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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

U.S. Senate

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I appreciate this opportunity to appear before you to present the Federal Reserve's monetary policy objectives for 1985. In accordance with the Humphrey-Hawkins Act, the semi-annual report of the Federal Reserve was transmitted to you this morning. That report reviews in detail economic developments and monetary policy in 1984, and sets forth for 1985 the plans for policy by the Federal Open Market Committee. This morning I would like to discuss the Committee's decisions and the outlook for the economy in the context of some important unfinished business facing all of us responsible for economic policy.

#### The Economic Setting

The familiar objective of monetary policy is to foster sustained economic growth and employment in a context of reasonable price stability. Stated so generally, that objective can hardly be challenged; it indeed encompasses the broad goals of economic stabilization policy generally.

Measured in those terms, there is clear reason for satisfaction in the performance of the economy last year. In summary, with real gross national product up by 5-1/2 percent over the year, and by about 12 percent in two years, we have enjoyed the strongest expansion since the Korean War period. On top of the gains in jobs in 1983, employment increased by over 3 million last year. The unemployment rate fell one full percentage point to 7.2 percent at year-end. Real incomes for the average American are up.

Prospects for sustained growth and productivity over time rest importantly on success in achieving and maintaining an environment of greater stability of prices and financial markets. In that light, it is encouraging that, contrary to widespread earlier expectations, the strong growth of 1984 took place without inflation increasing appreciably from the sharply reduced levels of 1982 and 1983. Specifically, the consumer price index increased around 4 percent last year, little changed from the previous two years, and prices of most goods (in contrast to services) at the wholesale and retail levels rose by less than that. While the evidence is less tangible, there are also encouraging signs that chronic expectations of future inflation have been damped.

The behavior of actual prices and nominal wages, which by some measures rose more slowly in 1984 than in 1983 despite expanding demands for labor, may in some part reflect those changes in attitude. Businessmen and workers no longer seem so preoccupied with a need to anticipate inflation in their pricing and wage decisions. And declines in bond yields after midyear seemed to reflect, to some degree, less fear of future inflation.

To be sure, a number of factors that may not be lasting have helped to hold price increases down. The continuing appreciation of the dollar and strong competition from imports have placed strong pressures on prices and wages in some manufacturing and mining industries. Widespread declines in

commodity prices cannot persist indefinitely. Unemployment is still higher than we would like to see. But it is also true that progress against inflation, as it is prolonged, can potentially feed on itself by encouraging restrained price and wage behavior.

As we start 1985, the immediate economic outlook appears reasonably favorable in these respects. Projections of Federal Open Market Committee members that I will be reviewing later in my testimony broadly parallel those of the Administration, the Congressional Budget Office, and many other observers; economic growth is expected to remain strong enough in 1985 to produce some further decline in unemployment, with little if any pickup in inflation.

But we must not be beguiled by those tranquil forecasts into any false sense of comfort that all is well. If the enormous potential of the American economy for growth and stability -- not just for 1985 but for the years beyond -- is to become reality, we need a sense of urgency, not of relaxation.

For one thing, with the general price level still rising in the neighborhood of 4 percent a year -- and with prices of services that today account for so much of the economy rising more rapidly than that -- we should not confuse evidence of progress against inflation with ultimate success. Indeed, the more favorable price expectations I noted a few moments ago

could prove fragile -- highly vulnerable to any indications that public policy is prepared to accept and accommodate to inflationary forces. That must be of particular concern in the conduct of monetary policy.

Perhaps more immediately, despite the strength of the overall expansion, some important areas of the economy are under strain and there have been recurrent international and domestic credit problems. Those strains and pressures are aggravated by underlying imbalances that, unless dealt with effectively, will undercut the long-term outlook.

One of those imbalances was highlighted by the slowdown in GNP growth we experienced in the third quarter. Such a "pause" is not an unusual feature of an expansion period. Demand does not grow smoothly, and occasional inventory imbalances will develop that require production adjustments. What was unusual last summer was that the slowing of demand growth was accompanied by a surge in imports, magnifying the effects on domestic producers. That summer import surge was reversed by year-end, but the underlying trend toward higher imports is clear. Our trade deficit increased to about \$110 billion in 1984, far higher than ever before, and the entire external current account deficit -- counting both goods and services -- has deteriorated by about \$100 billion since 1982. The sustainability of that trend, politically as well as economically, is, to say the least, questionable.

The rising trade deficit helps account for the failure of a number of important sectors to participate at all fully in the expansion. Agriculture, heavy capital equipment producers, and the metals industry, all of which face difficult structural problems in any event, are examples. They are further pressed by interest rates that, as you know, remain historically high, both in nominal terms and relative to recent inflation.

Looking abroad, growth in many industrial countries remains sluggish amid continuing high levels of unemployment, and depreciation of their currencies vis-a-vis the dollar seems to be one factor inhibiting more expansionary policies. Important developing countries are still struggling to restore stability and maintain growth while laboring under heavy debt burdens. In this interdependent world, these difficulties feed back on our own prospects.

It is no coincidence that the record external imbalance and continued high interest rates have been accompanied by large federal budget deficits -- deficits that according to projections of both the Administration and the Congressional Budget Office will only deepen in the years ahead in the absence of decisive corrective action.

Government deficits can be relatively benign and even useful in boosting incomes and purchasing power in the slough of recession and when private investment and credit demands are weak. It is also true that our growing volume of imports

over the last two years has provided an impetus for growth in other countries when other expansionary forces were weak. Moreover, the kind of obvious squeeze on, or "crowding out" of, domestic housing and investment that many anticipated as the expansion has developed has not been apparent.

We have been able to reconcile high deficits, sharply rising imports, and strong investment mainly for one reason: we have been able to attract an enormous amount of savings from abroad to supplement our own. The net capital inflow approached \$100 billion last year, and it will probably need to be still larger this year. Domestic net savings -- by individuals, businesses, and state and local governments -- are running at about \$325 billion, so the supplement from abroad adds close to a third to net savings generated internally. The net capital inflow was equivalent last year to more than half of the budget deficit.

