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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Ways and Means

House of Representatives

February 23, 1982

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 preoccupies the thinking of many potential investors in the market today.

In carrying the primary responsibility for originating 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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For use at 10 a.m., E.S.T.,
February 10, 1982

Board of Governors of the Federal Reserve System



Monetary Policy Report to Congress
Pursuant to the
Full Employment and Balanced Growth Act of 1978

February 10, 1982



Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 10, 1982

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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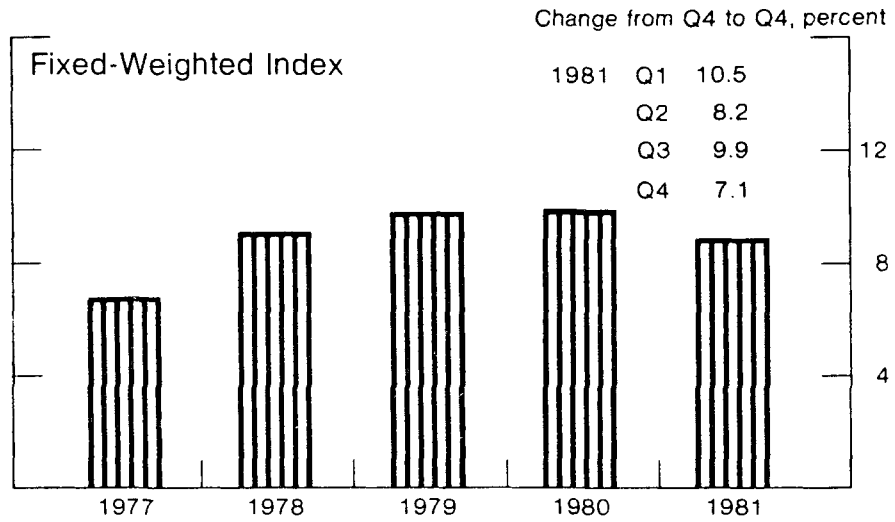
Section 1: Monetary Policy and the Performance of the Economy in 1981

The economy was growing rapidly as 1981 began, continuing the sharp cyclical rebound that started in mid-1980. Activity leveled out during the spring and summer, however, and it fell in the final quarter of the year. As a result, the rate of production of goods and services--real GNP--was only slightly higher at the end of 1981 than it had been a year earlier. With the weakening of output late in the year, the margin of unutilized plant capacity widened and the unemployment rate rose sharply to near postwar record levels.

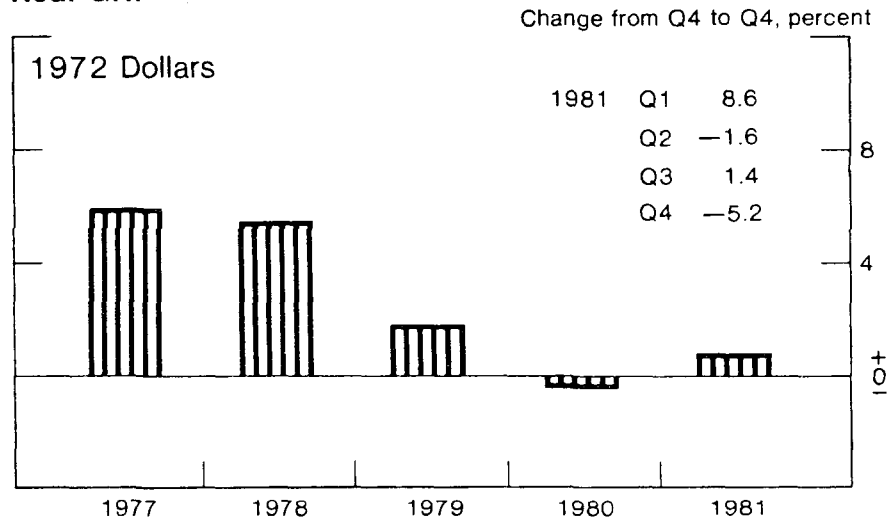
While economic activity was disappointing last year, there were emerging signs of progress in reducing inflationary pressures. The rate of price inflation slowed from the extremely rapid pace of the preceding two years, and as 1981 progressed there also were indications of an easing in the rate of wage increases, particularly in some key pattern-setting industries.

Confidence in the restoration of reasonable overall price stability is needed if economic growth is to be resumed on a sustained basis. The accelerating inflation of earlier years had been eroding the foundations of the nation's economy: capital formation had slowed; productivity was sagging; the functioning of basic market mechanisms was being impaired; and inequitable and capricious transfers of wealth were harming many of the weakest among us. The task of reversing the inflationary trend of earlier years was made more difficult because a decade of escalating prices and unsuccessful anti-inflation policies had led to firmly held expectations of continued high--if not accelerating--rates of inflation. Thus, it was recognized that reducing inflation would take time and that anti-inflation policies would

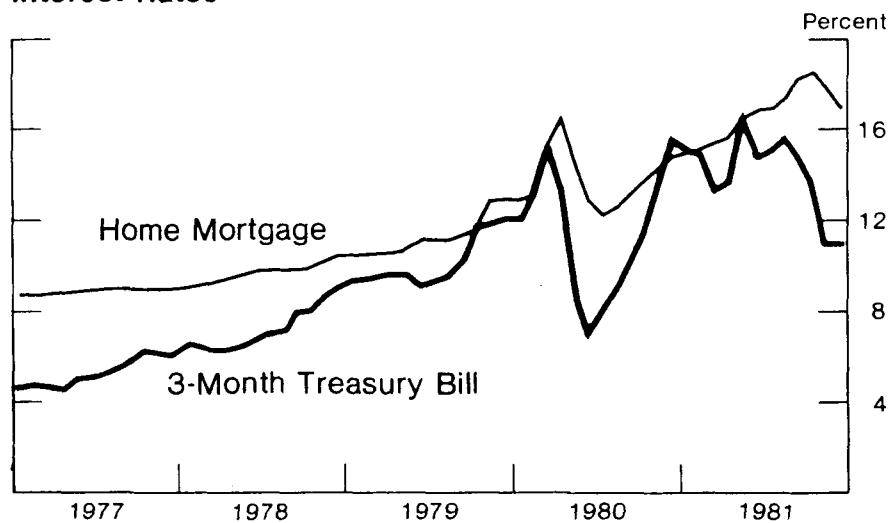
Gross Business Product Prices



Real GNP



Interest Rates



have to be applied with persistence if they were to be effective in altering expectations and slowing the rate of price increases.

