Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

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I appreciate this opportunity to participate in your hearings on the President's economic program. The responsibilities of the Federal Reserve are, of course, limited to monetary policy, but we must necessarily recognize the broad interrelationships among monetary and other policies bearing upon national economic performance. Your Committee has particular responsibility for initiating specific revenue and spending measures; in reaching your decisions, you must also take into account their implications for the overall fiscal position of the government and the implications for financial markets. It is at that point that our concerns intersect, and my comments this morning will be largely directed to that area.

I have often expressed my concern about the critical need to break the inflationary momentum that had come to grip the nation in the 1970's and spoken of the indispensable role that monetary policy has to play in that effort. At the same time, I have emphasized the extra difficulties that result from placing too heavy a burden on monetary policy alone in the fight on inflation -- difficulties manifested in exceptionally heavy pressures on financial markets and interest rates, and therefore on credit-dependent sectors of the economy.

Current developments both reflect needed progress on the inflation front and reinforce my concern about the burdens placed on monetary policy to bring about and sustain that progress. In the best of circumstances, ending an inflation, once it has become embedded in behavior and expectations, can be painful in the short run, however necessary that effort is to our future strength and
prosperity. The hard fact is the economy is now in the grips of a second recession in as many years. Recent developments have some of the characteristics of earlier cyclical downturns. But the current recession has been superimposed on a pattern of stagnation extending over a number of years -- years characterized by a rising trend of unemployment, lagging productivity, and particularly strong pressures on the older industrial sectors and regions. And, even now, after months of rising unemployment, interest rates have remained painfully high, delaying recovery in some important sectors of the economy.

In broad terms, I don't think there is any great mystery as to why the economy and financial markets have behaved in this way. During the 1970's, inflation increasingly became viewed as a way of life, and in the process economic incentives were distorted and our productive energies sapped. As we lost our most important financial yardstick -- a stable dollar -- interest rates rose and became highly volatile. As monetary policy moved to deal more forcefully with the inflation -- particularly in a context of fiscal imbalance -- the strain on financial markets became more acute. But the alternative course of trying to accommodate to inflation by providing excessive monetary growth would offer no lasting relief -- and probably little respite even in the short run -- for that approach would only feed inflationary expectations and reinforce the reluctance of lenders to commit funds for any substantial period of time ahead.
Now we can see clear signs of progress on the inflation front. A reversal of the pattern of the inflation rate ratcheting higher in each successive economic cycle would be an event of profound importance, not least in encouraging a return to much lower and more stable interest rates. We cannot "prove" that we have yet turned that corner. Indeed, some of the progress against inflation reflects the more immediate and temporary effects of recession-weakened markets, the pressures of extraordinarily high interest rates on commodity and other sensitive prices, and recent surpluses in petroleum and grain production. But we are also seeing signs of potentially more lasting changes in attitudes of business and labor toward pricing, wage bargaining, and productivity. Not surprisingly, the effort is most clearly apparent in industries where costs and wages have been most out of line, where international competitive pressures are particularly intense, or where regulatory change has encouraged greater price competition. But, I believe the pattern is likely to spread, "building in" lower rates of increase in nominal wages and prices over time. And, as the inflationary and cost pressures ease, the economy can resume a healthy growth pattern, with greater job opportunities, increasing productivity, and higher real wages.

But if that bright prospect is to be achieved, we simply cannot afford now -- just as the disinflationary process is beginning to take hold and beginning to be believed -- to abandon our monetary vigilance. Past failures to "carry through" have left a legacy of skepticism and uncertainty among workers and
businessmen, among consumers, and among participants in financial markets where lenders demand "inflation" and "uncertainty" premiums when committing their funds. Credibility in dealing with inflation will have to be earned by performance and persistence over time. Prudent fiscal and other policies must help in achieving that credibility. But I believe it is broadly and rightly recognized that, whatever those other policies, appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

As you know, I testified two weeks ago before the House and Senate Banking Committees to report the Federal Reserve's specific intentions with respect to money and credit growth for 1982. Without repeating the details, I'd like to highlight a few of the major points.

