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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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Mr. Chairman, Members of the Committee:

I very much welcome the opportunity to review with you the events of the past year in the area of monetary policy, and to outline our basic intentions and some of the key problems as we approach the future.

As you well know, this has been a turbulent year in the national economy and in financial markets. Partly because inflation and inflationary expectations are profoundly changing behavior patterns, economists and forecasters have been repeatedly surprised by developments in both the real and financial markets. Businessmen, consumers, and financial intermediaries have had to cope with more than usual uncertainty amid sharp fluctuations in sales, employment, and interest rates. Understandably, there has been a sense of frustration and disappointment, combined, I believe, with growing recognition of the fact that deeply seated economic problems building over a long period of years will take strong measures to solve.

Under the circumstances, Federal Reserve policy has understandably been the focus of a great deal of scrutiny. Some has concentrated on the techniques of policy implementation normally of concern only to specialists. Most commonly, the public discussion reflects broad concern about the fluctuations in, or level of, interest rates and their relationship to both inflation and sluggish economic performance. Constructive dialogue on these problems is always helpful -- and this Committee has contributed to it.

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I hope that a common understanding can emerge from this discussion that monetary policy indeed has an indispensable role to play in the effort to restore a stable, vital economy. That role requires that the Federal Reserve apply the measured, persistent restraint on growth in money and credit that is necessary to drain the momentum from inflationary forces in the economy and to encourage a return to stability in prices and unit costs. Misperceptions of the Federal Reserve's intentions in that respect can only detract from the effectiveness of our actions. At the same time, fully effective results will require concerted, complementary efforts from other directions as well.

Our focus on the objective of dealing with inflation recognizes that inflation has been the single most disruptive element on the economic scene. Inflation places tremendous pressures on the budgets of many households, distorts spending and saving decisions, inhibits productivity-expanding business capital formation, erodes the foundations of the domestic and international financial systems, and in the process saps confidence at home and abroad in our future. More specifically, unless there is a sense that inflation is decelerating, there can be, in my judgment, little hope of bringing about the sustained, balanced growth of production and real income that we seek. That deceleration requires that excessive monetary expansion must be avoided.

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That basic tenet of economic policy, on which economists of almost all schools can agree, is reflected in the broad concepts of monetary "targeting" that the Federal Reserve has adopted in recent years, a concept that looks toward a reduction in monetary growth over time, and which the members of this Committee and many others have strongly supported. I recognize that concept does not in itself resolve important questions about the precise magnitude of the targets or about the techniques of monetary control, matters about which, in fact, there are many differences of opinion. Nor does it offer exact guidance about how to react to new developments, surrounded as they inevitably are by uncertainty in interpretation and conflicting considerations.

The Federal Reserve's approach toward these problems can, I believe, best be clarified by reviewing the change in operating procedures introduced about a year ago and developments since that time. To that end, I am attaching to this testimony a statement reviewing our experience with the new operating techniques.

In reviewing that record, I trust that understandable questions and concerns about particular actions and techniques will not obscure the basic order and consistency in our efforts to control the growth of money and credit. Uncertainty on that point would be unfortunate. Let us recognize that slowing growth of money and credit in an inflation-prone economy, at best, is not a simple, painless job. Let us also recognize it must be done.

At least as important, we should be aware of the limitations of purely monetary actions. Acting on the basis of those

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understandings, we should be able to change expectations, to develop consistent policies to share the burdens, and look forward to the ultimate success of the effort.

Looking at the most recent situation, I believe it should be unambiguously clear that the Federal Reserve has been leaning hard against excessive monetary growth, and that we mean to maintain firm control as we look ahead.

I believe that our new approach has, over the year as a whole, helped avoid excessive monetary growth. But I am sure you agree that we should learn all we can from our experience.

To assist in that process, I initiated in September, roughly a year after the change in technique, a systematic study of our recent experience, drawing on staff throughout the Federal Reserve, so that we do not neglect opportunities to achieve further improvement in operating techniques and can better address broader policy issues. We are also acutely conscious of the fact that implementation of the Depository Institutions Deregulation and Monetary Control Act is itself altering the institutional framework of our activities, raising some new questions that must be carefully considered, particularly in connection with the introduction of NOW accounts nationwide. We expect to take advantage of these studies in the review of our 1981 targets required early next year and will, of course, share any relevant results with you at the time of our regular "Humphrey-Hawkins" testimony. Whatever further insights we can gain from that systematic study, I believe certain points are worth emphasizing now.

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As I have already indicated, 1980 has been an unusually turbulent and difficult year. Deeply embedded problems of inflation, low productivity and investment, the weakened competitive position of some key industries, and dependence on imported energy have made the economy vulnerable to non-monetary "shocks" and extremely sensitive to indications of changes in price trends, while impairing growth prospects. Expectations are highly volatile, and there is a sense of both impatience and confusion about setting the economy right.

All of this puts a special burden on those of us developing and implementing policy to "get it right," to communicate our purposes and intentions effectively, and to persevere with needed policies.

In that context, I am satisfied that the greater emphasis we have placed on monetary targeting in recent years, supplemented by the change in operating techniques, has assisted both in communicating what we are about and achieving the internal discipline necessary to act in a timely way. One can argue about the precise timing and degree of particular decisions. But the need for strong action last winter, prompted in part by growth in the aggregates, to head off an almost explosive rise in inflationary sentiment seems to me incontestable. Contrary to most expectations, the ominous "free fall" in economic activity during the spring quickly ended, in substantial part because our operating techniques led to a rapid "opening" of credit markets. And, while the episode is clearly not over,

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we have acted more quickly to rein in recent excessive monetary growth than would have been at all likely under the previous operating techniques.

The record shows, unambiguously, that we do take the targets seriously. But it also strongly suggests that no single target can reasonably be interpreted in isolation, and that the lower order aggregates, M-1A and M-1B, can be extremely volatile. All of them -- and the interrelationships among them -- are affected by institutional change in a way that cannot be quantitatively pinned down in advance.

A clear case this year is the relationship between M-1A and M-1B. The half-point difference in the ranges for these two aggregates set almost a year ago reflected an assumption that growth of ATS, NOW and similar accounts would be limited; those new types of account make up the entire difference between M-1A and M-1B. As the year wore on, NOW and ATS accounts have grown more rapidly than anticipated, perhaps because passage of the Monetary Control Act prompted commercial banks with the authority to do so to market those accounts more aggressively before their power was extended to potential competitors. As a result, we now know the difference between M-1A and M-1B will be more like 2 percent rather than the 1/2 percent we earlier assumed. What we cannot know with any accuracy is the extent to which ATS and NOW accounts were fed by flows from savings deposits or other funds not counted in M-1B, and how much reflected shifts from demand deposits, depressing M-1A. Put differently, if we arbitrarily assume NOW and ATS accounts substitute for savings

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deposits and demand deposits in roughly equal proportions, M-1A has been "artificially" depressed by 3/4 percent, and M-1B increased by about the same amount, relative to the targets set at the start of the year.

I make the point at some length because these shifts are expected to be much larger in the year ahead, when we will have nationwide NOW accounts, and will raise important questions of interpretation of both M-1A and M-1B. In essence, it is wrong to view either in isolation.

Other examples of institutional change abound, some of only negligible importance in interpreting the data but others significant. For instance, the explosive growth of money market funds earlier this year drew money into M_2 that otherwise would have been lodged in market instruments counted in none of the M's.

Without allowing for these institutional influences, the charts attached to this statement illustrate that the various aggregates now are running a little below or a little above the upper end of the ranges set almost a year ago. Obviously, for more reasons than pictorial or presentational nicety, I would be delighted to see the data gravitate more toward the mid-points of the established ranges as we receive data for the final two months. But I would warn you against attributing unwarranted importance to statistical precision in hitting the target in any given period. For one thing, a "bullseye" for one aggregate can imply a miss for another as

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relationships evolve in the course of a year. More fundamentally, experience here and abroad strongly points to the fact that relationships of monetary targets to income, inflation, and interest rates -- the variables we really care about -- are not known with precision. Shifts in technology, regulation (such as deposit ceilings), and market incentives are all important at times. That is why it seems to me the better part of wisdom to think in terms of reasonable ranges.

In essence, I believe monetary targeting has been, and should remain, an invaluable discipline, a means for communicating our intentions, and a benchmark for performance. Whatever the debate about technique and the significance of possible "misses" over the course of the year, the broad thrust of our policy has plainly been one of restraint, working against the strong inflationary momentum. I take satisfaction, limited as that satisfaction must be, that the inflationary process has not gained fresh momentum, despite the strong "shocks" from energy and (more recently) food prices, the rigidities and strong momentum built into wages and prices, and the trend of government spending and deficits. The restraining effort has been accompanied by strains and instability in financial

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and other markets. But I believe we have steered away from more treacherous inflationary storms -- storms that would have brought in their wake much more severe financial and economic dislocations.

