing appreciation of that, relative to the external performance of other countries recently.

You have to look at the other side of the equation. The fact is that some other countries have some very substantial and continuing current account deficits. In some cases they are having to cope with increased inflationary problems, so that, apart from the more technical considerations, attitudes have shifted considerably in favor of the dollar.

Senator TOWER. What do you see the potential impact on the dollar being as a result of actions being undertaken overseas—one instance I know of, and that is the Bundesbank raising its interest rates. What impact is that going to have?

Mr. VOLCKER. It should have the impact of strengthening the DM. I don't consider that, in a sense, a weakening of the dollar. But if you measure just by the DM-dollar exchange rate, if that action strengthens the DM, the dollar exchange rate relative to the DM goes down; it has been, historically speaking quite high in recent weeks, as you know.

Senator TOWER. Can we expect similar actions like that to be taken by other central banks in Europe?

Mr. VOLCKER. I would not necessarily think so. The DM has been under particular pressure. They are dealing with a situation that, in a sense, is peculiar to the DM.

Senator TOWER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman.

Chairman Volcker, let me just say at the outset—as a member of the Budget Committee—that I think you are going to see us meet the President's spending reduction goals. Whether these cuts will be enough in combination with all the other things we're talking about, is another question which needs further discussion.

With respect to the tax proposals, though, I think it is becoming clear that those are going to be changed. I think there is a growing sentiment both on the Senate and in the House, to make some changes in the tax program. And without getting you caught in that debate, but using your vantage point and expertise, I would like to ask you some questions about some tax alternatives.

PRESIDENT'S TAX CUT PROGRAM

If you look at the President's program in 1982, he is talking about the personal tax cut amounting to about a \$44 billion return. And the business side, the accelerated cost recovery system, at about \$9.7 billion, is a very dramatic stacking of the tax package in favor of personal tax cuts. In 1983 the same pattern pretty much prevails. You see \$81 billion on the personal side and about \$18.6 billion on the business side.

We have talked here many times before about the need to modernize the country, to improve productivity, to encourage saving, and turn the movement of savings into capital investment. Is this a satisfactory ratio in your mind?

If we were to change that and make it, say, closer to 50-50, do you have any feeling as to what that might do in terms of helping in the fight against inflation?

Mr. VOLCKER. I don't think you can answer the question purely as a matter of ratio. Obviously the program can be restructured to give more pinpointed incentives, so to speak. But I don't think you can answer the question generally in terms of a particular percentage.

If you took some of the cut away from personal and did something ineffective on the business side, you wouldn't improve anything.

Senator RIEGLE. I don't want to make it trivial.

Mr. VOLCKER. Obviously opinions differ in this area. You are going to have to make a judgment as to whether you are more effective cutting the marginal tax rates on individuals or doing something more explicitly directed toward savings and business investment.

Senator RIEGLE. Let me try to help you. I recognize you are trying to sort of work around the question, here. [Laughter.]

What I would like to know is this: Should we seriously consider beefing up the investment incentives on the front end of this program? Those of us who come from regions where we have major reindustrialization requirements and major capital investment requirements, feel strongly that this restructuring is needed.

Mr. VOLCKER. I have expressed an opinion in the past on the importance of looking at a variety of techniques that are directed toward the business investment savings area. I think that is a fair subject to review.

Senator RIEGLE. Let me ask you this: If it were 50-50, in your opinion, would that have any impact on productivity and any impact on inflation? Or do you think it doesn't really matter?

Mr. VOLCKER. Again, I just hate to express the view in terms of 50-50 on any ratio. It depends upon what you do. There are proposals made, for instance, to encourage personal savings through some kind of tax deduction or exemption.

Senator RIEGLE. How do you feel about that? Would you want to see that?

Mr. VOLCKER. It sounds like a good idea, but when you look at the proposals in detail, it is very hard to make them effective at the margin. Congress 2 years ago provided an exemption for some interest payments. My own feeling was that that involved a large revenue loss, and while it is pinpointed, probably without having any significant effect on savings incentives, because the great bulk of the people who saved were already beyond the limits where they would be affected at the margin by that change. I don't know where you list that on your priorities. It's a personal income tax change; it is a pinpointed personal income tax change; the problem is it is probably ineffective. Where we are having a little difficulty is the conclusion of the administration that they will get a very high incentive effect by changing marginal tax rates.

I think it is true you will get an incentive effect. I've always thought that you will from changing individual tax rates. Now you are asking me to balance that against a savings exemption of that kind of magnitude. I think the administration is right in that case. As balanced against some other possible approach that could be taken in the business area or elsewhere, you'd have to look at each approach individually. I think you should look at each proposal individually.

Senator RIEGLE. What I am trying to do is give you an opportunity to express a view as to whether the capital investment side of this program ought to be strengthened, and I would urge you to take it that way. If you don't, I want to go to another question before my time is up. [Laughter.]

Mr. VOLCKER. I think the whole name of the game, in a sense, ought to be the capital investment side, or the research side and the work side. The argument should be about how best to do that.

Senator RIEGLE. I think that's the issue here.

Mr. VOLCKER. I think it is an issue, and in that connection, I would think that Congress would well want to look at other approaches and reach a conclusion as to how much weight ought to be put on reduction in personal rates alone.

Senator RIEGLE. What I take that as is a suggestion that if we found a way to beef up the \$9.7 billion, or to somehow alter this ratio so that it was more favorable toward a greater share of capital investment in the near term, that you might see that as helpful.

Mr. VOLCKER. I am not going to take as my criterion the ratio. If you can come up with a package that you feel is more effective, given the basic objective, then I agree with you wholly. That ought to be your whole concern at this point, whether you can do it more effectively.

Senator RIEGLE. Let me ask you one more question. In this scaling of the tax reduction across the personal rates, the theory, as I understand it, as I listen to Mr. Stockman and Secretary Regan refer to it, is the general belief that folks in the high-income brackets are more apt to save their money, and therefore they ought to be given more to save; and the hope is that money will make its way into not just savings, but capital investment. On the other hand, folks at the lower-income levels on the margin are less able to save, or less apt to save, and therefore you don't get the same savings effect if you give the tax reduction to them.

Do you have any evidence at the Fed that would indicate that savings—that this proposal, in terms of the high tax cut at the higher income levels, will actually make its way into savings? In other words, it's one thing to give somebody the money, and it's another thing to do it with any kind of certainty that will make its way into capital investment, hopefully even a productive capital investment.

ENCOURAGE A HIGHER SAVINGS RATE

Mr. VOLCKER. I don't think we have special research at the Federal Reserve that bears on that point. I think it's fair to say that the general presumption of most economists is that you will get more savings and more investment incentive in relation to the

high marginal rates at the top than you will at the bottom, for obvious reasons.

Senator RIEGLE. Do you think we'll get what they're predicting? As you probably know, they're predicting a higher savings rate than we've ever seen before. Do you think that's realistic?

Mr. VOLCKER. I don't think it's very useful to speculate frankly, the evidence is, at best, muddly. It depends upon what time period you use in estimating the amount an individual will save out of his tax saving.

If you take the first month or two, the figure probably looks high, but then typically it diminishes rapidly, as time passes. I think the right way to look at it—and I think the way they've looked at it, in part at least—is that in terms of the program as a whole, it is important to raise the overall savings rate. You can't trace that to individual taxpayers.

Senator RIEGLE. I think you've got a hundred Senators that would agree to that.

Mr. VOLCKER. As you make progress on inflation, as the economy grows, you want to encourage a higher savings rate. That should be a major objective. You have to look for that result in terms of the package as a whole, not just in terms of this tax reduction.

Senator RIEGLE. My time is up.

Could we ask that we have something done for the record, Mr. Chairman? Could I ask—this augments the request of Senator Proxmire, I think.

The CHAIRMAN. Certainly.

Senator RIEGLE. I would like to ask the Federal Reserve to take its basic economic forecasting model and plug into it the Reagan program as it has been put forward, the spending cuts, the tax cuts, the magnitudes, the timing, and give us, if you would, what your model tells you in terms of what the outcomes will be, in terms of inflation rates down the line, deficits down the line, capital investment, whatever else that you put out—the reason I ask for that, I think that's a neutral way to get at least one more measurement of how this is likely to work.

As you know, one of the criticisms of the Reagan package has been—that it really isn't based on an economic model as much as it is on expectations. Could you do that for us?

Mr. VOLCKER. I understand your request, but I frankly am a little bit reluctant to do that. We have some models of the sort that you are referring to. We have never, to the best of my knowledge, presented forecasts coming out of those models in any kind of a public forum. And I feel a little bit strongly about it, because I don't have much faith in the models myself. [Laughter.]

I kind of hate to, crank this through a mathematical model—particularly for 2 or 3 years ahead. I have limited confidence in that kind of time frame.

Senator RIEGLE. That raises another problem, because if the Federal Reserve was to do it and your findings were at variance with what the Administration is predicting, somebody is wrong and either you need to change your model or they need to change theirs.

Mr. VOLCKER. That doesn't follow.

Let me express my own feeling---

Senator RIEGLE. I don't want to press past my time. I think we ought to get it settled if we can.

Mr. VOLCKER. If I can just express an opinion about the matter. I have limited confidence in any detailed economic forecasts these days, I think a limited confidence, amply justified by recent experience. These models—or any forecast, whether done econometrically or otherwise—have not been very accurate, even in the short run, recently.

I don't think you can escape the proposition that you put together a program that you think as a matter of general analysis is the best program that one can conceive of under current circumstances, and you move ahead on that program. That program should not rest upon whether a forecast suggests that the economy is going to take off 12 months from now, or 18 months, or just how long it takes.

I don't think you can escape the responsibility of putting forward the program that you think is the best, most balanced program, aimed at the variety of problems that we have; you can't escape that responsibility by taking assurance from an economic forecast that in itself is inevitably shaky.

I don't think, the inevitable uncertainty of a forecast in any way makes it difficult or impossible to come up with the best economic program you can shape.

I am reminded of the fact that for almost the whole time I have been sitting in my present job, the prevailing economic forecast has been that there's a recession next quarter.

We did have a recession one quarter, but only one quarter out of the seven that I've been here. I think you're deluded if you say, "Well, we've got a forecast. The majority of the economists are forecasting a downturn in the next half of the year, so we'll adopt this kind of economic policy or that kind of economic policy." You've got a 50-50 chance that that's going to be wrong, if that is the sole basis of the economic policy.

We do know some things. We know savings are low. We know inflation is high. I am convinced you're not going to deal with the growth problem and the savings problem and the productivity problem until you deal with inflation. You start with an economic program that's going to deal with inflation. You know productivity has been low; you know capital spending needs to be increased; so you put something in the program to deal with those.

CONFIDENCE IN ECONOMIC PROGRAM

You do that whether or not the economic forecast is correct as to what's going to happen in the fourth quarter of 1981 or the second quarter of 1982. I don't know precisely what's going to happen in those time periods, but I do know we have these basic problems and any economic program ought to be directed towards these economic problems. I am perfectly confident that if it is successfully directed toward these problems, you will have the best program that can be put together and you will have grounds for confidence that the economy is going to improve.

I'm going to have that confidence, however long we argue about a particular economic forecast, because I just don't put that much weight on any of them in any particular time period.

The CHAIRMAN. Gentlemen, I do think we have to proceed.

I'm certainly glad, Senator Riegle, that you didn't ask the Chairman another question. [Laughter.]

Before I turn to Senator Heinz, I can't resist a couple of editorial comments.

The first one is: After sitting on this committee for 6 years, may I agree about economic models. We have had the best liberal and conservative and Republican and Democratic economists before this committee. And I don't remember any of them being right in their forecasts in the last 6 years. [Laughter.]

The second comment I would make: I would tend to agree somewhat with Senator Riegle on the mix. If I were designing the tax package, I would like to see larger business cuts. But if the President had proposed a larger proportion of business cuts, I can see what the press would do with it—"Look at those darn Republicans, how they favor big business. They're doing it again to the poor people."

So I am pleased to have some of our Democratic colleagues believe in—that some more supply-side incentives for business are necessary.

Mr. VOLCKER. If I could just put a footnote on top of that. [Laughter.]

My skepticism on economic forecasts does not mean that economic analysis does not have a lot to tell us about how the program could be shaped and should be shaped.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. No, no. Not yet.

A footnote to the footnote is he has to say that, otherwise all the economists at the Fed will walk out en masse. [Laughter.]

The CHAIRMAN. Senator Heinz, now your time starts.

Senator HEINZ. Thank you, Mr. Chairman.

Chairman Volcker, as Senator Riegle said, 100 Senators agree that the savings rate ought to be increased if you can figure out how to do it.

You have indicated that there might be better ways of increasing the savings rate than the tax package proposed by President Reagan. What kinds of changes in that tax package would you recommend to increase the savings rate?

Mr. VOLCKER. I meant to make a broader statement.

Senator HEINZ. I'd like some specific—

Mr. VOLCKER. I think the most important thing for the savings rate is going to be more confidence in the outlook, particularly on inflation.

Senator HEINZ. We all agree.

Mr. VOLCKER. That bears particularly on the tax package.

Senator HEINZ. Having said that—

Mr. VOLCKER. I'll give you a negative answer first. I have not seen any proposal directed toward savings per se—that is, an exemption of some sort for savings per se—that has looked terribly effective to me, for the amount of revenue lost, for the reasons that I suggested earlier.

If you do something like the depreciation in the program, you get a double-barreled effect. You automatically generate the savings in the business community from the savings in taxes, and you have

provided an incentive to reinvest. That should be a pretty effective way of approaching that problem.

Other issues must be considered. It's particularly favorable for companies making heavy capital investments, and it's less favorable for companies that may be productive and useful but don't have the same proportion of capital spending.

Senator HEINZ. So you have no specific proposals that you believe would increase either business or personal savings in this tax package?

Mr. VOLCKER. I didn't come up here with specific proposals. You've got things to look at—

Senator HEINZ. Let's proceed then.

Some people say that where monetary policy is concerned our choice is between inflation or unemployment; others say it is between high and low interest rates. But, in fact, I believe—and I think some other people would agree, that it's really between long-run economic stability and instability. And we have had a lot of the latter.

There has been reported—excuse me. There has been prepared by the staff of the House Banking, Finance, and Urban Affairs Committee, by their Domestic Monetary Policy Subcommittee, a report. That report is really quite critical of the Fed, and it suggests that the Fed has concerned itself much too much with trying to meet will o' the wisp, short-term targets and has abandoned its responsibility to have a long-term, stable policy on the money supply.

Are you familiar with the report?

Mr. VOLCKER. I recall something about it. It is not fresh in my mind. In any event, I do not agree with the conclusion you state. Whether or not it is the conclusion of the report, I would violently disagree with the comment that you quoted from the report.

Senator HEINZ. The administration white book replaced the black book. In the white book there is some prescriptions absent from the black book for the Federal Reserve System and monetary policies. Specifically what President Reagan calls for is a gradual reduction in the growth of the money supply. Do you agree with that prescription?

Mr. VOLCKER. We have been following that policy, yes.

Senator HEINZ. The administration plan also over the next 2 to 3 years sees a substantial increase in economic activity. Is a policy of gradually ratchetting down on the money supply consistent with gradually ratchetting up? Or in some cases some forecasts dramatically ratchetting up on economic growth?

Mr. VOLCKER. Only if the inflation rate declines.

Senator HEINZ. And do you believe it will?

Mr. VOLCKER. That is the aim of our policy.

Senator HEINZ. I know what the aim is. Do you believe it will hit the target?

MONETARY TARGET RANGE

Mr. VOLCKER. Do I believe we will hit our monetary targets? Yes, our aim is to hit the monetary targets. My belief is that the inflation rate will come down. The question is the timing of this

whole process. But I think certainly you will not reach these objectives unless the inflation rate comes down.

Senator HEINZ. Now in your statement, obviously the Fed didn't hit a single one of its rather wide monetary target ranges in 1980, not a one.

Mr. VOLCKER. That is not true.

Senator HEINZ. As I read what you handed out, according to table one it would appear to be true, the possible exception being bank credit.

Mr. VOLCKER. Bank credit certainly is an exception. The M-1A and M-1B targets rest upon a particular estimate made of the shifts into NOW accounts. We either very narrowly missed it or we hit it, it depends upon, how these things are calculated. This looks at the fourth quarter; we were on the edge.

If you recalculated these figures and looked at the average for the year as a whole, and assumed that these applied to every quarter instead of the fourth quarter, we would have hit it for M-1. If you just look at December we would have hit it.

Senator HEINZ. I am going by what you gave the committee.

Mr. VOLCKER. I understand.

Senator HEINZ. And what you gave the committee, with the exception of bank credit, you missed your ranges. Now the point I would like to be very clear on is that yes, you may have missed your ranges by a little amount, but the ranges are now narrow. For M-1A the range is from $3\frac{1}{2}$ to 6. That is pretty broad. That is nearly a 100 percent of $3\frac{1}{2}$, the size of that range.

The range for M-1B between 4 to $6\frac{1}{2}$ is again pretty broad. That is again 50 percent on the base of 4, latitude 4 era.

So when you miss a range that broad it is a little bit like missing the entire target. Even if you miss the target by a few inches you still missed it. Now it seems to me that if the ranges mean anything they mean that you ought to be within not outside of the range.

Which brings me to my last concern and question. I think the Federal Reserve is a vital and important institution. We all salute the independence of the Federal Reserve System because its responsibilities are so important and need to be shielded from transient political influence. But what is unclear to me is what—when one organization or institution is vested with tremendous responsibility, the means of holding such an institution accountable ought to be. And my question is what should the accountability of the Federal Reserve—how should it be recognized when you miss?

Mr. VOLCKER. I think it is recognized by these hearings, in a general sense.

Senator HEINZ. Suppose you miss again?

Mr. VOLCKER. You would presumably question us as to why that took place, whether it was justified or not justified.

Senator HEINZ. And suppose you miss again? You know, each year the Fed misses by a $\frac{1}{2}$ or 2 or 3 points. At what point is there a means of facing up to the division of accountability and responsibility?

Mr. VOLCKER. The means exist in the nature of things, I suppose. Congress has delegated the responsibility to us. Congress always has the option—I don't recommend it obviously—of removing the

delegation; they could do so. But I think, in the broadest sense, our performance depends on whether you are satisfied with it.

Senator HEINZ. Some people have suggested that since there is some reluctance to deliver the policies of the Fed into the hands of the Congress, and there has been a general feeling that it is important, as stated by you and others, that the Fed should work in concert with the executive branch, why shouldn't, when the Fed misses its targets, the Chairman or the Board of some delegation of the Fed step forward and say we serve at your pleasure, Mr. President, and we have not done very well? Why shouldn't the Fed act a little bit more like a cabinet in the parliamentary system when a fellow comes up short on a vote of confidence?

Mr. VOLCKER. There may be good or bad reasons for missing the target, and I think it depends on whether you are satisfied in the last analysis that the reasons were good or bad over a period of time.

The theory is that exposing monetary policy to direct political control, which seems to me the implication of what you are saying, will over time, clearly lead to a less satisfactory performance rather than a more satisfactory performance.

Senator HEINZ. Not quite, because that is not what I suggested. What I suggested is that the Fed sets the targets.

Mr. VOLCKER. Certainly.

Senator HEINZ. And you figure out what targets you want to set?

Mr. VOLCKER. That is right.

Senator HEINZ. And the question is not what you set those targets at. The question is when you don't need the targets you set for yourself what should be the appropriate response of the elected branches of Government, the executive branch and the Congress? That question is not answered by anything that I have said or that you have said.

Mr. VOLCKER. The appropriate response is that you have hearings and satisfy yourself or remain dissatisfied as to the result. Let's not avoid some of the issues here. First of all the money supply series is inherently unstable. We have done an important study of this; control is not perfect by any means.

If you look at international experience, we have come as close to our targets, generally speaking, as have other countries that use these techniques. We have a more stable performance in those terms.

You have to ask whether you are asking us to do something that is possible or impossible—that is, on the technical side.

On another side, in the short run certainly, there is some tradeoff between the pressure on financial markets and the growth in money. We get a lot of complaints about interest rates, and a lot of complaints that we are much too tight. A lot of people think that that is the crucial issue, rather than how precisely you come out on the target. There are a variety of considerations involved.

All I can say is I don't know of any way of approaching this other than reaching a judgment about whether, broadly, we are following appropriate policies or not. I don't think you will get a magic answer to the significance of whether we are or are not a quarter of a percent above the range. That is one consideration, but it is not the whole of the factors bearing upon monetary policy. It

is one important factor which we consider; it is an important discipline on ourselves.

If we didn't have these targets last year—I can't be sure of this—my suspicion is that the growth of money and credit would have been much greater, because there were a lot of pressures on the markets. Traditionally over the years, it seems to me, the Federal Reserve had not pressed as hard as hindsight might suggest they could have pressed toward restraint.

Now these targets help us to be more disciplined, in my opinion. That doesn't say we are going to hit every target every year. In fact, as things turn out, it may be impossible to meet all the targets because they may unexpectedly turn out to be mutually inconsistent.

Senator HEINZ. I would like to point out that my time has expired and I thank you, Mr. Chairman.

The CHAIRMAN. I would just say you are suggesting something, John, that may be very dangerous, if the Fed should resign because of not meeting their monetary targets. And only using 1 year as an example, we passed the first current budget resolution of \$613 billion last June, and it is going to be around \$670 or \$680. So I guess it would follow then the entire Congress should resign. [Laughter.]

Senator HEINZ. Well, there is some merit. [Laughter.]

The CHAIRMAN. I don't disagree. I am just saying you might set a precedent.

Senator HEINZ. I think the Chairman is on to a very appropriate analogy.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. Mr. Chairman, although there has been discussion, a great deal of it about the targets and whether you missed or not, the most intriguing aspect of your report for me is in the longer section on page 22, net funds raised and supplied in the credit and equity markets and specifically the second quarter of 1980.

CREDIT MARKET ACTIVITY

Now you have mentioned the extraordinary range of activity in credit markets. But I had not appreciated until I saw this laid out quarter by quarter that, for example, net funds raised total all sectors in the second quarter was \$253 billion as opposed to the previous quarter at \$497 billion. And then this came all the way back to \$454 billion and finished at a strong \$534 billion for the final quarter.

Interestingly enough, foreign credit was highest in the second quarter as opposed to any of the other three.

The Federal Government had a reasonably steady pattern, moving upward toward the latter two quarters, whereas there was a devastating change in business and in household net funds raised in that period.

This indicates, it seems to me, that whatever you were doing at that point worked, as far as the changing interest rates and changing the amount of money that was being raised.

I went on into page 26 to find the explanation of why all of this changed, and apparently—and the explanation covers really sever-

al pages. But one of the factors which you cited is that the Fed came to a conclusion—and this is actually the sentence on page 28 of the report—that the sharp plunge in interest rates, even though it occurred against the backdrop of marked monetary weakness and steep recession, did arouse concerns in some circles about the system's commitment to anti-inflationary restraint.

And then later on in the next paragraph, the indicator of policy feared that the system is being inflationary because rates were falling sharply.

Now, as you look back on that particular quarter, is it a fact that the fear of the Nation at that point was that the Fed's policies were going to foster inflation? It seems to me that the criticism, if there is one made, of all of us operating in the political system is that following that precipitous drop of interest rates and the fears of substantial recession in the country and in the midst of a presidential campaign there were many, many pressures on the Fed and on lots of other people, for that matter on the Congress, for example, for spending or for hyping the economy in some way.

But clearly something occurred there in terms of combinations of your policies that was devastatingly effective with regard to lowering interest rates. Now why in your judgment did you change? Because that quarter alone spells the difference between missing or hitting the targets. As a matter of fact, as you pointed out, you missed on the low side during the period.

Mr. VOLCKER. At that point we were on the low side. I think it is illustrative of the point that certainly in any particular quarter, asking us to hit a target is asking us to do something we can't do. There is just too much fluctuation in the figure. But to explain that quarter, you have to consider that there are lags in this process.

What went on in the second quarter was basically a combination of two things. We had the sharpest decline in GNP in one quarter that we had ever had in the postwar period, which affected demand. We had credit controls in effect. Those two things were somewhat interrelated.

Senator LUGAR. Did the controls come before the fall? Or what is the relationship?

Mr. VOLCKER. The controls came in March. They came technically in the first quarter, but late in the first quarter, and they exerted their effect clearly, virtually entirely, during the second quarter. In fact, there was some anticipatory borrowing, which helped push up these figures in the first quarter; you will see those figures are quite high in the first quarter.

We had the artificial restraint, so to speak, on credit from the credit controls, plus the natural effect of a very sharp decline in economic activity. That is why the business and the household credit in particular declined so sharply.

The concern that you referred to about our policy, which was quite marked, I think, in some areas of the financial markets, was not about what was going on with credit at that moment. Their concern was that the rapid drop in interest rates would at some later time encourage excessive growth—excessive growth in credit and maybe excessive growth in the economy—and that it might not be consistent with a persistent anti-inflationary policy. Indeed, the

economy did recover much faster than virtually all economists had anticipated at that point.

It is another commentary on economic forecasting, I guess. As the economy got going again the credit demands headed up back toward the level that they were at earlier. This was exceptionally large, but you expect sharp fluctuations as economic conditions change, and you have got to look at these things over a period of time.

All of these are reflected in, and in some degree influenced by, changes in the money supply itself, which makes it very hard to say you must be on track in any particular quarter. I don't think there is any way of approaching this other than looking at the trend over a period of time.

Senator LUGAR. After the second quarter you released some of the constraints, did you not?

CREDIT CONTROLS RELEASED

Mr. VOLCKER. We released the controls during the second quarter, or very early in the third quarter.

Senator LUGAR. Why did you do that?

Mr. VOLCKER. Because they seemed to have accomplished their purpose. Quite simply, we were looking at the fact that the economy was in recession, the credit demands were repressed. The controls were put on, as far as I was concerned, as a purely temporary measure. When their usefulness was over we took them off.

Senator LUGAR. At that point wasn't the fight against inflation sort of given up? The cynicism of the public with regard to this is that, given the pressures of the President's campaign, that the economy really had to be revved up in the third quarter, that the recession had come at a very unfortunate time, and so, as a result, although maybe unwittingly, the Fed by moving into lack of restraint in allowing all forces to proceed again, contributed to an unfortunate result.

Mr. VOLCKER. I have to reject that interpretation, certainly the political aspects entirely. During the second quarter itself, as you noted, the money supply was low. We had not an abnormal situation, I suppose, a feeling on the part of some people, as reported here, that we were unduly easy in some sense, purely because interest rates were down. People looking at the same phenomenon through a differently set of glasses said, "My goodness, the money supply is low. You are unduly restrictive." We had appeals from both sets of people at the same time.

Senator LUGAR. I know the sorts of appeals. What I cannot understand is—I can understand those who want things to be revved up. What I can't understand is the rationalization that some way inflation would be assisted. I grant the point that if interest rates are down people might buy more cars, for example, might buy more houses, and apparently did so for a little while until they came up again. But would this have been all bad? In essence, didn't we have several of the best worlds all at the same time there and gave it up by moving in a different direction?

Mr. VOLCKER. You know, with hindsight you always want to play the game a little differently. And I have said before that once you do something different you don't know what otherwise would have

happened. But when I look over the past year, I am a little concerned that in an effort to maintain the stability of the money supply, we may have inadvertently encouraged some people wrongly, to conclude that things were too easy. In everyday nomenclature, the economic forecast prevalent at the time turned out not to be very accurate, and the economy did resume a growth trend earlier than was thought. Maybe we would have been better off, in a sense, not chasing the money supply quite so actively during that period. That is not a conclusion that everybody comes to.

Without taking the time to go through it in detail, I will point out that the chart on page 27 of the report attempts to follow our operating intentions. Remembering that nonborrowed reserves are our proximate policy tool in the sense of controlling the money supply. We pulled them down when inflation was very high and the economy was high in the first quarter. We pushed them up in the second quarter to hold up the money supply. From then on we held them essentially stable.

We were not trying to encourage that increase in the money supply that took place in August, September, October. It took us several months to get a real handle on it. But we were applying pressure right through that period, and by December, I think it is pretty clear, we had a handle on it. I think this chart makes it quite clear that we were applying pressure right through that period.

Senator LUGAR. My time has expired. But let me just get a quickie in. Why wouldn't you have made the rate range for this coming year lower generally? I appreciate you have made it a half point, but why not much lower?

Mr. VOLCKER. I think the implication of a half-point change in the range is of more than a half a point change in reality, because we set out to be within the range. We will see what happens, but our intent is to be within that range, which implies a larger rate of decline, given what happened in 1980, than the half-point reduction in the range itself suggests.

The Chairman. Senator Williams.

Senator WILLIAMS. Thank you, Mr. Chairman.

Chairman Volcker, in the report that you are submitting, in fact your appearance here—is a result of the Full Employment and Balance Growth Act of 1978, the Humphrey-Hawkins Act.

EMPLOYMENT AND MONETARY POLICY

I see very little in your submission—and I haven't been here through the entire morning of your testimony, but I'm told there is very little in your testimony about full employment. I just wonder what will the Fed monetary policy do for employment, and also why is there so little mention of full employment in the current debate over fiscal and monetary policy?

Mr. VOLCKER. I don't know how you define full employment. It's defined in that act as 4 percent, if I recall correctly.

Senator WILLIAMS. Right.

Mr. VOLCKER. That objective of 4 percent unfortunately is not realistic in the short run, and I think various administrations have recognized that.

I am wholly convinced—and I think I can speak for the whole Board and whole Open Market Committee—that recognizing that that objective for unemployment cannot be reached in the short run—the kinds of policies we are following offer the best prospect of returning the economy in time to a course where we can combine as full employment as we can get with price stability.

I bring in price stability because we will not be successful, in my opinion, in pursuing a full employment policy unless we take care of the inflation side of the equation while we are doing it. I think that philosophy is actually embodied in the Humphrey-Hawkins Act itself. I don't think we have the choice in current circumstances—the old tradeoff analysis—of buying full employment with a little more inflation.

We found out that doesn't work, and we are in an economic situation in which we can't achieve either of those objectives immediately. We have to work toward both of them; we have to deal with inflation. And the Federal Reserve has particular responsibilities in that connection.

Senator WILLIAMS. You have another report coming later in the year under that law. I hate to get into any attempted precision about timing and goals here, and I don't know what we can assume in terms of time and passage of the President's recently announced economic program, a program of substantial reductions of expenditure, the infusion of tax changes, both designed to bring on greater productivity.

It just seems to me none of this can have, in the short term—by your next report, for example—too much effect on either of the factors here, productivity or inflation.

Mr. VOLCKER. I think that's right.

Senator WILLIAMS. The public there expects great things to happen within a year. The polls show that. How do you look at things?

Mr. VOLCKER. I don't want to encourage overly optimistic expectations on the part of the public in the time frame that you are speaking of. I think we have a very difficult problem here. We discussed earlier that there's not going to be room for growth in a substantial way until we get the inflation rate moving down. We haven't, in my opinion, yet turned the corner on inflation. We've had a lot of pressure on the financial system. We have restrained growth in money and credit in general terms—I think that's quite clear, compared to the demands out there.

We have, I believe, prevented the inflationary situation from exploding, as it easily could have; we've been sitting on top of a boiling kettle. But we have not yet succeeded in turning the corner on inflation. We must do that; that's the first step; and that is going to be a difficult process. Nothing that's happened suggests that's easy.

We have gone through quite a lot of agony just keeping the lid on that kettle. We have got to get this thing turned around. That, in a sense, is the job for 1981.

If we can succeed at all in 1981—when I say “we,” I just don't mean the Federal Reserve; I mean public policy—we will then have begun to set the stage for the kind of growth and further progress on inflation that we would like to see.

But I think there is a very substantial risk of disappointment, as you suggest, if the hope is held out that this is going to happen magically in the next 6 months without a lot of stress and strain in the process.

Senator WILLIAMS. We are going to go through the agony here in those next 6 months. That's the way it seems to me.

DANGERS TO THE THRIFT INDUSTRY

There is one specific economic problem here that hit my office this week—and perhaps others, too. And that deals with one of the effects of the high interest rates. We all know the toll they're taking on homebuilders, automobile dealers, small businessmen, and individuals, too. They are also having a very, very destructive effect on the thrift industry, which is experiencing massive deposit outflows and severe earnings problems.

Money market mutual funds are often blamed for exacerbating the problem. I don't know if you call this disintermediation or not, but a massive amount of funds are flowing into the money market mutual funds from thrift institutions. I know that some of the members of the Board have expressed their opinions about the many problems that are presented by these funds.

Why don't I put three questions, and then if you could give us your feelings:

First, I would like to know what your views are on this explosive growth of money funds, and whether they complicate the conduct of monetary policy?

Second, do they take investment capital out of the economy?

And, third, do they pose a real and present danger to the thrift industry?

Mr. VOLCKER. I don't think they take money out of the economy, in the most general sense. I think it is true that the investment behavior of money market funds results, perhaps, in somewhat larger flows into the Eurodollar market than might otherwise take place. But the markets are closely interconnected anyway, and it's hard to argue that that's a very significant influence. The funds do buy Eurodollar, CD's, and so forth. One might assume that if the money came out of thrift institutions or commercial banks it might now flow a little more easily abroad. But those markets are very closely connected anyway, and it's hard to say that that is, in ordinary circumstances, a major influence.

Otherwise, the money comes back automatically someplace in the American economy. It may come back to somewhat different places than it otherwise would have, but it's not going out of the economy entirely. There is some distributional effect, but it doesn't take money out of the economy, *per se*.

As you know, we've put on some restraints on those funds when we had credit controls, partly because we felt that they were draining money from smaller banks and thrift institutions—which were particularly hard-pressed at that time—and in channeling the money into the central money markets or into the Eurodollar market, where there was already, in relative terms at least, more ability to borrow by the big companies that used those markets.

I think there is a structural question that arises that is relevant to the conduct of monetary policy over a period of time; that is, to

the extent money market funds are really running a transactions account business—checks, third-party payments—their shares do become a kind of money or quasi-money, but they operate without the same constraints—without reserve requirements in particular—that thrift institutions or commercial banks have when they are running a transactions account business.

Using a kind of broad logic, this development does suggest the reasonableness of equalizing the competitive conditions under which these institutions operate. Our analysis suggests that while that logic is correct, it's the kind of problem that would emerge over a period of time, because it depends on how actively they are using these transactions accounts.

You also raised the point as to the extent to which that complicates the very real problems that thrift institutions and commercial banks have at this time. That is a more immediate kind of question.

I think I would make two general comments. The problems the thrift institutions have is basically that they've got a lot of old assets that were bought in a different economic climate, when there wasn't much inflation, and they find it very difficult to make the adjustment to a high level of inflation; this comes back to the priority of dealing with inflation.

Second, as long as interest rates remain high, there are a number of alternative places for money to go other than money market funds, including into Treasury securities directly. The markets are very ingenious about developing new institutions or new techniques for attracting money when there is an interest rate discrepancy.

Therefore, I don't want to suggest that a change in money market funds, per se, will make a revolutionary difference in the condition of the thrift industry at this time, so long as the basic conditions of high market interest rates and high inflation remain.

Senator WILLIAMS. Do you have any suggestions for action now? If so, we'd like to hear about them.

Mr. VOLCKER. The Board of Governors, as a whole, has not considered this, but we would be glad to make such recommendations.

[Chairman Volcker subsequently furnished the following information:]

The Board will be considering this matter in the near future and will report its views to the committee.

Senator WILLIAMS. There are some ideas on the old rates that they're stuck with.

Mr. VOLCKER. I understand.

Senator WILLIAMS. Thank you very much.

The CHAIRMAN. Chairman Volcker, what Senator Williams just brought up is going to be my next line of questioning, so let me follow up in more detail.

At the time we were considering the problem of Federal Reserve membership decline there were different solutions. Senator Tower and I prefer to pay interest on reserves and have a voluntary system. That was not what was passed in H.R. 4986.

We do have a mandatory reserve system, whether an institution is a member of the Federal Reserve or not. At that time, one of the great arguments made for that was the necessity for reserves in

order to manage monetary policy. And yet we now have \$90 billion of money market funds floating outside of that, so it must have a more dramatic effect than you've indicated to Senator Williams; or else your whole thesis of needing mandatory reserves to manage the money supply is questionable, because \$90 billion is a lot of money to be floating outside the system.

Mr. VOLCKER. The only disagreement I would have with your comment is on the practical matter of how much emphasis to give at the moment to the \$90 billion out there. All of that \$90 billion is not acting like a transactions balance, which is where the reserve requirements are. In the past these funds have acted more like savings accounts where we're phasing out reserve requirements.

In fact, they are now a mixture in type, and my concern is that the mixture would get heavier on the transactions aspect over time. I think that's probably happening.

I'm fully with your logic, but I don't think you can say that \$90 billion is the equivalent of \$90 billion in transactions accounts.

TRANSACTION ACCOUNTS

The CHAIRMAN. Let's go to the transaction' accounts. Also for 5 years we struggled and finally came up with H.R. 4986, the so-called level playing field. For the first time the small institutions that Senator Williams is talking about--the thrifts, the S. & L's, the credit unions--have NOW accounts and share drafts all the way since January 1. They are very carefully regulated.

Here the securities industry and some of the giants like Merrill, Lynch are in the third-party checkwriting business, totally outside of that regulation. I don't know of anything I've seen that I believe is more patently unfair but probably legal. Merrill, Lynch is operating through Bank One in Columbus, Ohio. I happen to think Bank One in Columbus is either operating branches in my State or other places in violation of the McFadden Act or else Merrill Lynch is a bank. If it looks like a duck, walks like a duck, it must be a duck.

I'm concerned that the Fed is so interested in regulation--and there is no industry more carefully regulated in these transaction accounts than the financial community banks, savings and loans, and thrift institutions, and yet here we have this giant out there issuing checks, third-party checks. And I hear very little from the Fed.

Now in the State of Utah, the Utah Legislature is involved in the process right now of a 403-page bill, and what they are going to do with it, I don't know. But it really disturbs me when we talk about the so-called level playing field--and what one person's definition of a level playing field is is obviously different from someone else's--but I don't think anyone can conclude from the transaction accounts of money market funds--and I'm certainly bright enough to understand the difference between 17 percent and 5.25 percent interest and the advantages to the consumer--but the narrow issue, not the issue of money market funds or whether consumers should have that choice, but whether they should be allowed to write checks.

It seems to me, we've either got to let banks, financial institutions, get into municipal revenue bond writing and get into money market funds or else tighten the screws the other way.

I prefer less regulation, but still it seems the issue that Senator Williams is talking about—it is hurting some of the small institutions, and it is unfair competition that is created by Government, and we're going to have more hearings on this. I guarantee it.

So I would hope the Fed could get their act together and come up with some recommendations of what is an incredibly unfair competitive situation with the giants of the securities industry and the small little thrifts that are struggling with this high cost of money.

COMPETITIVE EQUITY

Mr. VOLCKER. I don't disagree at all that there's an equity problem. To the extent these are transactions accounts, the treatment is different, and it's inequitable, and I don't question that this helps bring pressure on financial institutions.

I simply did not want to suggest that bringing those funds into a situation of competitive equity would mean that the problems of the thrifts or the commercial banks would disappear, given the basic situation that exists.

The CHAIRMAN. Yesterday the Supreme Court issued a decision upholding the Fed's regulation permitting bank holding companies to sponsor, organize, and control closed end mutual funds—closed, end as you know, limiting the number of shares compared to open ended funds that continuously offer their securities.

Do you believe this decision means that the bank holding companies can offer closed end money market funds?

Mr. VOLCKER. I don't now. I'm not familiar enough with it.

The CHAIRMAN. Is it practical?

Mr. VOLCKER. I'd better not comment on the issue. I'm just not familiar enough with it at this point.

The CHAIRMAN. See, it's interesting when you start talking about level playing fields, when you start talking about banks getting into the securities business, then all the securities people put up their hands and say: "Hey, that isn't fair; they are banks."

Well, the banks and the thrifts have a right to say, "The securities industry are not thrift institution." So with third-party check writing, I'm disappointed that the Fed seems to have just overlooked what is obviously a very inequitable situation.

Mr. VOLCKER. I don't think it's quite fair to say we've overlooked it. The Merrill Lynch plan was before I was on the Federal Reserve Board, but it was looked at at that time. Apparently the legal conclusion was reached that it had been arranged in such a way as to thread its course between the banking laws and the security laws.

The CHAIRMAN. They have about four different laws. They've done a very good job of it.

Mr. VOLCKER. I think you'll recall that the money market fund issue was considered at the time the Monetary Control Act was considered, and I've had some discussion with Senator Proxmire and others as to whether it was logical to include them under the law on precisely the grounds that you are describing. The logic and

the equity was that the transactions accounts business should be brought into the level-playing-field concept.

At that time, what emerged was that we would not deal with that issue in the context of that particular law. But that doesn't close the issue forever, in my judgment.

The CHAIRMAN. The reason I'm so upset about it, Mr. Chairman—if there's anything I will try to do as chairman of this committee, it is to attempt to find equity, and there is no one that is more in favor of free competition than I. But here you have a situation of where Government is giving the competitive advantage to one sector over another. When the Government is in the process of delineating what the competition is—it isn't free competition. That's the problem. It's not one of just taking the thrift side at all, because you can solve it two ways. You can deregulate them and let the securities people scream, or you can put some more control on securities.

Mr. VOLCKER. That is why I stated precisely in my answer to Senator Williams that as a matter of logic, if they're doing a transactions account business, that business ought to come under the same rules, one way or the other, as you point out.

The CHAIRMAN. We'll see what can be done about that in the next few months so they are treated equitably.

My time is not up, but I do believe we should move along.

Senator RIEGLE. Can I just say, I agree with the concern that you have been raising. I hope we can press ahead on that issue.

The CHAIRMAN. Senator Proxmire?

Senator PROXMIRE. Chairman Volcker, John Berry, who as you know is the highly reliable, honest, accurate, precise reporter for the Washington Post—

[Laughter.]

Senator PROXMIRE [continuing]. Reported the following, and I quote:

Fed Officials fear that the administration's highly optimistic economic forecast which predicts a simultaneous increase in real output, a sharp drop in inflation, and rapidly falling interest rates beginning late in this year is setting public expectations much too high. If the central bank is successful in slowing money growth but at the cost of higher interest rates and lower levels of economic activity than predicted, there could be a public and Congressional backlash with the Federal Reserve.

That's you Paul Volcker cast as the villain—"we are being set up, one official said flatly." And that quote comes from the reliable, honest, accurate, precise John Berry, and I want to ask you, are you being set up?

Mr. VOLCKER. I won't characterize Mr. Berry, other than to say that my impression is not unlike yours. But he isn't quoting me, to the best of my knowledge, on that subject. I don't think there's anyone being set up. I expressed my concern earlier to Senator Williams about public expectations and the importance of dealing with this inflation problem, and I would be concerned if people thought that it was easy to get this situation turned around because in that—

Senator PROXMIRE. The administration and their top responsible spokesmen, like Mr. Stockman and others who have been making these predictions—they say we're going to have a sharp drop in inflation if we enact the President's program; we're going to have a

reduction in unemployment; we're going to have a very sharp drop in interest rates.

It seems to me that that is what the public expectation is built on more than anything else. And if we don't have that, then obviously the fall guy is going to be you.

INFLATION PREDICTIONS

Mr. VOLCKER. I don't think their projections of inflation by themselves are unreasonable. I hope we could accomplish that. I would hope we could accomplish more than that.

My concern is that the road from here to there may not be totally smooth, if I may put it rather conservatively. I don't know just what that road is going to be, but I don't think—

Senator PROXMIRE. You say their inflation predictions might not be unreasonable. How about the interest rate predictions? They have predicted that interest rates, the prime rate would drop to 8 to 9 percent next year.

Mr. VOLCKER. The interest rate should be related to the inflation rate in a general way over a period of time, a point that you have made yourself. I religiously refrain from forecasting interest rates. I, myself, just don't want to add to any impression that getting from here to there will be smoother. I would like to see it as smooth as possible, but whatever stress, strain, and pain there is I think is worth it. I think we have got to get to that result.

Senator PROXMIRE. In President Reagan's program for economic recovery, he has a chapter on controlling money and credit, calling for a reduction in monetary growth rates for the years ahead. The document says the administration will do nothing to undermine the Fed's independence. Are you familiar with President Reagan's plan?

Mr. VOLCKER. I'm familiar with the section that was written.

Senator PROXMIRE. Was the Fed consulted?

Mr. VOLCKER. I saw it before it came out.

Senator PROXMIRE. Was that the consultation—you saw it before it came out?

Mr. VOLCKER. You mean on the program?

Senator PROXMIRE. Yes.

Mr. VOLCKER. On the program itself, I have had quite a lot of contact with individual administration officials since Christmas time.

Senator PROXMIRE. You discussed this program with the Secretary of the Treasury and other officials?

Mr. VOLCKER. Yes.

Senator PROXMIRE. Has the Fed adopted the Reagan statement as its policy?

Mr. VOLCKER. We adopt our own policies as policies. But as I indicated earlier, that particular statement seems to me broadly consistent with what we have been saying all along.

Senator PROXMIRE. Did the Open Market Committee consider adopting the Reagan policy?

Mr. VOLCKER. No.

Senator PROXMIRE. Now I think Senator Heinz' questioning was very, very enlightening.

Mr. VOLCKER. I don't know whether there's any sort of misunderstanding. The Open Market Committee, per se, had no discussion about adopting "the Reagan policy," in terms of that sort. The Open Market Committee met to discuss these ranges before the Reagan program was announced, although obviously there have been a lot of—

Senator PROXMIRE. So your posture is simply that the Reagan program doesn't clash with or contradict your position? In fact, that's the position the Federal Reserve has had?

Mr. VOLCKER. Those comments do not clash at all. That's precisely the distinction I want to make.

Senator PROXMIRE. When Senator Heinz was questioning you, frankly I hadn't studied that table I, and it is startling, because I've been complaining for years, as you know, that the ranges are much too broad—M-1A, M-1B, and so forth. In every measurement of the money supply, as Senator Heinz pointed out, you were above the top part of the range, and if you take the midpoint as a comparison, in M-1A you were 50 percent over; M-1B, 30 percent over; M-1A about 60 percent over; M-1B again you were about 60 percent over; M-2 you were 40 percent over; M-3 you were 35 percent over.

You were above-higher—

Mr. VOLCKER. If I may interject, Senator, I don't think it's meaningful to say we were 35 percent—

Senator PROXMIRE. You were.

Mr. VOLCKER. If the target were 1 percent, and you missed by a quarter of 1 percent, you'd be 25 percent over. It's not economically meaningful. If the target was zero, we'd miss it by infinity. [Laughter.]

It is not a meaningful comparison. We are dealing with a series that is inherently volatiles. If I may refer back to the technical material—in it, I submitted that if we hit our reserve targets perfectly, or hit any reserve target perfectly—which we cannot do—in 1 month one-third of a time, the money supply figure would be off plus or minus 10 percent.

Senator PROXMIRE. I'm not talking about monthly fluctuations are one thing. This is for the entire year. You told us that you missed, and missed badly, in every case as far as the midpoint is concerned. As I say the ranges you make are so broad that it's like they say, you couldn't hit the broad side of a barn door if you fell against it.

Mr. VOLCKER. We have got to be realistic about what the real world is like. I commented that our money supply figures and our performance relative to these targets compares well internationally. We are dealing with a series that is not subject to the kind of close shortrun control that the question implies.

Senator PROXMIRE. I understand that. You made, I thought, a very interesting response when you told Senator Heinz that maybe it was right that it parts from the target. After all, the conditions change. The condition that changed was the second quarter of 1980 was the worst quarter we've had since the Great Depression. It was a terrific, calamitous, sudden, sharp drop in economic activity. Obviously in that time we shouldn't follow a restrictive policy. And apparently you didn't follow a restrictive policy.

Mr. VOLCKER. At that point, in fact, the money supply was low.

Senator PROXMIRE. It was, but it came back very fast because of that situation.

Mr. VOLCKER. It came back very fast. It came back, in some sense, too fast. It took us several months---

Senator PROXMIRE. It may be one of the reasons we recovered so rapidly from that disastrous second quarter--as a matter of fact, the way things worked out according to the technical definition of recession, we didn't have a recession, because we didn't have two successive quarters of negative growth. That was the only quarter in 1980 that we had negative growth.

Your policies probably did assist in the recovery. At the same time, however, it seems to me that may tell us something about how persistent you will be in following an anti-inflation policy if we dip again.

Mr. VOLCKER. I would like to think our performance does say something about how persistent we will be. You are looking, in terms of this chart, at how we came out with respect to one particular quarter during the year; that's the way we conventionally set forth these targets, fourth quarter to fourth quarter. But there is nothing ordained in heaven that says the fourth quarter is any more significant than any other quarter.

Senator PROXMIRE. The thing is, as Senator Heinz said, they are your figures. This is your table. You put it together. You handed it to us.

Mr. VOLCKER. I agree. And by convention, for simplicity of explanation, we want to capture the period during the year. We say, let's set forth the target fourth quarter to fourth quarter. But let's not mistake the convention, which is ours, as an explanation of all reality.

If we look at the annual average change in the money supply--which for some purposes is a more reasonable way of looking at it because it encompasses the money supply during the entire year--the growth in M-1A last year was 5.6 and the growth in M-1B was 5.9. If you interpret these targets as an average for the year, we would have been just inside them.

I don't think we ought to get hung up on a quarter of 1 percent. Our intent is to be restrictive, to restrain this growth, to reduce this rate of growth over time.