Developments during 1981 were broadly consistent with the continuing effort to reduce growth of money and credit to non-inflationary levels over time. There were, to be sure, some divergent movements among the various monetary and credit aggregates that we target. Those movements are largely explicable in terms of technological and regulatory change -- the introduction of NOW accounts nationwide, the enormous growth of money market funds, and other factors affecting the preferences of the public for different types of financial assets. Specifically, M1-B growth (adjusted for the estimated shift of funds into NOW accounts) decelerated further last year, averaging, over the year as a whole, a little more than 1 percent below the previous year -- the third
consecutive year of lower growth. From the fourth quarter of 1980 to the fourth quarter of 1981, M1-B growth (adjusted) was 2.3 percent, a little more than 1 percentage point below the lower end of the target that we had indicated was desirable at mid-year. The growth of the broader aggregate M2 -- about 9-1/2 percent over the four quarter period -- was a bit higher than in 1980, partly reflecting the extraordinary growth in money market funds.

As you know, the money supply increased particularly sharply in the early weeks of 1982, following fairly large increases in November and December. Increases of that size are unusual when production and incomes are weak, and the recent rise appears to be related in considerable part to the desire of individuals to place marginally more of their assets in highly liquid form. Interest rates, after falling sharply last fall, retraced part of that decline in January and early February, partly because the rising money supply was reflected in renewed pressure on bank reserve positions. More recently, monetary growth appears to be moderating, and bond markets have rallied.

These recent movements, in my mind, emphasize again two relevant points in assessing our monetary targets and their implications. First, in a large and complex economy, short-term fluctuations in money supply data -- for a month or even a quarter, and much more so from week to week -- can be anticipated as consumers and businesses adjust their cash holdings. So long as the trend
is appropriate, those short-term fluctuations should have no important implication for economic activity or inflation.

Second and more fundamentally, our targets are, by design, limited to amounts necessary to finance real growth in a framework of declining inflation. The stronger the inflationary momentum, and the more pressure on credit markets from other directions, the greater the risk that high interest rates will squeeze out housing, investment, and other private activity supported by borrowing.

We believe the targets for 1982 established this month (reaffirming tentative targets set out last July) will be consistent with recovery in business activity over the second half of the year. Our target range for M1 of 2-1/2 to 5-1/2 percent is consistent with growth in money over the year as a whole larger than during 1981, and the Federal Open Market Committee has suggested that, as things now stand, growth in the upper part of the range would be acceptable. The FOMC also suggested M2 growth toward the upper end of its 6-9 percent range (the same as last year) would also be acceptable. But these ranges also imply a "tight fit," in the sense they are predicated on the assumption and prospect of a further decline in the rate of inflation.

The fact is that consolidating and extending our progress on inflation will require continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint.
That restraint, by providing assurance that inflation will continue to decline, should over time be a powerful influence in bringing down interest rates as well, particularly in the long-term area. Indeed, prospects for any lasting relaxation of interest rate pressures would be dim without the continuing monetary discipline that success against inflation requires.

For the more immediate future, interest rate prospects depend crucially on other factors as well, and I am fully aware that interest rates are vitally important to the timing, strength, and sustainability of economic recovery. The most important of those "other" factors is surely the outlook for the Federal deficit, and it is a factor directly within your own purview.

As you know, this year, fiscal 1982, we will have a very large Federal deficit -- on the order of $100 billion. To a considerable extent, that deficit is a reflection of the recession, as it reduces revenues and raises outlays. In the particular circumstances of today, the current deficit, to a large degree, acts as an "automatic stabilizer" for the economy. The financing load should be manageable in a context of reduced credit demands by other sectors.

As we look ahead to 1983 and beyond, the situation is quite different, and that is the source of my concern about the budgetary situation. What is so disturbing is that the current services budget (taking account of the Administration's defense program) shows a sharply rising deficit, even if we assume revenues
are lifted and spending restrained by rather strong recovery. All the estimates before you, by the Administration, by the Congressional Budget Office, or by private forecasters, point in the same direction. In the absence of action to close the potential gap, the deficit will rise to about $150 billion or more in fiscal 1983, and to still larger amounts in later years. Looking at the same situation in another way, even if we assumed the unemployment rate would soon drop back to six percent or so -- about the level of the best recent years -- we would be faced with large and rising deficits unless strong new measures are taken to contain them.

