For release on delivery
9:30 AM, E.D.T.
July 28, 1982

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

July 28, 1982

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I am pleased to have this opportunity to meet with you again to review the monetary and budgetary situation in the light of our economic objectives. Just last week, I testified at some length before the Banking Committees of the Senate and House; instead of repeating that full statement this morning, I have attached it to my brief remarks today.

I do want to take this occasion to recognize particularly the leadership of members of this Committee in pressing for the budgetary savings reflected in the First Resolution. Given the nature of our budgetary problems, that step cannot be the last if we are to bring the fiscal deficit under control. But it does represent, in most difficult circumstances, encouraging evidence of the willingness and determination of the Congress to undertake the necessary effort.

In presenting our monetary and credit "targets" to the Banking Committees last week, I noted that the basic objective of Federal Reserve monetary policy is the fostering of an environment conducive to sustained recovery in business activity, while maintaining the financial discipline needed to restore reasonable price stability. In reviewing the appropriate means to those broad ends, the Federal Open Market Committee at its recent meetings concluded, in effect, that the quantitative objectives for the various Ms set forth at the beginning of the year should not be changed at this time, but that we would find an outcome around the top of those target ranges fully acceptable.

In reaching that conclusion, we considered carefully and explicitly the intent of the Congress, as expressed in the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

First Budget Resolution, that the Federal Reserve "reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy." In the light of that Resolution, as well as other factors, we debated the appropriateness of the monetary targets for 1982.

Analysis of past experience suggested strongly that the previously announced targets, particularly with growth around the top of the range, should provide enough money and liquidity to support moderate expansion over the remainder of this year. Pressing aggressively to reduce monetary growth well within the ranges did not seem desirable at this stage of economic developments, particularly in light of the evidence of a demand for liquidity for precautionary -- as opposed to transactions -- purposes. A sizable increase in the ranges, on the other hand, might imply a buildup of money and liquidity to the degree that it would impair the effort needed to maintain and extend the encouraging progress toward dis-inflation.

In reaching that judgment, we were conscious that the strong liquidity demands evident in recent months could shift quickly as the economy showed signs of recovery, and that raising the targets could easily be misconstrued as a willingness to tolerate more inflation. At the same time, the Committee clearly recognized that possible demands for liquidity in the current uncertain economic circumstances would continue to require a degree of flexibility and judgment in assessing appropriate needs for money in the months ahead.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

We could observe that, over the first half of the year, the desire of individuals and businesses to hold assets in relatively liquid forms appeared to be extraordinarily strong, apparently reflecting concerns about the business and financial situation. One reflection of that may be found in the large declines in the "velocity" of money over the recession period -- that is, the ratio of the gross national product to measures of money. That drop in velocity is particularly striking in view of the persistence of high interest rates, suggesting a heightened desire to hold money or liquid assets relative to earlier trends.

While velocity often fluctuates widely over short periods of time, trends have been much more stable over time. Assuming that velocity rebounds in the second half -- as typically occurs early in a period of economic recovery -- the targets established at the beginning of the year for the monetary aggregates should be fully consistent with economic expansion in a context of declining inflation. Postwar experience strongly points in that direction. However, the Committee explicitly considered the possibility that relatively strong precautionary demands for money could persist. In that event -- and it would inevitably involve elements of judgment -- growth of the aggregates somewhat above the targeted ranges would be tolerated for a time as consistent with the FOMC's general policy thrust.

In looking ahead to 1983, the Committee has decided to retain tentatively the existing targets. The FOMC will review the decision at the start of next year, taking account of, among

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

other things, the behavior of velocity over the remainder of this year. Since we expect that the monetary aggregates will be near the upper ends of their ranges at the end of 1982, the tentative targets for 1983 would be consistent with somewhat slower money growth next year. With inflation declining, the tentative targets should be compatible with continuing recovery at a moderate pace and an improvement in employment opportunities.

In approaching these policy decisions, I have been very conscious of the fact that monetary policy, however important, is only one instrument of economic policy. The attainment of our common objective of a strong and prosperous economy depends also on appropriately complementary policies in the fiscal sphere and in the private sector.

