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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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I appreciate the opportunity to meet with members of this distinguished committee today to discuss the direction of monetary policy and the prospects for the national economy. I have submitted for the record the official report from the Board in accordance with the Humphrey-Hawkins Act. I would now like to take a few minutes to underscore and amplify some of the points in that report, as well as to offer some more personal views on the problems -- and equally important, the opportunities -- that are before us.

As you know, the economy has been in recession for some months. The recession has some of the characteristics of earlier downturns. But it seems to me plainly wrong to think of the current state of the economy as simply reflecting "another" recession.

Rather, we are seeing the culmination of a much longer period of unsatisfactory economic performance extending well back into the 1970's -- performance marked by poor productivity, growing unemployment, much higher interest rates, and pressures on the real earnings of the average citizen and on the real profits of our businesses.

A number of factors have contributed to that deterioration in our performance, not all of them completely understood. But one pervasive element -- an element particularly relevant to monetary policy -- stands out: we found ourselves in the midst of the most prolonged inflation in our history, and that inflationary process had come to feed on itself. Incentives were distorted.

Too much of the energy of our citizens was directed toward seeking protection from future price increases and toward speculative activity, and too little toward production. Increasingly depressed and volatile capital markets reflected the uncertainties. Effective tax rates increased as inflation carried taxpayers into higher brackets. But, in a sluggish economy, those revenues did not keep up with our spending plans and programs.

Against that background, the notion that we might comfortably live with inflation -- or that we could accept inflation in the interest of strong growth -- was exposed as an illusion. I believe it is fair to say a clear national consensus emerged that turning back inflation had to be a top priority of economic policy -- that a stable dollar is a necessary part of the foundation of a strong economy.

Monetary policy has a key role to play in restoring that stability, and our policies are directed to that end. But recent developments have confirmed again that ending an inflation, once it has become deeply seated in expectations and behavior, is not a simple and painless process. The problems can be aggravated if too much of the burden rests on one instrument of policy. And the effort to restore stability will be more difficult to the extent policies feed skepticism and uncertainty about whether the effort will be sustained -- a skepticism rooted in past failures to "carry through." Monetary, fiscal, and other public policies are constantly scrutinized -- in financial markets and elsewhere -- to detect any signs of weakening in the sense of commitment to deal with inflation. To speed the transition to

lower interest rates and healthier capital markets, to reduce the costly elements of anticipated inflation built into wage and price contracts, to permit more confident planning for the future -- to, in fact, lay the base for sustained recovery -- credibility in dealing with inflation has to be earned by performance and persistence.

That, essentially, is what public policy -- and monetary policy in particular -- has been about for some time, and there are now signs of real progress on the inflation front. That progress is reflected to greater or lesser degree in all the widely used inflation indices. Consumer prices rose 8.9 percent last year, 3-1/2 percentage points less than the 1980 peak, and the inflation rate seemed to be trending lower still as the year ended. Finished goods producer prices have had an average increase at an annual rate of only about 4 percent for six months. Expectations cannot be so easily measured, but earlier fears that inflation might rapidly accelerate have plainly dissipated.

Those gains, to be sure, have elements that may not be lasting. Some prices are depressed by recession-weakened markets, and some by the pressures of high interest rates on inventories and speculative positions; exceptionally good crops last year have held food prices down; and surpluses have emerged in oil markets, following the enormous price increases of earlier years.

But we also see evidence of potentially more lasting changes in the trend of costs as management and labor in key industries come to grips with competitively damaging productivity and wage trends. I am aware that this process has just begun, and it has been centered largely in areas where competitive pressures are most intense. But as the emerging patterns spread, we will have succeeded in establishing one of the major elements for success in the fight against inflation and for reconciling, as we must, a return to greater price stability with growth, reduced unemployment, and higher real wages. Quite obviously, policies that encourage that process of cost moderation will have a large "pay off" in future economic performance.

I am acutely aware that progress on the inflation front has been accompanied by historically high levels of interest rates and heavy strains on financial markets. Those sectors of the economy particularly dependent on borrowing -- especially long-term borrowing -- have been hard hit.

