Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

U.S. Senate

July 18, 1985

I welcome the opportunity to review with you monetary policy in the context of recent and prospective economic and financial developments. The economic setting and the decisions of the Federal Open Market Committee with respect to the target ranges for the monetary and credit aggregates are set out in the semi-annual "Humphrey-Hawkins" Report. As usual, I would like to amplify and develop some aspects of those decisions in my testimony.

The Economic and Financial Environment

The pattern of slower, and more lopsided, growth in domestic output that developed during the latter part of 1984 became even more pronounced during the first half of 1985. Manufacturing activity overall has been essentially flat following exceptionally large gains earlier in the expansion period. The farming and mining sectors have remained under strong economic and financial pressure. But consumption -- supported directly and indirectly by large increases in personal and federal debt -- has continued to rise fairly strongly. Construction activity has also expanded, responding in part to lower interest rates. Despite recent losses of manufacturing jobs, employment growth in services and trade has been strong enough to keep the overall unemployment rate essentially unchanged at about 7-1/4 percent.

The contrast between marked sluggishness in the goods-producing sector of the economy and rising domestic consumption and demand is reflected in continuing strong growth in merchandise imports. Those imports in real terms are up by about 60 percent in three years; in manufactured goods alone the increase has been even more rapid. Overall, imports have now reached a level equivalent to 21 percent of the value of domestic production of goods. In contrast, exports have stagnated, and now account for only about 14 percent of goods output.

I can put the same point another way. Domestic final sales -- to consumers, to businesses, and to governments -- appear to have been expanding at a relatively brisk rate of more than 4 percent so far this year. Domestic output of goods and services has not nearly kept pace, rising at a rate of around 1-1/2 percent or perhaps less. That is partly because inventory accumulation has slowed. But it is mostly because more of the domestic demand is being satisfied by growing imports.

That was true earlier in the expansion period as well. But we have felt it more as growth in demand has slowed to a more sustainable rate. Another potentially disquieting development has been the apparent failure of productivity to maintain the strong gains achieved earlier in the expansion period. The implication is that the underlying trend may not have increased as much as hoped from the poor record of the 1970s.

Against those cross-currents in the economy this year, the Federal Reserve, in conducting its open market operations, has not appreciably changed the degree of pressure on bank reserve positions, which had already been substantially eased by the end of 1984. In May, the discount rate was reduced from 8 to

7-1/2 percent. That action was consistent with the general tendency of market interest rates to decline further over the period, extending the rather sharp reductions during the Autumn and early last winter. Both the discount and short-term market interest rates in May and June reached the lowest levels since 1978.

The relatively "accommodative" approach in the provision of reserves has been designed to provide support for the sustained growth of economic activity against a background of relatively well contained inflationary and cost pressures. Indeed, sensitive agricultural and industrial prices -- including prices of crude petroleum -- have been declining appreciably, and prices at the wholesale level have been almost flat. It is somewhat reassuring that the trend in wage and salary increases has, overall, remained at the sharply reduced pace established at the start of the recovery period, although the slowdown in productivity has been reflected in higher unit labor costs and some pressures on profit margins. Clearly, even if reduced, some momentum of inflation has persisted in the economy as a whole, and expectations remain sensitive. But so far this year, price increases have been concentrated largely in the service sectors.

Meanwhile, the broader measures of monetary growth -- M2 and M3 -- have remained generally within the target ranges established early in the year. However, currency and checkable deposits, measured by M1, have increased much more rapidly than envisaged. (See the attached charts.)

Until May, growth in that aggregate remained in an area reasonably close to the upper band of the target range. Given that the more rapid growth during that period followed some months of subdued expansion, the outcome through April was reasonably in line with FOMC intentions and expectations. More recently, in May and June, a new surge in M1 carried that aggregate much further above the targeted range.

At the same time, total non-financial debt has continued to expand substantially more rapidly than the GNP, propelled particularly by the federal deficit and consumer credit. As much as 1 percent of that debt expansion can be traced to a continuing -- and, from a structural point of view, disquieting -- substitution of debt for equity as a result of mergers and other financial reorganization. More generally, these developments also point up the apparent dependency of economic growth, under circumstances existing this year, on a relatively high level of debt and money creation.