Relaxing discipline on money growth might seem attractive to some as a means of alleviating stresses in financial markets. Indeed, in circumstances in which inflationary expectations and pressures are quiescent, the immediate effect of encouraging faster growth in money might be to lower interest rates, particularly in short-term markets. In time, however, an attempt to maintain lower interest rates by excessive money growth would founder. The net result would be to imbed inflation even more deeply into our economic system, and to make buyers of fixed-interest securities still more wary. Sooner or later, public and private demands for credit would reflect the higher price levels, and savings likely would be discouraged. Market pressures

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

would return in amplified force. Put simply, inflationary money creation provides no escape from the pressures of demands for credit, nor can money creation substitute for real savings.

We can, of course, affect that balance of demand and supply in credit markets by fiscal and other policies, and that is why I welcome the effort of the Congress to achieve greater fiscal restraint. I recognize -- and more importantly the markets recognize -- sizable obstacles remain in converting the intentions expressed in the First Budget Resolution into concrete legislative action; harmonizing the values and aims of the authorizing and revenue committees -- indeed the values and aims of our citizens -- within the constraints of budgetary discipline is always difficult, and no more so than in today's circumstances.

Moreover, the effort this year must be put in a larger perspective. Even if the objectives of the Budget Resolution are fully achieved for next year and the underlying economic assumptions are realized, the deficit in FY 1983 would be about as large as this year's. Moreover, the risks seem, in my judgment, all on the side of a still greater deficit, despite your important efforts. If the deficit turns out to be larger than expected entirely because of a shortfall in economic growth or inflation -- and I would point out that the members of the FOMC anticipate somewhat less real growth and inflation (and thus inflation-generated revenues) than the Congress -- that "add on" should not be a source of much concern. What is of concern is that you

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

are working from so large a "structural" deficit -- a deficit that would exist even in a relatively prosperous economy -- and that concern would mount to the extent the targeted savings are not achieved.

As we appraise the fiscal situation today, projected deficits continue to carry the implicit threat of "crowding out" business investment and housing as the economy expands -- a process that would imply significantly higher interest rates than would otherwise result. Your continuing leadership in prodding your colleagues in the Congress to deal with the budget dilemma thus remains crucially important to the outlook for interest rates and the credit markets.

Put more positively, significant progress in paring the deficits will contribute importantly to lower interest rates and reduced strains in financial markets within any monetary framework. That budgetary policy, as we see it, is not fundamentally a substitute for disciplined monetary policy but rather an essential complement.

When monetary policy alone must carry the burden of dealing with inflation, and when fiscal deficits absorb so large a fraction of the capacity of the economy to generate savings, pressures tend to concentrate on financial markets and on vulnerable credit-dependent sectors of the economy. Conversely, budget restraint relieves those pressures and risks directly, and would reinforce the growing sense of conviction that the inflationary tide has turned.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

While the Open Market Committee, in responding to the Budget Resolution, did not feel that larger growth in the money supply over time would be desirable, let me also say that I believe a credibly firmer budgetary posture would permit us a degree of greater flexibility in the short-run conduct of policy. Specifically, by damping concern about a resurgence of inflation or credit market pressures, fiscal restraint also lessens fears that short-run increases in the money supply might presage a continuing inflationary monetization of the debt. But any gains in that respect will of course depend on firmness in implementing the intentions set forth in your First Resolution, and encouraging confidence among investors and borrowers that the effort will be sustained and reinforced in coming years.

I need not dwell on the fact that we are in most difficult economic circumstances, with unemployment far too high, with strong pressures on financial markets, and with a sense of widespread uncertainty. We cannot build a sound program against infla on a base of continuing recession. But let us recognize, too, that we have come a long way toward turning back the inflationary tide that had come to grip our economy over the decade of the 1970s, and that there is promising evidence of improvements in productivity and efficiency underway. More recently, there are at least some signs that the "grid-lock" in the financial markets may be beginning to break up; interest rates, while still very high in historical perspective, have declined to the lowest levels for some time.

The challenge is to sustain that progress during a period of recovery, for it is that progress that is needed to extend and support economic expansion over the long years ahead. Monetary

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

and fiscal policies alike need to be directed, and work in concert, toward that objective. In that context, I and my colleagues believe a continuing dialogue with members of this Committee is highly constructive, and I welcome your comments and questions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis