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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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Mr. Chairman and Members of the Committee:

I am happy, at the very start of a new Congressional session and a new Congress, to discuss recent monetary and economic developments with you and to outline some of the key issues relating to monetary policy for 1981 and beyond. In that connection, I should also note that I reviewed the actions of the Federal Reserve during 1980 in greater detail in a recent statement before a Subcommittee of the House Banking Committee, which I have made available to each member of this Committee.

As you well know, the Congress itself has placed considerable emphasis in recent years on the formulation of our monetary objectives in quantitative terms. Target ranges for 1981 for various monetary and credit aggregates were tentatively set forth at mid-year in accordance with the Humphrey-Hawkins Act procedures. Those targets are being reviewed currently by the Federal Open Market Committee and our decisions will be reported to you next month. At that time, of course, they can be evaluated in the light of the overall economic programs of a new Administration. One of the major themes of my remarks this morning is the interrelationship between the fiscal position and outlook of the Federal Government, monetary policy, and conditions in the credit and capital markets.

So far as 1980 is concerned, it now appears that the level of economic output during the last quarter of the year

was about the same as during the final quarter of 1979. However, you are well aware there were sharp fluctuations in business activity during the year little anticipated in timing and magnitude, strong recurrent concerns that inflation might accelerate sharply or rise to a new and higher plateau, and -- related in large part to those economic developments -- strong short-term volatility in credit demands, interest rates, and some measures of the money supply.

The downturn in business in the second quarter, while exceptionally sharp, was also exceptionally short. Overall growth since July or August, while less than that immediately following most earlier recessions, has exceeded that anticipated by virtually every business forecast available during the summer. Employment growth resumed, but unemployment, while below peak levels, remained on a relatively high plateau of about 7-1/2 percent.

Some industries, such as automobiles and housing, have fallen well short of a normal cyclical recovery and, in the latter case at least, pressures on credit markets are being reflected in reduced activity currently. Some industries and areas of the country -- those characterized by a strong economic growth trend, concentrating on newer technologies, or benefitting from strong energy investment -- were relatively little affected by the recession and remain relatively buoyant.

As business turned up, so did concern about renewed inflationary pressures. The underlying inflation rate today appears at least as high, and probably higher, than a year ago. In addition, the possibility of a renewed surge in energy and food prices remains a particular source of concern. But the momentum of continuing inflationary forces throughout the economy is perhaps better reflected in a higher rate of increase in worker compensation, which accounts for some 75 percent of national income.

In judging monetary developments, we now have nearly complete (but still preliminary) data for the entire year. Measuring from the fourth quarter average of 1979 to the fourth quarter average of 1980, both M-1 series will be very close to the upper end of the growth ranges set at the beginning of the year assuming, as is appropriate and as shown on the attached charts, those ranges are adjusted for current estimates of actual experience with transfers into NOW and ATS accounts.* M-2, on the same quarterly basis,

*The difference in growth in 1980 between M-1B and M-1A was originally assumed to be at 1/2%, and the stated growth ranges reflected that assumption. Actual experience shows a difference of about 2%. Some of that greater difference reflected shifts into ATS and NOW accounts included in M-1B from demand balances, depressing M-1A relative to earlier assumptions. There were also shifts into NOW and ATS from savings accounts or other sources of funds, raising M-1B relative to earlier assumptions. Without these adjustments, M-1B in the fourth quarter was about 3/4% above the upper end of the target range; M-1A was somewhat above the midpoint of its target range.

appears to have been 1/2 to 3/4 percent above the upper end of its range; M-3 was roughly at the upper end, and bank credit was well within its range. Looking at available data for December alone, both M-1A and M-1B appear to have been within the indicated ranges.

In my judgment, no single monetary measure should be emphasized to the exclusion of others, nor should undue weight be placed on short-term changes or small deviations from targets, particularly when those deviations are not consistent from one measure to another. We know, not just in the United States but elsewhere, there can be a great deal of month-to-month or quarter-to-quarter volatility, especially in the narrower M-1 measures. That is particularly true when underlying economic conditions are rapidly changing.

