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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance, and Urban Affairs

House of Representatives

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I welcome the opportunity to meet again with this Committee to discuss the objectives and conduct of monetary policy. The Federal Reserve's official monetary policy report to Congress was submitted in February. Given the extensive nature of that report, my earlier testimony before the Senate Banking Committee, and your request to be brief, my comments today will be limited largely to updating the previous report.

When the Federal Open Market Committee was considering its annual growth ranges for money and credit in early February, incoming economic data were suggesting that a recovery was probably beginning. Price data had for some time been showing an encouraging drop in inflation, and a significant downward adjustment in petroleum prices appeared highly likely. The general view of the FOMC was that a moderate expansion in activity was likely this year and that this upturn would be consistent with continuing progress against inflation.

Subsequent developments have been consistent with that outlook. The pace of recovery has been uneven from month to month, but this is not out of the ordinary and production, employment, and spending all have moved up significantly. The size of the pickup in home building has been especially notable, coming as it has in the context of mortgage rates that are still high by historical standards. Inventory liquidation, which took place at a high rate in late 1982 and in January, appears to be subsiding, providing short-term impetus to activity.

The major sector that is continuing to lag is business capital spending, and exports remain depressed. Sluggish capital spending is not unusual during the early stages of an upturn, and exports are reflecting in part relatively slow economic performance abroad. But developments in those sectors also emphasize the remaining risks and uncertainties in the medium-term outlook, related in substantial part to the actual and potential pressures on interest rates and financial and foreign exchange markets growing out of the prospects for continuing huge Federal deficits and remaining inflationary concerns.

Currently, price performance has, if anything, been better than anticipated. Consumer prices were essentially unchanged between December and February, while producer prices declined about 1 percent over that period. I recognize that declines in energy prices have been a major factor in this recent price behavior, and the data clearly overstate the progress that has been made in reducing the underlying trend of inflation. But in recent quarters wage increases overall have moderated further to annual rates of four to five percent, providing, together with increases in productivity, a base for further slowing in unit labor costs.

At the same time, however, it is a troubling fact that a few recent wage settlements seem widely out of keeping with recent favorable price trends. Special considerations apparently influenced those settlements, but a tendency toward generalization

of cost-increasing wage bargains would clearly impair longer-term inflationary prospects and ultimately the sustainability of recovery.

The simple fact is that we have come a long way in setting the stage for non-inflationary expansion in which unemployment will decline and workers can again enjoy lasting increases in real income. But that process needs to be nurtured with care and discipline.

In no area is that discipline required more than in the Federal budgetary process. I take encouragement from the successful effort to reach a compromise on the Social Security legislation, helping to re-establish the financial viability of that system. But that is only a small step toward dealing with the structural budget deficit that looms ahead. The coming weeks will be critical to that effort, and your decisions are bound to have a large bearing on the outlook for interest rates

Our monetary targets for the year were set out in detail in my earlier statements. As indicated earlier, after a period of considerable institutional and other distortions in monetary relationships, those objectives will be reviewed as necessary in the light of all the evidence about the relationships between money and credit growth, on the one hand, and economic activity and inflation, on the other. Deposit flows in response to the advent of the money market deposit and Super NOW accounts have been massive. As expected, these inflows have had a major impact on the growth rates of some of the aggregates -- particularly M2

More broadly, for much of 1982, and continuing into 1983, movements in "velocity" have deviated significantly from past patterns. Necessarily in these circumstances, we have put a greater premium on judgment and less on "automaticity" in our operational decisions in responding to movements in the aggregates in recent months.

Starting with the broadest monetary aggregate, M3 growth appears to have been relatively little affected by the new instruments, as banks and thrifts responded to the stronger inflows into the new accounts included in M2 by running off a portion of their large CDs. In addition, declines in the money fund component that is included only in M3 also have offset part of the strength in M2 balances. Taking account of somewhat slower growth in March, its current level is very near the upper end of the FOMC's 6-1/2 to 9-1/2 percent annual range.

M2 has been most distorted by the impact of the new accounts. Precise calculation of the amount of funds diverted into that aggregate from assets not included in M2 is simply not feasible, and for that reason the target range set in February for that aggregate pertains to the period after the first quarter, by which time the distortions are expected to abate. Based upon what estimates of shifting are available, underlying M2 growth appeared to have been fairly strong for the first two months of the year, but some slowing seems to have developed in March.

Looking ahead, the annual growth range for actual M2 of 7 to 10 percent measured from the average of February and March still appears reasonable. That range allows for some limited residual shifting over the remainder of the year.

The impact of the new accounts on M1 also has been difficult to assess, but, in recent months, probably has been largely offsetting. Obviously, M1 has been growing at a rate substantially above that implied by the annual 4 to 8 percent target, and faster relative to GNP than would be suggested by past relationships. To some extent -- but it cannot be measured with any degree of certainty -- the decreases in "velocity" may reflect the changing nature of M1; with interest-bearing NOW and super NOW accounts making up an increasingly large proportion of M1, this aggregate may be influenced by "savings" behavior as well as by "transactions" motives. That is a longer term factor, and the growth in M1 over the shorter run may have been affected by the reduced level of market interest rates -- particularly relative to interest-bearing NOW accounts -- and slowing inflation, as well. The range of uncertainty on these points is substantial, and has led the Federal Open Market Committee to place less emphasis on M1 in its implementation of policy over the short term. Nonetheless, prolonged growth at high levels, particularly if the increases are spread among its various components, would be a cause for concern.