While fiscal policy and decisions made in the private sector have much to do with the course of economic developments, economic theory and experience alike indicate that progress toward price stability cannot be obtained without adequate restraint on the growth of money and credit. Monetary policy was conducted in 1981 with this crucial fact in mind. The Federal Reserve set objectives for the growth of the monetary aggregates that it believed would help to damp inflation and would lead to movement over time toward trend rates of monetary expansion consistent with the growth of potential output at stable prices.

Short-term market rates of interest began 1981 at record levels, as rapid growth of economic activity in the second half of 1980 had pushed up the demand for money and credit faster than could be accommodated within the target ranges for growth of the monetary aggregates and bank reserves. Early in 1981 these demands began to subside, pressures on bank reserve positions were relieved, and money market rates declined for a time. A bulge in money demand early in the second quarter was steadily resisted by restraining the supply of reserves, and in the process short-term interest rates moved back to their earlier highs. By midsummer, short-term interest rates were declining, as demands for money and credit slackened while the Federal Reserve expanded nonborrowed reserves in an effort to maintain adequate monetary growth. Those interest rate declines accelerated in October and November as the recession took hold.

On balance, short-term interest rates--although volatile--moved down considerably over the course of 1981. In contrast, long-term rates

rose substantially over the period, despite declines in the last quarter of the year. The pressure on long-term rates appeared to reflect a combination of factors. Anticipations that continued large federal budget deficits would clash with private credit demands particularly as the economy expanded, putting strong pressures on credit markets, were a continuing strong investor concern. Despite reductions in the growth of many federal spending programs, federal borrowing in calendar year 1981 siphoned off roughly a quarter of the total funds available to domestic nonfinancial borrowers. In the background were continuing doubts and skepticism that anti-inflation programs would be carried through. Moreover, the volatility of the markets may have inhibited aggressive buying of longer-term securities.

The tensions in credit markets in 1981 had their greatest impact on business and household capital formation. Housing construction fell to its lowest level in the postwar period; only 1.1 million new housing units were started in 1981. The weakness in real estate markets last year reflected a number of influences. Of paramount importance, in the short run, was the cost of mortgage funds. The average rate on mortgages closed for new homes was 15.3 percent in the fourth quarter of 1981, up from 12.6 percent a year earlier. But it was not higher mortgage rates alone that cut into housing demand: high prices also adversely affected the ability of those seeking new homes to afford the monthly payments. Although house prices changed little in 1981, over the preceding 5 years prices of new and existing homes had risen half again as fast as the overall rate of inflation. As a result, the share of average family disposable income needed to service the monthly payment on a typical new mortgage rose from 21 percent in 1976 to nearly 40 percent last year.

Slow income growth and rising unemployment, along with the increased cost of credit, combined to damp consumer spending in 1981--particularly for more discretionary, large ticket items such as autos, furniture, and appliances. Since the mid-1970s, household real after-tax income has only been rising at a 1/2 percent annual rate, compared with a long-run trend of 2 percent. At the same time, the prices of essential items such as food, gasoline, heating fuel, utilities, and medical services--as a group--have been rising faster than the overall inflation rate, and the share of disposable income devoted to these items has been increasing. The resulting squeeze on family budgets led many households to overextend themselves during the last half of the 1970s, taking on more and more debt to finance their purchases.

With household balance sheets debt-laden and credit costs rising, a retrenchment in consumer borrowing began in 1980, and continued through 1981. As the year progressed, it appeared that household balance sheets were improving. Consumer debt burdens (the ratio of monthly debt repayment obligations to income) declined to their lowest level in more than five years. Moreover, partly in response to the higher after-tax income following the tax cut on October 1, the saving rate rose from about 5 percent in the first three quarters of 1981 to 6 percent in the fourth quarter.

In real terms, personal consumption expenditures rose 1-1/4 percent over the four quarters of 1981. The gain was concentrated in the early months of the year as real consumer spending fell, on balance, over the final three quarters of 1981. Purchases of new automobiles were hardest hit. Sales of domestically produced cars totaled 6.2 million units in 1981, the poorest performance in 20 years. The depressed conditions in the auto sector were related,

in part, to the typical cyclical volatility in the demand for motor vehicles and to credit market conditions, which affected the cost of financing new car and truck purchases. However, the current problems in the industry appear to be related mainly to longer-term trends in automotive demand. These include: the rapid increase in the price of new cars, high gasoline and other operating costs, sluggish real income growth, intense foreign competition, and government regulations that have necessitated large investments to comply with emission control standards and to improve fuel efficiency. As 1981 was ending, it appeared that the auto industry was taking aggressive actions to reduce costs and to improve the competitiveness of its products.

Business firms, like households, restrained their spending on investment goods in 1981. Demand was damped by a substantial degree of excess capacity and by the rising trend in corporate bond rates throughout much of the year, which boosted the real cost of capital. In real terms, expenditures for new plant and equipment rose only 1-1/2 percent over the four quarters of 1981. Although spending for new structures increased during the year, real equipment outlays fell for the second year in a row; the biggest declines were for electrical machinery and transportation equipment, while spending for most other capital goods remained weak.