Now we are opening a crucial new chapter -- the challenge of restoring growth, productivity, and employment while visibly reducing inflation. As we look ahead to that challenge, you should be aware that targets and performances for monetary growth in the general area in which we have been operating, or lower, seem bound to be restrictive so long as the momentum of inflation remains strong. If we are to deal with inflation, I see no alternative. At the same time I have spoken before about the potential for collision and conflict between restrained monetary growth and the financial needs of an expanding and inflating economy. Recent developments provide a taste of the potential problem.

The point is sometimes made that, in theory, monetary restraint, sustained strongly enough and long enough, can alone do the job of restoring price stability. Perhaps so -- in the long run. But over what period of time and at what unnecessary cost, in recurrent pressures on financial markets, in inhibiting investment and dampening productivity, in lost output and deferred growth? The alternative of trying to accommodate real growth while living with inflation by freely creating money is ultimately even more threatening. Expectations of inflation would roar ahead, the whole process of inflation would quickly accelerate,

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and (I fear sooner rather than later) the growth and investment that is sought would crumble away, leaving us with an even more difficult situation.

These basic dilemmas and conflicts cannot be painlessly escaped by some technical change in monetary technique. I welcome informed debate on those matters -- after all they are part of our job and we want to draw on all the wisdom and evidence we can get to do our job better. But the world at large -- the real world of huge prolonged deficits, of wage bargaining building in rising costs for years ahead, of enormous pressure to protect established competitive positions and living standards even when productivity cannot support them -- will not focus on the technicalities of the various M's, the precise targets, or short-run fluctuations about those targets. What we must do is convey a general sense -- and make good on that message -- that excessive money and credit creation will not underwrite the inflationary process. Taken alone, as I have suggested, that commitment implies an extraordinarily heavy burden on monetary policy. So equally, we need the perception and the reality that essential monetary restraint will be combined with persistent and effective policies in other directions so that monetary restraint can be tolerable and sustainable.

In particular we must not flinch from the budgetary discipline necessary to complement the tax relief so desirable to foster incentives, investment, and increased productivity in

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our society. We must seize other opportunities to deal with price and wage rigidities and to promote productivity. We need to face up to the hard job of achieving valid regulatory objectives at less cost. We need to keep our markets open to competitive forces at home and from abroad.

It is a difficult agenda for action. But the rewards are enormous, for along that road lies the opportunity for achieving growth as we restore stability. I know of no other.

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Supplementary Statement - The New Operating Procedures

The new operating procedures announced on October 6, 1979, were described at the time as placing "greater emphasis in day-to-day operations on the supply of bank reserves and less emphasis on confining short-term fluctuations in the Federal funds rate."* The change was introduced at a time when inflationary expectations were rising dangerously and the expansion of credit and money supply was exceeding objectives.

The point was to underscore, in terms of public perception and debate, the central importance of maintaining control over monetary growth and bank reserves to deal with inflation, and to better discipline our internal policy-making with respect to monetary and credit growth, thus enhancing our ability to achieve our objectives. Earlier, policy judgments typically took the form of action to influence changes in money market interest rates in the direction and amounts deemed consistent with money supply or other objectives and, in the short run, efforts were made to constrain those interest rates within a

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*Federal Reserve announcement of October 6, 1979. The new operating procedures are described more fully in Appendix B of the Federal Reserve's Monetary Policy Report to the Congress, February 1980.

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rather narrow range. However, in a changing inflationary environment, judgments about the appropriate level of money market rates had, at least within very broad limits, become increasingly unreliable as a gauge or guide to policy, and in the then existing market circumstances, perceptions (right or wrong) that changes in money market rates would be limited seemed to be encouraging banks and other lending institutions to aggressively market credit.

Obviously, the change in technique reflected the significance we attach to monetary growth targets, and we felt the change enhanced our prospects for hitting those targets over a period of time. But I must also stress that no change in operating technique:

-- can resolve the issue of what the appropriate growth targets should be;

can eliminate the looseness -- indeed the instability, evident particularly in the short run -- in the relationship between changes in money, economic activity, and inflation;

can avoid judgments about the appropriate definition of "money" during a period of rapid institutional change and inflationary distortions; or

can substitute for ongoing appraisal of the significance of changing economic and financial conditions for monetary growth.

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Certainly, experience over the past several years suggests the relationship between the growth of the various money stock measures, as best we can measure them statistically, and the performance of the economy is not tight or immutable over relevant periods of time. In other words, we have to be prepared for, and analyze the significance of, changes in the turnover or velocity of money.

I know of no substantial body of economic analysis that suggests that fluctuations in monetary growth over a monthly, quarterly, or even somewhat longer period -- <u>if they are subsequently reversed</u> -- are significant in terms of the evolution of economic activity or inflation over a period of time. Indeed, all the evidence suggests that the economic effects of developments with respect to the money supply are spread out over considerable time; there is a kind of natural smoothing process in the transmission belt. The simple fact is that the short-run movements of the measured monetary aggregates are characterized by a considerable amount of "noise"; ironing out these fluctuations would be extremely difficult technically.*

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*These short-run fluctuations, here and abroad, are more pronounced in the narrower (M_1) definition of the money supply. Indeed, the evidence suggests the short-run instability of M_1 has generally been considerably more pronounced in other countries.

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Our current operating techniques automatically "lean" against deviations in money growth to help ensure they do not cumulate in one direction or another. Even so, short-term fluctuations in money growth (or in other related magnitudes such as reserves or the monetary base) can sometimes raise questions about our basic policy intentions, and thus influence expectations about market developments and the economy among those constantly probing for clues as to a change in our objectives or in the economic and financial market outlook. Unwarranted "expectational" effects, which can for a time influence market attitudes and behavior, can perhaps only be worn away by experience over time. That seems to me the likely result if we can successfully demonstrate that we do indeed take seriously our monetary goals and those goals are appropriate to our economic circumstances and objectives. The change in our operating procedures, combined with established procedures for the formulation and explanation of our monetary targets, have been designed to those ends.

More specifically, the procedure adopted in October 1979, emphasizing reserve "paths" and "targeting," offered the prospect of avoiding <u>persistent</u> "over" or "under" shoots of money and credit growth. In that sense it complemented steps taken earlier to end the practice of shifting the base for monetary targets forward every quarter. In simple terms, our present operating procedure involves, in the first instance,

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directing the Manager of the System Open Market Account to buy and sell securities with a view to providing the volume of nonborrowed reserves (the only portion of reserves subject to close short-run control) thought consistent with the targeted level of the money stock.

If the money stock (particularly M_1, to which most reserves are directly related) begins to move off the targeted path, banks will find it necessary to borrow more or less reserves through the discount window to meet their reserve requirements. Because banks are encouraged administratively to seek out other sources of funds before turning to the discount window, these variations in pressures on their reserve positions will affect money market interest rates and, in time, their lending or investment policies and the money supply. If money growth nonetheless moves more clearly "off course," action can be taken to speed the adjustment process by further constricting or expanding the supply of nonborrowed reserves.

Because there is a large amount of day-to-day variation in the supply of and demand for reserves, owing to such uncontrollable factors as variations in float or shifts of deposits within the banking system, it is inevitable that there will be greater short-run variability in the federal funds rate than was the case when the basic approach entailed constraining movements in that rate within a narrow band. Movements in the funds rate over somewhat longer periods might also have been

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expected to be sharper under the new operating procedure because they are no longer dependent on a "policy" decision as to the "appropriate" rate level, but rather reflect the tightening or easing of bank reserve positions that occurs when the monetary aggregates (and therefore the demands for reserves) deviate from their short-run targets. This does not mean that the federal funds rate -- and, more important, interest rates on instruments of longer maturities which are in any event beyond the immediate influence of the Federal Reserve -- would necessarily be expected to exhibit wider "cyclical" swings. With less likelihood of cumulative divergences of money from desired paths, there could be reason to look forward to milder cyclical swings in the economy and perhaps in interest rates as well.

Of course, what we have actually experienced in 1980 is substantial short-run volatility in both money and interest rates, combined with unusually sharp movements in economic activity and inflation, as measured or anticipated. These developments have been interrelated in complex ways. However, it seems to me to associate those developments primarily with the new operating techniques would be wrong. The past year has been one of extraordinary instability in the economic environment in which monetary policy is conducted. Dangerous turmoil in the Middle East, another tremendous surge in energy prices, the shifting prospects for the Federal budget, the temporary imposition of credit controls, short-term swings in the direction of economic activity that confounded forecasters,

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substantial variations in the rate of increase in major price indexes, and recurrent swings of sentiment about inflation and the economic outlook all left a strong mark on financial markets.

Against this backdrop of unsettlement, and the associated volatility of expectations, it would be unreasonable to expect that either interest rates or the demand for money would exhibit great stability. I recognize that fluctuations in money growth and interest rates did, on occasion, raise questions about our intentions, in that sense contributing to financial market uncertainty. But I must also note the expressed concerns, more often than not, have been inconsistent. For instance, during the spring, when the narrowly defined money supply and interest rates were both falling sharply, some interpreted the interest rate decline as indicative of a "retreat" by the Federal Reserve from the fight on inflation. Others interpreted the money supply decline as aggravating recessionary forces. Under the conditions existing, it seemed self-evident that more aggressive action to increase monetary growth would have tended to reduce interest rates still further, or vice versa. Yet, so long as observers from different schools of economic thought differ in their interpretations, concerns of the sort voiced seem bound to arise.