That same inflow of funds has encouraged a very strong dollar. The strong dollar, in turn, contributes importantly to the huge and growing trade deficit. Our policy dilemma is simple but perhaps not fully understood. We cannot logically welcome the capital inflow from abroad in one breath and complain about the trade deficit in the next. They are two sides of the same coin.

We are managing to finance the deficit and maintain housing and investment expenditures with the help of imported

capital. At the same time, the exporter, those competing with imports, and the farmer are being "crowded out."

Looking ahead, the stability of our capital and money markets is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets. So far, they have been not only willing but eager to do so. But we are in a real sense living on borrowed money and time.

It is up to all of us to make constructive use of both the money and the time. In essence, that is the challenge for all of us -- for monetary and fiscal policy, and for all the other policies that can contribute to a productive, growing economy.

#### Monetary Policy in 1984

As you will recall, the economy was expanding particularly rapidly during the early part of 1984, and demands for money and credit -- and for bank reserves to support monetary growth -- were also strong. By early spring, data available at the time showed M1 increasing at rates well into the upper portion of its range for the year, which targeted growth at 4-8 percent.\* At the same time, driven by the financing needs generated by rising levels of private spending and by the Federal Government,

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\*The data in this testimony for the monetary aggregates reflect recent seasonal and benchmark revisions. While the changes for the year as a whole were small, the revised data for M1 for the first half of the year are lower, and the second half higher, than reported earlier.



M3 and non-financial credit were expanding around or above the upper end of their long-term ranges.

The strong expansionary forces in the economy were reflected in some limited upward movements in interest rates in February and March, and early in the spring the Federal Reserve began to exert some additional restraint on reserves being supplied through open market operations. Consequently, depository institutions were forced to rely increasingly on borrowing at the discount window to satisfy demands for reserves. With credit demands and the economy continuing to expand strongly, and with markets concerned about the possibility that inflationary forces might reassert themselves as the period of strong expansion lengthened, interest rates moved noticeably higher in the spring. In April the Federal Reserve increased its discount rate  $1/2$  of a percentage point to 9 percent to bring this rate into better alignment with market rates and to discourage reserve adjustment at the discount window.

In May, a liquidity crisis developed in one of the largest commercial banks in the country, growing out of continuing concerns over weaknesses in its loan portfolio. The Federal Reserve, the FDIC, and the primary supervisor of the bank, the Comptroller of the Currency, worked closely together to support the orderly functioning of the institution while more permanent recapitalization and other elements of a long-term solution could be developed. Nonetheless, that incident, together with continuing concerns about international debt problems, for a

time contributed to uneasiness in banking markets, and interest rates on short-term private credit instruments rose appreciably above those on government securities.\*

Demands for money slackened after midyear as the economic expansion slowed. Long-term interest rates began to drop from the higher levels reached in the spring as inflation concerns moderated. With the problems of the Continental Illinois Bank contained and progress made toward restructuring the debts of some important developing countries, the abnormal interest rate spreads began to narrow, but the money markets as a whole remained under some pressure. By late August and September, with M1 growth moving toward the midpoint of its range and M3 expansion slowing toward the upper end of its range, and with some evidence that economic growth had slowed, the Federal Reserve began to ease pressures on reserve positions.

That process continued through the fall, and borrowing at the discount window fell steadily from September through January. Late in the year, total and nonborrowed reserves began to grow rapidly. Short-term interest rates declined between 2-1/2 and 3-1/2 percentage points over the last four months of the year. Reacting to these declines, and to an extent facilitating them, the Federal Reserve in two half-point steps reduced the discount rate to 8 percent, the lowest level since 1978.

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\*Attachments I & II summarize these and related developments, and the Federal Reserve response, more fully.

Several additional factors influenced judgments about the appropriate degree of easing of reserve positions during the fall. The dollar remained exceptionally strong in foreign exchange markets, potentially increasing pressures on some sectors of the American economy and a source of growing concern among some of our trading partners experiencing depreciating currencies vis-a-vis the dollar. At the same time, relatively favorable incoming data about prices and wages tended to allay concerns about actual and potential inflationary pressures. In fact, prices of many sensitive commodities were falling appreciably. In these circumstances, reserves could be provided more liberally, and growth in the money supply more actively supported without providing a basis for a destructive rise in inflation expectations.

The fall in interest rates and the more generous provision of reserves in the context of some increases in economic activity led to a rather strong revival of M1 and M2 growth around year-end, bringing both aggregates relatively close to the mid-points of their respective ranges. As monetary and credit growth continued at a relatively rapid pace into January, the easing process came to an end.

Unlike the pattern during much of 1982 and 1983, when M1 grew more rapidly than nominal GNP (that is "velocity" slowed), the income velocity of M1 rose 4 percent last year. That is broadly in line with cyclical experience in the past, taking

into account both the pattern of interest rate movements and income growth. M2 velocity also increased, rising around 1-1/2 percent following two yearly declines.

These developments provide some support for the view that velocity trends over time, as well as cyclical changes for these aggregates, may be returning to patterns more along the lines of earlier experience. In contrast, in 1982 and 1983, during a period of rapid transition to deregulation of deposit interest rates and substantial economic uncertainty, those earlier patterns had been disrupted and velocity had declined appreciably.

The rise in M3 and credit during 1984 exceeded expectations at the start of the year, and both measures exceeded by a considerable margin the upper limits of their ranges over the year as a whole. In fact, credit increased at its most rapid pace over the entire post-World War II period, both in absolute terms and relative to nominal GNP. Debt growth of this magnitude would appear to be much faster than consistent with the long-run health of our economy and financial system. It reflects to some degree the imbalances in our economy I emphasized earlier.

