Monetary Policy Objectives for 1982

With tentative monetary growth ranges for 1983

Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. With testimony presented by Paul A. Volcker, Chairman, Federal Reserve Board, July 20, 1982.

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Monetary Policy in 1982 and 1983

There is a clear need today to promote higher levels of production and employment in our economy. The objective of Federal Reserve policy is to create an environment conducive to sustained recovery in business activity while maintaining the financial discipline needed to restore reasonable price stability.

The Growth of Money and Credit in 1982

The annual targets for the monetary aggregates reported to Congress in February were chosen to be consistent with continued restraint on the growth of money and credit in order to exert sustained downward pressure on inflation. At the same time, these targets were expected to result in sufficient money growth to support an upturn in economic activity.

At its July meeting, the Federal Open Market Committee concluded that a change in the previously announced targets was not warranted at this time. Because of the tendency for the demand for money to run strong on average in the first half, and also responding to a congressional budget resolution, careful consideration was given to the question of whether some raising of the targets was in order. However, the available evidence did not suggest that a large increase in the ranges was justified; and a small change in the ranges would have represented a degree of "fine tuning" that appeared inconsistent with the degree of uncertainty currently surrounding the precise relationship of money to other economic variables. However, the Committee concluded, based on current evidence, that growth this year around the top of the ranges for the various aggregates would be acceptable.

The Committee also agreed that possible shifts in the demand for liquidity might require more than ordinary elements of flexibility and judgment in assessing appropriate needs for money in the months ahead. In the near term, measured growth of the aggregates may be affected by the income tax reductions that occurred on July 1, cost-of-living increases in social security benefits, and by the ongoing difficulties of accurately accounting for seasonal movements in the money stock. But more fundamentally, it is unclear to what degree businesses and households will continue to wish to hold unusually large precautionary liquid balances. To the extent the evidence suggests that relatively strong precautionary demands for money persist, growth of the aggregates somewhat above their targeted ranges would be tolerated for a time and still would be consistent with the FOMC's general policy thrust.

Ranges of Monetary Growth 1982[1]

	1982 Planned	**1982** Actual	**1982** Actual	**1981**
	QIV'81-QIV'82	QIV'81-QII'82	QIV'81-June'82	QIV Levels*
M1	2½ to 5½ percent	6.8 percent	5.6 percent	436.7
M2	6 to 9 percent	9.7 percent	9.4 percent	1807.4
M3	6½ to 9½ percent	9.8 percent	9.7 percent	2171.3
Commercial Bank Credit[2]	6 to 9 percent	8.3 percent	8.0 percent	1323.1

*Billions of dollars, seasonally adjusted.

The policy of firm restraint on monetary growth has contributed importantly to the recent progress toward reducing inflation. But when inflationary cost trends remain entrenched, the process of slowing monetary growth can entail economic and financial stresses. These strains—reflected in reduced profits, liquidity problems, and balance sheet pressures—place particular hardships on industries that depend heavily on credit markets such as construction, business equipment, and consumer durables.

Unfortunately, these stresses cannot be easily remedied through faster money growth. The immediate effect might be lower interest rates, especially in short-term markets. In time, however, such an attempt would founder, embedding inflation and expectations of inflation even more deeply into the nation's economic system. The present and prospective pressures on financial markets urgently need to be eased not by relaxing discipline on money growth, but by the adoption of policies that will ensure a lower and declining federal deficit. Moreover, a return to financial health will require the adoption of more prudent credit practices on the part of private borrowers and lenders alike.

Tentative Ranges for 1983

Looking ahead to 1983 and beyond, the FOMC remains committed to restraining money growth in order to achieve sustained noninflationary economic expansion. At its July meeting, the FOMC felt that the ranges now in effect could remain as preliminary targets for 1983. Because the monetary aggregates in 1982 will likely be close to the upper ends of their ranges, or perhaps even somewhat above them, the preliminary 1983 targets are fully consistent with a reduction in the actual growth of money in 1983.

In light of the unusual uncertainty surrounding the economic, financial, and budgetary outlook, the FOMC stressed the tentative nature of its 1983 targets. On the one hand, experience strongly suggests that, with economic activity on an upward trend, precautionary motives for holding liquid balances should begin to fade, contributing to a rapid rise in the velocity of money. Moreover, regulatory actions by the Depository Institutions Deregulation Committee that increase the competitive appeal of deposit instruments—as well as the more widespread use of innovative cash management techniques, such as "sweep" accounts—also could reduce the demand for money relative to income and interest rates. On the other hand, the long upward trend in the velocity of money since the 1950s took place in an environment of rising inflation and higher nominal interest rates that provided incentives for economizing on money holdings; as these incentives recede, the attractiveness of cash holdings may be enhanced and more money may be held relative to the level of business activity.