The pattern of economic activity last year shows the picture clearly. Over the course of 1981, the overall level of production of goods and services -- real GNP -- posted a slight increase. But at the same time, home building dropped to the lowest level in decades. Sales of consumer durables -- car sales in particular -- fell markedly. And now capital investment by businesses also appears to be adversely affected, running contrary to longer-term needs.

It would be simplistic to cite high interest rates as the sole cause of the difficulties in these vulnerable sectors. Part of the problem arises from other, and longer-term, factors, themselves associated with the inflationary process. In housing, for example, we have had a decade of increases in prices of homes almost double the rate of inflation in the economy generally and well in excess of the rise in average family income. "Sticker shock" still seems to be the major deterrent to new car sales as the industry comes to grips with long developing competitive and regulatory problems and the enormous challenge of adapting to the higher price of gasoline.

In the best of circumstances, coping with deep-seated inflation would pose difficulties. At the same time, we have had to adjust to the huge increases in the price of energy, to meet the need for a stronger defense, and to deal with the drag on incentives and investment resulting from rising marginal tax rates. All of that implies massive economic adjustments, the threat of a growing fiscal imbalance, and a difficult transition period. The high level of unemployment generally, and particularly distressing conditions in some of our older industrial centers, are one symptom. Lasting progress toward price stability -- and other needed adjustments -- cannot be built on prolonged stagnation, rising unemployment, and slow growth. The relevant question is not whether current conditions are satisfactory or tolerable -- they obviously are not. It is whether our policies, and our policy mix, promise to achieve the

needed results over time.

Monetary Policy in 1981 and the Targets for 1982

It is against that background that I would like to review monetary policy last year and discuss our intentions for 1982.

As you know, the main responsibility for dealing with inflation has fallen on monetary policy. I would emphasize that the process of restoring stability will proceed more easily and effectively, with less strain on financial markets and on credit-sensitive sectors of the economy, to the extent the effort is complemented and supported by other policies. But, in the end, history and theory alike confirm that no effort to turn back inflation can be successful without appropriate restraint on the expansion of money and credit. I believe the record of the past few years amply reflects the needed monetary discipline.

The Humphrey-Hawkins Act specifically requires that we translate our broad objectives into quantitative monetary and credit targets. More broadly, those targets have become one means of communicating our intentions to the public in a comprehensible way. The judgments involved in setting appropriate targets are never simple, and they have been increasingly complicated by the rapid pace of innovation in financial markets. Those innovations sometimes blur the precise meaning of the various monetary and credit aggregates, complicate their measurement, or change the economic significance of a particular target. In the circumstances, elements of judgment

are necessary in interpreting behavior of the aggregates, particularly when their movements diverge somewhat.

The events of 1981 surely reflect those facts, but they also seem to me to provide an unambiguous record of persistent monetary restraint. The targets we set for the year pointed toward a reduction in the growth of the monetary aggregates from the rates of expansion in 1980. In our 1981 report to the Congress, setting forth those targets, we also suggested that changing preferences of the public for different types of financial assets -- influenced by regulatory developments and new "products" offered by financial institutions -- might tend to push the broader aggregate M2 to the upper part of its specified range, and that judgments about the course of the narrow aggregates -- M1-A and B -- would require taking account of shifts into NOW accounts, particularly during the early part of the year when they were newly introduced nationwide. These expectations were borne out, but as the year progressed the divergences among some of the aggregates became even wider than expected.

Measured by comparing fourth quarter averages in 1980 and 1981, M1-B growth (adjusted for the estimated shift of funds into NOW accounts)* in 1981 was 2.3 percent, a little more than

*The "adjustment" allowed for shifts of funds into NOW accounts and similar instruments included in M1-B from sources outside of M1-B. The shift-adjustment was estimated on the basis of various surveys of depository institutions and individuals, as well as by statistical techniques. M1-B without adjustment rose by 5 percent, also below its indicated range. While the adjustment was necessarily estimated, we believe the "adjusted" data are more appropriate for assessing the trend in the money supply, particularly during the early part of the year when shifts were large.

one percent below the lower end of the target range specified a year ago (see Table 1 attached). You will recall that I reported to you in July that an outcome near the lower end of the range would be desirable.