Unduly prolonged, those developments would not provide a satisfactory financial underpinning for sustaining growth in a context of greater price and financial stability. For the time being, however, taking account of current and likely economic developments, the downward pressures on commodity prices, and the high level of the dollar that has prevailed in the foreign exchange markets, the growth in M1 and debt has not in itself justified a more restrictive approach toward the provision of reserves to the banking system.

After increasing sharply from already high levels in the early weeks of the year, the dollar more recently has fallen back against the currencies of other leading industrial countries, dropping abruptly over the past week or so to about the average levels of last summer. At these exchange rates -- still about 60 percent above the relatively depressed levels of 1979 and 1980 -- prospects for stemming the deterioration in our trade accounts, much less achieving a turnabout, remain uncertain. Much depends upon the rate of growth in other countries that provide the principal markets for our exports and are the source of our imports. In any event, the potential effects of interest rates and decisions with respect to monetary policy on exchange rates and the external sector of the economy have necessarily been a significant ingredient in FOMC deliberations.

The Outlook for the Economy

Members of the FOMC generally have projected a pickup in economic activity over the second half of 1985 and sustained growth through 1986. In those circumstances, while employment gains should remain substantial, unemployment would be expected to drop only a little if at all. The overall rate of price increase would be expected to remain close to the recent pattern, assuming dollar exchange rates do not vary widely from recent levels. (See Table I attached for the numerical projections.)

Obviously, neither the anticipated "stickiness" of the unemployment rate nor the projected inflation rate is entirely satisfactory, and a substantial range of uncertainty must be associated with any economic projections at this time. As I emphasized earlier, there are sharp differences in the performance of different sectors of the economy. Demand for and employment in services, where most upward price pressures have been concentrated, continue to expand rather strongly. Most sectors more immediately sensitive to interest rates and monetary conditions -- including construction and automobile sales -- have also been performing relatively well. Other sectors exposed to strong international competition are sluggish, and agriculture remains under strong financial pressure.

The Broad Policy Challenge

The cross-currents, dislocations, and uncertainties in the present situation point up one uncomfortable but inescapable fact. We are dealing with a situation marked by gross imbalances that can neither be sustained indefinitely nor dealt with successfully by monetary policy alone, however conducted.

> We are borrowing, as a nation, far more than we are willing to save internally.
>
> We are buying abroad much more than we are able to sell.
>
> We reconcile borrowing more than we save and buying more than we sell by piling up debts abroad in amounts unparalleled in our history.
>
> Our key trading partners, directly or indirectly, have been relying on our markets to support their

growth, and even so most of them remain mired in historically high levels of unemployment. Meanwhile, our high levels of consumption and employment are not being matched by the expansion in the industrial base we will need as we restore external balance and service our growing external debt. And, after 2-1/2 years of economic expansion, too many borrowers at home and abroad remain under strain or over-extended.

At their core, these major imbalances and disequilibria may lie outside the reach of monetary policy -- or in some instances, U.S. policy generally. But they necessarily condition the environment in which the Federal Reserve acts, along with all the current evidence about monetary growth, economic conditions, and prices.

In all our decisions, whether with respect to monetary or regulatory policies, we would like to work in a direction consistent with reducing the imbalances, or at the least to avoid aggravating them. That sounds obvious and straightforward. The difficulty is that, as things now stand, some policy actions that might seem, on their face, to contribute toward easing one problem could aggravate others. Nor can we afford to apply a mere poultice at one point of strain in the hope of temporary relief at the expense of undermining basic objectives.

Our monetary policy actions need to be conducted with a clear vision of the continuing longer-term goals -- a financial environment in which we as a nation can enhance prospects for sustained growth in a framework of greater stability. To succeed fully in that effort, monetary policy will need to be complemented by action elsewhere.

The 1985 and 1986 Target Ranges

As I indicated earlier, the recent surge in M1 in May and June has carried that monetary aggregate well above the target range set in February. M2 and M3, while also rising rather sharply in June, have remained generally within, or close to, their targeted ranges. Against the background of a high dollar, the sluggishness of manufacturing output, and relatively well contained price pressures, quick and strong action to curtail the recent burst in M1 growth has not been appropriate. The potential implications of the relatively strong growth in M1 since late last year nonetheless had to be considered carefully in developing our target ranges and policy approach.