Tentative Ranges of Monetary Growth 1983

Based on QIV'82 to QIV'83	
M1	2½ to 5½ percent
M2	6 to 9 percent
M3	6½ to 9½ percent
Commercial Bank Credit	6 to 9 percent

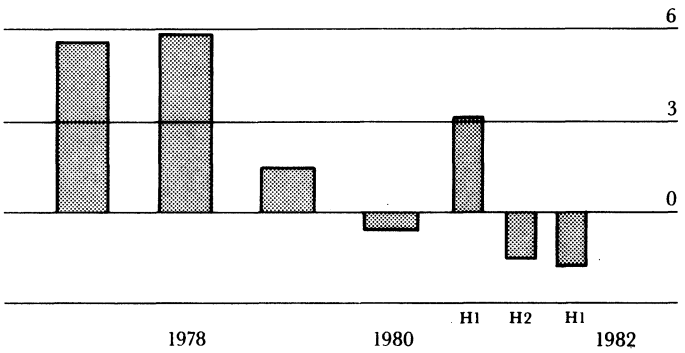
The Outlook for the Economy

The economy at midyear appears to have leveled off following sizable declines last fall and winter. Consumption has strengthened, with retail sales up significantly in the second quarter. New and existing home sales have continued to fluctuate at depressed levels, but housing starts nonetheless have edged upward. In the business sector, substantial progress has been made in working off excess inventories, and the rate of liquidation appears to have declined. On the negative side, however, plant and equipment spending, which typically lags an upturn in overall activity, is still depressed. The trend in export demand also continues to be a drag on the economy reflecting the dollar's strength and weak economic activity abroad.

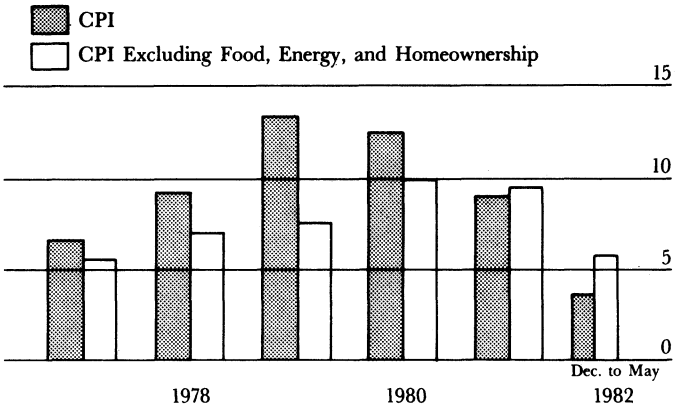
An evaluation of the balance of economic forces indicates that an upturn in economic activity is highly likely in the second half of 1982. Monetary growth along the lines targeted by the FOMC should accommodate this expansion in real GNP, given the increases in velocity that typically occur early in a cyclical recovery, and absent an appreciable resurgence of inflation. The 10 percent cut in income tax rates that went into effect July 1 is boosting disposable personal income and should reinforce the growth in consumer spending. Given the improved inventory situation, any sizable increase in consumer spending should, in turn, be reflected in new orders and a pickup in production. The continuing rise in defense spending and the associated private investment outlays needed for the production of defense equipment will be another element supporting real GNP growth. During its initial phase, the expansion is likely to be more heavily concentrated in consumer spending than in past business cycles; current pressures in financial markets and liquidity strains may inhibit the recovery in residential and business investment.

Real GNP — Change from end of previous period, annual rate, percent

1972 Dollars



Consumer Prices — Change from end of previous period, annual rate, percent



The excellent price performance so far this year has been helped by slack demand and exceptionally favorable energy and food supply developments. For that reason, the recorded rate of inflation may be higher in the second half of the year. However, prospects appear excellent for continuing the downtrend in the underlying rate of inflation. There has been significant progress in slowing the rise in labor compensation, and improvement in underlying cost pressures should continue over the balance of the year. Unit labor costs also are likely to be held down by a cyclical rebound in productivity growth as output recovers. Moreover, lower inflation will contribute to smaller cost-of-living wage adjustments, which will moderate cost pressures further.

A critical factor influencing the composition and strength of the expansion in economic activity over the next year and a half will be the extent to which pressures in financial markets moderate. This, in

turn, depends importantly on the progress made in further reducing inflationary pressures. A decrease in inflation would take pressure off financial markets in two ways. First, slower inflation will lead to a reduced growth in transactions demands for money, given any particular level of real activity. Second, further progress in curbing inflation will help lower long-term interest rates by reducing the inflation premium contained in nominal interest rates.

