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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I am pleased to be here this morning to review the conduct of monetary policy and to report on the Federal Reserve's objectives for the growth of money and credit for this year as well as tentative targets for 1982. You have already received our formal report, but I would like to briefly summarize some points and amplify others.

I do not need to belabor the point that the current economic situation is far from satisfactory. But we see some encouraging signs that we are beginning to make progress against inflation. I realize the evidence in the recent price data is not, by itself, conclusive. However, I strongly believe that we now have the clear opportunity and responsibility to achieve and sustain further progress on the price front. That progress, in turn, will be an essential ingredient in laying the base for a much healthier economy in the years ahead.

The process inevitably requires time and patience. It would obviously be much more pleasant for me to appear before you today were both unemployment and interest rates lower. High interest rates undeniably place a heavy burden on housing, the auto industry, small business, and other sectors especially dependent upon credit. The thrift industry, in particular, has come under heavy stress as its costs of funds exceed returns on fixed rate assets acquired when interest rates were much lower. The high level of U.S. interest rates also has repercussions internationally, complicating already difficult economic policy decisions of some of our major economic partners. The surprisingly strong growth in national output last winter has given way to a much more sluggish picture. With continuing sizable increases in the labor force, unemployment has not declined from higher levels reached last year. The trend of both productivity and savings remains low.

Amidst these difficulties, we must not lose sight of the fundamental point that so many of the accumulated distortions and pressures in the economy can be traced to our high and stubborn inflation. Moreover, turning back the inflationary tide, as we can see, is not a simple, painless process, free from risks and strains of its own. All that I would claim is that the risks of not carrying through on the effort to restore price stability would be much greater. Dealing with inflation is essential to our future well-being as a nation, and the Federal Reserve means to do its part.

As I noted, we have begun to see some tentative signs of a relaxation of price pressures. To be sure, much of the recent improvement in various price indicators is accounted for by some reversal of "special" factors that drove the inflation rate higher in 1979 and part of 1980. Instead of the huge increases of the last two years, energy prices have stabilized and some oil prices have even declined in the face of the recent production surpluses. Retail food prices have risen at rates of less than 1 percent this year, partly reflecting improved crop conditions, in contrast to the 10¼ percent pace in 1980. Commodity prices generally have been weak, as speculative forces have subsided under the pressure of the high cost of finance and more restrained price expectations. Despite sharply rising mortgage costs, the recorded overall cost of homeownership has been rising less rapidly.

Some of these developments could prove temporary. Special factors and short-term improvements in the prices most sensitive to credit restraint alone cannot be counted upon to sustain progress indefinitely. The deeply entrenched underlying rate of inflation is sustained by the interaction of labor costs, productivity, and prices. So far, there are only small and inconclusive signs of a moderation in wage pressures. Understandably, wages respond to higher prices. But in the economy as a whole, labor accounts for the bulk of all costs, and those rising costs in turn maintain the momentum of the inflationary process. Low productivity gains, high taxes, and unnecessary regulatory burdens aggravate the situation. Moreover, to the extent firms and their workers are shielded from the competitive consequences of poor productivity and aggressive price and wage policies, those attitudes are encouraged.

These considerations help point to the wide range of policies necessary to support a sustained and effective effort against inflation. Fortunately, recognition of the need is widespread, and progress is being made in a number of directions. But there can be no escaping the fact that monetary policy has a particularly crucial role to play and, in current circumstances, has a particularly heavy burden.

An effective program to restore price stability requires reducing growth in money and credit over time to rates consistent with the growth of output and employment at stable prices. That is the basic premise of our policies, and I believe consistent with the philosophy of the Humphrey-Hawkins Act mandating our report to you today on our monetary growth ranges. The periodic decisions we in the Federal Reserve reach about those monetary "targets," and the implementation of policy, are entirely within that broad policy context; essentially, they are matters of how much, how fast, not basic direction.

In approaching its mid-year review of the monetary and credit targets within this framework, the Federal Open Market Committee was faced with rather sharply divergent trends in the several aggregates during the first half of the year.

These trends were significantly influenced by the rapidity of market responses to regulatory or structural changes, including the exceptionally rapid growth of NOW accounts nationwide and of money market mutual funds.

