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Remarks

by

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The last time I met with the Washington press en masse was on the evening of Saturday, October 6. At that time, I outlined the elements and objectives of certain policy initiatives adopted by the Federal Reserve that day. Today, the occasion is not so extraordinary. But the time does seem appropriate, three months later, for some accounting of what has -- and has not -- been accomplished by the measures then undertaken, and how that approach fits into the more general economic and financial landscape.

The inflation rate is quite obviously about the same now as in September -- nor could we reasonably have anticipated improvement over that relatively short period. Contrary to most expectations, we know now that overall economic activity held up during the summer and fall, despite pronounced adjustments in the auto and housing industries. Nevertheless, the tendency to project declines "next month" or "next quarter" is still evident, and, for all their quality of deja vu, these projections reflect realistic awareness of the vulnerabilities built into the economy after one of the longest periods of business expansion on record.

The vulnerabilities, both on the side of inflation and business activity, have now been increased by the economic and financial fallout from the Iranian situation and by the partly related matter of oil pricing and supply. Perhaps it would be more to the point to insist that the economy will remain vulnerable to forces like these so long as we remain so heavily dependent on imported oil,

and recent events only underscore the need to come to grips with that problem. The reactions to oil prices and to the events in the Middle East in psychologically sensitive markets for precious metals, and to some extent in markets for other commodities and for foreign exchange, have interrupted the more favorable movements induced by the October actions. They are only the latest illustration of the extent to which we have permitted ourselves to become hostage to our energy dependence.

If I cannot yet record more striking progress in those areas, I can say that looked at from a different focus -- that of our immediate objectives in taking the October 6 actions with respect to monetary and credit developments -- the overall results have been remarkably in line with intentions. Specifically, there has been a clear and significant moderation in the growth of money and credit. September to December growth in M_1 , for instance, has been well within the interim target of 4-1/2 percent or lower set by the Open Market Committee in October, and virtually all the aggregates have subsided markedly from the excessive pace of the spring and summer.

There may well be an element of coincidence in that performance. We did not believe in October, and I do not believe now, that the new tactics of monetary control are so precise as to avoid some sizable fluctuations on a month-to-month or even a quarter-to-quarter basis. Nor, for that matter, is very short-term precision in regulating the money supply necessarily desirable, given the complexities and uncertainties of domestic and international factors bearing on the demand for money and economic performance.

But, after all the caveats, I cannot help but be encouraged by what has happened on the monetary and financial front. To be sure, there was a period of turmoil and unsettlement as the markets appraised and adjusted to the new approach. Perhaps reactions were exaggerated at first, but at least they reflected appreciation of the seriousness with which we approached the problem of containing inflation. Now, banking and financial markets appear to be functioning in an orderly way. Indeed, against the background of the events in the Middle East, it is worth pondering just what the state of financial markets, domestically or internationally, would be today had monetary and credit expansion not been brought under control.

Our policy, taken in a longer perspective, rests on a simple premise -- one documented by centuries of experience -- that the inflationary process is ultimately related to excessive growth in money and credit. I do not mean to suggest that the relationship is so close, or that economic reality is so simple, that we can simply set a monetary dial and relax. Changes in spending and saving habits, the shifting characteristics of different financial instruments having some of the characteristics of money, and the inflationary process itself, all affect the observed relationship between money and economic activity. The increased openness of our economy in general, and the growth of international financial markets in particular, has long since ended illusions of autonomy in policy. Spending and tax policy, a whole range of government regulatory policies, and the behavioral patterns of business and labor all affect the performance of the economy, and the relationship

between money, inflation and economic activity. But, with all the complications, I do believe that moderate, non-inflationary growth in money and credit, sustained over a period of time, is an absolute prerequisite for dealing with the inflation that has ravaged the dollar, undermined our economic performance and prospects, and disturbed our society itself.

