For release on delivery
Expected at 9:30 AM, E.S.T.

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

and

Subcommittee on International Trade, Investment and Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

November 13, 1979

I am pleased to participate in these hearings on the goals and conduct of monetary policy. As you know, this is a subject that has been the focus of considerable public attention and debate recently. That attention is symptomatic of the widespread concern and uneasiness about the performance and prospects of our economy. All of us -- members of this Committee, members of the Federal Reserve Board, and citizens generally -- would no doubt prefer more equable economic conditions, with the performance of financial markets and financial policies relegated to the back pages of the newspapers. But conditions being what they are, I can only welcome this opportunity to contribute to general understanding of the problems we face and the approaches we are taking to their solution.

I would like to set the stage for our dialogue this morning by reviewing briefly the decisions taken by the Federal Reserve on October 6, indicating both the circumstances that prompted those decisions and the objectives of our actions. In the process, it should be possible to address in a fairly concrete way some of the broader issues of monetary strategy that you have indicated you wish to examine.

Viewed from virtually any vantage point, economic developments in the weeks and months immediately preceding the Federal Reserve's October 6 announcement were disturbing. The level of business activity had dropped in the second quarter, and virtually all economists were either predicting a recession or felt a recession had already started. As the summer ended, however, signs began to emerge of a surprising degree of strength in spending. Subsequently available information, such as the 2-1/2 percent annual rate of increase in real GNP for the third quarter, the large increase in retail sales in August and September, and the record increase in consumer installment credit for September, has in fact confirmed this assessment.

In retrospect, the suspicion that the second quarter performance was heavily affected by the shortage of gasoline seemed confirmed. But the subsequent burst in spending was troubling because it seemed to reflect in considerable part a "buy now" attitude spurred by an intensification of inflationary expectations. Savings dropped to historically low levels, and some inventory imbalances seemed to be developing. Such a pattern could temporarily provide some strength to business activity. But, if extended, the clear threat was that the ultimate result would be to deepen and prolong anticipated adjustments in production and employment -- adjustments that in part are related to the oil price shock.

These unsettling developments were plainly related to the inflationary situation. The most widely watched price index had advanced to the range of 13 to 14 percent increase at an annual rate. Many Americans, as they struggled to balance their family budgets and suffered a continuing erosion in the value of their savings, began to doubt the prospects for a return to greater stability. While the acceleration of inflation this year has in large part been a reflection of a surge in energy prices, the question remained as to whether the higher rate of inflation would not be built into wage and other cost elements in the economy, defeating the prospects for some relaxation in price pressures as the bulge in energy prices passed. Consequently, in the absence of firm action to deal with inflation and inflationary expectations, there was a clear risk that the run-up in energy prices would work its way into wages and prices generally, thereby raising the nation's underlying inflation rate and, among other things, contributing to pressures on oil prices.

That risk was underscored by an apparent build-up of speculative pressures in commodity markets in September, carrying with it the potential of aggravating economic instability. Rapid price movements in gold and silver markets, while not of critical importance in themselves, seemed to reflect discouragement over our ability to deal with inflation, and the atmosphere began to affect movements in the prices of other metals. The danger was that the bidding up of prices in commodity markets not only would in itself reinforce the inflationary trends, but that it would lead to a brief and unsustainable surge of buying.

These same expectational forces were reflected in an atmosphere of increasing uncertainty in foreign exchange markets, and in September the dollar weakened against a number of other major currencies. The external value of the dollar is sensitive to perceptions and expectations about our economic prospects and policies, and especially to concern about our ability to deal with inflation. And, given the central position of the dollar in international financial markets, as well as the direct impact of a decline in the value of the dollar on the prices of imports, renewed instability in foreign exchange markets could undercut prospects for dealing with inflation generally and for achieving moderation in oil prices in particular.

Under these circumstances, there was in early October no conflict or meaningful "trade-off" between the domestic and international objectives of economic policy. Nor was there any real trade-off between inflation and unemployment. The clear and present danger was that failure to deal with inflation and inflationary expectations would in time produce more -- not less -- economic instability, ultimately with higher prices and greater unemployment.