For example, the budget deficit led to expansion of federal debt of 16 percent, an unprecedented rate of growth in the second year of a business cycle. The growth of the debt of non-federal sectors, at nearly 13 percent, also was

high relative to past experience. A portion of this growth in private debt -- perhaps around 1-1/2 percentage points - can be attributed to a huge volume of mergers, leveraged buyouts, and stock repurchases by businesses which had the effect of substituting debt for equity. Despite some sizable sales of new stock, non-financial corporations on balance retired about \$70 billion of stock last year.

Whatever the circumstances and justification for the particular companies involved, a financial structure that tends toward more debt (and shorter debt) relative to equity becomes more vulnerable over time. More cash flow must be dedicated to debt servicing, exposure to short-run increases in interest rates is magnified, and cushions against adverse economic or financial developments are reduced. These are factors that prudent lending institutions should take into account in evaluating new credits, and reports suggest that some banks did in fact review their policies toward mergers and leveraged buyout financing as the year wore on.

While the effect cannot be isolated, the rapid growth of debt relative to GNP may also reflect the fact that domestic spending increased appreciably faster than domestic production, which is what the GNP measures. A new machine, for instance, will require financing, whether purchased at home or abroad, and sharply increasing amounts of capital equipment have in fact been imported. As I indicated earlier,

directly or indirectly, that financing may be supplied from abroad, alleviating the pressures on our market. But the debt burden inevitably rests with the borrower.

#### Monetary Policy in 1985

At its meeting last week the FOMC agreed to some small changes in some of the ranges for the monetary and debt aggregates tentatively set out last July. The modifications are in response to analysis of information now available and do not represent any change in policy intentions. As shown on the attached table, for M1, the Committee reaffirmed the lower tentative range it adopted last July of 4 to 7 percent growth from the fourth quarter of 1984 to the fourth quarter of 1985. M2 is targeted to grow between 6 and 9 percent, the same range as used in 1984. The upper end of that range was increased by 1/2 percent from the tentative range for 1985 set in July. That small adjustment reflects a technical judgment -- based on assessment of recent developments -- that M2 could expand more in line with income growth this year, in keeping with the historic record of little trend growth in its velocity.

The upper end of the new M3 range of 6 - 9 1/2 percent was also set 1/2 percent higher than tentatively agreed in July. The associated monitoring range for credit was set at 9 to 12 percent, a percentage point above the 1984 range. Adjustments in both target ranges still contemplate a considerable slowing in these two aggregates from what actually occurred

in 1984. Even so, credit growth, fueled in part by the budget deficit, is expected to be quite strong, significantly exceeding the rate of expansion of GNP for the third consecutive year.

The Committee does not anticipate that growth of debt within the targeted range would necessarily pose significant new risks for the economy or the financial system in the year immediately ahead. However, a healthy financial structure will in time require more restraint on borrowing relative to the economic growth that, in the last analysis, provides the wherewithal to service the debt. One continuing problem in that respect is the extent to which the current tax structure tends to favor debt rather than equity financing, a point addressed in the Administration's reform proposals.

The ranges for growth in money and credit are expected by FOMC members and non-voting Reserve Bank Presidents to support another year of satisfactory economic expansion without an acceleration of inflation. Forecasts of real GNP growth centered around rates of 3-1/2 to 4 percent from the fourth quarter of 1984 to the fourth quarter of 1985 -- rates anticipated to be sufficient to reduce the unemployment rate to around 6-3/4 to 7 percent by year-end. Inflation, as measured by the GNP deflator, was expected most frequently to be in a range of 3-1/2 to 4 percent over the year, about the same rate as prevailed in 1984.\*

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\*These projections, now regularly set out in our Humphrey-Hawkins Reports, should not be interpreted as indicating "targets" for real growth or inflation in the short or longer run. As discussed in Attachment III, the Committee does not target a specific long-range growth path for the economy.

In view of the necessarily tenuous nature of any judgment about the outlook for exchange rates, FOMC members in preparing their projections assumed that the dollar would fluctuate in a range encompassing its level of recent months. They also assumed that the federal budget deficit would be reduced significantly in fiscal 1986 relative to base line projections, a development that would help damp both interest rate and inflationary expectations. Obviously, those assumptions suggest some of the important risks inherent in the outlook.

As I indicated in discussing 1984 developments, we entered 1985 with the various monetary aggregates growing relatively rapidly. The targets for this year take, as usual, the actual average for the fourth quarter of the previous year as a starting point (or "base"). Consequently, we are starting the year with the levels of the aggregates above the target ranges as they have been conventionally illustrated -- that is by so-called "cones" starting at a point late the previous year and widening through the current year. (See Charts I to IV.)

That conventional and widely used "picture" is essentially arbitrary. Interpreted rigidly (and wrongly), the narrowness of a cone in the early part of the year -- literally narrower than some weekly fluctuations in the money supply -- would attach policy importance to levels or movements in the various aggregates that in fact have no significance.

We have sometimes considered, and others have suggested, a better "pictorial" approach would be to illustrate the targets



by a different (but also necessarily arbitrary) convention -- parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period, as shown in the charts attached. The target range is then portrayed as maintaining the same width throughout the year. The current levels of the aggregates, as you can see on the charts, are within such parallel lines.\*

As a matter of economics and policy, rather than graphics, the Committee is not disturbed by the present level of M1 and M2 relative to its intentions for the year. It contemplates that, as the year progresses, growth will slow consistent with the target ranges.

Consistent with that approach, as I indicated earlier, the progressive process of easing reserve positions undertaken in the latter part of 1984 ended. The provision of reserves through open market operations is currently being conducted a bit more cautiously to guard against inadvertent "overshoots" in supplying reserves. Any further change in approach will, as always, depend upon assessments of the trend of monetary growth in the period ahead, evaluated in the context of the flow of information on the economy, on prices, and on domestic credit and exchange markets.