The Committee also decided to take explicit account of the growth of total credit in judging the appropriate rate of monetary expansion. While full data are not yet available for the first quarter, preliminary indications are that the aggregate debt of domestic nonfinancial sectors grew well within the 8-1/2 to 11-1/2 percent range projected by the FOMC. Within the total, Federal borrowing remains particularly strong, accounting for around 45 percent of the growth. Maintenance of growth in Federal borrowing at that proportion of the total would be without parallel in peacetime. For the time being, nonfinancial corporate borrowing has been moderate, largely reflecting reduced needs for external financing of inventory and capital investment. But, with the budget deficit projected to fluctuate around recent rates, an obvious question arises as to the capacity of the credit markets to absorb a resurgence of private credit demands as the recovery gathers momentum.

Taking account of credit as well as monetary behavior, and some indications that the burst of growth in at least the broader monetary aggregates may be subsiding, we believe our policy posture has been broadly consistent with the specific objectives we set out in February. Obviously, that implies an expectation that monetary growth will subside in the coming months, particularly for M2 and M1.

The larger question concerns the development of economic activity and prices during 1983 and beyond. The FOMC has presented the estimates of its members for GNP growth, inflation,

and other variables for 1983; while those estimates are now two months old, my sense is that the general contour anticipated today would be similar, perhaps, given recent data, with a bit stronger growth and less inflation. Those estimates, given the range of uncertainty in any forecast, are not out of keeping with the assumptions of the Administration and the Congressional Budget Office.

Mr. Chairman, you have requested some comment or response to the "sense of Congress" provision included in the House version of the first Budget Resolution pointing toward the Federal Reserve establishing numerical "objectives" with respect to certain key economic variables over several years ahead. The Board and the FOMC of course share the common objective of contributing -- insofar as monetary policy can -- to a growing, fully employed economy in a framework of reasonable price and financial stability. I would emphasize my belief that the "stability" objective is an essential complement of the "growth" objective over any reasonable period of time. But we are also very conscious of the limitations on monetary policy alone in achieving and reconciling those goals.

We now provide relatively short-term projections or forecasts of several economic variables -- comparable to the "assumptions" made for purposes of forecasting the budget outcome. Those Federal Reserve projections already provide a means of assessing the budget forecasts in the light of our assumptions as to economic activity. While I am not certain of the intent, the proposed Budget Resolution language

seems to suggest something more -- that the Federal Reserve agree upon some combination of growth, inflation, and unemployment as a kind of ideal path toward longer-run objectives and attempt to manipulate monetary policy to stay on that particular path.

The possible implications of that approach need consideration. I believe economic analysis strongly suggests that monetary policy over longer periods is particularly relevant for prices, and that, in any direct or short-term sense, the division between real and nominal GNP growth is not susceptible to monetary manipulation. To suggest otherwise -- by requiring the Federal Reserve to establish short-term "objectives" for a variety of nominal and real variables -- would be to encourage a degree of "fine tuning," and indeed over-reaction to current deviations from trend, that could well be counter-productive in terms of our (and your) basic continuing goals.

Moreover, experience amply demonstrates that economic conditions for even relatively short periods of a year or so cannot be forecast or estimated with the precision suggested by "point" forecasts. I am concerned that attempts by the Federal Reserve to express "objectives" in precise statistical terms year by year would encourage a false belief in the controllability -- certainly by monetary policy alone -- of an enormously complicated economy subject to a variety of strong forces, internal and external. Obviously, we do need to be concerned with whether the economy is developing reasonably satisfactorily in terms of our continuing long-run objectives -- and consider whether policy adjustments are desirable. But there is more than one pattern

consistent with the longer-run basic objectives. Our policy judgments depend upon assessments of the composition of the nominal GNP between real growth and inflation, the implications of short-term deviations from anticipated trends, the source of the "disturbances," and other factors that need to be weighed, one against another. None of this can easily, or at all, be captured by a limited series of statistical macroeconomic objectives at one point in time, and I believe the end result of the effort would be misleading to the Congress and the public.

I realize that, in a world that has been characterized by a great deal of economic uncertainty and interest rate instability, there is an understandable desire to, in a sense, "pin down" monetary policy in a way that can reduce the uncertainties about our economic future. The relevant question is how best to approach that end in a way that is truly productive and would encourage confidence, while retaining necessary flexibility. And, in that connection, I believe it is especially important in the case of monetary policy to approach the question in a way that will maintain an appropriate longer-term perspective, looking beyond the passing pressures of the day. Certainly, there should be no misconception that, in approaching our long-range objectives, monetary policy can relieve the need for difficult choices on the budget and other areas of economic policy.

All this is a large subject of fundamental significance for the formulation and implementation of monetary policy. It should be carefully and deliberately considered and debated before this Committee and other appropriate forums. I would urge that any proposed legislation in this area be taken up in that framework.