These are technical qualifications. The basic point remains that, judged broadly over reasonable periods of time, these monetary data are meaningful. Most fundamentally, they are important because persistent control of the money supply must be a crucial part of any anti-inflationary effort. The ranges set forth have also become a means of communication about our objectives, and the statistical results are a part of the process of accountability. They are a particularly useful focus for policy when the inflationary process itself distorts the economic significance of interest rates and other economic data.

Looked at from the vantage point of monetary targeting, recent developments provide a prime illustration of both the need for, and the problems associated with, restraint on monetary and credit growth. We want to restore a solid base for renewed and prolonged economic expansion while at the same time dealing with inflation -- and without controlling inflation the objective of sustained growth seems bound to elude us. What springs out clearly as the lesson from the events of the past few months is the desirability -- indeed the compelling need -- to combine the monetary restraint required to deal with inflation with appropriate and complementary fiscal and other policies.

Money and credit creation has clearly fallen well short of meeting all the demands that arise in an economy that is both expanding and inflating. As a result, money and capital markets have come under heavy pressure; currently, interest rates, despite some appreciable declines in recent weeks, are still near historical highs, placing heavy burdens on credit-dependent sectors of the economy. While economic growth in recent months has been greater than anticipated, there is understandable concern that the strong interest rate pressures may result in little further growth or actual declines in business activity in the months ahead. And, in a longer perspective, growth has been very limited for two years, unemployment is high, and there is substantial excess capacity in important industries.

Yet, in the light of the need to encourage a return to price stability, it could hardly be argued that the growth of money and credit has been unduly constricted, whether one looks at the results for the year as a whole or during the months of business expansion. Indeed, some have argued the reverse. As I already noted, monetary growth for the year has not fallen short of the intentions reported to (and generally supported by) this Committee in the past; most measures have been around the upper end of the established ranges.

What is clear in circumstances like these, when efforts to restrain monetary growth confront strong private credit demands, is that large new borrowings by the Federal Government, whether to finance budgetary deficits or off-budget programs, inevitably strongly aggravate interest rate pressures. As things stand, the deficit for the current fiscal year has been estimated in a range of \$50 to \$60 billion by informed observers, and the needs of the Federal Financing Bank could add more than \$20 billion. The demands by the Federal Government -- the nation's prime borrower, but itself insensitive to interest rates -- will be met. The question is how many other potential borrowers -- many with more productive uses of money -- are shouldered aside by market pressures.

From that point of view, it might appear that the restraint on money and credit creation jeopardizes prospects

for business expansion and the private job creation that would otherwise be desirable. But the creation of more money and credit than consistent with dealing with inflation would provide no escape from that apparent policy dilemma.

For one thing, interest rates and bond prices can be heavily influenced by expectational factors. To the extent economic trends and public policies seem to be consistent with more inflation rather than less, and to the extent governmental financing is expected to remain high, savings will be impaired or directed to inflation hedges, borrowing will be further stimulated, and interest rate pressures will remain strong, despite new money creation. Indeed, if money creation were to validate the inflationary expectations, the present policy problem would only be aggravated, even in the short run.

Far from finding their problems solved by money creation, those such as builders, thrift institutions, and small businessmen particularly vulnerable to a continuing escalation of interest rates, would find their prospects worsening over time.

Put simply, I do not believe monetary policy can reasonably take the risk of encouraging and validating the inflationary process by simply accommodating money and credit creation to the amounts demanded by an inflating economy. To be sure, strong credit demands pressing against a limited supply can contribute to exceptionally high interest rates for a time.

But consider the alternative. If the supply of money is not restrained, the net result would surely be to acquiesce in an inflationary process that over time would result in still higher interest rates, prolonged indefinitely.

