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I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

Use of monetary targeting procedures is justified on the presumption that "velocity" -- that is, the ratio between a given measure of money and the nominal GNP -- is reasonably predictable over relevant periods. At the same time, it can be readily observed that, in the short run of a quarter or two, velocity is highly variable. Those short-run deviations from trend need to be assessed cautiously, for they commonly are reversed over a period of time. However, we cannot always assume a rigid relationship between money and the economy that, in fact, may not exist

over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

While M1 is meant to be a measure of transactions balances, NOW accounts also have some characteristics of a savings account (including similar "ceiling" interest rates). This year there has been a noticeable increase in the public's desire to hold a portion of their saving in highly liquid forms, probably reflecting recession uncertainties. As a result, NOW accounts have grown particularly fast, accounting for the great bulk of the growth in M1, and at the same time the rapid decline in savings deposits has ceased. Overall, M1 growth so far this year has been somewhat more rapid than a "straight line" path toward the annual target would imply. To the extent the relatively strong demand for M1 reflects transitory precautionary motives, allowing some additional growth of money over this period has been consistent with our general policy intentions.

In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

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As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

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the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

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The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

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In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

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Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

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Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose 6½ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

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inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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For release on delivery
10:00 A.M., E.D.T.
June 15, 1982

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

June 15, 1982

I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

Use of monetary targeting procedures is justified on the presumption that "velocity" -- that is, the ratio between a given measure of money and the nominal GNP -- is reasonably predictable over relevant periods. At the same time, it can be readily observed that, in the short run of a quarter or two, velocity is highly variable. Those short-run deviations from trend need to be assessed cautiously, for they commonly are reversed over a period of time. However, we cannot always assume a rigid relationship between money and the economy that, in fact, may not exist

over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

While M1 is meant to be a measure of transactions balances, NOW accounts also have some characteristics of a savings account (including similar "ceiling" interest rates). This year there has been a noticeable increase in the public's desire to hold a portion of their saving in highly liquid forms, probably reflecting recession uncertainties. As a result, NOW accounts have grown particularly fast, accounting for the great bulk of the growth in M1, and at the same time the rapid decline in savings deposits has ceased. Overall, M1 growth so far this year has been somewhat more rapid than a "straight line" path toward the annual target would imply. To the extent the relatively strong demand for M1 reflects transitory precautionary motives, allowing some additional growth of money over this period has been consistent with our general policy intentions.

In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose 6½ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

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In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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For release on delivery
10:00 A.M., E.D.T.
June 15, 1982

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

Use of monetary targeting procedures is justified on the presumption that "velocity" -- that is, the ratio between a given measure of money and the nominal GNP -- is reasonably predictable over relevant periods. At the same time, it can be readily observed that, in the short run of a quarter or two, velocity is highly variable. Those short-run deviations from trend need to be assessed cautiously, for they commonly are reversed over a period of time. However, we cannot always assume a rigid relationship between money and the economy that, in fact, may not exist

over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

While M1 is meant to be a measure of transactions balances, NOW accounts also have some characteristics of a savings account (including similar "ceiling" interest rates). This year there has been a noticeable increase in the public's desire to hold a portion of their saving in highly liquid forms, probably reflecting recession uncertainties. As a result, NOW accounts have grown particularly fast, accounting for the great bulk of the growth in M1, and at the same time the rapid decline in savings deposits has ceased. Overall, M1 growth so far this year has been somewhat more rapid than a "straight line" path toward the annual target would imply. To the extent the relatively strong demand for M1 reflects transitory precautionary motives, allowing some additional growth of money over this period has been consistent with our general policy intentions.

In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

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In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

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over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

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In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

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not believed that the growth of the various Ms has been unduly large so far this year.

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Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

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Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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For release on delivery
10:00 A.M., E.D.T.
June 15, 1982

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

June 15, 1982

I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

Use of monetary targeting procedures is justified on the presumption that "velocity" -- that is, the ratio between a given measure of money and the nominal GNP -- is reasonably predictable over relevant periods. At the same time, it can be readily observed that, in the short run of a quarter or two, velocity is highly variable. Those short-run deviations from trend need to be assessed cautiously, for they commonly are reversed over a period of time. However, we cannot always assume a rigid relationship between money and the economy that, in fact, may not exist

over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

While M1 is meant to be a measure of transactions balances, NOW accounts also have some characteristics of a savings account (including similar "ceiling" interest rates). This year there has been a noticeable increase in the public's desire to hold a portion of their saving in highly liquid forms, probably reflecting recession uncertainties. As a result, NOW accounts have grown particularly fast, accounting for the great bulk of the growth in M1, and at the same time the rapid decline in savings deposits has ceased. Overall, M1 growth so far this year has been somewhat more rapid than a "straight line" path toward the annual target would imply. To the extent the relatively strong demand for M1 reflects transitory precautionary motives, allowing some additional growth of money over this period has been consistent with our general policy intentions.

