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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Ways and Means

House of Representatives

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Mr. Chairman:

I am pleased to be here this morning to discuss with you some considerations relevant to your deliberations about economic policy. The Ways and Means Committee of course carries the responsibility for originating tax legislation and has large spending programs under its immediate purview. The responsibilities of the Federal Reserve lie in the area of monetary policy. Mutual understanding of our purposes and policies seems to me critical to achieving more satisfactory economic performance and to the success of the program outlined by the President.

The economy entered 1981 on an upward trajectory, extending the recovery in activity from last year's brief but sharp recession. January saw further gains in retail sales, employment, and industrial production and -- despite high interest rates -- continued stability in housing starts. On the whole, the demand for goods and services has continued to prove more buoyant than most analysts had expected.

However, as we all know, unemployment and inflation remain at unacceptably high levels. There have been strong pressures in financial markets. Moreover, as things stand, the outlook is far from satisfactory. In particular, it is clear to me that we will be unable to have sustained economic expansion unless we are successful in bringing inflation down. Monetary policy is and will remain directed toward that priority objective. But, in my judgment, to continue to rely on monetary and credit restraint almost alone to deal with inflation would pose large and unnecessary risks -- risks of financial strains and of excessive costs in terms of growth and investment.

Last year, monetary restraint was the key factor in keeping inflation from accelerating in the face of rising oil prices and other factors. Important as it was, that "holding action" was accomplished only at the expense of historically high interest rates, impinging strongly on some areas of the economy and on investment generally. In these circumstances, the monetary restraint essential to deal with inflation urgently needs to be combined with other effective actions to relieve pressures on financial markets, to reduce costs, to spur investment and productivity, and to encourage risk-taking. In the best of circumstances, it will take time to bring results, and the process of change almost inevitably will involve some pain. But, with the new President seizing the initiative, I also believe we have a virtually unparalleled opportunity to achieve a consensus for effective action in a number of directions.

As you know, I testified last week before the House and Senate Banking Committees, presenting the Federal Reserve intentions with respect to monetary and credit growth for

1981. Without repeating the details, those targets are consistent with further reduction in the growth of money and credit this year. Against the background of the strong inflationary momentum in the economy, the targets are frankly designed to be restrictive, as they must be if we are to look toward a winding down of the inflationary process. And, while we only look a year ahead in setting out specific growth ranges for the various money and credit aggregates, further reductions will be necessary in the years ahead to return monetary growth to amounts consistent with the capacity of the economy to grow at stable prices.

The narrow money aggregates, M-1A and M-1B, are currently distorted by rapid institutional change -- the introduction of NOW accounts and other interest-bearing transactions accounts nationwide. Abstracting from the impact of shifts into those accounts, our intentions are reflected in a reduction of targeted growth ranges by one-half percent (to 3-5½ percent and 3½-6 percent) for M-1A and M-1B, 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 over the top of the target range.*

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*Growth, as statistically recorded and published, was 5 percent for M-1A in 1980 and 7-1/4 percent 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.

For 1981 the target ranges for growth of M-1A and M-1B <u>before</u> adjustment for these shifts are -4½ to -2 and 6 to 8½, respectively. See pp. 39-41 of the Federal Reserve Board's <u>Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978</u> for a complete discussion of the impact on the 1981 targets of nationwide NOW account growth.

Consequently, the new target ranges imply a significant reduction in the monetary growth rates.

The Committee did not change the targets for the broader M-2 or M-3 aggregates, which include various types of savings and time deposit accounts. The relationship between M-2, M-3 and the narrower aggregates has changed over recent years and this year's targets are consistent with further restraint across the entire range of monetary measures. Indeed, because actual growth in 1980 was 3/4 percent or more above the upper end of the indicated range, success in reaching the target range in 1981 implies significantly lower growth.

I cannot emphasize too strongly the need for care in interpreting the actual data for monetary and credit growth as the year progresses. As I indicated, both M-1 series are currently distorted by the shift into interest-bearing transaction accounts. As the year progresses, we anticipate the distortion will diminish, and we will provide estimates from time to time of the effects of the shifts on the data. But beyond that particular source of distortion, the data are subject to considerable volatility from month-to-month or quarter-to-quarter. What counts is the trend over a reasonable period of time.

Those technical considerations should not obscure the basic thrust of our policy posture. Our intent is not to accommodate inflationary forces but rather to continue the restraint on growth in money and credit that is necessary to squeeze out inflationary pressures. While there can be debate about timing and degree, the need for that basic discipline is common to virtually all schools of economic thought and is, of course, recognized in the Administration's program for economic recovery.

Restraint on monetary expansion does place broad limits on the potential growth of the nominal GNP -- that is, the combined result of changes in real output and the price level. It implies that all the demands for money and credit potentially generated by an economy both growing and inflating cannot be met. So long as inflation continues unabated or rises, real activity is likely to be constrained. But as inflation begins noticeably to abate, the stage will be set for stronger -- and sustained -- real growth. Monetary policy is, of course, designed to encourage and speed that disinflationary process. But the success of such a policy -- particularly the extent to which it can be pursued without great pressure on interest rates and aggravating strains in financial markets -- also will depend upon other public policies and private attitudes and behavior.