You may recall that somewhat similar high growth rates in M1 developed during the second half of 1982 and during the first half of 1983. At that time, important regulatory changes involving new accounts and affecting the payment of interest on checking accounts had taken place. Pervasive uncertainty during the latter stages of the recession appeared to affect desires to hold cash. Both circumstances made interpretation of the monetary data particularly difficult, and M1 was deemphasized. Those circumstances are not present today, at least not in the same degree.

However, one common factor, and an important factor, was at work during both periods. The rapid growth in M1 in 1982 and 1983 and this year followed sizable interest rate declines, with a lagged response evident for some months. Analysis strongly suggests that, as market interest rates decline, individuals and businesses are inclined to build up cash balances because they sacrifice less interest income in doing so. The possibility today of earning interest on checking accounts -- and the fact that these interest rates change more sluggishly than market or market-oriented rates -- probably increases that tendency.

Moreover, as I have suggested in earlier testimony, the payment of interest on checking accounts may over time encourage more holdings of M1 relative to other assets, or relative to economic activity, than was the case earlier. Partly for that reason, the upward trend in M1 "velocity" -- the ratio of GNP to M1 -- characteristic of the earlier postwar period may be changing.

That trend was, of course, established during a period when inflation and interest rates were trending upward. In contrast, over the past three and one-half years, velocity has moved irregularly lower, with the declines concentrated in periods of declining interest rates.

The earlier 1982-83 period of rapid growth in M1 was correctly judged not to presage a resurgence of inflationary pressures, contrary to some expectations. I would emphasize in that connection, however, that M1 growth was moderated substantially after mid-1983, and velocity rose during the period of strong economic expansion, as anticipated.

We simply do not have enough experience with the new institutional framework surrounding M1 (which will be further changed next year under existing law) to specify with any precision what new trend in velocity may be emerging or the precise nature of the relationship between fluctuations in interest rates and the money supply. Moreover, while the surge in M1, and the related drop in velocity, can be traced at least in substantial part to the interest rate declines of the past year, the permanence of the change in velocity will be dependent on inflationary expectations and interest rates remaining subdued. For those reasons, the Committee has continued to take the view that, in the implementation of policy, developments with respect to M1 be judged against the background of the other aggregates and evidence about the behavior of the economy, prices, and financial markets, domestic and international.

None of that analysis contradicts the basic thrust of a proposition that we have emphasized many times -- that excessive growth of money, sustained over time, will foster inflation. Certainly the burst in May and June cannot be explained by trend or interest rate factors. But, it is also true that monthly data are notoriously volatile, and sharp increases unrelated to more fundamental factors are typically moderated or partly reversed in following months.

In all these circumstances, the FOMC, in its meeting last week decided to "rebase" the M1 target at the second quarter average and to widen the range for the rest of the year to 3 to 8 percent at an annual rate. That decision implies some adjustment in the base of the M1 target range is appropriate to take account both of some change in trend velocity and a return of interest rates closer to levels historically normal.

We are, of course, conscious that, because of strong June growth, M1 currently is high relative to the rebased range, and the Committee contemplates that M1 will return within its range only gradually as the year progresses. Consistent with the conviction that a marked slowing in the rate of M1 growth is appropriate over time, the Committee tentatively set the target range at 4-7 percent for next year -- a decision that will be reassessed on the basis of the further evidence available at that time. Meanwhile, the lower part of the range set for the remainder of this year reflects the willingness of the FOMC, in appropriate surrounding circumstances, to tolerate substantially slower M1 growth for a time should the recent bulge in effect "wash out."

No changes were made in the target ranges for M2 and M3 and the associated monitoring range for debt this year. As was the case at the beginning of 1985, the Committee would find growth in the upper part of these ranges acceptable. The changes tentatively agreed for 1986 are small, limited to a 1/2 percent reduction in the upper limit for M3 and a 1 percent reduction in the monitoring range for debt.

These target ranges are felt to be fully consistent with sustained growth in the economy so long as inflationary pressures are contained. I should note again, however, that members of the FOMC are concerned about the persistent debt creation well in excess of the growth of the economy and historical experience, and therefore look toward some moderation in that growth next year, as reflected in the monitoring range set out. (The new ranges are set out in Table II attached.)