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Operations Since October 6, 1979

Looking back now, we can observe three rather distinct phases in monetary developments during the period of the new operating procedures: October 1979 to March 1980, April to July, and August to the present. These periods roughly correspond to spans, first, of strong credit and monetary growth and rising interest rates; second, of falling or sluggish monetary growth and declining interest rates, and then again of strong monetary growth and rising rates.

The introduction of the new techniques in October, coming at a time of strong money and credit growth and mounting inflationary expectations was accompanied by considerable turbulence in financial markets. However, coincidentally or not, monetary growth thereafter remained well within our targets and rather stable from month to month until early February. However, as growth in M_1 and other monetary measures picked up sharply in February, member banks needed more reserves to meet their reserve requirements. (Movements in reserves are traced monthly on Chart I. Money supply and bank credit data are on subsequent charts.) Because the path for nonborrowed reserves had been designed to accommodate only targeted increases in the narrowly defined money stock, member banks found it necessary to turn to the discount window in

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larger amounts to obtain the reserves they required. Because of the reluctance of banks to borrow for significant periods of time at the discount window, reinforced by our guidelines limiting access to the discount window, increased borrowings are normally associated with pressures on short-term market rates as banks are induced to slow credit expansion.

We took two additional steps in February that served to reinforce the restraint on monetary and credit expansion. One of these was to lower the previously established path for nonborrowed reserves, thereby increasing pressure on member bank reserve positions and inducing restraint on their lending and portfolio policies. The other step was a one percentage point hike in the discount rate.*

The decision to reinforce the pressures arising more or less automatically from the maintenance of a fixed path for nonborrowed reserves was based on several considerations. The first of these was simply the magnitude of the run-up in some of the monetary aggregates. Bank credit, too, had been growing at a particularly rapid pace in January and February, with business loan increases of 20 percent or more at an annual rate. These deviations from our ranges were of particular concern

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*The strongest pressure on reserve positions did not develop until mid-February and after, partly because of lags in reporting and reserve accounting.

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because of other developments affecting the inflationary outlook and expectations.

The preceding few weeks had seen a very serious deterioration in public confidence in the government's ability and resolve to rein in inflation. The Soviet invasion of Afghanistan led to discussion of enlarged defense outlays that might add to federal budgetary deficits; outsized increases in consumer and producer prices caused alarm, even though they should have been largely anticipated on the basis of previous changes in OPEC prices and mortgage rates; soaring prices for gold and silver both reflected and reinforced fears of accelerating inflation; and there was an anxiety in some circles that the traditional tools of monetary policy might prove inadequate to restrain aggregate demand pressures. On the last score, many analysts had been surprised by evidence that sales and orders had registered strong gains at the turn of the year in the face of historically high nominal rates of interest.

Perhaps the most dramatic manifestation of the intensification of inflationary expectations was the disarray in the bond markets. Bond yields had begun to soar in late January, even before the money markets (and M_1) had begun to firm. Postponements and cancellations of offerings became numerous and fears were expressed for the future of the long-term bond markets.

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During the formulation of a revised budget and other Administration economic measures to deal with the dangerous inflationary potential, the Federal Reserve continued to restrain its provision of reserves, and the money markets clearly reflected the tightening of reserve availability. Short-term market interest rates rose to record levels, although bond prices began to stabilize as the market responded to indications that the government was developing a strong anti-inflationary program.

On March 14, the President announced a set of measures to fight inflation, including steps taken in consultation with Congress to cut Federal expenditures and work toward a balanced budget. He also authorized the Federal Reserve to employ the extraordinary powers of the Credit Control Act. As you know, under the authority of that Act, we took certain measures to more directly restrain the expansion of credit, including a special deposit requirement on growth of certain consumer credit and money market mutual funds, and a tightening of marginal reserve requirements on managed liabilities of big banks. In addition the Federal Reserve undertook a voluntary program to restrain bank lending and added a 3 percentage point surcharge to the discount rate for frequent borrowing from the discount window by larger banks.

Over the second half of March, most market interest rates rose further, but following the new action perceptible weakening of money and bank credit soon became apparent. By early April

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interest rates were on the decline. These developments accelerated, and while the full magnitude of the decline in the money supply was apparent only some time after the event, the temporary contraction was large. M-1A, for example, declined at an unprecedented 17-3/4 percent annual rate for a single month in April.

By May, the decline ended. Renewed growth in late spring and early summer nevertheless left M-1A and M-1B low relative to the FOMC's objectives for several months. Bank credit continued to contract through June. Meanwhile the broader aggregates, M_2 and M_3, while declining or flat for a time, generally remained within target ranges.

The extraordinary fall-off in M_1 and bank credit, reducing reserve needs, was quickly reflected in the repayment by member banks of discount window borrowings. As the magnitude of the decline in the aggregates became apparent, the Federal Reserve also acted to reverse the earlier reduction in nonborrowed reserves and to maintain the volume of total reserves. The rapid expansion in nonborrowed reserves in April and May essentially offset the decline in adjustment borrowing by member banks, which was reduced to a frictional minimum by late May. Thereafter, nonborrowed reserves were provided at a rate believed consistent with restoring over time the narrow monetary aggregates to their longer-run target ranges.

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Several characteristics of that period are worth emphasizing for they bear on questions of both technique and policy. First was the fact that only the narrow money stock measures, M-1A and M-1B, were deviating appreciably from our longer-run ranges. The narrow money stock is characteristically much more volatile than the broader measures, not only in the U.S. but in other countries. Partly for that reason, and partly because of broader considerations, some students of monetary policy tend to place more weight on the broader aggregates. Indeed, a number of foreign countries engaged in the practice of monetary targeting focus exclusively on a broader aggregate.

The relative weakness in M-1A and M-1B during the early spring was clearly exceptional in terms of the typical behavior of transactions balances relative to other key economic variabl To be sure, real GNP dropped abruptly, and nominal GNP came to a standstill in the second quarter. Such a sharp reduction in nominal GNP growth ordinarily would be expected to reduce deman for transactions balances. During the spring, however, cash holdings fell substantially faster than nominal GNP growth. Th velocity of money, instead of falling as it normally does in recession, rose sharply, suggesting among other things that rapid repayment of consumer and other debt following the speci measures of credit restraint led, in the first instance, to depleted cash balances. In practice, the effects of the credi control program cannot be separated from other influences,

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including the strong possibility that earlier record levels of interest rates induced deposit holders to minimize demand deposits while searching for more remunerative ways of employing spare cash.

In these circumstances, matters of judgment arose as to how aggressively to supply reserves to restore M_1 to the established growth path. On one side, the sharpness of the decline in business activity itself -- which was then forecast to continue for some time -- might have suggested an effort to restore M_1 to "path" as quickly as possible to avoid any risk of exacerbating the downturn. But there were powerful considerations on the other side. Account had to be taken of the probability that the decline of interest rates itself would tend to increase money growth later in view of the lags in response in the banking system and among money holders. Account had to be taken, too, of the likelihood that special efforts connected with repayment of debt during the credit restraint program would tend to be reversed as the public sought to restore depleted cash balances.

If the drop in M_1 turned out to be an extraordinary, self-reversing deviation from past norms, related to lags and the credit restraint program, then strong action taken to offset it, by pressing excess reserves on banks, might have had to be quickly reversed, leading to a purposeless whipsawing of the money markets. Conversely, if the change in velocity reflected a more permanent desire to hold less cash by the public, the existing M_1 targets would be, in economic effect, less restraining on inflation than

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had been anticipated. Either possibility argued for some caution in dealing with the M_1 shortfall.

The other consideration involved more directly the potential impact of a deeper decline in interest rates, which would have been the immediate consequence of a more generous provision of reserves to boost monetary growth. We have, as you know, emphasized the limitations of using interest rates as a reliable indicator of the thrust of monetary policy. Nonetheless, we had to recognize that, even against the backdrop of a declining money stock, the already precipitous decline in interest rates might be misread as a fundamental reversal of policy -- a lessening of our resolve to fight inflation. Such a false interpretation could only have undermined the ultimate success of that effort; a perceived weakening in the fight on inflation would, in turn, ultimately impair prospects for a sustained economic recovery. The same uncertainty about our objectives could have complicated our task further by undermining confidence in the dollar on foreign exchange markets. The exchange value of the dollar did go through a wide swing over the first and second quarters, largely in response to the relative movement of U.S. and foreign interest rates. As it turned out, however, a cumulative downward movement that would have reflected eroding confidence was avoided.

These considerations remained relevant as some recovery of the monetary aggregates continued into July. By that time, the average levels of M-1A and M-1B were only slightly under the lower bounds of the FOMC's longer-run growth ranges for

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these aggregates, while M_2 and M_3 were in or moving into the upper halves of their ranges. At that point, in testifying before the Congress, I indicated that, in the light of the continuing inflationary problem, I did not feel that aggressive actions to push M_1 higher were desirable, even though the business outlook remained cloudy.