Measured in the same way, M2 slightly exceeded the upper end of its range after rather closely following the upper bound as the year progressed. The subsidiary target range for M3 was exceeded by a greater margin, reflecting in considerable part some changes in the composition of commercial bank financing patterns toward domestic sources that had not been anticipated, while bank credit fell within, but toward the upper part of, its range.

In judging trends over a period of time, annual averages may be more meaningful. As Table 2 illustrates, average annual M1-B (adjusted) growth has declined by an average of 1.1 percentage point since 1978, to a rate of 4.7 percent in 1981. On the same basis, M2 growth was steady in 1979 and 1980, but actually rose by more than 1 percentage point in 1981. Over those years, both aggregates have been affected by institutional change. Relaxation of interest rate ceilings applicable to time deposits of depository institutions and the enormous growth of money market funds (both included in M2) tended to raise the trend of M2 over the period as individuals had incentives to lodge a larger proportion of their assets in these instruments. Assets in money market mutual funds are not included in M1, but the enormous growth of those funds, providing virtually immediate

availability of funds and check-writing privileges, diverted some money away from checking accounts in depository institutions which are included in M1. Given the technical and institutional changes bearing on M1 and its relative volatility, its movements need to be assessed in the light of developments with respect to the other aggregates. Indeed, a number of analysts attach greater weight to M2.

Experience during 1981 also illustrates the variety of forces impinging on interest rates and credit market conditions. Over long periods of time, there should be a relationship between interest rates and inflationary expectations -- that is, both lenders and borrowers might reasonably anticipate a small positive return on loanable funds in "real" terms, after allowing for inflation. When economic conditions were relatively stable in the postwar period and inflation low, that relationship with respect to long-term interest rates was fairly steady. But history is replete with deviations for a time in either direction, and high levels of income taxation distort the comparison. Before taxes, "real" interest rates (measured on the base of actual inflation) were negative during part of the 1970's, but recently have been extraordinarily high. One factor, particularly in long-term markets, appears to be concern about whether public policy will, in fact, "carry through" the fight on inflation.

Even with inflation subsiding, the threat of prolonged large Federal deficits as the economy recovers points to a more imminent concern -- direct government competition for a

limited supply of savings and loanable funds. The clear implication is greater pressure on interest rates than otherwise, with those interest rates serving to "crowd out" other borrowers. The most vulnerable, of course, are home-buyers and others particularly dependent on credit. But the consequences for business investment generally are adverse as well.

Monetary policy, of course, influences interest rates, but the relationship has several dimensions. As monetary restraint reduces and eliminates the risk of inflation over time, it will work powerfully toward a more favorable climate for longer-term borrowing, and in the credit markets generally. In the short-run, should inflation, economic growth or other factors increase the need and desire to hold money, restraint on the supply of money will ordinarily be reflected in pressures on short-term rates. However, to accept inflationary increases in the money supply in an attempt to lower interest rates would ultimately be self-defeating; even in the short-run, market sensitivities might well give the opposite result.

Some of these inter-relationships were evident in 1981. Short-term interest rates fluctuated over a wide range, but generally trended down from peak levels in the spring or early summer, falling particularly sharply as the recessionary forces became apparent in the fall. That was a period when pressures on commercial bank reserve positions were easing, consistent

with our monetary and credit targets. However, longer-term interest rates continued to rise for months after the peak in short-term rates, influenced in substantial part by growing concern about prospective budgetary deficits.

As growth in the money supply rose more rapidly late last year, and a very sharp increase developed early in January, the reserve positions of banks came under some renewed pressure as Federal Reserve open market operations constrained the supply of reserves. At the same time, there were scattered signs recessionary forces might be waning. Short-term interest rates rose from early November lows, although they remain well below levels prevailing during much of 1981. Some long-term interest rates -- notably those on government securities -- returned close to earlier peaks, suggesting the impact of current and prospective Treasury financing.