The uncertainties surrounding M1, and to a lesser extent the other aggregates, in themselves imply the need for a considerable degree of judgment rather than precise rules in the current conduct of monetary policy -- a need that, in my thinking, is reinforced by the strong cross-currents and imbalances in the economy and financial markets. That may not be an ideal situation for either the central bank or those exercising oversight -- certainly the forces that give rise to it are not happy. But it is the world in which, for the time being, we find ourselves.

Complementary Policies

The massive trade deficit that has rapidly developed over the period of economic expansion is the most obvious and concrete reflection of underlying economic imbalances. The trade deficit, in an immediate sense, has been primarily related both to the strength of the dollar in the exchange markets and to relatively slow growth elsewhere in the world. In effect, much of the world has been dependent, directly or indirectly, on expanding demand in the United States to support its own growth. Put another way, growth in domestic demand in Japan, Canada, and Europe has been less than the growth in their GNP, the converse of our situation. And, even with surging exports to this market, output been increasing too slowly to cut into high rates of unemployment in Europe and elsewhere. As a consequence, the demand of others for our products has been relatively weak.

The strong competition from abroad has, in an immediate sense, had benefits as well as costs for this country. It has been a powerful force restraining prices in the industrial sector and in encouraging productivity improvement. The related net capital inflow has eased pressures on our interest rates and capital markets. We have been able to readily satisfy the higher levels of consumption driven in part by the budget deficit.

But those benefits cannot last. Sooner or later our external accounts will have to come much closer toward balance.

Indeed, as our debts increase, we will have to earn even more in our trade to help pay the interest.

In the meantime, the flood of imports, and the perceptions of unfairness which accompany it, foster destructive protectionist forces. The domestic investment we will ultimately need is discouraged while our companies shift more of their planned expansion overseas. And the larger the external deficits and the longer they are prolonged, the more severe the subsequent adjustments in the exchange rate and in our economy are apt to be. We will have paid dearly indeed for any short-term benefits.

These considerations have tempered the conduct of monetary policy for some time. Specifically, our decisions with respect to providing reserves and reducing the discount rate have been influenced to some extent by a desire to curb excessive and ultimately unsustainable strength in the foreign exchange value of the dollar. But we have also had to recognize the clear limitations and risks in such an approach.

The possibility at some point that sentiment toward the dollar could change adversely, with sharp repercussions in the exchange rate in a downward direction, poses the greatest potential threat to the progress we have made against inflation. Those risks would be compounded by excessive monetary and liquidity creation.

As I have said to this Committee before, there is little doubt that the dollar could be driven lower by "bad" monetary policy -- a policy that poses a clear inflationary threat of its own and undermines confidence. But such a policy could hardly be in our overall interest -- it would in fact be destructive of all that has been achieved.

The hard fact remains that so long as we run massive budgetary deficits, we will remain dependent on unprecedented capital inflows to help finance, directly or indirectly, that deficit. The net capital inflows will be mirrored in a trade deficit -- they are Siamese twins.

As things now stand, if our trade deficit narrowed sharply, both the budget deficit and investment needs would have to be financed internally, with new pressures on interest rates and a squeeze on other sectors of the economy -- some of which are now doing relatively well, such as housing, and some, such as farmers and thrift institutions, already under strong financial pressure. The implications for our trading partners and for the heavily indebted developing countries would be severe as well.

There has to be a way out of the impasse -- a way that would maintain and even enhance confidence in our own economy and prospects for stability, a way that would not simply shift the pressures from one sector of the economy to another, and a way consistent with the economic growth of other countries. But that way cannot be found by U.S. monetary policy alone.

What we can do is reduce our dependence on foreign capital, and the rising imports to meet our domestic demands, by curtailing the budget deficits that importantly drive the process. In that sense, the choice is before you -- in the decisions you will make in the budgetary deliberations that have been so prolonged.

The needed adjustments would be eased as well if other industrialized countries became less dependent on stimulus from the United States for growth in their own economies.