In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

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The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

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The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

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In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

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not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

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Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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For release on delivery
10:00 A.M., E.D.T.
June 15, 1982

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

June 15, 1982

I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

Use of monetary targeting procedures is justified on the presumption that "velocity" -- that is, the ratio between a given measure of money and the nominal GNP -- is reasonably predictable over relevant periods. At the same time, it can be readily observed that, in the short run of a quarter or two, velocity is highly variable. Those short-run deviations from trend need to be assessed cautiously, for they commonly are reversed over a period of time. However, we cannot always assume a rigid relationship between money and the economy that, in fact, may not exist

over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

While M1 is meant to be a measure of transactions balances, NOW accounts also have some characteristics of a savings account (including similar "ceiling" interest rates). This year there has been a noticeable increase in the public's desire to hold a portion of their saving in highly liquid forms, probably reflecting recession uncertainties. As a result, NOW accounts have grown particularly fast, accounting for the great bulk of the growth in M1, and at the same time the rapid decline in savings deposits has ceased. Overall, M1 growth so far this year has been somewhat more rapid than a "straight line" path toward the annual target would imply. To the extent the relatively strong demand for M1 reflects transitory precautionary motives, allowing some additional growth of money over this period has been consistent with our general policy intentions.

In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

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aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

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In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

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aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

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Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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For release on delivery
10:00 A.M., E.D.T.
June 15, 1982

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

Use of monetary targeting procedures is justified on the presumption that "velocity" -- that is, the ratio between a given measure of money and the nominal GNP -- is reasonably predictable over relevant periods. At the same time, it can be readily observed that, in the short run of a quarter or two, velocity is highly variable. Those short-run deviations from trend need to be assessed cautiously, for they commonly are reversed over a period of time. However, we cannot always assume a rigid relationship between money and the economy that, in fact, may not exist

over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

While M1 is meant to be a measure of transactions balances, NOW accounts also have some characteristics of a savings account (including similar "ceiling" interest rates). This year there has been a noticeable increase in the public's desire to hold a portion of their saving in highly liquid forms, probably reflecting recession uncertainties. As a result, NOW accounts have grown particularly fast, accounting for the great bulk of the growth in M1, and at the same time the rapid decline in savings deposits has ceased. Overall, M1 growth so far this year has been somewhat more rapid than a "straight line" path toward the annual target would imply. To the extent the relatively strong demand for M1 reflects transitory precautionary motives, allowing some additional growth of money over this period has been consistent with our general policy intentions.

In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

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Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

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In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

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The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

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In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

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not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

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One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

But it is also evident that some particular elements accounting for the sharp reduction in inflation are not sustainable; they have been achieved in a period of recession and slack markets, and have reflected some sizable declines in energy prices that now appear behind us. Progress toward reducing the underlying trend in costs, while real, has been slower. We have seen some polls that suggest many Americans do not in fact appreciate that inflation has slowed at all. That impression is plainly contrary to fact. But it is perhaps indicative of how deep seated impressions and expectations of inflation had become by the late 1970s, and it is suggestive of the concern of renewed higher inflation rates as economic activity recovers. No doubt those concerns continue to affect investment judgments and interest rates.

In this situation, one key policy objective must be to "build in" what has so far been a partly cyclical decline in

inflation, to encourage further reductions in the rate of increase in nominal costs and wages, and then to establish clearly a trend toward price stability. That approach seems to me essential to encourage and sustain lower long-term interest rates, which will, in turn, be important in sustaining economic growth.

While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

Let me emphasize that a strong program of credible budget restraint will itself work in the direction of lower interest rates.

The perception that future credit demands by the Federal Government would be lower would reinforce the emerging expectations of less inflation. The threat that huge deficits would preempt the bulk of the net savings the economy seems likely to generate in the years ahead -- with the likely consequence of exceptionally high real interest rates continuing -- would be dissipated. Confidence would be enhanced that monetary policy will be able to maintain a non-inflationary course, without squeezing of homebuilding, business investment, and other interest-sensitive sectors of the economy, and without excessive financial strains in the economy generally. And by dealing with very real concerns about the future financial environment, budgetary action would be an important support to the recovery today.