In contrast to fixed investment outlays, sizable unintended inventory accumulation boosted business financing requirements. As the year went on, unexpectedly weak demand led to a build-up of excess stocks in several industries. The most pronounced problem was in autos, but other manufacturers and retailers also found their inventory levels uncomfortably high relative to sales. On balance, total nominal business capital spending--fixed investment and inventories--rose about 20 percent above the 1980 average.

Early in 1981, strong economic growth helped boost corporate internal funds, greatly reducing corporate needs for external financing. But as the economy slowed, corporate profits turned sluggish and businesses were forced to rely more heavily on credit markets to satisfy their rising capital needs. The bulk of business borrowing last year was in short-term markets, as most firms felt it best to defer making long-run commitments in the current financial environment. With the accumulation of additional short-term debt, however, corporate balance sheet positions deteriorated further, and the ratio of short-term to total debt of the nonfinancial corporate sector rose to a record high.

Real purchases of goods and services at all levels of government rose only moderately during 1981 as a sharp increase in purchases by the federal government was partly offset by curtailed spending at the state and local level. The rise in federal spending on goods and services reflected another large increase in defense purchases, while federal payroll reductions helped to contain increases in nondefense outlays. At the state and local level, real purchases fell 2 percent owing to a combination of the withdrawal of federal support for many activities, the continued impact of tax limitation measures, and the effects of a sluggish economy on tax revenues.

The weighted-average value of the dollar against major foreign currencies rose by nearly one-fourth during the period from January to August. The dollar eased somewhat in the last part of 1981, but at the end of the year still remained well above its year-earlier level. The improvement in the inflation outlook in the United States was a factor in the appreciation of the dollar. Moreover, at various times during the year changes in

the differential between interest rates on dollar assets and rates of return on foreign currency assets also had a noticeable impact on exchange rates.

Real exports of goods and services increased in the first quarter of 1981, in part because of strong GNP growth in one of our major trading partners, Canada. But for the next three quarters, real exports declined in response to a slowing of economic growth abroad and the effect of the appreciation of the dollar in 1980 and 1981. The volume of imports, other than oil, rose fairly steadily throughout the year. The current account, reflecting this weakened trade performance, shifted from a surplus in the first quarter to a deficit by the fourth quarter.

Employment grew at a moderate rate during the first three quarters of 1981 and the unemployment rate edged down. Job increases were strongest in the service and trade sectors. As economic activity began to contract in the autumn, the demand for labor fell sharply and the unemployment rate climbed to 8.8 percent in December--only fractionally below its postwar high. Layoffs in the durable goods and construction industries accounted for much of the drop in employment. As a result, the unemployment rate of adult men--who tend to be more heavily employed in these industries--jumped to a postwar record of 7.9 percent in December of 1981.

Labor productivity (output per hour worked) showed considerable fluctuation during 1981, reflecting the course of economic activity. Productivity rose at a 1-1/4 percent annual rate in the first three quarters of 1981. However, as often happens at the beginning of a cyclical downturn, output fell more than employment in the fourth quarter and productivity declined, offsetting the gains earlier in the year. Averaging across short-run cyclical

movements, productivity has shown little improvement in recent years, and thus has provided virtually no offset to the impact of rapidly rising compensation on unit labor costs.

Compensation and wage increases did decelerate during 1981--with continuing progress observed throughout the year. But the slowing was moderate, reflecting the basic inertia of the wage determination process, where many union contracts last three years or more and nonunion wage agreements usually are set annually. By the second half of 1981, however, some changes in those traditional wage-setting practices were under way in several important industries: management and workers alike began to reconsider planned wage adjustments, some expiring contracts were renegotiated well in advance of termination dates, and labor agreements at a number of firms were modified in an effort to ease cost pressures and to enable them to compete more effectively. These adjustments, coupled with the progress seen in reducing inflation during 1981, suggest that the nation's anti-inflation policies have set the stage for a sustained unwinding of wage and price increases.

The trend in inflation improved noticeably during 1981, and by year-end virtually all aggregate price indexes were advancing well below double-digit rates for the first time since 1978. The consumer price index rose 8.9 percent over the course of 1981, down from the nearly 13 percent average rate in 1979 and 1980. Important factors in the slowing of inflation were exceptionally favorable agricultural supplies and declines, after the first quarter, in world oil prices. Inflation in areas other than food and energy--particularly consumer commodities and capital equipment--also began to abate, although price pressures persisted in the consumer service sector, notably for medical

care. As the year progressed, surveys of consumer expectations suggested that the inflationary psychology, which had increasingly permeated many aspects of economic behavior in earlier years, appeared to be subsiding.

Section 2: The Growth of Money and Credit in 1981

The Board of Governors in its report to Congress last February indicated that the System intended to maintain restraint on the expansion of money and credit in 1981. The specific ranges chosen by the Federal Open Market Committee (FOMC) for the various monetary aggregates anticipated a deceleration in monetary growth that would encourage further improvement in price performance. Measured from the fourth quarter of 1980 to the fourth quarter of 1981, and abstracting from the effects on deposit structure of the authorization of NOW accounts nationwide, the ranges adopted were as follows: for M1-A, 3 to 5-1/2 percent; for M1-B, 3-1/2 to 6 percent; for M2, 6 to 9 percent; and for M3, 6-1/2 to 9-1/2 percent. The associated range for commercial bank credit was 6 to 9 percent.

In formulating its objectives for 1981, the FOMC knew that the growth rates of the narrow aggregates would be affected markedly by shifts into NOW accounts which for the first time became available on a nationwide basis in January. Transfers into NOW accounts, which are included in M1-B, from savings deposits and other asset holdings not included in M1 were expected to be particularly large in the early months of the year. Thus, in order to avoid confusion about the intent of policy and to facilitate comparisons with previous years, the objectives announced for M1-B abstracted from such shifts.¹ Even after accounting for such shifts, however, the FOMC anticipated that the growth rates of the various aggregates were likely to diverge more than usual, reflecting the rapid pace of institutional change in financial markets. The FOMC indicated that if M1-B growth (adjusted for shifts into new NOW accounts and other

1. The shift adjustments were estimated on the basis of survey evidence and were published regularly over the past year.

checkable deposits) was about in the middle of its annual range, the growth of M2 was likely to be in the upper part of its range, given the popularity of the nontransactions components of M2 that pay market-related interest rates. It also was noted that the relationship of M3 and bank credit to their respective ranges would be influenced importantly by the pattern of credit flows that would emerge, and particularly by whether financial conditions would be conducive for corporations to refinance short-term borrowing in the bond and equity markets.