This was the setting for the decision on the monetary and credit targets taken by the Federal Open Market Committee last week. The sharp increase in the money supply in January carried the level well above the fourth quarter 1981 average, the conventional base for the new target, and somewhat above the lower end of the range specified for 1981. A large increase in the money supply, accompanied by higher interest rates, is unusual during a period of declining production and economic activity. Moreover, the composition of the money supply increase in the past three months is heavily concentrated in a rather small component of M1 -- NOW accounts, which are held by individua

That increase in NOW accounts has been accompanied by a reversal of earlier sharp declines in savings accounts -- another highly liquid asset -- and by declines in small time deposits, which provide a less liquid outlet for personal funds. Taken together, the evidence suggests some short-term -- and potentially "self reversing" -- factors may be at work, inducing individuals to build up highly liquid balances at a time of economic and interest rate uncertainty.

Taking those circumstances and others into account, the Federal Open Market Committee decided to adopt the tentative targets discussed last July:

for M1, 2-1/2 to 5-1/2 percent;

for M2, 6 to 9 percent;

for M3, 6-1/2 to 9-1/2 percent.

The associated range for bank credit is 6 to 9 percent.*

The M1 target is lower than the range specified a year ago for M1-B (3-1/2 to 6 percent shift-adjusted), but it is consistent with somewhat larger actual growth than experienced last year with the "adjusted" measure. The lower end of the range would now appear appropriate only if the pace of financial innovation again picks up -- for instance, a rapid spread of

*While all of the monetary ranges were set, as in previous years, on a fourth-quarter to fourth-quarter basis, the range for bank credit is measured from the average level in December 1981 and January 1982 to the fourth-quarter 1982 level. This adjustment in the base for bank credit is necessitated by the opening of International Banking Facilities on December 3, 1981, which led to a shifting of certain bank assets, formerly included in the domestic bank credit data, from U.S. offices to the IBFs.

arrangements for "sweeping" temporarily excess checking account balances into money market funds or other liquid assets not included in M1. Given the present level of M1 and the relatively slow growth last year, the FOMC at this time feels that an outcome in the upper half of the range would be acceptable, and that M1 could acceptably remain somewhat above the implied "growth track" during the period immediately ahead.

In that connection, I would point out that an outcome in the upper part of the range specified for 1982 would be roughly the equivalent of a rate of growth of 4 percent from the lower end of the range targeted in 1981, as illustrated on Chart II. Such a result would be entirely consistent with the objective I stated to your Committee in July.

The FOMC anticipates somewhat slower growth in M2 than a year ago, when the target was slightly exceeded. At present, an outcome in the upper half of the range appears more likely and desirable. Assets included in M2 account for a significant part of individual savings. Should total savings increase substantially more rapidly than now anticipated in response to tax incentives or other factors-- or if legal or regulatory changes, such as the wider availability of IRA accounts, result in a substantial volume of funds shifting into depository institutions from other sources -- growth might logically reach (or even slightly exceed) the upper limit.

Identifiable "structural" influences of that sort on M2, or other aggregates, must appropriately be taken into account in formulating policy steps and judging actual developments. For example, should developments in coming months provide solid evidence that the recent exceptional growth of M1 is indicative of some more fundamental and lasting change -- such as a desire by individuals to continue to hold more liquid "savings" in the form of NOW accounts -- the FOMC would, of course, reconsider that growth target at or before the regular mid-year review.

These technicalities should not confuse a simple message: consolidating and extending the heartening progress on inflation will require continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint. The growth ranges specified are, we believe, consistent with an economic recovery later this year, although we do not anticipate, by historical standards, a sharp "snap back." What is more important is that the recovery have a firm foundation -- that it be sustained over a long period. There will be more room for real growth -- and much better prospects for sustaining that growth over many years -- the greater the progress on inflation.

The Course Ahead

In approaching the future, the lessons of the past bear repeating. We cannot buy or inflate our way out of recession -- not without ratcheting up both inflation and unemployment over

time. We cannot turn the effort to deal with inflation "on and off" -- not without adversely influencing the decisions of those in the marketplace who commit funds for investment, with consequences for the recovery and productivity we want.

What we can do is set the stage for a much more favorable outlook -- a future in which progress toward price stability, lower interest rates, greater productivity, slower growth in nominal wages but higher real wages, all benignly interact to support growth and reduce unemployment. That's a process we have not seen sustained in this country for many years.