Another crucial influence on financial markets and thus on the nature of the expansion in 1983 will be the federal budgetary decisions that are made in coming months. The budget resolution that was recently passed by the House and Senate is a constructive first step in reducing budget deficits as the economy recovers, but appropriation and revenue legislation is needed to implement this resolution. How the budget process unfolds will determine future credit demands by the Federal government and thus the extent to which deficits will preempt the net savings generated by the private economy. A strong program of budget restraint would minimize pressures in financial markets and thereby enhance the prospects for a more vigorous recovery in homebuilding, business fixed investment, and other credit-dependent sectors.

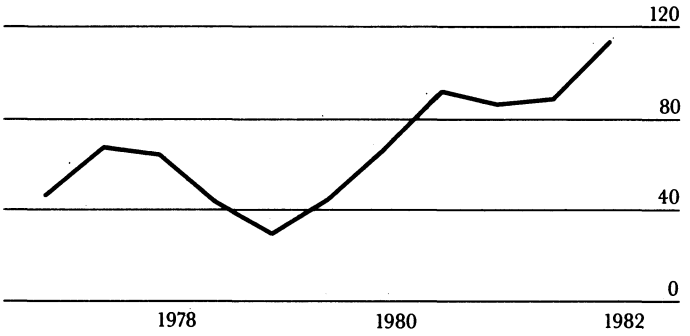
In assessing the economic outlook, the individual members of the FOMC have made projections for economic performance that generally fall within the ranges in the table below. In addition to the monetary targets discussed above, these projections assume that the federal budget will be put on a course that over time will result in significant reductions in the federal deficit.

Looking ahead, the Committee members, like the Administration and the Congress, foresee continued economic expansion in 1983, but currently anticipate a less rapid rate of price increase and somewhat slower real growth than the assumptions underlying the budget. The monetary targets tentatively set for 1983—which will be reviewed early next year—would imply, under the budgetary assumptions, relatively rapid growth in velocity.

Federal Government Borrowing

Seasonally adjusted, annual rate, billions of dollars

Combined Deficit Financed by the Public



FOMC Members' Economic Projections

		Actual*	Projected	
		1981	**1982**	**1983**
Changes, fourth quarter to fourth quarter, percent	Nominal GNP	9.6	5½ to 7½	7 to 9½
	Real GNP	0.7	½ to 1½	2½ to 4
	GNP Deflator	8.9	4¾ to 6	4 to 5¾
Average level in the fourth quarter, percent	Unemployment Rate	8.3	9 to 9¾	8½ to 9½

* Based on revised GNP data that were published after the full Humphrey-Hawkins report was submitted.

Testimony of Paul A. Volcker, Chairman, Federal Reserve Board

I am pleased to have this opportunity once again to discuss monetary policy with you within the context of recent and prospective economic developments. As usual on these occasions, you have the Board of Governors' "Humphrey-Hawkins" Report before you. This morning I want to enlarge upon some aspects of that Report and amplify as fully as I can my thinking with respect to the period ahead.

Crossroads on Inflation

In assessing the current economic situation, I believe the comments I made five months ago remain relevant. Without repeating that analysis in detail, I would emphasize that we stand at an important crossroads for the economy and economic policy.

In these past two years we have traveled a considerable way toward reversing the inflationary trend of the previous decade or more. I would recall to you that, by the late 1970s, that trend had shown every sign of feeding upon itself and tending to accelerate to the point where it threatened to undermine the foundations of our economy. Dealing with inflation was accepted as a top national priority, and, as events developed, that task fell almost entirely to monetary policy.

In the best of circumstances, changing entrenched patterns of inflationary behavior and expectations—in financial markets, in the practices of business and financial institutions, and in labor negotiations—is a difficult and potentially painful process. Those, consciously or not, who had come to "bet" on rising prices and the ready availability of relatively cheap credit to mask the risks of rising costs, poor productivity, aggressive lending, or over-extended financial positions have found themselves in a particularly difficult position.

The pressures on financial markets and interest rates have been aggravated by concerns over prospective huge volumes of Treasury financing, and by the need of some businesses to borrow at a time of a severe squeeze on profits. Lags in the adjustment of nominal wages and other costs to the prospects for sharply reduced inflation are perhaps inevitable, but have the effect of prolonging the pressure on profits—and indirectly on financial markets and employment. Remaining doubts and skepticism that public policy will "carry through" on the effort to restore stability also affect interest rates, perhaps most particularly in the longer-term markets.