The ultimate purpose of monetary restraint is, of course, to squeeze out inflation rather than real growth. But monetary restraint is at best a rough-edged tool; the restraint falls on those financing inflationary excesses and potentially productive projects alike. The hard fact is that in practice the purposes are typically indistinguishable. Home ownership is a cherished American dream, and buyers and sellers alike would like to see the process lubricated by low mortgage rates. But the seller is also interested in holding on to essentially inflationary gains, and the buyer is often motivated by a desire to capitalize on future inflationary appreciation. Many businessmen would like to expand plant or build inventory at lower interest rates. But these borrowings also finance higher wages and other costs. The consumer is tempted to buy now and pay later, and to maintain "investments" in presumed inflation hedges. Amidst all these mixed motives, it seems to me beyond human ingenuity to distinguish between "legitimate" and "illegitimate" -- "speculative" and "non-speculative" -- uses of credit in any systematic, sustainable way by a system of credit allocation.

Looked at another way, restraint in money and credit growth places broad limits on the growth of nominal GNP. Those limits are not precise. For periods of months or quarters, the relationship between changes in money or credit and the GNP can fluctuate over a considerable margin. At high levels of interest rates, the market is particularly ingenious at developing new forms of "money" and economizing on the use of credit. We currently are in a period of rapid institutional change that will affect the relationships among the aggregates, and their relation to GNP. But, even with these qualifications, the basic point remains: so long as inflationary forces are so strong and are expected to remain strong, money and credit targets in the area in which we are operating are likely to imply strong pressures on credit markets whenever business is strongly expanding, calling into question the sustainability of the advance.

Given enough time, sluggish business performance should itself tend to restrain inflation. But our objective as a nation must be to speed the disinflationary process. That will be a legitimate expectation only if we can succeed in changing attitudes and policies across a broad range of public and private behavior. Only then can we confidently anticipate that a relaxation of pressures on financial markets could be sustained, and that the stage will be set for full recovery and expansion.

The task is both difficult and painful because patterns of inflationary behavior are by now so deeply ingrained in individual attitudes that the process feeds on itself. That will change only when there is a visible, sustained commitment to policies that will in fact reduce the strong upward price thrust -- and permit market processes to penalize those speculating on inflation -- even when those policies, in the short run, entail risks and strains. Credibility in policy commitment will have to be earned by performance maintained through thick and thin. That is one reason we in the Federal Reserve take our own monetary and credit objectives so seriously -- in setting realistic targets in the first place, in explaining their implications and our methods for approaching them, and in substantially meeting them over reasonable periods of time. But monetary policy, indispensable as it is, is only one instrument, and, as I have emphasized, relying entirely on that instrument focuses the strains on financial markets and those most dependent upon them.

The fiscal posture of the Federal Government is the most important of the other instruments that can be brought to bear in changing both expectations and current reality. That posture has several dimensions.

The point has rightly been emphasized that the level of Federal taxation itself impairs incentives and adds to costs, and that taxes are not only high but rising. The

relevant question is not whether tax reduction is desirable in itself; it obviously is if we want a healthy private economy. The real debate is how that desirable -- even necessary -- objective can be achieved consistent with fighting inflation and reducing the pressures on financial markets -- pressures that could otherwise frustrate the beneficial effects. The concern is not limited to reducing the immediate deficit, important as that is as a source of current interest rate pressures. Even more significant in many ways is the forward planning necessary to assure that, as the economy returns to more satisfactory operating levels, the financial position of the government indeed returns to balance, making way for the private investment we need.

This is not the time or place for a detailed discussion of the budgetary problem. I would simply emphasize that the so-called "uncontrollables" that so often frustrate short-term budget control can in fact be controlled over a relevant time frame.

I do not underestimate the difficulties. Experience amply illustrates -- and private financial observers are conscious of the fact -- that official projections of government spending extending over several years ahead have almost invariably fallen far short of actual results. Part of the reason is that inflation itself has exceeded expectations. But the hard fact is old programs usually turn out to be

more costly than anticipated. New programs are added. And that insidious pattern cannot be changed unless Congress itself takes on the burden of modifying programs and laws that generate the bulk of the spending.