In summary, casting monetary policy objectives in terms of the aggregates has been a useful discipline and also has been helpful in communicating to Congress, the markets, and the general public the intent and results of the Federal Reserve actions. At the same time, we must retain some element of caution in their interpretation; the monetary targets convey a sense of simplicity that may not always be justified in a complex economic and financial environment. There is far from universal appreciation of the fact that the economic significance of particular aggregates is constantly evolving in response to rapid changes in financial markets and practices. Consequently, the Federal Reserve is continually faced with difficult judgments about the implications for the economy.

As you know, the Federal Open Market Committee soon will be meeting to review the annual targets for the monetary aggregates for 1982 and to formulate tentative targets for 1983. I would not presume to anticipate the precise decisions that will be made by the Committee. A wide array of financial and nonfinancial information will be reviewed in the process of considering the specific objectives. And, while I do not anticipate any significant change in our operating procedures in the near term, we will also continue to assess and reassess the means by which our policies are implemented. However, I do believe that you can assume that the decisions that do emerge from this review will reflect our continued commitment to disciplined monetary policy in the interest of sustaining progress toward price stability -- and, not incidentally, of encouraging a financial climate conducive to achieving and sustaining lower interest rates.

We can not yet claim victory against inflation, in fact or in public attitudes. But I do sense substantial progress -- and a clear opportunity to reverse the debilitating pattern of growing inflation, slowing productivity, and rising unemployment of the 1970s. The challenge is to make this recession not another wasted, painful episode, but a transition to a sustained improvement in the economic environment.

Central to that effort is an appropriate course for fiscal and monetary policy -- a course appropriate, and seen to be appropriate, for the years ahead. Critical elements in that effort

are the commitments to gain control of the federal budget and to maintain appropriate monetary restraint. Those policies provide the best -- indeed the only real -- assurance that financial market conditions will be conducive to a sustained period of economic growth and rising employment and productivity. In the long years to come, we want to look back to our present circumstances and know that the pain and uncertainty of today have, in fact, been a turning point to something much better.

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

June 15, 1982

I am pleased to appear before this Committee to discuss the conduct of monetary policy. In particular, I would like to focus on the monetary aggregates targeting framework in light of recent experience.

The Federal Reserve began reporting to the Congress specific numerical "targets" for the growth of the monetary aggregates in 1975. You will recall Congress had urged such an approach in House Concurrent Resolution 133. Subsequently, the reporting of growth targets for the aggregates was formalized in law with the enactment of the Full Employment and Balanced Growth Act of 1978, commonly referred to as the Humphrey-Hawkins Act. That law requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February, and to review those targets and formulate tentative objectives for the coming calendar year each July. The choice of the appropriate measures to "target," as well as the quantitative expression of those targets, are, of course, a matter for the Federal Reserve to decide.

The development of this formal reporting framework, focusing on the growth of certain monetary and credit variables, was a reflection in part of changes in attitudes toward monetary policy that occurred in the 1970s, and in part of a desire to improve communications and reporting about our intentions and policies. The worsening inflation problem focused increased attention on the critical linkage over the longer run between money growth and prices. There was a growing sense among some

that earlier "conventional" views of a trade-off between inflation and growth were no longer compatible with actuality, at least over the medium and longer run, and that inflation had emerged as a major economic problem. A number, including some members of Congress, placed increased emphasis on restraining growth of the monetary aggregates over time as a means of dealing with inflation, and urged establishing our intentions in that respect over a longer period of time ahead. More generally, aggregate targeting was thought to provide the Congress with a more clearly observable measure of performance against intentions, which in turn implied that targets should not be changed frequently, or without clear justification.

The formulation of specific monetary aggregates targets also has been consistent with the goals and approach of the Federal Reserve. A basic premise of monetary policy is that inflation cannot persist without excessive monetary growth, and it is our view that appropriately restrained growth of money and credit over the longer run is critical to achieving the ultimate objectives of reasonably stable prices and sustainable economic growth. While other policies must be brought to bear as well, the specific annual targets announced periodically by the Federal Reserve have reflected efforts to reconcile and support these goals.

It seems to me implicit in an aggregate targeting approach, as urged by the Congress, that interest rates in themselves are not

the dominant immediate objective or focus in assessing the posture of monetary policy, even though that remains the instinct of many. Interest rates are, of course, highly important economic variables, and they are intimately involved in the process by which the supply of money and other liquid assets are reconciled in the market with the demands for liquidity derived from the growth of the economy, inflation, and other factors. But interest rates are also importantly influenced by other forces as well, including expectations about inflation, about future interest rates, the budgetary posture, and other factors. The experience of the seventies emphasized some of the pitfalls and shortcomings of using interest rates as a guide for policy, particularly in an environment of generally rapid and rising inflation and correspondingly uncertain price expectations. In those circumstances, it is especially difficult to gauge the stimulative or restrictive influence associated with a given level of nominal interest rates. Recognition of these difficulties was an important element in the decision by the Federal Reserve to adopt procedures in October 1979 that placed emphasis, even in the shorter-run, on the supply of reserves rather than primarily on short-term interest rates as operational guides toward achieving an appropriate degree of monetary control.

While all these considerations have suggested the use of the framework of monetary aggregates targeting, we need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation, and flexibility in judging

developments in money and credit and in setting appropriate targets. One reason for that is the impact of financial innovations on the growth of particular measures of money and the relationships among them. In recent years, generally high and variable interest rates, and the continuing process of technological change and the deregulation of depository institutions, have provided powerful stimulus for far-reaching changes in the financial system. The proliferation of new financial instruments and the development of increasingly sophisticated cash management techniques have created a need to adjust the definitions of the monetary aggregates from time to time and to reassess the relationship of the various measures to one another and to other economic variables. A somewhat separable matter conceptually (but in practice hard to distinguish) is that businesses or families may shift their preferences among various financial assets in a manner that may alter the economic significance of particular changes in any given measure of "money" or "credit."

Use of monetary targeting procedures is justified on the presumption that "velocity" -- that is, the ratio between a given measure of money and the nominal GNP -- is reasonably predictable over relevant periods. At the same time, it can be readily observed that, in the short run of a quarter or two, velocity is highly variable. Those short-run deviations from trend need to be assessed cautiously, for they commonly are reversed over a period of time. However, we cannot always assume a rigid relationship between money and the economy that, in fact, may not exist

over a cycle or over longer periods of time, especially when technology, interest rates, and expectations are changing. Consequently, it is appropriate that the Federal Open Market Committee reconsider on a continuing basis, both the appropriateness of its annual targets and the implications of shorter-run deviations of actual changes from the targeted track.

The introduction of NOW accounts nationwide last year was illustrative of some of the difficulties arising from a changing financial structure. To some degree, the Federal Reserve was able to anticipate the impact. It was obvious, for example, that the rapid spread of NOW accounts, by drawing some money from savings accounts as well as demand deposits, would have important effects on the M1 aggregate, and last year's targets allowed for such effects. However, after accounting for these shifts into NOW accounts, the growth of the several aggregates was considerably more divergent than was anticipated, with M1 running relatively low while the increase in some of the broader aggregates was a bit above their annual objectives. Taking into account all of the financial innovations affecting the aggregates -- particularly the depressing effects on M1 of extraordinarily rapid growth in money market mutual funds -- and the relatively rapid growth of M2 and M3, we found the pattern of slow growth in M1 acceptable. Indeed, last year's experience seems to me a clear illustration of the need to consider a variety of money measures, rather than focusing exclusively on a single aggregate such as M1.

Thus far this year, the monetary aggregates have behaved more consistently, although M1 is running a bit stronger than anticipated relative to the other aggregates. With the major shift into NOW accounts, in terms of new accounts opened, mostly behind us, one source of distortion has been removed from the data. But I would also note that, as a result of that "structural" shift, NOW accounts and other interest-paying checkable deposits have grown to be almost 20 percent of M1, and there is evidence that the cyclical behavior of M1 has been affected to some extent by this change in composition.

While M1 is meant to be a measure of transactions balances, NOW accounts also have some characteristics of a savings account (including similar "ceiling" interest rates). This year there has been a noticeable increase in the public's desire to hold a portion of their saving in highly liquid forms, probably reflecting recession uncertainties. As a result, NOW accounts have grown particularly fast, accounting for the great bulk of the growth in M1, and at the same time the rapid decline in savings deposits has ceased. Overall, M1 growth so far this year has been somewhat more rapid than a "straight line" path toward the annual target would imply. To the extent the relatively strong demand for M1 reflects transitory precautionary motives, allowing some additional growth of money over this period has been consistent with our general policy intentions.