If you extended last year's target into January and February of this year, we would be comfortably inside right now. It depends upon just when you take the snapshot. But it is important---

Senator PROXMIRE. My time is up. But Mr. Chairman, the fact is that you are the ones that gave us this picture, and I think it was an accurate, an honest picture. And on the basis of what you gave us, you were way, way over your midpoint and you had a much more stimulating monetary policy than you indicated you would have.

As you say, statistics can prove anything you want, but these are your statistics.

Mr. VOLCKER. I think they are accurate statistics. All I am saying is that no set of relatively few numbers can portray all of reality, and that's as true of this table as any other series of six or seven numbers I can give you. And they have to be interpreted in a larger context.

The Chairman. Senator Riegle?

Senator RIEGLE. Mr. Chairman, on page 44 of the Fed report you show the economic projections for 1981 by the Federal Open Market Committee, and you show the range that the committee foresees versus that of the administration. I don't want to get into that right at the moment, but do you also make those projections for 1982?

Mr. VOLCKER. No.

Senator RIEGLE. They don't exist?

Mr. VOLCKER. No.

Senator RIEGLE. Is there a reason for that?

Mr. VOLCKER. Well, we have—

Senator RIEGLE. Let me not use my time that way. The point is, they don't exist for 1982. Would it be possible to get them for 1982?

Mr. VOLCKER. I could. The way we got these figures is by polling the committee, but we have not followed. [Laughter.]

We did not poll them for 1982.

Senator RIEGLE. I think that would be useful. I would like to just ask, as long as you are able to do it for 1981, maybe that also be done for 1982.

But let me go on from there, because there is a more specific question I want to ask. What is likely to take place in 1982? And, of course, none of us know that. We've got a plan here—

Mr. VOLCKER. That is my concern.

Senator RIEGLE. And ours as well. Assuming we are going to go ahead, and I think a lot of the program that is before us, the Reagan program, will be enacted. I think the spending cuts, by and large, will be made maybe in somewhat different areas, but I think in the aggregate we will be very close to those numbers. I think the tax numbers may be about the same, although it may be shifted around as between investment type versus personal tax cuts.

MAINTAIN TIGHT MONETARY POLICY

But my question to you is this: If we get out into 1982, and even if the program is put in place, for some reason it just doesn't work the way people thought it would—there might be outside shocks from OPEC and oil interruption, you know as well as I, bad harvest, other things that singularly or together could take and knock everything askew—if we find ourselves in a situation where the deficit starts ballooning, for whatever reason, and the inflationary expectations are still high—would it be the intention of the Fed, then, to maintain a very tough and tight monetary policy?

Mr. VOLCKER. Our present intention—and I don't see that intention changing—is to maintain the kind of monetary policy described in this report. Now, if those kinds of contingencies that you describe materialize, it would imply, I think, very heavy pressure on financial markets.

Senator RIEGLE. So I gather, and this relates to Senator Proxmire's question, that the responsibility to take some additional further action might then fall to the Fed, and you are prepared to take that action in terms of the restrictive monetary policy, if you feel that has to be done.

Mr. VOLCKER. The only way that I would restate your conclusion is changing the words "take further action." We intend to persist in this course, in terms of these monetary numbers. Its implications for financial markets depend upon all those other things that you rightly emphasize.

Senator RIEGLE. I think it's helpful for the Senate to be aware of your direction under different eventualities, because if the prospect was to be for a period of tight monetary policy, resulting in a continuation of relatively high interest rates, I think that presents a whole set of problems that we ought to try to forestall. I frankly would feel that would be a disaster, if we find ourselves in that situation.

Mr. VOLCKER. I agree with you. The conclusion I would draw from that is certainly not that we should ease up, because that is not going to help the inflationary situation or help us to get out of this problem at all. My conclusion from that is, in evaluating this program, you get in there as big a safety margin, so to speak, as you can, in terms of the Federal budgetary picture and spending in particular.

You have to operate on both sides of the equation, but the immediate instrument that you have and the key point is not to take risks on the expenditure side.

Senator RIEGLE. Now, the Reagan deficit projection for 1982 is \$45 billion. Is that an acceptable figure? If we hit that figure, will that be sufficient, from the Fed's point of view?

Mr. VOLCKER. I don't think I can analyze that figure in isolation. If you had a deficit of that size as clearly a transition toward a balanced budget, in circumstances in which the inflation rate was clearly coming down, in which there is a considerable margin of slack in the economy—which affects tax collections and affects certain payments on the other side—I don't think you could say that that deficit, under those particular set of conditions, was unreasonable.

Senator RIEGLE. Under worse conditions it would make you nervous, I take it?

Mr. VOLCKER. Under other conditions it would make me very nervous, yes.

Senator RIEGLE. Let me ask you this. When the President spoke to the Senate in the joint session the other night, in the course of his two paragraphs on the Federal Reserve and monetary policy, he said: We will consult regularly with the Federal Reserve Board on all aspects of our economic program, and so forth and so forth.

Is this a new practice? Have you found yourself now working in consultation with the administration, in a different way than was true in previous administrations?

Mr. VOLCKER. No. Of course it is very early in this administration.

Senator RIEGLE. So it's really not changed; is that what you're telling us?

Mr. VOLCKER. At this point.

Senator RIEGLE. On the question of the degree to which you were consulted on the economic package, was the Fed asked to give it its blessing in private conversation, or not?

Mr. VOLCKER. No.

Senator RIEGLE. It was not?

Mr. VOLCKER. No.

Senator RIEGLE. And does that also mean that it did not? Or did the Fed volunteer an opinion one way or the other?

Mr. VOLCKER. No.

Senator RIEGLE. It did not?

Mr. VOLCKER. No.

Senator RIEGLE. So it isn't fair to say it either has the blessing or the lack of blessing of the Fed.

Mr. VOLCKER. That is correct. That degree of formality, or whatever, was not at issue.

Senator RIEGLE. *Has there been any discussion to indicate that the process from this point forward may be different; that the Reagan administration may have something in mind in terms of coordination that would be different than past practice?*

Mr. VOLCKER. I don't have any indication of that. They've had some discussion with me about how these arrangements took place in the past, and how we felt we might handle it, just on a personal basis. Our meetings have been thus far, as a very practical matter, not necessarily less frequent, but perhaps less regular, perhaps because they are very occupied with getting this program together and with their various appearances up on the Hill.

We are very busy men at this point, so we have had to get together when we can, rather than on a very organized basis.

TAX POLICY

Senator RIEGLE. If I may, and hopefully without intruding on the privacy of the sessions, but I think it is important for us to know, if we can; and that is were you asked your opinion on the kind of tax cut that might work best or not?

Mr. VOLCKER. As you would expect in this kind of informal conversation, they informed me at times of what their planning was as to the cuts, and with respect to the size of the tax program, and how they were proceeding. I don't think it's fair to say that we had any particular dialog or debate about the shape of the tax cut. They determine that.

Senator RIEGLE. So you made no particular recommendation one way or the other on that?

Mr. VOLCKER. *We've had some discussion of the balance among tax reduction and expenditures, as you would expect. But I don't think I can go much beyond that. The shape of this program is entirely theirs.*

Senator RIEGLE. Might I just ask this? If by some means the Senate or the Congress were to decide to exactly reverse the proportions of the tax package—I'm not suggesting that it will, but just for the sake of the illustration, let's just suppose we reverse the ratios. Would that have any effect, in your mind—good, bad or otherwise—on the impact on inflation going out in time, or not?

Mr. VOLCKER. I really don't think I can give an intelligent answer in terms of proportions. I am interested in very general terms. There is a lot of debate about tax policy. It is not my direct responsibility. But I think the more that can be done in terms of incentives the better off you will be, and the job is to determine

what the best program is, putting the emphasis on that characteristic.

Senator RIEGLE. Let me ask your opinion. If you take the \$44.2 billion in the personal tax reductions in 1982, what would be your estimate as to the percent of that that would make its way into savings? What is your judgment on that?

Mr. VOLCKER. I can't look at it that way. I don't know. I think you can only answer the way I did before. You can only answer what the impact is of the total program—and that is a big component in the program—on the prospect for getting the total savings rate up; you can't try to trace through where particular dollars went and what an individual's behavior will be.

Senator RIEGLE. It is kind of a key question, isn't it? If you have a low margin or rate of savings on that it wouldn't help.

Mr. VOLCKER. I don't think it really is. I guess what I am saying is what is important is what is done to effect the marginal rate of savings or the average rate of savings for the economy as a whole. It is not so important to try to pick out what a group of individuals have done with their tax money. You can't really tell anyway, because after the first quarter or two, people's motivations become entangled with everything else.

Senator RIEGLE. You have got to remember we are borrowing to pay out the money. It is not as if we are going to be running a balanced budget in 1982. We are projecting a \$45 billion deficit.

Mr. VOLCKER. I would like to get a maximum impact on savings. You asked me for a technical judgment as to just how much of this will be saved. I think what econometric or analytic work has been done on this says it all depends on the particular setting of a tax program. In the very first month when somebody ends up with a bigger pay check, he may save it. He may stick it in his bank account. That is a form of savings.

So it looks like he is saving it for the first month or two. The question is what happens after the first month or two; all the analysis says what appears as savings in the first month or two rapidly diminishes as people restore a more normal position.

If you reduced taxes for 6 months and said you were going to raise them again you would get more saved than if you said you were going to reduce taxes permanently. That is what the analysis suggests.

I think the real question is not just what this part of the program does but what the program as a whole does to the total savings rate.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. I have some questions for the record, too. I would just like to call your attention, finally, Chairman Volcker, to pages 22 and 23 in the program of economic recovery, the administration's document on the economy and the economic policies. Those pages affect you, the Federal Reserve controlling money and credit.

And they say in the next to the last paragraph and following, economic scenario assumes that the growth rates of money and credit area steadily reduced into 1980 levels to one-half of those levels by 1986.

NONCOMMITTAL POLICY

How they can make that assumption without any commitment, and you have indicated to Senator Riegle that there has been no commitment, no promise, is beyond me, particularly in view of the fact this would go well beyond your term, of course. But it projects a policy which you might approve now, but it projects it in the future, and there is no commitment to abide by that policy; isn't that right?

Mr. VOLCKER. In a technical sense I think that is right. But that statement, again, is in general congruence with what we have been saying.

Senator PROXMIRE. General congruence. There is a very precise estimate by 1986 the growth rate would be one-half of what they are today.

Mr. VOLCKER. I thought there was an about in there.

Senator PROXMIRE. There is no about at all. To one-half those levels by 1986.

Mr. VOLCKER. The about may have been in another context. I would not interpret it as more; maybe less. I had seen a statement of that kind before it was issued, and my response was that I didn't know whether they would want to say it or not, but it seems to me if they want to make that assumption it is not out of keeping with the sense of what we have been saying.

Senator PROXMIRE. I understand that. There is just no commitment. Mr. Chairman, I just want to express the same concern that you did, that the thrifts are under heavy pressure from money market funds. We must fight inflation. But also we need to address the issue of equitable competition, which you discussed with the Chairman, between thrifts and money market funds, and we also need to consider the need to maintain free financial markets.

I hope, Chairman Volcker, that you will provide the committee with your guidance for the record on that issue, because the committee must be taking the issue up.

Mr. VOLCKER. We will.

The CHAIRMAN. Mr. Chairman, we appreciate your testimony today and your patience. I am sure as you are questioned on the performance of the Fed you must have sometimes an incredible desire to have us in the witness box asking us how we performed on our targets and on the fiscal side.

I would only close by saying that the ball is in our court. I cannot emphasize that enough, that unless we restrain the fiscal policy, unless we have cuts in the magnitude the President has asked for, not only in this year, that will not solve it at all unless those cuts in the out years are made as well.

You will be back here every 6 months and we will be talking about the same high interest rates and performance of the monetary aggregates. So I hope that from the condition of the economy that Congress will respond and we will do our part in helping to control inflation.

Mr. VOLCKER. I very much share those thoughts and those hopes, Mr. Chairman.

The CHAIRMAN. Thank you very much.

The committee is adjourned.

[Whereupon, at 12:30 p.m. the hearing was adjourned.]

[Complete statement of Chairman Volcker, copy of the report from the Federal Reserve Board, answers to subsequent questions of Senator Garn, and reprint of briefing materials from the Library of Congress Congressional Research Service follow.]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am pleased to be here this morning to discuss with you the Monetary Policy Report of the Board of Governors reviewing economic and financial developments over the past year, and setting forth appropriate ranges for growth of money and credit for 1981. Because I have already reviewed recent developments with the Committee, my emphasis this morning will be on the present and future concerns of monetary policy. In that connection, I would like to touch first on some more technical considerations of Federal Reserve operating techniques.

As you well know, 1980 was a tumultuous year for the economy and financial markets. While most measures of the monetary and credit aggregates grew at or very close to our target ranges for the year as a whole, there was considerable volatility from month to month or quarter to quarter. Moreover, interest rates moved through a sharp cycle, and had considerable instability over shorter time spans.

In the light of these developments, I initiated in September a detailed study by Federal Reserve staff of the operating techniques adopted by the Federal Open Market Committee in October 1979, looking, among other things, to the question of whether the particular techniques we employed contributed importantly to the observed volatility. Those techniques, as described in our Report, place emphasis in the short run on following a path of non-borrowed reserves.

The study drew upon the substantial body of staff expertise both at the Board of Governors and at the regional Federal Reserve Banks, thus bringing to bear a variety of viewpoints and analytic approaches. The Open Market Committee has had some discussion of the findings, and we are now at a point where the work can be made available to interested outside experts. To assure full review, Board staff will be arranging "seminars," as appropriate, with economists having a close interest in these matters.

Among the important questions at issue is whether alternative techniques would promise significantly better short-run control over the monetary and credit aggregates, and whether such techniques would imply more interest rate instability. We also examined again the significance for the economy and for basic policy objectives of monthly, quarterly, or longer deviations of monetary growth from established target ranges.

¹ For the convenience of the Committee and others, I have listed in this text some of the technical findings that may be of more general interest.

1. The work confirms that the week-to-week money supply figures are subject to a considerable amount of statistical "noise" -- unpredictable short-run variations related to the inherent difficulty of computing reliable weekly seasonal adjustment factors and other random disturbances. One analysis suggests the random element in the weekly M-1 data, as first published, is about \$3 billion, plus or minus. While those variations average out over time, they could amount to \$1½ billion on a monthly average basis, equivalent to a change of 4½ percent at an annual rate.

No clear evidence was found that, in the present institutional setting, alternative approaches to reserve (or monetary base) targeting would increase the precision of monetary control. Indeed, in current circumstances, some other approaches would appear to result in less precision in the short run. Perhaps more significant, the linkage between any reserve measure and money in the short run was loose; econometric tests seem to suggest that, even assuming absolute precision in meeting a reserve target (which is not in fact possible), monthly M-1 measures would be expected to deviate from the target by more than plus or minus 8 to 10 percent (at an annual rate) one-third of the time. Those deviations should tend to average out over time, so that much closer control could be achieved over a three-to-six month period, assuming no constraints on operations from interest rates or other factors. Those econometric results are consistent with the actual experience of 1980.

Pursuing the closest possible short-run control of the money supply by any technique entails a willingness to tolerate large changes over short periods of time in short-term interest rates -- greater than were experienced in 1980. The technique actually employed, as expected, contributed to more day-to-day or week-to-week volatility than earlier procedures, but presumably not so much as other, more rigid reserve targeting approaches. Experience in 1980 also strongly suggested that short-run changes in money market rates became more highly correlated with fluctuations in long-term interest rates, which may be of more significance to investment and financial planning. The degree to which that closer association reflected uncertainty and a learning process unique to 1980, or is inherent in reserve-based targeting, cannot be determined at this time.

Interest rate instability associated with the new techniques per se is extremely difficult to distinguish from other sources of interest rate fluctuation. However, the major swings in interest rates during the year -- historic peaks in early 1980, the sharp drop in the spring, and the return to historic highs --

can be traced to disturbances in the economy itself, to the imposition and removal of credit controls, to the budgetary situation, and to shifting inflationary expectations. Indeed, while much compressed in time, the broad interest rate fluctuations were, in relative magnitude, not out of keeping with earlier cyclical experience.

Money supply fluctuations last year over periods of a quarter or so were probably larger than might have been expected on the basis of econometric analysis of reserve control techniques. The inference from the study is that the credit control program and other external "shocks" could have been responsible. At the same time, the evidence is that the quarterly deviations in money growth from the trend for the year did not have an important influence on economic activity. If money growth had somehow been held constant, short-run interest rate variability would have been still larger.

In analyzing the results of the study, and given the basic intent to control monetary and credit growth within target ranges over a period of time, the Open Market Committee continues to believe present operating techniques are broadly appropriate. Assuming the present institutional structure, alternative reserve control approaches do not appear to promise more short-term precision. We do, however, have under consideration possible modifications and improvements. Without going into technical detail, such matters as more frequent adjustment of the discount rate, more forceful adjustments in the "path" for non-borrowed reserves when the money supply is "off course," and a return to contemporaneous reserve accounting are being actively reviewed. In each case, the possible advantages in terms of closer control of the monetary aggregates need to be weighed

against other considerations, including contributing to unnecessary short-run interest rate volatility.

As a personal observation, I would emphasize that swings in the money and credit aggregates over a month, a quarter, or even longer should not be disturbing (and indeed may in some situations be desirable), provided there is understanding and confidence in our intentions over more significant periods of time. A major part of the rationale of present, or other reserve based techniques, is to assure better monetary control over time. I believe, but cannot "prove," that the money supply in 1980 was held under closer control than if our operating emphasis had remained on interest rates. I hope 1980 was instructive in demonstrating that we do take the targets seriously, both as a means of communicating our intentions to the public and in disciplining ourselves.

In that light, I would like to turn to the targets for 1981. Those targets were set with the intention of achieving further reduction in the growth of money and credit, returning such growth over time to amounts consistent with the capacity of the economy to grow at stable prices. Against the background of the strong inflationary momentum in the economy, the targets are frankly designed to be restrictive. They do imply restraint on the potential growth of the nominal GNP. If inflation continues unabated or rises, real activity is likely to be squeezed. As inflation begins noticeably to

abate, the stage will be set for stronger real growth. Monetary policy is, of course, designed to encourage that disinflationary process. But the success of the policy, and the extent to which it can be achieved without great pressure on interest rates and stress on financial markets that have already been heavily strained, will also depend upon other public policies and private attitudes and behavior.

Abstracting from the impact of shifts into NOW accounts and other interest-bearing transaction accounts, growth ranges for the narrower monetary aggregates -- M-1A and M-1B -- have been reduced by one-half percent to 3-5½ percent and 3½-6 percent, respectively. Growth last year from the fourth quarter 1979 average to the fourth quarter 1980 average (when adjusted for shifts into NOW accounts) approximated 6-1/4 percent and 6-3/4 percent, just about at the top of the target range.* Consequently, the new target ranges imply a significant reduction in the monetary growth rates.

The Committee did not change the targets for M-2 or M-3. In the case of M-2, the upper end of the range was exceeded by about 3/4 percent in 1980, and there seems to have been

*Growth, as statistically recorded, was 5% for M-1A in 1980 and 7-1/4% for M-1B. Available evidence suggests about 2/3 of the transfer into interest-bearing checking accounts in 1980 reflected shifts from M-1A, "artificially" depressing M-1A and about one-third reflected shifts from savings or other accounts, "artificially" raising M-1B. The data and the targets cited in the text are calculated as if such shifts did not take place. Both adjusted and unadjusted data are shown in the attached tables.

some tendency recently for M-2, which includes new forms of market-rate savings instruments and the popular money market mutual funds, to grow more rapidly relative to the narrow aggregates. In the past few years, M-2 growth has been much closer to the growth of nominal GNP than has M-1 growth. Should those conditions prevail in 1981, actual results may well lie in the upper part of the range indicated. M-3, which includes instruments such as certificates of deposit used by banks to finance marginal loan growth, is influenced, as is bank credit itself, by the amount of financing channeled through the banking system as opposed to the open market. Changes in those aggregates must be assessed in that light.

I must emphasize that both M-1 series, as actually reported, are currently distorted by the shift into interest-bearing transaction accounts. Those shifts were particularly large in January, when for the first time depository institutions in all parts of the country were permitted to offer such accounts. As the year progresses, we anticipate the distortion will diminish, as has already been the case in February. However, any estimate of the shifts into NOW-type accounts for 1981 as a whole, and the source of those funds, must be tentative.

Survey results and other data available to us suggest perhaps 80% of the initial shifts during January into NOW and related accounts were from demand deposits included in M-1A, thus "artificially" depressing that statistic. The remaining

20% was apparently shifted from savings accounts (or other investment instruments), "artificially" increasing M-1B. More recent data suggest the proportion shifting from demand deposits, while still preponderant, may be slowly falling. Making allowance for these shifts, M-1A and M-1B through mid-February of this year have remained near the December average level. At intervals, we plan to publish further estimates of the shifts in accounts and their implications for assessing actual growth relative to the targets. But I cannot emphasize too strongly the need for caution in interpreting published data over the next few months.

Once these shifts are largely completed, we plan publication of a single M-1 series. In that connection, I must note that the behavior of an M-1 series containing a large element of interest-bearing deposits, with characteristics of savings as well as transactions accounts, is likely to alter relationships between M-1 and other economic variables. For that and other reasons, the significance of trends in any monetary aggregate even over long periods of time must be analyzed carefully, and, if necessary, appropriate adjustment in targets made.

Those technical considerations should not obscure the basic thrust of our policy posture. Our intent is not to accommodate inflationary forces; rather we mean to exert continuing restraint on growth in money and credit to squeeze out inflationary pressures. That posture should be reflected in further deceleration in the monetary aggregates in the years

ahead, and is an essential ingredient in any effective policy to restore price stability.

During 1980, despite the pressures arising from sharply higher oil prices and the strong momentum of large wage settlements and other factors, inflation did not increase. But the hard fact is we, as a nation, have not yet decisively turned back the tide of inflation. In my judgment, until we do so prospects for strong and sustained economic growth will remain dim. In that connection, forecasts by both the Administration and members of the Open Market Committee anticipate continuing economic difficulties and high inflation during 1981.

I have emphasized on a number of occasions that we now have a rare opportunity to deal with our economic malaise in a forceful, coordinated way. As things stand, the tax burden is rising; yet, in principle the need for tax reduction -- tax reduction aimed to the maximum extent at incentives to invest, to save, and to work -- has come to be widely recognized. Regulatory and other governmental policies have tended to increase costs excessively and damage the flexibility of the economy; but realization of the need to redress the balance of costs and benefits is now widespread. Despite efforts to cut back from time to time, government spending has gained a momentum of its own; now, the possibility of attacking the problem head on presents itself. We are all conscious of the high levels of

interest rates and strains in our financial system; yet, there is widespread understanding of the need for monetary restraint.

The new Administration is clearly aware of these realities and has set forth a program of action. It has seized the initiative in moving from opportunity to practical policy.

I know that the case is sometimes made that monetary policy can alone deal with the inflation side of the equation. But not in the real world -- not if other policies pull in other directions, feeding inflationary expectations, propelling the cost and wage structure upwards, and placing enormous burdens on financial markets with large budgetary deficits into the indefinite future.

That is why it seems to me so critical -- if monetary policy is to do its job without unduly straining the financial fabric -- that the Federal budget be brought into balance at the earliest practical time. That objective cannot be achieved in a sluggish economy. Moreover, tax reduction -- emphasizing incentives -- is important to help lay the base for renewed growth and productivity. For those reasons, the linchpin of any effective economic program today seems to me early, and by past standards massive, progress in cutting back the upward surge of expenditures, on and off budget.

We know the crucial importance of restraint on money and credit growth. When I am asked about the need for consistency among all the elements of economic policy -- a policy that can effectively deal with inflation and lay the groundwork for growth -- I must emphasize the need to combine that monetary restraint with spending control. Cutting spending may appear to be the most painful part of the job -- but I am convinced that the pain for all of us will ultimately be much greater if it is not accomplished.

TABLE 1

PLANNED AND ACTUAL GROWTH OF MONETARY AND CREDIT AGGREGATES
(percent changes, fourth quarter to fourth quarter)

M-1 targets and growth before and after shifts into ATS/NOW accounts

	After adjustments for shifts into ATS/NOW accounts		Before adjustments for shifts into ATS/NOW accounts	
	M-1A	M-1B	M-1A	M-1B
Planned for 1980	3½ to 6	4 to 6½	2½ to 4-3/4 ^b	4½ to 7 ^b
Actual 1980	6½ ^a	6-3/4 ^a	5	7½
Planned for 1981	3 to 5½	3½ to 6	-4½ to -2 ^c	6 to 8½ ^c

M-2, M-3 and Bank Credit Targets and Growth

	<u>M-2</u>	<u>M-3</u>	<u>Bank Credit</u>
Planned for 1980	6-9	6½-9½	6-9
Actual 1980	9.8	9.9	7.9
Planned for 1981	6-9	6½-9½	6-9

- (a) Reflects current estimates of the impacts on M-1A and M-1B of shifting from demand deposits and other assets into new ATS and NOW accounts not taken into account in 1980 targets. Growth of M-1A is about 1-1/4 percentage points larger than actual recorded data after adding back in shifts out of demand deposits; growth of M-1B is reduced by about 1/2 percentage point after taking out shifts into M-1B from savings accounts and other assets.
- (b) Target adjusted to reflect NOW/ATS account shifts referred to in note above.
- (c) Reflect tentative assumptions regarding impacts of shifts into new ATS and NOW accounts in 1981. Growth of M-1A is assumed to be reduced by roughly 7-1/2 percentage points by transfer from demand balances to NOW-ATS accounts; growth of M-1B is assumed to be increased by 2-1/2 percentage points by transfer from sources outside of M-1. These assumptions will be reviewed from time to time.

TABLE 2

GROWTH OF MONEY AND BANK CREDIT
(percent changes, fourth quarter to fourth quarter)

	After adjustment for shifting into NOW/ATS accounts		Before adjustment for shifting into NOW/ATS accounts		<u>M-2</u>	<u>M-3</u>	<u>Bank Credit</u>
	<u>M-1A</u>	<u>M-1B</u>	<u>M-1A</u>	<u>M-1B</u>			
1975	4.9	4.9	4.7	4.9	12.3	9.4	4.1
1976	5.8	5.8	5.5	6.0	13.7	11.4	7.5
1977	8.0	8.0	7.7	8.1	11.5	12.6	11.1
1978	7.9	8.0	7.4	8.2	8.4	11.3	13.3
1979	6.7	6.8	5.0	7.7	9.0	9.8	12.3
1980	6.3	6.7	5.0	7.3	9.8	9.9	7.9

APPENDIX S

TREATMENT OF RESERVE ITEMS FOR INSTITUTIONS
GRANTED THE BANKER'S BANK EXEMPTION

For those institutions filing a FR 2900 report that have been granted the banker's bank exemption¹ and are thereby waived reserve requirements, the treatment of items dealing with reserves on the EDDS/Flashwire data flows varies according to certain situations. Those micro data records that, in the discussion to follow, are indicated as inappropriate for an institution, may, by virtue of the EDDS system principle of variable item sets, be treated as zero or simply omitted from the respondent micro data (EDDS) record. Those macro data items indicated as inappropriate for an institution are not aggregated in the macro data (Flashwire) record for that entity type. It is therefore important to understand which items are inappropriate according to the various reporting situations of these exempt institutions. The following discussion depicts the various situations in which certain reserve items are inappropriate or appropriate for a reporting institution granted the banker's bank exemption:

<u>EDDS</u> <u>Item</u>	<u>Flashwire</u> <u>Item</u>	<u>Treatment</u>
0180	EROB } ECAS } EGOG } EPTO }	Inappropriate in all cases.
0115	EGAL	Appropriate <u>only</u> if the reporting institution is a pass-through correspondent.
0116	ERBO	Appropriate <u>only</u> if a clearing balance requirement has been established for the reporting institution, to be fulfilled in the second week following the current week.
0095	ETTA	Appropriate <u>only</u> if the reporting institution has a reserve balance with the Federal Reserve.
0110	EBRE	(1) If the reporting institution is a pass-through correspondent, the item is appropriate <u>only</u> if (1) the reporter has a reserve balance with the Reserve Bank; and (2) that reserve balance is unequal to the sum of the required reserve balances of its pass-through respondents ² plus any clearing balance requirement ² of the correspondent.

¹Currently, the only institutions that have been granted the banker's bank exemption are certain corporate central credit unions, whose data are aggregated with credit unions on the Flashwire.

²As established in the second week prior to the current week.

**Monetary Policy Report to Congress
Pursuant to the
Full Employment and Balanced Growth Act of 1978**

February 25, 1981



Letter of Transmittal

**BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 25, 1981**

**THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.**

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

Chapter 1

A Review of Developments in 1980

Section 1.1 Monetary Policy and the Performance of the Economy in 1980

The past year was marked by considerable turbulence in the nation's economy and credit markets. Output and employment experienced extraordinarily sharp swings--generally confounding forecasters inside and outside government--and so, too, did interest rates and financial flows. On balance, the level of the aggregate output of goods and services at the end of 1980 was little changed from that at the beginning of the year, and with a growing labor force, unemployment was appreciably higher. At the same time, inflation continued at about the same unacceptably high rate as in 1979.

Many factors--some of them beyond the realm of the purely economic--combined to produce this distressing performance. At bottom, however, the behavior of the economy demonstrated rather vividly the difficulties of overcoming a deeply entrenched inflation and, particularly, the stresses that arise when necessary monetary restraint is not adequately supported by other instruments of public policy.

As 1980 began, the underlying trend of price increase was approaching a double-digit pace, and a recent further jump in international oil prices threatened to worsen that trend. There was broad consensus that fighting inflation must be the top priority for national economic policy. The Federal Reserve shaped its policy for 1980 with the objective of reining in inflationary forces in the economy and establishing a framework within which decision-makers in both the public and private sectors could look forward over the longer run to a restoration of reasonable stability in the general price level.

The basic premise of the System's policy is the broadly accepted notion that inflation can persist over appreciable spans of time only if it

is accommodated by monetary expansion. The strategy to which the System has committed itself is to hold monetary growth to rates that fall short of such accommodation and thus encourage adjustments consistent with a return to price stability over time. To be sure, the relationships between the growth of money and the behavior of the economic variables of ultimate concern--such as production, employment, and inflation--are not in practice absolutely stable or predictable, especially in the short run. But the crucial fact is that rates of monetary expansion in the vicinity of those specified by the Federal Open Market Committee last February implied a substantial degree of restraint on the growth of nominal GNP--that is, the combined result of inflation and real growth. Put differently, the FOMC's ranges for monetary growth implied that, if inflation did not abate, there would in all likelihood be strong financial restraint on economic activity, reflected in an easing of pressures on markets for goods and services and thence on productive capacity, factors that in turn would help to contain the momentum of inflation. This stabilizing influence was especially critical in a circumstance in which the impulse of an OPEC price hike could easily have led to a ratcheting upward of the trend rate of inflation.

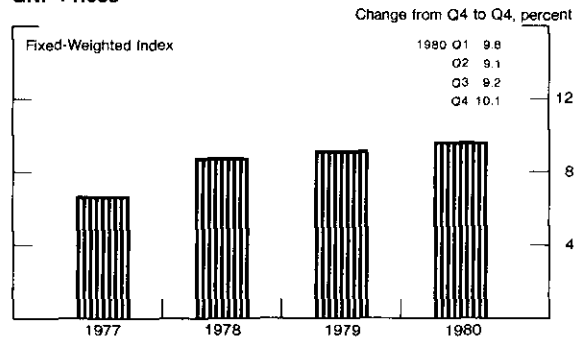
In the event, inflation did not abate in 1980; but neither did it gain new momentum, as many feared it might. Rather, the increases in most aggregate price indexes were about the same as were recorded in 1979. The fixed-weighted price index for gross national product rose 9-1/2 percent last year, a little more than in 1979, while the consumer price index rose 12-1/2 percent, somewhat less than in 1979. Such rates of inflation themselves result in a substantial increase in the amount of money needed to finance transactions. Thus, even though the monetary aggregates generally expanded

at rates near or a bit above upper ends of the FOMC's announced ranges, the steep rise in prices resulted in marked pressures in the credit markets that exerted restraint on economic activity and kept inflationary pressures from worsening.

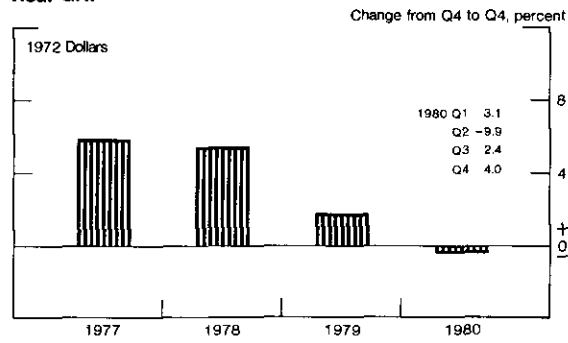
These developments did not occur evenly throughout the year. During the opening months, the late-1979 boost in imported oil prices combined with other factors--including strife in Afghanistan, unsettlement in the Middle East generally, and attendant fears that an escalation of defense spending might greatly enlarge already sizable federal deficits--to aggravate inflationary expectations. These expectations contributed importantly to the upward pressures on interest rates that were associated with the Federal Reserve's efforts to contain growth in the monetary and credit aggregates. Then, in March, President Carter announced an anti-inflation program that included the application by the Federal Reserve of special restraints on credit growth, utilizing the powers of the Credit Control Act of 1969.

The tightening of credit markets and the psychological impact of the credit restraint program on consumers contributed to the sharpness of the economic decline that occurred in the first half of the year, although a decline at some point had long been anticipated in the light of strong pressures on financial positions and other factors. The drop in real gross national product during the second quarter far exceeded the expectations of forecasters; in fact, it was the sharpest of the postwar period. However, with the slump in activity came a pronounced weakening of demands for money and credit and a steep decline in interest rates. The lowering of credit costs, coupled with removal of the special credit restraints, in turn was instrumental in bringing about an rebound in economic activity in the second half of the year which

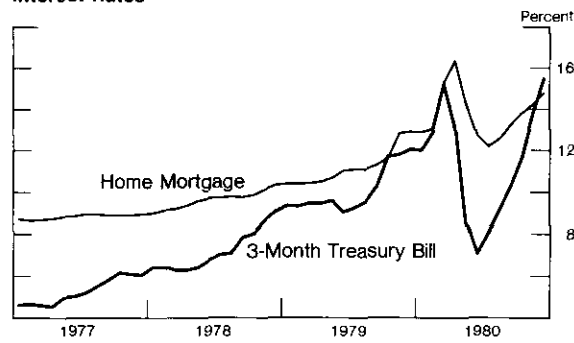
GNP Prices



Real GNP



Interest Rates

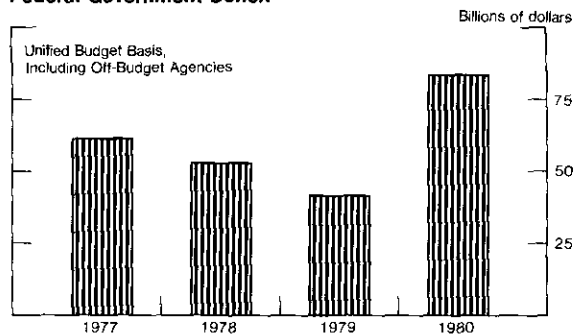


turned out to be unexpectedly early and strong and restored real GNP almost to its yearend 1979 level. During this period of recovery, the public's demands on financial markets grew and interest rates rose as the System attempted to hold monetary expansion within bounds.

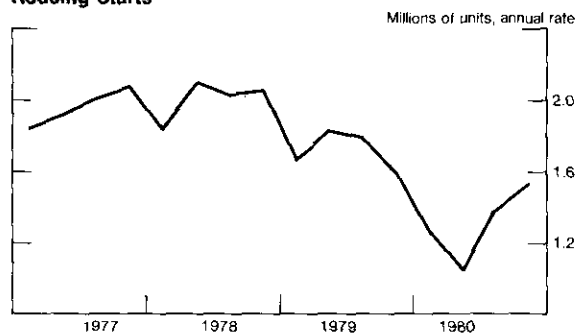
The financial pressures on the private sector of the economy last year were intensified by the competition of the federal government for the limited supply of credit. The federal deficit (unified basis, including off-budget agencies) grew from \$41 billion in calendar year 1979 to \$83 billion in calendar year 1980. During 1980, moreover, the massive federal deficit and repeated upward revisions in spending forecasts added to the prevailing mood of uncertainty and weakened public confidence in the government's willingness and ability to mount a successful anti-inflation effort.

In 1980, as in most periods of financial tension, it was those types of purchases that involve longer-term investments of large sums that were hardest hit. The residential construction sector, especially, was squeezed by high interest rates and, particularly in the first half of the year, by reduced credit availability. Housing starts fell from a 1.6 million unit annual rate in the fourth quarter of 1979 to a 1.1 million unit rate in the second quarter of 1980; they then snapped back sharply to just over 1.5 million units by the end of the summer, leveling off at that rate as interest rates moved upward again in the final months of the year. The mortgage markets have seen remarkably rapid institutional change in the past year, reflecting an adaptation to recurrent cyclical pressures on key lenders and to the difficulties potential homebuyers face with traditional mortgage instruments. Still, these changes have not insulated the real estate market from the effects of inflated home

Federal Government Deficit

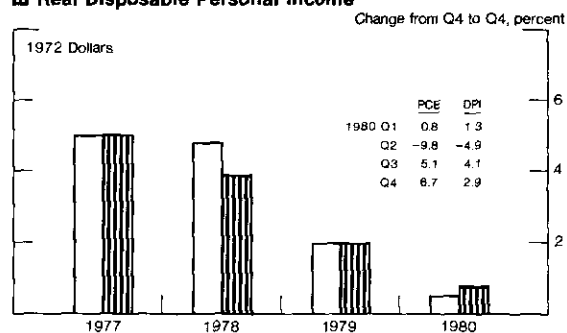


Housing Starts



Real Personal Consumption Expenditures

Real Disposable Personal Income



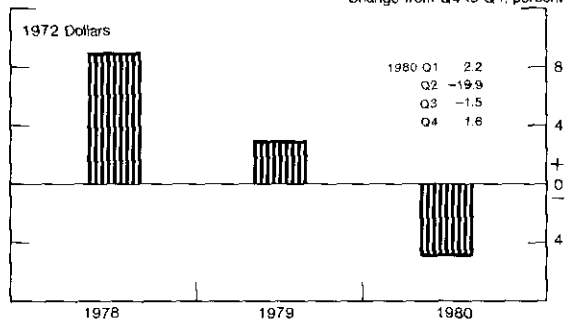
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prices and high mortgage rates on the willingness and ability of people to borrow and buy houses.

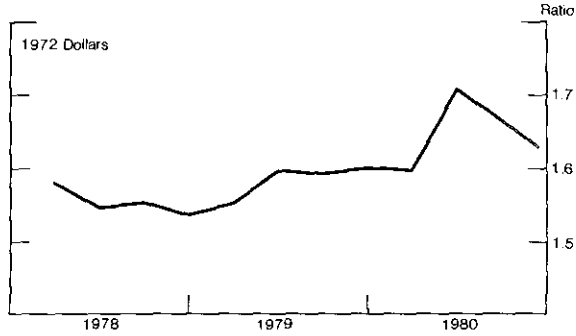
Credit conditions also played a role in damping personal consumption expenditures in 1980--particularly outlays on big-ticket durable goods. However, several other influences militated against a robust pattern of consumer spending. The period leading up to 1980 had been marked by weakness in real disposable personal income and by an erosion of the financial flexibility of households. Faced with budgetary strains caused by relatively rapid increases in the prices of such basic necessities as food and energy, many American families had sought to maintain customary consumption patterns--and in some cases to finance extra purchases in anticipation of inflation--by borrowing. A declining trend in the personal saving rate suggested that consumers were becoming overextended and that some weakening in spending relative to income was quite likely; indeed, the saving rate rose from 4.7 percent in the fourth quarter of 1979 (a 28 year low) to 6.2 percent in the second quarter of 1980. Automobile purchases, which tend to be deferrable in the short run, bore the brunt of the consumer retrenchment. Although credit conditions discouraged dealers from financing large inventories and to some extent were a depressant on demand for autos more generally, the steep increases in the prices of cars and gasoline appear to have been more decisive elements in the picture.

Business firms, like households, entered 1980 in a weakened financial condition. The preceding years of expansion had seen a substantial deterioration in aggregate measures of corporate liquidity; many enterprises were heavily burdened with short-term debt, and they thus were exposed to severe cash flow pressures when interest rates rose. The combination of deteriorating balance sheets, a high cost of capital, and slackening demands for final products resulted

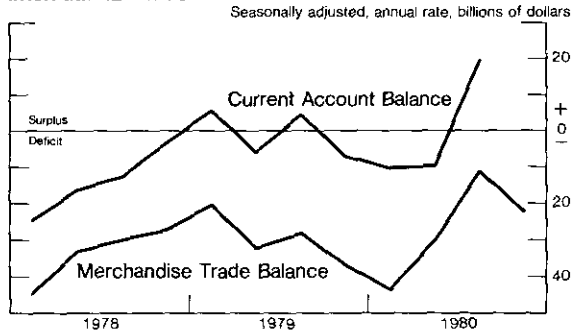
Real Business Fixed Investment



Business Inventories Relative to Sales



International Trade

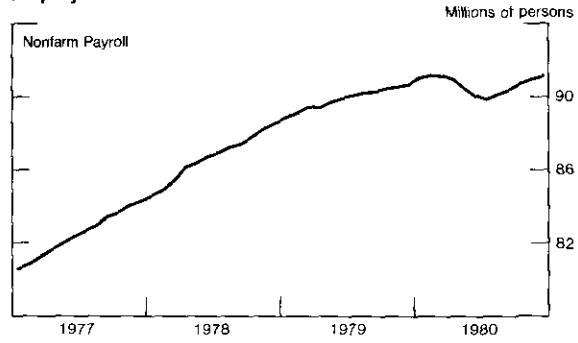


in a 5 percent drop in real business fixed investment during 1980. Some industries--particularly in the defense, energy, and high-technology sectors--did register gains in capital outlays, but those elements of strength were more than offset by declines in most cyclical manufacturing industries. Plant construction spending was especially weak. Meanwhile, businesses kept a tight rein on inventories, encouraged by the high costs of carrying stocks; a moderate accumulation during the first-half recession--concentrated in the automotive and related industries--was largely eliminated in the subsequent rebound.

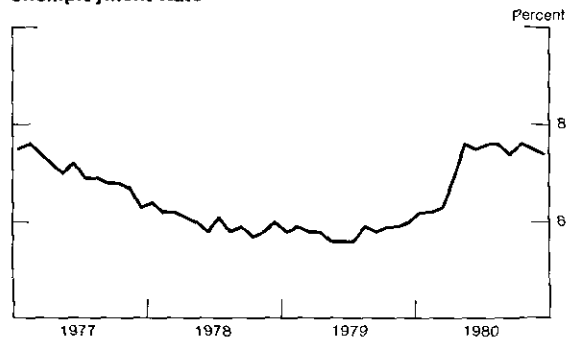
In the government sector, purchases of goods and services by the federal government rose moderately in real terms during 1980, reflecting in part a pick-up in defense outlays. At the state and local level, real purchases were about unchanged, owing to fiscal strains associated with a slowing of growth in tax revenues and cutbacks in federal grants as well as to political pressures for spending restraint.

The slackening of domestic aggregate demand worked to hold down imports; in the case of petroleum imports, the impact of decreased economic activity was reinforced by the incentive for conservation provided by a sharply increased relative price of oil and other energy products. At the same time, U.S. exports--including both agricultural commodities and other products--rose appreciably in real terms. Net exports thus registered a noticeable increase during 1980, and the U.S. current account moved into sizable surplus in the second half of the year. The trade and current account developments contrasted sharply with those of some other major industrial countries and contributed to a substantial appreciation of the dollar relative to continental European currencies over the course of the year.

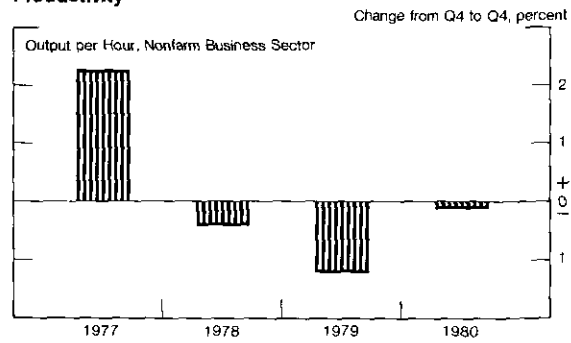
Employment



Unemployment Rate



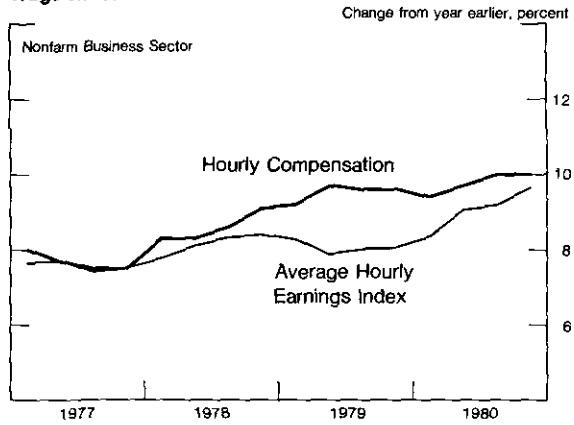
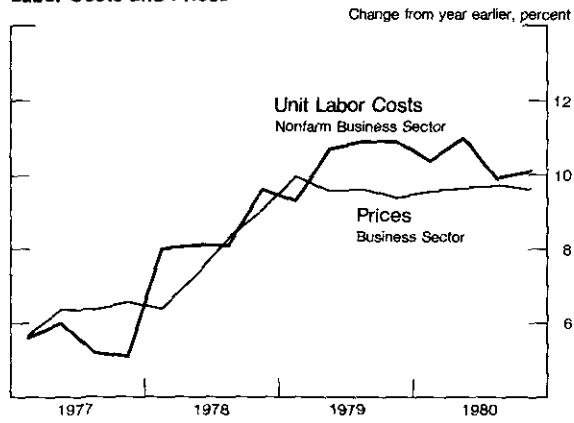
Productivity



Employment traced a path similar to that of output in 1980--that is, down substantially in the first half and up substantially in the second, with little net change. There was some alteration in the composition of employment over the course of the year, however, with jobs in manufacturing and construction decreasing and those in service industries increasing. The combination of this change in employment mix and a tendency for employers to lag in adjusting their work forces to lower levels of production contributed to a continued disappointing performance of labor productivity--output per hour worked--which showed no gain for the year.

With no moderating influence from the productivity side, the rise in unit labor costs reflected directly the behavior of wages and other labor expenses during 1980. In the nonfarm business sector, average hourly compensation--which includes employer contributions for social insurance and the cost of fringe benefits--rose 10 percent, a bit more than in 1979. However, this measure, because it does not account for changes in the mix of employment or in overtime, probably understates the acceleration in wage rates. For example, the index of average hourly earnings for production and nonsupervisory personnel, which does include adjustments for such factors, increased 9-1/2 percent in 1980 compared with 8 percent in 1979.

Wages typically are slow in responding to economic slack, and, given the large increases in consumer prices in 1979 and 1980, there were strong tendencies toward sizable catch-up wage hikes even in the face of an unemployment that reached 7-1/2 percent last spring. This tendency manifests itself in a direct way when formal cost-of-living escalator clauses exist. Such clauses are most common in the manufacturing sector, especially where there is collective bargaining by large industrial unions, and the acceleration of wage rates was in fact relatively pronounced in that sector.

Wage Rates**Labor Costs and Prices**

Section 1.2 The Growth of Money and Credit in 1980

In its report to the Congress last February, the Board of Governors indicated the plans of the Federal Open Market Committee regarding the growth of money and credit in 1980. As in previous years, the FOMC set desired ranges for the growth of several monetary aggregates and of commercial bank credit. Measured from the fourth quarter of 1979 to the fourth quarter of 1980, the growth ranges were as follows: M-1A, 3-1/2 to 6 percent; M-1B, 4 to 6-1/2 percent; M-2, 6 to 9 percent; M-3, 6-1/2 to 9-1/2 percent; and bank credit, 6 to 9 percent.^{1/} It was recognized that legislative initiatives--then pending--in the area of financial regulation could alter the desired rates of increase, as could any other unanticipated developments that indicated that the prescribed growth rates were inconsistent with the basic objectives of policy. As stated, however, the ranges suggested a clear deceleration of money and credit growth from the pace of 1979--a specification that appeared appropriate in terms of both the near-term and long-term requirements of anti-inflation policy.

As noted in the preceding section, the monetary and credit aggregates grew quite rapidly in the opening part of the year. Then, as economic activity began to fall rapidly, the growth of money and credit slowed markedly. Indeed, the narrow monetary aggregates, M-1A and M-1B, which are measures of the public's transactions balances, actually contracted significantly in the second quarter.

^{1/} M-1A is currency plus private demand deposits at commercial banks net of deposits due to foreign commercial banks and official institutions. M-1B is M-1A plus other checkable deposits (i.e., negotiable-order-of-withdrawal accounts, accounts subject to automatic transfer service, credit union share draft balances, and demand deposits at mutual savings banks). M-2 is M-1B plus savings and small denomination time deposits at all depository institutions, shares in money market mutual funds, overnight repurchase agreements (RPs) issued by commercial banks, and overnight Eurodollar deposits held by U.S. residents at Caribbean branches of U.S. banks. M-3 is M-2 plus large time deposits at all depository institutions and term RPs issued by commercial banks and savings and loan associations. Bank credit is total loans and investments of commercial banks.