The basic measures of transaction balances -- "narrow money" or M1 -- have risen relatively slowly after adjusting for the effects of the one-time shifts of funds into interest-bearing NOW accounts; those accounts were available for the first time nationwide, and have been aggressively marketed by banks and thrift institutions.* To a degree that cannot be precisely measured, individuals and businesses, spurred by high interest rates, appear to have intensified cash management practices designed to minimize the use of traditional transaction balances, tending to speed up the "velocity" relationship between M1 and GNP during early 1981. For example, to some limited degree, needs for "M1" transaction accounts may have been reduced by the growing popularity of money market funds -- not included in the definition of M1 -- which can be used as a substitute for demand deposits or NOW accounts.

At the same time, as shown on Table I, the broader aggregates, M2 and M3 (which do include money market funds and some other close money substitutes) have been rising at or above the upper end of the target ranges. You may recall I suggested to the Committee in presenting the targets for 1981, that these broader aggregates might well be expected to rise toward the upper part of their ranges. This expectation is reinforced by the further liberalization of interest ceilings of depository institutions by the Depository Institutions Deregulation Committee, a continued growth of money market funds, and potentially the availability of tax-exempt so-called "All Savers Certificates" at depository institutions, all of which could continue to result in some diversion of funds from market outlets into M2 and M3.

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*These shifts sharply depressed recorded (i.e., before "shift adjustment") M1A early in the year because the bulk of the NOW accounts reflected transfers from demand deposits which are included in M1A. Recorded M1B, which includes NOW accounts, was "artificially" increased to the extent funds were shifted into NOW accounts from savings accounts or other assets not counted as transaction accounts, but continue in part to serve the economic function of savings. The Federal Reserve publishes estimates monthly of "shift-adjusted" data based on a variety of sources. As the transfers diminish, as appears to be happening, the "adjusted" and "unadjusted" data will more closely coincide.

In the light of this situation, the Committee considered the possibility of making small adjustments in the 1981 ranges to account for the impact of institutional change. However, it seems probable that the strongest impact of the introduction of NOW accounts and of adjustments of cash management practices to high interest rates may be behind us. Therefore, the Committee did not feel that changes in the growth ranges for 1981 were justified. (All targets for 1981 and 1982 are shown in Table II.)

However, given developments during the first half of the year and the need to avoid excessive growth in coming months, the Committee agreed that growth in M1B near the lower end of its range for the year as a whole (3½-6 percent, after adjusting for NOW account shifts) would be acceptable and desirable, particularly should relatively strong growth in the other aggregates continue. As indicated at the start of the year, the Committee does feel it acceptable that growth in M2 and M3 be toward the upper part of their ranges (6-9 percent and 6½-9½ percent, respectively). Growth of bank credit, while often fluctuating considerably from month to month, is expected to remain within its specified range of 6-9 percent

In its tentative consideration of the targets for 1982, the Committee decided to plan for targeting and publishing a single M1 figure, equivalent in coverage to the present M1B. Assuming that further "structural" shifts into NOW accounts from non-transaction accounts are by that time minimal, "shift adjusted" targets and data should not be necessary. The tentative range for

M1 in 1982 was set at 2½-5½ percent, the midpoint of 4 percent is three-quarters percent below the midpoint of the closely comparable current range for M1B "shift adjusted."*

The tentative ranges for the broader aggregates in 1982 were left unchanged at 6-9 percent and 6½-9½ percent for M2 and M3, respectively. However, we would anticipate actual growth closer to the midpoint in 1982, consistent with the desired reduction over time.

Setting precise targets has inevitably involved us in consideration of the effects of technological and regulatory change on monetary measures. Those technical considerations should not obscure the basic thrust of our intentions -- that is, to lower progressively effective money and credit growth to amounts consistent with price stability. We believe the targets for both 1981 and 1982, and our operations, are fully consistent with that objective.

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*The tentative range for M1 in 1982 is substantially below the range of 6-8½ percent specified for recorded M1B growth for 1981. Recorded M1B data for 1981 have been strongly affected, particularly during the early months of the year, by the "one-time" shifts into NOW accounts of savings and other funds not included in the M1 series. These shifts are diminishing, and the new tentative target for 1982 assumes they will be essentially completed by the end of this year. The slightly wider range specified allows for the possibility of some residual shifting. That assumption will, of course, be reviewed at year end.

I have often emphasized that money supply data -- like many other financial and economic data -- have some inherent instability in the short run. The trend over time is what counts, both as a measure of monetary policy and in terms of economic effect. For some months in the latter part of 1980, as you will recall, the rise in M1 was relatively rapid. Against that background, the sluggish growth during most of the first half of 1981 was welcomed as a desirable offset by the FOMC, confirming the trend toward a lower rate of growth over time. At the same time, we have been conscious of the relative strength of M2 and M3. Those measures include money market funds, short-term repurchase agreements, and certain U.S.-held Eurodollars, that to a greater or lesser degree can serve as substitutes for M1 balances. With those components growing relatively rapidly, our experience this year, to my mind, reinforces the need to take account of all available information in assessing the significance of short-term movements in the monetary aggregates and judging our policy posture.