The annual target ranges for M1 and M2 assume that trends in velocity are returning to a more normal and predictable

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\*Attachment IV addresses the different but related questions of the appropriate "base" used in setting and illustrating targeted growth ranges.

pattern. However, there is some analysis that suggests the trend of velocity over time may be a little lower than the trend of 3 percent or so characteristic of much of the postwar period when interest rates were trending higher. Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee anticipates that those aggregates might end the year in the upper part of their ranges. The lower part of the M1 range would be consistent with greater cyclical growth in velocity than now thought likely. As usual, these ranges will be reviewed at mid-year, in accordance with Humphrey-Hawkins Act procedures.

### The Challenge Ahead

The approach toward monetary policy that I have outlined for 1985 is designed to promote, as best we can, our common objectives of sustained growth and stability. We can build on the strong progress of 1983 and 1984. There is forward momentum in the economy. The public at large seems to sense a greater degree of control over inflation than for many a year -- and I sense some chance of further progress toward price stability this year even as the economy grows.

Happily, despite the strength of the economic advance and the financing of a huge deficit, interest rates are today little above those of two years ago. The threats of financial dislocation growing out of the debt problems of much of the

developing world, or from more purely domestic financial pressures, have been well contained. Points of strain will, without doubt, require continuing attention this year. But, in the context of a healthy economy, they are capable of resolution.

By encouraging appropriate growth in money and credit, in discharging our supervisory responsibilities, in performing when necessary the essential functions of lender of last resort, and in our general surveillance of the financial system, the Federal Reserve can help build on that progress. We aim to do so.

But it is equally important to understand clearly what monetary policy and the Federal Reserve cannot do.

The progress against inflation, the strength of the dollar and the competition from abroad, and some margins (if diminishing) of capacity and manpower have provided a certain degree of flexibility in the conduct of monetary policy. But that limited flexibility would be abused at our collective peril. Credibility in the effort to deal with inflation is a precious thing. The lesson here and abroad, now and through history, is that, once a sense of price stability is lost, it can be restored only with pain and suffering.

The Federal Reserve can theoretically run the modern equivalent of the printing press -- we can create more money. But more money is not the same as correcting the gross imbalance

between our ability to generate real savings and the demands for those savings posed by housing, by investment and by the federal deficit.

To create money beyond that needed to sustain orderly growth would be to invite renewed inflation -- damaging incentives to save in the process. In contrast, to encourage savings from income would be to provide more of the real resources we need for future growth -- and it would help spur productivity and reduce price pressures in the process.

If that route isn't open to us -- and as a practical matter we probably can't do much right now to change ingrained savings behavior -- then the only constructive alternative is to attack the problem from the other side of the ledger by reducing the federal deficit.

For the time being, capital from abroad has been readily available to close the growing gap between our domestic savings and the demands upon them, moderating pressures on interest rates. Indeed, the money attracted partly by perceptions of our strength has come so freely we have an exceptionally strong dollar. But that same strong dollar contributes to a massive trade deficit that strains key sectors of industry and our agriculture, aggravating structural problems.

No doubt bad monetary policy could drive the dollar down -- a monetary policy that aroused inflationary expectations, undermined confidence, and drove away foreign capital.

But then, how would we finance our investment and our budget deficit?

Nor is the process of money creation adapted to relieving particular sectoral strains within our economy. We can and will, in our administration of the discount window and in our actions as lender of last resort, protect the essential financial fabric by supporting credit-worthy depository institutions faced with extraordinary needs.

But the evident problems of particular sectors, in the last analysis, will yield only to measures that support their efficiency and broaden their markets. That in itself is a large agenda, for government and those involved alike. And the process will be much easier if we at the same time address the basic imbalance between our capacity to save and our need to invest and to finance the government that I have emphasized today.

### Conclusion

I fully appreciate the difficulties of the decisions before you as you collectively approach those excruciating budgetary choices. As you do so, I know that you are aware of the priority that progressive reduction of the deficit deserves. That, indeed, would provide the most fundamental kind of reassurance that growth can be sustained in an environment of greater stability.

For our part, in the conduct of monetary policy, we in the Federal Reserve will be sensitive to both the opportunities and the dangers before us. We believe the approach I have outlined with respect to the monetary targets and our implementation of policy sensibly reflects and balances the concerns I am sure we share.