It soon became apparent as 1981 unfolded that the behavior of the aggregates was turning out to be even more divergent than had been anticipated. Growth rates of the shift-adjusted narrow aggregates were low in the opening months of the year, a development that was welcome following rapid growth in the latter part of 1980. A strong surge in April was offset by weakness over the remainder of the second quarter. On the whole, average growth in adjusted M1-B over the first half of 1981 was well below that which would have been expected on the basis of historical relationships among money, GNP, and interest rates. On the other hand, despite the weakness in M1-B, the broader aggregates expanded quite rapidly in early 1981. M2 growth over the first half was near the upper end of its annual range, while the expansion of M3 placed this aggregate above the upper bound of its range at midyear.

After reassessing its objectives for 1981 at midyear, the FOMC elected to leave unchanged the previously established ranges for the aggregates over the remainder of the year. However, in light of the reduced growth in M1-type balances over the first half of the year, indications that this weakness might reflect a lasting change in cash management practices of

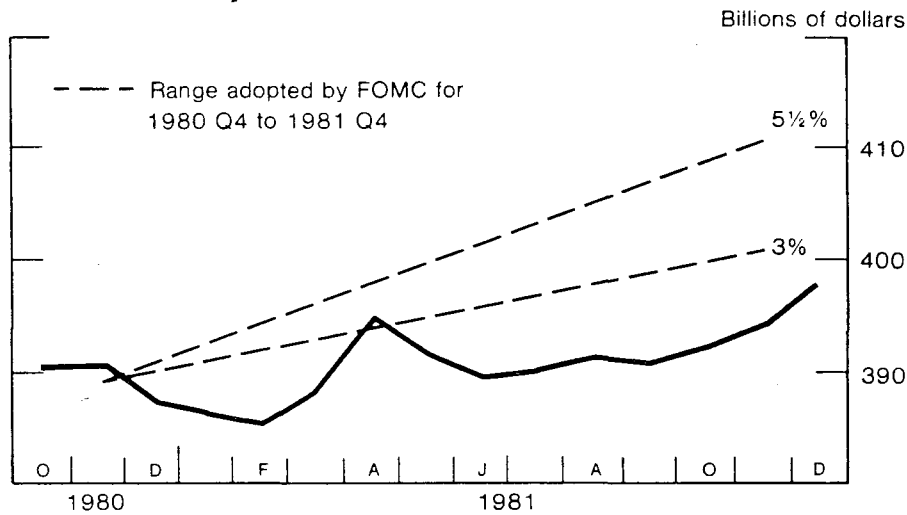
individuals and businesses related to the growth of alternative means of holding highly liquid funds, and given the relatively strong growth of the broader aggregates, the FOMC anticipated that growth of the narrow aggregates might likely and desirably end the year near the lower bounds of their annual ranges. Even so, given the sluggishness early in the year, this decision implied that growth of M1-A and M1-B would accelerate over the balance of the year. At the same time, the FOMC indicated that M2 and M3 might well end the year around the upper ends of their ranges. This expectation also reflected in part the possibility that regulatory and legislative actions as well as the popularity of money market mutual funds might intensify the public's preference to hold the type of assets encompassed in the broader aggregates.

Although growth of narrow money in the second half of the year was on average about the same as in the first half, M1-B strengthened appreciably in the final two months of the year. This acceleration appeared to reflect in part a lagged response to large short-term interest rate declines in the summer and fall and in part a shift in preferences for very liquid assets in an environment of heightened economic and financial uncertainty. Similarly, M2 growth in the second half was about in line with expansion in the first half, although growth in this measure also picked up at the end of the year. The expansion in M3, on the other hand, decelerated from the rapid pace of the first half, as sales of large CDs slowed in concert with a slackening in bank credit growth and stronger growth in core deposits.

Measuring growth for the year from the fourth quarter of 1980 to the fourth quarter of 1981, M1-B growth adjusted for shifts into NOW accounts was about 2-1/4 percent--1-1/4 percentage points below the lower end of its

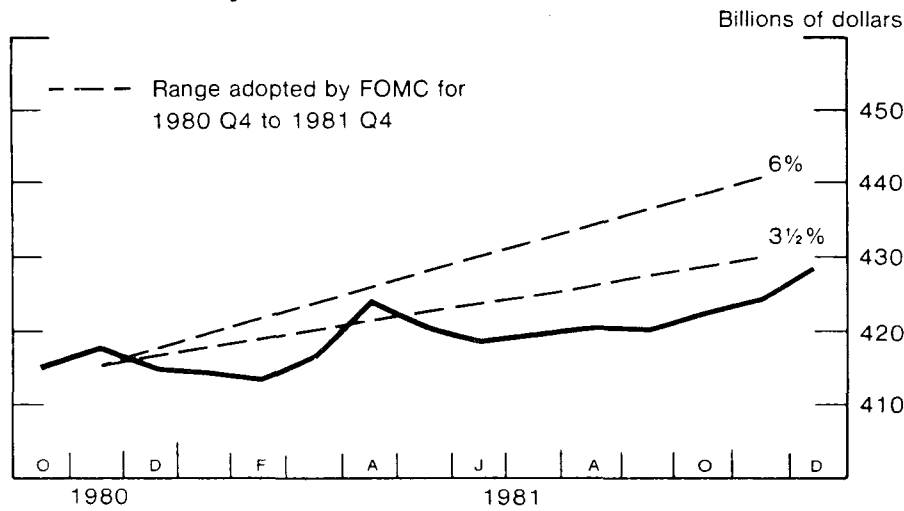
Growth Ranges and Actual Monetary Growth

