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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I welcome this opportunity -- my first -- to appear before this Committee to discuss the Federal Reserve Board's semi-annual report on monetary policy. As required by the Full Employment and Balanced Growth Act of 1978, that report presents the objectives for monetary growth adopted by the Federal Open Market Committee for the coming year and relates those objectives to economic trends over the past year and to the outlook for the year ahead.

In presenting the report to the Committee, I would like to make a few more personal remarks about the direction that monetary policy is taking and how those policies fit into a broader framework of action to deal with the evident problems of the economy.

The first point that I would emphasize is that the near-term outlook for real economic activity and employment remains highly uncertain. It never has been easy to forecast the direction of aggregate activity around cyclical turning points, and, as one prediction of imminent recession after another has gone awry, the past year has been a particularly humbling experience for economic forecasters.

Important uncertainties continue to cloud the outlook for 1980. One of the most critical questions is whether consumers, faced with lower real incomes and expecting higher prices, will continue to spend an extraordinarily high proportion of their income despite heavy debt burdens and reduced liquidity. Purchasing

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power is again being absorbed by sharply higher oil prices, and there is no assurance that that process will quickly come to an end. The President has, of course, submitted his budget for fiscal 1981. But international political developments have raised some new questions about prospects for defense spending in the years ahead, and there are uncertainties about other elements in the budget as it makes its way through the Congress.

In looking ahead and making judgments about these and other questions, most members of the Federal Reserve Board have shared the view of the Administration and most other economists that an economic downturn will probably develop sometime this year. However, such a result is by no means inevitable and many forecasters appear currently to be raising their sights.

Unfortunately, the range of uncertainty with respect to inflation is one of how much prices will rise, not whether. Price increases, at least as recorded in the most widely read indexes, could well accelerate in the first quarter partly because the latest round of oil price increases will be reflected in those numbers. The real question is how much progress can be made in reducing the inflation rate in the latter part of the year.

In the past, at critical junctures for economic stabilization policy, we have usually been more preoccupied with the possibility of near-term weakness in economic activity or other objectives than with the implications of our actions for future inflation. To some degree, that has been true even during the long period of expansion since 1975. As a consequence, fiscal and monetary

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policies alike too often have been prematurely or excessively stimulative, or insufficiently restrictive. The result has been our now chronic inflationary problem, with a growing conviction on the part of many that this process is likely to continue. Anticipations of higher prices themselves help speed the inflationary process.

Nor can we demonstrate that the result has been beneficial in terms of other objectives. To the contrary, unemployment has been higher in the 1970's than in earlier decades. Productivity growth has declined. Capital spending has not kept up with the needs of a growing labor force. Financial markets have been disturbed and depressed, and institutions responsible for a substantial share of mortgage financing are coming under strain. The recurrent weakness of the foreign exchange value of the dollar has undercut our economic stability at home and our leadership abroad.

The broad objective of policy must be to break that ominous pattern. That is why dealing with inflation has properly been elevated to a position of high national priority. Success will require that policy be consistently and persistently oriented to that end. Vacillation and procrastination, out of fears of recession or otherwise, would run grave risks. Amid the present uncertainties, stimulative policies could well be misdirected in the short run; more importantly, far from assuring more growth over time, by aggravating the inflationary process and psychology they would threaten more instability and unemployment.

The implications for monetary policy are clear. While there may be legitimate debate about the impacts of monetary policy in

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the short run, there is little doubt that inflation cannot persist in the long run unless it is accommodated by excessive expansion of money and credit. Put more affirmatively, restraint on growth in money and credit, maintained over a considerable period of time, must be an essential part of any program to deal with entrenched inflation and inflationary expectations. Accordingly, I see no alternative to a progressive slowing of growth of the monetary aggregates to lay the base for restored stability and growth.

The 1980 growth ranges established by the Federal Open Market Committee for the key monetary aggregates are in line with that basic, continuing objective. In the short run, we believe those targets are fully consistent with an orderly process of economic adjustment and modest growth, provided the inflation rate subsides as the year wears on. We also believe that, should inflationary pressures begin to build more strongly in the context of strengthening demand, those same targets would imply strong financial restraint. In fact, the restraint implied by the new targets would be inconsistent with higher rates of inflation over a significant period of time.