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Chart 1

# M1 Target Ranges and Actual

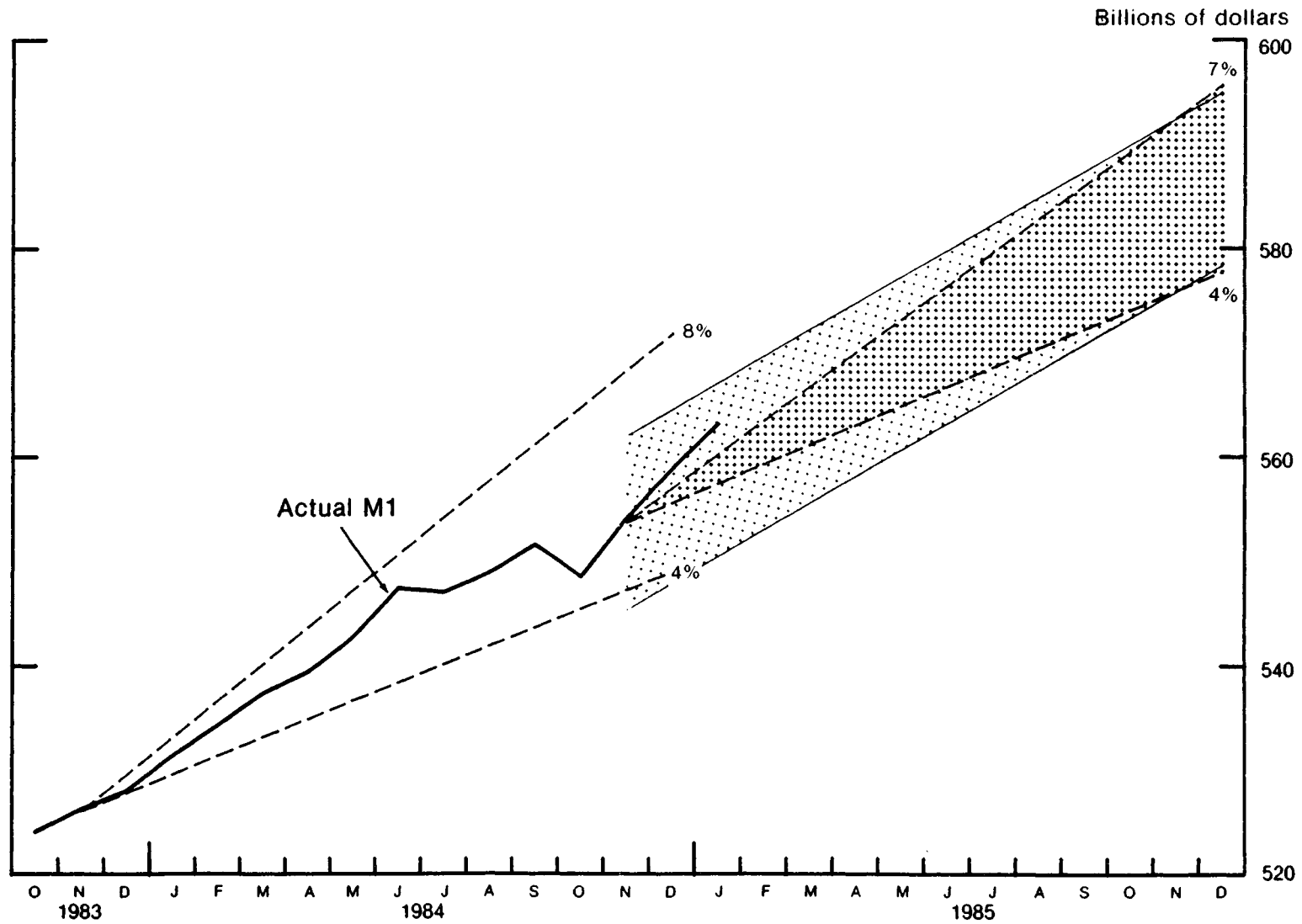


Chart 2

## M2 Target Ranges and Actual

