

For release on delivery  
10:00 A.M., E.S.T.

Statement by

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before the

Joint Economic Committee

February 5, 1981

I'm pleased to be here today to review with you the current economic situation, to share with you my views on some critical considerations in the shaping of monetary policy, and to explore the relationship of monetary and other economic policies. I have emphasized on a number of occasions that we now have a rare opportunity to adopt and reinforce policies to bring inflation under control and to set the stage for sustained expansion and productivity growth. That sense of opportunity stems, in substantial part, from a conviction that the American people recognize that we must decisively turn the corner toward price stability and reduce the demands on the Federal Government for spending and regulation. That will, in turn, lay the groundwork for restoration of vigorous and sustained economic growth.

At the same time, there must be understanding that reducing inflation will require changes in behavior patterns that have become deeply ingrained. In the short-run, some sacrifice and pain are inevitable. The discipline required will be amply repaid if strong policies are carried through with persistence and resolution.

To be successful, the effort must be carried out over a broad range of policies. Each of the policies will entail difficult choices, which must be confronted directly. But those choices will be made easier to the extent that policies are integrated in such a way as to avoid excessive burdens

or emphasis on one policy instrument or another, and do not work at cross purposes. It is in that light that I welcome this chance to discuss the Federal Reserve's commitment to a monetary policy consistent with reducing inflation and to consider some of the implications for other policies.

First, a few words about the current unsatisfactory economic situation. Last year, we experienced exceptionally sharp swings in real output and employment, and on balance there was virtually no economic growth. Inflation did not slow. Productivity performance remained dismal, and unemployment rose.

Looked at over a longer period, real wages have tended to decline, reflecting both the absence of productivity growth and sharp increases in the prices of basic items such as food and energy. Despite some recent improvement in household balance sheets, savings remain relatively low.

Some important industries -- including those related to energy and defense -- have continued to expand vigorously. However, a number of basic industries -- such as autos, steel, and housing -- came under severe pressures in 1980. Wide swings in consumer spending created uncertainties about future sales, and weak markets brought pressures on profits for many corporations. In addition, many firms had to contend with high and sharply fluctuating interest rates. With the slow growth of final sales over the year, the margin of unused plant and equipment in some industries remains

sizable. The contrasting movements in different sectors of the economy add to the complexities facing economic policy.

There has been a considerable softening in labor markets in many areas of the country. But there has been little reflection of that development in lower wage settlements or reduced cost pressures. With inflation high and real wages falling, the effects of unemployment have been offset by the desire to "keep up" with prices and to restore real income -- a desire that, however understandable, cannot be met so long as productivity fails to rise and higher energy and food prices must be absorbed. Instead, the self-defeating inflationary spiral is perpetuated.

The challenge is to break the insidious pattern of rising prices and costs that, itself, underlies so much of the problems of high unemployment, slow growth and high interest rates.

Inflation has been building for a long time. There are a number of contributing factors -- including insufficient saving and investment, declining productivity growth, large and persistent budget deficits, huge increases in oil prices and adverse events in agricultural markets -- accompanied at times by excessive growth of money and credit.

But whatever the particular causes of inflation, we are faced today with circumstances in which expectations and

behavior patterns tend to keep the momentum going, discouraging thrift, encouraging speculation, and building in higher costs for the future. Those attitudes must be changed. They will not be changed without strong and credible policy commitments, and, I suspect, visible evidence for a time that inflation is, indeed, subsiding.

Firmly disciplined monetary policy has a central -- indeed indispensable -- role to play in the process of restoring price stability. As you know, setting specific targets for monetary and credit growth is one aspect of that policy.

Last year's rapidly changing economic conditions, changing inflationary expectations, the imposition of credit controls in the spring, and other factors resulted in wide swings in the demand for money and credit. After a very sharp but very short downturn, the economy rebounded much more strongly than almost anyone expected last fall and early this winter. After falling short for a time, the monetary aggregates temporarily exceeded their growth targets. There was unusual -- and undesirable -- volatility in financial markets.