The precise growth ranges are described in the Report that has been distributed to you, and can be seen in the perspective of recent years in an attachment to this statement. I should emphasize that all these data are on the basis of revised definitions for the monetary aggregates, described in detail in Appendix A of the Report. These definitions incorporate some of the recently

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developed financial instruments that increasingly have been used in place of more conventional means of payment or claims on well established financial institutions. Because these new forms of "money" or "near money" generally have been expanding rapidly in recent years, the redefined aggregates tend to have somewhat faster growth rates over the past few years than the comparable aggregates as previously defined. (The aggregates as previously defined are shown in Table II attached.) The FOMC's new growth ranges for 1980 should not be directly compared with results based on the former definitions of the aggregates. What is significant is that the ranges for the newly defined aggregates in 1980 are expected to result in further slowing of monetary growth this year, following some deceleration over the course of 1979.

As I implied earlier, the behavior of interest rates and the degree of pressure on financial markets in the year ahead will depend critically on the performance of the economy and the strength of inflationary pressures and expectations. Experience suggests that if real activity in fact weakens, interest rates -- particularly for short-term instruments -- could tend to decline as demands for money and credit moderate. As inflationary forces tend to recede, the decline could be more pronounced, and spread more fully into longer term markets. In those circumstances, such market developments would be constructive, tempering any weakness in real activity, and tending to support investment activity and housing. At the same time, persistent restraint on monetary

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growth would be consistent with our resolve to resist inflation. The other side of the coin is that continued strong inflationary forces, accompanied by bulging credit demands, would tend to keep financial markets under strong pressure -- and that pressure should confine and dissipate those inflationary forces. In either case, movements of short-term market interest rates -- such as the federal funds rate -- should not necessarily be taken as harbingers of a fundamental change in the stance of monetary policy; that policy will in any event continue to be directed toward reining in excessive monetary growth.

Let there be no doubt; the Federal Reserve is determined to make every reasonable effort to work toward reducing monetary growth from the levels of recent years, not just in 1980, but in the years ahead.

The policy actions taken on October 6 of last year, which entailed changes in our operating techniques to provide better assurance of containing the growth in the money supply, were one demonstration of that commitment. And I can report that developments since that time with respect to monetary and credit growth have been remarkably consistent with our immediate objectives.

We cannot conclude from those results that our procedures ensure that money growth will always remain tightly on a narrow path over short periods of time, or that that is necessarily wholly desirable. From week to week or month to month, the relationship between bank reserves and the money stock is

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influenced by unpredictable shifts between different types of deposits and among institutions. There are transitory shifts in demands for money, associated for example with tax refunds, strikes, or the weather. Nonetheless, our new procedures should continue to give us better control over the monetary aggregates, and we are studying what, if any, other aspects of our institutional arrangements might be changed to enhance the efficacy of those procedures.

The increase in the discount rate announced on Friday is another reflection of our commitment to keep credit expansion under control. The most recent data for overall economic activity have, as you know, been relatively strong, and the inflation rate is currently responding to the new oil price increases. Stimulated in large part by international developments, indications are that inflationary anticipations have tended to rise once again, and in combination, these developments appear to be generating somewhat greater demands for money and credit. In the judgment of the Board, these developments underscore the need to take such measures as may be required to maintain firm control over the growth of money and credit.

Sustained monetary restraint is not an easy, automatic, and painless solvent for our economic difficulties -- the only claim I will make is that it is essential. It works, in part, by limiting the potential growth in nominal economic activity -- that is, growth measured in current, inflated dollars. If other policies are working at cross purposes, the restraint can be blunt, uneven, and decidedly

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uncomfortable, with too much of the impact in the short term falling on employment and income rather than on prices.

Our aim must be otherwise. What all of us would like to achieve is as rapid a transition as we can manage to a more stable and productive economy -- an economy in which we can have more real growth and less unemployment because inflation is dwindling away -- an economy in which real incomes are rising even though nominal wages are rising less rapidly -- an economy in which we can compete effectively abroad without a weak dollar.