In that setting, the priority for policy was decisive action to deal with inflationary pressures and to defuse the dangerous expectational forces that were jeopardizing the orderly functioning of financial and commodity markets. The Federal Reserve clearly had a key role to play in this situation. Although the solution to the problem of inflation should not reside with monetary policy alone, control over money and credit is an essential part of the overall policy framework. In the long run, inflation can continue only if it is nourished by excessive monetary expansion; in the short run, it was clear by early fall that the growth in money and credit was threatening to exceed our own targets for the year, and was nourishing inflationary expectations.

Efforts had been made during the summer to slow this excessive rate of money and credit expansion, largely by permitting money market interest rates to rise, a process accompanied by several increases in the discount rate. The October 6 actions involved a change in instruments and tactics to reinforce, and underscore, our intention to achieve moderation in the growth of money and bank credit.

The new steps taken did not reflect any change in our basic targets for the various monetary aggregates for 1979; they did provide added assurance that those objectives will be achieved. In doing so, the new measures should make abundantly clear our unwillingness to finance an accelerating inflationary process and our desire to "wind down" inflationary pressures.

One component of the October 6 package was a change in our operating procedures. In recent years, with the support of this Committee and others, explicit targets for the growth of money have been a central feature of our approach toward monetary policy. However, the operational guide from day-to-day in conducting open market operations has typically been the so-called federal funds rate -- the rate established in inter-bank trading of reserve balances. Translation of money stock objectives into day-to-day management of the federal funds rate is effective if the relationship between the public's demand for cash balances and short-term market interest rates is relatively stable and predictable. But in an environment of high and relatively volatile inflation rates, the relationship between interest rates and money (or for that matter, between interest rates and economic activity) is more difficult to appraise. Moreover, the operating techniques over time may have contributed to excessive supplies of credit by encouraging a view by banks or others that they could count on access to liquidity at interest rates reasonably close to whatever levels were currently prevailing.

Consequently, we are now placing more emphasis on controlling the provision of reserves to the banking system -- which ultimately governs the supply of deposits and money -- to keep monetary growth within our established targets. In changing that emphasis, we necessarily must be less concerned with day-to-day or week-to-week fluctuations in interest rates, because those interest rates will respond to shifts in demand for money and reserves. I would emphasize that, in an important sense, our objective has remained the same: to achieve the growth of money that we believe suitable to the nation's economic goals. What is involved is a tactical change in the approach to control of the money stock. We did not before, as we do not now, attempt to maintain a fixed or predetermined pattern of interest rates over time. But changes in interest rates will necessarily be observed and evaluated over time, along with the entire array of economic and financial variables, in reaching policy judgments.

We took two other actions on October 6. The Board approved a 1 percentage point increase in the discount rate so that restraint on bank reserves would not be offset by excessive borrowing from the Federal Reserve Banks. And we placed a special marginal reserve requirement of 8 percent on increases in managed liabilities of larger banks (including U.S. agencies and branches of foreign banks) because that source of funds (which is not included in the usual definition of the money supply) has financed much of the recent excessive build-up in bank credit.

Let me highlight a few points about our current approach, particularly as they bear on the broad issues of monetary strategy raised in Chairmen Mitchell and Neal's letter of invitation. First, the effort to restrain monetary expansion in the face of strong credit demands and rising levels of economic activity has initially entailed increases in market rates of interest. Whether those increases persist, or whether they subside rather promptly, will in the end be determined largely by the course of the economy and inflation. Control of the money supply is not synonymous with rising interest rates; it all depends upon the performance of the economy itself. In the long run, only the prospect of a lower inflation rate can create the environment for a sustained and substantial reduction in interest rates.

Second, some other important industrialized countries have recently experienced increases in their interest rates. These events have been interpreted by some observers as implying the existence of an "interest rate war" in the pursuit of conflicting exchange rate objectives. That interpretation seems to me unwarranted in circumstances where those countries are responding reasonably to inflationary pressures in their own economies.