M1-A Shift Adjusted *



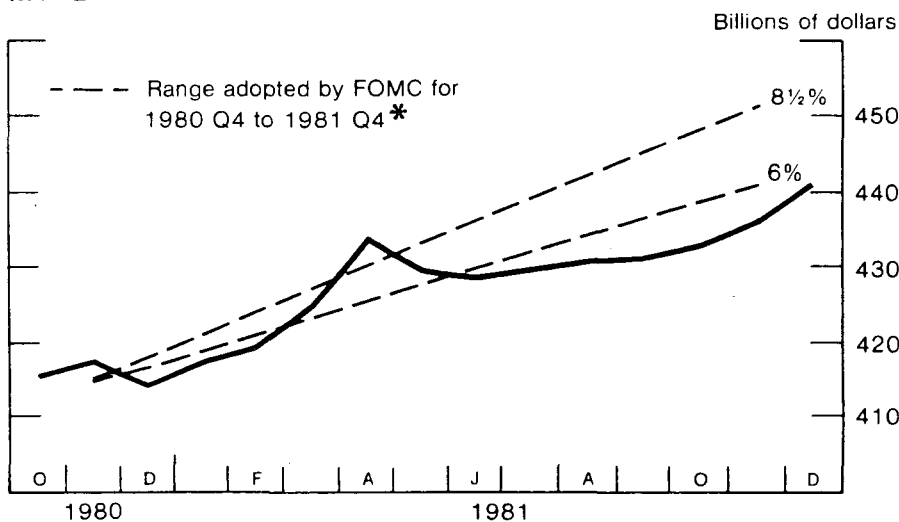
Annual Rate of Growth
 1980 Q4 to 1981 Q4
 1.3 Percent

M1-B Shift Adjusted *



Annual Rate of Growth
 1980 Q4 to 1981 Q4
 2.3 Percent

M1-B

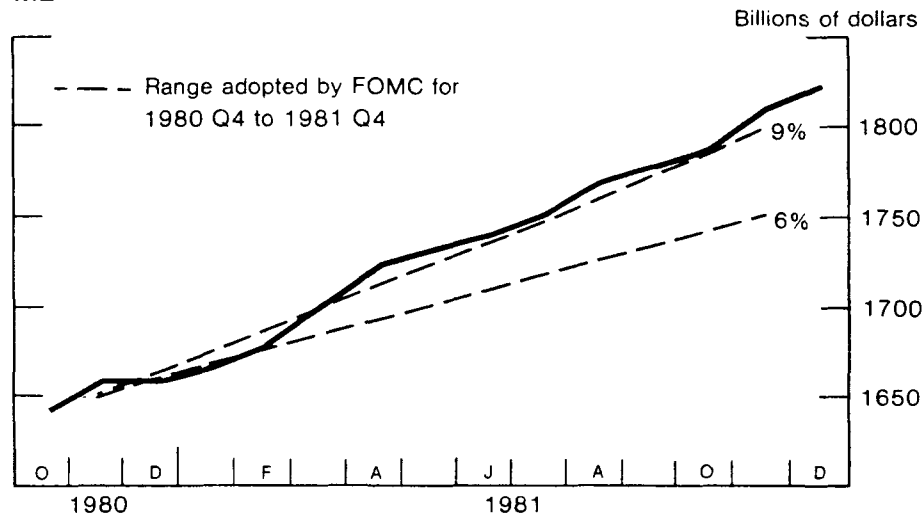


Annual Rate of Growth
 1980 Q4 to 1981 Q4
 5.0 Percent

* Adjusted for impact of nationwide NOW accounts.

