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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I appreciate the opportunity to appear before this Committee to present the Federal Reserve's views on the international implications of U.S. macro-economic policies, and particularly monetary policy.

Inevitably questions arise abroad, as they do in this country, about particular techniques and implications of U.S. ecomomic policies. After all, nearly all of the nations represented at the Ottawa Summit, and most others, are faced with difficult problems and choices in developing economic policy, and external influences on their interest rates and exchange rates inevitably raise new complications for some -- just as at times external developments complicate our own policy-making. However, the expression of such concerns should not be taken as disagreement with the basic intent or thrust of our policies, certainly not among those most closely concerned with financial policy. I base that judgment on my own discussions with central bankers and finance ministers abroad as well as on the conclusions reached in May at the meeting of the IMF's Interim Committee in Gabon and more recently at the OECD Ministerial meeting.

Accordingly, I expect that the President will hear a general endorsement of the broad purposes and objectives of U.S. economic policies when he meets next week with other heads of state and governments. Specifically, I believe that the priority the United States has attached to the fight against inflation is widely appreciated. Indeed, the leaders of these very nations, along with many others, have long urged us to adopt rigorous and convincing anti-inflation policies, and I do not believe they will change that attitude now.

Foreign officials do rightly stress that, in our interdependent world, U.S. economic developments and policies have ramifications for the policies and performance of other economies Our weight in the world economy, while relatively smaller than in the early postwar years, is still very significant, and leaders abroad have to take U.S. economic policies into account when they formulate their own programs. They do want us to be aware of the external implications of high dollar interest rates and a rising dollar, as we should be. The short-run effects -- abroad as well as at home -- can indeed be discomforting. But we should also have a sense of proportion about those effects.

The United States should not and can not assume the responsibility for all the economic difficulties of particular countries. In some instances -- for example, countries with sizable balance-of-payments deficits -- some depreciation of their currencies relative to the dollar may have been natural, and a number of countries have internal reasons for following firm monetary policies. Changes in exchange rate relationships within Europe have been relatively small recently, and most of the trade of those countries is not affected by the substantial appreciation of the dollar. The point is often made in the context of the dollar's appreciation that oil and other commodities are priced in dollars, but it should also be pointed out that monetary restraint in the United States has contributed importantly to squeezing out inflationary excesses in those markets.

In general, it is rarely easy to trace through the relative weight of different forces impacting on the economic policy problems of different countries. We all -- certainly including the United States -- must guard against a temptation to assign undue responsibility to external forces. I would remind you that any exchange rate involves two national currencies; a change in that exchange rate may reflect policies or developments in either country, or more likely both at the same time. The recent "strength" of the dollar vis-a-vis some currencies headlined in the press has been relative; it may be -- indeed has been -- influenced by conditions abroad, as well as in the United States. I would note that short-term interest rates in the United States are a bit lower today than at the turn of the year, and interest rate differentials are narrower with respect to continental European currencies. Yet the dollar has appreciated substantially against those currencies over the past six months.

Because of the potential for misunderstanding, and because developments and policies here do have effects on other countries whose leaders face difficult economic problems and choices, we have a clear responsibility to listen closely to their views, to explain our policies carefully, and to respond to constructive, substantive criticism. Prolonged misunderstanding is always dangerous, for economic and political friction could impair the fabric of the open international economy that serves us all. My perception is that, fortunately, there is broad understanding of our objectives and policies -- combined, of course, with a good deal of impatience in awaiting results, just as is sometimes the case at home.

The essential point about U.S. economic policies -- monetary, fiscal and other -- is our commitment to reducing inflation. Most of the foreign leaders with whom I have talked readily agree that it is in their countries' fundamental interest, as well as ours, that the United States make significant progress against inflation. Because of the dollar's role in world financial markets and because of the U.S. prominence in the world economy, a necessary condition for the restoration of stability in currency markets and for the resumption of sustained, worldwide economic growth is the restoration of greater price stability in the United States.

Obviously, they, as we, would like to see lower and more stable U.S. interest rates and less variation in exchange rates. Everyone would agree that reduced inflation and a clear sense of movement toward price stability must be the basis for maintaining such stability over time. Against that background, international discussions raise questions of means, not ends.

As you know, Federal Reserve monetary policy has been directed at restraint in the rate of growth of the monetary aggregates. Some observers -- and they are not confined to those outside our borders -- believe we are following a policy deliberately directed at achieving high interest rates and dollar appreciation. Such views are mistaken; the Federal Reserve has neither an interest rate nor an exchange rate objective. We do take the view that persistent restraint in the growth rates of the monetary aggregates is necessary to ensure lower inflation -- and therefore lower interest rates -- over time. I find no disposition among my colleagues abroad to question that necessity.

In the short run, interest rates are a function of the many factors that influence the demand for money and credit, including the budgetary position of the government, the strength of business activity, and the inflationary momentum. So long as actual and expected inflation and nominal demand remain strong, high interest rates should not be surprising. Only when inflation slackens significantly, and markets believe the slowdown will be sustained, can we look forward to meaningful, sustained declines in dollar interest rates, consistent with growth in real activity.

Relative interest rates can and do influence exchange markets. But that influence has to be judged in the context of other influences working at the same time. As I have already suggested, it would be a mistake to attribute the roughly 20 percent weighted-average appreciation of the dollar since December of last year primarily to the behavior of nominal interest rates on dollar assets. The differential between U.S. interest rates and short-term interest rates on average in foreign industrial countries has declined about 2-1/2 percentage points since the end of 1980. U.S. short-term interest rates are now about 1 percentage point less than their December average. Interest rates on the continent of Europe are appreciably higher, yet their currencies have depreciated substantially relative to the dollar. Interest rates in two of the Summit countries -- Japan and the United Kingdom -- have declined so far this year, and in one of those countries -- Japan -- the depreciation of its currency relative to the dollar has been smaller than that of the continental European currencies. The yen, as well as the Canadian dollar, has experienced a weighted-average appreciation so far this year.

Obviously, one must look beyond absolute or relative interest rates to explain the dollar's appreciation this year. Among the other relevant factors in the United States have been the first signs of some improvement in our relative inflation performance, a continuation of a relatively favorable U.S. current-account position, and favorable assessments of the potential of the new Administration's economic program. On the other side of the Atlantic, balance-of-payments deficits have been large, and there has been a sense of greater political change and uncertainty.

A number of foreign observers, while not questioning the need for monetary restraint in the United States have suggested that monetary policy should not carry so much of the burden of the stabilization effort either here or in their own countries. As you know, I have also often emphasized the importance of fiscal restraint and regulatory and other policies, alongside firm restraint on the money supply, in a comprehensive program to reduce U.S. inflation. At the same time, we all have to recognize the difficulties in changing these policies dramatically and quickly. We are in fact making progress in reducing the strong upward trend in government expenditures -- and I would remind you that the Administration has emphasized that more will need to be done in future years, particularly if we are to reap the benefits of tax reduction in a context of reduced budget deficits. The closer the budget is to balance, all else equal, the less pressure will be felt in financial markets, the lower interest rates will be, and the danger of abnormal exchange rate pressures will be lessened. But it would be unreasonable to expect a balanced budget overnight, and I believe there is a growing understanding abroad, as at home, that fiscal policy cannot easily be shifted in the short run. After all, most other governments are grappling with fiscal problems at least as difficult as our own.

It is equally important to recognize that there are no "quick fixes" available through monetary policy to lower or fine tune interest rates. If the Federal Reserve, for example, were to deviate from its policy of monetary restraint in an effort to lower interest rates, any seeming short-run relief would have to be balanced against the substantial risk -- for the United States and the rest of the world -- of excessive credit growth, a further hardening of inflationary expectations, and still greater interest rate pressures in the future.

"Like others, I shall applaud lower interest rates in the United States any day if they signal success in the battle against inflation. But I would look upon lower rates with mixed feelings if they promised more inflation and hence higher interest rates for the future." Those words are not mine, but those of a central bank colleague in Europe.* It seems to me they capture the essence of our policy problem.

Of course, as I suggested earlier, there is impatience for results. Monetary restraint is painful, and it cuts unevenl at home as well as abroad. Moreover, the burdens are not restricted to the industrial economies; developing countries are affected as well. Some are experiencing slower growth in their exports because of slack demand in the industrial world. They are all facing much stiffer borrowing terms in internationa markets than those to which they have been accustomed. It may be of little comfort to suggest that, in some cases, those terms may well have been too easy in the past -- internationally as well as domestically nominal interest rates have frequently

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*Remarks by Karl Otto Pohl, President of the Deutsche Bundes June 12, 1981, before the Roundtable of the International B Institute in Cannes.

been exceeded by actual inflation rates, encouraging excessive indebtedness and the postponement of needed adjustments. What we would all like to see is a reasonable middle ground, and more stability and predictability; we will not succeed unless we keep at it.

If we cannot promise instantaneous and easy results -- the answers do not lie in "fine tuning" fiscal or monetary policies -- we can and must make the effort necessary to explain our policies, formally and informally, in all the forums available to us, and to consider carefully the views of others. In that connection, I have long felt that the economic summits can help assure that our mutual economic concerns are fully discussed and addressed at the highest level, and the success of those meetings over time can be measured less by any concrete agreements than by the degree of understanding reached about our mutual problems and purposes.

Certainly we must all avoid the temptation to become inward looking during this difficult period. Intensification of trade restrictions would be damaging to the interest of all countries. Together we must seek effective ways to help developing countries cope with their own serious adjustment problems, not the least by maintaining and strengthening our commitment to cooperation and dialogue in the IMF and World Bank.

Most of all, it is crucial that we not fail in our basic purpose of restoring stability and laying the base for sustained growth. One wise foreign official, widely experienced in international affairs, recently put it to me roughly as follows: You cannot expect us to be enthusiastic about the effects of your policies; we will all have different opinions about just how you are going about it; but the fact is we have no agreed better alternatives to offer you. We can only wish you success.

I would only add that with success the present international concerns will fade in memory. We would do no one a service, at home or abroad, if we were to take actions that would jeopardize the prospects for that success.

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