This decline, occurring as it did at the same time that interest rates were falling sharply, was considerably greater than would have been expected on the basis of historical relationships among money, income, and interest rates. The weakness in the M-1 measures tended to restrain the growth of the broader monetary aggregates. Bank credit meanwhile contracted slightly.

At midyear, when the FOMC reassessed the monetary growth ranges for 1980, there were few, if any, signs of the then incipient economic recovery. The monetary aggregates, though again on the rise, were either below or in the lower portion of the previously announced ranges. The Depository Institutions Deregulation and Monetary Control Act of 1980 had been signed into law at the end of March, but there was no clear evidence yet of significant impact on the behavior of the monetary aggregates. In these circumstances, the Committee reaffirmed the ranges for money and bank credit that it had adopted in February, but it did indicate that, if the public continued to economize on the use of cash as strongly as in the second quarter, M-1A and M-1B might well finish the year near the lower end of their respective ranges.^{1/} Such a proviso was called for because a sustained downward shift in the demand for money implies that a given rate of monetary growth is more expansionary in its impact on the economy than would otherwise be the case.

Over the second half of the year, however, the monetary aggregates and bank credit grew very rapidly. There was a surprisingly swift and strong turnaround in economic activity. And simultaneously the public's demand for money retraced most of the evident downward shift of the first half. Both of

^{1/} There had been previous episodes, particularly in the mid-1970s, of lasting downward shifts in the demand for M-1 balances following rises in interest rates to new record high levels. Such interest rate movements evidently encouraged greater efforts to economize on holdings of nonearning assets.

these developments may have been associated with the phasing out of the extraordinary credit restraint program at the end of the second quarter. In retrospect, this program seems to have played a greater role than was apparent at midyear in influencing the particular patterns of spending and financial flows that developed in the spring and summer.

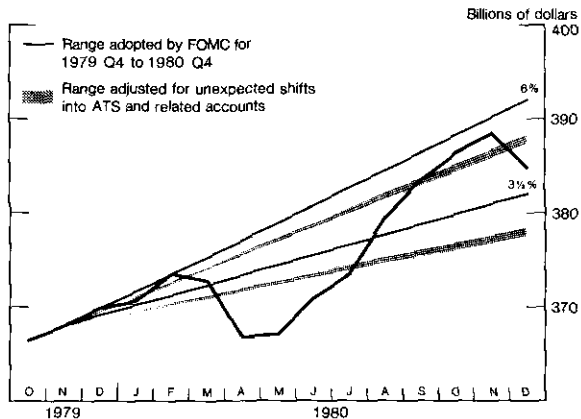
Although the Federal Reserve resisted the accelerating growth in money and credit--and did succeed in bringing about a clear deceleration in the latter months of the year--the growth of the monetary aggregates on a fourth quarter to fourth quarter basis in 1980 was generally near or a bit above the upper ends of the ranges announced by the System. Bank credit growth was within the range specified by the FOMC. The movements of the various financial aggregates are charted on the next two pages.

Considerable care must be exercised in assessing the behavior of M-1A and M-1B. Last February, when the ranges for the aggregates were set, it was assumed that the growth rates of the two aggregates would differ only by 1/2 percentage point, based on an expectation that, under prevailing statute, growth in automatic transfer service (ATS) and negotiable order of withdrawal (NOW) accounts would draw few funds from demand deposits (depressing M-1A) and savings deposits (boosting M-1B). With the passage of the Monetary Control Act, however, which authorized NOW accounts on a nationwide basis as of December 31, 1980, commercial banks began to promote ATS accounts more vigorously. As a result, actual growth of ATS and NOW accounts substantially exceeded the amount allowed for in the FOMC ranges for M-1A and M-1B.

As may be seen in the charts, M-1A increased 5 percent over the year ended in the fourth quarter of 1980, close to the midpoint of the FOMC's range for that aggregate; meanwhile, growth in M-1B was 7-1/4 percent, 3/4 percentage

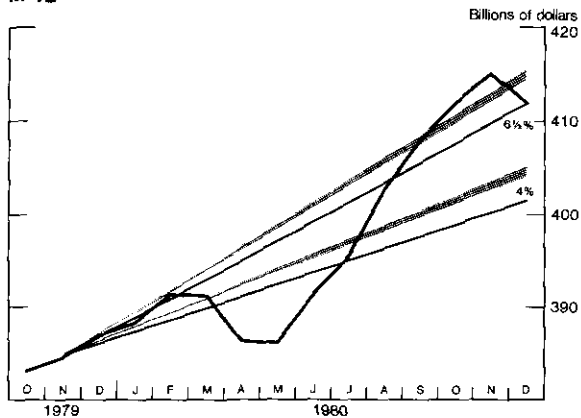
Growth Ranges and Actual Monetary Growth

M-1A



Rate of Growth
1979 Q4 to 1980 Q4
5.0 Percent

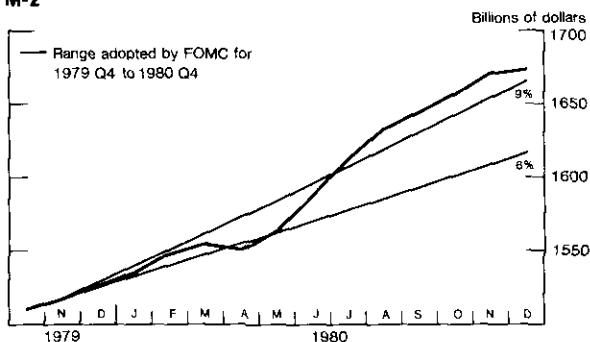
M-1B



Rate of Growth
1979 Q4 to 1980 Q4
7.3 Percent

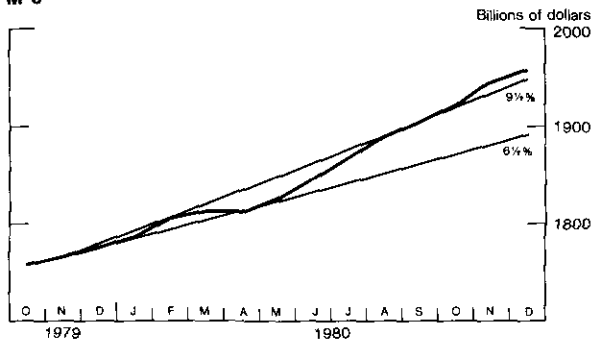
Growth Ranges and Actual Monetary and Bank Credit Growth

M-2



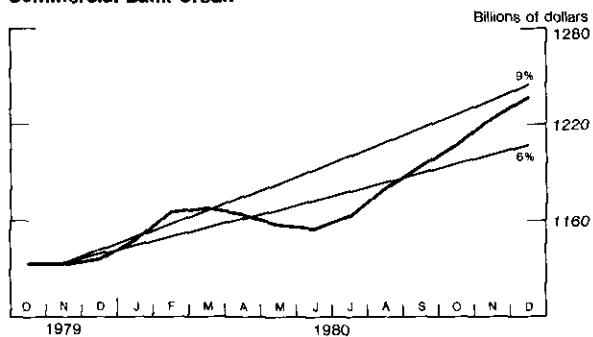
Rate of Growth
1979 Q4 to 1980 Q4
9.8 Percent

M-3



Rate of Growth
1979 Q4 to 1980 Q4
9.9 Percent

Commercial Bank Credit



Rate of Growth
1979 Q4 to 1980 Q4
7.9 Percent

point above the upper end of its longer-run range. But if the FOMC's ranges are adjusted for current estimates of the actual impact of shifting into ATS and NOW accounts, as shown in the chart by the shaded lines, the increases in both the narrow aggregates are close to the upper bounds of the FOMC's ranges for 1980.

It may be noted that, although conventionally fourth quarter averages have been adopted as the basis for measuring annual growth in the money and credit aggregates, the choice is somewhat arbitrary and is only one of many possible approaches. Moreover, citing figures for any particular calendar period does not necessarily give a clear sense of the longer-term trends, which are more relevant in assessing policy. For that reason, the table on page 19 offers measurements of annual growth on several bases. Owing to the particular monthly patterns over the past two years, the fourth quarter to fourth quarter calculations show a lesser tendency toward deceleration in the growth of M-1A and M-1B than do other measurements of the 1980 experience.

The effects on M-2 of shifting into ATS and NOW accounts likely are minor, since nearly all the inflows to those instruments appear to be from assets within this broad aggregate. For the year as a whole, M-2 grew about 9-3/4 percent, 3/4 percentage point above the upper end of the FOMC's range. All of the growth in the nontransactional component of M-2 occurred in those assets offering market-related yields—primarily 6-month "money market certificates," 2-1/2-year "small saver certificates," and shares of money market mutual funds. As of December, these assets accounted for 45 percent of the nontransactional component of M-2, compared with 28 percent a year earlier. In earlier periods of high interest rates, when such instruments did not exist, M-2 tended to decelerate markedly as disintermediation occurred, with savers shifting funds

Growth of Money and Bank Credit
(percentage changes)

	<u>M-1A</u>	<u>M-1B</u>	<u>M-2</u>	<u>M-3</u>	<u>Bank Credit</u>
Fourth quarter to fourth quarter					
1978	7.4 (7.9)	8.2 (8.0)	8.4	11.3	13.3
1979	5.0 (6.7)	7.7 (6.8)	9.0	9.8	12.3
1980	5.0 (6.3)	7.3 (6.7)	9.8	9.9	7.9
December to December					
1978	7.1 (7.8)	8.2 (7.9)	8.3	11.2	13.6
1979	5.2 (6.6)	7.5 (6.8)	8.9	9.4	11.5
1980	4.1 (5.2)	6.5 (5.8)	9.7	10.3	8.9
Annual average to annual average					
1978	7.7 (8.0)	8.2 (8.0)	8.9	11.7	12.3
1979	5.2 (6.8)	7.8 (7.0)	8.9	10.3	13.4
1980	4.6 (5.6)	6.4 (5.9)	9.1	8.6	8.3

Note: Numbers in parentheses are adjusted for the estimated impact of shifting to ATS and NOW accounts from other assets, and should give a better indication of the underlying trend of monetary expansion.

into market instruments. In 1980, the growing popularity of these relatively new assets may well have drawn some funds into M-2 from market securities such as Treasury bills, causing M-2 to grow somewhat more rapidly than in the preceding two years and also faster relative to M-1B.

M-3 grew almost 10 percent over the four quarters of 1980, 1/2 percentage point above the upper end of its longer-run range. Large time deposits expanded moderately at commercial banks and thrift institutions during the year; in the case of banks, which issue the bulk of these instruments, the borrowing was offset by a reduction of net liabilities to foreign branches.

Bank credit grew about 8 percent in 1980. Fluctuations in this measure followed the general pattern of aggregate credit flows in the economy, but they were exaggerated by changes in the composition of business borrowing. During the first quarter, nonfinancial firms avoided long-term borrowing at record high interest rates and turned instead to the commercial banks for funds. In fact, they appear to have borrowed beyond their immediate needs in anticipation of greater credit stringency. During the second quarter, as bond rates dropped sharply and as banks tightened their lending policies in response to the special credit restraint program, corporations issued an unprecedented volume of long-term securities and repaid outstanding bank loans. During the summer months, as interest rates began to rise, the pattern of financing began to reverse again and in the fourth quarter businesses again deferred long-term borrowing and tapped their banks for credit.

Broader measures of credit flows in the economy also exhibited a considerable cyclical fluctuation in 1980. Total funds raised by all sectors of the economy in credit and equity markets fell by almost one-half in the second quarter and then retraced most of that decline in the third quarter. For the year as a whole, aggregate funds raised were substantially less than in 1978 and 1979. Commercial banks provided about the same share of total credit flowing to all sectors as in 1979, while the share of thrift institutions rose somewhat.

NET FUNDS RAISED AND SUPPLIED IN CREDIT AND EQUITY MARKETS
(Billions of dollars)

Sector	1978	1979	1980 ^p	1980 ¹			
				Q1	Q2	Q3	Q4 ^p
NET FUNDS RAISED							
Total, all sectors	482	483	434	497	253	454	534
U.S. government	54	37	79	62	67	99	89
State and local government	24	16	21	21	12	24	27
Foreign	32	21	30	24	35	27	33
Private domestic nonfinancial	291	321	234	303	119	231	281
Business	128	156	133	163	79	133	155
Household	163	165	101	140	40	98	126
Domestic financial	81	88	70	87	20	73	104
Private intermediaries	40	36	23	32	-16	33	44
Sponsored credit agencies	23	24	24	34	16	12	36
Mortgage pool securities	18	28	23	21	20	28	24
NET FUNDS SUPPLIED							
Total, all sectors	482	484	435	498	253	456	534
U.S. government	20	23	26	29	30	24	21
State and local government	15	13	20	18	2	36	23
Foreign	40	-6	22	-8	47	22	27
Private domestic nonfinancial	51	81	29	74	-51	55	39
Business	-1	10	10	8	-10	22	22
Household	52	71	19	66	-41	33	17
Domestic financial	356	373	338	385	225	319	424
Private intermediaries	305	308	285	315	179	293	353
Commercial banking	129	121	104	117	-2	129	171
Thrift institutions	76	56	57	35	27	74	94
Insurance and pension funds	84	90	98	103	108	93	86
Other ²	16	41	26	60	46	-3	2
Sponsored credit agencies	26	29	25	40	6	24	32
Mortgage pool securities	18	28	23	21	20	28	24
Federal Reserve System	7	8	5	9	20	-26	15

1. Seasonally adjusted annual rates.

2. Includes finance companies, money market funds, real estate investment trusts, open-end investment companies, and security brokers and dealers.

p—Data for the fourth quarter of 1980 are preliminary.

Section 1.3 Issues in Monetary Control

Monetary growth in 1980 was, on balance, fairly close to the ranges specified by the FOMC. And, more important, the Federal Reserve's actions clearly imposed a significant--and essential--degree of restraint on the aggregate demand for goods and services in the economy. Nonetheless, particularly in view of the magnitude of the short-run swings in interest rates and financial flows in the past year, questions have been raised--inside as well as outside the Federal Reserve--about the techniques of implementing monetary policy and, especially, about the efficacy of the new operating procedures adopted in October 1979. These questions have been addressed in an intensive study of the recent period. A staff memorandum presenting an overview of the findings of that study and an evaluation of the new operating procedures is appended to this report.

As a prelude to discussing the key points raised by the staff work, it is useful to describe in broad outline the general approach of the Federal Reserve to monetary policy. For a number of years, monetary aggregates have played a key role as intermediate targets for policy, that is, as variables standing midway in an economic chain linking the proximate instruments of the Federal Reserve--open market operations, the discount window, and reserve requirements--to the variables of ultimate concern, such as production, employment, and prices. Economists have debated extensively the question of the optimal intermediate target variable, with the controversy centering on the virtues of monetary aggregates versus interest rates. The System historically has, in effect, taken an eclectic view, believing that it would be remiss in ignoring the information provided by the movements of any financial or economic

variable. However, it has perceived a clear value in focusing special attention on the behavior of the money stock, especially in an environment in which inflation is such a prominent concern. A special role for the monetary aggregates is, furthermore, dictated by the requirement of the Humphrey-Hawkins Act that the Federal Reserve report to the Congress on its objectives for monetary expansion.

Analysts of all schools agree that, over the long run, inflation cannot persist without monetary accommodation. Thus, careful attention to the trend of monetary expansion is an absolutely essential feature of responsible monetary policy. In addition, however, in a shorter-run context, monetary aggregates are attractive as intermediate targets because they provide a mechanism of "automatic stabilization." When the economy begins to expand too rapidly, the associated increase in the quantity of money demanded for transactions purposes comes into conflict with the monetary target, and this results in a rise in market rates of interest; the rise in interest rates, in turn, damps the aggregate demand for goods and services. Similarly, if there is a recessionary impulse to the economy, the associated reduction in the demand for cash balances leads to an easing of credit conditions that moderates the impact of that impulse. Pursuit of an interest rate target carries with it a greater danger that an unanticipated impulse to the economy will tend to be fully accommodated, with greater inflationary or recessionary consequence.

Open market operations are the major tool of monetary control. Prior to October 1979, the basic approach employed by the System was to supply or absorb reserves through open market operations with an eye to holding short-term interest rates--most immediately, the federal funds rate--within a relatively narrow but changing band thought consistent with the desired growth of the

money stock. This method placed considerable importance on the System's ability to predict the quantity of money the public would wish to hold at given interest rates. This never was an easy matter, but in 1979, particularly as the advance of prices accelerated and inflationary expectations became a more significant and volatile factor affecting economic and financial behavior, predicting the public's desired money holdings at given levels of nominal interest rates became exceedingly difficult. As a consequence, in October the Federal Open Market Committee altered its technique of monetary control, substituting the volume of bank reserves for interest rates as the day-to-day guide in conducting open market operations.

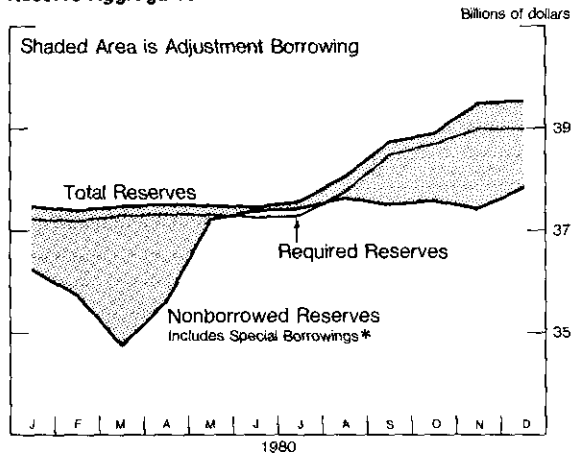
Under the approach adopted in October 1979, the FOMC sets short-run targets for monetary expansion, as it did previously, to guide operations between meetings. The staff then calculates corresponding paths for various reserve aggregates. A path for total reserves is calculated based on the expected relationship between reserves and the money stock--the so-called reserves-money multiplier. This relationship is variable and not known with certainty because of the differences in reserve requirements on various components of the monetary aggregates, which shift in relative importance from week to week; moreover, in addition to required reserves, depository institutions also hold a varying amount of excess reserves. A path for nonborrowed reserves then is calculated by making an allowance for the portion of total reserves expected to be provided through borrowings at the Federal Reserve Bank discount windows.

Between meetings of the FOMC, the Open Market Desk focuses on achieving a given level of nonborrowed reserves, the reserve measure that is controllable through open market operations on a day-to-day basis. If the monetary aggregates deviate from their prescribed growth rates, the resultant movement

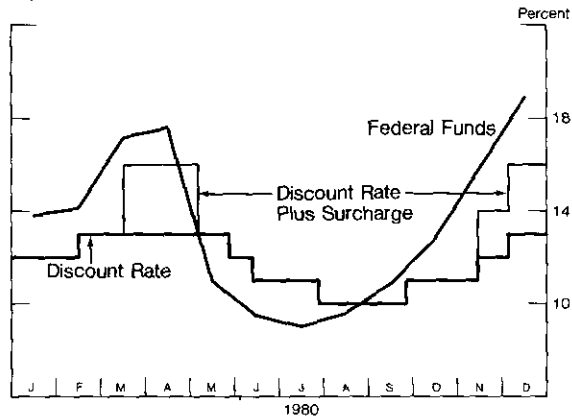
in required reserves is reflected in an increase or decrease in borrowing at the discount window. Owing to administrative limitations imposed by the Federal Reserve on the frequency, amount, and purposes of borrowing, an increase in borrowing puts upward pressure on the federal funds rate as individual depository institutions bid more aggressively in the market for the available supply of nonborrowed reserves in an effort to shift the need to borrow to other institutions. A decline in borrowing has the opposite effect. The resultant movements in short-term interest rates induce portfolio adjustments by depository institutions and the public that tend to move the money stock back toward the targeted level. If it appears that these automatic effects are not going to be prompt enough or strong enough--as evidenced in part by sustained deviations in total reserves from their path--the System can reinforce them by making adjustments in the path for nonborrowed reserves that increase the upward or downward pressures on money market interest rates. Similar effects can be achieved through changes in the discount rate, given the nonborrowed reserves path.

The workings of this mechanism of monetary control are illustrated clearly by the movements in reserves and interest rates during 1980, which are shown in the chart on the next page. During the early part of the year, when the money stock was running above the FOMC's short-run target, the volume of adjustment credit provided by the discount window (the vertical dimension of the shaded area) increased substantially while the amount of nonborrowed reserves provided through open market operations declined, partly as a consequence of reductions in the nonborrowed reserves path to hold down total reserves and restrain the growth of money over time. As can be seen, during this period the federal funds rate rose sharply. Restraint was intensified by increases in

Reserve Aggregates



Interest Rates



*Special borrowings consists of credit provided to institutions through the discount window to assist them in dealing with relatively severe and persistent liquidity problems. Because there is not the same pressure to repay such borrowing promptly as exists with normal adjustment credit, the broader economic impact of special borrowing is similar to that of nonborrowed reserves.

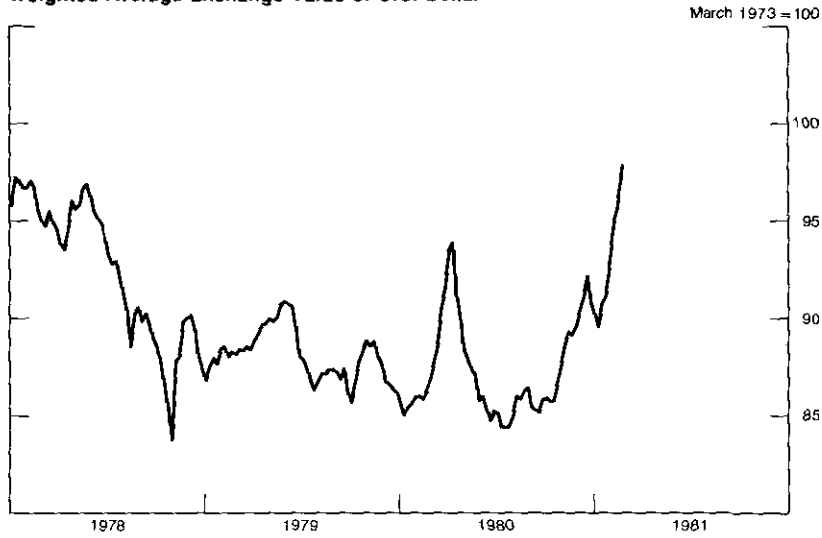
the basic discount rate and the introduction in mid-March of a surcharge on frequent borrowing by large banks.

As the monetary aggregates weakened in the spring, the pattern of the first quarter *was reversed*. The System countered the weakness of the aggregates by maintaining the supply of total reserves; this required substantial injections of nonborrowed reserves to offset the impact of the repayment of discount window borrowings. The federal funds rate fell very sharply.

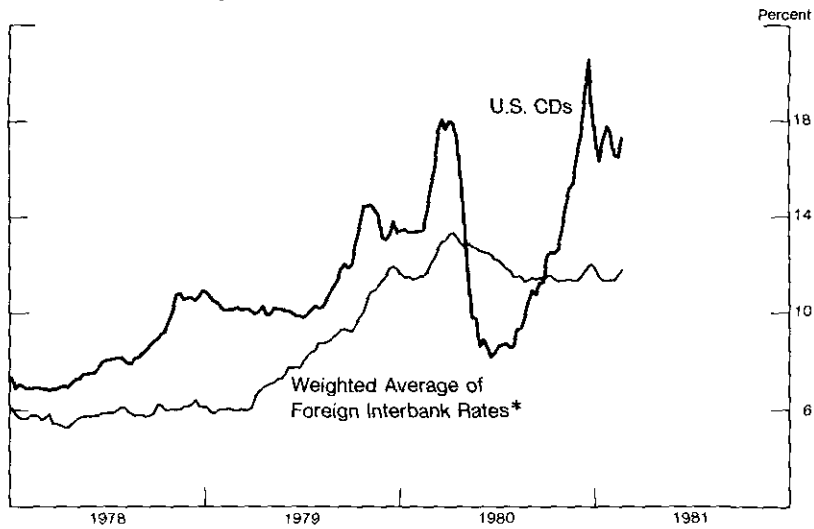
The sharp plunge in interest rates, even though it occurred against a backdrop of marked monetary *weakness* and steep recession, did arouse concerns in some circles about the System's commitment to anti-inflationary *restraint*. This nervousness *was evident* not only in domestic financial markets but in the foreign exchange markets too. By and large, the foreign exchange value of the dollar *had fluctuated* in a way that represented a fairly direct response to the pronounced relative movement of interest rates on dollar and foreign-currency denominated assets. But as U.S. interest rates reached comparatively low levels, there was a sense of a growing risk that downward pressures on the dollar might *accumulate*.

In a sense, the Federal Reserve was caught in an expectational cross-fire. On the one side, those who concentrate on the money stock in *assessing* policy feared that the System was being too restrictive because the various measures of money were slowing sharply or *contracting*; on the other, some of those in the financial markets and elsewhere who view interest rates as the indicator of policy feared that the System was being inflationary because rates were falling sharply. The FOMC, in weighing the risks, decided to *exercise* some caution in the latter part of the spring by setting its short-run monetary growth targets with a view to a gradual rather than *immediate* return to the longer-range path for the year.

Weighted Average Exchange Value of U.S. Dollar *



3-Month Interest Rates



* Weighted average against or of G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

The picture soon changed dramatically, however, for by mid-summer the monetary aggregates--buoyed by the surprising strong turnaround in economic activity--were rising rapidly. And as required reserves began to exceed nonborrowed reserves, borrowing and interest rates climbed. As in the first quarter, pressures on money market interest rates were reinforced by reductions in the path for nonborrowed reserves and by increases in the discount rate and imposition of surcharges on frequent borrowing. Borrowing and the federal funds rate continued to rise until mid-December when a drop in the money stock relieved some of the pressure on reserve positions.

The staff study has examined the experience of 1980 in considerable detail in an effort to assess the causes of the extreme variability of money and interest rates in 1980 and the efficacy of the new reserves-oriented operating procedure in achieving the objectives of policy. Certain key conclusions of the study may be highlighted:

- (1) *Nineteen-eighty was a year of extraordinary variability in money and nominal interest rates. In the case of money, however, it is important to note that comparisons with past years are complicated by the fact that monetary data for those periods have been considerably smoothed as additional information has been obtained on changes in seasonal patterns. If the 1980 figures are compared with the initial figures for earlier years, the difference in monetary variability is substantially reduced. Still, after making such allowances, it appears that money has been somewhat more variable over the past year, especially on a monthly or quarterly basis--though, as far as can be judged from available data, remaining within the range of foreign experience with money stock variability.*

- (2) Much of the variability--certainly the broad swings--in money and interest rates since October 1979 was attributable to an unusual combination of economic circumstances and not to the new operating procedures per se. The "real" and financial sectors of the economy were subjected to unusual disturbances in 1980. The imposition and subsequent removal of credit controls, especially, appears to have had a major impact on the demands for money and credit and to have strongly affected the behavior of money and interest rates in the second and third quarters.
- (3) Simulation exercises utilizing several models of the money market provided no clear evidence that, under present institutional arrangements, alternative operating techniques--using, say, total reserves or the monetary base instead of nonborrowed reserves as an operating target--would improve short-run monetary control.
- (4) It appeared clear that efforts to severely limit deviations in money from its longer-run growth path would require acceptance of much more variable short-term interest rates.
- (5) Short-run variability in the monetary aggregates does not appear to involve significant impacts on the behavior of the economy. Weekly and monthly changes in the monetary aggregates are inherently quite "noisy." Moreover, available models suggest that, because of the relatively long response lags involved, sizable quarterly (or even semi-annual) fluctuations in monetary growth--if offsetting--do not leave an appreciable imprint on movements in output and prices.

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- (6) The federal funds rate has been more variable since October 1979, as would be expected with use of a reserves operating target, but in addition very short-run fluctuations in other market rates both--short- and long-term--also have been larger in magnitude than formerly. These rates of interest have exhibited higher correlations than previously with movements in the federal funds rate. The reasons for this closer correlation between the federal funds and other rates in the very short run are not entirely clear, and it is not certain that such a pattern will prevail in the future. But, in any event, there are few signs that the resulting variability has imposed appreciable costs in terms of reduced efficiency of financial markets or of increased costs of capital in the period analyzed by the study. There are considerable difficulties in separating the effects of the new operating technique from those of other factors. However, it does appear that much of the strain on financial institutions and many of the changes in financial practices observed in the past year were related to the broad cyclical pressures on interest rates during the year, caused by accelerated inflation and heightened inflationary expectations, and to the changes in credit demands associated with the behavior of economic activity.

The Federal Open Market Committee has reviewed the staff's work. Fundamentally, the research suggests that the basic operating procedure represents a sound approach to attaining the longer-run objectives set for the monetary aggregates. However, the Committee and the Board of Governors will

be considering the practicability of modifications that might reduce slippages between reserves and money, without unduly increasing the risk of an unnecessarily heightened variability of interest rates. These include the possibility of prompter adjustment of nonborrowed reserve paths or of the discount rate at times when, in association with undesired movements in money, the levels of borrowing and consequently total reserves are running persistently stronger or weaker than projected. In addition, the Board has already indicated its inclination to switch from the present system of lagged reserve accounting to a system in which required reserves are posted essentially contemporaneously with deposits; it is continuing to study the practical merits of such a system, to ensure that the operating problems created for depository institutions and the Federal Reserve and the potentially increased volatility of the federal funds rate would not outweigh the possible benefits in terms of tighter short-run monetary control.

The Committee has continued to set broad ranges of tolerance for money market interest rates--generally specified in terms of the federal funds rate. These ranges, however, should not be viewed as rigid constraints on the Open Market Desk in its pursuit of reserve paths set to achieve targeted rates of monetary growth. They have not, in practice, served as true constraints in the period since October 1979, as the Committee typically has altered the ranges when they have become binding. But, in a world of uncertainty about economic and financial relationships, the interest rate ranges have served as a useful triggering mechanism for discussion of the implications of current developments for policy.

The reserves operating procedure--or any modification of it--needs to be viewed in the context of a number of practical considerations that affect

the basic targets for the monetary aggregates and the process of attaining them. First, targets need to recognize the lags in the adjustment of wages and prices which may limit the speed with which noninflationary rates of monetary expansion can be attained without unduly restraining economic activity. Second, the potential for costly disturbances in domestic financial or foreign exchange markets may occasionally require short-run departures from longer-run monetary targets. Third, precise month-by-month control of money is not possible, nor is it necessary in terms of achieving desirable economic performance. Finally, uncertainties about the relationship between money and economic performance suggest the desirability of a degree of flexibility in the targets--including the use of ranges for more than one measure of money--and the potential need to alter previously established targets.

Chapter 2

Monetary Policy and the Prospects for the Economy in 1981

Section 2.1 The Federal Reserve's Objectives for the Growth of Money and Credit

In its midyear report last July, the Federal Reserve indicated to the Congress that its policy in 1981 would be designed to maintain restraint on the expansion of money and credit. Nothing that has occurred in the intervening months has suggested the desirability of a change in that basic direction. Events have only served to underscore the importance of such a policy--and of complementary restraint in the fiscal dimension of federal policy as well.

Few would question today the virulence of the inflation that is afflicting this economy or the urgency of mounting an effective attack on the forces that are sustaining it. The rapid rise of prices is the single greatest barrier to the achievement of balanced economic growth, high employment, domestic and international financial stability, and sustained prosperity. The experience of the past year--the stresses and dislocations that have occurred--attests to the difficulty of dealing with inflationary trends that have been many years in the making, but it does not indicate that there is any less need to do so. Indeed, the need has become more urgent, for as price increases continue, the public's expectations of inflation becomes more and more firmly embedded, and those expectations in turn contribute to the stubborn upward momentum of wages and prices.

Persistent monetary discipline is a necessary ingredient in any effort to restore stability in the general price level. To be sure, other areas of policy are also important, but it is essential that monetary policy exert continuing resistance to inflationary forces. The growth of money and credit will have to be slowed to a rate consistent with the long-range growth of nation's capacity to produce at reasonably stable prices. Realistically, given the structure of the economy, with the rigidities of contractual relationships and the

natural lags in the adjustment process, that rate will have to be approached over a period of years if severe contractionary pressures on output and employment are to be avoided.

The ranges of monetary expansion specified this month by the Federal Open Market Committee for the year ending in the fourth quarter of 1981 reflect these considerations. They imply a significant deceleration of growth in the monetary aggregates from the rates observed in 1980 and other recent years. The ranges are: for M-1A, 3 to 5-1/2 percent; for M-1B, 3-1/2 to 6 percent; for M-2, 6 to 9 percent; and for M-3, 6-1/2 to 9-1/2 percent. It should be emphasized that, owing to the introduction of NOW accounts on a nationwide basis at the end of 1980, the monetary ranges have been specified on a basis that abstracts from the impact of the shifting of funds into interest-bearing checkable deposits; only by adjusting for the distorting effects of such shifts can one obtain a meaningful measure of monetary growth. The FOMC also adopted a corresponding range of 6 to 9 percent for commercial bank credit.

The ranges for M-1A and M-1B are 1/2 percentage point less than those the Federal Reserve sought in 1980. Since realized growth last year, after adjustment for the impact of shifting into interest-bearing checkable deposits, was close to the upper ends of the stated ranges for the period, the new ranges are consistent with a deceleration of considerably more than 1/2 percentage point.

The actual observed changes in M-1A and M-1B will differ by a wide margin; in fact, it is quite possible that, because of the movement of funds from demand deposits to NOW accounts, M-1A could contract this year, while M-1B could grow more rapidly in reflection of funds moving into NOW accounts from savings deposits and other assets. It must be stressed that valid comparison of actual year-to-year growth has to allow for this institutional change.

The behavior of M-1A and M-1B thus far this year has reflected this pattern, but in an exaggerated degree because of the large initial transfer of funds to NOW accounts. An addendum to this section discusses in some detail the distortions caused by shifting to NOW accounts and the expected behavior of M-1A and M-1B. As the discussion there indicates, any estimates of the extent and character of the prospective shift into NOW accounts must be tentative. The Federal Reserve will be monitoring the shifting into interest-bearing checkable deposits as the year progresses and will be assessing its impact on the expansion of the monetary aggregates. From time to time, the System will report its estimates of the adjusted growth of M-1A and M-1B so that the public and the Congress can better assess the consistency of monetary expansion with the FOMC's stated objectives.

The 1981 range for M-2 is the same as that in 1980; however, the upper end of the range is roughly $3/4$ percentage point less than the actual growth recorded in 1980. A reduction in the range does not appear appropriate at this time in light of what is known about the relationships among the various monetary measures, as affected by public preferences for various types of assets and by expected economic and institutional circumstances. In fact, there is a distinct likelihood that, consistent with the planned decline in the growth of the narrower aggregates, M-2 growth in 1981 will be in the upper half of its 6 to 9 percent range. With the changes in regulatory ceilings that have made small time deposits more attractive in comparison to market instruments and with the growing popularity of money market mutual funds, the nontransactional component of M-2 is likely to continue growing quite briskly. Moreover, if the tax cuts proposed by the President result in a marked increase in the proportion of income saved, this may contribute to relatively robust

M-2 growth, which has in any event tended in recent years to approximate the increase in nominal GNP.

The range for M-3 in 1981 is the same as that for 1980, but again is below the actual growth experienced last year. The deceleration would reflect the slower expansion specified for M-2, which accounts for more than three-quarters of the broader aggregate. Large time deposits at commercial banks--the other major component of M-3--likely will expand moderately again this year, but much will depend on the patterns of credit flows that emerge. The growth of bank credit is now expected to be about the same as in 1980. Household borrowing at banks could increase, especially in the consumer installment area, where credit use was severely damped for a time last year by credit controls. However, nonfinancial firms likely will wish to rely less heavily on bank borrowing than they did in 1980, in light of the deterioration of balance sheet liquidity that they have already experienced. Indeed, should credit market conditions be such as to encourage a substantial funding of short-term debt by corporations, commercial banks might play a lesser role in the overall supply of credit and M-3 could be damped by reduced bank reliance on large time deposits. On the other hand, if conditions in the bond markets are not conducive to long-term financing then bank credit and M-3 could be relatively strong.

Addendum: The Impact of Nationwide NOW Accounts on Monetary Growth in 1981

As noted in the preceding section, the behavior of M-1A and M-1B will be greatly affected this year by the advent, under the Monetary Control Act of 1980, of nationwide availability of NOW accounts and other interest-bearing checkable deposits. The phenomenon is qualitatively similar to what occurred in 1980 when growth in M-1A was depressed and growth in M-1B enhanced by the shifting of funds into ATS (automatic-transfer-from-saving) accounts--but the distortions in 1981 will be quantitatively much greater.

With the introduction of a new financial instrument like the NOW account, there may be a broad adjustment of the public's asset portfolios. Under the present circumstances, however, it seems reasonable as a practical matter to expect that the major impact will be a shifting of funds into the new accounts from existing nonearning demand deposits and from the interest-earning assets included in M-2 (especially highly liquid, relatively low yielding savings deposits). The analysis of experience in past years with NOW accounts in the Northeastern part of the country and with ATS accounts throughout the nation indicates that flows from demand and savings deposits have accounted for the great bulk of the growth of interest-bearing accounts. Furthermore, various surveys and other analyses have indicated that in the past roughly two-thirds of the funds flowing into ATS/NOW accounts have come from demand deposits and roughly one-third from savings deposits.

During January, a somewhat larger share of the funds flowing into interest-bearing checking deposits appears to have come from demand deposits--perhaps about 75 to 80 percent, with only about 20 to 25 percent coming from savings deposits (or, to a very limited extent, other sources). This change from past patterns appears to reflect a relatively fast adjustment on the part

of holders of large demand deposit balances at commercial banks. It is expected that the sources of subsequent growth in interest-bearing checkable deposits will be more along the lines of the past two-thirds/one-third break.

Depository institutions have marketed the new accounts very aggressively, many of them lining up a sizable number of customers before the end of 1980. Since December 30, the net growth of interest-bearing checkable deposits already has totaled more than \$22 billion. It obviously is extremely difficult to forecast the further growth of interest-bearing checkable deposits over the remainder of the year. A working assumption would be that the net increase in such deposits this year will amount to somewhere between \$35 and \$45 billion, which would mean that half, or a little more than half, of the funds already have been shifted. If the shares of funds coming from demand and savings deposits move promptly to a two-thirds/one-third proportion, the result will be a 7 to 8 percentage point depressing effect on M-1A growth and a 2 to 3 percentage point increase in M-1B growth. Taking the midpoints of these estimates and applying them to the basic ranges specified by the FOMC for monetary growth this year, the observed change in M-1A from the fourth quarter of 1980 to the fourth quarter of 1981 would be $-4\frac{1}{2}$ to -2 percent and that in M-1B would be 6 to $8\frac{1}{2}$ percent.

As indicated above, the growth of interest-bearing checkable deposits in January was extraordinarily rapid. This resulted in an extreme divergence of M-1A and M-1B movements. Observed M-1A contracted at a $37\frac{1}{2}$ percent annual rate in January, while M-1B increased at $12\frac{1}{4}$ percent annual rate. On the assumption that three-quarters to four-fifths of the funds flowing into interest-bearing checkable deposits came from demand deposits, both M-1A and M-1B, on an adjusted basis, showed only small growth in the early weeks of this year.

Section 2.2 The Outlook for the Economy

The economy entered 1981 on an upward trajectory, extending the recovery in activity from last year's brief but sharp recession. January saw further large gains in retail sales, employment, and industrial production. On the whole, the demand for goods and services has continued to prove more buoyant than most analysts had expected. Unfortunately, at the same time there has been no abatement of inflation.

The persistence of intense inflationary pressures jeopardizes the continuity of economic expansion over the remainder of the year. Moreover, unless the rise of prices slows, there can be little hope of an appreciable, sustained easing of interest rates or of a substantial improvement in the balance sheets of the many units of the economy that already have experienced a deterioration in their financial condition.

The near-term prospects for prices are not favorable. In the months immediately ahead, the major price indexes will reflect the effect of poor agricultural supply conditions on food prices and the impact of higher OPEC charges and domestic decontrol on energy prices. Increases in the Consumer Price Index, furthermore, will reflect--in a way that exaggerates the true change in the average cost of living--the rise in mortgage interest rates that occurred in the latter part of 1980.

Aside from these special factors, the basic trend of prices is linked closely to the behavior of unit labor costs, which constitute the largest element in costs of production. As noted earlier, poor productivity performance has contributed to rising costs. It is also quite clear that wage demands have been sizable. Despite the acceleration in wage increases that has occurred,

the wages of many workers have failed to keep pace with the upward movement of prices in the past few years. This development was virtually inevitable in light of the decline in productivity and the adverse terms-of-trade effects of the tremendous increase in foreign oil prices. So long as those conditions continue, the average worker cannot anticipate a rising living standard, and attempts to "make up" losses in real income will be reflected in strong cost and price pressures.

The condition of labor markets is, of course, a factor affecting wage decisions. Despite the fact that the overall unemployment rate stands at 7-1/2 percent, there are scarcities of skilled workers in some sectors of the economy. But, even where there is slack in labor demand, its impact on wages is rather slow in emerging; wages appear to have a strong momentum rooted in inflationary expectations, which are based to a great extent on past experience, as well as in attempts to maintain real income. Workers' wage demands are influenced by expectations about prices, as well as by patterns established in previous wage bargaining. Meanwhile, employers' wage offers are conditioned in good measure by their own sense of the prospects for inflation and of whether they will be able to pass along higher compensation costs by increasing prices.

It is essential that this momentum be turned in a favorable direction. To do so will require a commitment to monetary and fiscal restraint that is firm and credible, and a direction of other governmental policies toward fighting inflation. Labor and management must be persuaded that the inflationary process will not be accommodated--that wage and price decisions based on an anticipation of rapid inflation will prove inimical to their ability to maintain employment and sales volume. Put more positively, they have to be convinced that moderation in their individual wage and price actions will not put them at a relative disadvantage and will in fact produce a better economic environment for everyone.

Such an alteration of the expectational climate will not be easy to achieve. But it is important to do so. For, to the extent that those attitudes can be changed, the short-run costs of restraint on aggregate demand, in the form of economic slack, will be ameliorated. Conversely, prolongation of high wage and price demands would come into conflict with needed monetary and fiscal restraint, aggravating economic difficulties. In any event, once expectations are turned, further progress toward price stability should come increasingly easily so long as excessive pressures on productive capacity are avoided.

The policy of monetary restraint adopted by the Federal Reserve is intended to contribute to the process of breaking the momentum of inflation. Fiscal policy also has a crucial role to play. Cuts in federal taxes potentially can help to invigorate private capital formation and thereby enhance productivity, reduce costs, and pave the way for faster economic growth. But it is important that government spending be held firmly in check at the same time so that aggregate demand does not become excessive and so that the pressures of government demands on the credit markets do not impede the financing of private investment.

The members of the Federal Open Market Committee, in assessing the economic outlook, have recognized the possibility of some reduction this year in business and personal income taxes and some initial steps in the longer-range effort toward the slowing of federal expenditure growth. Given these working assumptions, the individual members of the Committee have formulated projections for economic performance in the current year that generally fall within the ranges indicated in the table on page 44. As may be seen in that table, the FOMC members' projections for output and inflation encompass those that underlie the Administration's recent budget proposal.

Economic Projections for 1981

	<u>Actual 1980</u>	<u>Projected 1981</u>	
		<u>FOMC members</u>	<u>Administration</u>
Changes, fourth quarter to fourth quarter, percent			
Nominal GNP	9.5	9 to 12	11.0
Real GNP	-0.3	-1-1/2 to 1-1/2	1.4
GNP deflator	9.8	9 to 10-1/2	9.5
Average level in the fourth quarter, percent			
Unemployment rate	7.5	8 to 8-1/2	7.7

The members of the FOMC see inflation as remaining rapid in 1981, although not as rapid throughout the year as seems likely to be the case early in the period. The failure of inflation to slow more quickly, and the large budgetary deficits in prospect for the year, are seen as resulting in continued strong demands for money and credit and in the maintenance of relatively high interest rates. Against this backdrop, economic activity is likely to show only intermittent strength, and unemployment probably will rise between now and the end of the year.

APPENDIX

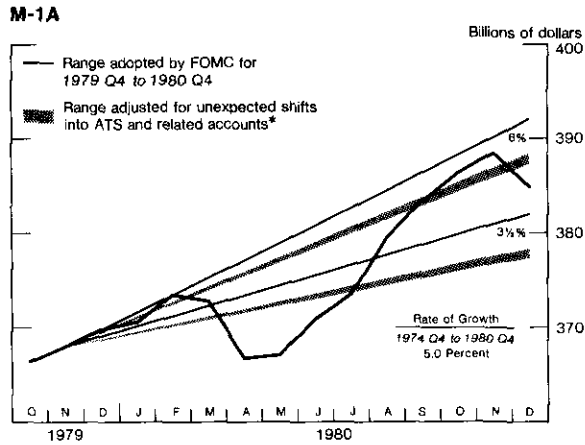
Staff Study of the New Monetary Control Procedure:Overview of Findings and Evaluation

This paper reviews experience with the new monetary control procedure established in October 1979 and evaluates implications for current and alternative control techniques. The new procedure involved employing reserve aggregates--on a day-to-day basis, nonborrowed reserves-- as operating tools for achieving control of the money supply. Less emphasis was thereby placed on confining short-term fluctuations in the federal funds rate--the overnight market rate reflecting the demand for and supply of bank reserves. The change in procedure, it should be pointed out, represented a technical innovation rather than a change in the broader objectives of monetary policy or in the monetary targets themselves. Target ranges for various measures of the money supply, together with the actual behavior of money in the course of 1980, are shown in the charts on the next three pages.

The paper is divided into three sections. Section I presents an overview of findings about effects of the new monetary control procedure on economic and financial behavior based on evidence gathered in staff papers.^{1/} Because the new control procedure was designed to strengthen the System's ability to control the money supply, section II (page A15) provides certain additional background analysis relevant to assessment of the role of money as an intermediate target for monetary policy. Section III (page A21) then contains an evaluation of the current operating procedure, and alternatives.

^{1/} A list of staff papers prepared is contained on page A33.

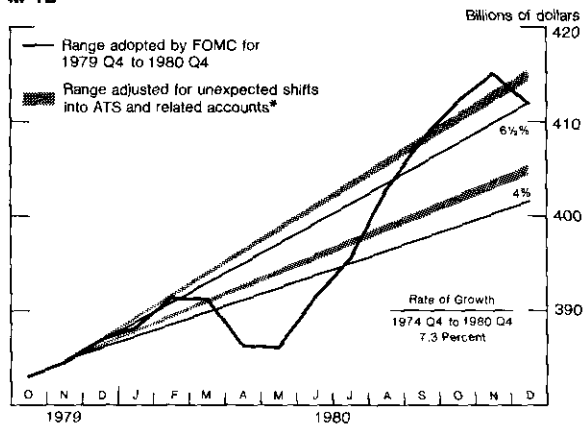
Growth Ranges and Actual Monetary Growth



* The shaded lines reflect adjustments that should be made for technical reasons to the original range for M-1A to allow for unanticipated shifts of existing deposits from demand deposits to interest-bearing transactions accounts, such as ATS (automatic transfer savings) and related accounts. At the beginning of 1980 it appeared that such shifts would have just a limited effect on growth of M-1A, and the longer-run growth range for M-1A was set only $\frac{1}{4}$ percentage point below the growth range for M-1B. Passage of the Monetary Control Act subsequently altered the financial environment by making permanent the authority of banks to offer ATS accounts and by permitting all institutions to offer NOW and similar accounts beginning in 1981. As the year progressed, banks offered ATS accounts more actively and more funds than expected were being diverted to these accounts from demand deposits. Such shifts are estimated to have depressed M-1A growth over the year 1980 by $\frac{3}{4}$ to 1 percentage point more than had been originally anticipated. The shaded range allows for these unanticipated shifts, and therefore in an economic sense more accurately represents the intentions underlying the original target.

Growth Ranges and Actual Monetary Growth

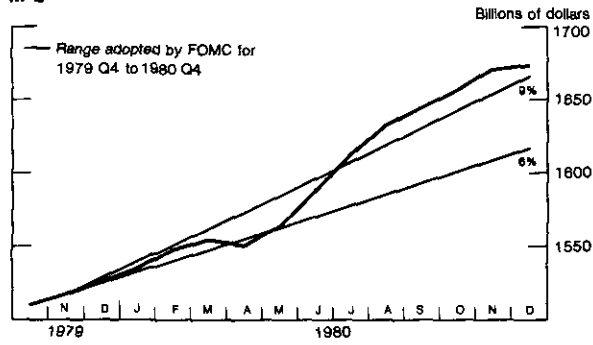
M-1B



* The shaded lines reflect adjustments that should be made for technical reasons to the original range for M-1B to allow for unanticipated shifts into interest-bearing transactions accounts from savings deposits and other instruments not included in M-1B. At the beginning of 1980 it appeared that such shifts would have just a limited effect on growth of M-1B, and the longer-run growth range for M-1B was set only 1/2 percentage point above the growth range for M-1A. Passage of the Monetary Control Act subsequently altered the financial environment by making permanent the authority of banks to offer ATS accounts and by permitting all institutions to offer NOW and similar accounts beginning in 1981. As the year progressed, banks offered ATS accounts more actively and more funds than expected were being diverted to the accounts. Such shifts are estimated to have increased M-1B growth over the year 1980 by 1/2 to 3/4 of a percentage point more than had been anticipated. The shaded range allows for these unanticipated shifts, and therefore in an economic sense more accurately represents the intentions underlying the original target.