Growth Ranges and Actual Monetary and Bank Credit Growth

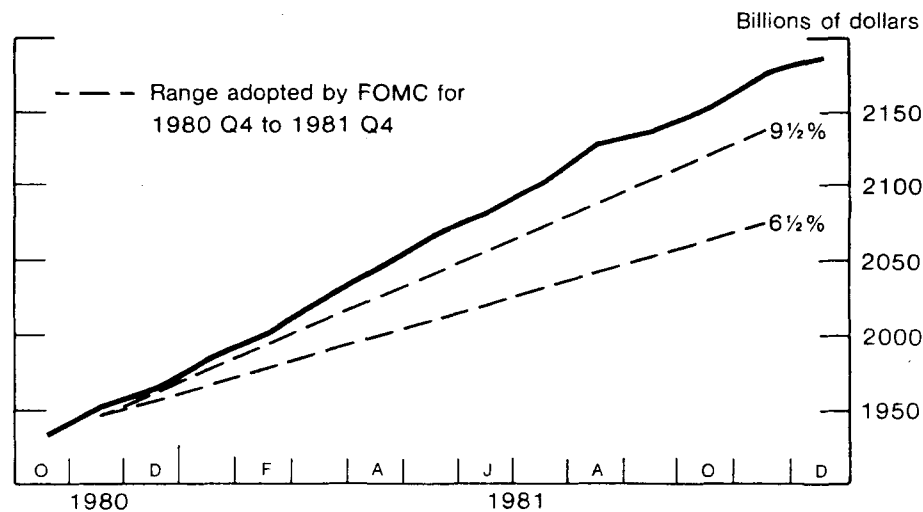
M2



Annual Rate of Growth

1980 Q4 to 1981 Q4
9.4 Percent

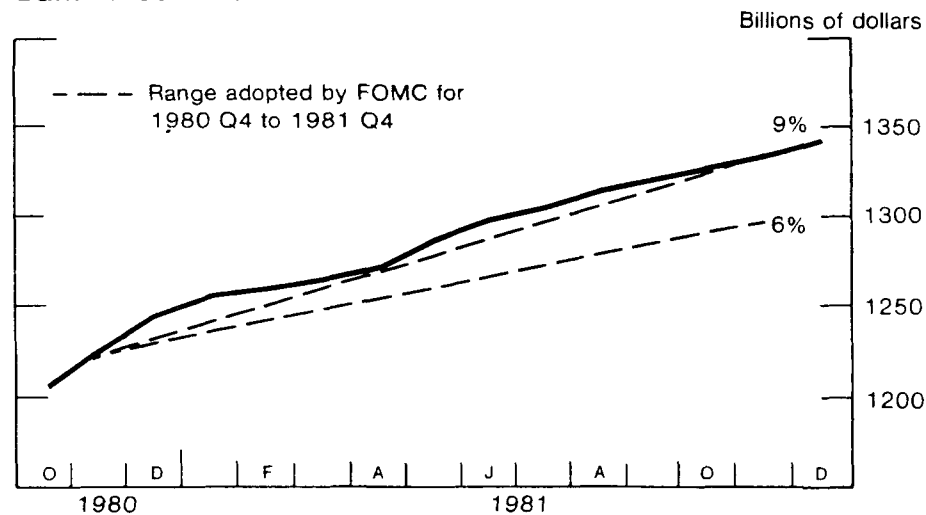
M3



Annual Rate of Growth

1980 Q4 to 1981 Q4
11.4 Percent

Bank Credit *



Annual Rate of Growth

1980 Q4 to 1981 Q4
8.8 Percent

* Data prior to February are adjusted for discontinuity in series. December figure is adjusted for shift of assets into International Banking Facilities.

targeted range.¹ Growth rates, of course, are affected by the particular pattern of variation that develops over the course of the year. Measuring expansion from December to December, "adjusted" M1-B growth in 1981 was at a 3-1/2 percent rate. On a yearly average basis, which reflects movements through the year as a whole relative to the level of the previous year, the increase was at a 4-3/4 percent rate. At the same time, measured from the fourth quarter of 1980 to the fourth quarter of 1981, growth of M2 was 9.4 percent, 0.4 percentage point above the upper limit of its range. Also, growth of M3 exceeded the upper end of its range by 1.9 percentage points, while bank credit growth was just inside the upper end of its annual range.

The table on page 14 puts the performance of the aggregates during 1981 into a somewhat longer-term perspective, showing two measures of annual growth. No matter which of the measures of annual growth is used, a marked deceleration in M1-B is apparent since 1978. The table also clearly illustrates that growth rates for the broader aggregates have been maintained around a higher level, and larger divergences have developed from M1-B growth. In considerable part, these differences can be explained by structural changes in financial markets.

As noted earlier, it was already obvious last February when the FOMC was meeting to set its objectives for 1981 that shifts into NOW accounts following their nationwide authorization at the beginning of 1981 would alter the behavior of the narrow aggregates. Data for early January had pointed to a very large movement of funds at the beginning of the year. However,

1. Unadjusted for shifts into NOW accounts, M1-B increased 5.0 percent from the fourth quarter of 1980 to the fourth quarter of 1981.

Growth of Money and Bank Credit
(percentage changes)

	M1-B ¹	M-2	M-3	Bank Credit ²
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	11.4	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	9.7	11.5	9.4

1. Growth rates for 1980 and 1981 adjusted for shifts to other checkable deposit accounts since the end of the preceding year.
2. 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.

the pattern and magnitude of subsequent movements could not be predicted with any certainty. As events unfolded, the shifts into NOW accounts were more concentrated in the early part of 1981 than was anticipated by the working assumptions of the Board's staff. Through June, the adjustments made to the aggregates to correct for such shifts had the effect of raising M1-A by \$28 billion and lowering M1-B by \$9-1/2 billion. Over the second half of 1981, further adjustments for shifts into NOW accounts raised M1-A by only another \$6 billion and lowered M1-B by about \$2-1/2 billion more. While these adjustments are imprecise and based on evidence from a variety of sources, data on the number of NOW accounts coupled with other available information confirm that the shifting of funds from demand deposits to new interest-bearing checking accounts tapered off considerably by the fall. A surge in NOW account balances near the end of the year and early in 1982 appeared to reflect primarily the precautionary savings behavior noted above rather than shifting of funds into new accounts.

As was indicated above, the growth of the narrow aggregates adjusted for shifts into NOW accounts was low in 1981 compared with the other aggregates and also relative to past relationships with income and interest rates. Continued high interest rates provided a substantial incentive for businesses to intensify efforts to pare narrow money balances and to make increasingly widespread use of sophisticated cash management techniques. At the same time, explosive growth of money market mutual funds (MMMFs), many of which offer check-writing or other third party payment services comparable to conventional checking accounts, appeared to induce some households to minimize checking account balances. Also, the broader availability of NOW accounts

may have stimulated households to reconsider in a more general way their habits of cash management.

Likewise, the strong growth of M2 over the past few years reflected changing financial practices. Money market funds and instruments offered by depository institutions that pay market-related interest rates have been accounting for an increasing proportion of M2, as such assets have become much more competitive with open market instruments. Indeed, the attractiveness of small time deposits was enhanced last year by the liberalization of the interest rate ceilings on small savers certificates and to a limited extent by the introduction of all savers certificates. Even so, three-fourths of the increase in the nontransactions components of M2 was accounted for by MMMFs which grew 140 percent last year.

The distortions in the aggregates resulting from the expansion in MMMFs are difficult to quantify. Surveys of household behavior and data on account turnover suggest that most shareholders of money funds have made little or no use of their accounts for transactions purposes. Thus, the direct substitution effect of MMMFs on the growth of M1 has appeared small, perhaps on the order of 1 percentage point on the rate of growth for the year. However, indirect effects may have been larger as the potential availability of such a highly liquid asset may facilitate holding less funds in demand and NOW accounts.