In fact, the evidence now seems to me strong that the inflationary tide has turned in a fundamental way. In stating that, I do not rely entirely on the exceptionally favorable consumer and producer price data thus far this year, when the recorded rates of price increase (at annual rates) declined to 3½% and 2½%, respectively. That apparent improvement was magnified by some factors likely to prove temporary, including, of course, the intensity of the recession; those price indices are likely to appear somewhat less favorable in the second half of the year. What seems to me more important for the longer run is that the trend of underlying costs and nominal wages has begun to move lower, and that trend should be sustainable as the economy recovers upward momentum. While less easy to identify—labor productivity typically does poorly during periods of business decline—there are encouraging signs that both management and workers are giving more intense attention to the effort to improve productivity. That effort should "pay off" in a period of business expansion, helping to hold down costs and encouraging a revival of profits, setting the stage for the sustained growth in real income we want.

Economic Strains

I am acutely aware that these gains against inflation have been achieved in a context of serious recession. Millions of workers are unemployed, many businesses are hardpressed to maintain profitability, and business bankruptcies are at a postwar high. While it is true that some of the hardship can reasonably be traced to mistakes in management or personal judgment, including presumptions that inflation would continue, large areas of the country and sectors of the economy have been swept up in more generalized difficulty. Our financial system has great strength and resiliency, but particular points of strain have been evident.

Quite obviously, a successful program to deal with inflation, with productivity, and with the other economic and social problems we face cannot be built on a crumbling foundation of continuing recession. As you know, there have been some indications—most broadly reflected in the rough stability of the real GNP in the second quarter and small increases in the leading indicators—that the downward adjustments may be drawing to a close. The tax reduction effective July 1, higher social security payments, rising defense spending and orders, and the reductions in inventory already achieved, all tend to support the generally held view among economists that some recovery is likely in the second half of the year.

I am also conscious of the fact that the leveling off of the GNP has masked continuing weakness in important sectors of the economy. In its early stages, the prospective recovery must be led largely by consumer spending. But to be sustained over time, and to support continuing growth in productivity and living standards, more investment will be necessary. At present, as you know, business investment is moving lower. House building has remained at depressed levels; despite some small gains in starts during the spring, the cyclical strength "normal" in that industry in the early stages of recovery is lacking. Exports have been adversely affected by the relative strength of the dollar in exchange markets.

I must also emphasize that the current problems of the American economy have strong parallels abroad. Governments around the world have faced, in greater or lesser degree, both inflationary and fiscal problems. As they have come to grips with those problems, growth has been slow or non-existent, and the recessionary tendencies in various countries have fed back, one on another.

In sum, we are in a situation that obviously warrants concern, but also has great opportunities. Those opportunities lie in major part in achieving lasting progress—in pinning down and extending what has already been achieved—toward price stability. In doing so, we will be laying the base for sustaining recovery over many years ahead, and for much lower interest rates, even as the economy grows. Conversely, to fail in that task now, when so much headway has been made, could only greatly complicate the problems of the economy over time. I find it difficult to suggest when and how a credible attack could be renewed on inflation should we neglect completing the job now. Certainly the doubts and skepticism about our capacity to deal with inflation—which now seem to be yielding—would be amplified, with unfortunate consequences for financial markets and ultimately for the economy.

I am certain that many of the questions, concerns and dangers in your mind lie in the short run—and that those in good part revolve around the pressures in financial markets. Can we look forward to lower interest rates to support the expansion in investment and housing as the recovery takes hold? Is there, in fact, enough liquidity in the economy to support expansion—but not so much that inflation is reignited? Will, in fact, the economy follow the recovery path so widely forecast in coming months?

These are the questions that we in the Federal Reserve must deal with in setting monetary policy. As we approach these policy decisions, we are particularly conscious of the fact that monetary policy, however important, is only one instrument of economic policy. Success in reaching our common objective of a strong and prosperous economy depends upon more than appropriate monetary policies, and I will touch this morning on what seem to me appropriately complementary policies in the public and private sectors.

Review of Money Growth in 1982

Five months ago, in presenting our monetary and credit targets for 1982, I noted some unusual factors could be at work tending to increase the desire of individuals and businesses to hold assets in the relatively liquid forms encompassed in the various definitions of money. Partly for that reason—and recognizing that the conventional base for the M1 target of the fourth quarter of 1981 was relatively low—I indicated that the Federal Open Market Committee contemplated growth toward the upper ends of the specificied ranges. Given the "bulge" early in the year in M1, the Committee also contemplated that that particular measure of money might for some months remain above a "straight line" projection of the targeted range from the fourth quarter of 1981 to the fourth quarter of 1982.

