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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Policy

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

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I am pleased to have this opportunity to discuss issues bearing on the coordination of monetary and fiscal policies and on the request to this Committee, contained in the First Budget Resolution, to frame a sense of the Congress resolution with respect to appropriate information bearing on the assumptions and goals of monetary policy. Chairman Garn has also requested a review of how the Federal Reserve formulates monetary policy and the types of assumptions or goals that are used in policy formulation.

Broadly stated, the goals of all our general economic policies are clear enough -- we all want to see sustained economic growth, high levels of employment, and price stability. Those general economic objectives are basic to the formulation of monetary or other policies. But, as you know, we cannot always reach all those goals in the short run or continuously, and monetary policy, by itself, cannot satisfy all of them even over time.

Fiscal, regulatory, and other policies of the government and wage and price policies in the private sector all affect economic activity, prices, productivity, and the rate of economic growth, and particularly bear upon our ability to reconcile our several goals. Moreover, the domestic economy has come to be influenced more and more by external developments. The oil price shocks are only the most obvious example. The recent problems with major debtor countries, exchange rate

behavior, and economic growth in other countries, as it affects demand for our exports, all have influences on our economy in one degree or another, frequently in ways that cannot be fully, or at all, compensated for by monetary policy.

But the Federal Reserve does need to take account of these kinds of developments at home and abroad as it formulates policy, and they could affect prospects for achieving the basic economic goals of economic activity, prices, and employment within a given time frame. The fiscal policy of the Federal Government is one of the most important of those factors, but not the only one.

The Formulation of Monetary Policy

Monetary policy is reflected mainly in decisions by the Board of Governors on the discount rate and by the Federal Open Market Committee, which normally meets eight times a year, about open market operations. The members of the Board and the Committee regularly receive a wide variety of economic and financial information about the economy in preparation for these decisions. The great bulk of that information consists of publicly available statistics, surveys, and reports, but the material is also analyzed' and summarized by staff at the Board, in written documents as well as oral presentations. The staff often presents forecasts for several quarters ahead, based on a combination of econometric and judgmental techniques. Alternative forecasts may be set forth, depending upon different policy assumptions, and areas of uncertainty are emphasized. Individual members of the FOMC will also have available to them analyses and forecasts prepared at

the different Federal Reserve Banks.

At meetings of the FOMC, Committee staff also usually sets forth, for purposes of discussion, alternative approaches that might be considered by the Committee in its formulation of policy decisions. This material attempts to set out the implications of possible approaches, including alternative monetary and credit targets for a year ahead, as well as an evaluation of alternative short-run approaches to attainment of such targets. These analyses suggest the direction of possible impacts on market developments, recognizing those developments may be dominated by other factors including, over time, budgetary decisions. The FOMC also reviews closely recent developments in domestic and international financial markets and the implementation of Federal Reserve operations since the last meeting.

Policy discussions center on the members' own assessments of the economic and financial outlook, and their view of its implications for the formulation of policy.

Underlying these discussions, there is common acceptance of the broad goals I stated at the start, which are, of course, incorporated in law. At the same time, individual members may well have different points of concern or emphasis in the short run, they may disagree about the outlook, and they bring to the table different conceptual or analytic emphases. For instance, some members will tend to put more weight on particular money supply developments, while others will put more stress on the developing conditions in credit markets. I believe all members consistently

recognize the need to consider the implications of current policy over a considerable period of time, but, in particular situations, there will be differences as to the relative weights put on short or longer-run factors, or on price, growth, or other objectives. (I have attached in this respect records of discussion for two recent meetings. These policy records, which are released to the public about seven weeks or so after each meeting, indicate the range of economic and financial variables that are taken into account in the formulation of policy.)

These differences in approach are natural to a degree in a committee structure made up of independently appointed officials. In the end, the differences have to be reconciled in a specific operational decision. But the differences in emphasis and assumptions about the economic outlook that lie behind the decision are one reason why we have felt it more constructive to provide the Congress, in our semi-annual reports, with a range of assumptions about economic variables rather than a simple "objective" about which, in the short run at least, any consensus might well be artificial.

When setting a course for monetary policy, the Committee members take the government's fiscal policy basically as a "given." There is often, of course, a degree of uncertainty about the likely budgetary developments, particularly in the period before a budget resolution is adopted and implemented. Looking several years ahead, the uncertainties increase.

Typically, however, the dimensions of the budget can be approximated well enough to provide a reasonable basis for assessing the direction of its impact on overall economic performance and credit market conditions.