That transition will be speeded to the extent all of us show, not just in our words but in our deeds, that the fight on inflation is in fact of the highest priority. We cannot expect that workers will long be restrained in their wage demands, or businessmen in their pricing policies, if they feel the consequence of self-restraint will be to fall behind in a race with their peers or their costs. We cannot simply rail at "speculators" in foreign exchange, or gold, or commodity markets if our own policies seem to justify their pessimism about the future course of inflation. We cannot reasonably bemoan low savings, historically high interest rates and congestion in credit markets so long as the return on savings does not reflect the anticipated rate of inflation and the Federal Government itself runs large deficits, adding to borrowing demands.

Rising demands for wages and cost-of-living protection, anticipatory price increases, skyrocketing gold and commodity prices, sharply declining values in the bond markets -- all of

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these are symptomatic of the inflationary process and undermine the economic outlook. But none of them are inevitable, provided we turn around the expectations of inflation.

To achieve that essential objective will require sustained discipline, not just in monetary policy, but in other areas of public policy. That discipline will certainly need to be reflected in the budgetary decisions of this Congress.

I fully appreciate the need for structural reform and reduction in taxation. Partly because of inflation, the total tax take, relative to GNP, is reaching a new peacetime high, discouraging investment, adding to costs, and blunting incentives. We need to reverse that process. But the President nonetheless seems to me correct in emphasizing that the time has not yet come for tax reduction. Budgetary balance is neither here nor in prospect. Tax cuts, to put the point simply, need to be earned by spending restraint. That is where the challenge lies.

Beyond the broad decisions about monetary and fiscal policy, there is much more that can be done here and now to speed up the process of restoring price stability. For instance:

> We can curtail more decisively our dependence on foreign energy, even at the expense of increased costs in the short-run, because the alternative is to have still higher prices imposed on us by foreign suppliers over the indefinite future.

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- We can move to eliminate the impediments to competition still imposed in some industries by government regulation.
- We can revise legislation that tends to ratchet up wages at the expense of employment.
- We can review the mass of environmental, safety, and consumer regulations to make sure these worthy objectives are reached without undue impact on costs.
- We can resist pressures to protect industries from foreign competition, particularly those industries with relatively high wage structures and wage settlements which have been sluggish in responding to the changing needs of the American consumer.

The list is neither exhaustive nor new. We have been slow to act because so much of it seems to cut across the grain of political sensitivities and, taken individually, many of the measures will not have a dramatic effect. But taken together, the effect would be large and none of it is out of keeping with our basic objectives in economic and social policy.

I sense we are rightly coming to the conclusion that accelerating inflation, declining productivity, and energy dependence are not sustainable options for the United States. In concept, policies to wind down inflation have wide support. What remains is the challenge of converting intellectual consensus into practical action.

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The Federal Reserve has a key role to play in that process. We intend to do our part -- and to stick with it.

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Table 1

Growth of the Newly Defined Monetary Aggregates
(Percentage change, fourth quarter to fourth quarter)

	M-1A	M-1B	M-2	M-3
1975	4.7	4.9	12.3	9.4
1976	5.5	6.0	13.7	11.4
1977	7.7	8.1	11.5	12.6
1978	7.4	8.2	8.4	11.3
1979	5.5 (6.8)*	8.0 (7.0)*	8.8	9.5
1980 FOMC range [midpoint]	3.5-6 [4.75]	4-6.5 [5.25]	6-9 [7.5]	6.5-9.5 [8.0]

*Adjusted for effects of introduction in late 1978 of NOW accounts in New York State and automatic transfer accounts nationwide.

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Table 2

Growth of the Old Monetary Aggregates
(Percentage change, fourth quarter to fourth quarter)

	M-1	M-2	M-3
1975	4.6	8.4	11.1
1976	5.8	10.9	12.7
1977	7.9	9.8	11.7
1978	7.2	8.7	9.5
1979	5.5 (6.8)*	8.3	8.1
1980 FOMC range** [Midpoint]	3.5-6 [4.75]	5-8 [6.5]	5-8 [6.5]

*Adjusted for effects of introduction in late 1978 of NOW accounts in New York State and automatic transfer accounts nationwide.

**Staff estimates of ranges equivalent to those specified by Federal Open Market Committee for the new monetary aggregates.

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