Related in some respects to the budgetary problem, and in some ways even more difficult to control, are the myriad government programs that in one way or another tend to build in higher costs in the private economy or insulate firms or workers from market pressures. These programs are justified in major part by the national consensus that, in our market-oriented system, those subject to special risks and dislocations not of their own making are entitled to an economic "safety net." Other programs reflect our real concerns about the environment, health, and safety. Those fundamental objectives are not likely to be -- nor should they be -- changed. But we do urgently need to find ways to make sure that an appropriate balance is maintained -- that the protections do not exceed what is necessary and justified, and they do not unduly impair incentives to produce efficiently and control costs.

All of this implies an enormous effort by a Congress and an Administration in the months ahead -- and public understanding of what is at stake. But the result would, in my judgment, repay that effort many times over. As the message is sent and heard that, in a realistic time frame,

we can indeed succeed in achieving the expenditure control that makes the needed tax relief prudently possible, the private sector should indeed respond vigorously with job creation and greater productivity.

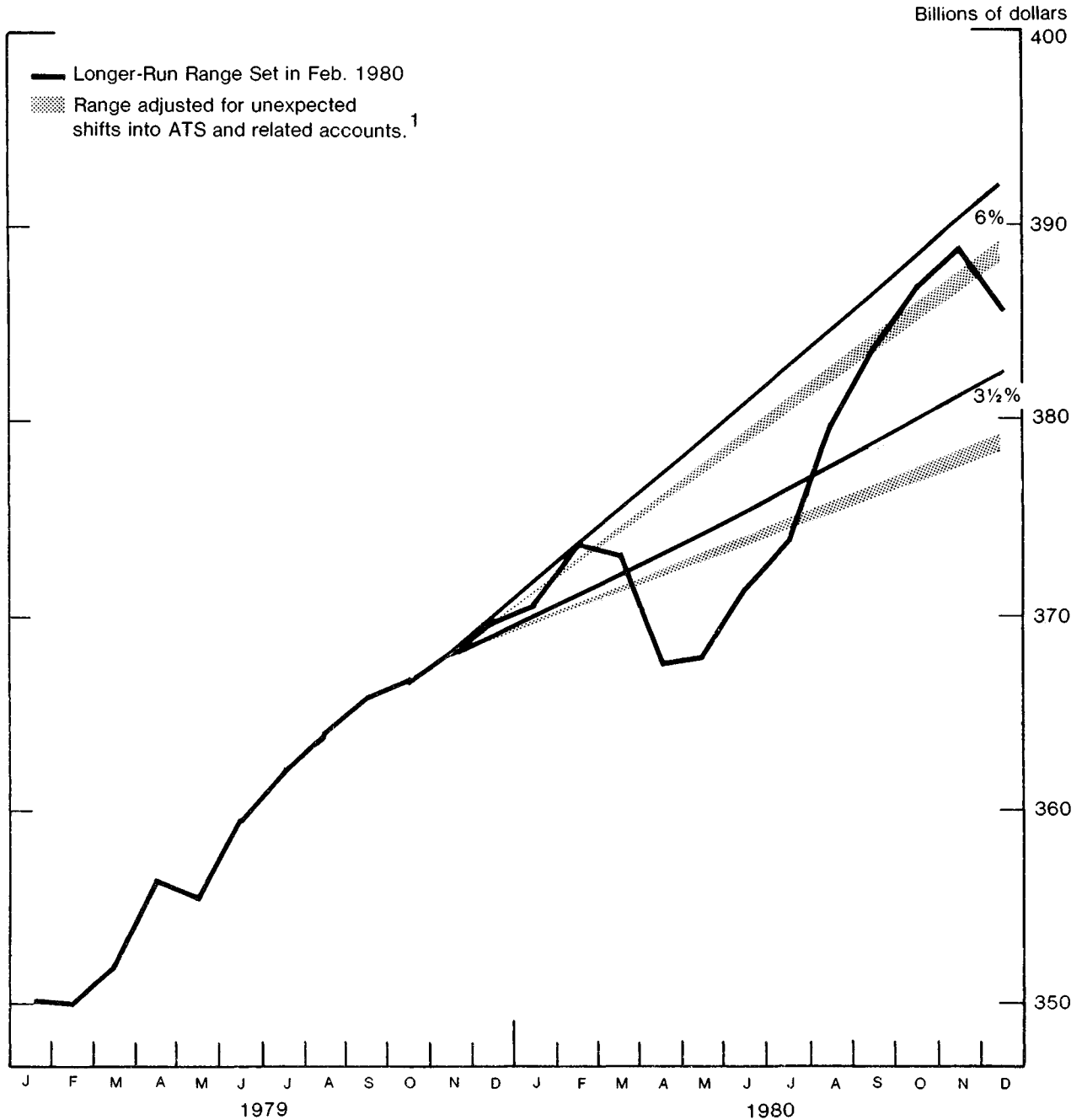
I am conscious in some of my own contacts and correspondence -- as you must be in yours -- of a rather plaintive note emerging. In principle, no one likes inflation. But, the implicit argument goes, if strong financial pressures, budget cuts, and regulatory changes are a necessary part of the process of restoring price stability, then perhaps it's easier to live with inflation after all.