More fundamentally, what recent experience also confirms is that demands for money and credit growing out of an expanding and inflating economy, pressing against a restrained supply, will be reflected in strong pressures on interest rates and credit markets -- pressures that in turn restrain the growth in business activity. Some important sectors of the economy are relatively impervious for one reason or another to direct financial restraint --

energy, high technology, many services, and defense. Those sectors have been strong sustaining forces in the economy generally, and particularly in some geographic areas. The brunt of the restraint falls on other credit-dependent sectors, and, as the dollar has sharply appreciated, increasingly on exporters faced with a less favorable competitive position. Should interest rates decline in response to weakness in the economy, many of those sectors would likely, and rather promptly, rebound.

In a longer time frame, the outlook for interest rates will depend importantly on confidence that inflation will be controlled, and on actual progress toward greater price stability, as well as such factors as the Federal deficit. Differences of opinion about these matters help to account for the relatively wide range of forecasts now characteristic for the period ahead, including those set forth by members of the FOMC. (Table III sets forth the range of those projections.)

I cannot fully resolve all those uncertainties in the outlook for you this morning. What does seem clear to me is that progress on inflation is a prerequisite for lasting improvement in financial markets, and for sustained, balanced growth. I can also emphasize the policies that seem to me necessary to speed the transition to more equable financial markets and to a more prosperous, productive economy generally.

First, as I have already indicated, curbing inflation will require persistent restraint on the growth of money and credit. An attempt to escape from high interest rates and strains on financial markets and institutions by abandoning that restraint would be self-defeating. By encouraging expectations of more inflation, that approach would soon stimulate even more borrowing, further reduce incentives to save, and ultimately result in still higher interest rates and more economic difficulty. You and I know that, after a decade and more of disappointment, there is persisting skepticism and doubt about the ability of the nation to persevere in an anti-inflation program. I believe that skepticism is unwarranted, but we must make that claim good by our actions. Indeed, sustained monetary restraint, by encouraging greater confidence in the price outlook, will in time help bring interest rates lower.

Pressures on financial markets can also be relieved by actions from other directions, entirely consistent with the anti-inflation effort and the longer-run needs of the economy. Specifically, government deficits and credit programs absorb a large fraction of our available limited savings. You are well aware that the Administration and the Congress are hard at work on both sides of that question. It requires a difficult balancing of priorities. Some forms of tax reduction are justified by the need to improve incentives and to reduce costs. But if we are to be convincing in our efforts to reduce the deficit at the same time, Congress will need to maintain and even intensify the courageous effort to reduce the upward trend in spending.

Monetary restraint implies that the growth in the current value of our output -- the nominal GNP -- will also be restrained. To the extent that restraint falls on prices, the more room there will be for the growth in real output we want. I have already suggested that the recent improvement in the price performance has some elements that we cannot count on continuing. But, along with the present slack in many labor and product markets, the more encouraging price data certainly helps create a more favorable setting for changing the fundamentals of pricing policy and wage behavior in ways that can be sustained.

A bulge in labor compensation early this year, and continuing large increases in unit labor costs, have reflected in substantial part a "catch up" in wages after last year's large rise in the consumer price index, as well as sizable increases in the minimum wage and social security taxes. These sources of pressure should be much diminished or absent in the period ahead. Intensified by the appreciation of the dollar, there are also strong competitive incentives domestically and internationally, on important industries to control costs.

In these circumstances, there is a compelling logic, from an overall economic view, in looking toward a sense of greater caution and restraint in both wage and pricing behavior. What is at issue is the extent to which that need will seem equally compelling, viewed from the specific shop floor or the individual executive suite. These decisions are, of course, made continuously in the non-union sector of the economy, but a crucially important round of union wage bargaining begins next January, potentially setting a pattern for several years ahead.

That is one reason why we need to be clear and convincing in specifying our monetary and fiscal policy intentions, and their implications for the economic and inflation environment. Without room for financing both high levels of inflation and strong growth, inflationary behavior by individual firms can jeopardize markets, jobs, and profits.

The lesson already seems apparent in some key industries. Government can and should help directly by removing unnecessary regulatory burdens, and by reviewing laws and practices that actually inhibit competitive pricing and add to costs. I believe it can also help indirectly by making clear that industries suffering from problems of their own making are not entitled to new governmental protection.