As events developed, M1 and M2 both remained somewhat above straight line paths until very recently. M3 and bank credit have remained generally within the indicated range, although close to the upper ends. Taking the latest full month of June, M1 grew 5.6% from the base period and M2 9.4%, close to the top of the ranges. To the second quarter as a whole, the growth was higher, at 6.8% and 9.7%, respectively. Looked at on a year-over-year basis, which appropriately tends to average through volatile monthly and quarterly figures, M1 during the first half of 1982 averaged about 4¾% above the first half of 1981 (after accounting for NOW account shifts early last year). On the same basis, M2 and M3 grew by 9.7% and 10.5%, respectively, a rate of growth distinctly faster than the nominal GNP over the same interval.

In conducting policy during this period, the Committee was sensitive to indications that the desire of individuals and others for liquidity was unusually high, apparently reflecting concerns and uncertainties about the business and financial situation. One reflection of that may be found in unusually large declines in "velocity" over the period—that is, the ratio of measures of money to the gross national product. M1 velocity—particularly for periods as short as three to six months—is historically volatile. A cyclical tendency to slow (relative to its upward trend) during recessions is common. But an actual decline for two consecutive quarters, as happened late in 1981 and the first quarter of 1982, is rather unusual. The magnitude of the decline during the first quarter was larger than in any quarter of the entire postwar period. Moreover, declines in velocity of this magnitude and duration are often accompanied by (and are related to) reduced short-term interest rates. Those interest rate levels during the first half of 1982 were distinctly lower than during much of 1980 and 1981, but they rose above the levels reached in the closing months of last year.

Desire for Liquidity

More direct evidence of the desire for liquidity or precautionary balances affecting M1 can be found in the behavior of NOW accounts. As you know, NOW accounts are a relatively new instrument, and we have no experience of behavior over the course of a full business cycle. We do know that NOW accounts are essentially confined to individuals, their turnover relative to demand accounts is relatively low, and, from the standpoint of the owner, they have some of the characteristics of savings deposits, including a similarly low interest rate but easy access on demand. We also know the great bulk of the increase in M1 during the early part of the year—almost 90% of the rise from the fourth quarter of 1981 to the second quarter of 1982—was concentrated in NOW accounts, even though only about a fifth of total M1 is held in that form. In contrast to the steep downward trend in low-interest savings accounts in recent years, savings account holdings have stabilized or even increased in 1982, suggesting the importance of a high degree of liquidity to many individuals in allocating their funds. A similar tendency to hold more savings deposits has been observed in earlier recessions.

I would add that the financial and liquidity positions of the household sector of the economy, as measured by conventional liquid asset and debt ratios, has improved during the recession period. Relative to income, debt repayment burdens have declined to the lowest level since 1976. Trends among business firms are clearly mixed. While many individual firms are under strong pressure, some rise in liquid asset holdings for the corporate sector as a whole appears to be developing. The gap between internal cash flow (that is, retained earnings and depreciation allowances) and spending for plant, equipment, and inventory has also been at an historically low level, suggesting that a portion of recent business credit demands is designed to bolster liquidity. But, for many years, business liquidity ratios have tended to decline, and balance sheet ratios have reflected more dependence on short-term debt. In that perspective, any recent gains in liquidity appear small.

In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transaction purposes during the months of recession, strong efforts to reduce further the growth rate of the monetary aggregates appeared inappropriate. Such an effort would have required more pressure on bank reserve positions—and presumably more pressures on the money markets and interest rates in the short run. At the same time, an unrestrained build-up of money and liquidity clearly would have been inconsistent with the effort to sustain progress against inflation, both because liquidity demands could shift quickly and because our policy intentions could easily have been misconstrued. Periods of velocity decline over a quarter or two are typically followed by periods of relatively rapid increase. Those increases tend to be particularly large during cyclical recoveries. Indeed, velocity appears to have risen slightly during the second quarter, and the growth in NOW accounts has slowed.

The Monetary Targets—Balance of 1982

Judgments on these seemingly technical considerations inevitably take on considerable importance in the target-setting process because the economic and financial consequences (including the consequences for interest rates) of a particular M1 or M2 increase are dependent on the demand for money. Over longer periods, a certain stability in velocity trends can be observed, but there is a noticeable cyclical pattern. Taking account of those normal historical relationships, the various targets established at the beginning of the year were calculated to be consistent with economic recovery in a context of declining inflation. That remains our judgment today. Inflation has, in fact, receded more rapidly than anticipated at the start of the year potentially leaving more "room" for real growth. On that basis, the targets established early in the year still appeared broadly appropriate, and the Federal Open Market Committee decided at its recent meeting not to change them at this time.

However, the Committee also felt, in the light of developments during the first half, that growth around the top of those ranges would be fully acceptable. Moreover—and I would emphasize this—growth somewhat above the targeted ranges would be tolerated for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money. We will look to a variety of factors in reaching that judgment, including such technical factors as the behavior of different components in the money supply, the growth of credit, the behavior of banking and financial markets, and more broadly, the behavior of velocity and interest rates.