On balance, most of the monetary aggregates did finish the year within or very close to our target ranges. But it was also evident that the expansion of money was not sufficient to meet the demands for financing rising prices, large deficits and faster real growth.

I am well aware the resulting increase in interest rates placed a particularly heavy burden on housing, small business and other credit-sensitive sectors of the economy.

The basic point is, however, that we cannot escape that problem by simply creating more money. In the end, that course could only aggravate inflation. Indeed, if the Federal Reserve were perceived to be validating the inflationary process, inflationary expectations would surge leading to still higher interest rates. In the end, lower interest rates are dependent on reducing inflation, and restoring price stability will require lower rates of monetary and credit growth.

In pursuing that necessary approach of monetary restraint, the pressures converging on financial markets can be relieved by appropriate fiscal and other policies aimed toward restoring productivity, reducing costs, and restoring budgetary balance. Events in financial markets last year demonstrated all too clearly the dangerous strains that arise in credit markets when necessary monetary restraint is accompanied by large deficits and expanding business activity.

The proposition that the budget can be balanced or move into surplus only when the economy is operating at reasonably satisfactory levels has merit. But the record of the past decades, even by that test, is poor. We have

had only one balanced budget in the last twelve years and two in the last twenty -- periods that included mostly prosperous years. Furthermore, government spending continues to consume an ever increasing share of our national resources, making balance more difficult and requiring a tax load that is itself a drag on the economy. According to the budget just submitted by the outgoing Administration, Federal budget and off-budget spending will approach one-quarter of the GNP this fiscal year. Federal taxes will be equivalent to 21.4 percent of GNP -- close to the wartime record of 21.9 percent.

Against that background, I see no escape from the proposition that a large cutback from projected increases in spending in coming years is a crucial linch pin in an effective overall economic program. I know how difficult that will be to accomplish in practice. Many people will support cutbacks in general, but not in their favorite program -- and virtually every program is somebody's favorite. Furthermore, any realistic expenditure control program must extend over years, and include important "uncontrollable" items -- including entitlement programs.

Administration spokesmen have rightly emphasized the purpose of the program should not be simply one of aiming towards a balanced budget but making room for large tax reductions. In fact, taxes are rising. Without a cut,

Federal receipts will reach the highest level ever in Fiscal Year 1982 relative to GNP. I do not doubt the proposition that our level and structure of taxation reduces incentives, acts as a deterrent to investment and distorts economic decision making. But it is critically important that tax reduction proceed in harness with spending restraint, and as a practical matter the credibility of that approach will depend on early Congressional action to deal with spending. The point is only reinforced by the consensus that one large element in the budget -- defense spending -- needs to be increased.

I would also emphasize the relevance to any attack on inflation of changing or modifying other government policies that have tended to increase costs or reduce competitive pressures. Over the years we have established a number of programs which have the objective of sheltering different groups from unanticipated economic setbacks or from competitive forces. We have also embarked on extensive and expensive new efforts to promote safety, to improve the environment, and for other purposes. Each of these programs has laudable and even necessary objectives. It can also be legitimately pointed out that most of them, taken individually, do not have a decisive impact on inflation.

However, I believe the effect of many of these programs, taken together and operating over a number of years, has been much more important. Their cumulative impact has been to



contribute significantly to the inflationary bias in our economy. Like cutting the budget, addressing this problem will require difficult tradeoffs. But I believe this is an area we have paid far too little attention to in the past, and one which I would encourage all of us to look at more carefully in the future, with the intention of seeking their objectives with less cost in real terms or in inflation.

I do not want to minimize in any way the enormous challenge facing the Congress, the Administration and the Federal Reserve. However, I do believe we may be seeing fundamental changes in public attitudes which should make things possible now that have not been possible in the past. I am confident we can capitalize on this new found opportunity, taking whatever short-term sacrifice is involved in the interest of restoring a stronger and more stable economy.

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