The direct effect of MMMFs on M2 appears more substantial in dollar terms. Presumably, the great bulk of the \$20 billion inflow in 1981 to MMMFs catering only to institutional investors was funds that otherwise would have been invested in assets not included in M2. In addition, it seems likely

that a small portion of the \$90 billion growth in other types of MMMFs also reflected diversions from assets not in M2.

In light of the sizable distortions created by the growth of institution-only MMMFs, M2 has been revised to exclude such funds but they will continue to be a component of M3. In addition, M2 has been revised to include retail RPs. Retail RPs, which previously had been a component only of M3, were promoted on a substantial scale in 1981, likely attracting funds mainly from household small time deposits and MMMF holdings and thus resulting in a downward bias on M2 growth. The net effect on M2 growth of reclassifying institution-only MMMFs and retail RPs, along with other minor revisions, was small.

M3 increased more rapidly than M2 last year largely because of the substantial expansion in large CDs, particularly over the first half of the year. With growth of core deposits weak on balance over the year, depository institutions increased their managed liabilities to support expansion in loans and investments.

Bank credit growth accelerated somewhat in 1981 but stayed just within the upper end of its annual target range. The pick-up in bank credit growth was concentrated in business loans. Growth in this category was bolstered by the high level of corporate bond rates through most of the year, which tended to focus business credit demands on short-term borrowing such as bank loans and commercial paper. Although merger activity contributed significantly to the growth of loan commitments over the year, actual takedowns for this purpose influenced loan growth only slightly. Real estate loans at banks in 1981 grew at about the same moderate pace as in the prior year, while

consumer lending strengthened a little from 1980. Security holdings at banks grew somewhat more slowly than loans in 1981.

The bank credit data in December were affected by the shifting of assets to accounts in the newly authorized International Banking Facilities (IBFs). It is estimated that about \$22 billion of loans to foreign customers were shifted from U.S. offices to IBFs in December. The data presented in this report are adjusted for this shift. Without this adjustment, the increase in bank credit from the fourth quarter of 1980 to the fourth quarter of 1981 was 8-1/4 percent, one-half percentage point less than shown by the adjusted data.

Broader measures of credit flows reflected the slowing pace of production and income in 1981 and the effects of high interest rates. Households and businesses continued to increase their borrowing over the first three quarters, but their use of credit contracted in the fourth quarter in response to the weakening of the economy. In view of the high level of long-term interest rates during most of 1981, virtually all of the increase in funds raised was in short-term debt instruments. Overall, net funds raised by nonfinancial sectors rose 7 percent in 1981 and continued to fall relative to GNP for the third consecutive year.

Section 3: The Federal Reserve's Objectives for the Growth of Money and Credit

The Federal Reserve remains committed to restraint on the growth of money and credit in order to exert continuing downward pressure on the rate of inflation. Such a policy is essential if the groundwork is to be laid for sustained economic expansion.

There was a distinct slowing of inflation during 1981, and the prospects for further progress are good. Failure to persist in the effort to maintain the improvement would have long-lasting and damaging consequences. Once again, underlying expectations would deteriorate, with potentially adverse effects on financial markets, particularly long-term rates. The result would be to embed inflation even more deeply into the nation's economic system--with the attendant debilitating consequences for the performance of the economy. A failure to continue on the current path would mean that the next effort would be associated with still greater hardship.

Progress toward price stability can be achieved most effectively and with the least amount of economic disruption by the concerted application of monetary, fiscal, regulatory and other economic policies. But it is quite clear that inflation cannot persist over an extended period unless financed by excessive growth of money. Thus, a policy of restraint on the growth of the monetary aggregates is a key element in an anti-inflation strategy.

Targets for the monetary aggregates have been set with the aim of slowing the expansion of money over time to rates consistent with the needs of an economy growing in line with its productive potential at reasonably stable prices. The speed with which the trend of monetary growth can be lowered without unduly disturbing effects on short-run economic performance depends, in part, on the credibility of anti-inflation policies and their

effects on price expectations as well as on other forces influencing interest rates and credit market demands, including importantly the fiscal position of the federal government. More technically, financial innovation or other factors affecting the demand for specific forms of money need to be monitored.

In its deliberations concerning the target ranges for 1982, the Committee recognized that the recent rapid increase in M1 placed the measure in January well above the average level during the fourth quarter of 1981, the conventional base for the new target. Experience has shown that, from time to time, M1 growth can fluctuate rather sharply over short periods, and these movements may be at least partially reversed fairly quickly. The available analysis suggested that the recent increase reflected in part some temporary factors of that kind, rather than signalling a basic change in the amount of money needed to finance nominal GNP growth.

In the light of all these considerations, the FOMC reaffirmed the following ranges of monetary expansion--tentatively set out in mid-1981--for the year ending in the fourth quarter of 1982: for M1, 2-1/2 to 5-1/2 percent; for M2, 6 to 9 percent, and for M3, 6-1/2 to 9-1/2 percent.¹ The FOMC also adopted a corresponding range of 6 to 9 percent for commercial bank credit. These ranges are the same as those agreed to in July and reaffirm the

1. The objective for growth of narrowly defined money over 1982 is set in terms of M1 only. Last February, when the FOMC set its targets for narrow money, it was recognized that regulatory changes allowing for the establishment of nationwide NOW accounts would distort the observed behavior of M1-A and M1-B. Accordingly, the targets were set on a basis that abstracted from the shifting of funds into interest-bearing checkable deposits. Based on a variety of evidence suggesting that the bulk of the shift to NOW accounts had occurred by late 1981, the Federal Reserve reaffirmed in December its previously announced intention that starting in January 1982 shift adjustments would no longer be published and only a single M1 figure would be released with the same coverage as M1-B.