That is pure delusion. Experience here and abroad indicates unambiguously that we have not been successful in living with inflation -- that in an economy like ours persistent inflation, stagnation, and reduced productivity are inexorably related, and that left alone inflation will get worse, not better.

The fact is we now have one of those rare opportunities to marshal a national consensus for those measures necessary to restore the base for more vigorous growth and prosperity. Of course, we can always let the opportunity pass to another day, but then we had better recognize the nation would soon face still more difficult dilemmas. That cannot be the responsible course.

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Targeted and Actual M-1A

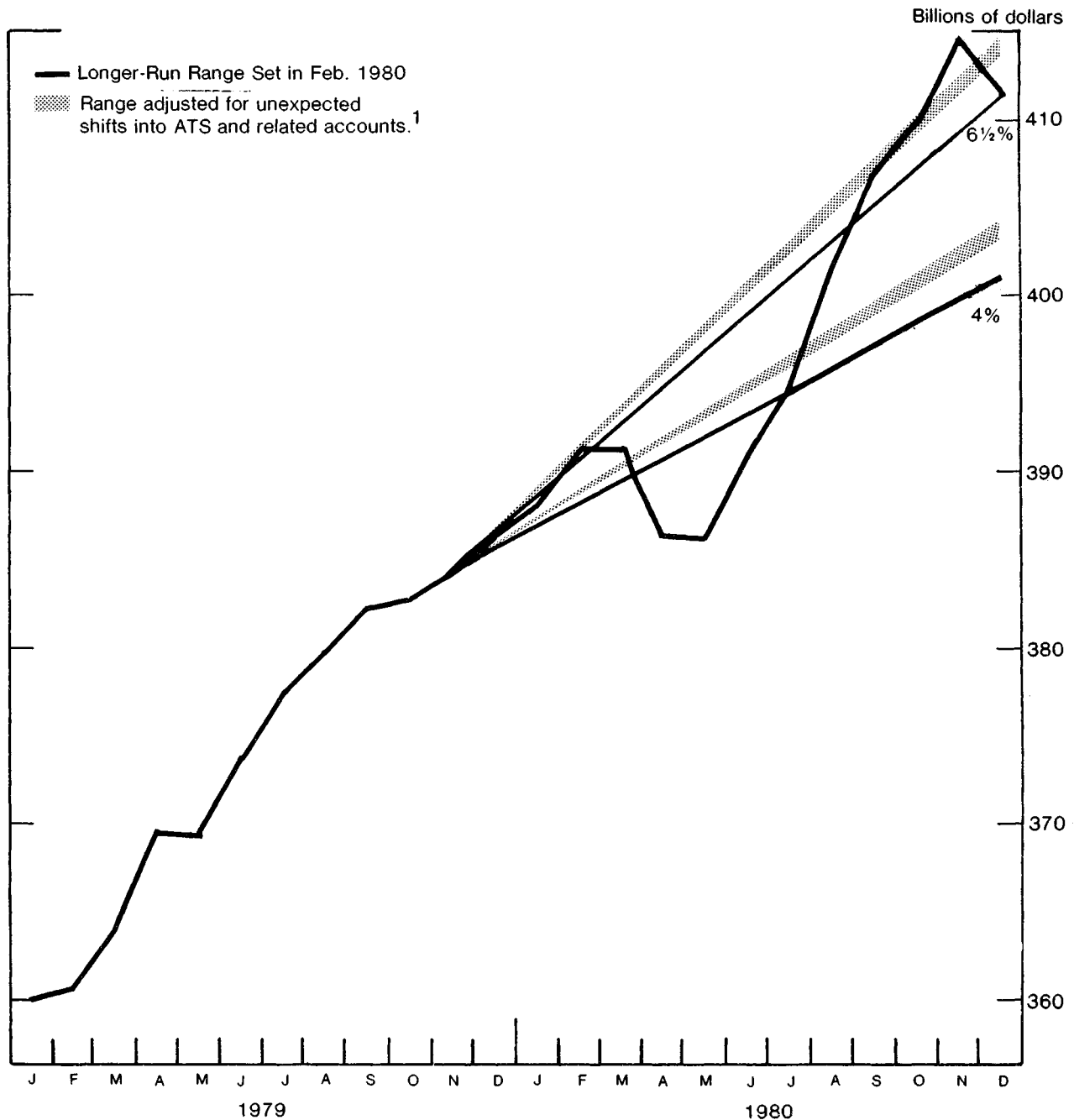


Note: December based on data through December 24, 1980.

1. The shaded lines reflect adjustments that should be made for technical reasons to the original range for M-1A to allow for unanticipated shifts of existing deposits from demand deposits to interest-bearing transactions accounts, such as ATS (automatic transfer savings) and related accounts. At the beginning of 1980 it appeared that such shifts would have just a limited effect on growth of M-1A, and the longer-run growth range for M-1A was set only 1/2 percentage point below the growth range for M-1B. Passage of the Monetary Control Act subsequently altered the financial environment by making permanent the authority of banks to offer ATS accounts and

by permitting all institutions to offer NOW and similar accounts beginning in 1981. As the year progressed, banks offered ATS accounts more actively and more funds than expected were being diverted to these accounts from demand deposits. Such shifts are estimated to have depressed M-1A growth over the year 1980 by 3/4 to 1 percentage point more than had been originally anticipated. The shaded range allows for these unanticipated shifts, and therefore in an economic sense more accurately represents the intentions underlying the original target.