Today, we are acutely aware of disturbed capital markets, high interest rates, economic slack, and a poor productivity record. But, when the economy begins to expand, productivity should rise; tax and other measures already in place or under way should help reinforce a better trend. Productivity growth, in turn, will permit prices to rise more slowly than wages -- more modest wage and salary increases in dollars will then be consistent with more growth in real earnings, encouraging further moderation in wage demands and sustaining the disinflationary process. As confidence returns to securities markets, prices of bonds and stocks should rise, and lower interest rates and more favorable capital market conditions will in turn support the continuing growth in investment and productivity. With appropriate budgetary and monetary discipline, the process could be sustained for years.

That is not an impossible vision. We saw something of it in the early 1960's. As recently as the mid-1970's, coming out of a deep recession, we seemed to be moving in the right direction -- and then lost our way. Some of the essential elements of a brighter future -- as well as some of the hazards on the way -- are reflected in the longer-term projections of both the Administration and the Congressional Budget Office now available to you.

From the standpoint of public policy, much of the groundwork has been laid. I have spoken of the key role for monetary policy, and of our record and intentions in that regard. The tax program enacted last year can, in the right context, have favorable effects on incentives and on investment. The excessive burden of regulation is being addressed.

But, of course, for the process to get fairly started we need to resolve some large outstanding questions as well -- questions that hang heavily over financial markets and prospects for interest rates, inflation, and early recovery.

I have referred on many occasions to the key importance of winding down the cost and wage pressures that tend to keep the inflationary momentum going. The process appears to be starting, and the faster it takes hold the better the outlook for growth and reduced unemployment. But, clearly, prospects for early and sustained expansion -- an expansion that can be broadly shared by industries now severely depressed -- is dependent on access to capital and credit on more favorable

terms. Pumping up the money supply cannot be the answer to that problem -- excessive money and the inflation it breeds are enemies of the real savings needed to finance investment.

What we can do is relieve the concerns the markets understandably have -- concerns reflected so strongly in the budgetary documents before you from both the Administration and your own Budget Office. Without action to cut spending -- or, if that fails, to raise new revenues -- we would face the prospect of deficits rising to unprecedented amounts, whether measured in dollars, in relation to the GNP, or as a proportion of our limited savings and the supply of loanable funds. We can debate among ourselves just what level of deficit is tolerable in coming years and what is not. We can be tempted to sit back and let a year pass as we discuss what programs should be cut or where revenues can be raised. But I think we all know that, without action, we would be on a collision course between our need for new plant, equipment and housing and our capacity to save -- and it would be more difficult to reconcile the requirements for a sound dollar with our desire to grow.

It could be argued we have a little time. A large deficit in the midst of recession should be manageable; it indeed provides some support for the economy in a time of stress. There are also large potential sources of demand in the private economy. The latest economic indicators are not so weak as they were. We can see we are making some progress against inflation, perhaps as fast as could reasonably have been anticipated. In all these circumstances, a degree of patience is needed -- and justified.

But delay is another matter. In my judgment, the more progress we can see in restraining costs, and the more resolute your budgetary action, the earlier we can be assured a prompt and strong recovery.

The course of action we have set in the Federal Reserve seems to me consistent with that sense of direction and urgency. But no single instrument of policy can, alone, do the job. We look forward to working with you and your colleagues in the weeks and months ahead to meet these challenges constructively.

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Table 1

Monetary Growth 1981

	<u>1981 Ranges</u>	<u>1981 Actual*</u>
M1-B	6 to 8-1/2 percent	5.0 percent
M1-B (shift adjusted)	3-1/2 to 6 percent	2.3 percent
M2	6 to 9 percent	9.4 percent
M3	6-1/2 to 9-1/2 percent	11.3 percent
Bank Credit	6 to 9 percent	8.8 percent**

*Fourth quarter to fourth quarter

**December level used for calculating this 1981 growth rate incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

Table 2

Growth of Money and Bank Credit
(percentage changes)

	<u>M1-B*</u>	<u>M2</u>	<u>M3</u>	<u>Bank Credit</u>
Fourth quarter to fourth quarter				
1978	8.3	8.3	11.3	13.3
1979	7.5	8.4	9.8	12.6
1980	6.6	9.1	9.9	8.0
1981	2.3	9.4	11.3	8.8**
Annual average to annual average				
1978	8.2	8.8	11.8	12.4
1979	7.7	8.5	10.3	13.5
1980	5.9	8.3	9.3	8.5
1981	4.7	9.8	11.6	9.4**

*Growth rates for 1980 and 1981 adjusted for shifts to other checkable deposit accounts since the end of the preceding year.