Federal Reserve's commitment to reduce inflationary forces. As has been typical in the past, these changes are measured from actual fourth quarter levels from the previous year.¹

During 1981, M1-B (shift-adjusted) rose relatively slowly in relation to nominal GNP.² On the assumption that the relationship between growth of M1 and the rise of nominal GNP is likely to be more normal in 1982, and given the relatively low base for the M1-B range, the Committee contemplated that growth in M1 this year may well be in the upper part of its range. At the same time, the FOMC elected to retain the 2-1/2 percent lower bound for M1 growth tentatively set last July in recognition of the possibility that financial innovations--especially techniques for economizing on the use of checking account balances included in M1--could accelerate, with restraining effects on M1 growth.

The actual and potential effects on M1 of ongoing changes in financial technology and the greater availability of a wide variety of money-like instruments and near-monies strongly suggest the need for also giving careful attention to developments with respect to broader money measures in the implementation of monetary policy. The range for M2 growth is the same as in 1981 when actual growth slightly exceeded the upper bound of the range. The Committee contemplated that M2 growth in 1982 would be somewhat below the 1981

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

2. M1-B velocity, before shift adjustment, rose at a rate closer to historical experience. However, the shift of funds from savings accounts or other sources of funds not included in measures of the narrow money supply temporarily depressed that velocity figure, particularly early in the year.

pace, although probably in the upper part of the range. However, should personal saving, responding to recent changes in tax law or other influences, grow substantially more rapidly in relation to income than now anticipated, or should depository institutions attract an exceptionally large inflow to IRA accounts from sources outside measured M2, growth of M2 might appropriately reach--or even slightly exceed--the upper end of the range. The ability of depository institutions to compete for the public's savings will, of course, also be affected in part by deregulatory decisions that may be made by the Depository Institutions Deregulation Committee.

The 1982 ranges for M3 and bank credit were left unchanged from those for 1981. These aggregates again will be influenced importantly by the degree to which credit demands tend to be focused on short-term borrowing and are funded at home or abroad.

Section 4: The Outlook for the Economy in 1982

Economic activity still appears to be contracting; industrial production and employment certainly declined further in January, with the extent of the fall worsened by exceptionally bad winter storms. Demand in the key sectors that had led the decline--housing and consumer spending--showed some signs of leveling off as the year began, and the recent cuts in production likely have helped to relieve some of the remaining inventory imbalances. Recent weather-related disruptions may affect the incoming data for a time, but it would appear that the economy is in the process of bottoming out, and a perceptible recovery in business activity seems likely before midyear.

One element supporting final demands in the economy is the federal government. Part of the recent expansion in the deficit reflects the cushioning effects of reduced taxes and increased government expenditures that result from declining income growth and rising unemployment. In addition, however, the build-up in defense spending is a continuing source of stimulus. The second phase of the tax reductions that occurs in July will provide another expansionary impetus to the economy. At the same time, the deficit--particularly if expected to continue at exceptionally high levels in later years--adversely influences current financial market conditions.

The Federal Reserve's objectives for money growth in 1982 are consistent with recovery in economic activity. The expansion is likely to be concentrated initially in consumer spending. Given the substantial margin of excess capacity, outlays for business fixed investment may remain weak, particularly if long-term interest rates continue to fluctuate near their current high levels. A continuation of high levels of long-term rates also

would inhibit the recovery in residential housing, although demographic factors will continue to buttress demands in that sector.

The effort to deal with inflation is at a critical juncture. The upward trend in inflation clearly has been halted and the process of reversal is underway. There are signs that price setting, wage bargaining, and personal spending decisions are beginning to be made that over time will serve to moderate, rather than intensify, inflationary pressures. Nonetheless, the behavior of financial markets and other evidence strongly suggests that there continues to be considerable skepticism that progress in reducing inflation will be maintained. Lasting improvement in financial markets--particularly for longer-term instruments--is dependent on confidence that progress against inflation will continue; looming federal deficits have served to shake that confidence. Prospects for lower interest rates and for sustaining recovery over a long period--indeed for the timing of recovery--are thus tied to prospects for a more stable price level.

How we emerge from the current recession will be crucial to further curtailing inflation. The recovery phases that have followed recent recessions have sometimes been associated with an acceleration of inflation. However, if monetary and fiscal policies are appropriately disciplined, this pattern need not recur; and recovery from the current recession will be consistent with further progress towards achieving sustainable growth, price stability, and lower levels of interest rates.

Given the current circumstances and in light of the monetary aggregate objectives for the coming year, the individual members of the FOMC have formulated projections for economic performance in 1982 that generally fall

within the ranges indicated in the table below. The members of the FOMC expect inflation to continue to moderate in 1982. At the same time, real activity is expected to accelerate with most of the growth coming in the second half of the year. With inflation continuing to be substantial and the prospect of the federal budget deficit remaining large even as the recovery gathers momentum, demands for credit should intensify as the year progresses. In these circumstances, the recovery is likely to be somewhat restrained, with the result that unemployment probably still will be substantial at year-end.

Economic Projections for 1982

	Actual 1981	Projected 1982	
		FOMC members	Administration
Changes, fourth quarter to fourth quarter, percent			
Nominal GNP	9.3	8 to 10-1/2	10.4
Real GNP	0.7	1/2 to 3	3.0
GNP deflator	8.6	6-1/2 to 7-3/4	7.2
Average level in the fourth quarter, percent			
Unemployment Rate	8.3	8-1/4 to 9-1/2	8.4

The FOMC member's projections generally encompass those that underlie the Administration's recent budget proposals. The consensus view of the FOMC anticipates an improvement in inflation during 1982 comparable with the Administration's as well as a similar outlook for the labor market. The

Administration's projection for real growth falls at the high end of the FOMC consensus. If, in the event, prices and wages should respond more rapidly to anti-inflation policies than historical experience would suggest or should more favorable productivity trends develop, then the recovery could be faster without adverse pressures developing on prices, wages, and interest rates.