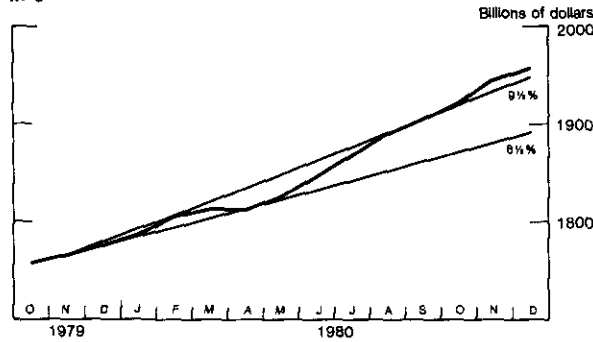
Growth Ranges and Actual Monetary and Bank Credit Growth

M-2



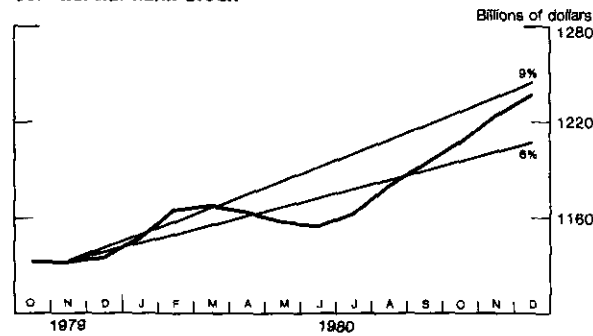
Rate of Growth
1979 Q4 to 1980 Q4
9.8 Percent

M-3



Rate of Growth
1979 Q4 to 1980 Q4
9.9 Percent

Commercial Bank Credit



Rate of Growth
1979 Q4 to 1980 Q4
7.9 Percent

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I. Overview of Findings with Regard to Experience
since Adoption of New Procedure

Questions investigated in reviewing experience with the new control procedure included, among others, its impact on precision of money control, volatility of interest rates, the course of economic activity, and exchange market conditions. There were, of course, other influences on financial markets and the broader economy that were surely of far more importance than the particular technical innovations under consideration here. Indeed, a major problem has been to distinguish the impacts of the new procedure per se from larger influences operating on the economy. This difficulty is particularly acute given the relatively short period of time since the new procedure was implemented--a period of time that may have been too short for market participants to have fully adjusted to the new environment and a period of time in which markets were buffeted by changing inflationary expectations, fiscal uncertainties, credit controls, and oil price shocks.

A. Relation between reserves and money

1. Over the operating periods between FOMC meetings, actual nonborrowed reserves fell below the Trading Desk's operating target by about .3 of one percent on average; the average absolute miss was about .4 of one percent. These deviations reflected in part errors in projection of uncontrollable factors affecting reserves (such as float). In addition, the Desk at times accommodated to variations relative to expectations in banks' demand for borrowing in the course of a bank statement week (for example, an unexpected willingness by banks to obtain reserves by borrowing heavily over a weekend). Total reserves came out somewhat above

-A3-

intermeeting period paths, by about .2 of a percent on average; the absolute miss averaged about .8 of a percent. The individual intermeeting period misses reflected deviation of money stock from short-run targets, variations in excess reserves, and multiplier adjustments to the original path (to take account of changes in required reserves for a given level of deposits) that turned out to be incomplete.

2. Econometric evidence from simulations of monthly money market models carried out with various reserve measures as operating targets (nonborrowed and total reserves and the monetary base), given the existing institutional framework, buttresses indications from actual experience last year that the relationship between reserves and money is relatively loose in the short run. Over the one year period since October 1979, the mean absolute error of misses in the level of M-1B relative to target path during the 4- to 7-week operating periods between FOMC meetings was a little over .6 of one percent. This degree of variability was in line with--in some cases less than and in some cases more than--model simulation results (holding various reserve measures at pre-determined target levels for the simulations).^{1/} In comparing the models and the reserve technique actually used, it should also be observed that model simulations generally implied more interest rate variability last year than proved to be the product of the technique actually in use.

^{1/} The root mean square errors of actual misses and simulated model misses ranged around .7 to .8 of a percent over short-run operating periods of a month or so. This would mean that, with disturbances similar to last year's, two-thirds of the time M-1B would generally come within plus or minus .7 to .8 of one percent of the intermeeting target path over approximately a one-month period (or, expressed in annual rate terms, within a range of plus or minus 8 to 10 percentage points over such a period).

3. In the model simulations of the past year, control of money supply through strict adherence to a total reserves or the total monetary base target produced more slippage than control through their nonborrowed counterparts. This phenomenon largely reflects the presence of multiplier disturbances on the supply side that would be generated, for example, in the current institutional environment by changes in deposit mix and hence in required reserves for any given level of money supply. In the model simulations, use of total reserves or the total base as an invariant target over the control period does not permit these disturbances to be cushioned by changes in borrowings.

4. Judgmental predictions of the multiplier relationship between reserves or base measures and money made since the shift in operating procedure were generally superior to, though on a few tests not significantly different from, forecasts derived from econometric models.

5. Over a longer period than a month (or than an intermeeting period) errors in the predicted relationship between money and reserves may be expected to average out--that is, over time, errors in one direction tend to be offset by errors in the other. Simulations of the Board's monthly model suggest that such a process is at work. In actual operations over a one-year period since October 1979, the absolute miss in the level of M-1B when individual misses relative to the short-run target paths are averaged over three or four intermeeting periods was reduced from a little over .6 of a percent (reported in paragraph 2) to over .4 of a percent. This represents a somewhat smaller reduction than would have been expected from certain results, and may have reflected the nature of unusually large, unanticipated successive month-to-month changes in money

-A5-

demand last year, first in one direction and then in the other. These changes were related in part to identifiable special factors such as the imposition and subsequent removal of the credit control program. Accommodation to such special and temporary factors, as they emerged, might tend to lengthen the period over which deviations from monetary targets could be expected to average out, but would, by the same token, tend to dampen fluctuations in interest rates that would not have contributed to better control of money over time.

B. Variability in money growth

1. Evaluation of the variability of money supply series is importantly affected by the seasonal adjustment process. Seasonal factors applied during a current year are unable adequately to reflect changing seasonal patterns in the course of that year; after a year is over, therefore, reestimation of seasonal factors often tends to smooth variability. Based on current seasonal adjustment factors for the year just past (that is, factors before seasonal revisions that taken account of the influence of actual experience this year), variability in weekly, monthly, and quarterly growth of M-1 (and also M-2) was substantially greater than in any year during the past decade. However, when the variability in money growth during the year from October 1979 to October 1980 is compared with variability in earlier years, with earlier years adjusted using seasonal factors that were current in those years, nearly all of the heightened variability in weekly growth of M-1, and a sizable *portion of the monthly and quarterly variability, is removed*. While this comparison makes it seem probable that seasonal factor distortions are overstating variability in the year just past, the extent cannot be

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assessed with confidence until a number of years have passed. In general, it would appear that money has been more variable over the past year, especially on a monthly and quarterly basis--though so far as can be judged from the available data, still generally well within the range of foreign experience with money supply volatility.

2. The variability in money growth of the past year appears to be related to an unusual combination of circumstances:

a. There were large swings within the year in the demand for money resulting from sharp short-run variations in economic activity caused in large part by factors independent of the new monetary control procedure, such as the imposition and subsequent removal of the credit control program. The imposition and subsequent removal of the credit control program may have also increased the variability of money growth through a more direct channel, as the associated large variation in bank loans was accompanied by temporary changes in demand deposits--for example, as large loan repayments were initially made from existing demand balances.

b. In addition, econometric evidence from a variety of models suggests that there were "unexplained" factors other than economic activity and interest rates causing substantial fluctuations in money demand. In particular, money levels fell considerably short of model simulations (given GNP and interest rates) in the second quarter, when money growth was negative. Relatively rapid growth in subsequent quarters reflected in part a tendency for money levels to move back toward more normal relationships with GNP and interest rates.

3. The money targets on which reserve paths were based reflected the intention to return money over time to the long-run objective following

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divergences. In 1980 the target for narrow money in the month following the FOMC meeting typically implied making up about 30 percent of the difference between the projected level of the money stock in the month of the meeting and the long-run target path. If disturbances in 1980 had been more representative of those prevailing in the 1970s, simulations using the Board's monthly model suggest that the reserve operating technique would have kept money closer on a month-by-month basis last year to long-run objectives than actually was the case. These simulations also indicate a distinct trade-off between variability of the federal funds rate--and money market rates generally--and the speed with which attempts are made to return the money stock to its longer-term path once it moves off path. The more rapid the attempted return to path, the larger are the implied fluctuations in money market rates.

4. Interpretation of money supply volatility is complicated by the large amount of noise in weekly and monthly changes in first published figures for the narrow monetary aggregates (and for monthly changes in M-2) resulting from transitory variation and seasonal factor uncertainty. Based on data for the 1973-79 period, the estimated standard deviation of the noise factor for monthly changes in M-1A and M-1B is about \$1.5 billion (4-1/2 percent at an annual rate), and about \$3.3 billion for weekly changes. For M-2, the estimated standard deviation of noise in monthly growth rates is 3-1/2 percent at an annual rate. The noise factor declines for growth rates over longer periods of time.

C. Variability of interest rates

1. As had been expected, the federal funds rate has been more variable on an intra-day, intra-weekly, and inter-weekly basis since the new procedure was implemented. Intra-day and day-to-day variability has tended

-A8-

to be at least twice as large as before, as have weekly changes after adjusting for trend. This greater variability of the federal funds rate reflects the role of nonborrowed reserves as an operating guide for the Desk.

2. There has also been heightened variability of interest rates on Treasury securities of all maturities following adoption of the new operating procedure. Based on data from which cyclical movements were removed, the variability in Treasury yields measured on a weekly average basis has been at least twice as large as before October 1979.

3. The relationship over interest rate cycles between the federal funds rate and yields on Treasury securities of all maturities has been essentially the same before and after October 1979, suggesting that the underlying linkage between the federal funds rate and other market rates has remained about unchanged. At the same time, however, correlations between very short-run nonsystematic movements in the funds rate and other market rates have increased substantially since the new procedure was implemented. This higher correlation possibly reflects the sensitivity of market participants to day-to-day changes in the funds rate in the uncertain environment that prevailed last year but possibly also reflects concurrent adjustments in market interest rates generally, particularly short rates, that tend to occur as closer control is sought over the money supply, given variations in money demand.

D. Effects on domestic financial markets

The swings in interest rates last year, and the high levels reached, clearly affected behavior in financial markets. It is difficult, to isolate the role of the new operating procedure, as such, in contributing

-A9-

to interest rate swings or changes in market behavior. It is likely that large cyclical variations in interest rates would have developed last year in any event if the basic monetary aggregate targets were pursued by other operating techniques in the face of cyclical variations in money and credit demands that were exceptionally large and compressed in time. And adjustments that took place in financial market behavior last year largely represented adaptations that would have been expected on the basis of past cyclical experience--for example, constraints on housing finance--or were related to the special credit control program. Market adjustments that might have primarily reflected adaptations to the new procedure as such are likely to be those more associated with a perceived greater continuing risk of short-term interest rate volatility--adjustments that would be difficult to detect in an environment like that of last last year, which was dominated by cyclical changes in credit flows, a credit control program, and inflationary expectations.

1. Mortgage markets. Greater interest rate volatility since October 1979 may have hastened the trend in process for a number of years toward more flexible mortgage instruments, such as variable rate, renegotiable, and equity participation mortgages. In addition, mortgage bankers and other originators in their commitment policies appear to have attempted to avoid some of the risk of interest rate changes occurring between the time a commitment is made and funds are extended. They have done so by setting rates or points at the time of closing, shortening the period for guaranteed fixed-rate mortgage commitments, and by imposing large nonrefundable commitment fees to discourage cancellation if rates should decline.

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2. Dealer market for Treasury and Agency Securities. Wider bid-ask spreads on Treasury bills appear to have emerged last year. Evidence on such spreads for coupon issues is difficult to interpret; spreads rose considerably a few months prior to introduction of the new procedure, and thereafter remained wider than in earlier years. Greater uncertainty about interest rates may have influenced dealers to maintain leaner inventory positions relative to transactions; turnover of dealer inventories rose last year as a very large expansion in gross transactions outpaced the rise in the level of inventories.

3. Underwriting spreads on corporate bonds. Underwriting spreads on corporate bonds issued on a negotiated basis did not widen, on balance, over the year since October 1979. However, data on competitively bid issues suggest that spreads on such issues have widened. This might tend to raise bond costs, but any such effect last year would appear to have been very small relative to the more basic supply and demand conditions affecting markets.

4. Commercial bank behavior. Bank behavior last year was strongly influenced by a number of factors other than the new procedure, such as the imposition and removal of the special voluntary credit restraint program, marginal reserve requirements on managed liabilities, and increasing reliance, especially by small banks, on money market certificates as a source of funds. It is difficult to detect changes in behavior associated with the new procedure per se. There appears to have been some increased reliance on floating rate loans, especially for term loans, but this trend was evident prior to October 1979.

-All-

5. Futures markets. Futures market activity expanded rapidly in the period following October 1979, raising the possibility that the new procedure led to an increased desire to hedge against expected greater interest rate fluctuations. However, the expansion in activity represented a continuation of the trend of recent years, as has been the case with other market adaptations noted above. It is virtually impossible to separate growth in futures activity arising from attempts to reduce exposure to interest rate risk in the new environment from underlying trend growth connected with increasing familiarization by the public with the variety of financial futures instruments that are becoming available.

6. Liquidity premiums. An attempt was made to determine whether there was an increase last year in liquidity premiums, manifested by a rise in long-term rates relative to short-term rates. Such a result might be expected if risk-averse financial market participants attempted to protect themselves from a perceived risk that the new procedure would make for greater interest rate variability and hence greater risk of capital loss on holdings of longer-term issues. There appears to be little, if any, evidence that liquidity premiums became greater last year--although as noted in paragraphs 2 and 3 above there may have been some increase of transactions costs in financial markets.

E. Exchange market and other external impacts

1. The spot value of the dollar appreciated by more than 5 percent in the 14-month period subsequent to late September 1979, though there were pronounced cycles that coincided with intermediate-term movements of interest rates in the United States.

2. Day-to-day movement in money market rates related to the new procedure could have had some influence on very short-term exchange rate

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volatility. Spot rates have displayed more variability on a daily basis since the new procedure was adopted, reflecting greater daily variability of interest rate differentials between U.S. dollar and foreign currency assets. The evidence on weekly and monthly exchange rate movements also suggests more variability, but the evidence is not so conclusive as that for daily variability.

3. There is little evidence of a significant increase in the variability of foreign interest rates, apart from in Canada, on a monthly basis related to the new procedure as such. Some countries, especially developing countries with currencies tied to the dollar and with inflexible interest-rate structures, appear to have experienced some technical difficulties over this period connected, for example, with the impact of interest-rate variability on financial flows.

4. The evidence does not suggest that the new operating procedure has contributed to the variable nature of gross U.S. international capital flows since the fall of 1979. Significantly greater contributing factors were the credit control program and marginal reserve requirements on managed liabilities.

5. The proposition that more short-term variability of exchange rates could have adverse effects on the domestic price level, because price increases caused by currency depreciation would not be fully offset by the reverse effect of currency appreciation, is not supported by econometric evidence. Therefore, the short-term variability of exchange rates since October 1979 would not itself appear to have raised the domestic price level. Meanwhile, the underlying trend toward appreciation since that time would have had a favorable effect on the price level.

F. Economic activity

1. Assessing the contribution of the new procedure as such to the pattern of economic activity and inflationary expectations is complicated--as noted at other points in this paper--by the force of other factors that were importantly influencing the markets for goods and services over the recent period, including the effect of the basic money supply targets themselves. Certain "fundamentals"--such as the previous sharp increase in oil prices, the relatively low saving rate, and the illiquid balance sheet of the household sector--suggest that economic activity would have contracted in any event in 1980. In addition, prices and real economic activity were strongly influenced by the highly sensitive state of inflationary psychology, the imposition and removal of the credit control program that lasted from mid-March to early July 1980, and erosion of fiscal restraint.

2. Nevertheless, to the extent that the new control procedure encouraged more prompt interest rate adjustments in response to cyclical fluctuations in money and credit demands, it probably exerted some influence on the pattern of economic activity. It may have hastened the slowdown in economic activity--especially in housing and possibly consumer durables--in early 1980 and also hastened the recovery in the summer, as interest rates advanced rapidly to peak levels and then contracted sharply. Psychological reactions to the credit control program, however, may have been an important influence on the depth of the recession and the promptness and strength of the subsequent rebound. There was a sharp contraction in spending following introduction of the program, and relief on the part of both financial institutions and borrowers as the program was phased out probably encouraged a sizable resurgence of spending.

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3. In view of the lags in the response of capital spending plans to changes in credit conditions, the new procedure does not appear to have exerted much influence on plant and equipment spending during the past year. The timing of inventory movements, by contrast, may have been altered to the extent that the new procedure had effects on the pattern of final sales and on movements in short-term financing costs.

4. The new control procedure was adopted in part to provide more assurance that inflation would come under control (as money growth was restrained), and thereby to reduce inflationary expectations. It is difficult to measure inflationary expectations, let alone to attribute changes to a technical change in monetary control procedures in so highly unsettled a period as last year. Indirect evidence about inflation expectations based on changes in interest rates is obviously difficult to interpret, since interest rates are also influenced by other factors. Some direct evidence about consumer expectations of inflation can be gleaned from the Michigan survey. No clear improvement in inflationary attitudes is evident until into the spring, probably related in large part to the sharp contraction of economic activity in the second quarter. There did not appear to be any significant worsening of expectations, as judged by the Michigan survey, in the latter part of the year as the economy strengthened.

5. The Board's large-scale quarterly econometric model, as well as two other much more simplified models used for comparative purposes, were employed to help evaluate the extent to which the actual fluctuations in money and interest rates affected economic activity in the course of the year. These models, of course, all suffer from an inability to take account adequately of attitudinal changes and other behavioral factors

-A15-

related to the special conditions of a particular year, including any attitudinal changes that might be occasioned by the shift in operating procedure. Simulation results suggest that, because of long response lags, the pattern of economic activity last year would not have been particularly sensitive to efforts at smoothing the quarter-to-quarter pattern of either money growth or of interest rate variations, though smoothing money growth had slightly more impact. The smoothing of money growth would have been at the cost of even greater interest rate variability than was actually observed over the last five quarters.

II. General Considerations

Evaluation of the current and alternative operating techniques to be discussed in section III depends very much on the role accorded intermediate targets, particularly the monetary aggregates, in the formulation of monetary policy. This section examines advantages and disadvantages involved in employing monetary aggregates, or for that matter interest rates, as intermediate targets, and also examines certain limitations on the feasible range of target settings.

A. Advantages and disadvantages of monetary aggregates as intermediate targets

1. Advantages

a. Money stock control tends to work toward stabilizing GNP when the economy is buffeted by disturbances to spending on goods and services and shifts in inflation expectations; such factors appeared to be an important influence on economic and financial behavior last year. If spending surges unexpectedly, for example, as it did in the

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second half of 1980, adherence to a money stock target would automatically lead to tighter financial markets, tending to offset some of the surge in spending. Similarly, if spending were to weaken unexpectedly, and very substantial weakness developed in the second quarter of last year, efforts to hold to a money stock target would lead automatically to lower market rates of interest, which would tend to partially restore spending to desired levels.

b. Current approaches emphasizing control of monetary aggregates rest on the proposition that planned deceleration in monetary growth will lower inflation over time by limiting funds available to finance price increases and encouraging expectations and behavioral patterns consistent with reduced inflation.

c. By clearly communicating to the public the Federal Reserve's objectives for monetary policy, a monetary aggregates targeting procedure enables private decision-makers to better plan their activities and to make wage and price decisions that are more harmonious with non-inflationary growth in money and credit.

d. Targeting on monetary aggregates involves adjustments of market interest rates, in response to underlying changes in demands for credit, that might otherwise be unduly delayed, either on the down- or up-side.

2. Disadvantages

a. Looseness in the relationship between money demand and nominal GNP reduces the significance of monetary aggregates as a target, particularly in the short run. Unexpected shifts in this relationship lead to undesirable interest rate movements with strict

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adherence to money supply targets. Last year, there was evidence of looseness in this relationship. For example, as noted earlier, econometric models suggest a sizable downward shift in the demand for money in the second quarter, given actual GNP and interest rates.

b. Attempts to achieve steady growth in monetary aggregates on a month-by-month or even quarter-by-quarter basis can lead to large interest rate fluctuations, given the high degree of variability in short-run money flows and the relatively interest-inelastic demand for money over the near term. Large fluctuations in interest rates have certain risks; for instance, they might endanger financial institutions that are unable to make timely compensating adjustments in their balance sheets, adversely affect the functions of securities and exchange markets, and lead to confusion about the basic thrust of policy.

c. Money supply targeting procedures might themselves introduce recurrent cyclical responses of economic activity following an economic disturbance. Whether this is a realistic risk depends on the nature of response functions in the economy. It would be a high risk in the degree that: (i) money demand was very insensitive to interest rate changes (and thus interest rates would need to change sharply to maintain steady money growth in response to an exogenous disturbance from the goods market), and (ii) there was no significant current impact on spending from such changes in rates but impacts were felt over later periods. It would be difficult to attribute the cyclical behavior of economic activity over the past year to

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such a process, though, given model estimates of the interest-elasticity of money demand and of relatively long lags between interest rates and spending (with such lags implying a longer cycle than observed last year).

d. The concept of money is elusive, and is becoming more so as new substitutes evolve for traditional transactions media, and as improvements in financial technology facilitate the ability of the public to shift funds about for payments purposes.

B. Interest rates as targets

1. Advantages

a. Control over total spending can be strengthened by greater emphasis on stabilizing interest rates when disturbances stem mainly from the monetary sector rather than from markets for goods and services.

b. Control over rates might make for greater short-run stability in financial markets, since market institutions might be relatively certain about the terms and conditions under which they can "safely" meet near-term credit demands.

2. Disadvantages

a. It is very difficult to determine the appropriate interest rate level, particularly in an inflationary environment in which shifting expectations of inflation are continuously altering the relationship between real and nominal market rates of interest.

b. Efforts to stabilize interest rates tend to amplify economic cycles stemming from cyclical variations in the demand for goods

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and services, since by stabilizing rates, pro-cyclical growth in money and credit would be heightened. An upswing in the demand for goods and services, for example, would be accompanied by an expansion in the volume of money and credit. By contrast, with a money stock targeting procedure resistance would be introduced automatically through increases in interest rates.^{1/}

c. While interest rate targets could in concept be adjusted promptly so as to minimize the likelihood of a pro-cyclical monetary policy, in practice the institutional decision-making procedure often limits the ability to make sizable adjustments in the target. This could constrain interest rate variations when rates are taken as the intermediate target of monetary policy.

C. Limitations in the targeting process

Regardless of whether monetary aggregates or interest rates are selected as intermediate targets, there appear to be a number of limitations on the monetary authority's range of choice of the particular target setting and the precision with which the target is pursued.

1. The particular target setting must take into account the capacity of the economy and financial markets to adjust to the targets, and the degree to which the implications of those targets can be understood by and are acceptable to the larger public whose behavior patterns are involved. Inflexibilities in wage and price determination, for example, have implications for the degree to which monetary targets can be reduced, without risking unduly adverse implications for economic activity in the short

^{1/} Even with a money stock procedure such resistance may not be sufficient to hold nominal GNP down to a previously desired level if the upward shock in demand for goods and services involves a rise in velocity—as it well might if it resulted from, say, expansion in Federal spending.

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run. This would be less of a limitation to the extent that attitudinal shifts--either in response to announced monetary targets or other factors--brought upward wage and price pressures down in line with monetary targets. Experience of the past year has not yet provided a basis for believing that the lengthy lags between money growth and price changes have been shortened significantly or that inflation expectations have begun to respond more rapidly to the money control procedure per se.

2. The question may arise as to whether disturbances in domestic, or foreign exchange, markets may on occasion require short-run departures from intermediate-term targets of monetary policy. However, these markets appear to have adjusted to a substantial degree of interest rate or exchange rate fluctuation during the past year.

3. Precise month-by-month control of money does not seem possible, given existing behavior patterns in the economy and financial markets and institutional factors. Nor is there evidence that such close control is needed to attain the underlying economic objective of encouraging non-inflationary economic growth. Statistical investigation suggests that "noise" alone accounts for substantial variation in monthly money growth rates. Moreover, model simulations indicate that variations in money growth above or below targets lasting a quarter or so are not likely to have substantial economic effects.

4. Uncertainties involving the relationship between money demand and GNP--as evidenced by unexpected variations in such demand last year--suggest the need for a degree of flexibility in target setting (ranges may be preferable to point estimates), and also suggest the possibility

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that, at times, there may be a need for large deviations from pre-determined targets or for changes in the targets. On the other hand, deviations from target ranges involve the risk of changes in market expectations that are counter-productive (for example, when money supply runs strong relative to target, inflationary expectations may be heightened, compounding the difficulties of controlling inflation). In general, though, in the degree that there is success in achieving targets over time, expectations are less likely to be adversely affected by short-run deviations in money growth.

III. Evaluation of Operating Procedures

Because the past year was in many ways exceptional--and because a year, or 15 months, in any event is too short a time frame within which to judge whether observed relationships are accidental to the period or are lasting--evaluation of the new control procedure, and possible alternatives, must at best be quite tentative. The choice of operating procedure would be influenced by the predictability of certain financial and economic relationships and by the capacity of markets to adjust to operating techniques without severe distortions--evidence about which was presented in section I. In addition, the desirability of retaining the present reserve procedure (with or without possible modifications), of shifting to an alternative reserve procedure, or indeed of shifting back entirely to a federal funds rate operating guide depends in part on the value to be placed on relatively tight short-run control of money, given uncertainties about the likely sources of potential disturbances in economic and financial conditions.

If there were complete certainty about economic relationships, the choice of operating procedure would not be particularly critical, for a given money stock target would be associated with unique, known values for the federal funds rate, nonborrowed reserves, and the monetary base. And the monetary authority could achieve its objectives no matter which of these instruments was selected for operating purposes.

In practice, however, markets are continually subject to disturbances that are not known in advance. The principal kinds of disturbances are those occurring in overall spending (the market for goods and services), those occurring in the demand for money (independently of GNP and interest rates), and those affecting the supply schedule for money (such as deposit mix or banks' demand for excess reserves). Moreover, such disturbances--all of which were evident last year--can be of a temporary, or self-reversing variety, or they can be permanent.

Alternative operating procedures tend to produce different outcomes for the pattern of interest rates and money growth in the face of these disturbances. With some procedures, and depending on the source of the disturbance, interest rates would be changed more, while with others the money stock and other financial quantities would absorb more of the impact. The choice of operating procedure therefore involves, among other things, judgments about whether there is more risk to monetary policy's ultimate objective of non-inflationary growth from procedures that tend to emphasize interest rates as operating targets with some implication of a relatively gradual change in rates, or from those that tend to work more directly against money supply variations.

A. Assessment of present operating procedure

The present reserve operating procedure proved flexible enough to permit some accommodation in the short run to unexpected shifts in money demand, given GNP and interest rates, that occurred last year. At the same time, the procedure worked to limit the extent to which changes in demands for goods and services (and thus in transactions demands for money) were reflected in actual money growth. Actual money growth deviated from short-run targets last year, but there were large accompanying changes in interest rates that tended, over time, to set up forces bringing money back toward path. Nonetheless, money growth over time deviated more from path than might have been expected relative to the average degree of looseness that seems to exist in reserve-to-money relationships.

While the experience of last year may have been atypical because of the nature of disturbances during the year, still a number of modifications to the operating procedure used since October 1979 might be considered for their potential value in reducing slippage in money relative to reserve paths. These modifications all have certain disadvantages, however, that need to be weighed against their varying advantages for more precise monetary control, to the degree that closer control in the short-run is considered desirable.

1. Evidence of the past year suggests that during an intermeeting period relatively prompt downward (or upward) adjustments in the original nonborrowed reserve path may be needed in an effort to offset, over time, increased (or decreased) demand for borrowing when money is strengthening (or weakening) relative to target. As an alternative, more prompt upward (or downward) adjustments in the discount rate would tend to discourage

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(or encourage) borrowing over time (in practice the actual level of borrowing will not change until money demand changes sufficiently to alter reserves demanded to meet reserve requirements).^{1/} These adjustments run the risk of increasing the volatility of short-run interest rate movements in view of the transitory fluctuations often experienced in short-run money demand. However, they could also dampen the amplitude of longer-term swings of interest rates by more promptly leading to adjustments by banks that bring money growth back toward path.

2. More fundamental changes in the administration of the discount window and in the way discount rates are structured and varied could be considered for strengthening the relationship between reserves and money.

a. At an extreme, discount window borrowing might be limited to emergency needs. This is tantamount to adhering to a total reserves or monetary base path. However, this would eliminate the valuable buffering function of the discount window. The window buffers the money stock (and the markets) from disturbances affecting the supply of money (such as changing demands for excess reserves and changes

^{1/} Experience has demonstrated that it is difficult to determine in advance the appropriate level of borrowing to be employed in constructing the nonborrowed reserve path consistent with the short-run money supply target. This level of borrowing would depend on a projection of market interest rates consistent with the money supply target path and knowledge of depository institutions' willingness to borrow, given the spread between market rates and the discount rate, and could differ significantly from borrowing levels based on or ranging around recent experience. In attempting to forecast borrowings, evidence from models may be usefully weighed along with judgmental assessment of particular conditions at the time. However, in view of considerable uncertainties about interest rate projections, the high degree of year-to-year variability in the success with which models project economic and financial relationships, and in light of the heightened variability in demands for discount window credit evident last year, projections of borrowing demand from interest rate forecasts and past bank behavior are subject to a considerable degree of error.

in the deposit mix affecting required reserves). Its role in that respect was evident from the results of model simulations showing a weak relationship between total reserves or the monetary base and money (when reserves or the base are treated as exogenously determined). In addition, the discount window cushions markets from the full impact of variations in money demand that may be transitory or which the FOMC may wish at least partially to accommodate. Finally, lagged reserve accounting requires access to the discount window in the short run on occasions when required reserves run above the non-borrowed reserve path (if that path is to be maintained).^{1/}

b. Another approach to consider would be to eliminate administrative guidelines at the discount window and to substitute a graduated discount rate schedule for adjustment credit--in contrast to emergency and other longer-term types of discount window credit--based on, say, size of borrowing. This approach would tend to make the relationship between borrowing and short-term market rates more certain by eliminating from the decision to borrow the uncertainties connected with administrative guidelines. It also thereby transforms the highest discount rate on the schedule into an upper limit for the federal funds rate. There are, however, legal questions about the System's ability to use size of borrowing as a criterion, administrative problems in overseeing the adequacy of collateral and the financial condition of a vast number of potential regular borrowers, and difficult questions with regard to the appropriate gradient for the discount rate schedule.

^{1/} Even with contemporaneous instead of lagged reserve accounting, it is by no means clear that banks would be able to make needed adjustments reducing their required reserves within a statement week--except at the expense of relatively extreme interest rate movements.

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Too steep a gradient risks undue market interest rate fluctuations, particularly at times when borrowing demands may be changing for transitory reasons, while too flat a gradient--and at the limit a perfectly flat one--would tend to eliminate the incentive of banks to make portfolio adjustments that would bring money supply back to target.

c. The recent policy of applying a surcharge above the basic discount rate for frequent borrowing (by larger banks) represents a step toward a graduated discount rate structure within the present administrative guidelines and tends, when applied, to speed up the response of market rates to overshoots or undershoots of money relative to path. This approach has the attraction of flexibility, but in practice it has proved difficult to assess, because of the limited experience with it thus far.

d. Another approach to speeding up the response of banks within present administrative guidelines would be to tie the discount rate to market rates, either as a penalty rate or not. However, this approach tends to limit flexibility and raises the danger of upward or downward ratcheting of market rates in the short run that may be excessive for monetary control needs and unduly disturbing to the

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functioning of markets.^{1/} While a tied rate accelerates the response of market rates, the change may be counter-productive--particularly if money behavior was going to reverse itself naturally or if the rise in borrowing was needed to moderate shocks from the supply side--and could intensify short-run money supply and interest rate cycles.

3. A closer short-run relationship between reserves and money could be attained by measures that strengthen the link between required reserves and deposits in the particular money stock that is being controlled. One such measure would be a shift from lagged reserve accounting (LRA) to contemporaneous reserve accounting (CRA), which the Board has already announced that it is contemplating. Such a shift would make the link between current reserves and current deposits stronger, though there still would be relatively sizable slippage between reserves and money from other sources. The monetary control advantages of CRA apply particularly to the short run. They have to be weighed against (i) the benefits of LRA for reducing the cost of reserve management by the banks, (ii) the contribution of LRA to the Trading Desk's ability to assess reserve supply conditions, and (iii) judgments about the adequacy of monetary control under LRA over a longer-term period.

^{1/} This danger is greatest in the degree that the discount rate is tied to a current or very recent market rate. If required reserves expand rapidly in the current week, banks will have to borrow the added required reserves that are not being accommodated by the nonborrowed reserve target. As a result market rates must rise to the point where banks are willing to borrow from the discount window. With an attempt to maintain a "penalty" discount rate, the new market rate would therefore have to move temporarily above the discount rate which could not be maintained, in those circumstances, above current market rates. Market rates would go up by the amount needed to re-establish the normal spread of market rates over the discount rate (that emerges from pressures generated by discount window administration and banks' reluctance to borrow). But this rise in rates may well bring about a further rise in the discount rate if an attempt is made to re-establish a "penalty" rate, entailing yet a further rise in market rates, so long as required reserves remain at an advanced level.

4. The present relatively complicated reserve requirement structure, even apart from LRA, makes for considerable slippage in the relation between reserves and money. While the Monetary Control Act has tended to simplify the required reserve structure, it will be a number of years before the new structure is fully phased in. Because of the unpredictability of shifts in deposit mix, in the ratio of currency to deposits, as well as in banks' demand for excess reserves, judgmental multiplier adjustments to original paths were made week-by-week last year as new information was obtained. Model simulations suggest money-reserve relationships would have otherwise been more variable on average. Thus, there is no reason not to continue making such adjustments, though it remains unclear, because multiplier changes are so erratic, whether full adjustment should be made to each week's added information.

5. It appears from tentative results based on the Board's monthly money market model that the faster the FOMC attempts to move back toward the longer-run target for money, once off target, the more likely is the long-run target to be hit, assuming no federal funds rate constraint. However, these results also suggest that the more quickly a return to path is sought, the more substantial fluctuations in money market rates are likely to be. And experience of the past year suggests these more substantial fluctuations would be transmitted broadly through the rate structure. Moreover, for a more rapid return beyond a certain speed--perhaps around 3 months--it seems as if the gain in reducing the chance of departures from longer-term money targets is small compared with the increasing chance of a wider range of variability in money market rates.

B. Assessment of other targeting procedures

i. Monetary base or total reserves

A. The principal reason for adopting these measures as day-to-day operating guides would be to ensure more precise control of money. However, there is no clear evidence that money can be controlled more closely through use of a strict total reserves or monetary base operating procedure under the present institutional framework than through current procedures. Indeed, most of the evidence suggested that these measures could produce more slippage because of supply-side shocks to the money multiplier. These shocks tend to be partially offset by changes in borrowing with a nonborrowed reserves day-to-day operating target. Under a total reserves or base target, there would not automatically be an offsetting tendency. In practice, though, the precision of a total reserve or base target would be improved through judgmental adjustments to the reserve path that offset multiplier shifts. Improvements could also be effected, and the need for judgment reduced, by further simplification of the reserve requirement structure (such as removal of the reserve requirement on nonpersonal time deposits if the FOMC wishes to control mainly narrow money) and by a return to CRA. While such changes would tighten the linkage between reserves and money, shifts between currency and deposits would still tend to be a factor causing slippage--with model simulations indicating greater slippage with the monetary base as the operating target (which is essentially currency plus total reserves) than with total reserves. With a monetary base target, short-run volatility in currency would lead to large variations in

money supply because changes in the public's holdings of currency would need to be offset by equal changes in bank reserves; and these changes in reserves would, given the fractional reserve system, force a multiple change of deposits in the money supply. With a reserves target, the changes in money supply would be no larger than the currency variation; consequently, money supply would be less volatile with a reserves target.

b. In any event, strict adherence to total reserve or base targets appears to be impractical over short-run operating periods in the current institutional setting. With the present LRA system, it is clearly not feasible. If CRA were adopted, such targets might become somewhat more practical, though efforts to attain them would accentuate short-run interest rate fluctuations. Such fluctuations, given the inelasticity of money demand relative to interest rates over the short run, would stem from the inability of the reserve supply to provide at least partial accommodation to transitory money demand variations, and would also result from remaining multiplier slippage. In the process, borrowing at the discount window would fluctuate widely, as banks reacted to efforts by the Open Market Desk to reach the total reserve target.

c. While there are practical questions about the feasibility of targeting on total reserves (or the base) on a day-to-day or week-to-week basis, in a longer-run context a path for such reserve aggregates, properly adjusted for multiplier shifts, could serve as a general guide in helping to make adjustments in the nonborrowed reserve path or in indicating the need for a change in the basic discount rate--as is, in fact, present practice. For example, when total reserves are

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running strong relative to its adjusted path, this can be taken as an indication to hold back on the supply of nonborrowed reserves relative to its path (in order over time to offset the rise in borrowing) or to raise the discount rate (in order over time to discourage a rise in borrowing).

2. Federal funds rate target

a. Model simulations, given existing institutional arrangements, indicated that in concept slippage in short-run money stock targets could be little different on the whole under a funds rate targeting regime than under a nonborrowed reserves regime. However, in practice--to be reasonably certain of attaining its long-run target--the FOMC would need to be willing to move the funds rate quite actively when it was the operating instrument and be able to predict fairly well the appropriate extent, and indeed the direction, of the required change. Uncertainties in those respects of course were among the factors leading to a shift toward reserve targeting.

b. A federal funds rate operating target would have advantages if the FOMC wished to provide more scope for being accommodative to variations in money demand, either because of uncertainties about the proper path of money growth within its longer-run target band or because of a belief that money demand disturbances are more likely to occur than disturbances in the market for goods and services.

c. The federal funds rate range under the current reserve operating procedure has been much wider than under the earlier funds rate targeting regime. Moreover, the range under the new procedure has generally been changed as the limits were approached--a practice

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that has been consistent with evidence suggesting that a wide range of variation in the funds rate is a by-product of efforts to attain tight control of the money supply. In that context, a relatively narrow acceptable funds rate range would only have advantages in the degree that the FOMC (i) felt more scope could be given in a particular period, for one reason or another, to variations of money from a pre-set target, or (ii) felt that narrow funds rate limits provided a device that, given the need to make judgments about sources of economic and monetary disturbances, would prompt further assessment of underlying monetary and other conditions by the Committee in the interval between meetings.

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- Euzler, Jared. Economic Disturbances and Monetary Policy Responses.
_____ and Lewis Johnson. Cycles Resulting from Money Stock Targeting.
- Greene, Margaret. The New Approach to Monetary Policy--A View From the Foreign Exchange Trading Desk.
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- Keir, Peter. Impact of Discount Policy Procedures on the Effectiveness of Reserve Targeting.
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United States Senate

COMMITTEE ON BANKING, HOUSING, AND
 URBAN AFFAIRS
 WASHINGTON, D.C. 20510

March 16, 1981

The Honorable Paul A. Volcker, Chairman
 Board of Governors of the Federal
 Reserve System
 Federal Reserve Building
 Washington, D. C. 20551

Dear Mr. Chairman:

The Banking Committee appreciated your appearing before it on February 25 to present the Federal Reserve's monetary policy report. In order to complete the Committee's hearing record, your responses to the following questions would be appreciated:

1. Much of economic policy to this day is based upon an idea of Irving Fischer known as the equation of exchange. This simply suggests that if one multiplies the quantity of money by the velocity of that money, the product will be equal to the product of the number of transactions in the economy multiplied by the average price of each transaction. This equation has been used to "show" that if velocity is stable (and it was suggested that it was), and if we are near full employment so that the number of transactions does not increase greatly, then an increase in the quantity of money will lead to higher prices and vice versa. This was used to prescribe monetary policy for some time.

Is there any validity to this equation in today's world? Is velocity stable, or at least predictable? If the concept here is no longer valid, is there any way to justify activist monetary policy, especially in a world in which we have trouble even deciding how much money there is?

2. The Reagan tax program purports to have as its purpose increasing savings.

Wouldn't it serve that purpose better to have less income tax cuts and more exclusion of taxable interest on savings? It would seem that such a policy would better increase capital formation.

3. Mr. Greenspan was quoted by Mr. Hobart Rowen recently as saying that if thrift institutions were given massive loan aid the resultant inflation rate would double from 10 to 20% with interest rates going sky high.

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Mr. Greenspan raised a basic question *therefore* about the economy in relation to the stability of the financial system.

May we have your comments?

4. We heard Mr. Stockman say recently that if the Reagan program is adopted intact there would be a dramatic change in interest rates to the 8 or 9% range within a very short period of time.

Do you agree or disagree with Mr. Stockman?

5. During your confirmation hearing, you expressed some concern over the threat to the Fed's ability to actually control the growth of the money supply posed by the innovativeness of financial markets which has resulted in the creation of forms of money or near money springing up which are outside of your direct control. These innovations, combined with the uncertainty over NOW accounts, make me wonder if your concern is greater or less than it was 18 months ago?
6. During the last several weeks M1-A has shown a marked decline, while M1-B has grown at a moderate rate. Presumably this behavior is due to NOW accounts that were authorized nationwide as of January 1.

Has the growth of NOW accounts been consistent with the Board's expectations, and has the shift of funds been from demand deposits and savings in the proportions expected?

Would you say that the week-to-week changes on M1-A and M1-B remain useful indicators of Federal Reserve policy or would you caution the public against watching them?

And, would there be any benefit in changing the way the M1-A and M1-B data are published--perhaps publishing them as monthly averages as is done with M2 and M3, or only on a non-seasonally adjusted basis, or only in component deposits not aggregated?

7. The discount rate has been at 13% since December 1980. During that time the prime lending rate has been as high as 20 3/8% and is now 19. Borrowing has been averaging \$1.7 billion per day. This implies a high subsidy being given to borrowing banks--perhaps \$200-\$300 million at an annual rate.

Can this subsidy be justified?

Given the recent strong desire by the electorate to let the free market work in this economy, why not have the discount rate

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be at or above the rate paid for similar funds in the market place rather than at the ad hoc discretion of the Federal Reserve?

8. An interesting column by James Lebhenz in the WASHINGTON POST on Sunday, February 22, 1981, indicates that short-term interest rates have declined by 500 basis points, but long-term Treasury rates have increased by 125 basis points. Last April, a 500 basis point decline on short-rates produced a 174 basis point decline in long rates.

Why the difference? Why have long-term rates increased rather than declined?

What does this indicate about inflationary expectations and the possibility of future economic growth?

9. Some are very concerned over the apparent tremendous growth in banks' loan commitments over the past few months.

How much impact would such an increase in commitments have?

10. In the past, you have recognized "the challenge of restoring employment, growth and productivity while at the same time visibly reducing inflation." An important goal of the Humphrey-Hawkins Act -- The Full Employment and Balanced Growth Act of 1978 -- is to reduce unemployment. Unemployment in Michigan is currently at 13.7%. Employment has not been restored or unemployment reduced in the seventh largest State in the country.

In your opinion, what specific steps should be taken -- which are not currently being taken -- to reduce unemployment?

11. Has the Federal Reserve done any studies on the effect of high interest rates on different regions of the country? For example, is there any difference between the effect of high interest rates in the State of Michigan -- which is a large industrial State -- and say a predominantly rural, agricultural State? What is the difference?

Your cooperation in providing the Committee with your additional views is appreciated.

Sincerely yours,


Jake Garn
Chairman

JG*JCrn



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 25, 1981

PAUL A. VOLCKER
CHAIRMAN

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Garn:

Thank you for your letter of March 16 forwarding additional questions in connection with your Committee's hearing on February 25. I am pleased to enclose my responses to the questions.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

CHAIRMAN VOLCKER'S RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY
CHAIRMAN GARN AS A FOLLOW-UP TO THE HEARING HELD BEFORE THE
SENATE BANKING COMMITTEE ON FEBRUARY 25, 1981

- (1) The equation of exchange is perhaps best viewed as a mathematical identity defining the concept of velocity. In that sense it certainly is as correct today as it ever was. However, it can serve as a framework for policy only in the broadest terms.

As I have stressed on many occasions, the relationship of money to spending--that is, velocity--is a rather loose one, especially in the short run. The problem of defining money is a facet of this looseness. In the short run, velocity is quite variable and not fully predictable. And the same is true of the division of changes in nominal spending between gains in real output and inflation. This variability and unpredictability does argue for a cautious approach to monetary activism or fine-tuning.

In a longer run context, however, there are discernible trends to velocity that enable one to relate in a rough way the growth of money to the growth of nominal GNP. Moreover, over such long periods--several years in length--it is possible to define the trend of real GNP, particularly of potential output; given that reference point, one can relate the trend growth rate of money to the trend of inflation, at least to a useful approximation. It is this long-range connection between money and inflation that underlies the Federal Reserve's view that a moderation over time in monetary expansion is an essential part of the fight against inflation.

(2) I believe that it is appropriate to focus major attention in the design of a tax cut package on the implications for capital formation. Higher levels of saving and investment are needed to improve productivity performance and thus pave the way for the reduction of production costs and for rising living standards. How to provide the maximum incentives for capital formation at the minimum cost in terms of lost federal revenues is a complex technical matter on which I cannot offer definitive answers. I am inclined to think that incentives for investment are likely to be the most cost-effective approach, with the investment essentially bringing forth the corresponding saving; however, there undoubtedly is some role for direct incentives to saving as well. Unfortunately, many of the proposals I've seen in this area appear likely to be rather inefficient. For example, the interest exemption legislated last year probably will provide little impetus for additional saving since many people already have interest income in excess of the exemption level. It is important that savings incentives be focused on encouraging additional saving--and particularly additional total saving, not just saving in one form that represents a substitution for other forms.

(3) Thrift institutions are facing some significant difficulties today; "massive loan aid" would not, however, appear an imminent requirement. Even if credit assistance in some form were provided at some point, it is not at all clear that it would have an inflationary impact. If such assistance were provided through the Federal Reserve discount window, the impact on overall reserve availability could be offset through open market operations to keep monetary expansion within bounds. Credit assistance might be provided through other channels, of course, but I see no necessary reason for such an impact on inflation or interest rates.

The dangers in a major financial crisis tend generally to run in the direction of recession and deflation. The Federal Reserve, in its role as lender of last resort, would make every effort to prevent a liquidity crisis from arising as a result of anticipated or actual institutional failures. It is important, however, that we not exaggerate the dangers of such developments and undertake rash "bail out" actions on a broad scale. It might indeed be said that an excessive readiness through the years to bring forth a federal safety net when financial institutions or businesses have encountered difficulties has fostered a disdain for traditional rules of sound finance and has contributed indirectly to the inflationary process. Thus, while we cannot afford a cumulative financial disturbance, we must be willing to allow the market to exert a measure of discipline if we are to encourage the sort of financial and business practices that form the foundation of a stable economy.

- (4) Mr. Stockman has, I believe, revised his statement a bit. It is my understanding that he is not predicting a quick return to such low rates. In any event, there is an important and accurate element in Mr. Stockman's general view--namely, that a reduction in inflationary expectations is the key to a significant, sustained decline in interest rates.
- (5) The rapidity of financial innovation does remain a concern as we attempt to set appropriate targets for monetary expansion and then to achieve those targets. The impact of NOW accounts is a dramatic example, but, as you suggest, it is just one of many changes affecting the behavior of money. I don't think we can as a practical matter put an end to such innovation--nor would it be desirable. But I would wish that there was a more general appreciation of the need, in such an environment, for some flexibility in policy. I find it difficult to square the obvious fact of dramatic change in institutions and markets with the calls from many of our critics for more rigid approaches to monetary policy.

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(6) The movements of the narrow monetary aggregates have, as you say, been distorted recently by the introduction of NOW accounts on a nationwide basis. The growth of NOW balances has been somewhat faster than we expected before the year began, and the degree to which shifting from demand deposits has accounted for the inflow to NOWs has been a bit greater than expected.

The weekly M-1 numbers are extremely "noisy." Given the large random fluctuations they exhibit, I have always cautioned against placing great importance on any weekly change. We have examined the question of whether our publication policy should be changed, and are soliciting public comment on this issue at this time. Our thinking on this score was outlined in a recent letter to you, which I am submitting here for the record.

(7) The issue of the discount rate is a complex one. It was examined in some detail in the recent staff study of the Federal Reserve's monetary policy operating procedures. I am uncomfortable about the "subsidy" problem; the use of surcharge on frequent borrowing by large banks has reduced the extent of the phenomenon, but it does not eliminate it. As I have indicated in Congressional testimony (and is discussed at length in the staff study), the concepts of a tied or penalty discount rate are not without their shortcomings. The Board is continuing to wrestle with this question in the hope of finding a solution that avoids unreasonable subsidies but does not at the same time introduce new difficulties in monetary control or unduly exacerbate short-run interest volatility.

(8) Short- and long-term interest rates tend to fluctuate together (although the amplitude of fluctuation in long rates generally is smaller), but this need not be so over every particular time span. The broad movements in rates over the past year or so certainly have conformed to this pattern, and in recent weeks both short- and long-term security yields have dropped. Temporary departures from this pattern may reflect unusual supply conditions or other special factors.

It is true that long-term interest rates are still very high by historical standards, and this is an indication of prevailing concerns about the persistence of high rates of inflation. Lowering those expectations is certainly important to provide an environment more conducive to improved economic performance.