**December level used for calculating these 1981 growth rates incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

Table 3

Monetary Growth Targets 1982

M1*	2-1/2 to 5-1/2 percent
M2	6 to 9 percent
M3	6-1/2 to 9-1/2 percent
Bank Credit	6 to 9 percent**

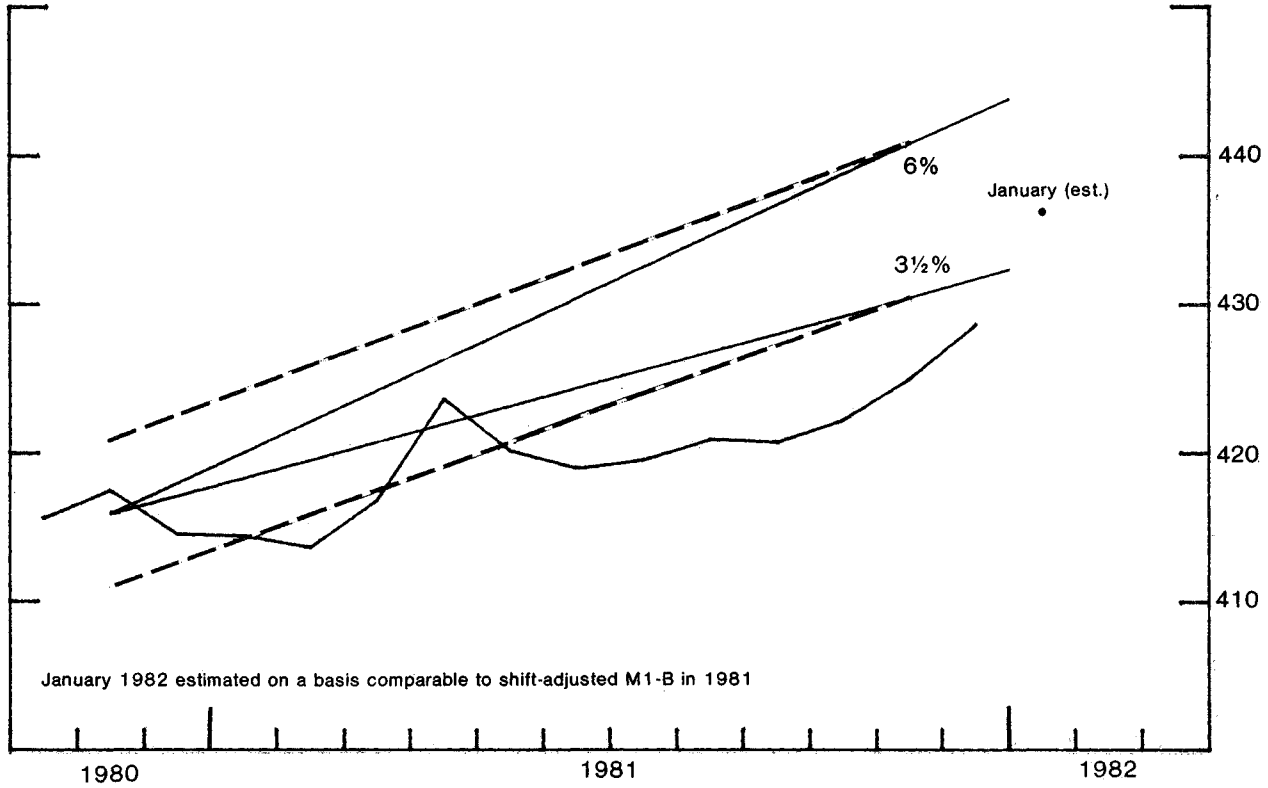
*The objective for growth of narrowly defined money over 1981 is set in terms of M1. Based on a variety of evidence suggesting that the bulk of the shift to NOW accounts had occurred by late 1981, the Federal Reserve is publishing only a single M1 figure in 1982 with the same coverage as the former M1-B.