Within a matter of weeks, our concerns became quite different, as a pattern of more rapid monetary expansion developed. That pattern came to threaten our ability to achieve our targets for the year.

In retrospect, the persistent high rate of monetary growth since July appears excessive; however, during much of the period, as events unfolded, the picture was one of considerable ambiguity. Much of the extraordinary growth took place in a single week in August when the M_1 figures jumped by about $10 billion. We know that weekly figures often are unreliable indicators of trends, and available projections suggested that that increase was probably in large part an aberration. Indeed, data for a few subsequent weeks showed declines, and it was not until well into September that our growth targets appeared in any jeopardy.

From our present vantage point, it seems clear that the early and surprisingly sharp upturn in economic activity in midsummer led to more demand for money, importantly accounting for the sharp rise in the narrower monetary aggregates. The extent of that rebound in economic activity was not clearly apparent

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until data were received in late September and October. Nevertheless, as soon as monetary growth picked up our operating techniques "automatically" began to bring bank reserve positions under mild pressure as use of the discount window increased. That pressure was reinforced on several occasions by reducing the provision of nonborrowed reserves. Total bank reserves have, to be sure, expanded sharply -- a mechanical concomitant of the rise in M_1 -- but banks have had to borrow those reserves from the Federal Reserve; we have not supplied them on our own initiative through the open market. The need to exert restraint has also been reflected in changes in the discount rate as market rates rose.

Interest rates generally have, as you know, risen very substantially since August. The restraint on reserve and money growth has clearly played a role in this rise, but a number of other factors have also been important, particularly in the long-term markets. The unexpected brevity of the recession, the related revival of acute concern about inflation, and the possibility of substantial tax cuts resulting at least for a time in larger deficits, led borrowers and lenders to anticipate higher interest rates.

The past few weeks have seen some tendency for growth in the monetary aggregates to moderate. It is clearly a matter of judgment whether actions already taken will maintain monetary growth precisely within the desired path, but plainly operations are directed to that end.

* * * * * * * *

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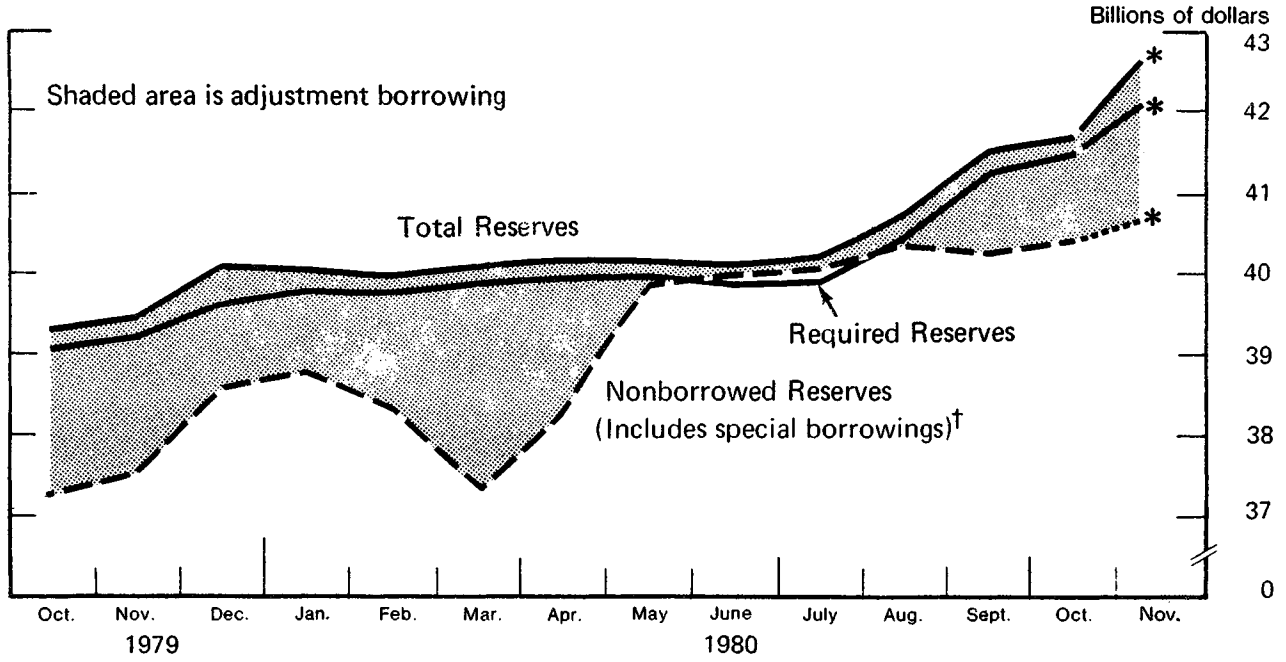
Chart 1

Reserve Aggregates



† 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.

* Average of first two weeks of November, 1980.

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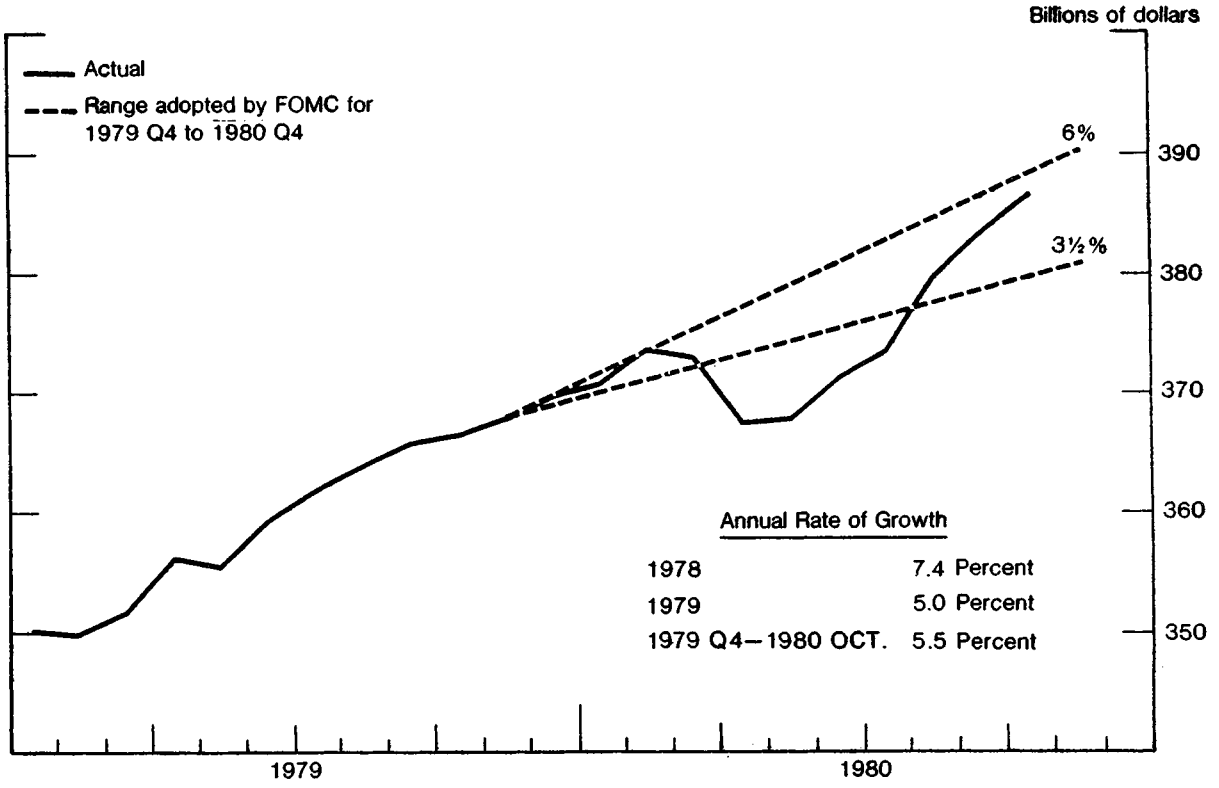
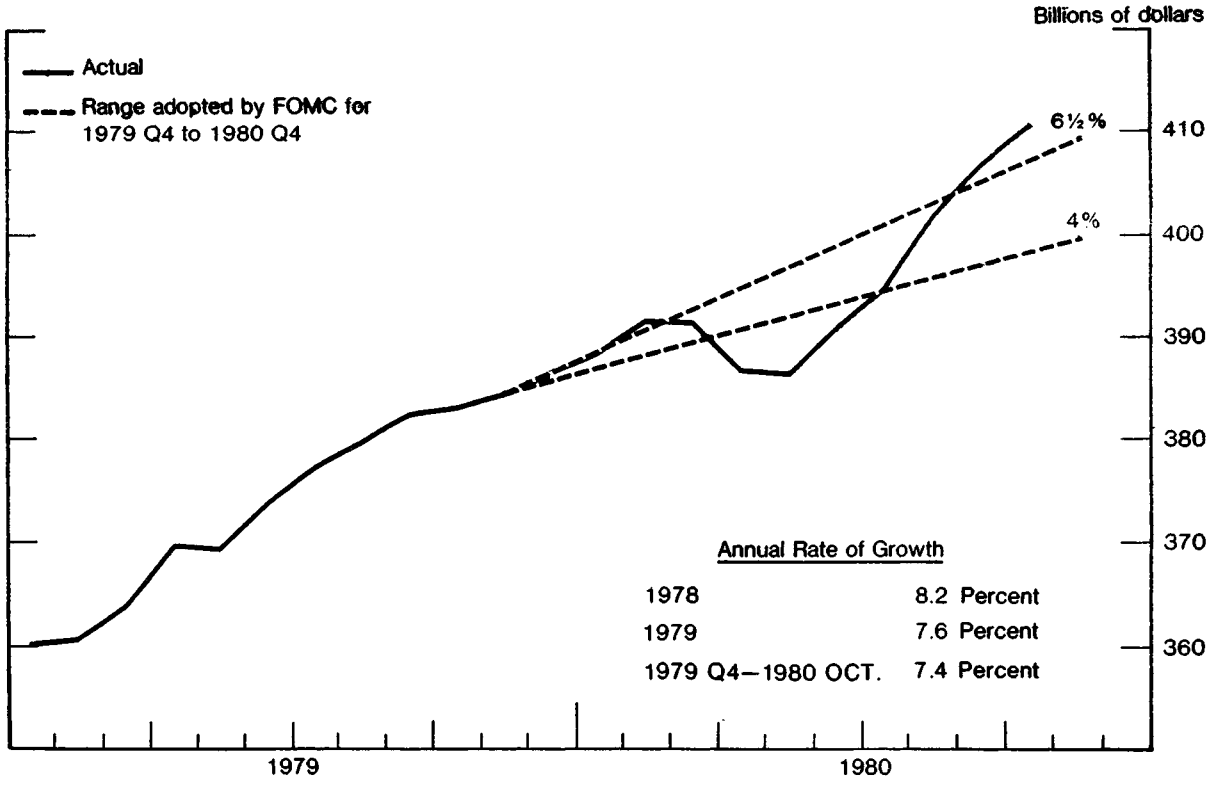
Chart 2