There is, of course, always the possibility that national economic goals and policies will not mesh. I know of no protection against that possibility, other than working continuously with our partners abroad to ensure that policies take into account our mutual interdependencies and don't move in mutually damaging directions. Within limits, all major industrial countries have several tools of economic policy at their disposal, and particular elements can be emphasized or deemphasized at particular times. Intervention in foreign exchange markets can sometimes be helpful -- although experience illustrates clearly that intervention alone cannot substitute for more fundamental actions over time if stability in exchange markets is to be maintained. We continue, on a day-to-day basis, to monitor developments in foreign exchange markets, and I am satisfied that, if and when intervention is necessary, our actions can be closely coordinated with those of key monetary authorities abroad to maximize their effectiveness. Meanwhile, we shall continue to consult with our trading partners to assure mutual clarification of our policy objectives and decisions.

In that connection, I do not anticipate, in practice, the sharp dichotomy between "foreign exchange" and "money supply" oriented monetary policy strategies outlined in your recent letter. The fact is that, for the foreseeable future, a policy looking toward attaining and maintaining a noninflationary growth in money at home would appear broadly compatible with our concern about the international position of the dollar. I do not, in any event, view our domestic and international problems as distinct and separable. Recent experience has shown -- all too clearly -- that weakness in the value of the dollar internationally is symptomatic of basic problems here at home.

It is fundamentally inflation that raises questions about the stability of holdings of dollar-denominated assets or the outlook for our balance of payments, thereby prompting recurrent downward pressures on the dollar in exchange markets. And it is inflation and the distortions it creates that constitute a major impediment to the resumption of balanced, sustainable economic expansion at home. In that sense, the problems confronting us on the domestic and international fronts demand a common response, and an essential element in that response must be a firm and credible monetary policy, seeking and attaining appropriate restraint on growth in money and credit over time.

The suggestion has been made that this process could be speeded by setting out a specific target path for growth in the money stock over a number of years ahead. Mr. Neal's bill would incorporate such a strategy in law. In examining this question, members of the Federal Reserve Board remain of the view that there are decisive drawbacks to setting out so precise a growth target over so many years ahead.

We recognize that approach is rooted in a central element of truth -- that a return to price stability will require, over time, a substantially reduced rate of monetary and credit growth. Indeed, the Federal Reserve has often reiterated in the past the need to reduce growth in money over time if we are to deal with inflation. Moreover, some observers would go further, arguing that by clarifying our intentions in a numerically precise and simple way we could more decisively change expectations about inflation, assist in achieving a national consensus, and thus change behavior in a constructive way.

However, experience shows that many forces can affect the financial requirements of the economy at any time. Other governmental policies, institutional changes, exogenous shocks to the economy -- emanating from both domestic and foreign sources -- and changes in the public's money preferences can alter the relationship between money and economic performance. Rigid adherence to a fixed money stock path set for years ahead might therefore turn out to be inappropriate, sometimes needlessly wrenching financial markets or unduly constricting our flexibility in responding to some cyclical or other disturbances. If, on the other hand, the targets are changed, or interpreted more flexibly, unnecessary confusion could arise, and the basic rationale would then be undermined.

Furthermore, even though we hope that our new operating procedures will bring some improvement, we must recognize that monetary control will always be imprecise. Recent events indicate quite clearly that even the problem of specifying precisely the monetary variable that should be controlled over a period of years is a very knotty one; what serves as money in our rapidly changing financial system is far from a constant.

For all of these reasons -- and despite the underlying element of truth in the broad proposition relating inflation to excessive monetary growth -- I think that it would be a mistake to attempt to set rigid and narrow long-range monetary targets. A legislative approach -- even one with some built-in leeway -- would raise the further basic question as to whether Congress would want to inject itself so directly into these judgments, filled with technical complexity and doctrinal controversy. It does not seem to be consistent with the approach taken by the Congress in establishing the Federal Reserve System 65 years ago, and consistently adhered to since, that these decisions should emerge from a dispassionate, professional, deliberative process and be shielded from partisan pressures.

I would suggest strongly that the present system, under which the Federal Reserve reports its intentions and its targets to the Congress within the framework of the Humphrey-Hawkins Act, is a much more promising approach. It preserves a necessary degree of flexibility in monetary management, while providing a good basis for communication. While our experience has been limited, the present arrangement seems to be working well. The line of responsibility and accountability is clear.

I am sure other members of the Board, as myself, have profited from your attention to these important issues of monetary policy. We particularly welcome your concern with developing policies appropriate to the longer term future, and look forward to working with you as we develop and announce new monetary targets.

* * * * * *