I believe it is timely for me to add that, in these circumstances, the Federal Reserve should not be expected to respond, and does not plan to respond, strongly to various "bulges"—or for that matter "valleys"—in monetary growth that seem likely to be temporary. As we have emphasized in the past, the data are subject to a good deal of statistical "noise" in any circumstances, and at times when demands for money and liquidity may be exceptionally volatile, more than usual caution is necessary in responding to "blips."*

We, of course, have a concrete instance at hand of a relatively large (and widely anticipated) jump in M1 in the first week of July—possibly influenced to some degree by larger social security payments just before a long weekend. Following as it did a succession of money supply declines, that increase brought the most recent level for M1 barely above the June average, and it is not of concern to us.

It is in this context, and in view of recent declines in short-term market interest rates, that the Federal Reserve yesterday reduced the basic discount rate from 12 to 11½ percent.

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*In that connection, a number of observers have noted that the first month of a calendar quarter—most noticeably in January and April—sometimes shows an extraordinarily large increase in M1—amplified by the common practice of multiplying the actual change by 12 to show an annual rate. Those bulges, more typically than not, are partially "washed out" by slower than normal growth the following month. The standard seasonal adjustment techniques we use to smooth out monthly money supply variations—indeed, *any* standard techniques—may, in fact, be incapable of keeping up with rapidly changing patterns of financial behavior, as they affect seasonal patterns. A note attached to this statement sets forth some work in process developing new seasonal adjustment techniques.

The Monetary Targets—1983

In looking ahead to 1983, the Open Market Committee agreed that a decision at this time would—even more obviously than usual—need to be reviewed at the start of the year in the light of all the evidence as to the behavior of velocity or money and liquidity demand during the current year. Apart from the cyclical influences now at work, the possibility will need to be evaluated of a more lasting change in the trend of velocity.

The persistent rise in velocity during the past twenty years has been accompanied by rising inflation and interest rates—both factors that encourage economization of cash balances. In addition, technological change in banking—spurred in considerable part by the availability of computers—has made it technically feasible to do more and more business on a proportionately smaller "cash" base. With incentives strong to minimize holdings of cash balances that bear no or low interest rates, and given the technical feasibility to do so, turnover of demand deposits has reached an annual rate of more than 300, quadruple the rate ten years ago. Technological change is continuing, and changes in regulation and bank practices are likely to permit still more economization of M1-type balances. However, lower rates of interest and inflation should moderate incentives to exploit that technology fully. In those conditions, velocity growth could slow, or conceivably at some point stop.

To conclude that the trend has in fact changed would clearly be premature, but it is a matter we will want to evaluate carefully as time passes. For now, the Committee felt that the existing targets should be tentatively retained for next year. Since we expect to be around the top end of the ranges this year, those tentative targets would of course be fully consistent with somewhat slower growth in the monetary aggregates in 1983. Such a target would be appropriate on the assumption of a more or less normal cyclical rise in velocity. With inflation declining, the tentative targets would appear consistent with, and should support, continuing recovery at a moderate pace.

The Blend of Monetary and Fiscal Policy

The Congress, in adopting a budget resolution contemplating cuts in expenditures and some new revenues, also called upon the Federal Reserve to "reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy." I can report that members of the Committee welcomed the determination of the Congress to achieve greater fiscal restraint, and I want particularly to recognize the leadership of members of the Budget Committees and others in achieving that result. In most difficult circumstances, progress is being made toward reducing the huge potential gap between receipts and expenditures. But I would be less than candid if I did not also report a strong sense that considerably more remains to be done to bring the deficit under control as the economy expands. The fiscal situation as we appraise it, continues to carry the implicit threat of "crowding out" business investment and housing as the economy grows—a process that would involve interest rates substantially higher than would otherwise be the case. For the more immediate future, we recognized that the need remains to convert the intentions expressed in the Budget Resolution into concrete legislative action.

In commenting on the budget, I would distinguish sharply between the "cyclical" and "structural" deficit—that is, the portion of the deficit reflecting an

imbalance between receipts and expenditures even in a satisfactorily growing economy with declining inflation. To the extent the deficit turns out to be larger than contemplated entirely because of a shortfall in economic growth, that "add on" would not be a source of so much concern. But the hard fact remains that, if the objectives of the Budget Resolution are fully reached, the deficit would be about as large in fiscal 1983 as this year even as the economy expands at a rate of 4 to 5 percent a year and inflation (and thus inflation generated revenues) remains higher than members of the Open Market Committee now expect.