Growth Ranges and Actual Monetary Growth

M-1A



M-1B



Note: Last figure plotted is October 1980

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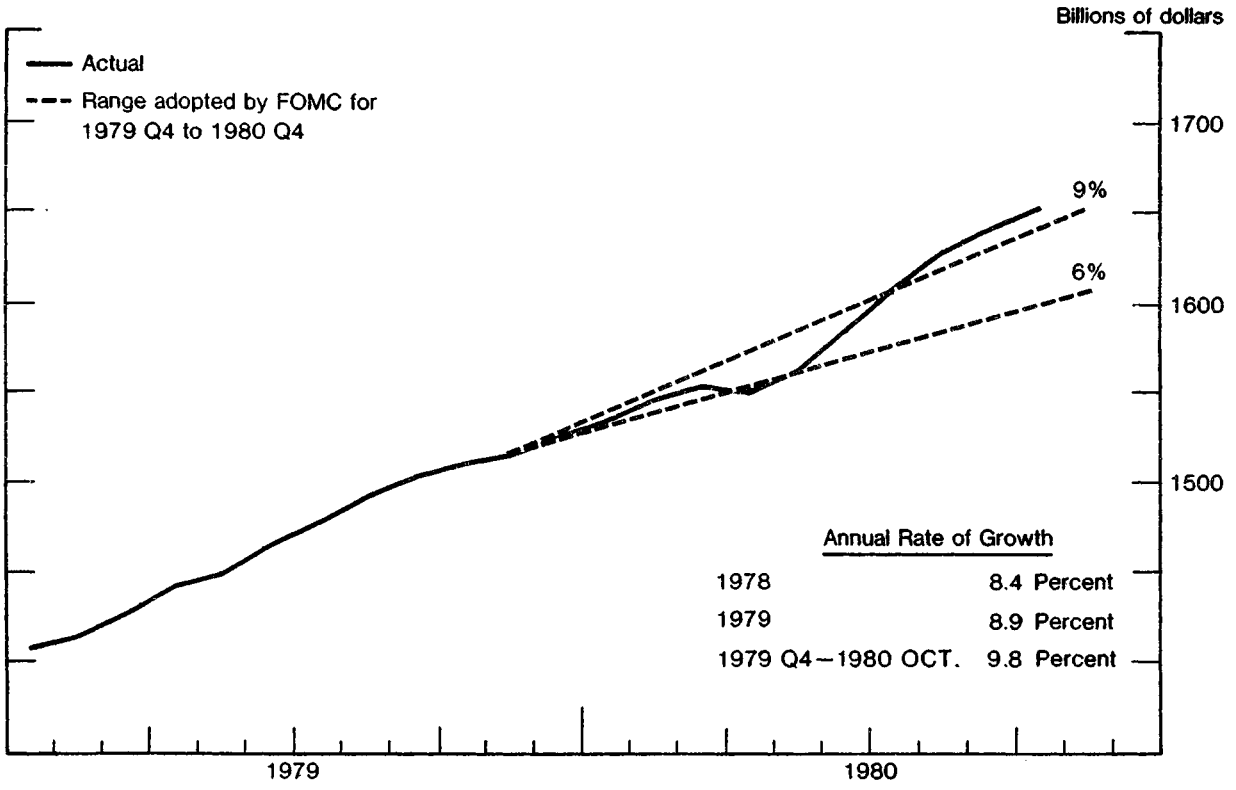
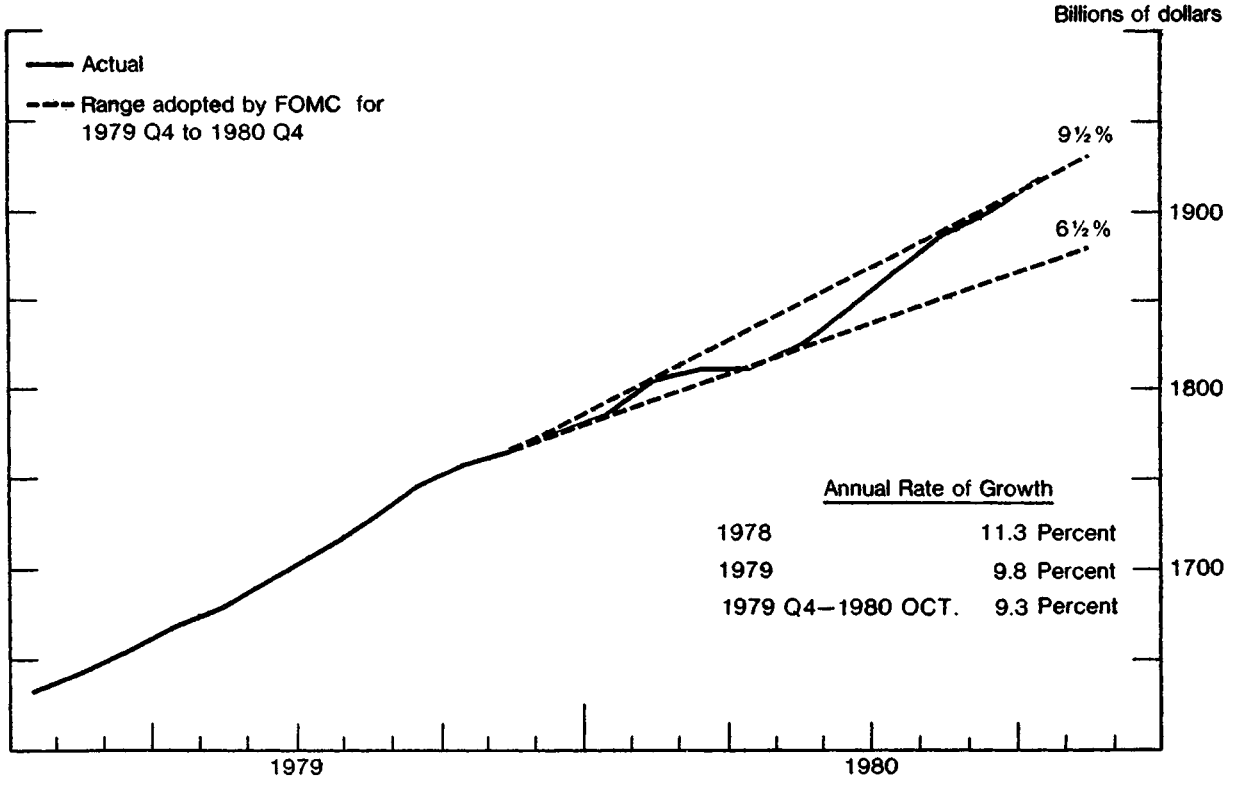
Chart 3