(9) Loan commitments do constitute a potential call on the resources of a bank. Rising levels of unused commitments in effect represent a reduction in the liquidity of the banking system, all other things equal. By the same token, they represent a source of liquidity for the business firms holding the commitments. We at the Federal Reserve watch the loan commitment figures to gauge both the liquidity of the banks and the potential borrowing by businesses.

(10) Unemployment is high by historical standards on average across the country, and especially high in some areas where there are concentrations of industries--such as automobile manufacture--that are experiencing particular difficulty. It is worth noting, however, that the proportion of the population employed is also at a high level. Structural changes in the work force have tended to push average unemployment rates above the norms of the past.

There clearly is a role in employment policy for well-designed programs to increase the mobility of labor and for action to remove the restraints on wage flexibility that inhibit hiring, particularly of lower skilled workers. What is most critical over the long run, however, is the adherence to anti-inflationary monetary and fiscal policy that will foster a stronger economy that is more competitive in world markets.

(11) The Board has not undertaken any detailed studies of the regional impact of high interest rates. Certainly, there is the possibility of a differential impact, owing to relative concentrations of capital intensive industry or cyclically sensitive durable goods production. In the present instance, the cyclical problems experienced in the state of Michigan have been reinforced by difficulties associated with the failure of the U.S. manufacturers to gear their production of automobiles to models that are competitive in terms of price, quality, and fuel economy with foreign-made cars. It would be fair to say, however, that all areas of the country are sharing in the difficulties caused by the high interest rates that have been the result of inflation and the effort to contain it.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

March 24, 1981

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Garn:

The concerns and questions raised in the recent letter from you and Senator Proxmire about weekly money supply data have been discussed and debated by the Federal Reserve Board, the Federal Open Market Committee, and the staff for some time. The issues are extremely important and strong arguments--other than Freedom of Information Act implications--can be made for and against publication of weekly data.

There is nearly unanimous agreement by all observers that weekly money statistics are extremely erratic and therefore poor indicators of underlying trends. While monthly data can often deviate considerably from such trends, the weekly observations are particularly "noisy". Week-to-week changes are quite large and recent estimates indicate that the "noise" element--attributable to the random nature of money flows and difficulties in seasonal adjustment--accounts for plus or minus \$3.3 billion in weekly change two-thirds of the time. Such a large erratic element appears intrinsic to money behavior, rather than implying poor underlying statistics. In 1980, weekly M-1A and M-1B statistics revised on average only about \$300 million between the first published and "final" data several weeks later, though in twelve weeks, revisions were larger than \$500 million, and the largest single revision was \$1.6 billion.

The great preponderance of active market participants are by now aware of the highly volatile nature of the weekly series. Publication has had that educational advantage, and the data to be used with a certain caution. However, from time to time overreactions have occurred.

The Honorable Jake Garn
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As a result of concerns about the reaction to and significance of weekly figures, the Federal Reserve has considered possible revisions to its current publication schedule or to its method of presentation. One option might be to delay weekly publication an additional seven days to incorporate more data--an important issue with additional reporters under the Monetary Control Act. This could reduce revisions to the weekly statistics. On the other hand, this option would increase the risk of inadvertent leaks and would increase the interval over which market participants might react to guesses and rumors of money stock changes, based in part on fragmentary data such as may be available in the weekly figures from large banks on deposits and loans. Even if no greater volatility in interest rates occurred over the unpublished interval, lagged publication of a more accurate, but still different than expected, change in weekly money might simply postpone the market reaction. In any event, weekly revisions are usually small, as noted above, relative to the underlying volatility of the series.

Another option might be to publish seasonally unadjusted money data in order to reduce the "importance" of the statistics. Our concern here is that market participants would then create their own seasonally adjusted series. The availability of a large number of conflicting series would only heighten market confusion, and might inevitably lead to questions to the Federal Reserve about what it considers to be the "normal seasonal" change in a particular week if what might seem to be an unusual change occurs in a seasonally unadjusted figure.

Another approach might be to publish data only monthly--as is now done, because of data reporting problems, with M-2 and M-3--and/or to publish weekly, but only a moving average series of weeks. Under the monthly approach, market participants would still try to estimate weekly series from bank balance sheets and clearing house data, and the market could be swept by rumors and guesses on movements in the money supply. And they would also probably attempt to glean the weekly number from a moving average series. In any event when a monthly figure was finally published, deviations from market expectations could cause yet further changes in interest rates as the new information was incorporated into market expectations. I might note that this has not been a significant problem with monthly publication of M-2 and M-3. A relatively small portion of these aggregates are supported by reserves, and they have played a less important role in the day-to-day targeting process than M-1.

In general, there is considerable merit to the view that weekly data as such convey little information and that weekly seasonal adjustments are subject to substantial uncertainty. However, the Board is not certain at present that the public interest would necessarily be better served if any of the alternatives noted above were adopted. While no one can be sure of their judgment in this respect, it does

The Honorable Jake Garn
Page 3

seem possible that volatility of money market conditions could be encouraged by misinterpretation of fragmentary data as well as by the continued availability of the present weekly data.

We will, of course, continue to review the money supply publication schedule, taking account of the constraints imposed by the Freedom of Information Act. To aid in our assessment of the value of weekly money supply data, we plan to ask for public comment on the desirability of continuing the weekly *series*, or of shifting to the options noted above. Our decision will be taken in the light of those comments. Should Freedom of Information Act requirements present difficulties in the light of the appropriate course, we will consult with you further.

I appreciate your interest in these questions. They are of concern to all of us.

Sincerely,

Identical letter also sent to Senator Proxmire.



Washington, D.C. 20540

Congressional Research Service
The Library of Congress

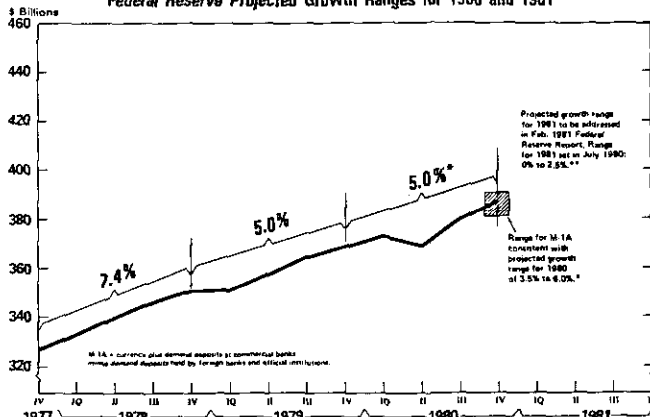
BRIEFING MATERIALS FOR FEBRUARY 1981 MONETARY POLICY OVERSIGHT

Congressional review of economic policies, including monetary policy, is conducted on a coordinated basis pursuant to the Full Employment and Balanced Growth Act of 1978 (P.L. 95-523). The Act requires the Federal Reserve to submit a monetary policy report to the Congress twice annually. The reports are to present a review of recent economic trends, a statement of objectives for growth of money and credit, and an assessment of the relationship of the growth objectives to economic goals set forth in the Economic Report of the President.

This document contains presentations of monetary and financial measures which are constructed to assist in reviewing the Federal Reserve's monetary policy report to the Congress for February 1981. Included are charts portraying money and credit growth in relation to Federal Reserve one-year targets, the velocity of money and selected interest rates as well as tables showing data for selected monetary and financial measures.

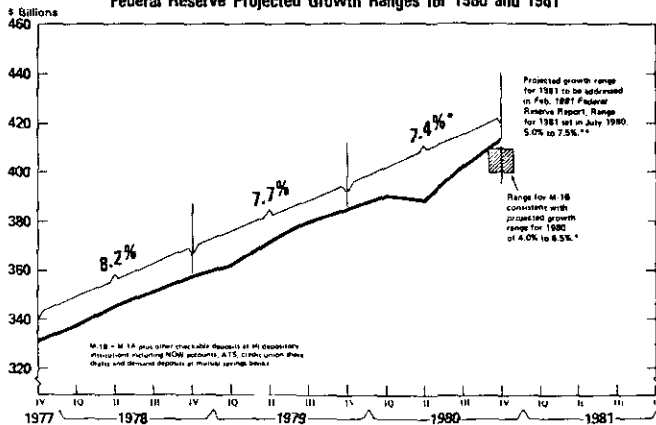
CRS-1

MONEY SUPPLY (M-1A)
Actual Levels and Growth Rates, 1977-1980 and
Federal Reserve Projected Growth Ranges for 1980 and 1981



* The Federal Reserve stated on 1/7/81 that deposit shifts resulting from passage of the Monetary Control Act decreased M-1A growth for 1980 by 1/2 percentage point below growth initially anticipated.
 ** The projected growth range for 1981, announced in July 1980, includes an anticipated reduction in M-1A growth of 2 percentage points resulting from shifts from demand deposits to interest-bearing transactions accounts. Several forms of the latter accounts were authorized in 1/7/81 by the Monetary Control Act.
 Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as of January 1981.

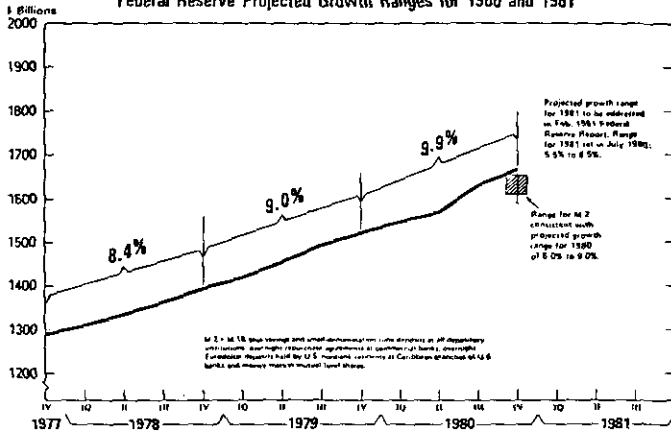
MONEY SUPPLY (M-1B)
Actual Levels and Growth Rates, 1977-1980 and
Federal Reserve Projected Growth Ranges for 1980 and 1981



* The Federal Reserve stated on 1/7/81 that deposit shifts resulting from passage of the Monetary Control Act increased M-1B growth for 1980 by 1/2 of a percentage point over growth initially anticipated.
 ** The projected growth range for 1981, announced in July 1980, includes an anticipated increased growth for M-1B of 1 1/2 percentage points resulting from shifts from savings accounts to interest-bearing transactions accounts. Several forms of the latter accounts were authorized as of 1/7/81 by the Monetary Control Act.
 Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as of January 1981.

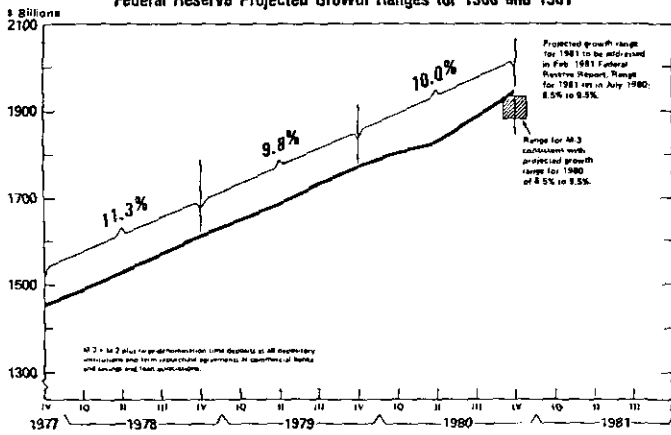
CRS-2

MONEY SUPPLY (M-2)
Actual Levels and Growth Rates, 1977-1980 and
Federal Reserve Projected Growth Ranges for 1980 and 1981



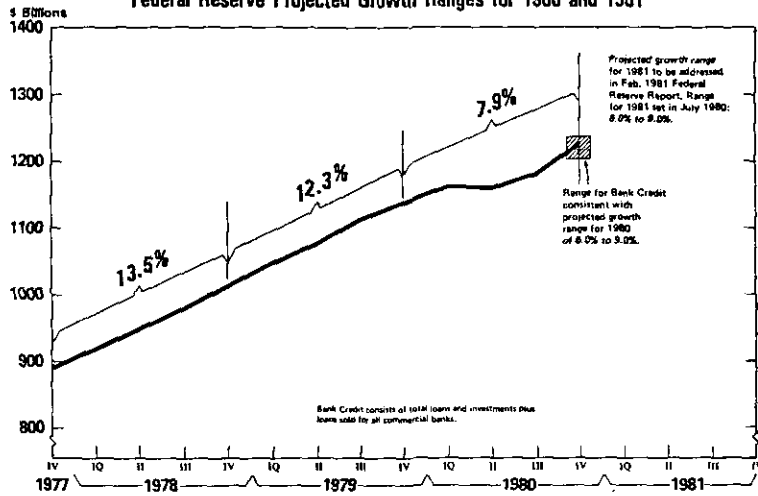
Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as of January 1981.

MONEY SUPPLY (M-3)
Actual Levels and Growth Rates, 1977-1980 and
Federal Reserve Projected Growth Ranges for 1980 and 1981



Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as of January 1981.

BANK CREDIT
Actual Levels and Growth Rates, 1977-1980 and
Federal Reserve Projected Growth Ranges for 1980 and 1981



Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as of January 1981.

GROWTH RATES FOR SELECTED MONETARY AND CREDIT AGGREGATES, 1975-1980
AND FEDERAL RESERVE ONE-YEAR TARGETS, 1980-1981
(Seasonally adjusted compound annual growth rates, percent)

time period ^{1/}	Monetary aggregates				Bank credit
	M-1A	M-1B	M-2	M-3	
1975	4.7	4.9	12.3	9.4	4.1
1976	5.5	6.0	13.7	11.4	7.5
1977	7.7	8.1	11.4	12.6	11.1
1978	7.4	8.2	8.4	11.3	13.5
1979	5.0	7.7	9.0	9.8	12.3
1980	5.0 ^{2/}	7.4 ^{2/}	9.9	10.0	7.9
1980: first quarter	4.6	6.0	7.6	8.3	9.8
second quarter	-4.3	-2.4	5.7	6.0	-0.5
third quarter	12.0	15.4	17.0	13.6	7.2
fourth quarter	8.4	11.3	9.6	12.4	15.7
1980: targets ^{3/}	3.5 to 6.0	4.0 to 6.5	6.0 to 9.0	6.5 to 9.5	6.0 to 9.0
1981: targets, subject to revision in February 1981 Federal Reserve Report ^{4/}	0.0 to 2.5	5.0 to 7.5	5.5 to 8.5	6.5 to 9.5	6.0 to 9.0

^{1/} Annual data are for periods from the fourth quarter of the previous year to the fourth quarter of the year indicated. Quarterly data, entered for 1980, are for periods from the previous quarter and are stated at annual rates.

^{2/} The Federal Reserve stated on 1/7/81 that deposit shifts resulting from passage of the Monetary Control Act modified growth of M-1A and M-1B for 1980 in relation to growth initially anticipated, decreasing M-1A growth by 3/4 to 1 percentage points and increasing M-1B growth by 1/2 to 3/4 of a percentage point.

^{3/} Announced by the Federal Reserve in its Monetary Report to the Congress, February 19, 1980.

^{4/} Targets for 1981 appearing above, announced by the Federal Reserve in July 1980. These targets take into account shifts of deposits arising from passage of the Monetary Control Act.

Sources: Calculated from data series of the Board of Governors of the Federal Reserve System, accessed January 1981 from data files of Data Resources, Inc.

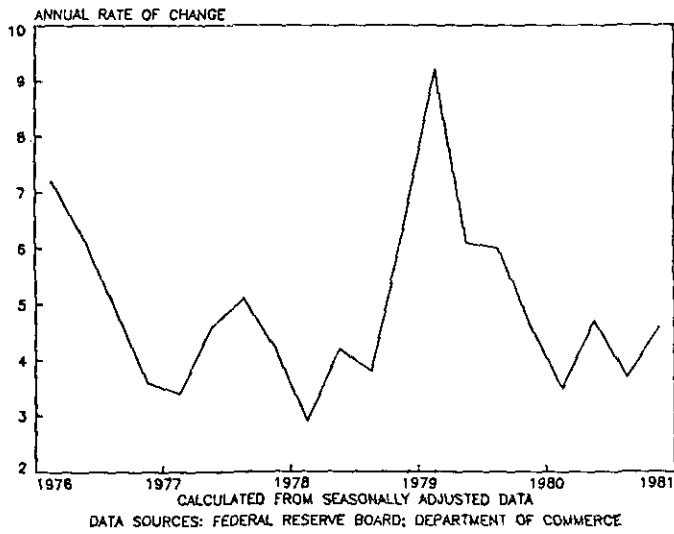
GROWTH RATES FOR SELECTED RESERVE AGGREGATES AND THE MONETARY BASE, 1975-1980
 (seasonally adjusted compound annual growth rates, adjusted for
 changes in reserve requirements, percent)

<u>1/</u> time period	total reserves	required reserves	nonborrowed reserves	monetary base
1975	0.5	0.3	4.3	5.4
1976	1.2	1.2	1.4	7.1
1977	4.7	4.8	2.1	8.3
1978	6.2	6.3	6.3	9.1
1979	2.7	2.4	0.4	7.8
1980	7.0	6.8	7.7	8.7
1980: first quarter	4.0	5.2	2.9	7.7
second quarter	0.4	0.6	7.6	5.4
third quarter	6.9	5.9	13.0	10.2
fourth quarter	17.5	16.0	7.4	11.6

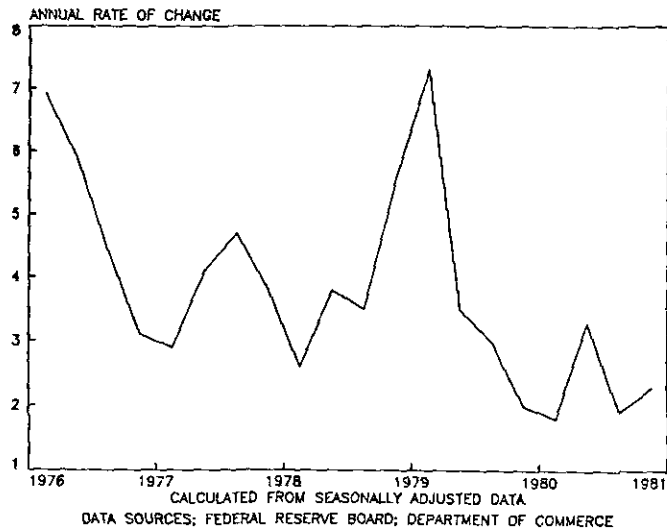
1/ Annual data are for periods from the fourth quarter of the previous year to the fourth quarter of the year indicated. Quarterly data, shown for 1980, are for periods from the previous quarter and are stated at annual rates.

Sources: Calculated from data series of the Board of Governors of the Federal Reserve System, accessed January 1981 from data files of Data Resources, Inc.

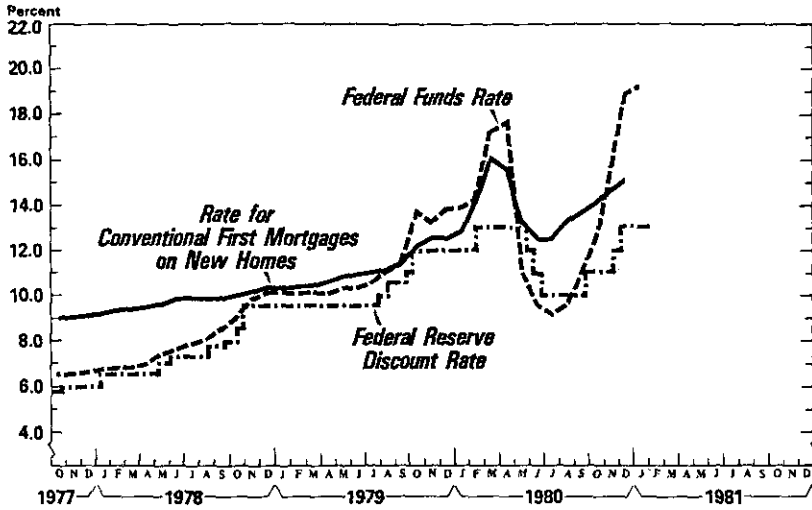
CRS-6
 INCOME VELOCITY OF MONEY (M-1A)
 % CHANGE FROM SAME QUARTER, PREVIOUS YEAR



INCOME VELOCITY OF MONEY (M-1B)
 % CHANGE FROM SAME QUARTER, PREVIOUS YEAR



SELECTED INTEREST RATES
 October 1977 through January 1981



* The Federal Reserve imposed the following discount rate surcharges applicable to borrowings for more than one week in a row or more than 4 weeks in a calendar quarter by institutions with deposits of \$500 million or more: March 14, 1980 through May 6, 1980 - 3 percentage points; November 17, 1980 through December 7, 1980 - 2 percentage points; and December 8, 1980 and in effect as of January 30, 1981 - 3 percentage points.

Data Sources: Board of Governors of the Federal Reserve System and Federal Housing Administration Department of Housing and Urban Development.

SELECTED INTEREST RATES, 1975-1980
(average, percent per annum)

Year or Month	Treasury bills, 3 month, new issues	Treasury bonds, over 10 years, composite	Corporate Aaa bonds, Moody's	Prime commercial paper, 3 months	Prime rate charged by banks	New home mortgage yields FHA/HUD series	Federal Reserve Discount rate ^{1/}	Federal funds rate
1975	5.84	7.00	8.83	6.25	7.86	9.10	6.25	5.82
1976	4.99	6.79	8.43	5.24	6.84	9.00	5.50	5.05
1977	5.26	7.06	8.02	5.55	6.82	9.00	5.46	5.54
1978	7.22	7.89	8.73	7.94	9.06	9.70	7.46	7.94
1979	10.04	8.74	9.63	10.97	12.67	11.14	10.28	11.20
1980	11.61	10.81	11.94	12.66	15.27	13.95	11.77	13.36
1980:								
Oct.	11.58	11.20	12.31	12.52	13.79	14.10	11.00	12.81
Nov.	13.89	11.83	12.97	15.18	16.06	14.70	11.47	15.85
Dec.	15.66	11.89	13.21	18.07	20.35	15.05	12.87	18.90
1981:								
Jan.	14.72	11.65	12.81	16.58	20.16	NA	13.00	19.08

^{1/} The Federal Reserve imposed the following discount rate surcharges applicable to borrowing for more than one week in a row or more than 4 weeks in a calendar quarter by institutions with deposits of \$500 million or more: March 14, 1980 through May 6, 1980 -- 3 percentage points; November 17, 1980 through December 7, 1980 -- 2 percentage points; and December 8, 1980 and in effect as of January 30, 1981 -- 3 percentage points.

Sources: Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, and Moody's Investors Service.

FUNDS RAISED IN U.S. CREDIT MARKETS

[In billions of dollars; quarterly data are seasonally adjusted at annual rates]

	1975	1976	1977	1978	1979	1979 (IV)	1980 (I)	1980 (II)	1980 (III)
Total funds raised, by instrument:	223.5	296.0	392.5	481.7	482.3	448.3	502.4	266.0	446.4
Investment company shares	-.1	-1.0	-.9	-1.0	-2.1	-5.1	-2.5	13.8	-4.2
Other corporate equities	10.8	12.9	4.9	4.7	7.6	10.6	13.7	9.1	11.2
Debt instruments:	212.8	284.1	388.5	478.0	476.8	442.8	491.2	243.2	439.5
U.S. Government securities	98.2	88.1	84.3	95.2	89.9	116.5	117.0	100.5	134.0
State and local obligations	16.1	15.7	23.7	28.3	18.9	22.2	20.8	14.8	23.4
Corporate and foreign bonds	36.4	37.2	36.1	31.6	32.9	26.9	28.5	63.4	38.3
Mortgages	57.2	87.1	134.0	149.0	158.6	152.3	149.2	71.2	126.5
Consumer credit	9.7	25.6	40.6	50.6	42.2	31.1	25.9	-44.2	6.1
Bank loans, n.e.c.	-12.2	7.0	29.8	58.4	52.5	24.8	52.5	-10.7	74.3
Open market paper	-1.2	8.1	15.0	26.4	40.5	28.6	50.8	33.0	7.3
Other loans	8.7	15.3	25.2	38.6	39.5	40.3	46.6	15.1	29.6

Source: Board of Governors of the Federal Reserve System. 1980(III) based on incomplete data.

CRS-9

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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1981

WEDNESDAY, MARCH 4, 1981

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room 5302, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Schmitt, and Proxmire.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The committee will come to order.

One week ago, the committee discussed the Federal Reserve Monetary Policy Report with Chairman Volcker. The Fed has indicated its resolve to maintain slow, but steady, growth of the money supply. Chairman Volcker announced reduced targets for growth of the monetary aggregates during 1981.

While I generally support the Fed's initiatives, I share the concerns of other committee members that the Fed's specific monetary goals and techniques be effective. Although I may differ with the Fed on certain matters, I wholeheartedly agree with Chairman Volcker's often repeated statement, that the budget and the deficit must be reduced before long-term economic progress can be made.

On this second day of hearings, the committee will explore the relationship between the Fed's monetary policy objectives and the administration's economic plan with testimony from Dr. Murray Weidenbaum, the Chairman of the Council of Economic Advisers. The hearing will conclude with testimony from two distinguished economists, Dr. Jerry Jordan of the University of New Mexico, and Dr. David Jones of Aubrey Lanston Co. in New York.

Before I turn to you, Dr. Weidenbaum, I would like to ask Senator Proxmire, if he has any opening remarks, he would like to make.

Senator PROXMIRE. No, thank you, Mr. Chairman.

The CHAIRMAN. Dr. Weidenbaum, we would be happy to have you proceed with your testimony.

STATEMENT OF MURRAY L. WEIDENBAUM, CHAIRMAN, THE PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Dr. WEIDENBAUM. Thank you, Mr. Chairman, Senator Proxmire. It's a real pleasure to be back before the Banking Committee. I particularly welcome this opportunity to discuss some important economic aspects of current policy developments.

This surely is a time that merits careful analysis of impending policy changes, and that covers a wide range of monetary, fiscal, and regulatory decisions.

As you are well aware by now, the President's program involves a four-pronged approach to our Nation's economic problems. Each of these four elements should be considered a necessary complement to the other three. Each is worthy of extended discussion and analysis by itself.

The CHAIRMAN. Excuse me, Doctor. We can hear you fine, but if you would pull the mike closer to you for those in the back.

Dr. WEIDENBAUM. Thank you, Senator, this morning I would like to share with you a few thoughts on particular aspects of the four elements which have not, in my opinion, received the attention they deserve.

PROSPECTIVE IMPACT OF THE PROGRAM

However, before I turn to each element individually, let me briefly summarize the overall prospective impact of the program. Over the near-term, at least through midyear, we expect real growth will continue to be very sluggish and that inflation will continue at or near double-digit rates. Thus, the year-to-year real growth in 1981 is estimated at a modest 1.1 percent and the inflation rate, as measured by the Consumer Price Index, at 11.1 percent.

Assuming prompt implementation of the administration's program, we then anticipate more rapid growth—over 4 percent in 1982 through 1986—and steady reduction in the rate of inflation. While the unemployment rate is anticipated gradually to decline on a yearly average basis during this period, progress will be steady but undramatic, and month-to-month fluctuations in this volatile series should be anticipated.

Let me begin with monetary policy, a topic for which this committee has oversight responsibility. Some historical perspective may be useful. In 1951, the administration of President Harry Truman reached an understanding with the Federal Reserve Board which was popularly known as the "Accord." The Accord relieved the Fed of its prior commitment to hold interest rates down, in order to help the Treasury finance the budget deficit at relatively low costs.

The 1951 Accord and the congressional hearings dealing with it at that time stressed that the coordinated use of fiscal and monetary policy is necessary for effective Government action against economic instability. Direct controls over wages and prices were eschewed and the Federal Reserve was given more flexibility to control the growth of money and credit. Also stressed was the need for consultation between the administration and the independent Federal Reserve System. These steps marked the beginning of a successful postwar stabilization effort that eventually brought price stability to the United States and world economies.

I don't want to draw historical parallels too tightly, but I think there is considerable similarity between President Reagan's first major address to the Congress on economic policy. That address emphasized the need for coordinated fiscal and monetary policy.

He stressed—as Congress recommended 30 years ago—the close consultation between the independent Federal Reserve and the administration on all aspects of our economic program. We have certainly done that, and we are delighted to see the strong support from Chairman Volcker.

In an attempt to be as informative as possible about the linkages between monetary policy and the rest of the program, we have included in the white paper describing the President's program, an explicit statement of the rate of monetary growth which would be consistent with the administration's targets:

The policies that are proposed in the program will help to advance the efforts of the independent Federal Reserve System. In particular, the substantial reductions of the Federal Government's deficit financing and the achievement of a balanced budget in 1984 and the years that follow should enable the Federal Reserve System to reduce dramatically the growth in the money supply.

To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986.

The white paper goes on to point out that, with the Federal Reserve gradually but persistently reducing the growth of money and credit, inflation should decline at least as rapidly as anticipated. Since interest rate movements are largely a mirror of price expectations, reduction in one will produce reduction in the other.

Although the entire white paper is a statement of the administration's economic program, it should be noted that the section on monetary policy benefited from close consultation with Federal Reserve officials. Subsequent events will enable us to judge the significance and usefulness of this development, especially in terms of the actual ability of the Federal Reserve System to achieve a steady and substantial reduction in the growth of the money supply.

I note that the Chairman of the Federal Reserve Board has announced a one-half percentage point reduction in the target ranges for M-1A and M-1B for 1981. Last year, the Federal Reserve operated at the high end of the target ranges, or slightly above. If the growth of the monetary aggregates were to end the current year at or around the midpoint of the target ranges, that would represent a reduction in monetary growth consistent with the administration's program. Monetary growth rates fluctuated sharply during the past year—due in part, no doubt, to independent factors which were difficult to control.

Nevertheless, there are improvements in the implementation of monetary policy that can be made, such as those suggested in recently completed studies by the Federal Reserve staff. And we assume the system will continue to seek other ways to improve control procedures.

Further, I want to emphasize the need at this time to keep close to the long-run growth targets during the year—and to try to avoid the kinds of month-to-month fluctuations we saw last year—even if that means increased interest rate volatility. I would suspect that stability in monetary growth would reduce interest rate volatility. The objectives of increased confidence and heightened expectations for the future could be served if both fiscal and monetary policies were to be perceived by savers and investors, and financial markets in general, as being significantly more stable and predictable than in the past.

REGULATORY POLICY

I would like to turn to an important related subject, regulatory policy. In the various areas of economic policymaking, it is important to learn from the policy experiences of the past. For example, while we concentrate on reforming and improving the existing regulatory apparatus of the Federal Government, we should be alert to the possible imposition of new Government burdens on the economic process.

In this connection, we should be mindful of the pressures for restricting the flow of trade and investment, both between regions of this Nation and among the nations of the globe. Acquiescence to such pressures would represent a backward step at a time when economic policy is being geared to reducing the degree of Government intervention in the marketplace.

Although we all are aware of the conditions that give rise to these protectionist or interventionist sentiments, surely the worst answer is for governments to erect barriers to commerce. Such a response would not serve the interest of consumers nor would it help to expand productive employment. For too long, we have acquiesced in Government policies—like trade restrictions—that individually add “only” two-, or three-, or five-tenths of 1 percent to the Consumer Price Index. We have to stop feeding the fires of inflation with a steady stream of concessions to special-interest groups who are oblivious to the harm done to the American consumer.

Rather, we need to create the type of healthy economic environment in which regions and industries can enhance their competitive positions in a positive way. That, of course, is the major thrust of the Reagan administration’s economic program—to provide greater incentive to the private sector to increase saving, investment, production, and employment. The effort underway to reduce the burdens of existing regulation and to carefully screen new regulation, surely is a concrete example of positive incentives.

In terms of tax policy, very briefly, our tax program is another key part of the economic policy package. The desire to reduce the scope of governmental intervention by business decisionmaking can be seen in the tax proposals that President Reagan has urged the Congress to enact. Note the clear underlying direction of the administration’s tax program—to reduce the role of the tax collector in business decisionmaking. This basic approach can be seen in the recommendation for a far simpler system of depreciation allowances than the status quo, as well as in the proposed across-the-board reduction in personal income tax rates.

If there is any consistent, overriding theme that is common to all of these proposals for dealing with the Nation’s serious economic problems, it is the compelling need to reduce the intrusion and power of Government in the private sector of the economy. That reduction of the size of Government must involve all of the many dimensions of Government intervention—expenditures, taxes, credit, and regulation. That, in turn, will enable this Nation once again to rely on the private enterprise system as the primary engine of economic growth and progress.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Weidenbaum. And I assume from your statement you do have some additions, and we will include your entire statement, as well as the additions in the record.
[Complete statement follows:]

"ADVANCING ECONOMIC ANALYSIS AND ECONOMIC POLICY"

Statement
of

The Honorable Murray L. Weidenbaum, Chairman
The President's Council of Economic Advisers

I welcome this opportunity to discuss some important economic aspects of current policy developments. This surely is a time that merits careful analysis of impending policy changes, which cover a wide range of monetary, fiscal, and regulatory decisions.

As you are well aware by now, the President's program involves a four-pronged approach to our nation's economic problems. Each of these four elements should be considered a necessary complement to the other three. And each is worthy of extended decision and analysis by itself.

This morning I would like to share with you a few thoughts on particular aspects of the four elements which have not, in my opinion, received the attention they deserve. However, before I turn to each element individually, let me briefly summarize the overall prospective impact of the program. Over the near-term, at least through mid-year, we expect real growth will continue to be very sluggish and that inflation will continue at or near double-digit rates. Thus, the year-to-year real growth in 1981 is estimated at a modest 1.1 percent and the inflation rate (as measured by the CPI) at 11.1 percent.

Assuming prompt implementation of the Administration's program, we then anticipate more rapid growth - over 4% in 1982 through 1986 - and steady reduction in the rate of inflation. While the unemployment rate is anticipated gradually to decline on a yearly average basis during this period, progress will be steady but undramatic, and month-to-month fluctuations in this volatile series should be anticipated.

Monetary Policy

Let me begin with monetary policy, a topic for which this Committee has oversight responsibility. In 1951, the Administration of President Harry Truman reached an understanding with the Federal Reserve Board which was popularly known as the "Accord". The Accord relieved the Fed of its prior commitment to hold interest rates down in order to help the Treasury finance the budget deficit at relatively low costs.

The 1951 Accord and the Congressional hearings dealing with it at that time stressed that the coordinated use of fiscal and monetary policy is necessary for effective government action against economic instability. Direct controls over wages and prices were eschewed and the Federal Reserve was given more flexibility to control the growth of money and credit. Also stressed was the need for consultation between the Administration and the independent Federal Reserve System. These steps marked the beginning of a successful postwar stabilization effort that eventually brought price stability to the U. S. and world economies.

Similarly, President Reagan's first major address to the Congress on economic policy emphasized the need for coordinated fiscal and monetary policy. He stressed -- as Congress recommended 30 years ago -- the close consultation between the independent Federal Reserve and the Administration on all aspects of our economic program.

In an attempt to be as informative as possible about the linkages between monetary policy and the rest of the program, we have included in the White Paper describing the President's program an explicit statement of the rate of monetary growth which would be consistent with the Administration's targets:

"The policies that are proposed in the program will help to advance the efforts of the independent Federal Reserve System. In particular, the substantial reductions of the Federal Government's deficit financing and the achievement of a balanced budget in 1984 and the years that follow should enable the Federal Reserve System to reduce dramatically the growth in the money supply.

To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986."

The White Paper goes on to point out that, with the Federal Reserve gradually but persistently reducing the growth of money and credit, inflation should decline at least as rapidly as anticipated (see attached excerpt). Since interest rate movements are largely a mirror of price expectations, reduction in one will produce reduction in the other.

Although the entire White Paper is a statement of the Administration's economic program, it should be noted that the section on monetary policy benefitted from close consultation with Federal Reserve officials. Subsequent events will enable us to judge the significance and usefulness of this development, especially in terms of the actual ability of the Federal Reserve System to achieve a steady and substantial reduction in the growth of the money supply.

I note that the Chairman of the Federal Reserve Board has announced a 1/2 percentage point reduction in the target ranges for M1A and M1B for 1981. Last year, the Federal Reserve operated at the high end of the target ranges, or slightly above. If the growth of the monetary aggregates were to end the current year at or around the mid-point of the target ranges, that would represent a reduction in monetary growth consistent with the Administration's program. Monetary growth rates fluctuated sharply during the past year -- due in part, no doubt, to independent factors which were difficult to control. Nevertheless, there are improvements in the implementation of monetary policy that can be made, such as those suggested in recently completed studies by the Federal Reserve staff. And we assume the System will continue to seek other ways to improve control procedures. Further, I want to emphasize the need at this time to keep close to the long-run growth targets during the year -- and to try to avoid the kinds of month-to-month fluctuations we saw last year -- even if that means increased interest rate volatility. The objectives of increased confidence and heightened expectations for the future could be served if both fiscal and monetary policies were to be perceived by savers and investors, and financial markets in general, as being significantly more stable and predictable than in the past.

Regulatory Policy

In the various areas of economic policymaking, it is important to learn from the policy experiences of the past. For example, while we concentrate on reforming and improving the existing regulatory apparatus of the Federal Government, we should be alert to the possible imposition of new government burdens on the economic process. In this connection, we should be mindful of the pressures for restricting the flow of trade and investment, both between regions of this Nation and among the nations of the globe. Acquiescence to such pressures would represent a backward step at a time when economic policy is being geared to reducing the degree of government intervention in the market place.

Although we all are aware of the conditions that give rise to these protectionist or interventionist sentiments, surely the worst answer is for governments to erect barriers to commerce. Such a response would not serve the interest of consumers nor would it help to expand productive employment. For too long we have acquiesced in government policies -- like trade restrictions -- that individually add "only" two, or three, or five-tenths of one percent to the consumer price index. We have to stop feeding the fires of inflation with a steady stream of concessions to special-interest groups who are oblivious to the harm done to the American consumer.

Rather, we need to create the type of healthy economic environment in which regions and industries can enhance their competitive positions in a positive way. That, of course, is the major thrust of the Reagan Administration's economic program -- to provide greater incentive to the private sector to increase saving, investment, production, and employment. The effort underway to reduce the burdens of existing regulation and to carefully screen new regulation surely is a concrete example of positive incentives.

Tax Policy

Our tax program is another key part of the economic policy package. The desire to reduce the scope of governmental intervention by business decisionmaking can be seen in the tax proposals that President Reagan has urged the Congress to enact. Note the clear underlying direction of the Administration's tax program -- to reduce the role of the tax collector in business decisionmaking. This basic approach can be seen in the recommendation for a far simpler system of depreciation allowances than the status quo, as well as in the proposed across-the-board reduction in personal income tax rates.

Budget Restraints

Monetary, tax, and regulatory reforms are vital parts of our economic program. The leading edge, of course, is the program of budget restraint. It is important to understand that the effort to control the growth of government spending cannot be a one-shot affair. We must expect pressures for

greater government spending to arise continually. Thus the advocates of economy in government must constantly be on their guard. What is so heartening in this Administration is the President's consistent response to those pressures for more spending -- to redouble our efforts to achieve our targets for limiting Federal spending and reducing the budget deficit.

Let me try to strike a note of realism on the basis of many years' involvement in budget matters. The estimates of future expenditures are always subject to periodic revision. Many factors affect the rate at which appropriated funds are expended: administrative procedures, availability of resources in the private sector, price changes, demands by those "entitled" to certain government benefits, etc. Interestingly, not all changes in expenditure estimates are necessarily in one direction. Over the years we have seen downward revisions as well as upward changes.

Overriding Theme

If there is any consistent, overriding theme that is common to all of these proposals for dealing with the Nation's serious economic problems it is the compelling need to reduce the intrusion and power of government in the private sector of the economy. That reduction of the size of government must involve all of the many dimensions of government intervention -- expenditures, taxes, credit, and regulation. That, in turn, will enable this Nation once again to rely on the private enterprise system as the primary engine of economic growth and progress.

Attachment -- excerpt from The White House, *America's New Beginning: A Program for Economic Recovery*, Washington, D. C. U. S. Government Printing Office, February 18, 1981.

VI. Controlling Money and Credit

Monetary policy is the responsibility of the Federal Reserve System, an independent agency within the structure of the government. The Administration will do nothing to undermine that independence. At the same time, the success in reducing inflation, increasing real income, and reducing unemployment will depend on effective interaction of monetary policy with other aspects of economic policy.

To achieve the goals of the Administration's economic program, consistent monetary policy must be applied. Thus, it is expected that the rate of money and credit growth will be brought down to levels consistent with noninflationary expansion of the economy.

If monetary policy is too expansive, then inflation during the years ahead will continue to accelerate and the Administration's economic program will be undermined. Inflationary psychology will intensify. Wages, prices, and interest rates will reflect the belief that inflation — and the destructive effects of inflation — will continue.

By contrast, if monetary policy is unduly restrictive, a different set of problems arises, unnecessarily aggravating recession and unemployment. At times in the past, abruptly restrictive policies have prompted excessive reactions toward short-term monetary ease. As a result, frequent policy changes can send confusing signals, and the additional uncertainty undermines long-term investment decisions and economic growth.

With money and credit growth undergoing steady, gradual reduction over a period of years, it will be possible to reduce inflation substantially and permanently. In this regard, the Administration supports the announced objective of the Federal Reserve to continue to seek gradual reduction in the growth of money and credit aggregates during the years ahead. Looking back, it seems clear that if a policy of this kind had been successfully followed in the past, inflation today would be substantially lower and would not appear to be so intractable.

Until recently, the Federal Reserve had attempted to control money growth by setting targets for interest rates, particularly the rate on Federal funds. Experience here and abroad has shown repeatedly that this interest rate management approach is not sufficient to achieve reliable control. Mistakes in predicting movements in economic activity or tendencies on the part of policymakers to avoid large interest rate fluctuations can lead to undesirable gyrations in the rate of money growth.

Under new procedures the Federal Reserve adopted in October 1979, the Federal Reserve sets targets for growth of reserves considered to be consistent with the desired expansion in the monetary aggregates. Interest rates are allowed to vary over a much wider range in response to changes in the demand for money and credit. A number of factors — such as the introduction of credit controls and their subsequent removal and frequent shifts in announced fiscal policies — have contributed to pronounced fluctuations in interest rates and monetary growth over the past year. At the same time, we need to learn from the experience with the new techniques and seek further improvements. The Federal Reserve has undertaken a study of last year's experience. We look forward to the results and encourage them to make the changes that appear warranted.

In that connection, success in meeting the targets that the Federal Reserve has set will itself increase confidence in the results of policy. Otherwise, observers are likely to pay excessive attention to short-run changes in money growth and revise anticipations upward or downward unnecessarily. Without confidence in the long-term direction of policy, such short-run changes may lead to unwarranted but disturbing gyrations in credit, interest rates, commodity prices, and other sensitive indicators of inflation and economic growth.

Better monetary control is not consistent with the management of interest rates in the short run. But, with monetary policy focusing on long-term objectives, the resultant restraint on money and credit growth would interact with the tax and expenditure proposals to lower inflation as well as interest rates.

The Administration will confer regularly with the Federal Reserve Board on all aspects of our economic program. The policies that are proposed in the program will help to advance the efforts of the independent Federal Reserve System. In particular, the substantial reductions of the Federal Government's deficit financing and the achievement of a balanced budget in 1984 and the years that follow should enable the Federal Reserve System to reduce dramatically the growth in the money supply.

To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986.

With the Federal Reserve gradually but persistently reducing the growth of money, inflation should decline at least as fast as anticipated. Moreover, if monetary growth rates are restrained, then inflationary expectations will decline. And since interest rate movements are largely a mirror of price expectations, reduction in one will produce reduction in the other.

The CHAIRMAN. As you have described it, the administration's economic program consists of four integrated parts— a reduction in the growth of Federal expenditures, a reduction in Federal tax rates, relief from Federal regulatory burdens, and a monetary policy on the part of the Federal Reserve System which is consistent with those policies.

TYPES OF COORDINATION

Can you describe for the committee, what type of coordination has been accomplished between the administration and the Fed to insure that we do have consistent fiscal and monetary policies, yet preserving the independence of the Fed?

Dr. WEIDENBAUM. Yes. Mr. Chairman, first of all, at the procedural or institutional level, the President in his very first week in office held a lunch meeting with the Chairman of the Federal Reserve Board and the troika, the three key economic policy advisers, the Secretary of the Treasury, the Director of the Budget, and Chairman of the CEA. It was, as I described it subsequently, a "get-to-know-you" session.

What I think was very significant was the President opened that lunch meeting, restating his commitment to the independence of the Federal Reserve. We then went on to point out the two-way street, and we have done this subsequently in a variety of public forums, as well as private meetings, that there is a two-way street. There is an important responsibility on the part of the executive branch and the legislative branch, for that matter, to conduct the kind of fiscal policy which enables the Federal Reserve to maintain a monetary policy to fight inflation. It is extremely difficult for

example, for the Federal Reserve to conduct a coherent, consistent monetary policy, at a time when, as in the previous administration the President urges the imposition of credit controls, and shortly thereafter, eliminates the credit controls.

Those arbitrary actions make it extremely difficult to conduct Federal Reserve policy. However, we think the fiscal policy that we have designed—steady, predictable reduction in the growth of Government spending, steady, predictable reduction in the use of the off-budget credit mechanisms, our plan to reduce and eliminate deficit by fiscal year 1984, and to keep the budget in balance in the years thereafter—is our fundamental contribution to this two-way street.

Periodically, the Chairman of the Council of Economic Advisers meets with the Chairman of the Federal Reserve Board. The members of the Council of Economic Advisers meet with the members of the Federal Reserve Board. The Secretary of the Treasury and his colleagues have similar relationships with the Chairman and members of the Federal Reserve Board.

Communications are frequent. They are close. But, of course, we are mindful of the different responsibilities that we have. So we feel free to communicate our views and certainly we welcome the advice that the Federal Reserve Board has given over the years on fiscal policy. I think sometimes that has been very useful advice. And we think the flow of advice also should be a two-way street.

So as I point out in my statement, we have some ideas on targets for monetary growth which we have stated both in the white paper and in my statement this morning.

The CHAIRMAN. Are the Federal Reserve's monetary aggregate targets for 1981 consistent for the administration's program.

Dr. WEIDENBAUM. Yes, they are.

The CHAIRMAN. And even in light of the administration's assumption that the money growth rates in 1986 will be reduced to one-half of what they are in 1980?

Dr. WEIDENBAUM. Yes, Mr. Chairman, I would expect that most of that growth, that most of the reduction in the growth rate in the money supply would occur between now and 1984. That is the year of our target to balance the budget. I do think that monetary policy and fiscal policy are now on the same path.

The CHAIRMAN. Well, the Fed didn't meet its targets for 1980, even though they were rather broad ranges. Their ranges for M-1B in 1981 are one-half percent below the actual M-1B growth rate for 1980. This apparently takes into account projected shifts caused by NOW accounts. Does the administration's plan to reduce M-1B by one-half by 1986 take into account NOW shifts?

Dr. WEIDENBAUM. The plan to reduce M-1B by one-half is, of course, the Federal Reserve's plan, their determination.

In my statement I refer to operating closer to the middle of the range rather than the high end of the range, as was the case last year. And should that be the case, I think that there is adequate allowance there for the institutional shifts, that is, the NOW accounts.

The CHAIRMAN. When Chairman Volcker testified last week, he was generally supportive of the administration's program; however, the Fed's economic projections for 1981 are not entirely consistent

with the administration's. For example, the Fed predicts the unemployment rate will be between 8 and 8½ percent, whereas, the administration projects 7.7 percent rate. The Fed estimates that real GNP will increase or decrease in the minus 1½ to plus 1½ percent, while the administration projects a real GNP growth of 1.4 percent. In other words, the administration paints a rosier picture than the Fed.

How do you respond to these differences in projections?

Dr. WEIDENBAUM. I must say, I find the two sets of numbers quite close.

The CHAIRMAN. Close enough for Government work? [Laughter.]

Dr. WEIDENBAUM. I would say, were I still a private macroeconomic forecaster, which I have been for many years, that both of these were within the forecasting range variable, frankly.

BUDGET CUTS ACCOMPANIED BY TAX CUTS

The CHAIRMAN. Chairman Volcker also indicated last week that he wants to see budget cuts accompanied, but not preceded, by tax cuts. Do you agree that they should proceed in tandem?

Dr. WEIDENBAUM. I think there is a compelling case for the two to proceed in tandem. I should note that when a few years ago the Senate Finance Committee asked me that question, I had a different relationship between the cart and the horse. I urged the Senate Finance Committee to enact multiyear tax rate cuts first, so that the long-term budget planning on the expenditure side could be made in the context of a lower set of tax rates, and therefore, thereby avoiding the kind of budget deficits that arise when the process is reversed, when appropriations are made in the context of a higher expected set of tax rates. Then the Congress cuts taxes, and then we wind up with a larger budget deficit.

I think that at this point, wisdom is on the side of the two going in tandem, but I certainly wouldn't delay the tax cuts. I think the state of the economy makes prompt action highly advisable.

The CHAIRMAN. What if the tax cuts were passed and the budget cuts were not, what would you advise the President to do? Go ahead and accept the tax cuts, without the expenditure cuts to go with them?

Dr. WEIDENBAUM. Well, the President, as you know, has the very wise attitude of not making a decision on a bill until it reaches his desk. I obviously think that is the proper position to take. I think frankly, Mr. Chairman, the onus is on us to convince the Congress of the strong desirability of accelerating action on both the tax and expenditure sides of the budget, so that the two truly do go in tandem.

