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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

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I am pleased to be here this morning to discuss with you the Monetary Policy Report of the Board of Governors reviewing economic and financial developments over the past year, and setting forth appropriate ranges for growth of money and credit for 1981. Because I have already reviewed recent developments with the Committee, my emphasis this morning will be on the present and future concerns of monetary policy. In that connection, I would like to touch first on some more technical considerations of Federal Reserve operating techniques.

As you well know, 1980 was a tumultuous year for the economy and financial markets. While most measures of the monetary and credit aggregates grew at or very close to our target ranges for the year as a whole, there was considerable volatility from month to month or quarter to quarter. Moreover, interest rates moved through a sharp cycle, and had considerable instability over shorter time spans.

In the light of these developments, I initiated in September a detailed study by Federal Reserve staff of the operating techniques adopted by the Federal Open Market Committee in October 1979, looking, among other things, to the question of whether the particular techniques we employed contributed importantly to the observed volatility. Those techniques, as described in our Report, place emphasis in the short run on following a path of non-borrowed reserves.

The study drew upon the substantial body of staff expertise both at the Board of Governors and at the regional Federal Reserve Banks, thus bringing to bear a variety of viewpoints and analytic approaches. The Open Market Committee has had some discussion of the findings, and we are now at a point where the work can be made available to interested outside experts. To assure full review, Board staff will be arranging "seminars," as appropriate, with economists having a close interest in these matters.

Among the important questions at issue is whether alternative techniques would promise significantly better short-run control over the monetary and credit aggregates, and whether such techniques would imply more interest rate instability. We also examined again the significance for the economy and for basic policy objectives of monthly, quarterly, or longer deviations of monetary growth from established target ranges.

For the convenience of the Committee and others, I have listed in this text some of the technical findings that may be of more general interest.

1. The work confirms that the week-to-week money supply figures are subject to a considerable amount of statistical "noise" -- unpredictable short-run variations related to the inherent difficulty of computing reliable weekly seasonal adjustment factors and other random disturbances. One analysis suggests the random element in the weekly M-1 data, as first published, is about \$3 billion, plus or minus. While those variations average out over time, they could amount to \$1½ billion on a monthly average basis, equivalent to a change of 4½ percent at an annual rate.

2. No clear evidence was found that, in the present institutional setting, alternative approaches to reserve (or monetary base) targeting would increase the precision of monetary control. Indeed, in current circumstances, some other approaches would appear to result in less precision in the short run. Perhaps more significant, the linkage between any reserve measure and money in the short run was loose; econometric tests seem to suggest that, even assuming absolute precision in meeting a reserve target (which is not in fact possible), monthly M-1 measures would be expected to deviate from the target by more than plus or minus 8 to 10 percent (at an annual rate) one-third of the time. Those deviations should tend to average out over time, so that much closer control could be achieved over a three-to-six month period, assuming no constraints on operations from interest rates or other factors. Those econometric results are consistent with the actual experience of 1980.

Pursuing the closest possible short-run control of the money supply by any technique entails a willingness to tolerate large changes over short periods of time in short-term interest rates -- greater than were experienced in 1980. The technique actually employed, as expected, contributed to more day-to-day or week-to-week volatility than earlier procedures, but presumably not so much as other, more rigid reserve targeting approaches. Experience in 1980 also strongly suggested that short-run changes in money market rates became more highly correlated with fluctuations in long-term interest rates, which may be of more significance to investment and financial planning. The degree to which that closer association reflected uncertainty and a learning process unique to 1980, or is inherent in reserve-based targeting, cannot be determined at this time.

4. Interest rate instability associated with the new techniques per se is extremely difficult to distinguish from other sources of interest rate fluctuation. However, the major swings in interest rates during the year -- historic peaks in early 1980, the sharp drop in the spring, and the return to historic highs --

can be traced to disturbances in the economy itself, to the imposition and removal of credit controls, to the budgetary situation, and to shifting inflationary expectations. Indeed, while much compressed in time, the broad interest rate fluctuations were, in relative magnitude, not out of keeping with earlier cyclical experience.

Money supply fluctuations last year over periods of a quarter or so were probably larger than might have been expected on the basis of econometric analysis of reserve control techniques. The inference from the study is that the credit control program and other external "shocks" could have been responsible. At the same time, the evidence is that the quarterly deviations in money growth from the trend for the year did not have an important influence on economic activity. If money growth had somehow been held constant, short-run interest rate variability would have been still larger.

In analyzing the results of the study, and given the basic intent to control monetary and credit growth within target ranges over a period of time, the Open Market Committee continues to believe present operating techniques are broadly appropriate. Assuming the present institutional structure, alternative reserve control approaches do not appear to promise more short-term precision. We do, however, have under consideration possible modifications and improvements. Without going into technical detail, such matters as more frequent adjustment of the discount rate, more forceful adjustments in the "path" for non-borrowed reserves when the money supply is "off course," and a return to contemporaneous reserve accounting are being actively reviewed. In each case, the possible advantages in terms of closer control of the monetary aggregates need to be weighed

against other considerations, including contributing to unnecessary short-run interest rate volatility.