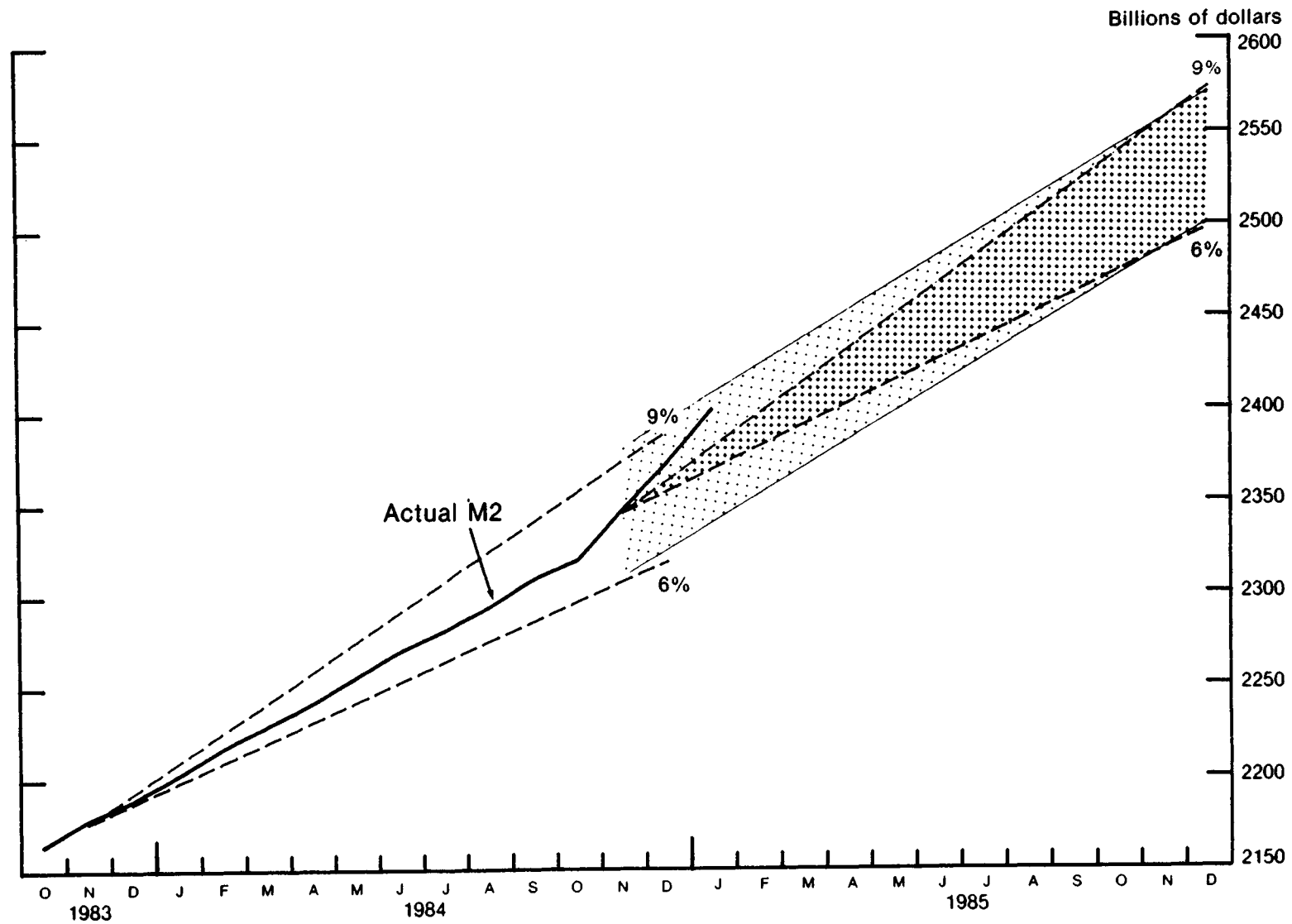




Chart 3

### M3 Target Ranges and Actual

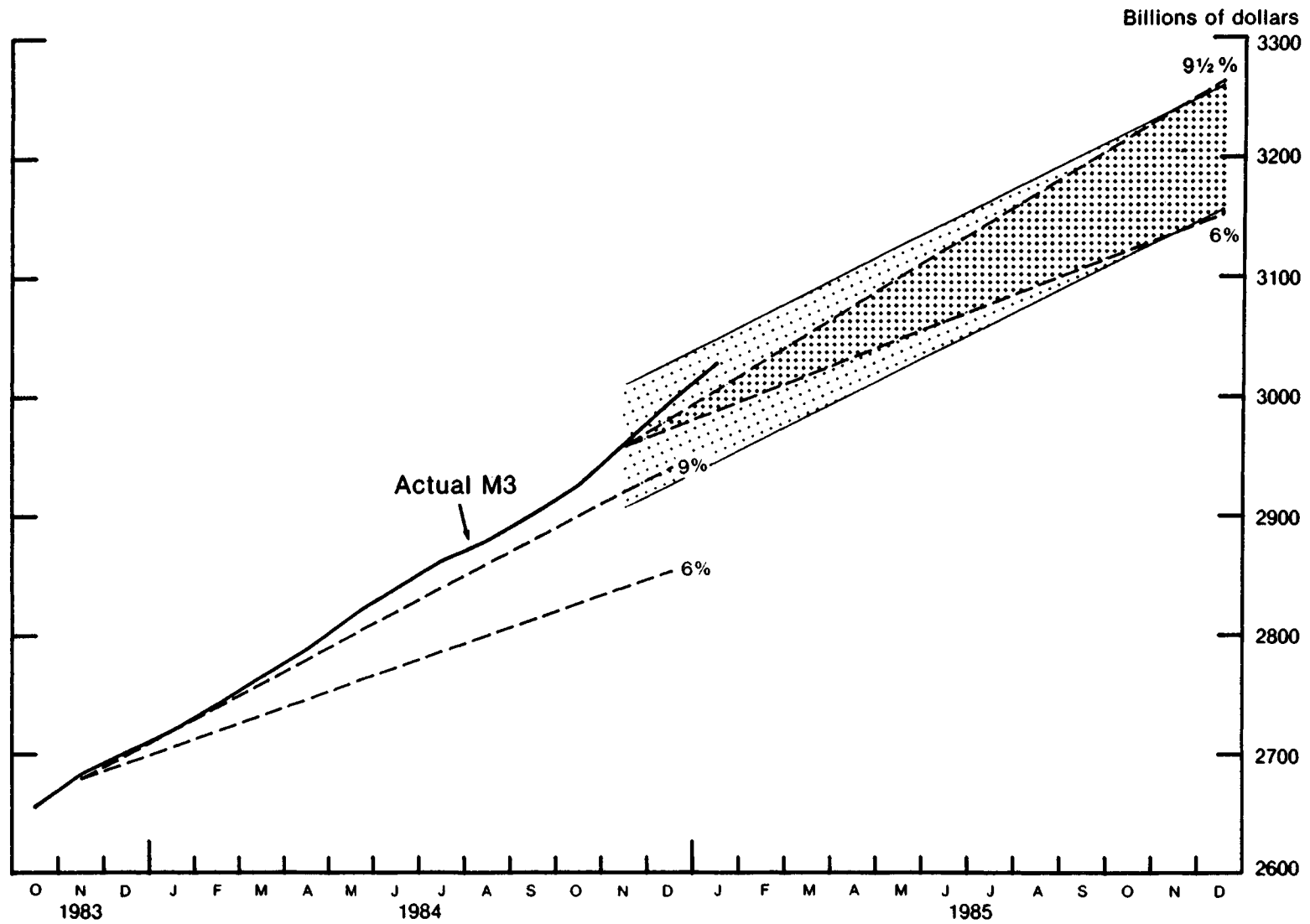
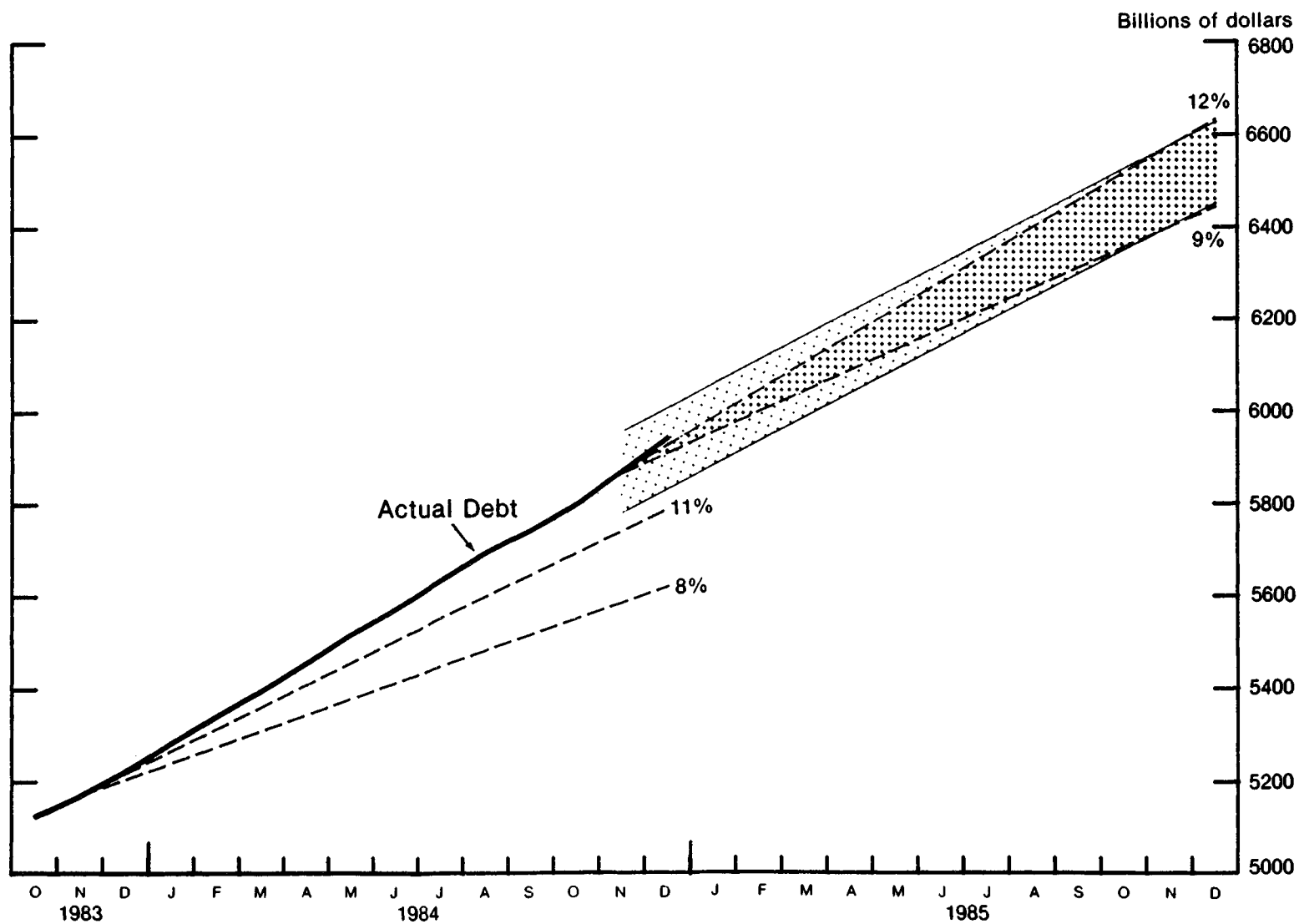