I am a central banker. I can well appreciate and sympathize with the priority that those countries have attached to budgetary restraint and particularly to the need to restore a sense of price stability in their own economies. They have had a large measure of success in those efforts in the face of depreciation of their currencies vis-a-vis the dollar, which has made the process more difficult. The pull of capital into the United States, and the reduced outflow from the United States, has also had effects on their own financial markets and interest rates, and thus on the possibilities for "home grown" expansion. But as those adverse factors diminish in force, or even begin to be reversed, opportunities surely exist for fostering more expansion at home, in their own interest as well as that of a better balanced world economy.

All of the industrialized countries, working with the International Monetary Fund, the World Bank, and by other means, need to continue to support the efforts of much of the developing world to restore the financial and economic foundations for growth in their countries. That process, under the pressure of the "debt crisis," has been underway for some years. By its nature, the fundamental adjustments required pose challenging questions of economic and political management. There is a certain irony in observing the enormous difficulties in our own political process in achieving -- so far without success -- deficit reductions equivalent to one to two percent of our GNP while much poorer countries with much greater demands upon them are cutting their deficits by much larger relative amounts.

That effort -- along with others -- is justified only by its necessity to their own economic health. It is hardly surprising that progress has been uneven, that from time to time setbacks are encountered, and that impatience and frustration surface politically. But I know of no realistic shortcuts or substitutes for the effort to place their own economies on a sounder footing, any more than we can ultimately escape our own responsibilities to put our budget in order.

What is so encouraging is that the strong effort that has been made in most of the indebted countries is yielding some tangible results. A measure of growth has been restored in Latin America as a whole. With interest rates lower and many debts restructured, debt burdens are gradually but measurably being reduced.

For the most part, the heavily indebted countries are still a long way from regaining easy access to commercial credit markets. Extraordinary cooperative efforts by the IMF, the World Bank and commercial banks will continue to be required for a time to make sure external financing obligations are structured in a way that matches ability to pay. As always, the ultimate success of all those efforts -- most of all those by the borrowers themselves -- will depend upon orderly growth, reasonable interest rates, and access to markets in the rest of the world, which will be determined by our actions and those of our trading partners.

Conclusion

We have had a relatively strong economic expansion in the United States over the past 2-1/2 years as a whole. At the same time, the rate of inflation has remained at the lowest level in more than 15 years. That combination should be a source of great satisfaction. But 2-1/2 years is not, in itself, terribly significant in the economic life of the nation. What will count is whether we can build on that progress, and extend it over a long time ahead.

The inherent strength of our economy and the momentum of our expansion have carried us a long way. We have done a lot to lead the world to recovery. The longer-term opportunities are still there for the taking. But we also do not need to look far to see signs of strain, imbalance, and danger.

In these circumstances, monetary policy has accommodated a sizable increase in monetary and credit growth, and interest rates have dropped appreciably even though they are still relatively high in real terms. In that way, economic growth has been supported at a time when the dollar has been particularly strong and inflationary pressures, at least in contrast to the 1970s and early 1980s, quiescent. But there are obvious limitations to the process of monetary expansion without threatening the necessary progress toward stability upon which so much rests.

Plainly, there are implications for other policies as well. The widely shared sense that other nations should do more to open markets, to deal with the structural rigidities in their economic systems, to encourage growth -- to get their own houses in order -- is certainly right. We can legitimately cajole, and urge, and bargain to those ends.

But there can also be no doubt that it all will come much easier as the United States does its part. Monetary policy must be part of that effort. But we also do need to come to grips with the budget deficit. We do need to avoid a witch's brew of protectionism.

The success of the world economy -- and of our fortunes within it -- is in large measure dependent on us. That is the inescapable consequence of size and leadership.

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Table I

Economic Projections for 1985 and 1986*

	FOMC Members and other FRB Presidents Range	Central Tendency
1985		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	6-1/4 to 7-3/4	6-1/2 to 7
Real GNP	2-1/4 to 3-1/4	2-3/4 to 3
Implicit deflator for GNP	3-1/2 to 4-1/4	3-3/4 to 4
Average level in the fourth quarter, percent:		
Unemployment rate	6-3/4 to 7-1/4	7 to 7-1/4
1986		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	5-1/2 to 8-1/2	7 to 7-1/2
Real GNP	2 to 4	2-1/2 to 3-1/4
Implicit deflator for GNP	3 to 5-1/2	3-3/4 to 4-3/4
Average level in the fourth quarter, percent:		
Unemployment rate	6-3/4 to 7-1/2	6-3/4 to 7-1/4