Targeted and Actual M-1B

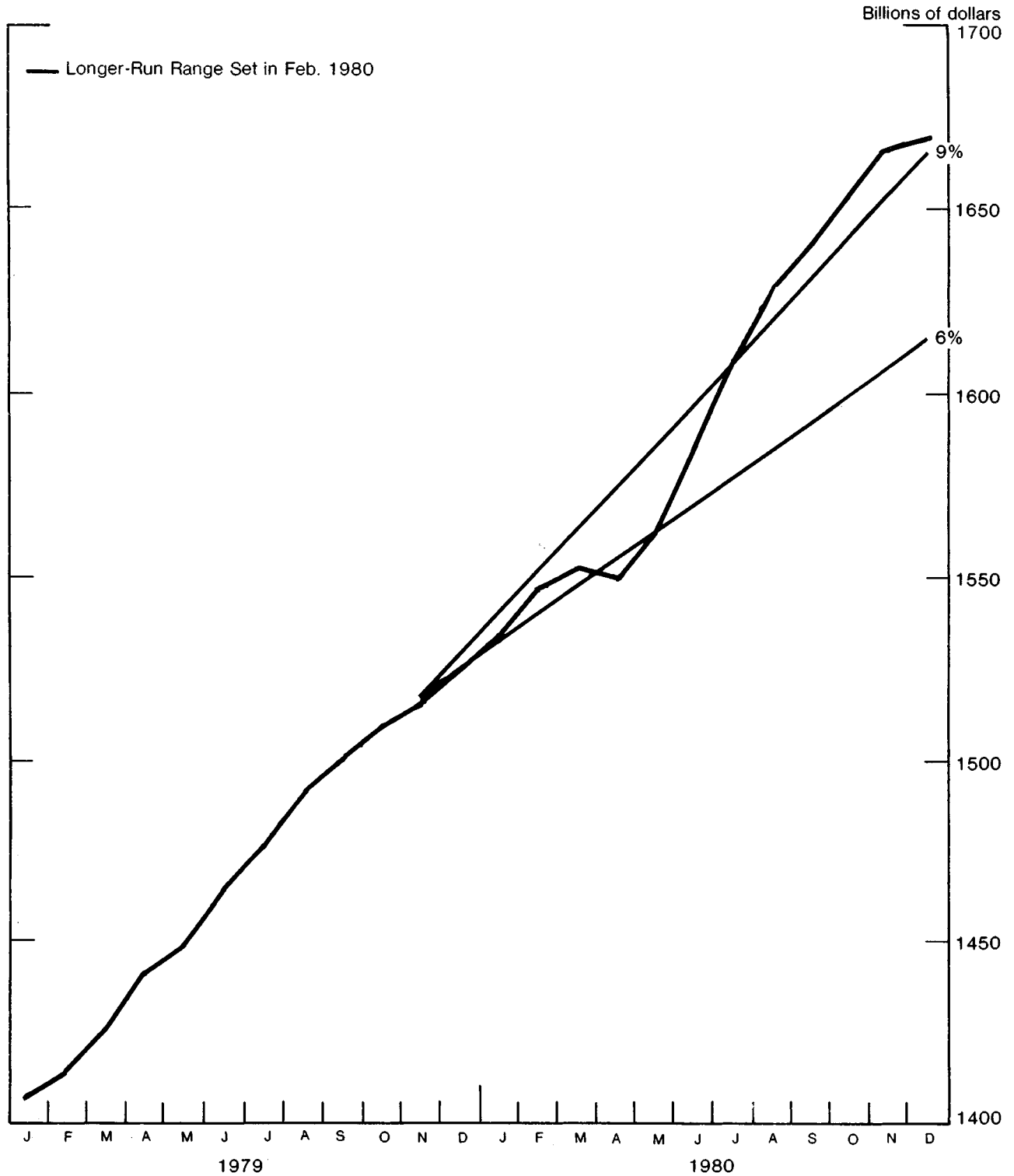


Note: December based on data through December 24, 1980.

1. The shaded lines reflect adjustments that should be made for technical reasons to the original range for M-1B to allow for unanticipated shifts into interest-bearing transactions accounts from savings deposits and other instruments not included in M-1B. At the beginning of 1980 it appeared that such shifts would have just a limited effect on growth of M-1B, and the longer-run growth range for M-1B was set only 1/2 percentage point above the growth range for M-1A. Passage of the Monetary Control Act subsequently altered the financial environment by making permanent the authority of banks to

offer ATS accounts and by permitting all institutions to offer NOW and similar accounts beginning in 1981. As the year progressed, banks offered ATS accounts more actively and more funds than expected were being diverted to the accounts. Such shifts are estimated to have increased M-1B growth over the year 1980 by 1/2 to 3/4 of a percentage point more than had been anticipated. The shaded range allows for these unanticipated shifts, and therefore in an economic sense more accurately represents the intentions underlying the original target.

Targeted and Actual M-2



Note: December based on partial data.

Targeted and Actual M-3 and Bank Credit