Growth Ranges and Actual Monetary Growth

M-2



M-3



Note: Last figure plotted is October 1980

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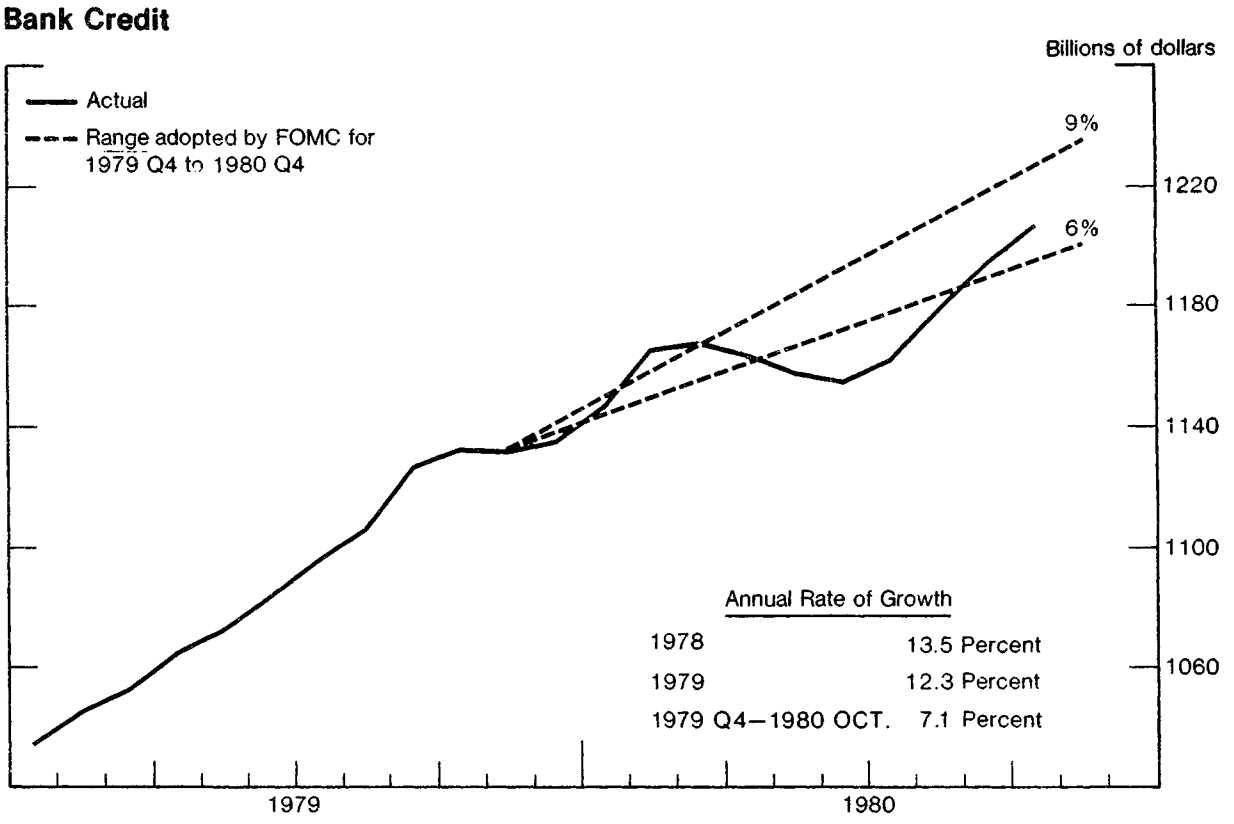
Chart 4

Growth Range and Actual Bank Credit Growth



Note: Last figure plotted is October 1980

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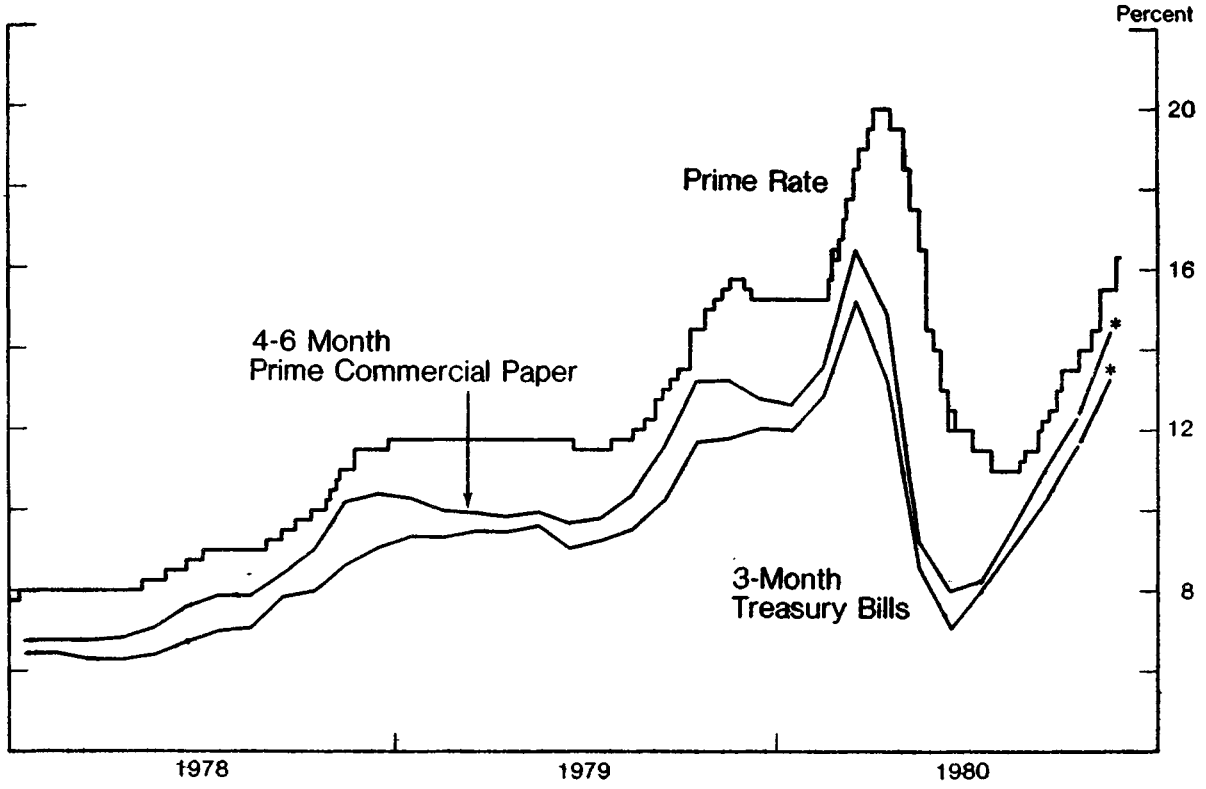
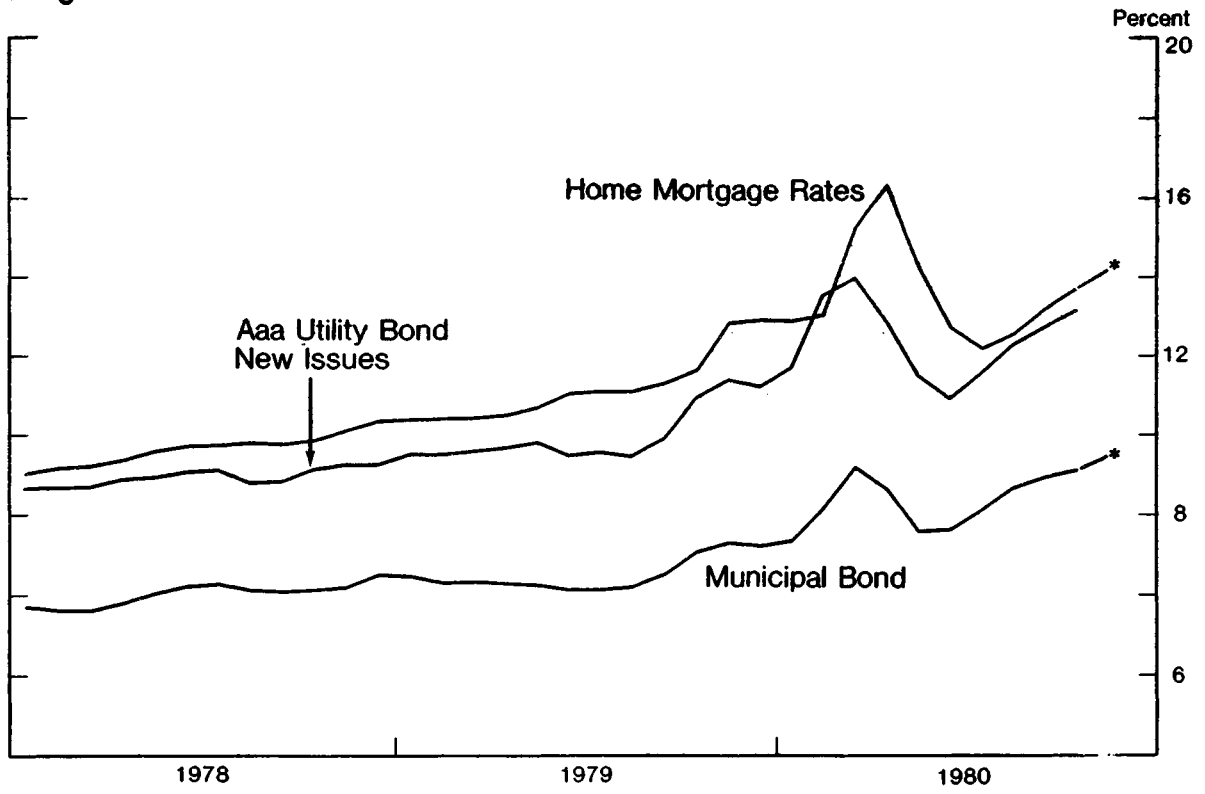
Chart 5