In considering the question posed by the Budget Resolution, the Open Market Committee felt that full success in the budgetary effort should itself be a factor contributing to lower interest rates and reduced strains in financial markets. It would thus assist importantly in the common effort to reduce inflationary pressures in the context of a growing economy. By relieving concern about future financing volume and inflationary expectations, I believe as a practical matter a credibly firmer budget posture might permit a degree of greater flexibility in the actual short-term execution of monetary policy without arousing inflationary fears. Specifically, market anxiety that short-run increases in the Ms might presage continuing monetization of the debt could be ameliorated. But any gains in these respects will of course be dependent on firmness in implementing the intentions set forth in the Resolution and on encouraging confidence among borrowers and investors that the effort will be sustained and reinforced in coming years.

Taking account of all these considerations, the Committee did not feel that the budgetary effort, important as it is, would in itself appropriately justify still greater growth in the monetary aggregates over time than I have anticipated. Indeed, excessive monetary growth—and perceptions thereof—would undercut any benefits from the budgetary effort with respect to inflationary expectations. We believe fiscal restraint should be viewed more as an important complement to appropriately disciplined monetary policy than as a substitute.

Time to Move Ahead

In an ideal world, less exclusive reliance on monetary policy to deal with inflation would no doubt have eased the strains and high interest rates that plague the economy and financial markets today. To the extent the fiscal process can now be brought more fully to bear on the problem, the better off we will be—the more assurance we will have that interest rates will decline and keep declining during the period of recovery, and that we will be able to support the increases in investment and housing essential to healthy, sustained recovery. Efforts in the private sector—to increase productivity, to reduce costs, and to avoid inflationary and job-threatening wage increases—are also vital, even though the connection between the actions of individual firms and workers and the performance of the economy may not always be self-evident to the decision makers. We know progress is being made in these areas, and more progress will hasten full and strong expansion.

But we also know that we do not live in an ideal world. There is strong resistance to changing patterns of behavior and expectations ingrained over years of inflation. The slower the progress on the budget, the more industry and labor build in cost increases in anticipation of inflation or Government acts to protect markets or impede competition, the more highly speculative financing is undertaken, the greater the threat that available supplies of money and credit will be exhausted in financing rising prices instead of new jobs and growth. Those in vulnerable competitive positions are most likely to feel the impact first and hardest, but unfortunately the difficulties spread over the economic landscape.

The hard fact remains that we cannot escape those dilemmas by a decision to give up the fight on inflation—by declaring the battle won before it is. Such an approach would be transparently clear—not just to you and me—but to the investors, the businessmen and the workers who would, once again, find their suspicions confirmed that they had better prepare to live with inflation, and try to keep ahead of it. The reactions in financial markets and other sectors of the economy would, in the end, aggravate our problems, not eliminate them. It would strike me as the cruelest blow of all to the millions who have felt the pain of recession directly to suggest, in effect, it was all in vain.

I recognize months of recession and high interest rates have contributed to a sense of uncertainty. Businesses have postponed investment plans. Financial pressures have exposed lax practices and stretched balance sheet positions in some institutions—financial as well as non-financial. The earnings position of the thrift industry remains poor.

But none of those problems can be dealt with successfully by re-inflation or by a lack of individual discipline. It is precisely that environment that contributed so much to the current difficulties.

In contrast, we are now seeing new attitudes of cost containment and productivity growth—and ultimately our industry will be in a more robust competitive position. Millions are benefitting from less rapid price increases—or actually lower prices—at their shopping centers and elsewhere. Consumer spending appears to be moving ahead, and inventory reductions help set the stage for production increases.

Those are developments that should help recovery get firmly underway. The process of disinflation has enough momentum to be sustained during the early stages of recovery—and that success can breed further success as concerns about inflation recede. As recovery starts, the cash flow of business should improve. And, more confidence should encourage greater willingness among investors to purchase longer debt maturities. Those factors should, in turn, work toward reducing interest rates, and sustaining them at lower levels, encouraging in turn the revival of investment and housing we want.

I have indicated the Federal Reserve is sensitive to the special liquidity pressures that could develop during the current period of uncertainty. Moreover, the basic solidity of our financial system is backstopped by a strong structure of governmental institutions precisely designed to cope with the secondary effects of isolated failures. The recent problems related largely to the speculative activities of a few highly leveraged firms can and will be contained, and over time, an appropriate sense of prudence in taking risks will serve us well.

We have been through—we are in—a trying period. But too much has been accomplished not to move ahead and complete the job of laying the groundwork for a much stronger economy. As we look forward, not just to the next few months but to long years, the rewards will be great: in renewed stability, in growth, and in higher employment and standards of living. That vision will not be accomplished by monetary policy alone. But we mean to do our part.