The CHAIRMAN. Chairman Volcker did not appear fully supportive of the administration's tax cut proposals. He supports tax cuts in general, but he kept stressing in his testimony that business incentives were the critical ingredients for economic growth. Would it be better to target more of the tax cuts toward the business side rather than the personal tax cuts?

Dr. WEIDENBAUM. I very frankly strongly favor the distribution between personal tax cuts and business tax cuts that we have arrived at. The reason I say that is my major concern about the flow of savings to finance badly needed expansion in business in-

vestment. I would like to see the saving pool in this country come in much larger proportion from families and individuals, rather than relying too heavily on business.

I think it is a question of balance, to be sure. We have certainly the largest business tax cut, I believe, ever proposed, in the form of our liberalized depreciation allowance proposal. But I think it is vitally important to raise the now depressed—and 5 percent is a depressed rate—of consumer savings. I think it is vitally important to raise that, hopefully, to the traditional 7 percent, which has been the historic norm. I think we have, in many regards, a far healthier economy from our package than one that relied exclusively on the business sector to generate savings for the private enterprise system.

The CHAIRMAN. Well, my time is up, but I would just like to have one follow-on, with Senator Proxmire's permission. I would agree with you that individual savings are highly important, and although I favor the President's tax package, I am not able to determine how much, or if there will be significant savings as a result of the individual tax cuts. My question is why did we not consider some specific individual tax cuts that would directly generate savings, such as an exemption on the first \$1,000 on individual returns and \$2,000 on a joint return on savings accounts. And then in order to get the tax cut and the tax benefit, people would save to do that.

Dr. WEIDENBAUM. Well, I can give you my response. And it really gets down to my philosophy of government. As an economist, I very much want to see a larger level of saving, but I don't really want the Federal Government to tell people directly or indirectly that they have to save more.

I would like to see the creation of an economic environment which gets people voluntarily to save more, and I think the real answer there is to reduce the inflation, and even more important, inflationary expectations, which I think are at the heart of the depression in the savings rate.

The CHAIRMAN. Well, I would agree with you, but in the short run, it would seem to me some more specific incentives for savings might be helpful.

My time is up, and I don't want to intrude more on Senator Proxmire's time.

Senator PROXMIRE. I believe you and the Reagan administration are calling for both more conservative fiscal and monetary policy. I applaud that. I think you are absolutely right.

I think it will slow inflation if you persist in it. But you contend this conservative policy will also stimulate the economy and will provide for a big increase in growth, to go from 1 to 4 percent next year and even higher levels of growth in succeeding years.

What is there in our historic experience to persuade us that if we only jam on the monetary and fiscal brakes that the economy will grow more rapidly? That contradicts the usual assumptions.

Dr. WEIDENBAUM. I would use somewhat different language in a term describing the impact.

Senator PROXMIRE. All right. Ease down on the brakes then.

Dr. WEIDENBAUM. I would use the term incentives to describe the impact of our program on the capacity of the economy. I think it is

vitaly important to increase the supply side of the economy to provide the necessary incentives to increase saving and investment.

Senator PROXMIRE. Well, I understand the theory. What I am asking for is historic experience that would indicate that this kind of policy will work either here or in any other country.

STOP AND GO POLICY

Dr. WEIDENBAUM. First of all, I think what is quite clear is the traditional stop-and-go policy has not worked. If anything the risks are in maintaining the status quo. And I urge you to compare our tax proposals, for example, with early tax proposals which were much more consumption oriented.

Senator PROXMIRE. Let me just interrupt again. I am not challenging that this is the right policy. I think this is a policy that is necessary and in the long run will result in growth. I am just concerned that you are giving us such an optimistic scenario that there is going to be bitter disappointment next year when we don't get 4 percent growth. We may not get it, and then the feeling will be that the program is a failure.

I would hope that you would look at it on a long-term basis and recognize that it may take 2 or 3 or 4 years before you can bring prices down and get the economy on a sounder, more stable basis and then get the growth.

You are talking about growth of 4 percent next year.

Dr. WEIDENBAUM. Yes, I am, and I think that is badly needed. And very frankly, no disrespect to the distinguished Senator, but what you describe sounds like these stop-and-go policies which have been tried so frequently in the past, and that is, concentrate only on one of those objectives. Either concentrate on fighting inflation or concentrate on expanding growth rate and reducing unemployment.

I think if there is any lesson from the American economic history in recent decades it is the stop-and-go policy doesn't work and we need a comprehensive sustainable policy that simultaneously fights the interrelated twin evils of high inflation—

Senator PROXMIRE. I will ask my question again. Can you give me any historic experience which would show that this kind of policy has worked in the past anywhere, here or in any other country?

Dr. WEIDENBAUM. Well, first of all, there are periods both in the United States and in Western Europe where we have seen substantial reduction.

I will be glad to provide historical detail for the record.

[The following information was received for the record:]

EXAMPLES OF LOWER INFLATION AND HIGHER GROWTH IN SELECTED COUNTRIES

[Percent change, year-over-year]

	Inflation (Consumer Price Index)	Real growth (gross domestic product)
Germany:		
1975.....	6.0	- 1.8
1976.....	4.5	5.2

EXAMPLES OF LOWER INFLATION AND HIGHER GROWTH IN SELECTED COUNTRIES—Continued

(Percent change, year-over-year)

	Inflation (Consumer Price Index)	Real growth (Gross domestic product)
Italy:		
1975	17.0	-3.6
1976	16.8	5.9
Canada:		
1975	10.8	1.1
1976	7.5	5.8
Japan:		
1971	6.1	5.1
1972	4.5	9.3
1975	11.8	1.4
1976	9.3	6.5
1977	8.1	5.4
1978	3.8	5.9
United Kingdom:		
1977	15.8	1.0
1978	8.3	3.6
United States:		
1971	4.3	13.4
1972	3.3	15.7
1975	9.1	1.1
1976	5.8	15.4

¹ Gross national product.

Dr. WEIDENBAUM. We have had periods where we have seen strong growth rates accompanying reductions in the inflation rate. There surely is evidence of that.

Senator PROXMIRE. I hope you can supply that for me, because again I think there seems to be a contradiction that you can have both a growth rate accompanied by a fall in the rate of inflation, particularly the kind of fall that you have predicted.

Dr. WEIDENBAUM. Very frankly, Senator, there used to be a concept called the Phillips Curve, that there was a trade-off between inflation and unemployment. I think that idea has been thoroughly discredited, because we have seen the obverse of that. We have seen rising inflation and rising unemployment.

Senator PROXMIRE. We have seen that, but we haven't seen the reverse.

Dr. WEIDENBAUM. This is precisely why I am here to urge the Congress to adopt a true innovation in economic policy, a break with the past.

Senator PROXMIRE. Now this morning's New York Times has an interesting article which you may or may not have read, talking about the Reagan administration having a split economic team, a sharp division. It is an article by Steve Ratner. He is an outstanding reporter.

Dr. WEIDENBAUM. I share that view.

PRAGMATISTS VERSUS THEORISTS

Senator PROXMIRE. He reports that there is a rather disturbing division here, that you and Mr. Stockman are lined up on one side as the pragmatists versus the so-called supply side theorists in the

Treasury Department and elsewhere. And he gives a couple of examples of how you have had clashes and you prevailed, but indicating that there is this division, No. 1, on forecasts; that you and Stockman were persuasive in denying the so-called supply siders, Norm Ture and some of the others, their desire to come forward with a much more optimistic forecast. In the second place, that they had a much more vigorous attack on the Fed, the Federal Reserve Board and its policies, and you softened that. And my question is, What substance is there in this kind of speculation?

Dr. WEIDENBAUM. Very frankly, it has not been my policy to comment on such speculation, but let me describe the situation as clearly as I can.

First of all, a good deal of staff work inevitably is done prior to the development of the final forecasts that are used and in the final language that appears in such official documents as the white paper. And surely some of those staff interpretations were more optimistic or some less optimistic than the ones finally determined. That is par for the course.

I can say this, that the economic projections used in the President's February 18 message to the Congress represent the position of the administration. I believe they are a reasonable, doable, realistic scenario of the economy.

They are based on a major supply side oriented tax cut. In fact, as you recall my answer to one of your own questions, I couched my response in what I truly believed to be the proper relevant supply side orientation, which is the essence of the tax program.

Senator PROXMIRE. Well, let me just say I am not trying to get into this because of the gossip about personalities. What I am concerned about is particularly the latter part. But I understand there were three positions with respect to what the administration might do as far as monetary policy is concerned.

One was quite a stringent position taken by people in the Treasury Department that the administration's position should be quite critical of the Fed. And second is that that should be toned down, that you should have what you finally ended up with, a chapter on the Federal Reserve Board and the policies that should be followed. And a third policy that Chairman Volcker urged, that you not have a chapter on the Fed policy, and that he urged you to take it out, but that he failed and you put it in anyway.

Dr. WEIDENBAUM. Let me assure you that the Secretary of the Treasury, the Director of the Office of the Management and Budget, and the Chairman of the Council of Economic Advisers have a very strong concurrence on that white paper, on the material in that; that the various staffs available to us provide us advice, guidance, and suggestions.

We have a responsibility. We feel free, of course, to accept and project or to modify or ignore the various staff inputs available to us. But the President has given us the responsibility to be his principal economic advisers and we do not shy from that responsibility. And I will take personal responsibility for the preparation of that white paper.

Senator PROXMIRE. Yes. But my question related also to the position taken by the Chairman of the Federal Reserve Board, Mr.

Volcker. He was reported to have requested that you not have that chapter in your paper.

Dr. WEIDENBAUM. I obviously was anxious to get the informal views of the Chairman of the Federal Reserve Board, and obviously we gave them very considerable weight. But this is not a joint statement. The white paper is the statement of the Reagan administration's economic program, and I urge you to take it on that basis.

Senator PROXMIRE. Well, I understand. At any rate you did not accept the request of the Chairman of the Federal Reserve Board. You included—

Dr. WEIDENBAUM. There was no official request, you appreciate.

Senator PROXMIRE. No official request, but there was a desire expressed by the Chairman according to this reliable report.

Dr. WEIDENBAUM. Well, as I say, I would not comment on this informal discussion, because very frankly if I did that might reduce the promptness, the usefulness of such discussions in the future. And I am delighted that we have a continuous interchange of ideas and comments. I think the acid test of our relationship is the strong support that the Federal Reserve Chairman has given to the Reagan administration's economic program, which I find very heartening.

Senator PROXMIRE. Now, as you may know, last summer Dr. Burns announced the formation of a committee to fight inflation, consisting of seven eminent Democrats and six eminent Republicans, including Dr. Burns, former Treasury Secretary Blumenthal, Frederick Demming, Douglas Dillon, Paul McCracken, George Mahon, William McChesney Martin, Wilbur Mills, George Schultz, William Simon, and John Williams.

COMMITTEE RECOMMENDATIONS

They proposed a series of steps to fight inflation, some of the which the administration is following in your policies but three others which you are not, and one is a balanced budget, which they gave very high, the top priority, No. 1.

You are not going to balance the budget this year, next year or 1983, or maybe in 1984.

Another was, they recommended we schedule reductions in business taxes in each of the next 5 to 7 years and reduce the capital gains tax. They said nothing about the personal income tax cuts, and since then the committee has indicated, the Burns committee, that they feel that they should take a back seat to balancing the budget, very much of a back seat.

And finally, they recommended a series of measures to increase productivity, including increased research and development, improved manpower training, productivity councils, due to individual plants, none of which the administration seems to be interested in pushing.

Why is the administration not supporting what seems to be a logical and very broadly supported anti-inflation effort?

Dr. WEIDENBAUM. First of all, Senator, my understanding is that much of our program moves in the very same direction as that recommended by that distinguished group; in fact, many members of that group have warmly endorsed our program.

To be specific, we share their concern about balancing the budget. We inherited a budget deficit for the current year in an order of magnitude of \$60 billion. It is our determination not just to seek a one-shot balanced budget, but to reduce and ultimately by 1984 eliminate deficit spending as a way of life in this Nation.

So I concur with their view on balanced budgets in the strongest way.

Now, on the reduction of business taxes. Again, we have recommended the most ambitious program of business tax reduction ever submitted to the Congress, and the enactment of our proposals on individual tax rates will effectively reduce the capital gains tax.

And finally, we strongly share their concern with productivity. And that is a central feature of our very ambitious regulatory relief effort, as well as the expectation behind so much of the justification for the individual tax relief to encourage a higher level of saving, a higher level of investment and hence a restoration of our traditional strong growth and productivity.

So I find, by and large, the statements of that distinguished committee very supportive of our approach to economic policy.

The CHAIRMAN. Senator Schmitt?

Senator SCHMITT. Thank you, Mr. Chairman. And welcome, Dr. Weidenbaum. I am very happy to see you in the position you are holding and look forward to working with you in the future.

One of the puzzles, of course, of this whole business is: How do you monitor and in fact anticipate changes in money supply under current policies so that you can modify that policy and improve the monetary situation in the country?

For example, I think we know historically that there is a direct correlation in retrospect between the rate of growth of the money supply, and the excess of that growth in relation to the value of goods and services. Furthermore that difference is a close measure of the inflation rate some 12 to 18 months prior to the measurement of that difference, if I have made myself clear.

Senator PROXMIRE. Yes, sir.

Senator SCHMITT. I think historical analysis is quite persuasive, but our problem, of course, is how to deal with that fact in the present and in the near future. Do you have any suggestions on how can we make better use of the knowledge that there is a direct correlation—despite the fact that at any instant of time we have trouble seeing just what is happening within the money supply and its affects upon the value of goods and services?

Dr. WEIDENBAUM. Senator, let me make an attempt to be helpful, and you may want to follow up your original question.

I am still mindful of the concern about high interest rates these days. And so many people, when they think of monetary policy, they think of high interest rates. I think modern economic analysis is quite clear, that the genesis of high interest rates is high inflation and expectations of high inflation. And that is the vital link.

It is the excessive growth in the money supply that is at the heart of the inflation problem facing our Nation. Therefore, to deal with high interest rates, to deal with high inflation and the expectations thereof, it is vital to embark on a policy to maintain a policy of predictable, steady and moderate growth in the money supply.

However, it is not a matter of looking at the money supply hourly or daily or taking the temperature even weekly. I think we need—

Senator SCHMITT. That can be counterproductive, can't it?

Dr. WEIDENBAUM. Yes, it can, to the extent people do that. I think we need to look at money supply trends over a broader period of time by quarters, by half-years, and also annually. I think the approach to monetary policy is truly vital, that is concern over the growth of the money supply. There are various measures. I think given the institutional shifts in the NOW accounts, and the money market mutual funds, for example, a battery of indicators, including the monetary base, is needed to really keep abreast of developments in that aspect of the economy.

I think, however, what we need to do, if I understand the thrust of your question, Senator Schmitt, is to monitor the changes in these key monetary aggregates, including monetary base, to see the underlying direction of movement.

This is why I find Chairman Volcker's statement so heartening that the Federal Reserve is moving down their target range for the growth in money supply. That is a very clear signal of a directional change, so that, given steady decline in the growth rate of the money supply, we now will have the basis, coupled with the steady reduction in deficit spending and deficit financing, we now will have the basis for a less inflationary economy.

Senator SCHMITT. Dr. Weidenbaum, I appreciate what you have said and agree with it. But the difficulty that we have, is it not, that if we achieve say, today, within the quarter, a measurable decrease in the rate of growth of the money supply it would take something like 12 to 18 months to, on an historical basis, see a measurable decrease in the inflation rate? This would be a consequence of that decrease in the rate of growth in the supply, assuming a constant production of a constant rate of growth of the value of goods and services. I believe the historical evidence is, that there is about that kind of lag time.

The Congress has a terrible time dealing with the kinds of situations in which there is that much inertia built into the economy.

Dr. WEIDENBAUM. It has been a while since I studied the question of lags in monetary and fiscal policy, but I have studied it on earlier occasions. Very frankly, I didn't see in my studies any clear consensus as to the length of those lags. I would expect, very frankly—

Senator SCHMITT. But there is a lag.

Dr. WEIDENBAUM. Yes, but it may be shorter in the coming year because so much of the impact is on expectations.

Senator SCHMITT. The psychology thing?

Dr. WEIDENBAUM. Yes, that can turn around quite quickly. Very frankly, I think financial markets at home and abroad are waiting for a signal, not a signal involving talk by the administration but, frankly, action by the Congress. When the Congress enacts that major package of tax reduction along with expenditure reduction, the largest program of expenditure reduction ever, that will be a powerful signal to financial markets, to investors, and to savers, that there is a seed change in the inflationary environment in this

Nation. And I think that seed change can occur far more quickly than the traditional lags would indicate.

MEASURING THE MONEY SUPPLY

Senator SCHMITT. A final question. Do you think that the normal means of measuring the money supply, whatever M you take, takes into account the actual availability of money? I mean to include the availability of credit that will affect the effective money supply, if I may use that term, versus the actual number of dollars that are out there in the market.

Dr. WEIDENBAUM. This is a subject, Senator, that I have written on as a private scholar, pointing out the need to constantly update our measures of the money supply as the institutional changes shift. Specifically the growth of money market mutual funds. The movement of NOW accounts. This is why I refer to a battery of aggregates rather than concentrating on any single one.

I have been urged by specialists in this area to give special attention to the monetary base as the measure which is least subject to influence by these changing institutional structures of our financial markets.

Senator SCHMITT. Changes, say, that result in money moving more rapidly from transaction to transaction which can have the effect of increasing the effective money supply at least temporarily?

Dr. WEIDENBAUM. Yes, sir, which, of course, also points out why we need to look at velocity as well as—

Senator SCHMITT. Well, that is basically the term I was using, but it is not used very commonly. And you think, though, that velocity is important particularly for shorter term examination of what is happening with the economy?

Dr. WEIDENBAUM. Yes, sir.

Senator SCHMITT. I don't think there is any historical evidence that velocity has any long-term effect, and maybe that is understandable.

Dr. WEIDENBAUM. It is certainly very difficult to predict velocity and changes in velocity. I think people who have tried to do that are very well aware of it.

Senator SCHMITT. Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Weidenbaum, how good is the CPI as an indicator of real inflation?

CPI INADEQUATE MEASURE

Dr. WEIDENBAUM. It is truly an inadequate measure. There are many shortcomings to the CPI. And the housing component certainly is the most serious one.

No doubt, the chairman is aware of the experiments, on the part of the Bureau of Labor Statistics, with alternative concepts of the CPI. We have very limited data for these experimental indexes.

I think it would be very worthwhile to study in depth some of these alternative indexes, to see whether the CPI should be revised. But, given the extensive use of the CPI in collective bargaining agreements and business agreements and government activities, I

think the change should be made very carefully, on a totally non-partisan basis.

I do point out that the relationship between the CPI and what we call the GNP deflator, the more comprehensive measure of price changes in the economy, is a changing one.

That is, in recent years, given high interest rates or rising interest rates, the CPI has gone up much faster than the GNP deflator.

If you notice, in our economic projections accompanying the White Paper—or as part of the White Paper—we show, in the 1980's, as we approach 1986, that the CPI would be, under our scenario, rising less rapidly than the GNP deflator, precisely because we would anticipate interest rates to be coming down very substantially.

So, in recent years, the CPI has overstated the rate of inflation.

I could see a period in 1984, 1985, 1986 where the CPI would understate the degree of inflation. I think we need to be mindful of that, in making any shifts.

The CHAIRMAN. Well, everybody seems to agree that it is inaccurate, and that it has such a dramatic effect, either way. As you say, in the future, it may go the other way. But, certainly it has in it a lot of automatic escalators—COLA's and things of that nature.

It is contributing to the inflationary problem, certainly, to the Government spending in the period you have just talked about.

It would seem to me that the administration ought to look very carefully at making some changes—and I certainly have none to recommend. I am not an economist. I don't know what you would do with it.

But I certainly think that, again, where everybody thinks it is so inaccurate, why are we basing such a tremendous amount of shift—in not only the private sector, but in Federal spending—on what everybody agrees is an inaccurate measure?

Dr. WEIDENBAUM. Mr. Chairman, if we really had—and when I say “we,” I mean Government extending over several administrations—had adequate foresight, the Consumer Price Index should have been modified very fundamentally, many years ago.

One of the problems, as I see it now, is a question of equity. Programs have been indexed to the CPI—have been overindexed, so to speak. Should the program of the administration succeed—which I expect to be the case—that will be compensated in the future.

Now, if we suddenly shift the price indices, that compensation—that offset—won't occur. So, I think we need to exercise great care in the timing of the change, particularly from the viewpoint of minimizing the drain on the Treasury from these indexed programs.

The CHAIRMAN. The leading indicators are down. Certain officials at OMB have anticipated a recession in the middle quarters of 1981.

What is your opinion?

Dr. WEIDENBAUM. We are in a soft economy. That is very clear. There is no single quarterly pattern that emerges from our year-to-year forecasts. There are a variety of quarterly patterns which are consistent with our very modest 1-percent growth in real GNP in 1981.

I am not prepared, at this point, to provide a quarterly forecast. I would say that the softness in the economy is a compelling reason for rapid action by the Congress on the tax and expenditure parts of the program. Because the upturn that we are forecasting in the economy is based on the enactment of our program.

I would expect that the economy, in the absence of the enactment of the Reagan administration program—that the economy would stay soft and, perhaps, worsen.

The CHAIRMAN. And your forecast would be out the window?

Dr. WEIDENBAUM. Our forecast assumes, very clearly—and we state that—the enactment of President Reagan's program.

The CHAIRMAN. In October of 1979, the Fed announced a change in its monetary policy implementation, away from fine tuning interest rates, to maintaining a closer watch over the money supply.

This past year has seen both interest rates and monetary aggregates go up.

What is your opinion of the effectiveness of the Fed's change in techniques?

Dr. WEIDENBAUM. Hope springs eternal.

I hope that, in the year ahead, the Federal Reserve System has better results. I think it was a fine statement of policy.

I think it is a question of implementation.

But, Mr. Chairman, I think we have to be mindful of the difficulties put in the way of the Fed in carrying out those policies. The difficulties that I referred to earlier, were essentially not of their doing. That is, looking back at 1980, the large budget deficit that had to be financed, the growing off-budget agencies of the Federal Government that had to be financed, plus the stop-and-go effect of the imposition and the elimination of the credit controls.

All that invariably, inevitably, made the Federal Reserve's role in carrying out its policies far more difficult. And I think, needlessly so.

The CHAIRMAN. Much discussion has taken place over the economic condition of the United States, compared with other Western industrialized countries.

I would appreciate any comments that you would like to make, on the techniques of central banks, in West Germany and some of the other countries that have been discussed so much in this committee; compared to the monetary policy technique of our own Fed.

Dr. WEIDENBAUM. Very frankly, Mr. Chairman, I'm not expert in those matters.

But, from my very modest observations, it is quite clear that monetary policy—West Germany, I think, is a cogent example—monetary policy quite clearly is central to keeping down the inflation rate. That is the lesson that I get from looking at the German economy.

Of course, they, in turn, received a very powerful and difficult lesson in inflation. And I hope that we can learn from their experience, in avoiding undergoing their sad experiences.

REVIEWING OPERATIONAL POLICIES

The CHAIRMAN. Another issue that has come up in this committee's hearings—both in January, with Chairman Volcker, and again a couple of weeks ago—has been the Fed's apparent reluc-

tance to change some of its operating techniques. And I'm specifically talking about lagged reserve accounting and the below-market discount rate.

Chairman Volcker did announce in the committee hearings last week that the Fed is reviewing the need to change those operational policies.

In your opinion, would a contemporaneous reserve accounting market-related discount rate be beneficial?

Dr. WEIDENBAUM. Mr. Chairman, mindful of the independence of the Federal Reserve System, I would not, in my present position, make such specific recommendations.

I do state, in my—

The CHAIRMAN. I would. And I have.

Dr. WEIDENBAUM. I should hope you do, sir.

But, in my position, I merely acknowledge the staff studies, and point out our expectation that the Federal Reserve Board—the Federal Reserve System—will give serious consideration to those policies, for changing its procedures.

But that, of course, is a judgment on the part of the independent Federal Reserve System. We wish them well in their deliberations.

The CHAIRMAN. Senator Proxmire?

Senator PROXMIRE. Dr. Weidenbaum, the President is asking for budget cuts of \$41 billion. Is that right?

Dr. WEIDENBAUM. That is the present number.

He has given us a very specific set of marching orders, you understand, Senator. And that is to keep the lid on spending, to attain our deficit reduction objectives. So that the efforts to find additional economies in Government can surely continue unabated.

Senator PROXMIRE. The arithmetic of this adds up something like this: \$41 billion in budget cuts for fiscal year 1982; a tax cut of \$52 billion; defense outlays will increase by \$7 billion, maybe more.

So, we start with a deficit this year of \$50 billion; and we add the arithmetic here—\$65 billion to \$70 billion. Even with the most optimistic assumptions for stimulus, growth, et cetera, it seems we're looking at a deficit in 1982 of \$40 billion or \$50 billion.

Do you think that deficit will help us to flight inflation?

Dr. WEIDENBAUM. Senator, I would have liked to have seen a smaller deficit.

I think, however, given the needs of this Nation for a stronger national defense; given the needs of this Nation to maintain what we call the "safety net" of essential programs for the needy; given the many responsibilities that the Congress has given the executive branch—that the budget estimates that we have presented—and which, on March 10 we will present in far more detail—represent the most responsible program of budget restraint that we could develop.

Senator PROXMIRE. Now, supposing things don't work out as you would like them to work out. Supposing, instead of inflation moderating next year, it stays at the present level and maybe increases some—it is at 11 percent or 12 percent as your expectation for this year. Say it goes to 11 percent or 12 percent next year.

Will you persist, under those circumstances, in asking for the big personal tax cut that you are requesting?

Dr. WEIDENBAUM. Well, first of all, it is our expectation that the Congress this year will approve the 3 year personal tax cut; and that that trend will set in motion the expansion of the supply capacity of this Nation, which is the basic way of dealing with the inflation.

That is, increasing the production of goods and services.

Senator PROXMIRE. I stand corrected. That is right. I understand that. And, of course, we have to act this year.

Doesn't it seem wise, however, in view of what many would view as the fragility—or the insubstantial nature—of forecasts generally—even your forecasts—the great possibility that we might continue to have inflation at double-digit levels?

Wouldn't it seem wise, under those circumstances, to enact a 1 year tax cut and see how it works? And then see if we could afford to go ahead with the second installment?

Dr. WEIDENBAUM. Senator, if this was the traditional Keynesian demand-side type tax cut, I would say it shouldn't be a 3 year tax cut. In fact, it shouldn't be a 1 year tax cut.

But the substantial reduction in marginal rates, which is the essence of the supply-side-oriented tax cut, I think is essential to expand employment, savings, and investment. And I urge you to look at the major extent to which the budget deficit rises, from the expansion of those entitlement programs, which are paced by the state of the economy.

So, to the extent that the business and personal tax cuts together can succeed in providing incentives for a larger, a faster rate of economic growth, not only will that expand the tax base, bringing in more revenues; but it simultaneously will reduce the need for these spending programs. And, hence, they will reduce the inflationary pressures, on both the expenditures side and the revenues side.

Therefore, I urge you, as part of our anti-inflationary strategy, to promptly act on the tax cuts for all 3 years, at the outset.

And, as I stated earlier, I think it is vital that Government spending be planned in the context of a lower set of tax rates.

Senator PROXMIRE. Well, now, all of this is based on a new theology that may or may not turn out to be—

Dr. WEIDENBAUM. Senator, this is economic analysis I am expending, to the best of my ability. I give my sermons on Sunday, as I told the mayors.

Senator PROXMIRE. Well, I think you are still giving us a sermon. It may be a very wise and correct sermon. You may be confirmed by historical experience; but you may not.

Dr. WEIDENBAUM. I was confirmed by the Senate.

NO INCREASE IN THE DEBT LIMIT

Senator PROXMIRE. Well, I was one of a small minority in the Senate that voted against increasing the debt limit. And I think I was right in doing that. And I think here is a real instrument—if you want to balance the budget for sure, just say “no increase in the debt limit; no trillion-dollar debt.”

Now, the President will have an opportunity. I understand why he did it this time. The Carter spending put him into a position where he felt that he couldn't responsibly take that action.

But, supposing he digs his heels in, here, at \$985 billion, and says: "No more increase in the national debt; that's it. Unless, of course, we have a deep recession or have a military emergency. But otherwise, no increase."

We would simply have to come forward with cuts, whether we like it or not. We would have to do it.

You would create a situation, a crisis situation, in which Congress would have no choice. The President could say: "All right, if you don't do this, that means we're not able to pay 36 million people who vote and who get social security benefits. If you don't make the cuts elsewhere, it means we can't pay the Army, Navy, and Air Force."

The pressure on us in Congress would be irresistible. Then, we would have to balance the budget.

Dr. WEIDENBAUM. Senator, that reminds me of the Herblock cartoon, a few years ago, showing a great big fat dog labeled "government spending deficit," and a small doghouse labeled "debt limit"; and Congress telling the big dog: "You get in there."

Senator PROXMIRE. Maybe we ought to tell him to get in there.

Dr. WEIDENBAUM. There's no way that big dog, which represents the expenditures under the appropriations that the Congress enacted, is going to get into that smaller doghouse.

Senator PROXMIRE. Well, you put that dog on a fast diet. I will tell you. [Laughter.]

Dr. WEIDENBAUM. The responsibility is on the Congress to reduce the size of that dog.

There is no substitute for appropriating less, in the first place.

Senator PROXMIRE. Well, I'm not talking about creating a situation, however. The President has the power; he can veto any increase in the debt limit. And I'm sure, if he did so, and if he lent the force of his office, there's no way Congress would override that veto.

If he does that, then we do conform with what you're asking for. We make the cuts.

We are told by the Chairman of the Federal Reserve Board that cuts are the key. And I think you take the same position, too. We have to make those cuts. They are absolutely essential. We must make them.

We may not make them. We may not make them as deep as we should.

But one way the President can absolutely assure that we make them, without any question, without a doubt, is to say: "We're not going to increase that debt limit unless you have a catastrophic situation."

It doesn't take a constitutional amendment to do all that that embodies. It's not that rigid. The President can change his mind and approve an increase in the debt limit.

But, if he would say under these circumstances: "We think that fighting inflation is the most important thing in the world," what a marvelous psychological message that would give to the public.

We would know, then, that we would cut the spending and balance the budget.

Dr. WEIDENBAUM. That's like telling your wife, who has incurred all of those charge bills, "I won't pay the bill when it comes at the end of the month."

The thing is to control the use of the charge plate at the beginning. That's the only way to soundly manage either family finances or Government finances.

Senator PROXMIRE. No. It's not. It's like taking the charge card away from your wife.

Dr. WEIDENBAUM. That's the idea precisely.

Senator PROXMIRE. That's what you do with the debt limit.

Dr. WEIDENBAUM. No, sir. That's what you do when you appropriate too much, and I'm urging you to appropriate less.

Senator PROXMIRE. Dr. Weidenbaum, we've been through this for years. We've been trying to persuade Congress—

Dr. WEIDENBAUM. Precisely. The debt limit hasn't worked as, in fact, a control over Government spending.

Senator PROXMIRE. No President has ever said it. It's like President Reagan did this time; he said: "Increase it."

Dr. WEIDENBAUM. There's no substitute for appropriating less. And that is what—precisely what President Reagan has urged. If anything, we are urging a reduction in the appropriations that are outstanding.

I hope you join us promptly in that high priority.

Senator PROXMIRE. Oh yes. I'm with you all the way, as you may know.

Dr. WEIDENBAUM. We welcome your support.

Senator PROXMIRE. Except in the dairy price support area. [Laughter.]

Nobody's perfect.

My time is up.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. Just one comment, Mr. Chairman.

I was listening to the charge card analogy, and I assume it had nothing to do with the legislation we reported earlier this week.

I would only say to my good friend, Senator Proxmire, that the analogy, it seems to me, with respect to the charge card and the debt ceiling, is not taking away the charge card.

The analogy is really when you get all of the bills from your friendly American Express or Visa company, saying that you have purchased a car, a home, an around-the-world trip. And you, at that point, say: "No. I'm not going to pay my bills."

That is the same effect as the vetoing of a debt ceiling bill. By the time you get to the debt ceiling bill, all of the commitments have been made; all of the appropriations have been released; all of the money that has been committed through entitlements has been committed. All of the budget authority, in other words, has been obligated. All of the bills are coming due.

One of the big bills that comes due is the refinancing of the debt. And to not, at some point, face up to that is to be unrealistic. And that is where the President's economic program is very realistic.

It says what we have to do is stop all of this obligational authority. And the President has been extremely bold.

The CHAIRMAN. Like price supports. Right?

Senator HEINZ. Mr. Chairman, I don't want to get into any unnecessary discussion with somebody from the Minnesota-Wisconsin area on the subject of price supports.

The CHAIRMAN. We have dairy farmers in Utah. It just takes political courage.

Senator HEINZ. Mr. Chairman, we are well aware of your political courage. And I knew this discussion would get us into that.

Anyway, just to wrap it up, Mr. Chairman, I think that what the administration indeed deserves to be commended on is the fact that they recognize the charge card problem. And what they're trying to do is to put this country on more of a pay-as-you-go basis.

Thank you, Mr. Chairman.

Dr. WEIDENBAUM. Thank you, Senator, for those kind remarks.

The CHAIRMAN. Senator Schmitt?

TAX PACKAGE TIMING

Senator SCHMITT. Mr. Weidenbaum, it has been suggested in hearings that the Appropriations Committee held some weeks ago—which, unfortunately, you were not yet able to participate in—that the tax package might be more properly constructed in terms of its timing. The package would be constructed to give us a bigger window in which to work the spending reductions without as much of an immediate short-term impact on deficits.

The package would clearly allow for directly investment-related cuts—that is, job creation, business creation cuts—be retroactive to January 1 of this year. Also the more personal cuts would be postponed to January 1 of next year, to give us a full 12-month window in which to work.

If I understand the President's proposals, that window is really about 6 months long; and since July 1 comes very quickly, it is probably not, in truth, a window at all.

Do you have any further comments on that?

Should we consider expanding that window?

Dr. WEIDENBAUM. Senator Schmitt, I hope you don't. The economic problem facing this Nation is a problem for today. Those high interest rates are a very serious problem to many institutions today. That soft economy and the high unemployment again is economic distrust right now; and I think investors, financial markets, business decisionmakers, as well as many consumers, are looking toward the Congress for action, for decision, not for delay.

Senator SCHMITT. I am not proposing that. I am proposing the package be enacted. I am just talking about the schedule and timing, and with direct reference to the interest rates.

I don't know whether you would agree or not, but the principal pressure on those interest rates has been the borrowing by the Federal Government. Any time the Federal Government wants to borrow money it goes to the head of the line and pays what the market demands, in order to get that money. It's been doing it at a \$60 billion rate for several years.

Dr. WEIDENBAUM. I share your concern. I do think, however, that making those personal tax rate reductions effective July 1 is really an essential part of the program, because we need to expand the pool of private saving as rapidly as possible, and July 1, is not too soon at all.

Senator SCHMITT. Well, let me suggest some other means to expand that pool. As you know, our savings rate is the lowest in the industrialized world. The Japanese are saving from 20 to 25 percent of their disposable income. Many Europeans are saving 15 to 18 percent, I believe are the recent numbers. We are at 3 to 3½ percent.

I detected, unfortunately, surprisingly little interest in removing the tax on interest and dividend income in this country.

Dr. WEIDENBAUM. Very frankly, it is my personal view, having studied the tax code over a long period of time, that specially targeted provisions are not the most productive course of action. General purpose tax reductions, where the decisions really are made by families, by individuals, as to how much they want to spend, how much they want to save, is the much more desirable way.

In other words, I strongly share your concern that we have more saving in this economy. But I think the healthier way to do it, the more economically efficient way to do it, is to create an environment in which voluntarily, without looking at the tax collector over your shoulder, citizens voluntarily increase their saving. And in my diagnosis, the major barrier to saving today is the inflation and the inflationary expectations. And, therefore, I think the prompt enactment of our package in the form that we have prepared it, will do more to reduce those inflationary expectations, and hence restore the a higher savings rate, than any specifically targeted thing.

Senator SCHMITT. Mr. Weidenbaum, the problem is—and I am fully sympathetic to the President's package; we can debate the timing at another time—the biases against savings, even under your program. Anybody who puts money in a savings account today is doing it because of patriotism, not because they are going to earn any money.

SAVINGS ACCOUNTS LOSING MONEY

I happen to have some savings and I keep them there because I think I should have a savings account. I think it is important, and I hope more and more people do. However I am losing money on that savings account; and there is nothing in the President's program in the short term, and when I say that I mean 2 or 3 years, that is going to significantly change that loss to a gain looking at inflation and other factors.

What I am saying is that you need, I think, to build into that package some real incentives to put money into savings and into investment. At this point you don't have them there.

Dr. WEIDENBAUM. I would like to offer just two quick points. First of all, the Treasury is considering items for inclusion in a second round of tax proposals. And you might wish to call it to their attention, although I am sure they are already aware of the specifically targeted approach to savings.

I anticipate from the prompt enactment of our program, a significant increase in savings in the course of the coming year. First of all, we are talking about a declining Federal deficit and we are taking action not only to achieve a reduction in the deficit per se,

but in total Government financing, in the total Government competition with private borrowers.

Senator SCHMITT. Off-budget as well?

Dr. WEIDENBAUM. Precisely. One of the things we are urging is that the Government credit programs, wherever possible, charge market rates of interest. And I think that will do more—that one change will do more to reduce the off-budget drain on capital markets, and hence, increase the effective pool of saving available for the private sector.

Senator SCHMITT. Well, when I speak of the savings rate, I am talking about either a full exemption or a percent of savings—not the specific dollar amount. I don't think that solves the problem at all. It is helpful to those who are already saving. It is not helpful to increase the amount of savings. I hope that you will continue to look at that issue, and there are other ways to encourage people to create a situation where they can earn money on savings. They can't do that today, and I think you are going to be disappointed. I am afraid you are going to be disappointed in how much money actually goes into savings, and the relatively low rate of return investments, because there is no monetary incentive to do that. You aren't going to earn anything today.

Dr. WEIDENBAUM. I think it is a question of comparison, Senator.

Senator SCHMITT. You are too far away right now, with the 12 percent inflation rate. You are just too far away from earning anything on a savings account.

Dr. WEIDENBAUM. Those of us, for example, who are saving to put our children through college, really don't have an alternative. It is a question of what savings instrument do you use? But quite clearly, if anything, the inflation increases your need to save because of the higher cost of schooling. So to that extent, quite clearly, I think there is a continuing need for savings on the part of the average consumer.

Senator SCHMITT. Well, my time is up. I don't understand that. Any money you put into a savings account is losing value. The interest you gain on it—

Dr. WEIDENBAUM. But if you spend all of that on current consumption, none of it will be available.

Senator SCHMITT. I agree. But all of the incentives are to spend, or to invest in real estate or something like that; rather than to put it in where it is directly usable by the economy.

Dr. WEIDENBAUM. Again, I think this is why we need to deal with the fundamental problems facing the economy.

Senator SCHMITT. I have no argument with you. I am just afraid that the short-term effect of the policy without some incentives to save, is not going to be what you anticipate.

The CHAIRMAN. Dr. Weidenbaum, as you know from several meetings you and I have had, you have, or the administration has no more ardent supporter of cutting the budget than this Senator.

Dr. WEIDENBAUM. Yes, sir.

The CHAIRMAN. And as I have said, I am willing to accept the cuts in dairy price supports, even though there are dairy farmers in my State. Even more politically sensitive, I am willing to accept cuts in the central Utah project, the secondmost arid State in the country. Water is absolutely vital to not just growth, but sustaining

the present population of that State. No public official in 20 years, in either the Republican or Democratic Party, or at the State or National level, has been willing to accept cuts; but I feel the budget situation is so critical that even there, whatever the political heat is, I will accept the President's recommendations.

But the thing that I am absolutely incapable of understanding is when you recommend cutting the vital water project, dairy price supports, why tobacco subsidies are not on the hit list? A product that is a known killer, certified by the Surgeon General. It causes heart disease, lung cancer, emphysema, and associated other problems.

We ban cyclamates because if your rat drinks half a million gallons, it may get cancer. [Laughter.]

The CHAIRMAN. We talk about banning saccharin. But the one thing that we absolutely know causes cancer, the Federal Government is subsidizing it in our austerity plan. There is no recommendation to cut.

Dr. WEIDENBAUM. First of all, Mr. Chairman, I personally and most sincerely want to thank you for your strong support of budget restraint where it hurts, as well as where it just affects the other fellow. In the case of the farm price supports, as in many other areas, we went after the biggest opportunities first. And we emphasized the reduction in the dairy price supports, because that represents such a very large drain on the Treasury, and hence reducing—

The CHAIRMAN. I understand the economics. But milk is helpful.

Dr. WEIDENBAUM. Not in excess, of course. [Laughter.]

I am a nonsmoker.

The CHAIRMAN. My baby drinks milk. He does not smoke. [Laughter.]

Dr. WEIDENBAUM. I neither smoke nor drink milk, so I am really neutral on this.

Let me point out, in all seriousness, we have embarked on a long-term program of expenditure restraint. The initial results, and only the initial results, have been presented to the Congress. We continue to look for future opportunities for saving, and personally I welcome the chairman's suggestion and I will pass that on to my colleagues in the administration to seriously consider your recommendation, Mr. Chairman.

The CHAIRMAN. I would appreciate that, because all of us across the country have particular programs that affect our States more dramatically than some others. And I would suggest tobacco State Senators might be willing to bear their share even if it is symbolic, even if it is not a large amount of money. Because if I had my way, there would be no subsidies for any product that causes the kind of problems that tobacco does. And I am not moralizing. I am talking about the proven antihealth problem. The No. 1 cause of preventive disease.

Dr. WEIDENBAUM. As the chairman knows, as a private citizen I have written extensively, or frequently rather, in support of the chairman's position.

ARE TAX CUTS INFLATIONARY?

The CHAIRMAN. Let me ask you one other question about the tax cuts. Is it not true that in actual fact, in reducing Federal revenues there is no tax cut? Even the President's \$51 billion, there will still be in the neighborhood of \$40 billion of tax increase collectively on the American people?

Dr. WEIDENBAUM. Yes, indeed. In fact, were it not for—if Congress were not to enact the tax rate reductions proposed by the President, there would be an increase in the average tax burden on the average family because of the ratchet effect of inflation pushing people into higher brackets, plus the increases in payroll taxes. So that in order to avoid an increase in the burden of taxation on the average family, it is necessary to enact the tax cut.

The CHAIRMAN. So the argument, really, about tax cuts is not valid. It is whether we slow the increase of taxation on the American people?

Dr. WEIDENBAUM. Yes, sir.

The CHAIRMAN. Is there any reason to believe that if Government takes that \$100 billion away from us and spends it, that that is less inflationary than if they leave part of it with us to decide how we spend?

Why is it the attitude of some in Government, as it was during the campaign, we constantly heard that tax cuts were inflationary? Why is it more inflationary to leave money with you and I to spend, then to have this Congress take it away from us and decide the priorities of how it should be spent?

Dr. WEIDENBAUM. It isn't. First of all, we can debate what the savings ratio is going to be in the private sector. Will it stay down at 5 percent? Will it rise back to 7 percent, or go higher than that? But the savings rate is not only zero, it is negative in the public sector.

So surely, if we are concerned about savings and investment, restoring the position of the private sector is paramount. Savings come from the private sector.

The CHAIRMAN. Isn't it also true that when we are looking at the future, as far as balancing budgets, as much as I favor a balanced budget and always have, is it not a higher priority to reduce Federal spending as a percentage of the gross national product than to achieve a balanced budget?

My point is this: That you could have a \$3 trillion balanced budget. We can have a balanced budget. We can increase taxes.

Dr. WEIDENBAUM. Precisely.

The CHAIRMAN. But if you drain all of that money out of the private sector, and we are already at 40 percent of GNP as being taxed away by State and local government, we could balance the budget. We could tax at a 50-percent rate and balance the budget. So I want to establish that the importance of tax cuts is to reduce the involvement and the percentage of the public sector in the private capital markets.

Dr. WEIDENBAUM. Yes, indeed. If there is any common theme to all of our proposals, it is to reduce the size, the power, the intrusion of Government in the American economy; Government in all its dimensions; expenditures, taxes, credit programs, and regulation.

The CHAIRMAN. I would ask my other two colleagues, if they are here, if they would have any other questions?

Senator PROXMIRE. I would just like to ask two very quick questions. One is, I wonder if you have any idea how we, as the agency, the arm of Government that created the Federal Reserve Board and with jurisdiction over the Federal Reserve Board, this committee particularly can persuade the Fed to stay within its targets.

As Senator Heinz brought out with very skillful questioning when Chairman Volcker was here, they miss their target on every single measurement of the money supply. They were over it on all seven measurements over their range, and the range was a very broad range. Talk about the midpoint; they missed the midpoint by anywhere from 30 percent to 50 percent above it.

Now, one way we might be able to do this is to try to persuade them to narrow their range, or do what they do in Germany and have a single target. In other words, say the increase in the money supply for next year is going to be 4 percent for certain measurement, or 6 percent, or whatever. And then we could hold them to perhaps a closer level.

But on the basis of their past performance, even if they stay within the range, it can be a rather high increase. And I notice that you emphasize that they should hit at the midpoint of the range.

So do you feel it would be good policy for us to do what we can to try to persuade the Chairman of the Federal Reserve Board to narrow that range just as much as possible, and maybe to reduce it to a single figure?

Dr. WEIDENBAUM. I think it is very useful for this committee, as you do regularly, to call in the Chairman of the Federal Reserve Board so he can report to the Congress, and get whatever guidance the Members of the Congress want to give the Federal Reserve System. Because after all, the Federal Reserve is a creature of the Congress. The Federal Reserve is independent of the executive branch of Government. Nevertheless, I think we need to be mindful of the actions that are taken both in the legislative as well as the executive branch, which make it difficult for the Federal Reserve to carry out that policy.

Eliminating the power to regulate credit, the credit controls, I think would be very useful, so last year's sad experience of on-again, off-again credit controls does not reoccur. I think that would certainly be useful. And second, that the reduction in the deficit again—

Senator PROXMIRE. This committee recommended that. And we did, as the chairman just pointed out to me, sunsetted that as of 1982, the credit controls.

Dr. WEIDENBAUM. The sooner the better, I would say.

And surely steady progress in eliminating the budget deficit is another vital contribution that enables the Federal Reserve to follow their stated policy more closely.

GARN-PROXMIRE RESOLUTION

Senator PROXMIRE. Now, the final question I have is I hope you will find it in your heart to support the Garn-Proxmire resolution on monetary policy. This says monetary policy would express the

views of the Burns committee on how they should follow a conservative anti-inflation monetary policy.

Dr. WEIDENBAUM. A resolution bearing the names of Senator Garn and Senator Proxmire is one that I would give the greatest consideration to. However, not having read the resolution, I am not prepared to comment on it at this point.

Senator PROXMIRE. Well, some things you won't accept on faith, although that doesn't include the administration's views.

Dr. WEIDENBAUM. I would expect that to be an important contribution to economic policy.

Senator PROXMIRE. Well, we will send this to you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. I have just a brief question or two. In the administration's economic recovery plan, as set forth in the white paper, there is a very laudable statement about how you want a consistent, strong monetary policy through the Federal Reserve. And if this question has already been asked earlier, please say so, and you make it even shorter. But the Fed has suggested a set of targets for 1981, and I assume you have seen them.

Dr. WEIDENBAUM. Yes.

Senator HEINZ. Does that meet your prescription? Does that fit with your objectives, the set that has been suggested?

Dr. WEIDENBAUM. Yes. And, Senator Heinz, I say in my statement that achievement of those targets, especially toward the midpoint of the range, clearly would be consistent.

Senator HEINZ. You would rather have it closer to the midpoint than at the upper range?

Dr. WEIDENBAUM. I think closer to the midpoint would represent greater progress in achieving the inflationary objectives, or the anti-inflationary objectives.

Senator HEINZ. Suppose the Fed does this year what it did last year, which is it misses the range in every single instance. What policy should there be for dealing with somebody who has accepted responsibility by setting a target, and says that target is over there on the wall and I can hit it, if not in the middle, I can always hit at least the entire target, even if it is in the white ring as opposed to the red or yellow in the middle. And the person keeps throwing the darts into the wall. What do you do about that?

Dr. WEIDENBAUM. As an analyst, the first thing I would ask is, why did they miss it? If it was due to factors effectively beyond their control, I would understand. If not, I would encourage them to give even greater consideration to changes in operating procedures, which is again a point I covered in my statement.

Senator HEINZ. One last question. When you and Senator Garn were discussing the tax cut, you were quite properly pointing out that the increase in taxes that is built into our tax system is so severe that really what the administration is proposing in terms of a so-called tax cut is little more—may not be even any more—than keeping people from having—the average person, from having a higher average tax burden.

Does the Administration's plan in fact reduce the average tax burden, or does it hold it pretty much the same?

Dr. WEIDENBAUM. The enactment of our program would reduce the tax burden on the average family.

Senator HEINZ. So it goes a little bit beyond?

Dr. WEIDENBAUM. Yes, sir. However, that still would be above the average tax burden of, say, 5 or 10 years ago.

Senator HEINZ. Very well. Thank you very much.

Dr. WEIDENBAUM. Thank you, Senator.

Senator SCHMITT. Mr. Weidenbaum, that's the direct tax burden? I mean, there is nothing yet to really envision to reduce the indirect tax burden that comes with things like windfall profits taxes and other things that are passed on to the taxpayer as a consumer?