In looking back at events since October 6, I cannot help but be encouraged by the understanding and broad base of support for our actions that has emerged. In one sense, of course, policies of restraint are never calculated to win popularity contests. All of us would like to see interest rates as low as possible. But what is impressive to me is the growing understanding that the exceptionally high levels of interest rates are ultimately an outgrowth of the inflationary process itself. We are learning that money creation cannot substitute for the productivity, savings, and resources we need to support economic growth but rather, in excess, will only impair prospects for sustained growth. Indeed, I am acutely conscious that the question I receive most frequently is not why did you do it, but rather, "Will the Fed stick with it?"

My own short and simple answer to that question is yes.

I do not intend to qualify that answer.

But I do want to be clear -- clear about what the "it" is that we intend to stick with. There are two analytical points that seem to me essential to that understanding.

"It," in the sense of our October 6 actions, is restraint of the money supply, reducing its growth over time toward levels consistent with price stability. There is really nothing new about the concern of monetary policy with the monetary aggregates. What is new is the method we are using to control the rate of monetary growth, which we believe, in present circumstances at least, provides greater assurance that our goals can be reached.

For a number of years, the Federal Reserve developed the practice of focusing attention in its daily operations largely on short-term interest rates, not to the exclusion of concern about the money supply but rather in the expectation that changes in those interest rates would influence the demand of the public for money. However, in recent years, institutional, technological and market forces have rendered the relationship between interest rates and money balances substantially less predictable. Moreover, the significance of a particular level of interest rates is more difficult to interpret during a period of accelerating inflation. Banking and other institutions grew accustomed to only relatively small and predictable policy and interest rate adjustments. Money always seemed available at a price not very far removed from before. As a result, more aggressive lending policies may have developed -- policies that could only be sustained over a long period by accelerating increases in the money supply.

Ultimately the Federal Reserve was not prepared to validate those increases. That was the background for one important element in our October 6 actions. We changed our operating procedures in a manner to emphasize control of the supply of money by means of restraining the volume of reserves available to support deposits in the banking system. In turn, this approach necessarily implies less direct influence over movements of interest rates.

Against the pattern of large credit and money growth in earlier months, the immediate result was sharply higher interest rates and lower stock prices in the weeks immediately after October 6 as institutions, in effect, moved to cut the suit to fit the cloth. In more recent weeks, perhaps partly in reaction to calmer appraisals of the balance of credit demands and supplies, some market interest rates have moved significantly below the earlier peaks. This took place during a period when money growth was comfortably within our intentions. Yet, no sooner did some interest rates fall than questions arose whether the Fed was in some sense backing off.

What should be clear in the context of our new operating procedures is that interest rates can and will respond to credit demands, to economic conditions, and over time to inflationary expectations without any change in the basic thrust of a monetary policy directed toward bringing the growth of money and credit toward sustainable, non-inflationary levels. Indeed, assuming the downward adjustment in economic activity so widely predicted for 1979 does occur in 1980, historical patterns would suggest some moderation in interest rates would naturally accompany this process.

The basic point is that whether, when, and to what extent interest rates move lower will depend basically on market forces they reflect trends in economic activity, and over time, inflation. If rates do move lower, that eventuality should not be misinterpreted or misconstrued as a weakening of our resolve to contain inflation. Indeed, the prospects for sustaining declines in interest rates beyond any cyclical adjustment will ultimately reflect the success of the fight against inflation. In that context, lower interest rates would not only be appropriate in facilitating recovery, they would be evidence of a healthier economic situation and certainly consistent with a stronger dollar internationally.

Progress in our efforts, I must point out, will not be reflected in the price data for the next few months. Those statistics are bound to reflect cost and price trends already built in to the economy, the new oil prices, and not least (in the case of the consumer price index) the higher level of mortgage rates reached in the fall. Lags in turning the price statistics are inevitable. Meanwhile, in judging our policies, our results against our intentions -- indeed in judging the prospects for inflation over a period of time -- I would urge you to keep at least one good eye on the money supply ball. That is "it."

My second point is an outgrowth of the first. Specifically, if money is "it," we must be able to define and measure it. In a world of rapid financial innovation, ever changing laws and regulations, and heightened interest rate sensitivity by individuals and businesses, there is a widespread consensus that our current

statistical measures are not adequate. But capturing the essence of the reality of money in a simple statistic or two in the midst of institutional change is a difficult process; in a sense we have a moving target.