As you know, the FOMC expresses its policy intentions over time, as required by the Humphrey-Hawkins Act, in terms of monetary and credit targets. Those annual targets are expressed in ranges and attention is paid to several measures, rather than a single statistical definition of money or credit. The use of ranges rather than "point" targets reflects in part the impracticality -- and many would argue the undesirability -- of controlling monetary growth precisely. More broadly, the ranges, and the related judgment about which target or targets are more significant at particular times, provide an element of, to me appropriate, flexibility in the face of shifts in relationships of the aggregates to the economy or other unforeseen developments. The Committee can, of course, change targeted growth ranges (as was the case in July with respect to the M1 ranges) if deemed necessary or desirable in the light of events. But I believe there is, and should be, a presumption that such changes will be made only in the light of highly persuasive evidence.

The results of the FOMC's deliberations about longer-run money and credit targets, and the associated economic outlook, are presented to the Congress twice a year in the Board's "Monetary Policy Report Pursuant to the Full Employment and Balanced Growth Act of 1978." In that report, we currently provide the Congress with annual ranges of growth for M2, M3, M1, and total credit.

In addition, the Congress is given associated economic projections covering the same period for nominal GNP, real GNP, the implicit price deflator, and the unemployment rate.

In February these monetary ranges and associated economic projections are shown only for the current year. In July, the monetary ranges and projections are shown for the current year and the ensuing year.

The associated projections are shown in a range sufficient generally to encompass all Committee members, and -- beginning this year -- also for a much narrower range (labelled the "central tendency") to capture the expectations of most Committee members. These projections or forecasts reflect the views of the individual Committee members as to the implications of monetary policy decisions, as well as other factors, such as fiscal policy, but the members may not have a common view in those respects. Those projections are also compared with Administration forecasts for the same period, and they could also be compared with forecasts by the Congressional Budget Office or the assumptions that lie behind the budget resolution adopted by Congress, depending upon the time period.

These semi-annual reports to Congress, as presently structured, seem to me to provide a reasonable basis upon which the Congress can evaluate the implications of the Federal Reserve's monetary policy and to come to a view about whether monetary and fiscal policies are appropriately complementary. No doubt, they can be improved -- which I take it is one of

your concerns about which I will say a few words in a moment. At the same time, I believe we should be cautious about placing too much weight -- in either monetary or fiscal policy -- upon a particular, and fallible, projection.

The uncertainties inherent in any economic forecast are one reason why the presentation of ranges of views, rather than a "point" forecast, is useful. Even so, events have, not infrequently, carried one or more economic variables outside the forecast range, and part of the policy problem is deciding how to respond to such unforeseen developments. Some unexpected changes may be favorable -- stronger growth or lower inflation -- and would not necessarily call for any adjustment in policy; others may be clearly unfavorable in terms of expectations or longer-term objectives; perhaps more frequently there will be a mixture of "good" and "bad" news. In none of these cases should it automatically be assumed that policy adjustments to reach a pre-set objective for the year are necessarily desirable.

In that connection, the essence of the policy problem is the need to look beyond any short forecast period to the longer-term cumulative effects of policy on the economy. What may appear a reasonable and desirable trade-off in the short run -- say, between more growth and less inflation, or more growth and budgetary restraint -- may well turn out to have sharply adverse effects if repeated over time.

The "Coordination" of Fiscal and Monetary Policy

On the face of it, more "coordination" always sounds better than less -- in our fiscal and monetary affairs as in other policies. But, in concrete instances, coordination may have an ambiguous meaning. Does it mean, for example, that measures which increase a deficit should be accompanied by more rapid money growth, so that the larger deficit could presumably be readily financed for a time -- at the longer-run risk of inflation? Or does it mean that a higher deficit should be accompanied by less rapid money growth to help assure that the deficit does not generate inflationary pressures -- at the possible expense of greater near-term market pressures? Answers will depend on particular circumstances, on judgments about the relevant time frame, and other factors.

Similar questions can be asked about measures to reduce the deficit. Should the Federal Reserve raise money growth, leave it unchanged, or lower it if Congress takes steps significantly to reduce the deficit below current expectations built into the economic outlook? The answer would again depend in part on one's analytic framework, but more pragmatic answers would depend on assessment of the effects on interest rates, credit markets, and private spending of reduced Federal credit demands, the sensitivity of inflationary expectations to changes in money targets, and judgments about the trend of business activity.

As this suggests, there is no simple trade-off between fiscal and monetary policy. The budgetary decision will, of course, affect the distribution of the available supply of credit in the economy and interest rates, and the mix of consumption and investment, but monetary policy cannot automatically offset the distributional or market effects of fiscal policy.