Dr. WEIDENBAUM. That is right, Senator.

Senator SCHMITT. So the net tax burden is still increasing quite rapidly over the foreseeable future?

Dr. WEIDENBAUM. I'm afraid you are right, which indicates the need for future attention to the tax system, which is why the administration and the President specifically, has talked about developing a second round of tax proposals.

Senator SCHMITT. Does the rapid increase in the popularity of the money market mutual funds, which I think in a year or two has jumped from about \$11 billion to \$95 billion, represent purely a transfer of existing investments? Or is this a net increase in savings?

Dr. WEIDENBAUM. I frankly have not done a study of that. To my knowledge, the typical investment, the typical saver, the typical investment in money market mutual funds is similar to competitive thrift institutions, as far as I understand the arrangement.

I would suggest, however, that the inflation and the high interest rates that we are now experiencing are a major factor in the shift toward money market mutual funds, and I wouldn't be surprised in a regime of lower interest rates to see another rearrangement of savings patterns.

Senator SCHMITT. Well, I think you are right, but in the meantime the normal or traditional thrift institutions are having some difficulty, are they not, dealing with this shift from their resources from their deposits to these funds?

Dr. WEIDENBAUM. Yes, we are aware of and are very closely monitoring developments in the thrift institutions.

Senator SCHMITT. There is also a tendency for those money market funds to move out of the more rural States, from the thrift institutions in the smaller population States into centralized banking areas, such as New York, Chicago, et cetera.

Dr. WEIDENBAUM. I really have not made such a study, Senator.

Senator SCHMITT. I hope you will look at that. Although it may seem like a detail, it is not a detail to thrift institutions in Albuquerque, N. Mex., or elsewhere that see their deposits moving into these other areas.

Dr. WEIDENBAUM. Having moved here from the Midwest, I am mindful that not all of the wisdom of this Nation is in the Northeast nor necessarily should all of the financial resources be there.

Senator SCHMITT. Some of the big institutions are on the West Coast, too, so we won't discriminate.

OPERATING LOANS DIFFICULT TO OBTAIN

And finally with respect to interest rates, we really are seeing, not only in construction where most of the publicity has been, but in agriculture and other businesses that require operating loans in order to conduct their year's business. We are seeing the extraordinary difficulty these small and medium size businessmen and farmers are having to obtain operating capital for this year.

Has the administration begun to focus on this? This is something that is going to happen this year, and I don't think even your economic plan or anybody's economic plan can prevent extraordinary difficulty in certain parts of the country?

Dr. WEIDENBAUM. The Federal Government continues to maintain a variety of financial institutions in the farm sector under the auspices of both the Department of Agriculture and, of course, the whole galaxy of credit agencies under the Farm Credit Administration, off budget as well as on budget.

Senator SCHMITT. I will tell you those loan mechanisms are not working nearly as well or, in some places apparently, adequately for this year's crop. They are not working as well as business attempting to provide operating capital for agriculture. And other businesses are having trouble getting to it because of those interest rates or just because the money is not there.

Dr. WEIDENBAUM. Very frankly, in my analysis of various Government credit programs and their effects, I have described them, maybe too tersely, as robbing Peter to pay Paul and that the real answer is to increase the pool of savings available to the private sector. And there is no substitute for that. And here Government directly can't do much to help. It can do a great deal and does a great deal to hinder.

Senator SCHMITT. It can help by getting out of the marketplace as fast as possible. Senator Proxmire I think, though, brought us down to Earth when he, as I agree, said that even with all your Herculean efforts and maybe more that will be required it is going to be tough to get that Federal deficit much lower than it is this year and the same pressures are going to exist. Maybe we can reduce off-budget borrowing. We always should talk about deficit and off-budget borrowing. That is the competition that the private sector has from the Federal Government and it has been over \$100 billion for several years.

Dr. WEIDENBAUM. I should urge the Congress to consider very carefully the proliferation and overly rapid expansion of off-budget borrowing which has occurred much faster than on-budget credit programs. These have literally, through the Federal Financing Bank, become a form of back-door financing. However, I think we certainly are moving in right direction in our own recommendations to reduce the use of the Federal Financing Bank.

Senator SCHMITT. Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Weidenbaum, we appreciate your testimony today. Thank you very much.

Dr. WEIDENBAUM. Thank you, Mr. Chairman and Senator Schmitt.

The CHAIRMAN. Now I would like to call to the table Dr. Jerry Jordan and Dr. David Jones.

We appreciate your patience, gentlemen.

Senator SCHMITT. Mr. Chairman, would you yield just for a moment? I would like to welcome Dr. Jordan from my almost hometown of Albuquerque. He is relatively new in the Albuquerque area. We are certainly excited about having him at the Anderson Schools of Management, one of the fastest growing, at least in terms of reputation, economic and research institutions in the country. We are excited about its future and we are particularly excited about having Dr. Jordan there to help lead us on.

Welcome to the committee, Doctor, and that is not to any way say that Dr. Jones isn't appreciated also.

The CHAIRMAN. We are happy to have both of you with us. And we took longer with Dr. Weidenbaum than I anticipated, and we would appreciate it if you could summarize your statements, and your entire written statements will be included in the record. Then we would be able to get to questions more rapidly.

Dr. Jordan, would you like to begin?

STATEMENT OF JERRY L. JORDAN, DEAN, ROBERT O. ANDERSON SCHOOLS OF MANAGEMENT, UNIVERSITY OF NEW MEXICO

Dr. JORDAN. Thank you very much, Mr. Chairman and Senator Schmitt. I appreciate this opportunity and I will summarize the main points of my statement.

Chairman Volcker's statement in October 1979 that there would be significant changes in the Federal Reserve's approach to monetary policy gave us a lot of reason to believe that the results would have been better than they actually have been. The difficulties of implementing gradual reduction in monetary growth down to a noninflationary rate are not quite as great as the experience of last year might suggest.

I think that a slow, noninflationary monetary growth is a necessary underlying condition to achieve the other objectives of our economic policies. It is not going to be sufficient to solve all of our problems, but it can be done. It not as technically difficult as some have suggested.

Recent news reports have emphasized the disparity between the economic forecasts of the economy for the next 4 years. I think this attention to rival forecasts is all out of proportion to the importance of such exercises. Whether the administration, or the Federal Reserve Board, or Congress forecasts are more accurate for this year and for next year and beyond is of much less importance than the public's confidence that any of the economic policymakers have the knowledge to deal with the problems.

FED'S REPUTATION DAMAGED

The Fed's reputation as an effective inflation fighting institution has been so adversely damaged by events of the last decade or so that I doubt that their views on the economy and the appropriate policies to deal with the present circumstances carry very much weight with the public. But restoring the public's confidence in our central bank is essential if the other policies proposed by the administration and those eventually enacted by Congress are to be successful.

Last year the growth of the money supply fluctuated over such an extremely wide range that it is hard to have confidence that the net outcome for the year was more than merely accidentally close to the Fed's intentions. Reactions to the new target growth ranges for 1981 are bound to be met by considerable skepticism. That is not a very healthy situation.

The variance of the growth rate of the money supply around its underlying trend becomes important when the deviations exceed periods of three or four months or longer. The recent past pattern consistently has been one in which sharp accelerations in monetary growth, or decelerations, for a few months have been followed by sharp reversals. There is a risk that a sharp deceleration in monetary growth early in 1981 will foster expectations of an offsetting sharp reacceleration later this year. That development would be very damaging to any potential for an anti-inflationary program to be successful.

It would be wrong to say that restrictive monetary policies this year must cause a recession in order to effectively reduce inflation. But we should expect that a contraction in economic activity is likely to occur. The depth and the duration of any recession that does occur will be more a function of the credibility of the Government's commitment to reduce inflation and the expeditious implementation of whatever fiscal policies Congress agrees to than it will be other forces.

If it were universally believed that the Fed would have the support of the legislative and the executive branches of Government for as long as necessary to achieve price stability, then I think that the real economic cost of eliminating inflation would be minimal. Other countries have done so. But if individuals in their roles as consumers, workers, labor leaders, business leaders and Government officials do not believe that we have the national will to persevere until inflation is eliminated, and if they continue to base their economic decisions on the assumption that inflation in the early 1980's will come close to matching, if not exceeding, the inflation in the late 1970's, then the real economic costs and the dislocations associated with strongly anti-inflationary policies will be considerable.

The highly expansionary growth rates of money during the spring and summer of 1979 gave way to a marked reduction in monetary growth in the winter and spring of 1980. Then the sharp decline of M-1B, a narrow measure of the money supply, occurred in the second quarter of last year when credit controls were put in effect.

Monetary growth in the second half of 1980 was excessively expansionary. No matter how you look at it, there is simply no excuse for the Federal Reserve having permitted such an explosion in growth of bank reserves and the money supply in such a highly inflationary environment.

ERRATIC MONETARY GROWTH

It is important to analyze why monetary growth was so erratic last year in order to guard against a repeat occurrence this year or later.

After Chairman Volcker's very dramatic Saturday evening announcements in October 1979, monetary growth decelerated to a significantly less inflationary pattern. For a while it appeared that the Fed's deemphasis of control over daily interest rate fluctuations, and the increased emphasis on growth of bank reserves, would produce a steadier and less inflationary growth of money. But the imposition of credit controls in March of last year severed access to the credit markets for many individuals and businesses and caused the sharpest decline in real final sales and real output in recent decades.

Interest rates declined mainly because the demand for real goods and services was declining. Interest rates were being pulled down by a contracting economy in an environment of credit controls. But the Fed was reluctant to let interest rates decline as rapidly as market forces would indicate. So open market operations provided for only a very small growth of bank reserves and the money supply contracted sharply. It is important to understand the policy actions actually became more restrictive while interest rates were declining.

The credit controls were removed in early summer and the economy began to bounce back from the artificially depressed level of the spring quarter. The increase in real economic activity implied an increase in credit demands to finance this greater activity. Naturally, short-term interest rates began to rise from the sharply lower levels that they had fallen to during the period of controls. But since it was at that time generally accepted that the economy was in a recession, and most forecasts suggested that the recession would continue through most of the second half of the year, the Fed was reluctant to allow interest rates to rise for fear that it would prolong or possibly deepen the recession.

The initial rebound of economic activity was accompanied by a large injection of reserves into the banking system in an attempt to moderate the tendency for interest rates to be pulled up by the strengthening credit demands. The extremely rapid acceleration in monetary growth that ensued caused many observers to believe that the Fed had prematurely abandoned its anti-inflationary policies and that renewed expansion was being stimulated before any lasting progress had been made.

The rapid increases in bank reserve and money growth raised concerns about continued high inflation, and that put further upward pressure on market interest rates, and that caused the Fed to inject more reserves. Ultimately the monetary actions became highly expansionary for a full half-year, even though interest rates were rising and there were complaints about the price of credit. The rising interest rates were an indication of a strengthening economy and rising credit demands and should not be interpreted as the result of a restrictive or tight money policy.

The second half acceleration of monetary growth did stimulate economic activity that is lasting into early 1981. However, it also has resulted in intensified inflationary pressures and in higher interest rates.

Chairman Volcker reemphasized the importance of a sustained deceleration of monetary growth to a noninflationary level and the target ranges for 1981 represent a slight further reduction com-

pared to the ranges for last year. But it should be recognized that the mistake that the Fed made in the second half of last year by permitting extremely high growth rates to occur will create problems now in 1981. During the second half of the year M-1B grew at a 12.8 percent annual rate, over double the upper limit of the Fed's range for 1981.

The achievement of a 6 percent or lower growth of M-1B this year will represent a significant deceleration of monetary growth compared to the second half of last year. After somewhat of a lag that deceleration in monetary growth can be expected to have a retarding effect on total spending in GNP this year. The growth of M-1B at the upper limit of the Fed's 3.5 to 6 percent range for the four quarters of 1981 would be consistent with total spending (GNP) growth of about 9 or 10 percent. That would compare with last year's 9.8 percent.

If inflation in 1981 is about the same as it was in 1980 that will mean we will have another year of no growth of real output. But I am more optimistic about inflation this year than most people are, and I believe that the deflator will rise by 1 or 2 percentage points less this year than it did last year.

RECOMMENDATION

My recommendation for 1981 is that the monetary base grow no more than 7 percent at an absolute maximum. I would prefer around 6 percent as a centerpoint target for the monetary base. That would be consistent with the growth of M-1B below the upper limit of the Fed's target, and it would take us more rapidly toward a noninflationary growth path.

If I am correct that inflation and interest rates do decline this year, it is important that declining interest rates not be misinterpreted. If it is taken as a sign that the Federal Reserve is shifting to a less restrictive stance or that the anti-inflationary policies are once again being abandoned in favor of antirecessionary policies because unemployment is going to be rising, the dollar would weaken on foreign exchange markets and domestic credit demands would start to increase rapidly again.

Also, following the economic contraction that we are likely to experience this year, there would be an interim short-run tendency for market interest rates to be pulled up by strengthening credit demands in a recovering economy. At that time it will be a mistake to once again misinterpret rising interest rates as being an indication of a more restrictive policy. The point is that market interest rates have to be allowed to be pulled down and then be pulled back up again by real economic forces and not be resisted by the Federal Reserve or misinterpreted by the rest of us.

I am optimistic that the rates of inflation and levels of interest rates we experienced in 1980 are going to turn out to be a secular peak as well as a cyclical peak.

Congress should make it clear to the Fed that they expect monetary growth to remain within the announced target ranges. If present implementation procedures are not adequate, the Fed should make those changes that are necessary to insure that the announced target ranges are reliable guides to the actual growth that can be expected by the private sector.

The performance of the economy in 1981 is now going to be adversely affected by what the Fed did last year. In turn, the performance of the economy in 1982 will be strongly influenced by the implementation of monetary policy this year.

Thank you.

The CHAIRMAN. Thank you very much.

[The complete statement follows:]

STATEMENT BY JERRY L. JORDAN
DEAN, ROBERT O. ANDERSON SCHOOLS OF MANAGEMENT
UNIVERSITY OF NEW MEXICO

BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

March 4, 1981

TESTIMONY

Mr. Chairman and Members of the Committee

I am pleased to have this opportunity to present my views on the economic outlook and monetary policy. In the six years of Congressional oversight hearings since Concurrent Resolution 133 was first passed, the quality of discussion concerning the issues involved in the Conduct of monetary policy has been improved considerably. Understanding of the problems of formulation and implementation of monetary policy has been improved, and I am hopeful that in the future the execution also will improve.

The announcement by Chairman Volcker in October 1979 of significant changes in the Federal Reserve's approach to monetary policy gave us reason to expect that subsequent results would have been better than has been the case since then. The difficulties of implementing a gradual reduction of the trend rate of monetary growth, as announced by Chairman Volcker almost 18 months ago, are not as great as the experience of 1980 might suggest. I do not believe a slow and relatively steady growth of the money supply would be technically difficult to achieve. I also do not believe that such a monetary policy is sufficient to solve all of our national economic problems. But I do believe that it is a necessary underlying condition that must be met in order for other economic policies to have a chance of working in the way they are intended.

Recent news reports have emphasized the disparity among various forecasts of the economy for the next few years. This attention to rival forecasts seems to me to be out of proportion to the importance of such exercises. Whether the Administration, the Federal Reserve or the Congress has the most accurate forecast for this year and beyond is of much less importance than the public's confidence level that any or all of our national economic policymakers have the knowledge and the will to deal with our problems.

The Federal Reserve's reputation as an effective inflation fighting institution has been so severely damaged by events of the past decade that I doubt that their views on the economy and the appropriate policies for the circumstances carry much weight with the public. Yet restoring the public's confidence in our central bank is essential if the other policies proposed by the Administration and those ultimately enacted by Congress are to be successful.

The Federal Reserve is a creation of Congress, and it is appropriate that the legislative branch of government monitor the policy actions of the central bank. These hearings provide a useful forum for debating, and attempting to reconcile, the longer-run impact of monetary and fiscal policies on inflation, employment and real growth. Clearly stated and consistent objectives for the price level, capital formation, productivity improvement, and real tax burdens would be a major contribution to the functioning of the nation's financial markets and to the performance of the dollar in foreign exchange markets.

The requirement that the Federal Reserve announce monetary growth targets is potentially an important contribution to the objective of promoting economic stability, but only if the targets can be relied upon. Decisionmakers in the private sector, both management and labor leaders, would find it valuable to know in advance the rate of inflation that will be tolerated by the monetary authorities. The credibility of the central bank's stated intentions is the key to the success of monetary policies in Germany, Switzerland, and other countries that also announce monetary growth targets.

Last year the growth of the money supply fluctuated over such an extremely wide range that it is hard to have confidence that the net outcome for the year was more than merely accidentally close to the Fed's intentions. Reactions to new target growth ranges for 1981 are bound to be met by considerable skepticism. That is not a healthy situation. At this time it is less important which measure of monetary growth the Fed chooses to emphasize than it is that they demonstrate a much greater degree of success of staying within an announced target range. The variance of the growth rate around an underlying trend becomes important for periods of three to four months or longer, and at the present time I would be willing to accept a somewhat higher average growth of a given measure of monetary growth if a steadier growth path could be assured. But, I do not believe such trade-offs are necessary. The question of the appropriate rate of growth of money at any time is a question of what rate the public is willing to believe will be sustained. The recent past pattern consistently has been one in which sharp accelerations and decelerations of monetary growth for a few months have been followed by sharp reversals, there is a risk that a sharp deceleration of monetary growth in early 1981 would foster expectations of an offsetting sharp reacceleration later. That development would be very damaging to the potential for the Administration's program to be successful.

An understanding of the role of expectations about the future and the highly variable lags between policy actions and results is necessary to interpret economic developments this year. It would be wrong to say that restrictive monetary policies this year must cause a recession in order to effectively reduce inflation. However, we should expect that a contraction of economic activity is likely to occur sometime this year. The depth and duration of any recession that does occur will be a function of both the credibility of the government's commitment to reduce inflation and the expeditious implementation of whatever fiscal actions Congress agrees to.

The central issue is no longer the relative importance of monetary versus fiscal policies nor money supply versus interest rates as it was in the past. Now the central issue is consistency and credibility. Declarations of a renewed commitment to combat inflation were made with such increasing frequency during the past fifteen years, only to be abandoned before lasting progress was made, it should be expected that for some time the public will remain skeptical about the durability of policies implemented this year. The ultimate total cost to the economy in terms of lost output and reduced employment of an effective anti-inflationary set of policies will depend on how rapidly the public begins to believe that this time the policymakers will persevere.

If it were universally believed that the Federal Reserve would have the total support of the legislative and the executive branches of government for as long as necessary to achieve price stability, then the cost of a successful policy to eliminate inflation would be minimal. However, if individuals in their roles as consumers, workers, labor leaders, business leaders, and government officials do not believe that we have the national will to persevere until inflation is eliminated, and if they base their economic decisions on the assumption that inflation in the early 1980's will be at least as high as in the late 1970's, then the real economic costs and the dislocations associated with strongly anti-inflationary policies could be considerable.

Restoring credibility about the commitment to persevere against inflation will not be easy. Participants in financial markets suffered large losses in recent years when they prematurely anticipated a downturn of inflation and interest rates. Consumers and homebuyers have been conditioned to believe that there is no benefit to delaying purchases based on the expectation of relative price stability. The psychology of "buy now before prices rise further" is deeply entrenched. Workers have watched average consumer goods prices rise more rapidly than wages on average

in recent years and will not be easily convinced that their compensation for accepting smaller wage increases now will come in the form of smaller price increases in the future. Major corporations have been willing to borrow long-term even at the highest interest rates in history in the belief that high inflation will continue and they will repay their debts with greatly depreciated dollars. If a policy of permanently reducing inflation is going to be successful, all those attitudes must be changed.

The skeptics argue that monetary policies will become highly stimulative once again as soon as real output declines and the unemployment rate begins to rise rapidly. These pessimists about U. S. inflation finally must be proven wrong, or our standards-of-living will continue to stagnate indefinitely. I will not repeat all of the arguments as to why reduction of the trend rate of inflation is essential. However, I am convinced it is necessary before we can: restore the soundness of the financial system; achieve once again higher rates of saving, investment and productivity; stabilize our currency in foreign exchange markets; and create an environment where high rates of employment can be sustained.

There should be no controversy over whether reducing inflation is worth the cost. The notion of a stable inflation rate is an illusion. Either monetary and fiscal policies are geared towards reducing the long-run trend rate of inflation, or the average rate of inflation can be expected to continue ratcheting upwards. I don't see how there can be any question about the harmful effects of the secular rise of inflation since the early 1960's, and I don't see how there can be any doubt about the benefits that would come from eliminating inflation in the 1980's.

Monetary Policy Actions in 1980

Monetary growth in 1980 was highly erratic and expansionary on balance. Growth rates for the monetary base and MIB on a quarter-to-quarter basis for the past two years were as follows:

	<u>Monetary Base</u>	<u>MIB</u>
1979/Q1	6.8%	4.9%
Q2	7.3	10.8
Q3	9.8	9.9
Q4	9.3	5.0
1980/Q1	6.0	6.1
Q2	5.6	-2.3
Q3	11.1	14.2
Q4	10.5	11.3

The highly expansionary growth rates of the spring and summer of 1979 gave way to a marked reduction in monetary growth in the winter and spring of 1980. The sharp decline in MIB in the second quarter of last year occurred at the time the credit controls were in effect. At that time, concern was expressed by some observers that monetary policy was becoming excessively restrictive, even though interest rates were also declining rapidly.

Monetary growth in the second half of 1980 was excessively expansionary no matter how you look at it. There is simply no excuse for the Federal Reserve having permitted such an explosion of growth of bank reserves and money in this highly inflationary environment. I believe it is important to analyze why monetary growth was so erratic in 1980 in order to guard against a repeat occurrence in the future.

Following the dramatic Saturday evening announcements by Chairman Volcker on October 6, 1979, monetary growth decelerated to a significantly less inflationary growth path. For a while it appeared that the Fed's de-emphasis of control over daily interest rate fluctuations and increased emphasis on growth of bank reserves would produce a steadier and less inflationary growth of money.

Interest rates rose to unprecedented levels in the first few months of last year as a result of several forces--heightened uncertainty following the Iranian seizure of our Embassy and the Soviet invasion of Afghanistan; concern in the credit and capital markets over the implications of the continuing large Federal borrowing requirements, especially in view of the necessity for increased military spending; and, the sharp, short-run, upward pressure on the rate of inflation following the latest round of large world oil price increases.

The imposition of credit controls last March was too strong of an action taken much too late. The controls severed access to the credit markets for many individuals and businesses and caused the sharpest single quarter decline in real final sales in recent decades. Interest rates declined because the demand for real goods and services was declining. The interest rates were being pulled down by a contracting economy in an environment of credit controls. However, the Federal Reserve was reluctant to allow interest rates to decline as rapidly as market forces were indicating. Consequently, open market operations provided for only a very small growth of bank reserves and the money supply declined sharply. It is important to understand that policy actions actually become more restrictive as interest rates declined.

The credit controls were removed in early summer and the economy began to bounce back from the artificially depressed level of the spring quarter. The increase in real economic activity--as indicated by the rise in retail sales, housing starts, industrial production, and other measures--implied an increase in credit demands to finance greater activity. Naturally, short-term market interest rates also began to rise from the sharply lower levels they had fallen to while the controls were in effect. However, since it was generally accepted that the economy was in a recession, and most forecasts suggested the recession would continue through most of the second half of the year, the Federal Reserve was reluctant to allow interest rates to rise for fear that it would prolong or possibly

deepen the recession. As a result, the initial rebound of economic activity was accompanied by a large injection of additional reserves into the banking system as open market operations were geared to moderating the tendency for interest rates to be pulled up by strengthening credit demands. The extremely rapid accelerations of monetary growth that ensued caused many observers to believe that the Federal Reserve had prematurely abandoned its anti-inflationary policies, and that renewed expansion was being stimulated before any lasting progress against inflation had been made.

The process became one that fed on itself for several months. Rapid increases in bank reserve and money growth raised concerns about continued high inflation; that put further upward pressure on market interest rates which, in turn, caused the Fed to inject more reserves through open market operations. In my view, monetary policy actions became highly expansionary in the second half of the year, even though interest rates were rising and there were complaints about the price of credit. The rising interest rates were an indication of a strengthening economy and rising credit demands and should not be interpreted as the result of restrictive or "tight" monetary policies.

Monetary Growth in 1981

The latest available data indicate that the growth of a narrow measure of the money supply (M1B) was down slightly in the four quarters ending in Q4/1980 compared with the prior year. The growth of the monetary base at the end of the year was the same as the prior year. The growth rates at the end of each year compared with the prior year end for the past three years was as follows:

	<u>Monetary</u> <u>Base</u>	<u>M1B</u>
Q4/77-Q4/78	9.4%	8.2
Q4/78-Q4/79	8.3	7.6
Q4/79-Q4/80	8.3	7.1
1981 target range	?	3.5-6

As noted earlier, the growth rates of these measures were down sharply in the first half of 1980, then up sharply in the second half of the year. The second-half acceleration of monetary growth stimulated a renewed expansion of economic activity that has continued into early 1981. However, it also resulted in intensified inflationary pressures and higher interest rates.

Chairman Volcker has re-emphasized the importance of a sustained deceleration of monetary growth to a non-inflationary level, and the target ranges for 1981 represent a slight further reduction compared with the ranges for last year. But, it should be recognized that the mistake the Federal Reserve made in the second half of last year by permitting extremely high growth rates to occur will create problems in 1981. During the third and fourth quarters of 1980, M1B grew at a 12.8 percent annual rate, which is over double the upper limit of the range announced for 1981. The achievement of a 6 percent or lower growth of money this year will represent a significant deceleration of monetary growth compared with the second half of last year. After somewhat of a lag, that deceleration of monetary growth can be expected to have a retarding effect on total spending (GNP) growth of the economy.

Growth of M1B at about the upper limit of the Fed's 3.5 to 6 percent target range for the four quarters of 1981 would be consistent with total spending growth of about 9 to 10 percent, which would compare with the 9.8 percent increase in 1980. If inflation in 1981 were to continue at about the same rate as in 1980, we would have another year of no growth in real output. However, I am more optimistic about inflation this year than most, and believe the implicit price deflator will rise by 1 to 2 percentage points less in 1981 than in 1980.

My recommendation for 1981 would be for a growth of the monetary base of no more than 7 percent at the absolute maximum, and a center-point target of 6 percent would be preferred. That would be consistent with a growth of M1B below the upper

limit of the Fed's announced target range, and would take us more rapidly towards a non-inflationary monetary growth.

Prospects for Reducing Inflation

I am not as convinced as others apparently are about the intractability of recent rates of inflation. There is a tendency to forget how rapidly inflation has declined in earlier periods in the country and in other countries when the determination of the government was unmistakable. In 1974, the prices rose on average by 12 percent in this country, but by 1976 the rate of inflation was under 5 percent. A 50 percent reduction in the rate of inflation within a two-year period is attainable, and should be the underlying objective of monetary policy. Target growth rates of money supply should not be at all influenced by anyone's forecast of real output. The approach to monetary policy I would recommend would be to set a target for inflation for the middle of the decade, then derive a monetary growth path that would be consistent with that objective and stick to it.

As people begin to revise downwards their expectations about future inflation, interest rates would begin a sustained decline. How rapidly interest rates decline is more dependent on the public's convictions about an anti-inflationary policy being sustained than any other variable. I happen to be personally optimistic that interest rates will decline significantly this year and next, but at this point I would not advise anyone to place a very large bet that that will be the case. If investors act on the expectation that interest rates will decline, but they go up, large losses will be incurred. However, if investors expect interest rates to remain high, but then decline, then it is only a matter of foregone opportunities to make capital gains. It is this asymmetry that makes it so difficult to convince financial market participants that they should restructure their portfolios on the assumption of a sustained decline of inflation and interest rates.

If I am correct and inflation and interest rates do begin to decline later this year, it is important that declining interest rates not be misinterpreted. If it is taken as a sign that the Federal Reserve is shifting to a less restrictive stance, or that anti-inflationary policies are once again being abandoned in favor of anti-recessionary policies, the dollar would weaken on foreign exchange markets and domestic credit demands would start to increase rapidly again.

Similarly, following the economic contraction that is likely to occur this year, there will be an interim short-run tendency for market interest rates to be pulled up by strengthening credit demands in a recovering economy. It would be a mistake to once again misinterpret rising interest rates in that circumstance as being an indication of a more restrictive policy. The point is that market interest rates must be allowed to be pulled down and then up again by real economic forces, and not be resisted by the policymakers nor misinterpreted by the rest of us.

In conclusion, I am optimistic that the rates of inflation and levels of interest rates we experienced in 1980 will turn out to be secular peaks as well as cyclical peaks. Congress should make it clear to the Federal Reserve that they expect monetary growth to remain within the announced target ranges. If present implementation procedures are not adequate, the Fed should make those changes necessary to insure that announced target ranges are reliable guides to the actual money growth that can be expected. The performance of the economy in 1981 will be adversely affected by what happened in 1980. In turn, the performance of the economy in 1982 will be influenced by the implementation of monetary policy actions this year.

The CHAIRMAN. Dr. Jones?

STATEMENT OF DAVID M. JONES, VICE PRESIDENT-
ECONOMIST, AUBREY LANSTON CO.

Dr. JONES. Mr. Chairman, I will depart from the text and I will summarize, if it's all right with you, my essential points.

I want to bring to this committee the view, today, that we are at a critical and urgent juncture in Government policy. We may be starting to turn the corner against inflation psychology; but we desperately need the help of the Congress.

Fed policy is on the right track, and the objectives of the Federal Reserve are laudable, in attempting to lower money supply growth, year by year, with a view toward reducing inflation.

The administration is on the right track, in one of the most major budget cuts we've seen in the past 50 years.

But Fed control over the money supply is limited, as I will talk about in a moment. Accordingly, it is difficult for the Fed to assure Congress that it will hit the stated target for the aggregates.

FLAW IN ADMINISTRATION'S BUDGET PROGRAM

Second, there is an inherent flaw in the administration's budget program. The administration says: "We want budget-breaking tax cuts, together with large spending cuts," at a time when inflation is already too high, and financial strains are already too great. We cannot have our cake and eat it too.

We must face the fact that spending cuts come first, and tax cuts should come only later, if we want our financial markets to get out of the mess they are in in 1981, in one piece.

Here, I think Congress can play an absolutely critical role. What I would like to see is Congress enlarge upon the spending cuts of the administration, not reduce them, so that the psychological picture can be improved. I call it the "psychological threshold."

It looks as though, judging things from the bond market, that threshold is a \$50 billion spending cut in fiscal 1982. The administration is toying with that level. We don't have an exact number. The last official one I saw was \$41.4 billion. Presumably, modifications are coming.

What I would like to see Congress do—for psychological impact, more than anything else—is to top the Reagan administration in their determination to cut spending in a way that will result in lower inflation levels.

Second, in terms of Congress role here, I would like to see the tax cuts postponed. I would like to see the business tax cuts deferred to January 1982; and I would like to see the individual tax cuts—which, contrary to supply-side thinking, I think are potentially very inflationary—delayed to July 1982.

Finally, on the tax matter, I would like to see the business sector receive not 20 percent of the total net tax cut in 1982 fiscal year; but 50 percent.

So, I think, at this juncture, the ball is in the court of Congress.

The administration and the Fed, for the first time in recent memory, are moving together in a way that can change inflation psychology.

But they can't make it without Congress taking the initiative, improving upon an already good program offered by the administration; but adjusting the timing in a critical way, to reduce: No. 1, Treasury borrowing in the markets, which is becoming critical at this time; and No. 2, to reduce inflation psychology.

PROBLEMS WITH REDUCING THE MONEY SUPPLY GROWTH

Allow me, if I might, to enlarge a bit on the Federal Reserve's problem.

It is well and good—and I certainly agree with Jerry and the tone of this committee—that the Fed should be charged with reducing the money supply growth each year.

But there are three essential problems:

The state of the art of monetary control is simply not adequate to assure that those annual targets can be met. It was a matter of luck, more than anything else last year, that we even came close. And, as was so well pointed out by the committee, we exceeded the target levels.

What is the problem? In 1979, which is the most recent year for which we have official evidence, the Fed's miss in estimating reserves for the next week, which should be a relatively easy task, was \$840 million on average, per week.

It is difficult, in view of the unpredictability of changes in float and other factors affecting reserves, for the Fed even to get a fix on next week's reserves, in hopes of achieving monetary control; let alone next month's reserve changes. The actual change in total reserves, week by week, in 1979 was only \$360 million. So, the mistake the Fed made in estimating reserves for the next week—which is absolutely critical for any kind of tight money control program—totally swamped the actual dollar change in total reserves.

The problem is that these factors are not under Fed control.

A second factor: There are extremely wide fluctuations in the linkage between reserves and money; in part, because of volatility and large CD's, which are a financial instruments—not money—but against which banks must hold reserves.

Second—and perhaps we can find out the reasons from Utah bankers, or others—there was a tendency earlier this year for bank demand for excess reserves—mostly smaller banks apparently—to surge upward; perhaps out of concern over NOW accounts or concern over new reporting under the Monetary Control Act.

In January, reserves were at three times normal levels—nearly \$700 million. That is high-powered money. When banks demand excess reserves, those reserves don't go into raising the money supply.

So, the volatility is difficult to predict. It could be getting worse, rather than better, in the linkage between reserves and money.

And, finally, the linkage between the money supply and the economy, which we're trying to hit, is extremely volatile. Velocity, in essence, is what we're talking about here.

And, in that respect, I would recommend an excellent article which appeared in the February 1981 Morgan Guaranty Monthly Survey—if I could have it put in the record—suggesting that velocity, even of M-2, which is a broader monetary measure, is so volatile as to make it difficult to be sure how a given target of money growth will, in fact, relate to the economy. Particularly on a short-term quarterly basis.

[The article referred to follows:]

Copied from

The Morgan Guaranty Survey.

February 1981

The Pitfalls of Mechanical Monetarism

THE highly publicized shift by the Federal Reserve some sixteen months ago toward more emphasis on bank reserves and less on interest rates as the instrument for monetary policy was widely viewed at the time as a major move in a direction that monetarists had been urging for years. Nevertheless—and despite the fact that the Federal Reserve came close to its monetary growth objectives for the full year 1980—criticism of the monetary authorities by monetarist economists has not subsided.

Instead, there has been a steady drumbeat of complaint in recent months about the Fed's performance—with the main charge being that, as a result of the Fed's failure to be monetarist enough, 1980 saw an unnecessary and undesirable degree of volatility in both monetary growth and interest-rate movements. Grumbings have been heard about making the Fed "more accountable," and it is clear that some of the monetarists who either have found their way into the ranks of the new Administration or have maintained close advisory links to it are hopeful that the Federal Reserve can be influenced to mend its ways.

The issues involved here are obviously of great importance. The quality of the Fed's performance can make an enormous difference to the health and stability of the American economy. If monetarist criticism serves to improve that performance, so much the better. Indeed, there can be no doubt that in important ways such criticism already has helped. The evidence is persuasive that the long preoccupation of System officials with very close interest-rate management was inimical to noninflationary monetary growth. The shift in October 1979 to greatly diminished emphasis on interest rates—fostered in significant part by monetarist criti-

cism—unquestionably was a constructive move.

It does not follow, however, that all the elements of monetarist complaint about Fed performance in 1980 are valid or that the nation's interest would be well served by strict adherence to every aspect of the monetarist prescription.

"Unnecessary" fluctuations

The key monetarist complaint about the conduct of monetary policy in 1980 is that it did not succeed in holding monetary growth steady throughout the year. Professor Milton Friedman* and others accuse the Fed of having erred in letting the money supply (as measured, for example, by M1B) decline between mid February and May, rise too rapidly from May to October, and decline between mid November and the end of the year. These "unnecessary" fluctuations in monetary growth, it is asserted, not only greatly intensified the magnitude of cyclical fluctuation of the economy within the year (aggravating the recession and accentuating the rebound) but also caused interest rates to be much more volatile than they otherwise would have been.

Untangling cause and effect in economic data is rarely easy. There obviously are other explanations besides that offered by the monetarists for the particular cyclical configuration of 1980—including one which emphasizes the key importance of the shock of March 14's credit controls. But one need not get bogged down in the details of competing explanations to evaluate the monetarist criticism of last year's Fed policies. At the heart of that criticism are two propositions which transcend the specific events

*See, for instance, "A Memorandum to the Fed" by Dr. Friedman in *The Wall Street Journal* of January 30, 1981.

The Morgan Guaranty Survey

of 1980. The first is that the link between money growth and economic activity is stable even in the short run. And the second is that the Fed has the ability to maintain close control over the growth rates of the various monetary aggregates even over short intervals. The evidence to support these contentions is shaky at best.

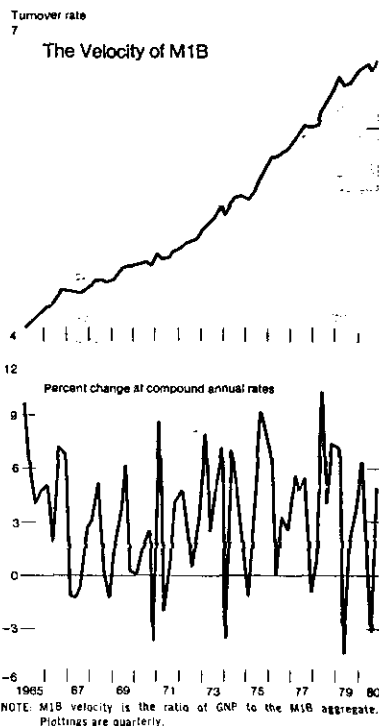
Searching for stability

The concept of the velocity of money provides a useful approach for gauging just how stable the link is between money and economic activity. The velocity of any of the monetary aggregates is simply the ratio of nominal GNP to the level of that aggregate. Thus, velocity measures how many dollars of economic activity are being carried out with a single dollar of money, or how many times a dollar of money "turns over" in the course of a year.

Pragmatic monetarists have long argued that the appropriate money supply to use as a policy target is the one whose velocity is most stable. That test has tended to point away from narrowly defined aggregates (such as M1A and M1B*), since, with the uptrend of interest rates in the postwar years, great strides have been made in the efficiency with which money is used in carrying out transactions. The velocities of the narrower aggregates indeed have shown a decided long-term upward trend. The monetary authorities can try to allow for the trend factor. But any allowance is complicated by the fact that shifts have occurred from time to time in the steepness of the trend.† Even were it not for the challenge of trend estimation, it is clear

*M1A includes currency in circulation and demand deposits; M1B includes currency and demand deposits plus checkable deposits at both banks and thrift institutions.

†Right now, such a shift may be occurring in M1A velocity growth because of the introduction of NOW ac-



from the substantial quarter-to-quarter volatility of M1B's velocity (lower panel, chart above)

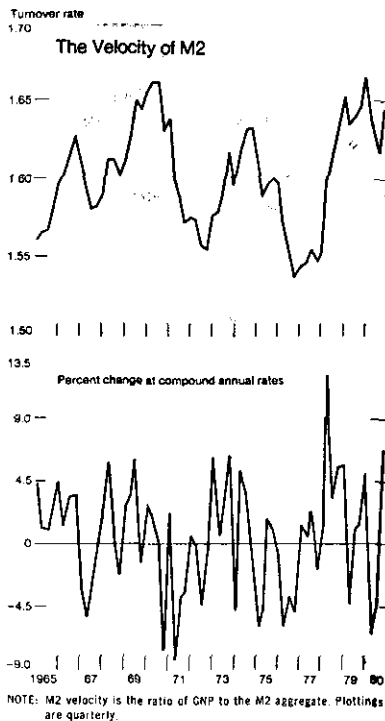
counts nationwide. As individuals shift funds from regular checking accounts to NOW accounts, which are included in M1B but not in M1A, the same dollar amount of economic activity will tend to be carried out with a smaller amount of M1A than before—i.e., the velocity of M1A during this transition period will tend to increase over and above its former trend rate of growth. While M1B will not be affected by shifts from checking to NOW accounts, to the extent that funds are also shifted from savings to NOW accounts, M1B will grow faster than usual and the growth of its velocity will tend to decline.

that a lot of slippage occurs in the short run between what happens to a narrow aggregate such as M1B and what happens to gross national product.

The trend problem present in the velocities of the narrower aggregates is absent in the velocity of M2.* As can be seen in the upper panel of the accompanying chart, the velocity of M2 has shown no appreciable trend either up or down in the last decade and a half. However, while the velocity of M2 shows no secular trend, its quarterly variations, as can be seen from the lower panel of the chart, are of comparable magnitude to those of M1B. This erratic behavior of money's "second dimension" (as velocity is sometimes called) inevitably means that—however money is measured—there is simply no way in the short run of confidently assessing the appropriateness or inappropriateness of variations in the money stock itself.

In the past, monetarists have typically acknowledged that changes in the rate of money growth over short time spans, if soon reversed, do not necessarily imply subsequent changes in economic activity. Thus, the attention given to short-run swings in money growth during 1980 (and the allegation of virtually simultaneous impact on economic activity) is something new for monetarists. The fact is that monetarists have almost always argued that changes in money growth affect economic activity only with a considerable time lag. Not only have they not advanced persuasive evidence of a simultaneous effect; their call for tight short-run control of money supply smacks of the kind of

*M2 includes currency in circulation, demand deposits at commercial banks, other checkable deposits, savings and small-denomination (i.e., under \$100,000) time deposits at all depository institutions, overnight RPs issued by commercial banks, money market mutual fund shares, and overnight Eurodollar deposits of U.S. nonbank residents at Caribbean branches of U.S. banks.



"fine tuning" which monetarists have so consistently criticized for many years.

How feasible is tight control?

Totally apart from the question of whether it is important to prevent temporary deviations of the aggregates from target, there is the issue of whether *it is even possible* for the Fed to achieve close control over money growth in the short run. In this regard, it is important to rec-

ognize that the quantity of money at any time is a function not just of the actions of the Fed. What the Fed effectively controls is the amount of reserves which it makes available to the financial system through open market operations and at the discount window.* But the quantity of money that a given level of reserves will support can vary significantly depending on changing public preferences for different components of money and, indeed, depending on the public's choice as between money and other financial assets. The fact that reserve requirements differ importantly according to the kind of deposit held and the nature of the depository institution accepting the deposit is, of course, very significant in explaining why no uniquely determinable volume of money results from a particular volume of reserves. (The Depository In-

stitutions Deregulation and Monetary Control Act of 1980 complicated these requirements still further.†)

The Fed is fully capable of guiding the growth of any monetary aggregate back toward a desired trajectory if such aggregate has tended to veer away. But it cannot hope to hold money-supply estimates precisely on a desired trajectory at all times and must realistically expect that deviations above and below that trajectory will occur from time to time,** reflective of changing private-sector preferences that are impossible to predict precisely. Experience has shown that the relationship between reserves and money—like that between money and GNP—is loose, and that selecting the appropriate growth rate of reserves to achieve desired money growth is inevitably a matter of trial and error.

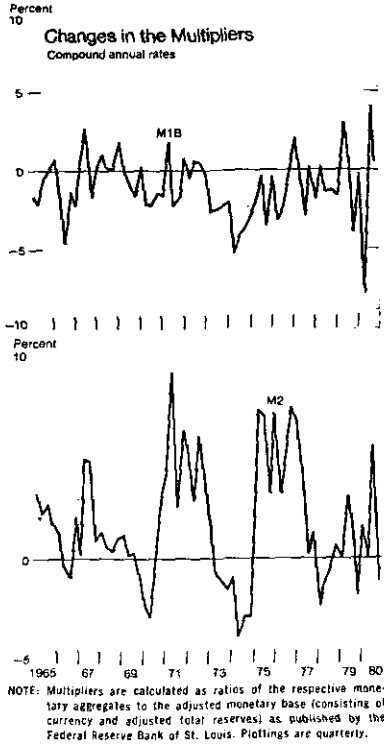
*"Effectively" controlling reserves does not, to be sure, imply precise control on a current-week basis. Indeed, in order to simplify accounting and reserve-posting by financial institutions, the Fed allows them in any given week to calculate required reserves on the basis of the deposits they held two weeks earlier rather than on the basis of contemporaneous deposits. Technically, this means that the Fed in a given week does not have discretion as to what volume of reserves to supply in total. Required reserves, based on two-week old deposits, are given and the Fed must either supply them in the form of nonborrowed reserves or allow financial institutions to make up any deficiency of nonborrowed reserves by borrowing at the discount window. However, if the Fed at any point finds itself needing to supply more reserves in total than it wants to (because deposit generation has been proceeding more rapidly than implied by money targets), it can force an adjustment in lending- and deposit-generating activities of financial institutions simply by limiting the supply of nonborrowed reserves. The disciplining influence on financial institutions of restricting nonborrowed reserve availability works in two ways: through the high discomfort many financial institutions feel when they find themselves pushed into the discount window; and through the forced reappraisal of asset and liability management practices that occurs as the Federal funds rate rises and carries other rates with it. By means of adjusting infusions of nonborrowed reserves, the Fed always has the ability to guide total reserves back to a desired trajectory any time they have veered away from that trajectory. Lagged-accounting procedures do not detract from that ability in any significant way.

The money multiplier

Just as the concept of velocity summarizes the link of money to GNP, an analogous concept—the money multiplier—is useful in evaluating the relationship between reserves and money. The money multiplier, however, is not simply the ratio of money to reserves. Currency held by the public must also be taken into account in calculating the money multiplier, since currency is a part of the money supply that is provided by the Federal Reserve but not a part linked to the reserves held by financial institutions. The accommodation of currency is achieved by calculating the money multiplier as the ratio of money to the total of reserves and

†In the December 1980 Federal Reserve Bulletin, seventeen tabular entries and 78 lines of footnote are devoted to describing existing reserve requirements for depository institutions.

**This is especially the case since initial estimates of money-supply figures are often revised and rerevised by substantial amounts.



currency—the so-called monetary base—rather than to reserves alone. This puts currency in both the numerator and denominator of the money multiplier and thus frees the multiplier from a distorting influence that would arise if currency's presence in the money supply were not explicitly allowed for.

The money multiplier makes it possible to distinguish between the growth in money that stems from variations in the amount of re-

serves and currency provided by the Fed, and the growth that stems from changes in the amount of money supported by each dollar of reserves and currency. The latter component of money growth—summarized by changes in the multiplier—reflects the multitude of decisions the public makes about the composition of their financial assets.

The chart on this page shows how the M1B and M2 multipliers have fluctuated in recent years.* Mere visual inspection of the multiplier relationships should suffice to warn just how difficult it would be for the Fed to keep money growth tightly on target by manipulating the monetary base. Given the magnitude of the variations in the multipliers, it is puzzling that anyone should believe that a policy of steady reserve growth should be expected to produce steady money growth, particularly if the focus is on relatively short time spans.

Market constraint

The Fed itself probably would not be overly concerned with short-run variations in money growth if the financial markets did not react so much to these movements. Unfortunately, the

*The reserves series used to calculate the monetary base, and the multipliers appearing in the charts on this page, is total reserves, as adjusted by the Federal Reserve Bank of St. Louis to compensate both for seasonal factors and for changes in reserve requirements. When reserve requirements change, so does the level of deposits which can be supported by a given amount of reserves—i.e., the effect is the same as if the Fed had changed the level of reserves in the financial system. If the multipliers were calculated from an unadjusted monetary base, moves by the Fed to change reserve requirements would appear as changes in the multipliers. But that would be inconsistent with the reason for introducing the concept of the multiplier in the first place: to separate the impact on the money supply of actions by financial institutions and the public from the impact of actions by the Fed, the former being measured by changes in the multiplier, and the latter by changes in the base.

Fed is caught in a bind somewhat of its own making: One reason for the market's attention to short-run changes in money growth is the fact that, in the past, such movements have been allowed to cumulate. The Fed thus has a *credibility problem to contend with*. But the Fed's recent willingness to allow a sharp rise in short-term interest rates at the very start of an economic recovery in order to restrain the aggregates has helped significantly to convince market participants that the Fed is now very seriously committed to its money-growth targets.

In that sense, the upside part of last year's interest-rate volatility yielded an important psychological dividend that will continue to grow if the Fed maintains a policy of monetary restraint. Curiously, however, because of the need to reestablish credibility, the Fed has helped impart a greater degree of importance to mone-

tary targetry in the short run than is justified by the looseness of the relationships between reserves and money and between money and economic activity. The fact is that, given the looseness of those relationships, no one can be sure that any particular target is precisely the right one or that it will not actually prove perverse to the health of the economy under changing conditions. But to the extent that the public now measures anti-inflationary determination, as it apparently does in considerable measure, by whether specified monetary targets are being met, the Fed has limited practical ability to depart from its targets even briefly. The Fed is constrained even if it is thoroughly convinced that departure from its targets is desirable because of changing circumstances. This is unfortunate. The nation needs continuing monetary discipline. It does not need—and indeed would be ill served by—rigid mechanical monetarism.

February 1981

Dr. JONES. So, I would submit that Fed policy is imperfect, and that it will be unable to do the job alone, without major financial catastrophe in 1981.

BOND MARKET BEST SOUNDING BOARD

The bond market is perhaps the best sounding board for where we stand now. There is a tendency to believe that the Fed, in fact, means business, although control is understandably imperfect. And there is a tendency to feel that, perhaps, President Reagan is going to be tougher with the budget than we have ever seen before.

But the verdict is still open.

The bond market, in recent days, has been swamped by Treasury borrowing at \$36 billion projected in this quarter, alone, the highest quarterly level we've ever seen. That interest rate pressure reinforced, of course, by inflationary expectations, poses major threats for the savings and loan industry this year, for mutual savings banks this year, for insurance companies this year.