As a personal observation, I would emphasize that swings in the money and credit aggregates over a month, a quarter, or even longer should not be disturbing (and indeed may in some situations be desirable), provided there is understanding and confidence in our intentions over more significant periods of time. A major part of the rationale of present, or other reserve based techniques, is to assure better monetary control over time. I believe, but cannot "prove," that the money supply in 1980 was held under closer control than if our operating emphasis had remained on interest rates. I hope 1980 was instructive in demonstrating that we do take the targets seriously, both as a means of communicating our intentions to the public and in disciplining ourselves.

In that light, I would like to turn to the targets for 1981. Those targets were set with the intention of achieving further reduction in the growth of money and credit, returning such growth over time to amounts consistent with the capacity of the economy to grow at stable prices. Against the background of the strong inflationary momentum in the economy, the targets are frankly designed to be restrictive. They do imply restraint on the potential growth of the nominal GNP. If inflation continues unabated or rises, real activity is likely to be squeezed. As inflation begins noticeably to

abate, the stage will be set for stronger real growth. Monetary policy is, of course, designed to encourage that disinflationary process. But the success of the policy, and the extent to which it can be achieved without great pressure on interest rates and stress on financial markets that have already been heavily strained, will also depend upon other public policies and private attitudes and behavior.

Abstracting from the impact of shifts into NOW accounts and other interest-bearing transaction accounts, growth ranges for the narrower monetary aggregates -- M-1A and M-1B -- have been reduced by one-half percent to 3-5½ percent and 3½-6 percent, respectively. Growth last year from the fourth quarter 1979 average to the fourth quarter 1980 average (when adjusted for shifts into NOW accounts) approximated 6-1/4 percent and 6-3/4 percent, just about at the top of the target range.* Consequently, the new target ranges imply a significant reduction in the monetary growth rates.

The Committee did not change the targets for M-2 or M-3. In the case of M-2, the upper end of the range was exceeded by about 3/4 percent in 1980, and there seems to have been

*Growth, as statistically recorded, was 5% for M-1A in 1980 and 7-1/4% for M-1B. Available evidence suggests about 2/3 of the transfer into interest-bearing checking accounts in 1980 reflected shifts from M-1A, "artificially" depressing M-1A and about one-third reflected shifts from savings or other accounts, "artificially" raising M-1B. The data and the targets cited in the text are calculated as if such shifts did not take place. Both adjusted and unadjusted data are shown in the attached tables.

some tendency recently for M-2, which includes new forms of market-rate savings instruments and the popular money market mutual funds, to grow more rapidly relative to the narrow aggregates. In the past few years, M-2 growth has been much closer to the growth of nominal GNP than has M-1 growth. Should those conditions prevail in 1981, actual results may well lie in the upper part of the range indicated. M-3, which includes instruments such as certificates of deposit used by banks to finance marginal loan growth, is influenced, as is bank credit itself, by the amount of financing channeled through the banking system as opposed to the open market. Changes in those aggregates must be assessed in that light.

I must emphasize that both M-1 series, as actually reported, are currently distorted by the shift into interest-bearing transaction accounts. Those shifts were particularly large in January, when for the first time depository institutions in all parts of the country were permitted to offer such accounts. As the year progresses, we anticipate the distortion will diminish, as has already been the case in February. However, any estimate of the shifts into NOW-type accounts for 1981 as a whole, and the source of those funds, must be tentative.

Survey results and other data available to us suggest perhaps 80% of the initial shifts during January into NOW and related accounts were from demand deposits included in M-1A, thus "artificially" depressing that statistic. The remaining

20% was apparently shifted from savings accounts (or other investment instruments), "artificially" increasing M-1B. More recent data suggest the proportion shifting from demand deposits, while still preponderant, may be slowly falling. Making allowance for these shifts, M-1A and M-1B through mid-February of this year have remained near the December average level. At intervals, we plan to publish further estimates of the shifts in accounts and their implications for assessing actual growth relative to the targets. But I cannot emphasize too strongly the need for caution in interpreting published data over the next few months.

Once these shifts are largely completed, we plan publication of a single M-1 series. In that connection, I must note that the behavior of an M-1 series containing a large element of interest-bearing deposits, with characteristics of savings as well as transactions accounts, is likely to alter relationships between M-1 and other economic variables. For that and other reasons, the significance of trends in any monetary aggregate even over long periods of time must be analyzed carefully, and, if necessary, appropriate adjustment in targets made.

Those technical considerations should not obscure the basic thrust of our policy posture. Our intent is not to accommodate inflationary forces; rather we mean to exert continuing restraint on growth in money and credit to squeeze out inflationary pressures. That posture should be reflected in further deceleration in the monetary aggregates in the years

ahead, and is an essential ingredient in any effective policy to restore price stability.