I must emphasize the risks and difficulties of dealing with inflation entirely by monetary policy -- of failing to bring other policies into support of that objective. If budgetary and other policies pull in the opposite direction -- if those policies feed inflationary expectations, propel the cost and wage structure upwards, add unnecessary regulatory costs, and fail to reduce and in time eliminate deficit financing -- then the danger of a kind of collision in financial markets between public and private borrowers will be intensified.

But that risk can be minimized in the short run, and the groundwork laid for renewed prosperity in the 1980's, by forceful coordinated actions. Fortunately, there appears to be broad recognition of the nature and urgency of our problems and a willingness to bring to bear a new discipline in fiscal and regulatory policy.

To that end, the new Administration has set forth a sweeping new program of action encompassing an array of spending cuts and tax reductions. There will properly be debate about the specific components of that program. Estimates of its precise impact on the economy this year and next will vary, just as such estimates would be challenged for any program. The simple fact is that we have not been able to count on any economic forecasting technique to provide consistently reliable results in recent years in the face of the virtually unprecedented nature of our economic problems, severe energy shocks, and volatile expectations. In these circumstances, I personally would be cautious in interpreting the results of any economic model so far as the precise timing and magnitude of future economic developments are concerned. But that does not mean that valid judgments cannot be reached about the general shape, size, and direction of needed policy changes. Economic analysis seems to me to point clearly to the following conclusions:

1. Against the background of the Federal tax burden reaching the highest level in our history, tax cuts are needed to encourage greater investment, productivity, and work effort.

2. At the same time, a continued need to finance huge budgetary deficits in congested financial markets into the indefinite future would threaten the availability of funds to private borrowers, including businesses that must undertake the needed productive investment as well as to the homebuilding industry and others heavily dependent on borrowed funds. In these circumstances, the amount of tax reduction that can be prudently undertaken is dependent on cutting back the inexorable rise in Federal spending, on and off budget. The larger the spending cuts, the greater the prospects for reducing the strains in financial markets and for turning back inflation.

4. In the best of circumstances, there are limits to the amount of revenues that, in the short run,can be foregone as a result of tax cuts. Thus, from the standpoint of general economic policy, the emphasis in tax reduction should, to the maximum extent feasible, be placed on measures that promise to increase incentives to work, to invest and to save.

5. At a time when we are fighting inflation, other governmental policies that increase costs, inhibit competition, and impair the flexibility of the market economy need urgent review. Costs of regulatory policies must be assessed against the benefits. Our markets must be open to competition from home and abroad to spur innovation and productivity, and government should reexamine policies that tend to place an excessively high and rising floor under certain costs and prices.

This Committee is deeply involved in the crucial fiscal decision-making. I know that tax and spending cuts, by their very nature, involve difficult considerations of fairness as well as economic efficiency. It is not appropriate for the Federal Reserve to intrude on the details of that decision-making process. But I would emphasize one point central to economic policy generally and the relationship to monetary policy in particular.

To me, the linchpin of the whole economic program is early and, by past standards, massive progress on cutting back the upward surge of Federal expenditures. Those spending cutbacks are necessary to clear the way for sizable tax reduction and to permit early progress toward the goal of a balanced budget.

I know the difficulties and constraints -- the need to increase defense spending, to protect the truly needy, to pay interest, and to maintain strength and continuity in other essential programs. But the budget is huge and has increased by more than a third in real terms over the last decade. Surely, there is ample room for cutting if there is the will, and the Administration proposals for specific cuts over a broad array of programs point the way.

I must emphasize that, from the standpoint of general economic policy, <u>all</u> the risks seem to me on the side of not cutting back the rise in spending enough. Every dollar of added savings can only help head off tensions in financial markets, make room for more private investment, and provide an appropriate setting for prudent and needed tax reduction. In that connection, I would remind you that even the specific cuts proposed by the Administration, large as they are, are only a kind of progress payment toward what needs to be done to bring the budget into balance in reasonably prosperous economic conditions. Further very sizable reductions are indicated in its program for fiscal 1983 and beyond. The sooner that process is started, the better will be the prospects for changing public attitudes and economic performance.

I would like to make one last point before concluding. The need to reduce inflation as part of any effective economic program is now widely recognized, and the Federal Reserve has an indispensable role to play in that process. How soon our efforts in that direction succeed, and how soon we can look forward to healthy growth and reduced unemployment, will depend in large measure on how quickly attitudes toward inflation change in the private sector, and how those new attitudes are reflected in pricing and wage decisions. Strong upward momentum in wage contracts and pricing policies will ultimately be inconsistent with a commitment to monetary and fiscal restraint, and inimical to the interests of both the nation and the particular firms and workers involved. After years of inflation, attitudes and expectations are not likely to change easily. That is why our commitment to restraint must be strong, visible, and sustained.

I believe the monetary targets of the Federal Reserve are consistent with that need. Demonstrated progress on the fiscal side is also a necessary ingredient. And, in the end, we will need to see visible progress toward price stability -- an objective that for far too long has eluded us. All of this will inevitably require harsh choices. But I know of no feasible alternatives. And, I am convinced the difficulties for all of us will ultimately be much greater if these choices are not squarely confronted now.

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