Any institution that has invested in longer term debt—and I've seen the market value of that debt fall dramatically—any institution that suddenly must pay prohibitive costs for funds available for lending.

So, I would submit that the moment is critical. The time is now. And the key factor in breaking inflation psychology this year lies in the hands of the Congress—again, if anything, to out-Reagan Reagan, in terms of budget cuts; and, No. 2, to be careful about the tax cut timing. That could be the most critical element in the entire program.

Spending cuts, first; tax cuts, later.

Thank you, very much, Mr. Chairman.

[Complete statement follows:]

Testimony by

Dr. David M. Jones
Vice President and Economist
Aubrey G. Lanston & Co. Inc.

"The Impact of Federal Reserve Policy
and the Reagan Budget Measures on
Financial and Economic Activity in 1980"

There has never been a greater need or opportunity in our country for effective Government monetary and fiscal policies. The objective is, of course, to dampen raging inflationary pressures. Ideally, the combined anti-inflation efforts by the Federal Reserve, the Reagan Administration and the Congress should rival in intensity of course for wholly opposite reasons, the anti-depression actions of the Roosevelt Administration nearly 5 decades ago. Nothing short of an all-out, coordinated effort will work--given the deeply embedded inflation psychology which has ravaged our economy and our currency over the past decade and a half. Encouragingly, the Federal Reserve, under the able leadership of Chairman Volcker, has made considerable progress towards establishing anti-inflation credibility over the past year or so, though Fed efforts at short-term monetary control understandably have left much to be desired. Similarly, President Reagan has launched, as the first major act of his new Administration, an impressive array of anti-inflation spending cuts.

The anti-inflation ball is now in Congress' court, and there is no time to waste. In recent weeks the Government securities market has been choking on a massive flood of Treasury debt arising from years of fiscal irresponsibility. Resulting financial market strains and record-high interest rates on both Government securities and private debt such as corporate bonds have discouraged business investment on productivity-enhancing plant and equipment. In order to break the vicious circle of fiscal irresponsibility, escalating inflation, and prohibitively high interest rates, Congress must act promptly and boldly. Perhaps most importantly, Congress should consider enlarging upon, rather than diminishing, President Reagan's proposed Federal spending cuts. In addition, Congress should delay final action on the President's tax cut proposals until the precise magnitude of the spending cuts can be determined. Moreover, the effective dates of these somewhat controversial supply-side enhancing tax cut measures should be delayed until 1982.

Federal Reserve Policy

The Federal Reserve has recently made real progress in establishing anti-inflation credibility. In his report to this Committee last week (and elsewhere) Fed Chairman Volcker emphasized that we currently have a "... rare opportunity to deal with our economic malaise in a forceful, coordinated way." Summing up the Fed's appropriate and commendable general policy stance, Chairman Volcker has stated "...our intent is not to accomodate inflationary forces; rather we mean to exert continuing restraint on growth in money and credit to squeeze out inflationary pressures. That posture should be reflected in further deceleration in the monetary aggregates in the years ahead, and is an essential ingredient in any effective policy to restore price stability".

To the credit of Congress, the Fed's anti-inflation credibility has been enhanced by its highly visible reports to Congress in February and July of each year on annual objectives for monetary expansion under the provisions of the Humphrey-Hawkins Act. The monetary authorities have not only sought to lower their targets for monetary expansion each year with a view to dampening inflationary pressures, but they have, more importantly, acted recently with conviction when these targets were in danger of being exceeded. For example, in the closing months of 1980 an unexpectedly brisk rebound in economy activity and related increases in individuals' and businesses' demands for money and credit threatened to push monetary growth far above the Fed's 1980 targets. The Fed responded by clamping down on bank reserve positions through its open market operations, and tolerating a sharply higher Federal funds rate (and other money market rates) with a view to dampening excessive money growth.

As matters turned out, actual 1980 growth in the Fed's various monetary and credit aggregates exceeded target limits, though the misses were relatively small. For the M_1A and M_1B aggregates, for instance, actual growth exceed Fed targets by only .25 of a percentage point last year. In the case of the broader M_2 and M_3

aggregates the misses on the high side of the targets were slightly larger at .8 and .4 of a percentage points respectively. The point is that the Fed made a real effort to reign in money growth to a pace close to target levels late last year, irrespective of the fact that the economy was still in the early stage of recovery-- following a drastic free fall in economic activity in the second quarter of 1980. Moreover, there is every reason to expect a repeat of such Fed tightening moves should similar monetary excesses prevail towards the end of this year, or next.

While the Fed's overall policy approach is praiseworthy, a word of caution is in order. There is a current misconception--both within some Fed policy-making circles and, more ominously, among the numerous "monetarist" economists at the Treasury and elsewhere in the Reagan Administration--that monetary policy can be reduced to a simple mechanical process. In essence this simple-minded view is that the money supply can be stabilized if only the Fed would give its undivided attention to the reserve-money relationship. This misguided viewpoint emphasizes the need for some added technical refinements such as a shift to contemporaneous reserve accounting from lagged reserve accounting and a change in the discount rate to a floating or penalty rate, solutions that would only add to already excessive interest rate volatility.

This "ivory tower" monetarist view, to put it bluntly, bears little, if any, relationship to reality. The "state of the art" of Fed monetary control is simply not sufficiently advanced to guarantee short-term monetary objectives. Consider the following items:

- (1) In 1979 (the latest year for which official data are available) the average weekly Fed miss in estimating bank reserves was a whopping \$840 million. This error factor actually swamped the change in total bank reserves which averaged \$360 million per week in this period.
- (2) Wide fluctuations in the reserve-money multiplier casts doubt on the proposition that steady reserve growth (even assuming the Fed could accurately forecast reserves) should be expected to produce steady money growth.

(3) The public's (individuals' and businesses') demand for money is inherently unstable, rather than stable as the monetarists claim. For example, in 1980 ^A M₁ growth fluctuated violently from a decline of 20% (annual rate) in April to a 19.3% increase in August.

In light of these glaring imperfections in the monetary control mechanism, the Fed must fall back largely on psychology and the powers of persuasion. The current reality is that Fed policy-makers must typically react to unstable monetary and economic fluctuations rather than initiating control. Minor reserve accounting refinements in the money control apparatus will do little good. In these circumstances the monetary authorities must, above all, continue to demonstrate consistency and steadfast determination to slow money and credit growth sufficiently to wring inflationary excesses out of the economy.

In its day-to-day operating framework, Fed policy should be a continuous process of observation and adjustment. Specifically, when, say, the recent trend in money growth is excessive the Fed must convince banks and other lenders that it will continue to tighten until a slowing in money growth occurs. When the Fed, in such a situation, clamps down on bank nonborrowed reserve growth, banks are forced to scurry to the Fed discount window for additional funds. However, the discomfort felt by banks availing themselves of the privilege of borrowing at the Fed (including administrative limits on the frequency, amount and purpose of such borrowings) eventually causes banks to become more selective in their investment and loan activities thereby slowing deposit (money) growth. If the Fed conveys sufficient determination in this tightening process it may speed up the 2-3 month bank asset adjustment process, particularly as related sharp increases in short-term interest rates lead to unsettled conditions in the markets for CD's and other sources of bank funds. At the extreme "crunch" case, banks may turn off their new lending activities out of fear that they will be unable to roll over their maturing CD's or other term liabilities. The restraint-related jump in interest rates will, of course, have the additional side effect of causing

the public to conserve its money balances, thereby acting as a further dampening factor on observed money growth.

Looking ahead, Fed policy in 1981 is likely to be characterized by "more of the same", including extremely volatile short-term interest rates and Fed difficulties in dampening wide savings in the public's demand for money. Between now and mid-1981, for example, it is a good bet that an increasingly hesitant economy, combined with effort by consumers and businesses to improve their fragile financial positions by paying off excessive short-term bank loans, will result in generally sub-par money growth. In these circumstances, the Fed is likely to respond by easing pressures on bank reserve positions, with a resulting drop in short-term interest rates. Fed policy-makers have resolved not to repeat their generally acknowledged mistake of easing too fast and too far last spring, but the results remain to be seen. Later in 1981, Fed policy makers may conceivably face the opposite conditions should confidence in the Reagan economic program cause a late-1981 pick up in economic activity and money growth. The Fed would most likely tighten in these circumstances, pushing interest rates again sharply higher, thereby threatening to choke off economic recovery for a third time in two years.

The Reagan Budget Program

Can the Reagan Administration and the Congress, working together on the fiscal front, help to smooth out the potential financial and economic instability resulting from an imperfect and hard-pressed monetary policy? The answer is emphatically, yes! Currently, the best way to break the vicious cycle of inflation, inflation psychology, and high interest rates is to cut Federal spending deeply and across the board. For fiscal year 1982 the "psychological threshold" for an effective anti-inflation budget cut appears to be in the vicinity of \$50 billion. The Government bond market is a good sounding board for the perceived fiscal responsibility (or lack thereof) of the Administration and Congress. This was vividly demonstrated last February when a bond market collapse (a kind of vote of no-confidence) forced President Carter to rethink his excessively unbalanced budget. The recent collapse in prices of Government

bonds, pushing interest rates on 30-year issues above 13%, suggests that participants are skeptical of the Reagan Administration's ability to push its spending cut program through Congress promptly and largely in tact. The Congress could help dispell these market fears by recommending Federal spending cuts in excess of the \$41.4 billion (plus modifications) proposed by President Reagan in order to insure that the budget impact in fiscal 1982 is sufficiently anti-inflationary. (In this connection it should be noted that merely removing the borrowing of certain agencies from the Federal Financing Bank is not sufficient to reduce the Federal government's intrusion into the private sector.)

In order to strengthen prospects for a reduction in inflation psychology, while at the same time insuring sustained longer-term growth in real economic activity, the Congress should also make three important changes in the President Reagan's proposed tax cuts. First, the tax cuts should be shifted to more heavily favor incentives for business spending on new plant and equipment, with a view to enhancing productivity and reducing inflationary bottle necks. As the President's tax cut proposal now stands businesses' relative share of the net \$51.9 billion tax cut proposed for fiscal 1982 is only 20%. Businesses' share of the tax cut should be closer to 50%. Second, tax cuts for individuals--which, contrary to supply-side thinking, are potentially inflationary--should be considered on a year-by-year basis rather than over the 3-year period proposed by the President. Finally, the effective dates of the new tax cuts should be postponed until January 1, 1982 for business and June 1, 1982 for individuals in order to cut down on the Federal deficit and related borrowing, and to help reduce inflationary expectations.

Financial and Economic Conditions

The urgency of lessening the inflationary strains on our financial markets can't be emphasized enough. Because of inflation, recurring periods of tight money, and a prevailing inverted yield curve (higher short-term interest rates than longer-term rates), the underpinnings of such key financial sectors as our savings and loan industry, mutual saving banks, and insurance companies are becoming increasingly

shaky. *Earnings* are under pressure and longer-term asset values are deeply depressed (particularly longer-term mortgages and bond holdings). Also many financial institutions find that lendable funds (deposit) footings are either eroding or prohibitively expensive.

At the same time, the unsettled financial market conditions are inhospitable to financially strained non financial businesses. For many smaller business, in particular, the unexpectedly onerous cost of short-term borrowing

is almost too much to bear. Even adjusted for the 8.4% inflation rate last month, the real cost of borrowing is at an all time high. Recently, many businesses financial positions have come under special strain as their efforts to borrow in the longer-term bond market in order to acquire the funds to repay excessive and burdensome short-term debt have been thwarted by unsettled bond market conditions. Government competition for funds has contributed to these *unsettled bond market conditions with Treasury* new money borrowing in the current January-March period projected at an all time quarterly high of at least \$36 billion.

The simple fact is that time is running out. Unless Congress makes drastic moves to reduce the strain on the markets from Government borrowing, a massive wave of financial and corporate bankruptcies will likely swell up before this year is out. This threat is reinforced by the one critical flaw in the Reagan economic program. It is the attempt to link budget-breaking tax cuts to spending cuts in fiscal 1982, while, at the same time, calling for increasing monetary restraint (in the form of a halving of money growth by 1986). The problem is the next 6 to 12 months. In order for financial strains to ease and interest rates to decline, something must give. Either inflation must suddenly ease dramatically (any relief is more likely to come later than sooner) or real economic activity (production and jobs) must collapse.

At the very least, the prevailing financial strains are likely to result in a second recessionary phase in 1981 (following the first phase which began last February and ended last July or August). Specifically, real economic growth is expected to fall by 2-3% at an annual rate in the second quarter of 1981 and by 1-2% in the third quarter of this year. Also contributing to this reemerging weakness in the U.S. economy will be wide-

spread recessionary conditions in Western Europe conditions that were not present in the first stage of U.S. recession last year.

The future course of the U.S. economy depends even more than usual on how carefully fiscal and monetary policies are designed. There is hope if fiscal prudence prevails and spending cuts come first, followed by carefully designed tax cuts--aimed not at a quick and potentially inflationary fix through consumer stimulus but at a potential for future sustained real growth through productivity-enhancing capital investment and research. When the anti-inflation burden is shared by fiscal policy in this way, then monetary policy can, hopefully, be managed in a way less unsettling to the financial markets.

Table 1
 Selected Monetary Aggregates
 Actual Growth vs. Fed Targets
 (Annual percentage change)

	M1-A		M1-B		M2	
	Actual	Target	Actual	Target	Actual	Target
Annual Growth ⁺						
1979	5.0		7.7		9.0	
1980	(6 1/4)	3 1/2 - 6	(6 3/4)	4 - 6 1/2	9.8	
	5	(2 1/4 - 4 3/4)	7 1/4	(4 1/2 - 7)		
Quarterly Growth ⁺						
I	3.4	4 1/2			7.5	6 1/2
II	2.1	4 1/2			8.5	6 1/2
III	13.5	6 1/2	17.1		14.3	12
IV	1.5	2 1/2	3.8		7.1	7 1/4
Monthly 1980						
January	2.6		4.3		6.8	
February	9.4		9.6		10.1	
March	1.9				5.4	
April	-20.0		-15.6		3.2	
May	1.3		0.6		10.3	
June	12.4		16.2		18.3	
July	8.4		12.9		18.8	
August	19.3		21.8		14.9	
September	12.3		15.8		8.7	
October	9.1		11.8		8.8	
November	6.5		8.7		10.4	
December	-11.1		9.0		2.0	

() Figures in parenthesis adjusted for impact of ATS and NOW accounts.

⁺ - Fourth quarter average to fourth quarter average.

+ - Measured from last month of quarter.

Source: Board of Governors of the Federal Reserve

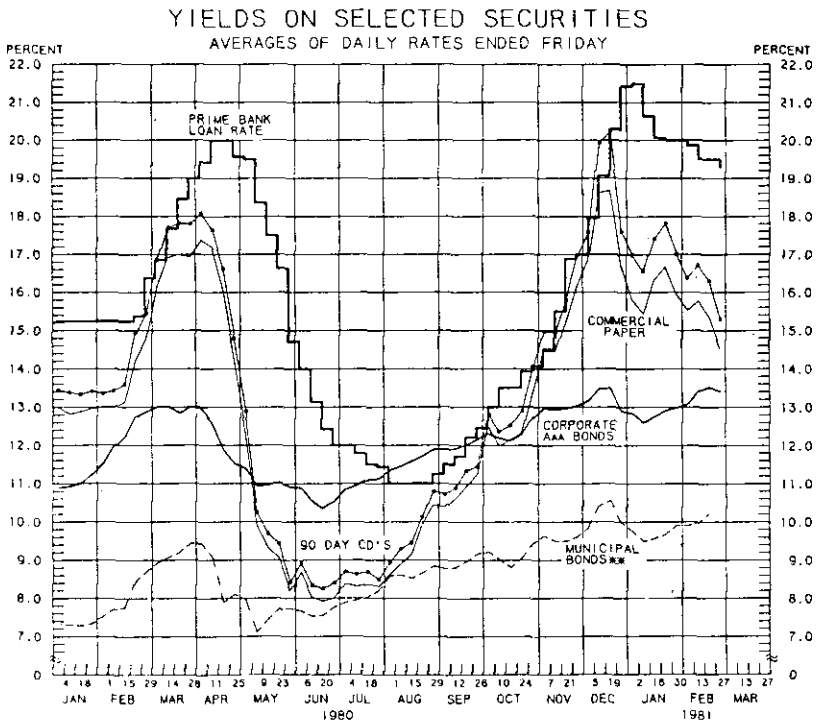
Table II

Federal Receipts, Spending and Deficits
(Millions of dollars)

<u>Fiscal year</u>	<u>Receipts</u>	<u>Spending</u>	<u>Deficit (-) or surplus</u>
1960	92,492	92,223	269
1961	94,389	97,795	3,406
1962	99,676	106,813	7,137
1963	106,560	111,311	- 4,751
1964	112,662	118,584	- 5,922
1965	116,833	118,430	1,596
1966	130,856	134,652	- 3,796
1967	149,552	158,254	- 8,702
1968	153,671	178,833	-25,161
1969	187,784	184,548	3,236
1970	193,743	196,588	- 2,845
1971	188,392	211,425	-23,033
1972	208,649	232,021	-23,373
1973	232,225	247,074	-14,849
1974	264,932	269,620	- 4,688
1975	280,997	326,151	-45,154
1976	300,005	366,418	-66,413
Transition quarter	81,773	94,728	-12,956
1977	357,762	402,710	-44,948
1978	401,997	450,804	-48,807
1979	465,940	493,635	-27,694
1980	520,050	579,613	-59,563
1981e	605,000	670,000	-65,000

Sources: Department of the Treasury and Office of Management and Budget.
e-estimated by Aubrey G. Lanston & Co. Inc.

Chart I



LATEST DATA PLOTTED ARE AVERAGES OF RATES AVAILABLE FOR THE WEEK ENDING: FEBRUARY 27, 1981

1981	90 DAY CD'S	PRIME COMMERCIAL PAPER ***	PRIME BANKERS' ACCEPTANCES	CORPORATE AAA BONDS	CORPORATE BAA BONDS	MUNICIPAL BONDS **
JAN. 2	16.99	15.80	16.28	12.83	15.09	9.76
9	16.35	15.43	15.03	12.59	14.93	9.49
16	17.42	16.33	17.08	12.76	14.96	9.57
23	17.82	16.67	17.38	12.91	15.08	9.68
30	17.03	15.94	16.38	12.98	15.15	9.91
FEB 6	16.38	15.53	15.92	13.07	15.32	9.90
13	16.71	15.77	16.23	13.41	15.41	9.99
20	16.31	15.34	15.48	13.51	15.36	10.22
27 *	15.29	14.53	14.85	13.40	15.36	N. A.
MAR. 6						
13						
20						
27						

* AVERAGE OF RATES AVAILABLE.
 ** U.S. BUYER'S AVERAGE INDEX OF 20 MUNICIPAL BONDS, THURSDAY DATA.
 *** DATA ARE 4-MONTH COMMERCIAL PAPER RATES.
 N. A. - NOT AVAILABLE

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Table III

Consumer Spending, Prices and Savings
(Month-to-month percent change)

1980	Personal Consumption Expenditures (Current dollars)	Personal Consumption Expenditures (Constant 1972 dollars)	Implicit PCE Deflator	Savings as a % of Disposable Personal Income
January	+1.8			4.8
February	.3		+1.2	4.9
March	+1.0		+1.4	5.3
April	-1.0		+ .5	5.8
May	.2		+ .5	6.2
June	+1.0	+ .4	+ .6	6.2
July	+1.9	+1.3	+ .6	6.0
August	+ .9	+ .2	+ .8	6.1
September	+ .7	.4	+1.1	5.9
October	+2.0	+1.3	+ .7	5.6
November	+1.3	+ .7	+ .7	5.2
December				4.9

Source: U.S. Commerce Department

The CHAIRMAN. Dr. Jones, I couldn't agree with you more, on the part of your comments about the expenditure reductions.

I would like to out-Reagan Reagan. I think \$41 billion is an absolute minimum, and would like to see larger cuts.

But I disagree with you on the tax side. I think they should go hand in hand. I'm not in favor of tax cuts without the expenditure cuts in the same fiscal year.

But I would like you to explain to me why you feel—or you want, by delay, to increase the tax burden on the American people again.

More than \$100 billion taken out of the economy, at a time when we do not have the funds available for modernization of automobile plants, steel mills, and so on; and Japanese competition.

I won't argue at great length on the individual tax cuts. But I think the business tax cuts, the incentives for capital formation, are far past due. We should have had them years ago, or we might not have been in the difficulty we are in now.

So, could you expand on why you are so forceful on at least that part of delaying those tax cuts?

I would just take the absolute opposite position: That we would injure the economy by waiting until January of 1982.

DELAY OF TAX CUTS

Dr. JONES. Two points, in answer to your excellent question:

The cruelest tax of all is inflation. And I feel that the juncture is critical, and the timing is critical. What we need is, essentially, a big bang. Maybe as big a bang as Roosevelt gave, on the opposite side of the fence, in his antidepression policy.

The point is that the best way to get full and maximum impact on inflation psychology—psychology first, we will see the results later—as was so well pointed out in the earlier questioning of Dr. Weidenbaum—is to be sure that:

No. 1: We get maximum effect in reducing inflation of that budget program. And the danger I see in the program is, that if you take it in terms of what is proposed, what we gain in terms of fighting inflation in fiscal 1982, in terms of spending cuts, we lose potentially in terms of fighting inflation.

On the tax cut side, I agree completely with your point about business. I wouldn't be quite as urgent about postponing business tax cuts to January 1982 as I would the individual income tax side. I think supply-side economics, which we were talking about earlier—it was being discussed earlier this morning—consists of two parts: one is a tested part, I will certainly admit, and that is by giving tax incentives to businesses, one can indeed—going all the way back to the Kennedy administration—see new plant and equipment spending, improved productivity, and reduced longer term inflationary results.

The point is this, though. On the consumer side, it is the radical part of supply-side economics. We are supposed to save more if we get greater tax cuts. That is untested, unproven, in terms of the evidence.

No. 2: We are supposed to work harder if we get tax cuts. I don't know about Jerry, but I may play harder with my tax cuts. Although it is difficult to measure the productivity of some economists, including myself, I recognize that.

But the point is that I'm looking for maximum impact.

I recognize that postponing business tax cuts even for an extra year is going to cause some problem in the sense that we don't get the new plant and equipment improvements. But I'm willing to pay that price to get maximum anti-inflation impact.

The CHAIRMAN. You also postpone a return in increased revenues, as a result of a tax cut. Kennedy found out that it produced more revenue than it lost. Not immediately, obviously.

But, the point of it is you're also increasing that revenue from a tax cut.

Dr. JONES. Slightly.

But, again, the question, in terms of the financial market impacts and in terms of the psychology, would tell me, at least, that the benefits of a postponement outweigh the negatives which you point out.

The CHAIRMAN. What about the experience we've had in the past, of tax cuts, where less income is then sheltered? People in the high marginal rates aren't trying to find places to prevent it from being taxed, at all, with lower marginal tax rates.

Dr. JONES. That is possible.

But again, to me, that is—

The CHAIRMAN. It's not only possible; it has happened in the past.

Dr. JONES. It has. But it is a secondary consideration, in the moment at hand.

In essence, what I want to see is maximum big bang effect. And I think there is a reasonable way to come out.

The CHAIRMAN. The only problem I have with all of these fears—as Senator Proxmire expressed, and many of our Democratic colleagues—is that the Reagan program won't work.

Well, you know, sometimes after all of these years in the minority, I stop and wonder if our philosophy does work. Because we haven't tried it.

But if Senator Proxmire hadn't left, I would say: "Well, we are familiar with the typical economy we've had for many, many years. And we know that that doesn't work." And certainly not just to blame it on Democrats; Republicans have participated, as well.

But the point of it is: If we don't have ample evidence from what has happened the last 2 or 3 years—that these high, high levels of taxation, increasing to 22 percent of GNP, don't work—then I'm willing to gamble. I'm willing to try something else. Because we have totally failed, and botched up this economy. I don't know how we could have done it worse than we have.

Dr. JONES. I'm willing to gamble, too. I think your point is extremely well taken.

But I feel a slight shift in timing—and maybe it's because of my participation in the bond market—timing is everything there—a slight shift in timing will give us, hopefully, the benefits of fresh and new ideas, in the form of some supply-side logic; but without major damage being done to this program, or to the economy, or to the financial markets in 1981.

I think, in a sense, we haven't thought out, to the full, the potential problems that could exist.

Take the savings and loan industry. As a result of more pressure, short term, on interest rates, because of excessive Government borrowing, due to a linkage of tax cuts to the spending cuts—

We are essentially at a critical juncture. Many S. & L.'s thought they couldn't make it through last year. The ability to get through this year—should Government borrowing continue as excessive—may be even more remote for them.

So, my feeling is a sense of urgency about the current market conditions. And I feel, even trying new ideas, that the timing shift on balance has more benefits than costs.

The CHAIRMAN. Dr. Jordan, how do you feel about the timing of the tax cuts?

CORPORATE TAX CUTS

Dr. JORDAN. I would do the tax cuts—especially those that are in the form of corporate, or accelerated depreciation—immediately. As soon as possible.

The mix of the whole package—

The CHAIRMAN. I like your answer better. [Laughter.]

Dr. JORDAN [continuing]. Will have to be geared toward encouraging accumulation of productive real assets, and productivity enhancing technology.

We have shifted, over the last 15 years, at an accelerated rate—particularly in the last 5 years, since the first sharp oil price

increases—the mix of our resources, going toward current consumption—both in the private sector and the Government sector.

The oil price increases amount to, in present value terms, a transfer of wealth from this country to the exporters of oil.

As a nation, we have the choice to take that transfer either out of current consumption or out of future consumption. By trying to maintain current consumption levels, everything from the first \$50 tax rebates and all the other policies since then, and the fact that the Government has increased as a share of the national income, meant that, by default, the transfer to OPEC has come out of future consumption.

We need to tilt the mix of our resources back away from current consumption, toward future consumption. Which means new, truly productive, capacity, in addition to the investment—what is counted as investment spending—that goes to clean air, and clean water, and all of the rest.

That can only be accomplished, I think, with something like accelerated depreciation and an across-the-board corporate rate.

The people don't understand, really, I believe, that businesses don't pay taxes. It is a matter of deciding which type of tax that the people pay, do you want to cut. The type of tax I would encourage to do away with is the double taxation of dividends, and get the corporate rate down as much as possible, as quickly as possible.

The CHAIRMAN. Well, I think you're absolutely right. People don't understand that businesses don't pay taxes. That people pay taxes.

And, as a result, we always get into this populist argument of: "Well, there they go, treating the big rich boys and businesses, and not having the individual cuts."

My time is up.

Senator Schmitt?

Senator SCHMITT. Thank you, Mr. Chairman.

Dr. JORDAN, in your statement, you said M-1B grew at 12.8 percent annual rate. I think that in the last two quarters of last year the gross national product probably was growing at something like 3 percent in the same period of time.

Dr. JORDAN. In real terms, yes.

Senator SCHMITT. Now, would that imply, to you, that the built-in inflation rate has risen to 10 percent?

Dr. JORDAN. I believe, right now the underlying rate is probably around the 10-percent range, measured by something like the overall deflator, or the personal consumption component of the deflator. Yes.

Senator SCHMITT. And what your recommendations would do is, basically, set a target that would, hopefully, within 12 to 18 months, get that built-in rate down to 5 percent or 6 percent?

Dr. JORDAN. It would probably take longer than 12 to 18 months to get it down to 5 percent or 6 percent. That depends upon the credibility of the program.

Other experience—for instance, Germany after the hyper-inflation, after World War I—or even in this country in 1971, when the initial impact effect of the wage-price freeze demonstrated the

psychological effect that can be achieved when you capture the people's imagination.

If they really want to believe it's going to work, you can get a very pronounced effect. That is what we are still looking for to happen this time.

Senator SCHMITT. What do you think the so-called psychological component of the earned interest rates is?

That is, the component that you might relate to people's expectation of money as a commodity.

What is the future value going to be and how much of it is there going to be available?

Dr. JORDAN. I think both the long-term bond yields and short-term market rates are considerably above what is consistent with underlying conditions. They are certainly above what is consistent with a program of deceleration of inflation.

The bond market demonstrates, by the yields you observe, that they simply don't believe—or they are not really willing to bet—that inflation is going to come down.

I think that you could have, this year even, a drop as much as 200 basis points, 2 percentage points, in long-term bond yields, if people believed that the program would be sustained—not just this year, but beyond.

The capital gains to individuals, too, by investing long-term financial assets, if they believe inflation interest rates are going to come down, are considerable. They are foregoing that right now, for the fear that it may actually go the other way. In the past, when individuals acted prematurely in betting that inflation and interest rates would come down, they lost. And that experience is making people twice as cautious, now.

I think that short-term interest rates may have as much as a 5-percentage point difference between what would be consistent with underlying on-going inflation and what we are observing in the markets right now. That much can come out very quickly.

Senator SCHMITT. So, you think that if the Congress and the administration work together and are successful in showing a major new thrust in Federal fiscal policy; and that if the Federal Reserve sticks to its guns; that, within a few months, the interest rates—that are holding up construction and some agricultural activities, and some other business activities—would drop as much as 5 percent?

Dr. JORDAN. Yes.

I believe the short-term—for instance, 90-day Treasury bill rates—will be below 10 percent this year, if people believe that this program is going to be enacted and maintained.

Senator SCHMITT. Do you think it's going to take actual enactment?

Do you think it's going to take the President's signing the whole thing more or less into law, in October, for this to happen?

Dr. JORDAN. If will start happening, and the markets will start to assimilate the information as they observe the kinds of discussion that take place; the questions about whether it will be a 1-year tax cut or a multiyear tax cut.

I am not convinced that the current projections for budget expenditures do represent a reduction as a share of national income.

They do so only if you assume a high growth in annual income, over the next 5 years.

I would like to see a lower growth path for Government expenditures over the next few years.

Senator SCHMITT. So, you would agree with Dr. Jones, that we ought to seriously consider taking a bigger cut than what the administration apparently is coming up with now?

Dr. JORDAN. Yes. I do, very much.

Senator SCHMITT. How much bigger. 25 percent?

Dr. JORDAN. Well, the approach I would use would be to set targets for the growth of nominal income, over the next 4 or 5 years, would be the path of sharply decelerating the growth of nominal GNP total spending in the economy. And then, set your ceiling on the Government's spending, as a share of that, to bring it down sharply from the 23-percent level to something 20 percent, or even less.

The administration's numbers project, I think, 19.4 in 1986. But that is based on a much higher assumption of nominal income growth than I'm willing to accept.

I would like to see a much lower growth path than that.

In effect, what we're talking about is cutting the growth of nominal spending in half, over the next 4 or 5 years.

Senator SCHMITT. Do you think the incentives within the savings-investment economy exist, so that decreases in the marginal rate will actually result in a measurable increase in savings and investment.

Dr. JORDAN. It will go in that direction. It will be positive. I'm not convinced that it is sufficient. After the fact, the economy only saves, when it also invests. I would like to see more focus on the investment side. There is a tendency at times to think first you have to stimulate savings, and then investment will occur. I would go the other way around. I would go directly trying to stimulate investment, in the confidence that the savings will be forthcoming to support it.

DOUBLE TAXATION

Senator SCHMITT. How do you feel—and then I will ask Dr. Jones the same question. Do you think we should remove any kind of tax disincentive for savings and investment, as generally exists in other industrialized countries? You mentioned, I believe, double taxation.

Dr. JORDAN. Yes. Double taxation of dividends.

Senator SCHMITT. How do you feel about the exemption of savings income and investment income entirely?

Dr. JORDAN. Well, the exemption of savings income, in the form of certain types of financial assets, deposits, for instance, in financial institutions, doesn't necessarily increase the total aggregate amount of saving, unless you can be sure that it is going to go into long-lived productive assets. It may just cause a substitution of one form of savings instrument for another form. So you've got to be sure that investment side is being stimulated simultaneously with that action. Regulation Q has been the most negative antisaving device that we have had since the 1930's. It has had a very pervasive negative effect on this economy throughout the 1970's, and the

action last year to phase out Regulation Q, even though very, very slowly, is very positive.

I think it is much more important to eliminate the double taxation of dividends than it would be to have an interest tax exemption.

Senator SCHMITT. But you're saying that if you did both, they would be synergistic? You would get more bang for the buck, so to speak?

Dr. JORDAN. Yes, it would have a more positive effect, and it might be a nice companion to the phasing out of Regulation Q ceilings, because the phasing out of Reg Q ceilings is going to put upward pressure on the liability costs of financial institutions, while a disinflationary program is going to reduce the returns to the financial institutions on the asset side. So you're going to have an interest margin squeeze. You can have reluctance of the financial institution to take on new commitments. If you exempted savings or some part from taxation, then the financial institutions could attract savings at lower nominal interest rates than otherwise, and they would be operating in a healthier condition.

Senator SCHMITT. Dr. Jones, my time is up, but would you care to comment briefly?

Dr. JONES. Yes. Two points. One has to do with the overall national savings rate. I think that the key consideration there is the Federal sector. If we run budget deficits as we have for 20 out of the last 20 years through fiscal irresponsibility, that the chance of generating enough economy in this economy to promote investment, which I certainly concur is critical right now, is virtually hopeless. We have to change that policy. That is one of the reasons why I want that budget to move as quickly as possible toward balance. Ideally, the budget should be budgeted over the cycle, so that in expansion periods we should see surpluses in the Federal budget, which is perhaps the biggest source of savings of all.

The second point is that I would agree that direct savings incentives for individuals is a very appropriate idea, particularly with the untested feature of the supply-side reasoning of the economy. I sense that many administration economists are saying over and over again to themselves, "Supply side economics works. Supply side economics works." And I wonder if they're not trying to convince themselves, as well as those of us brought up on other knowledge. Now it may work, but I would like to help guarantee it working with direct savings incentives.

Senator SCHMITT. So would I. Thank you, Mr. Chairman.

The Chairman. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

FEDERAL RESERVE ACTIVITIES CRITICISED

Mr. Jordan, in your statement, I read that as a fairly stiff indictment of the Federal Reserve's activities subsequent to the imposition of credit controls. I read your statement, both your written and your verbal, as being extremely critical of that Board, which was represented here by Mr. Volcker a few days ago. Am I characterizing your testimony inaccurately, when I say that you believe that they acted irresponsibly?

Dr. JORDAN. I wouldn't say "irresponsibly." I would say maybe incompetently. What Chairman Volcker did in 1979, was very bold and very courageous. It captured the imagination of observers of the Fed policy, that something really would be different in the future. The actions of the subsequent spring were very disappointing. The Fed was reluctant to let interest rates drop sharply as the economy contracted in an environment of controls, because they were afraid that it would cause the dollar to weaken on foreign exchange markets. It was a policy focused more on the exchange rate than it was on the money supply, so the money supply contracted very sharply, and when the controls were lifted, interest rates started to move up again, and the Fed was afraid that rising interest rates *abort the recovery or deepen the recession*. And so they tried to resist that.

So it means that they took their eye off the money supply. They first let it drop too sharply, and then they let it expand too sharply. They didn't do what Chairman Volcker said he was going to do in October of 1979, and we're now going to have to pay a price, and I'm afraid maybe a large price, in 1981, for that mistake.

Now he says that he is going to get back to the policy that he announced in 1979. His problem is like that all of his predecessors in the Fed—they kept stating intentions that we could all applaud as the right thing for the Central Bank to be doing, and they kept missing, time and time again. And now he made that mistake in 1979, he's going to have to recover from it.

Senator HEINZ. Now when Mr. Volcker was here, he pleaded that it was not a question of incompetency, he pleaded that this was simply beyond the ability of mortal men. Why do you disagree?

Dr. JORDAN. Since I have read the statements of the record of policy actions released after every meeting last year, the dissents that did occur, the reasons for those dissents, my observations of the Fed over the last 14 years—I was employed by the Federal Reserve for 8 years—I think I understand their operating procedures fairly well. I have studied this large document of their explanations, and I am convinced that they simply didn't want interest rates to go up, mainly, because it was not only perceived to be a recession—their forecasts were that the economy would decline in the second half, and it didn't—but also because it was an election year.

Senator HEINZ. So your case against the Fed as being—is really that they were woefully incompetent as judged by the minutes of Federal Reserve meetings?

Dr. JORDAN. That they refused to let interest rates rise as rapidly as the market would have dictated? Yes, sir.

Senator HEINZ. Now the same man is Chairman of the Federal Reserve this year as last year: Mr. Volcker. Everybody I've talked to holds him in very high esteem. He is obviously an intelligence man, and I think you yourself do.

Dr. JORDAN. Very much so.

Senator HEINZ. And you yourself underline one of the major concerns, which is, after a decade of Federal Reserve pronouncements of how they're going to whip inflation, if not now, then, and now again, and a record of performance that somehow doesn't ever seem to measure up to Arthur Burns' or anybody else's pronounce-

ments, that the credibility of what Mr. Volcker is saying and doing is necessarily cast into some doubt, and it would be extremely valuable for the economy, for Ronald Reagan, for the economic program, were the Fed's word to be considered in this instance, as opposed to previous instances, good, which you are saying, as I understand you, that the road to hell seems to have been paved with Fed good intentions.

Now my question is, what should Ronald Reagan or the Congress do, in order to assure that when the Fed sets some targets which it freely selects, and which it freely supposes to meet, what should we do, what mechanism of accountability for the performance goals they set for themselves, should we adopt, if any, because there is none now, Q.E.D.?

Dr. JORDAN. First, I agree with the suggestion that Senator Proxmire made today, and has made many times, that a single-point target would be better than a range, because of the information conveyed by that.

Senator HEINZ. And you like the monetary base?

Dr. JORDAN. I prefer the monetary base, but I would adjust it in conjunction with M-1B at this time, for additional information as to what is going on in the economy. But the monetary base can be controlled much more directly. It is their balance sheet, consolidated with the Treasury's monetary accounts. They can hit that quite closely, certainly, on a monthly basis. It is not necessary to hit it on a weekly basis, but they can do a good job there too. It is the same target that the Swiss National Bank and the Federal Bank of Germany uses. The people understand that the Central Bank can hit it if they want to, and so there is credibility when they announce their targets, that there is a tendency to believe them.

We don't have that. It would be a very healthy thing if we did. The thing that is missing, as you suggest, is sanctions. The Fed has announced targets so regularly in the past and proceeded to miss them, and nothing happens, that—well, it is just not a safe bet.

Senator HEINZ. What kind of sanctions makes sense?

MONITORING THE FEDERAL RESERVE BOARD

Dr. JORDAN. It has been suggested by a group of private economists that monitors the Federal Reserve regularly, on a semiannual basis, that closely observe their actions, as well as their words, that requesting the resignation of the Federal Reserve Board would be appropriate.

Senator HEINZ. You mean the entire Board, or would the head of the Chairman be sufficient?

Dr. JORDAN. No, I would recommend the entire Board.

Senator HEINZ. That seems like very severe punishment.

Dr. JORDAN. Not that the resignations would be accepted, or at least not necessarily for all seven of them, but that it would demonstrate that it was going to get close scrutiny—the decision for them to continue would be closely looked at, and there would be an explicit decision. It is not that they automatically stay in office, if they are not responding, but that they are expected to perform, and if they don't perform, then it is going to be looked at as to whether or not they ought to be replaced, just to assure that the

public knows that a very close serious evaluation is going to take place.

These targets and the achievement of the target is such an important variable right now, that I just don't feel that the rest of the program is going to work, if that doesn't. And we have to have something new to communicate very effectively to the Congress that created the Federal Reserve and that oversees the Federal Reserve, that it is going to do whatever it can to make sure that they are going to be achieved.

Senator HEINZ. Would the group to which you refer—I assume it is the so-called Shadow Open Market Committee.

Dr. JORDAN. Yes, it is.

Senator HEINZ. Has the group formally made that suggestion in any public way?

Dr. JORDAN. It was discussed at their meeting last September, but I do not recall whether or not it was made a part of the press release—the “Directive,” as it was called. I do know that the proposal will be made again at their meeting later this month.

Senator HEINZ. At this point, do you feel that it is a suggestion that the Reagan administration or the Congress, this committee and its counterpart committee in the House should take seriously? It would require statutory enabling legislation, I would think.

Dr. JORDAN. I think it could be in the form of a resolution, as a request that this be considered. I am not for a minute suggesting that Chairman Volcker or Vice Chairman Schultz should be replaced. I strongly support them. I would not recommend that their resignations be accepted if they were submitted. It may be voluntarily on their part to offer to resign. I think it is to make the point that they are serious about these targets, and the Congress is serious about these targets. I can't think of anyone right now that I would rather see as the Chairman of the Board of the Federal Reserve. I think that Volcker is the right man. He has been the right man since he went in August 1979, and I hope he stays there. But I think it is to communicate how serious the Fed is about their targets and how seriously the Congress is about their targets.

Senator HEINZ. Mr. Jordan, thank you. I want to direct one last question with the Chairman's indulgence to Dr. Jones. Two, really. One question with two parts.

First, would you agree with Mr. Jordan on his analysis and his solution, and second, to the question of technically making it easier for the Fed to do what they say they're going to do, do you endorse the principle of getting rid of lag reserve accounting, and second, do you believe, as I believe Mr. Jordan believes, that if you control over an extended period of time, only the monetary aggregates, not that you don't have to control M-1B and the other monetary aggregates?

Dr. JONES. I totally disagree with Dr. Jordan on the question of Federal Reserve policy. I would categorize the view he offers as mechanical monetarism, and I see no evidence in recent Federal Reserve experience that it is possible to achieve tight control over any particular policy aggregate with effective economic results. That is what we're aiming for. It is quite possible, technically, to control some kind of reserve aggregate, but if it bears up for a loose relationship to the economy and to inflation, I'm really not

sure what the exercise is all about, with the exception of the word "credibility," which I personally feel Paul Volcker is beginning to achieve as a very responsible and effective Fed Chairman. I think what we do, if we lift up arbitrary growth rates in these aggregates, as almost a political football, is we make the Fed a political animal, and I would never want to see that kind of emphasis.

Senator HEINZ. Does that mean that you feel that the targets which they themselves set, in fact, are political footballs?

Dr. JONES. They could become one, if the Fed was subject to dismissal on the basis of some kind of arbitrary time frame for not meeting them.

Senator HEINZ. Well, what is the meaning given the very broad range that they encompass—M-1A, last year, the range was from 3½ to 6 percent. A very broad range. What is the meaning of those targets, if you are not within the range.

NO GUARANTEE OF HITTING TARGETS

Dr. JONES. Well, the point is this, that the difficulties in hitting those, in view of the very unstable public demand for money, are overriding in many cases. It is impossible to perfect policy to the point of guaranteeing that as of the fourth quarter of 1980 or 1981 or 1982, that the Fed, in fact, will be able to hit with precision those targets. And let me add another point. Even if they do hit those targets with some degree of precision, it is going to put an even greater burden on other sectors of the economy.

That is one of the problems and the flaws in the program, as I see it now. Tax cuts plus budget cuts, at a time when the Fed is reducing money supply, means something has to give. Either interest rates continue to go up, as the government is borrowing more and more, and the financial sector becomes subject to perhaps major bankruptcy or insolvency problems, or the real economy has to give, that is jobs and production are lost, or ultimately, hopefully, inflation comes down.

The problem is the arbitrary nature of these targets. I think you have to make a very important distinction between a group of public officials who are discharging their responsibilities, which I firmly believe the Fed is doing, and their statements that they mean to do as much as they can, and the idea that you can—the contrasting idea in my view that you can mechanically tell them that on December 31, they are going to hit their targets. The numbers for the monthly period of last year speak for themselves.

The Federal Reserve started a money-control experiment. They think in terms of reserves. And I would also disagree with Dr. Jordan on his reading of the Fed policy record. Virtually the entire reading of the Fed policy record is now in terms of reserves and money. We had a reasonably fair test of the Fed operation to emphasize money according to their view money supply growth fluctuated approximately from minus 20 in April M-1A to plus 19 percent in August to minus 11 percent in December.

Now we can say credit controls were relevant, and they were. The public pulled back. It paid off loans in April. They started to borrow some in August. But the question is December. Nothing was unusual at that particular point.

The point is, that Dr. Jordan and the mechanical monetarists assume that the public demand for money is stable. I say it is highly unstable, and I have a perfect case in point for 1981. Instead of credit controls being the problem in terms of volatile public demand for money in 1981, my bet would be, it is balance-sheet rebuilding. What, for example, would happen if the business sector started to borrow in the bond market and repaid bank loans. The money supply would fall.

Dr. Jordan would conclude the Fed has gone too far the other way. I would conclude that the public's demand for money, in this case, corporate lending activity, is highly volatile and varies over the cycle.

So I'm trying to say that we have to face reality in this matter of monetary control, and I would put full confidence in Fed Chairman Volcker. He is probably the best Fed Chairman we've had since Marriner Eccles.

The CHAIRMAN. I would like to comment, however, on this discussion we had with Chairman Volcker the other day on whether the Fed Chairman should resign or not. And Dr. Jones, I agree with you; I don't believe that they can be precise enough or that that could have any real effect.

As I made the comment in that hearing, and I will make it again, that if the Congress was asked to resign on the basis of the targets that we set for fiscal policy, we would be resigning every other month. You look at just the budget estimates. Last year, forgetting the 6 years I've been here, we started out and passed the budget resolution, \$613 billion last June 12, and promised the American people a \$200 million surplus. And then suddenly, by September 15, the budget was so badly out of balance we just ignored the law in the Budget Control Act and adjourned until the lame turkey session, so we could hide from the American people what happened in the budget.

So I really don't see in this case, Dr. Jordan, a useful tool in asking them to resign if they don't meet their targets. But the Fed would be able to do a much better job, and an easier job, and I am sure then we would be able to—we would all be agreeing with Dr. Jones, that the present Board is doing a fantastic job, if we had stable fiscal policy and balanced budgets. And then you might could pin that on the Fed, where they have some stable economic conditions.

But I don't care who the Chairman of the Federal Reserve Board is; as long as we spend \$50 or \$60 million a year more than we take in, they are going to have to monetize that debt. And I can be critical of some of the technical managements of the Fed, and I am—the lack of a penalty on the discount window, and the borrowed versus nonborrowed reserves, and mechanical things like that—but I would sure hate to sit and pick targets for this year and be told I was going to go to the guillotine if they were not met. And I know you are not advocating that they necessarily be accepted, but I just can't believe that we can be that precise in those.

And I do think that the key is here in Congress. I suppose that, Dr. Jones, this is the important point you have made, is it is with us, and a lot of people don't realize that a President cannot spend one dime not appropriated by the Congress. He can recommend, he

can plead, yell, scream, shout, threaten, veto. But nevertheless, the entire appropriations process is here with the Congress. And we tend to look for scapegoats and blame the economic problems on the Fed or a President; anybody but ourselves.

I wish there was some way we could get that over to the American people, that the solution to this problem is going to primarily come of the fiscal side when we finally decide to forget our own parochial interests and face up to the economic realities, rather than the political realities. We might find a lot of those people out there will vote for us, even after we have voted.

As a matter of fact, we might be surprised at how the votes would go, because I think the American people are ready for fiscal restraint in this country, even though they will yell and scream about individual programs. Overall, I really think they will support the program.

But let me say that the testimony from both of you has been very, very impressive. You obviously have a very detailed knowledge of the economy. And although there are some differing opinions, we do appreciate your testimony and I was just going to close. But if Senator Proxmire would like to ask some questions?

Senator PROXMIRE. No, no. I am not going to detain the committee any longer. I want to apologize for having had to leave. I have great respect for both of you gentlemen.

The CHAIRMAN. You missed some very fine testimony.

ECONOMIC FUTURE DEPENDS ON FISCAL PRUDENCE

Senator PROXMIRE. Well, I know that, and I was particularly impressed by the conclusion of Mr. Jones' statement. I would just like to commend you on it, because I think you were right when you said that the future course of the U.S. economy depends, even more than usual, on how carefully fiscal and monetary policies are designed. It is hoped that fiscal prudence prevails and spending cuts come first, followed by carefully designed tax cuts aimed not at a quick and potentially inflationary fix or consumer stimulus, but the potential for future sustained real growth and productivity-enhancing investment and research.

Hallelujah. I think you are absolutely on target on that. That is absolutely correct, and I hope we can do that. I think that this is going to determine whether or not we have more stable prices, whether we have the kind of growth we need, and I think that is the key to our success, and I am so happy that you have emphasized this.

The CHAIRMAN. Dr. Jones would probably support cuts in milk price supports, too.

Senator PROXMIRE. Well, he would. Let me just say that you can stop beating me over the head with that, Jake. The Agriculture Subcommittee this morning, by a 14 to 2 vote, voted in favor of supporting the President and denying the dairy farmers of Wisconsin their price supports. That will mean a cut for every Wisconsin farmer one third of his income will be cut, by \$5,850. Right now he is making \$2.87 per hour, on the average, and this is going to put him down below \$2 an hour. So it is going to be a cruel, tough, unfortunate cut for Wisconsin dairy farmers, but a great triumph for the President.

The CHAIRMAN. Just beating you over the head gives you the opportunity to make those speeches in defense of your constituents.

Senator PROXMIRE. Unfortunately, the Wisconsin press is not here this morning. But I want to thank you very much, your presentations were very good.

The CHAIRMAN. You all should know that if former Chairman Proxmire and I did not have the opportunity to beat each other over the head, this committee wouldn't be any fun at all. We have had much mutual respect and fun with each other over the last 6 years; and if we couldn't stick the knives in each other, it would be terrible to listen to this economic theory all day long.

But gentlemen, thank you very much. We appreciate your testimony. *The committee is adjourned.*

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

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