In recognition of this outlook, the Administration has, as you know, proposed substantial measures to reduce the potential deficit for fiscal 1983, and the years beyond. The emphasis is on spending reductions, but some revenue measures are also proposed. That program is estimated to reduce the projected fiscal gap by $56 billion in 1983 and $84 billion in 1984. If enacted, as proposed, it would go a very considerable way toward dealing with the fiscal problem.

As you consider those and other proposals, I must emphasize the threat that, unless substantial budgetary actions are undertaken, private borrowers would be squeezed out of the market, with adverse consequences for homebuilding, for business investment, and for other credit-dependent sectors. In other words, the budgetary outlook, as it stands, does not seem to me consistent with the expansion in private investment we seek, and have sought to encourage through tax reduction and other measures.
The problem is not simply one for the future -- for 1983 and 1984 and beyond. Financial markets constantly look ahead -- any lender or borrower tries to anticipate and "discount" what lies ahead. Anticipations of a future "squeeze" are translated into present high interest rates, into a desire to "stay short" in lending, into a reluctance to set into motion plans to build and to invest. Moreover, the deep-seated public instinct that sustained large deficits will lead, sooner or later, to pressure to create more money to finance those deficits, or will otherwise stimulate inflation, undercuts the effort to restore stability.

I would also point out that, even with measures as large as those proposed by the Administration, we would be left with historically high deficits in relation to GNP or our probable savings potential, as the projected recovery proceeded. And those projections have little margin for misjudgment of the underlying trend in spending or revenues, in interest rates, in the inflation rate and the like -- areas where any projection has an element of uncertainty. I note, in that respect, that projections of the existing budgetary gap by the Congressional Budget Office run somewhat higher than those of the Administration.

The potential for continuing squeeze on financial markets could be alleviated by increases in business and personal saving. Such saving has been abysmally low in recent years. Greater price stability, positive real interest rates, and the tax measures introduced last year, all should work in the direction of greater savings. But to count on a dramatically large increase
in savings to "bail" us out of the budgetary problem would be to miss the point, at best. We need larger saving to finance higher levels of business investment and housing construction; we cannot afford to have it dissipated in financing prolonged excessive budget deficits -- deficits that, as matters stand, would absorb, or more than absorb, a reasonable projection of increased savings.

Given the nature of the problem before us, and the clear risks of underestimating the size of the budgetary problem, I can only conclude that the Congress should set its sights for still larger budgetary savings, keeping in mind the widening gap now projected beyond fiscal 1983.

Credible steps to assure substantially declining Federal deficits as the economy expands, looking toward balance as we restore satisfactory levels of unemployment, would be enormously helpful in resolving some of the problems in our financial markets today. Indeed, such action could have a galvanizing effect in bringing about lower interest rates because it is concern about the budgetary prospects that pre-occupies the thinking of many potential investors in the market today.

In carrying the primary responsibility for tax legislation and for certain large spending programs, your Committee has the excruciating job of translating general budgetary objectives into concrete legislation. You must make choices involving social, national security, and programmatic considerations far beyond the purview of the Federal Reserve or
my competence. As a purely economic matter, I do believe that, in general, lower taxes -- particularly lower marginal income tax rates -- will permit the private economy to perform more effectively, tending to increase incentives and to reduce distortions. From that standpoint, spending control clearly deserves priority. But to the extent the needed job cannot be done by expenditure control alone, I see no alternative to considering new sources of revenue.

The difficult economic circumstances of today should not blind us to the fact that we have much upon which to build. We can see the tangible progress against inflation. The Administration and the Congress have taken action to spur productivity, work, and savings through the tax system. The inexorable upward trend in spending has been bent lower. Regulatory reform is underway.

From that perspective, what we need is not any basic change in direction, but a sense of urgency and persistence in "carrying through." That has clear implications for continued discipline in monetary policy. And it has direct implications for dealing with the budgetary problem that looms so large before you.

Seldom, in my experience, has the challenge been so clear for all to see. And seldom has there been so strong a consensus on the need to meet it with bold measures. It is those facts that give me confidence that you and your colleagues, working with the Administration, will find the way to reconcile
the competing priorities among the particulars of spending and revenue decisions in a way consistent with needed reduction in the deficit. The quicker that can be done, the brighter, in my judgment, will be the outlook for the economy.

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