The Federal Reserve has had this matter under study, with the help of outside experts, for some considerable amount of time. We will be prepared to publish new definitions of the monetary aggregates shortly. They may not be the last, for the pace of financial innovation, if anything, seems to be accelerating. We have no choice but to recognize that the Congress has not finally resolved important questions related to A.T.S. and NOW accounts.

All of this will, inevitably, pose problems of communication and understanding. Some of the new M's may rise more slowly, while others may rise more rapidly, than present measures relative to GNP. We will proceed as carefully and as intelligently as we can in changing definitions and explaining differences. But, in the final analysis, reality is too complicated to pick out a single figure at this single point in time that can fully capture the essence of money and will not behave somewhat differently than the numbers relative to economic activity.

All of this raises the specter of misinterpretation of our actions and objectives. To avoid confusion, we will need the help and understanding of all of you that follow and help interpret the numbers.

Beyond this maze of technical and definitional questions lies the more fundamental question: is restraint on the money

supply really adequate -- or for that matter really necessary -- to deal with inflation? Theory and experience permits only one answer -- it is necessary, and in concept, it can do the job. But the real question, the harder question, is how fast, with what pain, at what cost to other objectives in the short run -- and here the answers, as you know, are not so simple. They depend crucially on other forces and other policies -- and whether those forces are working at cross purposes or as part of a consistent, coherent pattern.

I have already referred to the disturbances related to energy prices and supplies. What has happened in that area in the past month or two has at best set back the timetable for visible and sustained relief from inflation by a quarter or two, while complicating the process of business adjustment. But predictable effects of that kind would be mild relative to the domestic and international strains implicit in still further spiraling of international oil prices -- a process that ironically has seemed to be encouraged not by any current shortage, but by uncoordinated stockpiling out of fear and uncertainty. But therein lies an opportunity -- if we only fully seize it. Catalysing support for the long-term effort toward conservation and developing alternate energy supplies, is one dimension. But even more immediately, no work seems to me more crucial today than the renewed efforts among consuming countries in the IEA and other forums to find coordinated means for relieving market pressures here and now.

Energy is, of course, not the only source of concern. The agenda of needed and possible actions -- public and private -- to restrain costs, to improve productivity, to shed excessively costly and redundant regulations is as familiar as it is difficult. I will comment on only one element of that long agenda now -- the need for prudence in our fiscal decisions.

I know a strong case can be made for well-structured tax changes -- but only at the right time. If we have learned anything in these recent years, I hope we have learned the consequences of undertaking policies that, with the best will in the world, anticipate the worst in terms of the business outlook and weigh lightly in the balance potential inflationary consequences of budget deficits. Most of all, I hope we resist temptations that could arise simply to pump fresh purchasing power into the economy at the first sign of recession. It would forestall altogether subsequent opportunities for a coherent tax reduction program -- a program that can be earned by expenditure restraint over time -- to help deal with the urgent underlying problems of productivity and costs. The discipline shown by the Administration and the Congress in resisting the temptations to move too early on the tax question has been reassuring.

In the final analysis, economic performance is conditioned by the nature of our expectations and our understanding. Over the past decade or more, one expectation that has come to be almost universally shared is that prices would move higher -- and so long as that expectation is held it tends to become a

self-fulfilling prophecy. Meanwhile, insidiously our real economic performance, in the sense of productivity growth, has deteriorated. The one problem has contributed to the other.

To break that cycle, we need to change expectations. One indispensable element in the process is singularly in the domain of the Federal Reserve -- we must have a credible and disciplined monetary policy that is characterized by sustained moderation of growth in money. Alongside that policy we need to understand that real growth will depend on real performance -- most of all to promote productivity, savings and investment. When those approaches are built into our expectations and into our decision making, then our present intentions can more easily become tomorrow's realities. We would truly have in place the elements of "sticking with it," not just in 1980, but for many years beyond.

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