Interest Rates

Short-term



Long-term



*Latest figure plotted is week of November 12, 1980

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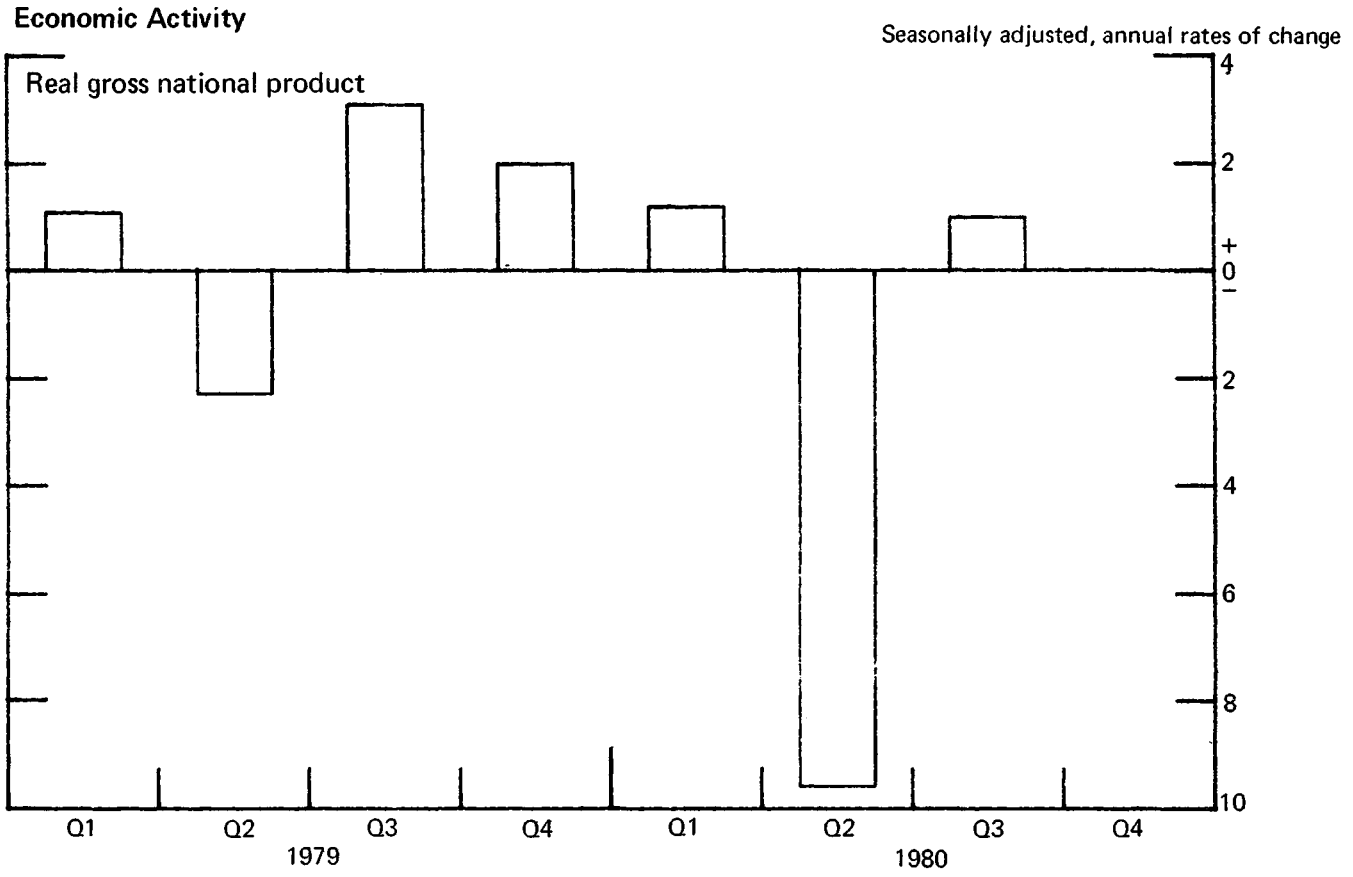
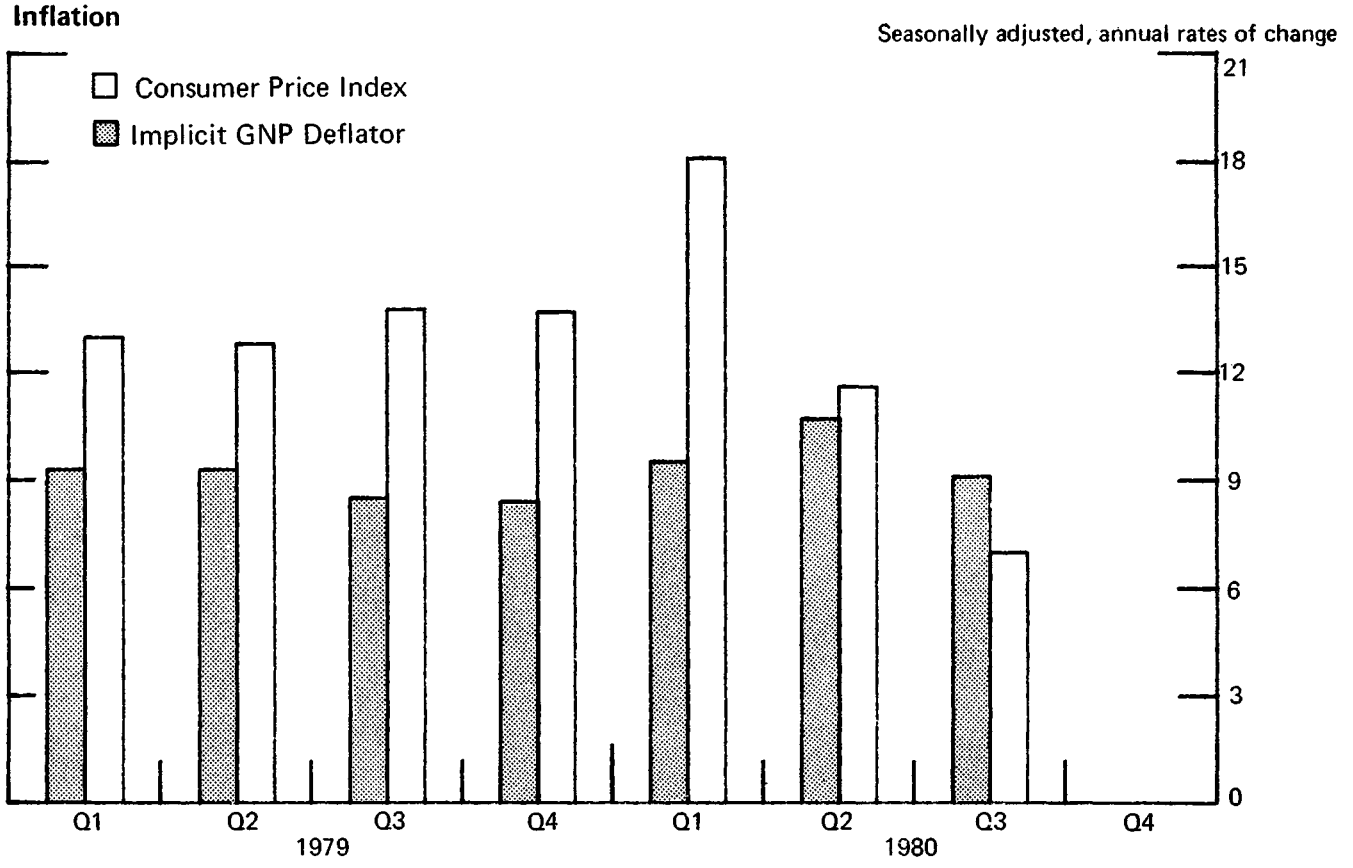
Chart 6