Chart 4

# Debt Monitoring Ranges and Actual



Attachment I  
The Implications for Monetary Policy of the Near Failure  
of the Continental Illinois Bank

The condition of the Continental Illinois Bank -- the seventh largest in the United States at the beginning of 1984 -- had been a matter of concern to regulatory authorities and market participants for some time, particularly after the failure of the Penn Square Bank in the middle of 1982 brought to light large loan losses and weaknesses in credit policy. Continuing profit and loan problems culminated in rumors of possible impending failure and a liquidity crisis in May 1984, involving withdrawal or failure to renew billions of dollars of deposits in the bank over a few days.

The FDIC, the Federal Reserve, and the Comptroller of the Currency, with the cooperation of a group of major banks, developed arrangements to provide temporary capital and liquidity support pending more permanent solutions and reorganization. The Federal Reserve -- acting as lender of last resort -- provided large amounts of funds through the discount window to maintain the bank's liquidity. That lending rose irregularly from around \$3 billion during most of May to a peak of more than \$7 billion in August. During the autumn the amount of outstanding loans declined to much reduced levels.

Provision of funds through the discount window has the effect of expanding total bank reserves, and unless otherwise offset, the lending to the bank would have had the effect of

expanding the money supply well beyond targeted ranges. To maintain consistency of reserve provision with FOMC intentions, essentially equivalent amounts of reserves were absorbed by open market operations. While the large borrowings necessarily involved some added technical difficulties and uncertainties in the conduct of open market operations, the Committee was able to achieve its reserve objectives.

At the same time, however, the liquidity crisis of Continental Illinois Bank, particularly in an environment in which international debt and other credit problems were attracting attention, generated concern about possible threats to the stability of other financial institutions. As a result, interest rates on banking liabilities rose appreciably relative to interest rates on Treasury securities during the spring. More cautious funding and lending policies by a number of banks appeared to have some effect on maintaining short-term interest rates at higher levels than might otherwise have been the case.

The extraordinary concerns in the marketplace dissipated as the year wore on, reflecting some sense of progress in dealing with both the international debt situation and points of domestic financial strain. Strong liquidity pressures at one of the largest savings and loan organizations during the late summer and fall, requiring sizable liquidity support by the Federal Home Loan Bank System, had lesser effects on market attitudes.

The experience of 1984, together with supervisory efforts and the strong continuing pressures on some sectors of the economy have underscored for depository institutions the importance of adequate capital and prudent lending policies, and other means of assessing and controlling risk. Substantial efforts have been made by many of the larger banking organizations to increase capital ratios and to review credit standards. In time, in the environment of a growing economy, these efforts should be reflected in stronger institutions and a reinforced banking system.

Attachment II  
The International Debt Situation in 1984

At times during 1984, concerns about the external debt problems of key borrowing countries continued to be an important factor affecting attitudes in financial markets. As the year began, markets had substantial doubts about the viability of the Brazilian adjustment program, the programs of the new Venezuelan and Argentine governments were unknown, and there was some sense of weariness among the borrowing countries and their creditors. Tensions were aggravated by increases in dollar interest rates in the spring and early summer.

Subsequently, concerns in financial markets receded somewhat as interest rates moved lower, clear progress was recorded in narrowing some countries' external imbalances, and plans for long-term debt restructuring were developed for some of the largest borrowers.

The improvements in external accounts in Mexico and Venezuela in Latin America, and in Yugoslavia and Hungary in Eastern Europe, produced current account surpluses last year. Brazil's current account deficit was essentially eliminated, and a number of other countries had reduced deficits.