I interpret the Congressional interest in coordination as seeking ways to elucidate these choices rather than implying a simple or fixed trade-off between fiscal and monetary policy. I also believe the present reporting framework provides an appropriate basis for such analysis and discussion, but that it could be improved in one aspect.

Specifically, during the past year, the FOMC has presented an annual range of growth for total nonfinancial debt of domestic economic sectors as one of its longer-range money and credit targets. It may be of further help to the Congress in its deliberations on the budget if, in that framework, we amplified the discussion of the implications of the budget outlook, or alternative budgetary outlooks depending on whether a budget resolution has been passed, for the distribution of debt between the private and governmental sectors and for potential credit market pressures. While I have often touched upon these matters in testimony, implications or risks with respect to the availability of credit to the mortgage market, the bond market, and other loan markets could be noted more directly in the Report itself.

Such judgments, in the nature of things, could not be precise, and many other important factors -- the inflation outlook, the strength of economic activity, and others -- impinge strongly on credit flows and interest rates. Moreover, I do not believe a central bank should engage in the highly uncertain process of interest-rate forecasting. Within that limitation, however, I do believe our Reports could constructively be amplified in the way I have suggested.

With regard to the specific request that the Senate Banking Committee report by September 30 a sense of the Congress resolution bearing on the coordination of monetary and fiscal policy under present circumstances, I would note the economic projections in our Mid-Year Report were based on a budget assumption that is not greatly different from that contained in the most recent budget resolution, although we did factor in the contingency that some of the savings and revenue action called for in the resolution might not be achieved. The projections with respect to growth and inflation are also generally consistent with the Administration forecasts and do not differ greatly from assumptions underlying the Budget Resolution.

As I spelled out in my testimony last week, I do believe prospects for lower interest rates and for sustained and balanced recovery would be enormously assisted by more vigorous and earlier action to deal with the budgetary deficits. As things now stand, rising private credit demands, in reflection of rising private activity,

are beginning to clash with the continuing heavy financing needs of the government. The FOMC has not felt that an appropriate response to that development would be still higher targets for monetary and credit growth, with the potential for greater inflation (and ultimately higher interest rates) that course could imply. More progress toward reducing the deficit would maximize the prospects, consistent with these targets, for lower interest rates over time, supporting housing and other interest-sensitive sectors of the economy in particular, and reducing the risks of credit market congestion generally.

Targeting the GNP

The question has been raised whether "coordination" would not in some sense be better achieved if the Federal Reserve were to provide "objectives" for nominal and real GNP and prices instead of the projections we now give. I do not believe so. The issue is more than semantic. As detailed in the Appendix to this statement, a GNP objective for monetary policy would turn attention away from the role of other public and private policies in affecting economic activity and prices, promise much more than could be delivered, and risk concentration on short-term (and not readily controllable) results at the expense of continuing longer-range objectives.

I well understand that budgets must incorporate certain assumptions as to business activity, both because of the necessity for specific revenue and spending forecasts and because the timing and nature of the underlying policy decision may be influenced by the near-term outlook. But we should not lose a sense of skepticism about the accuracy of any forecast -- as illustrated by events this year. Moreover, to the extent possible, the budget outlook and structure should be evaluated independent of a particular phase of the business cycle. For instance, in making judgments looking ahead as to how much the deficit should be cut, estimates of the structural, continuing portion of the deficit are relevant.

I do not believe it wise in either monetary or fiscal policy, to commit ourselves to a particular short-term objective for, say the GNP or prices, that may or may not turn out to be attainable, and the acceptability of which may depend upon circumstances unknown at the time the objective is established.

Conclusion

Debate and consensus about our longer-term economic objectives and methods of reaching them are inherent in the policy-making process. Through our reports and testimony, we in the Federal Reserve want to contribute constructively to that process -- and I believe we do by means of detailing our monetary policies, by setting forth our economic projections and assumptions, and by publishing and analyzing economic data and trends. As I have suggested, we could provide additional analysis on the possible effects of broad fiscal policy decisions.

We have not wished, and do not now wish, as an organization to make more specific recommendations about budgetary policy, such as the nature of saving or spending decisions, areas that are not our responsibility, although I, or others in the Federal Reserve, are sometimes asked to comment as a matter of personal opinion. I also believe we should resist the temptations to set out short-term "objectives" in such specific terms as to invite unrealistic expectations, counter-productive "fine tuning," and ultimate disappointment. Within those limitations, I look forward to working with you in responding to the request in the Budget Resolution to explore possibilities for improving the flow of information, understanding, and "coordination."

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