In arriving at such a judgment, the pattern of growth in the broader aggregates should be considered. There also have been important institutional changes in recent years affecting the behavior of M2 and M3. For example, an increasingly large share of the components of M2 that are not also included in M1 pay market-determined interest rates. This reflects the spectacular growth of money market funds in recent years as well as the increasing availability at banks and thrift institutions of small-denomination time deposits with interest rate ceilings tied to market yields. An important consequence is that cyclical or other changes in the general level of interest rates do not have as strong an influence on the growth of M2 as in the past.

The broader aggregates are presently at or just above the upper end of the ranges of growth set forth for the year as a whole. In February, we reported to the Congress that M2 and M3 would appropriately be in the upper half of their ranges, or at or even slightly above the upper end, should regulatory changes and the possibility of stronger savings flows prove to be important. In that regard, I must point out we have yet to go through a full financial cycle with such a large money fund industry or with the regulatory and legal changes recently introduced. In these circumstances, it is clear that interpreting the performance of the monetary and credit aggregates must be assessed against the background of economic and financial developments generally -- including the course of and prospects for business activity and prices, patterns of financing, and liquidity in various sectors, the international scene, and interest rates. It is in that broader context that we have

not believed that the growth of the various Ms has been unduly large so far this year.

The point I am making is that a large number of factors have impinged -- and in all likelihood will continue to impinge -- on the growth of the monetary aggregates, possibly in the process modifying the relationship of any particular measure of "money" to economic performance. The relationships have been good enough over a period of time to justify a presumption of stability -- but I do believe we must also take into account a wide range of financial and nonfinancial information when assessing whether the growth of the aggregates is consistent with the policy intentions of the Federal Reserve. The hard truth is that there inevitably is a critical need for judgment in the conduct of monetary policy.

Looking back at the last few years, money growth has certainly fluctuated rather sharply from time to time in the United States (and, I might note, in other countries as well). As I earlier noted, relationships have also been affected by a variety of financial innovations. But the trend over reasonable spans of time has generally been consistent with the announced targets of the Federal Reserve, and the restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation. This longer-run and broader perspective is what should be kept in mind when considering growth in the

aggregates. The tentative decision (not yet implemented) to publish the M1 data in the form of four-week moving averages is designed to divert undue attention from the statistical "noise" in the weekly movements in M1 and to encourage knowledgeable observers to focus on broader trends in the whole family of aggregates.

One obvious frustration in the current circumstances is that interest rates, particularly longer-term rates, still are painfully high despite the protracted weakness in the real economy and a marked deceleration in the measured rate of inflation. With the unemployment rate currently at a new postwar high, there is an understandable inclination to want to get interest rates down quickly to encourage a rebound in activity.

Nothing would please me more than for interest rates to decline, and the progress we are making on inflation, as it is sustained, should powerfully work in that direction. But, I also know that it would be shortsighted for the Federal Reserve to abandon a strong sense of discipline in monetary policy in an attempt to bring down interest rates. It may be that the immediate effect of encouraging faster growth in the aggregates would be lower interest rates -- particularly in short-term markets. But over time, the more important influence on interest rates -- particularly longer-term interest rates -- is the climate of expectations about the economy and inflation, and the balance of savings and investment. In that context, an effort to drive interest rates lower by money creation in excess of longer-run needs and intentions would ultimately fail in its purpose and would threaten to perpetuate policy difficulties and dilemmas of the past.

When long-term interest rates decline decisively, it will be an indication of an important change in attitudes about the prospects for the economy. One essential element in this process must be a widespread conviction that inflation will be contained over the long run. The decline in inflation evident in all of the broadly based price indices over the past year is highly encouraging. For example, in the 12-month period ending in April, the CPI rose $6\frac{1}{2}$ percent compared to 10 percent over the previous 12 months. Over the past few months, the CPI has been virtually stable.

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While monetary policy is only one of the instruments that can be brought to bear in restoring price stability, it is both necessary to that effort and widely recognized to be such. These circumstances emphasize the need to avoid excessive monetary growth, with the threat it would bring that the heartening progress against inflation would prove only temporary.

I think that it also is quite clear that the prospect of huge and rising budget deficits as the economy recovers has been another element in the current situation raising concerns about long-term pressures on interest rates. I take encouragement from the efforts of the House and Senate to begin to come to grips with this problem. At the same time, we are all aware of how much remains to be done, not only to reach agreement on a budget resolution for fiscal 1983, but to take the action necessary to implement such a resolution in appropriation and revenue legislation. Moreover, as you well know, further legislation will be needed beyond that affecting fiscal 1983 to assure elements in the structural deficit are brought more firmly under control.

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