*The Administration has yet to publish its mid-session budget review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

Table II

Long-run Growth Ranges for the Aggregates
(Percent increase, QIV to QIV unless otherwise noted)

	Adopted in February for 1985	Adopted July 1985: 1985	Adopted July 1985: Tentative for 1986
M1	4 to 7	3 to 8 1/	4 to 7
M2	6 to 9	6 to 9	6 to 9
M3	6 to 9-1/2	6 to 9-1/2	6 to 9
Domestic Non-financial debt	9 to 12	9 to 12	8 to 11

1/ Annual rate of increase over the period from QII 1985 to QIV 1985.

Chart 1

M1 Growth Ranges and Actual

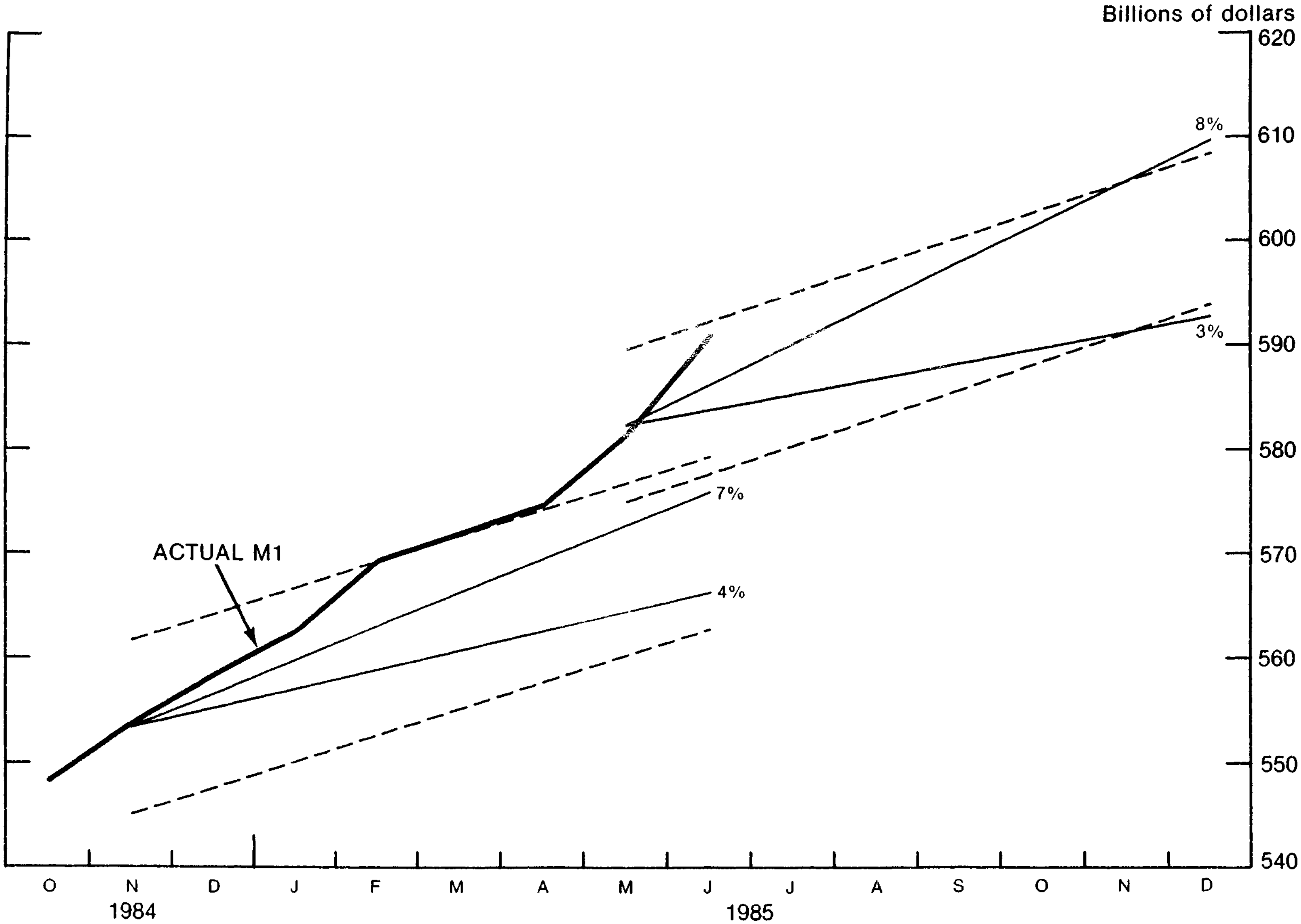

Chart 2

M2 Growth Range and Actual

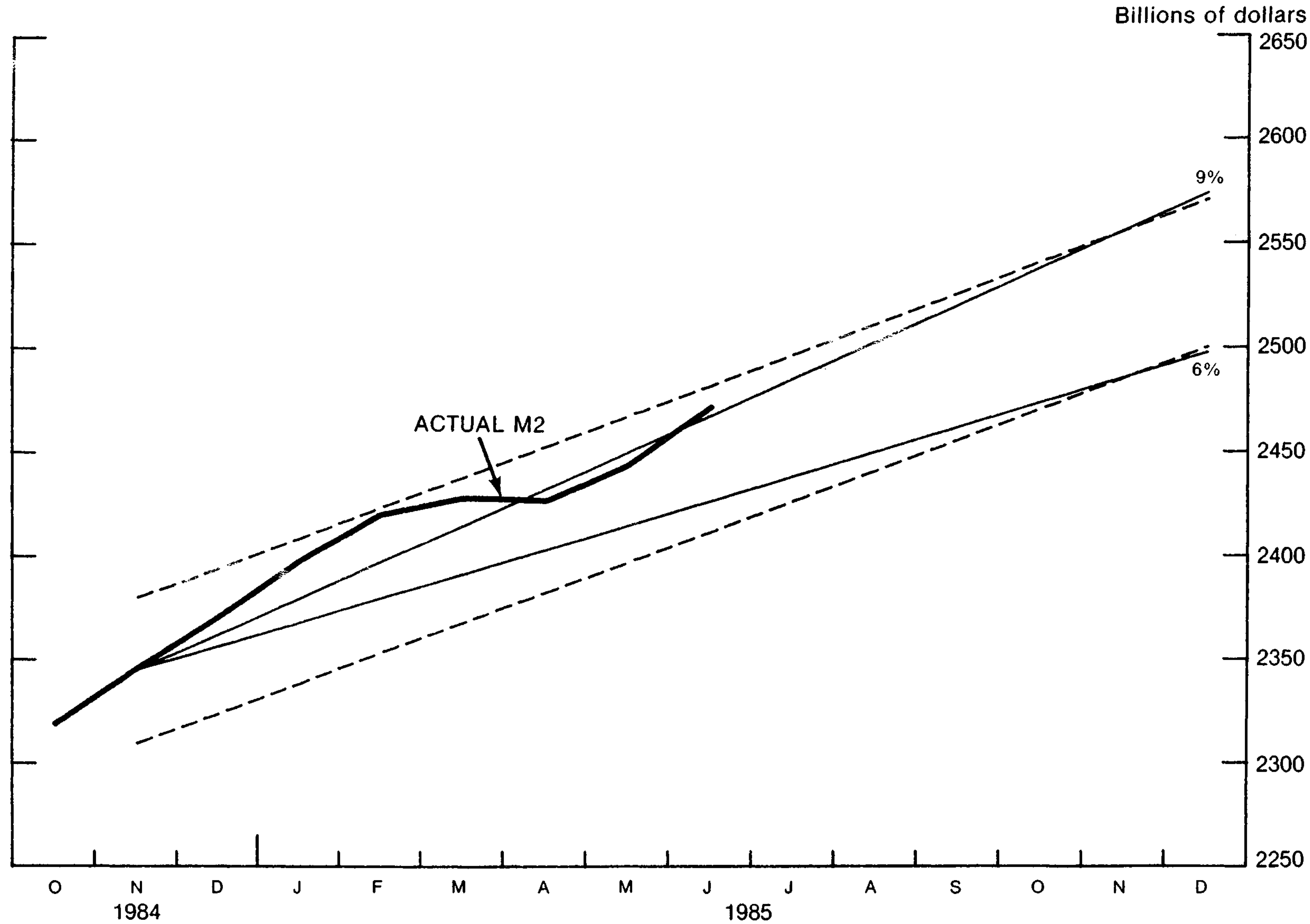

Chart 3

M3 Growth Range and Actual

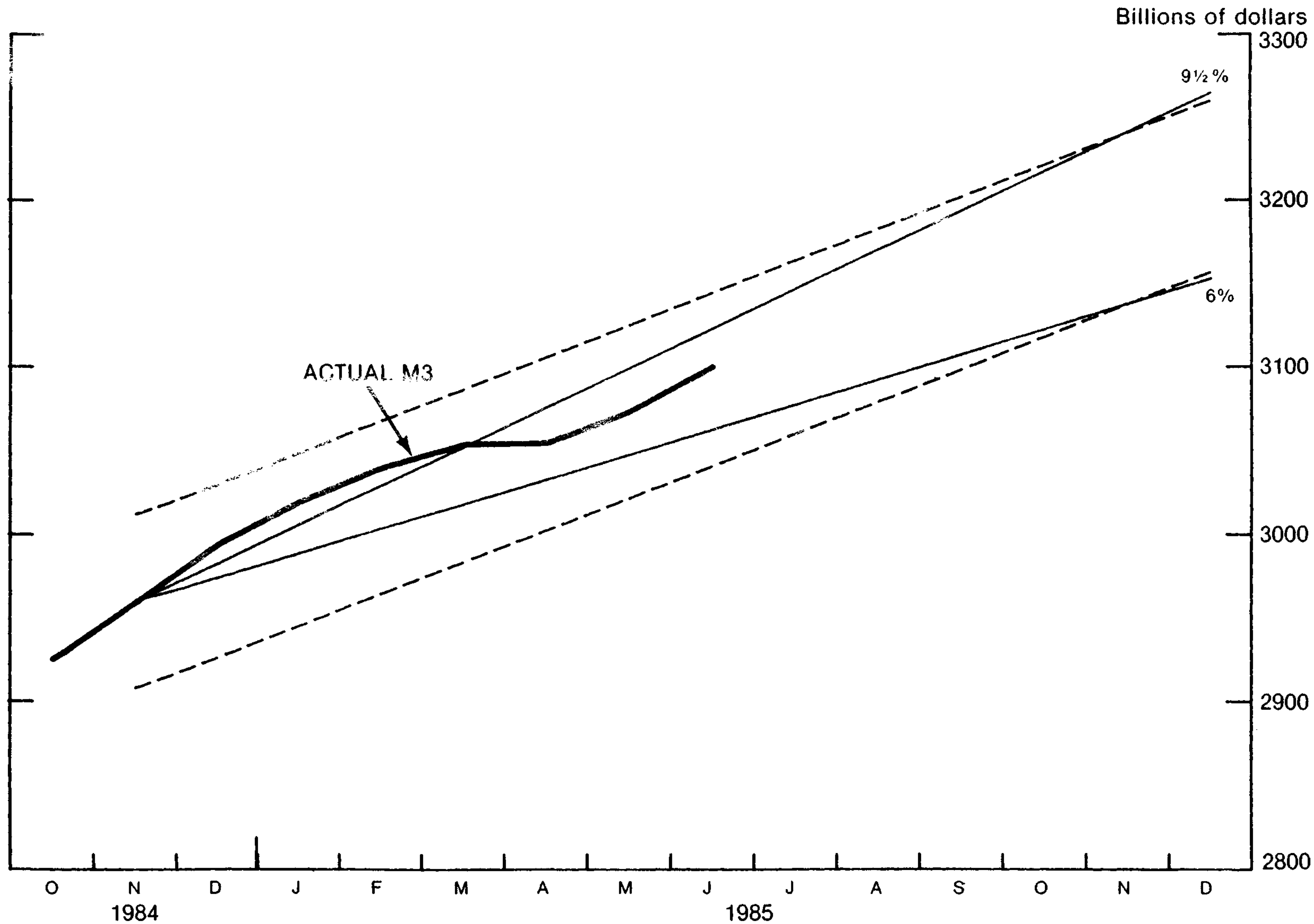

Chart 4

Debt Growth Range and Actual