**The bank credit data after December 1981 are not comparable to earlier data because of the introduction of International Banking Facilities. Thus, the targets for 1982 are in terms of growth from an average of December 1981 and January 1982 to the fourth quarter average of 1982.

Growth Ranges for 1981 and Actual

M1-B SHiFT-ADJUSTED

Billions of dollars



M2

Billions of dollars

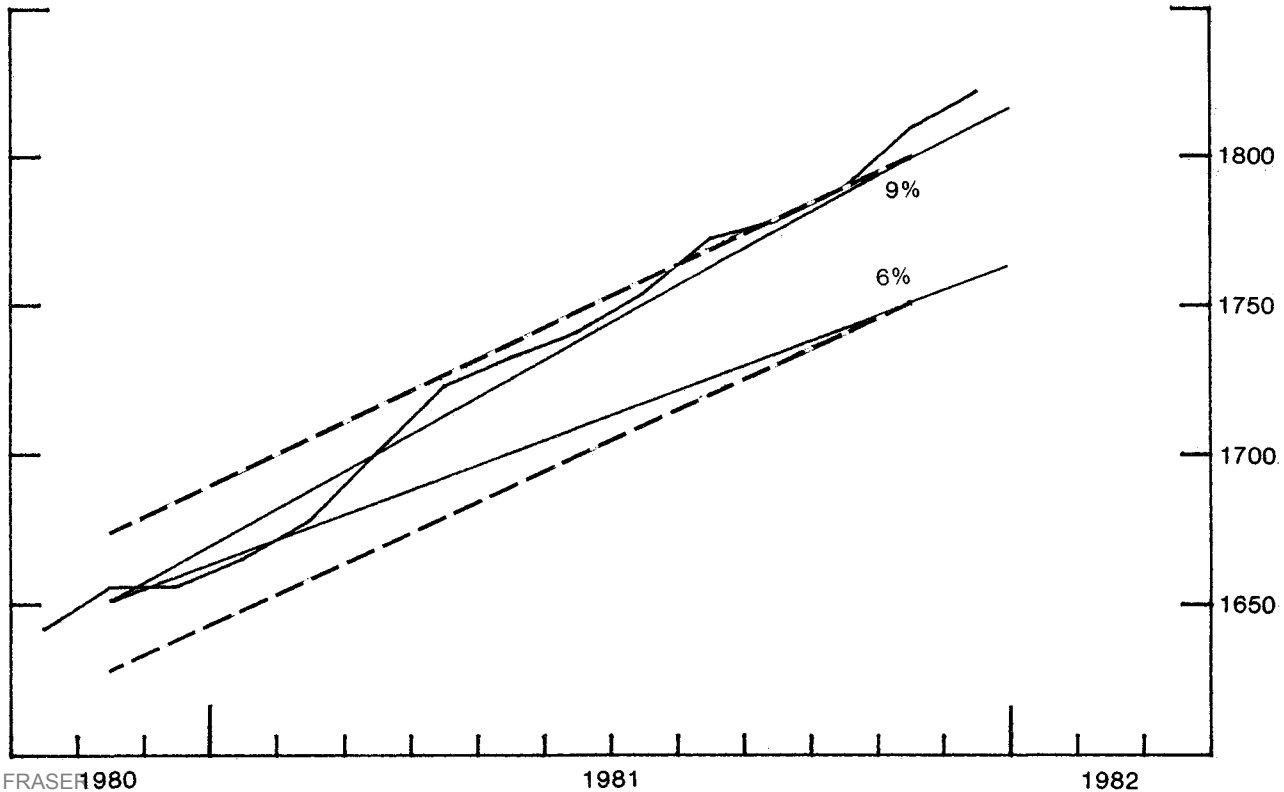


Chart 2

Growth Ranges for and Behavior of M1, 1981 and 1982