This progress was facilitated in many cases by significant increases in exports, particularly to the United States, and in most cases was accompanied by a recovery -- or at least a slower rate of decline -- of imports. Such developments,

coupled with continued moderate capital inflows, contributed to sizable increases in the international reserves of many of these countries and to the prospects of reduced demands for extraordinary external financing in the future. At the same time, most of those countries managed to achieve domestic growth.

Against this background, several of the major borrowing countries were able to move on to a second phase in their adjustment and financing programs. One important initiative, when warranted by progress in adjustment, has been planning for longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico and Venezuela; serious negotiations have begun with Brazil and Yugoslavia; and the financing package prepared for Argentina contains some longer-term elements.

However, it is also evident from developments in 1984 and the first months of 1985 that the process of adjustment which began in 1982 is far from complete, particularly on the internal side. Financial markets will remain sensitive to indications of progress or the lack thereof. Cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required. The need for imaginative and constructive solutions to the problems faced by individual countries is not over.

Attachment III  
Targeting Real Growth

Questions sometimes arise as to whether the Committee's forecasts for real GNP growth or prices are in the nature of short-run targets toward which the Federal Reserve "fine tunes" policy, or whether the Committee has preconceptions about just how rapidly the economy can and should grow over the medium or longer run.

The answer to those questions is no. Monetary policy is, of course, broadly directed toward sustaining the growth process in a non-inflationary environment. But the Committee as a group has no preconceived notion as to just how rapid growth can or should be over a particular period of time, without straining our resources or giving rise to price pressures and imbalances that would make it ultimately unsustainable.

Our capacity for growth over time depends on such variables as the trends in productivity, in the labor force, in incentives to save and invest, and in other factors over which monetary policy has essentially no direct or long-run influence. There are other policies, public and private, quite outside the purview of monetary policy that will influence both our growth potential and actual growth paths over time. There are debates in and outside the Federal Reserve as to some of these factors that affect economic growth, but annual monetary targets and operational decisions do not, and need not, rest on such assumptions for the long run.



For instance, the Committee would presumably welcome faster growth than predicted for 1985 if that proved consistent with moderating inflationary forces, and indeed, less inflation than anticipated would tend to encourage greater growth, consistent with our monetary targets. Indeed, the relationship between money and economic growth at any point in time is sufficiently loose that many other factors bear upon actual performance.

In sum, policies are periodically reassessed in light of incoming information about prices, output, exchange rates and other variables bearing on our growth potential and prospects for inflation. In practice there is sufficient flexibility in our targeting procedures to accommodate information that might suggest greater or lesser growth potential over time.

Attachment IV  
The Base for Monetary Target Ranges

Some questions have been raised concerning the "base" used by the Open Market Committee in deciding on targets for the monetary and credit aggregates for the calendar year. Consistent with the Humphrey-Hawkins Act procedures, the Committee's target ranges are specified each February as a range of growth from the fourth quarter of the previous calendar year to the fourth quarter of the current calendar year.

The convention that is usually used, is that the beginning point -- or "base" from which growth is measured -- is taken to be the fourth quarter average growth of a particular monetary or credit aggregate. Other "bases" could be used -- and occasionally have been used -- if the conventional base period is seriously distorted, by institutional change or otherwise.

During its recent meeting the Committee, as it has from time to time, discussed the issue of the desirability of choosing a base for 1985 for one or more of the aggregates other than the conventional one. It concluded that none of the fourth quarter averages for the targeted aggregates were distorted in a manner that strongly suggested the desirability of departing from the usual convention, and that such a departure might indeed confuse communication of the Committee's intentions. It also noted that the average level of both M1 and M2

during the fourth quarter of 1984 was reasonably close to the mid-point of the previous year's range, an alternative base suggested by some. M3 and credit ran significantly above the 1984 ranges. Rebasing those aggregates at the mid-point of the 1984 ranges would thus have implied a wrenching adjustment in the levels of those aggregates, a result that would be contrary to the Committee's intentions. Essentially, such a change would have implied a substantial tightening to bring the growth of those aggregates into the new ranges, or, alternatively, a specification of ranges of growth for 1985 that would have been extraordinarily high and quite out of keeping with longer range intentions.

More broadly, a decision to regularly target growth from the mid-point of a previous year's range would seem to imply the continuing validity of a judgment made a year earlier that the mid-point of a previous range is in some sense a uniquely "correct" level of a monetary aggregate. The Committee does not share such a conviction. Instead, it believes that the appropriate trend of each aggregate needs to be judged in the light of evidence as to velocity changes and other factors as they emerge over time.

In setting targets for any year, the Committee is, of course, aware of the base level of the aggregate. Adjustments in the new target ranges themselves, or in the conduct of policy within those ranges, can take account of any modest distortions

in the base. Such considerations are reflected in the discussion of policy in the testimony.

Growth Ranges for the Aggregates for 1984  
in Comparison with Actual Growth  
(QIV to QIV)

<u>Percent Increases</u>		
	<u>Ranges</u>	<u>Actual Growth</u>
M1	4 to 8	5.2
M2	6 to 9	7.7
M3	6 to 9	10.5
Domestic Nonfinancial Debt	8 to 11	13.4

Growth Ranges for the Aggregates Adopted for 1985  
in Comparison with Tentative Ranges and Those for 1984  
(QIV to QIV)

<u>Percent Increases</u>			
	<u>Adopted Ranges for 1985</u>	<u>Tentative Ranges for 1985 Set in Mid-1984</u>	<u>Ranges for 1984</u>
M1	4 to 7	4 to 7	4 to 8
M2	6 to 9	6 to 8-1/2	6 to 9
M3	6 to 9-1/2	6 to 9	6 to 9
Domestic Non- financial Debt	9 to 12	8 to 11	8 to 11