Appendix—Alternative Seasonal Adjustment Procedures

For some time the Federal Reserve has been investigating ways to improve its procedures for seasonal adjustment, particularly as they apply to the monetary aggregates. In June of last year, a group of prominent outside experts, asked by the Board to examine seasonal adjustment techniques, submitted their recommendations.[3] The committee suggested, among other things, that the Board's staff develop seasonal factor estimates from a model-based procedure as an alternative to the widely used X-11 technique that provides the basis for the current seasonal adjustment procedure,[4] and release the results.

The Board staff has been developing a procedure using statistical models tailored to each individual series.[5] The table on the last page compares monthly and quarterly average growth rates for the current M1 series with those of an alternative series from the model-based approach.

Differences in seasonal adjustment techniques do not change the trend in monetary growth, but, as may be seen in the table, they do alter month-to-month growth rates owing to differing estimates of the distribution over time of the seasonal component in money behavior. Short-run money growth is variable under both the alternative and current techniques of seasonal adjustment, illustrating the inherently large "noise" component of the series. However, the redistribution of the seasonal component under the alternative technique does on average tend to moderate month-to-month changes somewhat.

The Board will continue to publish seasonally adjusted estimates for M1 on both current and alternative bases at least until the annual review of seasonal factors in 1983. A detailed description of the alternative method will be available shortly.

Growth Rates of M1 Using Current[6] and Alternative[7] Seasonal Adjustment Procedures

		1981		1982	
		Current	Alternative	Current	Alternative
Monthly Average-Percent Annual Rates	Jan.	9.8	1.4	21.0	11.4
	Feb.	4.3	7.5	−3.5	1.3
	Mar.	14.3	16.0	2.7	6.4
	Apr.	25.2	22.6	11.0	4.5
	May	−11.4	−10.3	−2.4	0.5
	June	−2.2	−0.6	−1.6	1.3
	July	2.8	2.2		
	Aug.	4.8	5.3		
	Sept.	0.3	3.1		
	Oct.	4.7	0.0		
	Nov.	9.7	11.1		
	Dec.	12.4	15.4		
Quarterly Average Percent Annual Rates	QI	4.6	3.5	10.4	9.5
	QII	9.2	9.6	3.1	3.4
	QIII	0.3	0.9		
	QIV	5.7	5.5		

Footnotes

1. **M1** is the sum of currency held by the public, plus travelers' checks, plus demand deposits, plus other checkable deposits (i.e., negotiable order of withdrawal (NOW), automatic transfer service (ATS) accounts, and credit union share draft accounts.)

M2 is M1 plus savings and small denomination time deposits, plus shares in money market mutual funds (other than those restricted to institutional investors), plus overnight repurchase agreements and Eurodollars.

M3 is M2 plus large time deposits at all depository institutions, large denomination term repurchase agreements, and shares in money market mutual funds restricted to institutional investors.

Bank credit is total loans and investments of commercial banks.

2. Because of the introduction of International Banking Facilities (IBFs), the bank credit data beginning in December 1981 are not comparable to earlier data. Thus, the target for 1982 was stated in terms of growth from the average level of December 1981 and January 1982 (shown in the last column) to the average level in the fourth quarter of 1982, so that the initial shift of assets to IBFs that occurred at the end of the year would not have a major impact on the pattern of growth. Actual growth rates for bank credit are calculated from the December–January base.

3. See Committee of Experts on Seasonal Adjustment Techniques, *Seasonal Adjustment of the Monetary Aggregates* (Board of Governors of the Federal Reserve System, October 1981).

4. The current seasonal adjustment technique has most recently been summarized in the description to the mimeograph release of historical money stock data dated March 1982. Detailed descriptions of the X-11 program and variants can be obtained from technical paper no. 15 of the U.S. Department of Commerce (rev. February 1967) and from the report to the Board cited in footnote 1.

5. The model-based seasonal adjustment procedures currently under review by the Board staff use methods based on the well-developed theory of statistical regression and time series modeling. These approaches allow development of seasonal factors that are more sensitive than the current factors to unique characteristics of each series, including, for example, fixed and evolving seasonal patterns, trading day effects, within-month seasonal variations, holiday effects, outlier adjustments, special events adjustments (such as the 1980 credit controls experience), and serially correlated noise components.

6. Current monthly seasonal factors are derived using an X-11/ARIMA-based procedure applied to monthly data.

7. Alternative monthly seasonal factors are derived using a model-based procedure applied to weekly data.

A copy of the full report to Congress is available free of charge from Publications Services, Federal Reserve Board, Washington, D.C. 20551.

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