What this all adds up to is that we are at a critical point in the fight on inflation.

We see the first stirrings of progress in the recent data.

With enormous effort, the Administration and the Congress are moving together to attain control of spending. We all know much remains to be done for future years, but the unparalleled effort bodes well for the future. With a full measure of success, the most urgently needed tax reduction can be responsibly reconciled with reduced deficits.

We in the Federal Reserve are committed to reducing growth in money and credit.

There is, I believe, a genuine urge to let the competitive marketplace work, and to review government practices that unnecessarily add to costs or limit competition.

These policies can and will be effective. But if they are to work, they must be sustained with conviction. Then, the apparent reluctance of many to bet on reduced inflation -- in financial markets, in wage bargaining, in pricing, and in other economic decisions -- will change. As they do, the unwinding of the inflationary process should be much easier.

In a real sense, the hardest part of the job faces us now and in the months immediately ahead. We must demonstrate our ability to carry through on our good intentions -- not just in monetary policy, but in the fiscal and other areas as well.

I have talked at some length this morning about the technical aspects of monetary policy and our numerical targets for the various monetary aggregates. I have reemphasized why the Federal Reserve must be and is determined to avoid excessive growth in money and credit. I have stressed the key role other policies, including budgetary restraint, must play if we are to make real progress toward price stability and relieve pressures on financial markets.

That may all seem abstract and even singleminded, given the pressing problems of the real world.

For far too long, we have not had acceptable economic performance. The average worker has found his or her real income growing slowly if at all. The overall unemployment rate, high as it is, does not reflect the intensity of the problem for some groups and areas, and the burden too often falls on those least able to bear it. Interest rates are at extraordinary levels.

We in the Federal Reserve are acutely aware of these problems. We do not restrain money and credit for its own sake, or simply because inflation is an evil in itself.

Financial discipline is a means to an end. It is an essential part -- if only a part -- of strengthening our economy so that productivity and living standards can rise and worthwhile jobs can be found, not just for a few months, but for the longer period ahead.

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Table 1

GROWTH RANGES AND ACTUAL GROWTH IN MONEY AND CREDIT
(All data percent at annual rates)

	Growth Ranges	Actual	
	1980_{Q4} - 1981_{Q4}	1980_{Q4} - 1981_{Q2}	1980_{Q4} - Latest Data
M1-B*	3-1/2 to 6	2.2	2.6 (July 8)
M2	6 to 9	9.5	8.7 (June)
M3	6-1/2 to 9-1/2	11.5	11.1 (June)
Bank Credit	6 to 9	8.9	8.7 (June)

*Adjusted for shifts into NOW accounts. The range for recorded M1B associated with the "shift-adjusted" M1B range at the start of the year was 6 to 8-1/2 percent. Actual growth in that measure from 1980_{Q4} to 1981_{Q2} was 6.8 percent at an annual rate. With NOW account growth larger than anticipated at the beginning of the year, the divergence between the recorded and shift-adjusted data should be slightly greater than anticipated at the start of the year.

Table 2

GROWTH RANGES AND ACTUAL GROWTH OF MONETARY AND CREDIT AGGREGATES
(Percent changes, fourth quarter to fourth quarter)

	M1-A	M1-B	M2	M3	Bank Credit
Growth Range for 1980	3-1/2 to 6	4 to 6-1/2	6 to 9	6-1/2 to 9-1/2	6 to 9
Actual 1980	6-1/4 [1/]	6-3/4 [1/]	9.6	10.2	8.0
Growth Range for 1981	3 to 5-1/2 [2/]	3-1/2 to 6 [2/]	6 to 9	6-1/2 to 9-1/2	6 to 9
Growth Range for 1982	n.a.	2-1/2 to 5-1/2 [3/]	6 to 9	6-1/2 to 9-1/2	6 to 9

1. Adjusted for unanticipated transfers into ATS and other similar accounts from other assets.
2. Adjusted for shifts into NOW accounts.
3. Assumes negligible impact of shifting into NOW accounts.

Table 3

FOMC MEMBERS' ECONOMIC FORECASTS

	Actual	Projected	
	1980	1981	1982
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.4	10 to 11-1/2	9-1/2 to 12-1/4
Real GNP	-.3	1 to 3-1/2	1 to 4
Implicit GNP deflator	9.8	7-1/2 to 9	6-1/2 to 8-1/2
Average level in fourth quarter			
Unemployment rate (percent)	7.5	7-1/2 to 8-1/4	7 to 8-1/2