During 1980, despite the pressures arising from sharply higher oil prices and the strong momentum of large wage settlements and other factors, inflation did not increase. But the hard fact is we, as a nation, have not yet decisively turned back the tide of inflation. In my judgment, until we do so prospects for strong and sustained economic growth will remain dim. In that connection, forecasts by both the Administration and members of the Open Market Committee anticipate continuing economic difficulties and high inflation during 1981.

I have emphasized on a number of occasions that we now have a rare opportunity to deal with our economic malaise in a forceful, coordinated way. As things stand, the tax burden is rising; yet, in principle the need for tax reduction -- tax reduction aimed to the maximum extent at incentives to invest, to save, and to work -- has come to be widely recognized. Regulatory and other governmental policies have tended to increase costs excessively and damage the flexibility of the economy; but realization of the need to redress the balance of costs and benefits is now widespread. Despite efforts to cut back from time to time, government spending has gained a momentum of its own; now, the possibility of attacking the problem head on presents itself. We are all conscious of the high levels of

interest rates and strains in our financial system; yet, there is widespread understanding of the need for monetary restraint.

The new Administration is clearly aware of these realities and has set forth a program of action. It has seized the initiative in moving from opportunity to practical policy.

I know that the case is sometimes made that monetary policy can alone deal with the inflation side of the equation. But not in the real world -- not if other policies pull in other directions, feeding inflationary expectations, propelling the cost and wage structure upwards, and placing enormous burdens on financial markets with large budgetary deficits into the indefinite future.

That is why it seems to me so critical -- if monetary policy is to do its job without unduly straining the financial fabric -- that the Federal budget be brought into balance at the earliest practical time. That objective cannot be achieved in a sluggish economy. Moreover, tax reduction -- emphasizing incentives -- is important to help lay the base for renewed growth and productivity. For those reasons, the linchpin of any effective economic program today seems to me early, and by past standards massive, progress in cutting back the upward surge of expenditures, on and off budget.

We know the crucial importance of restraint on money and credit growth. When I am asked about the need for consistency

among all the elements of economic policy -- a policy that can effectively deal with inflation and lay the groundwork for growth -- I must emphasize the need to combine that monetary restraint with spending control. Cutting spending may appear to be the most painful part of the job -- but I am convinced that the pain for all of us will ultimately be much greater if it is not accomplished.

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TABLE 1

PLANNED AND ACTUAL GROWTH OF MONETARY AND CREDIT AGGREGATES
(percent changes, fourth quarter to fourth quarter)

M-1 targets and growth before and after shifts into ATS/NOW accounts

	<u>After adjustments for shifts into ATS/NOW accounts</u>		<u>Before adjustments for shifts into ATS/NOW accounts</u>	
	M-1A	M-1B	M-1A	M-1B
Planned for 1980	3½ to 6	4 to 6½	2¼ to 4-3/4 ^b	4½ to 7 ^b
Actual 1980	6¼ ^a	6-3/4 ^a	5	7¼
Planned for 1981	3 to 5½	3½ to 6	-4½ to -2 ^c	6 to 8½ ^c

M-2, M-3 and Bank Credit Targets and Growth

	<u>M-2</u>	<u>M-3</u>	<u>Bank Credit</u>
Planned for 1980	6-9	6½-9½	6-9
Actual 1980	9.8	9.9	7.9
Planned for 1981	6-9	6½-9½	6-9

- (a) Reflects current estimates of the impacts on M-1A and M-1B of shifting from demand deposits and other assets into new ATS and NOW accounts not taken into account in 1980 targets. Growth of M-1A is about 1-1/4 percentage points larger than actual recorded data after adding back in shifts out of demand deposits; growth of M-1B is reduced by about 1/2 percentage point after taking out shifts into M-1B from savings accounts and other assets.
- (b) Target adjusted to reflect NOW/ATS account shifts referred to in note above.
- (c) Reflect tentative assumptions regarding impacts of shifts into new ATS and NOW accounts in 1981. Growth of M-1A is assumed to be reduced by roughly 7-1/2 percentage points by transfer from demand balances to NOW-ATS accounts; growth of M-1B is assumed to be increased by 2-1/2 percentage points by transfer from sources outside of M-1. These assumptions will be reviewed from time to time.

TABLE 2

GROWTH OF MONEY AND BANK CREDIT
(percent changes, fourth quarter to fourth quarter)

	After adjustment for shifting into <u>NOW/ATS accounts</u>		Before adjustment for shifting into <u>NOW/ATS accounts</u>			<u>Bank Credit</u>	
	<u>M-1A</u>	<u>M-1B</u>	<u>M-1A</u>	<u>M-1B</u>	<u>M-2</u>		<u>M-3</u>
1975	4.9	4.9	4.7	4.9	12.3	9.4	4.1
1976	5.8	5.8	5.5	6.0	13.7	11.4	7.5
1977	8.0	8.0	7.7	8.1	11.5	12.6	11.1
1978	7.9	8.0	7.4	8.2	8.4	11.3	13.3
1979	6.7	6.8	5.0	7.7	9.0	9.8	12.3
1980	6.3	6.7	5.0	7.3	9.8	9.9	7.9