Economic Activity and Inflation





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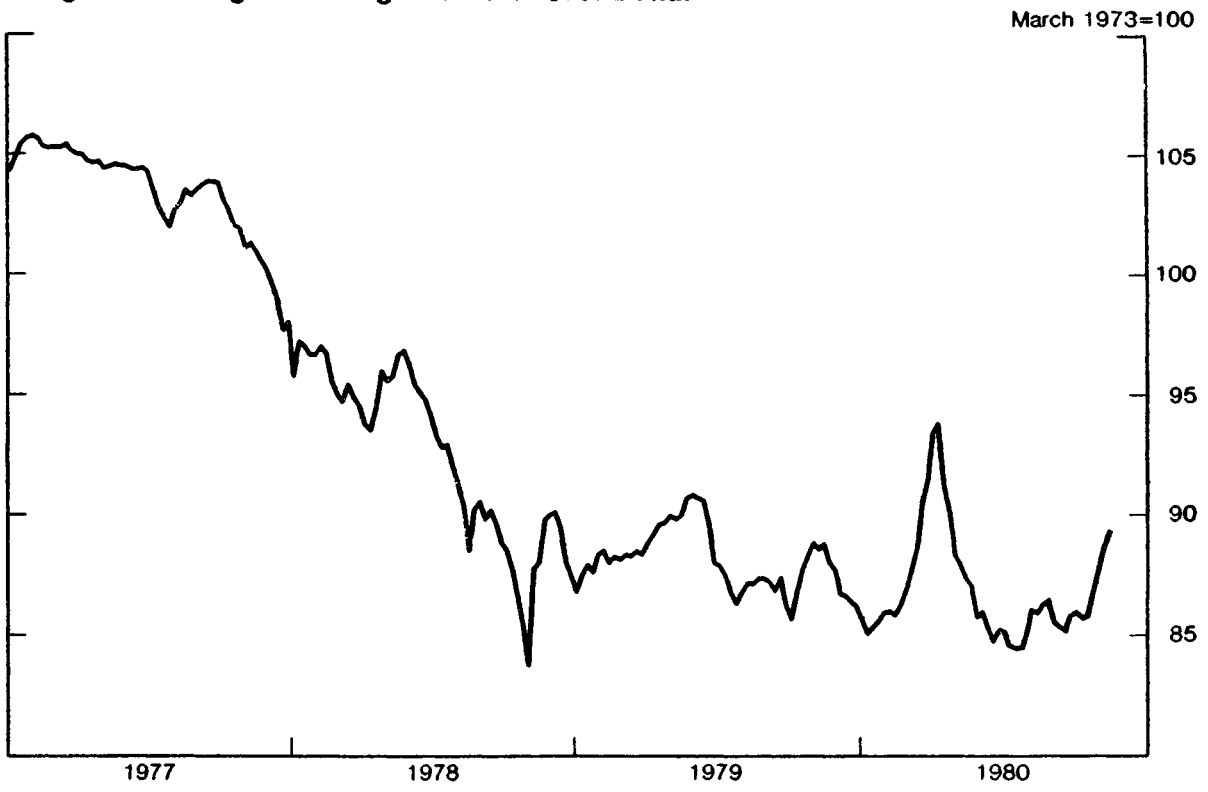
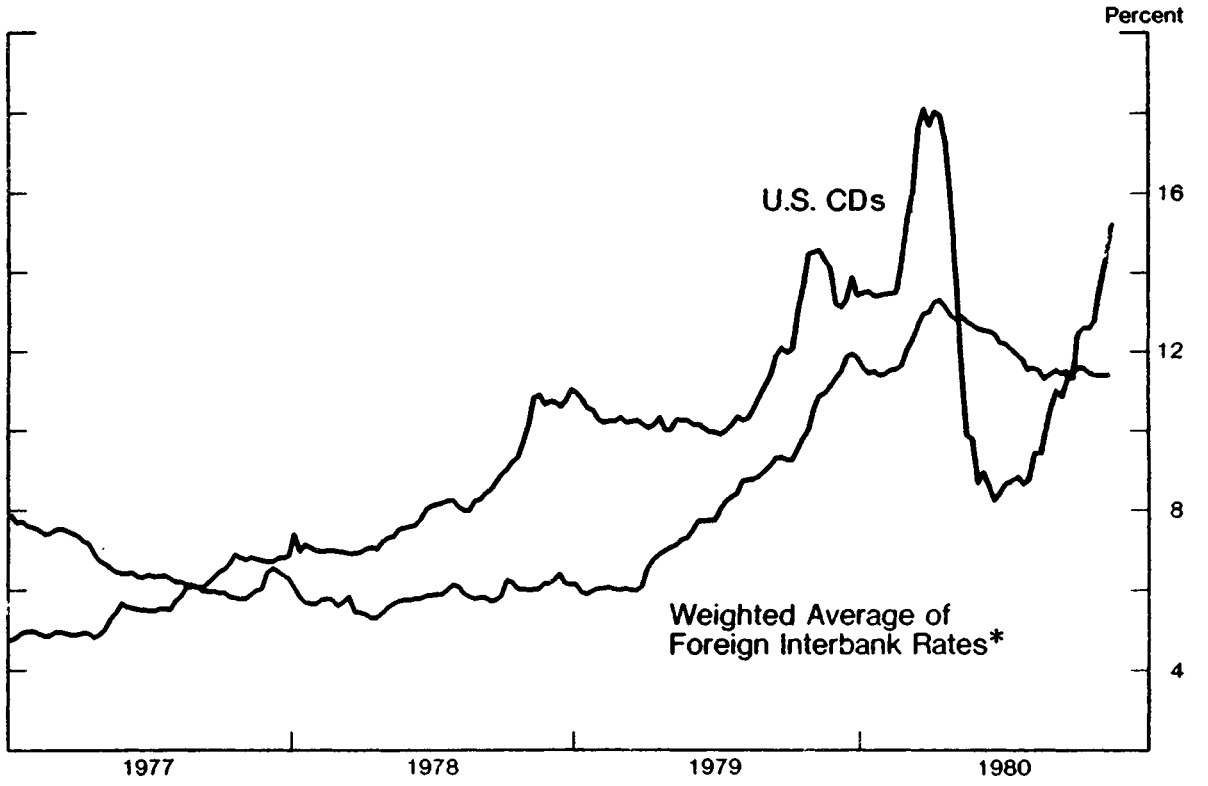
Weighted Average Exchange Value of U.S. Dollar*



3-Month Interest Rates



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

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Table 1

Quarterly Variability of Monetary Growth in Major Industrial Countries

	Average Annual Growth Rate	Variation in Growth around Average Rate*	Variation Relative to Average Growth	Sample
	(1)	(2)	(3) = (2) ÷ (1)	
Narrow Money				
Canada: M1	8.8	7.1	.80	1973:Q1-1980:Q3
France: M1	10.4	5.4	.52	1973:Q1-1980:Q2
Germany: M1	7.6	5.7	.75	1973:Q1-1980:Q3
Japan: M1	10.7	6.9	.65	1973:Q1-1980:Q2
Switzerland: M1	4.2	10.9	2.59	1972:Q1-1980:Q2
U.K.: M1	11.5	8.9	.78	1973:Q1-1980:Q3
U.S.: M1A	5.5	2.8	.50	1973:Q1-1980:Q3
Broad Money				
Canada: M2	14.0	3.7	.27	1973:Q1-1980:Q3
France: M2	13.4	3.4	.26	1973:Q1-1980:Q2
Germany: CBM	7.8	2.9	.37	1973:Q1-1980:Q3
Japan: M2	12.3	3.4	.28	1973:Q1-1980:Q2
Switzerland: M2	8.8	8.4	1.00	1975:Q4-1980:Q2
U.K.: ~~£~~M3	12.6	7.5	.60	1973:Q1-1980:Q3
U.S.: M2	9.3	3.1	.34	1973:Q1-1980:Q3

*As measured by standard deviation.

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Table 2

Annual Monetary Growth in Major Industrial Countries*

	1976	1977	1978	1979	1980	Most Recent Quarter
Narrow Money						
Canada: M1	2.6	10.4	11.0	4.8	6.3	Q3
France: M1	11.5	8.9	12.3	10.8	9.6	Q2
Germany: M1	7.3	9.9	13.3	4.6	1.0	Q3
Japan: M1	15.2	5.3	12.4	6.9	4.7	Q2
Switzerland: M1	7.6	5.2	21.9	-0.2	-16.7	Q2
U.K.: M1	13.5	18.7	15.4	10.9	2.3	Q3
U.S.: M1A	5.5	7.7	7.4	5.0	4.0	Q3
Broad Money						
Canada: M2	13.3	12.0	12.4	17.5	16.1	Q3
France: M2	14.6	12.8	13.4	13.5	11.9	Q2
Germany: CBM	9.1	9.4	11.8	6.1	4.5	Q3
Japan: M2	14.6	10.5	12.5	10.8	8.8	Q2
Switzerland: M2	2.2	7.3	7.9	11.1	28.2	Q2
U.K.: £M3	10.8	7.3	14.0	13.0	17.9	Q3
U.S.: M2	13.7	11.5	8.4	8.9	9.6	Q3

*Growth is measured from the fourth quarter of previous year; the 1980 figure is the seasonally adjusted growth between 1979:Q4 and the most recent quarter for which data are available, expressed at an annual rate.

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