
Monetary Policy Objectives for 1983

Midyear Review of the Federal Reserve Board

July 20, 1983

Monetary Policy Objectives for 1983

With Tentative Monetary Growth Ranges for 1984

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, 1983.

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Monetary Policy in 1983 and 1984

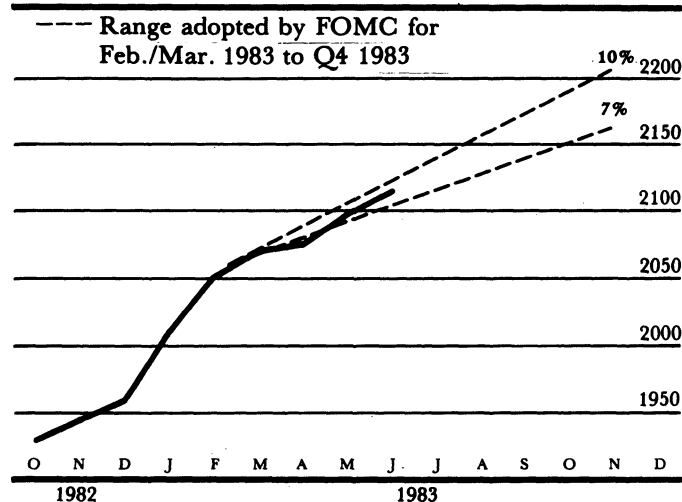
Growth in Money and Credit

During July, the Federal Reserve reviewed its 1983 target ranges for money and credit and established tentative ranges for 1984 in light of its basic objectives of encouraging sustained economic recovery while continuing to make progress toward price stability. In setting these ranges, the Federal Open Market Committee recognized that the relationships among the money and credit aggregates and economic activity in the period ahead are subject to considerable uncertainty. Consequently, it was emphasized that, in implementing policy, the significance to be attached to movements in the various measures of money would depend on evidence about the strength of economic recovery, the outlook for prices and inflationary expectations, and emerging conditions in domestic and international financial markets.

The Committee reaffirmed the 1983 ranges for the broader monetary aggregates—M2 and M3. The tentative ranges for next year set for these aggregates were reduced by $\frac{1}{2}$ percentage point.

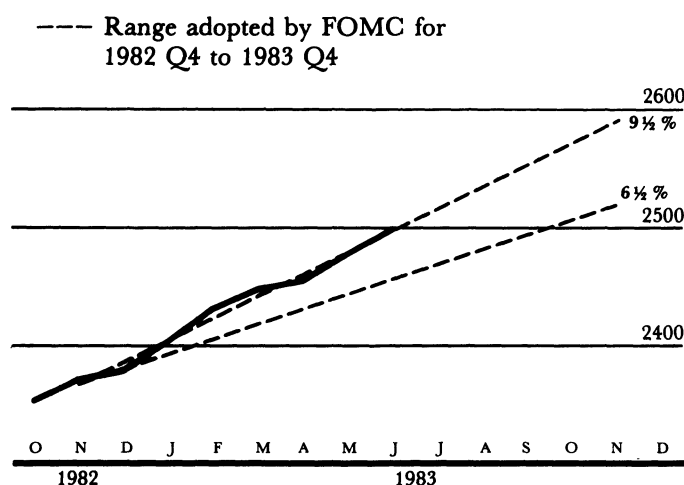
M2

Billions of dollars



M3

Billions of dollars



In setting these tentative ranges, it was expected that shifts into money market deposit accounts (MMDAs) would not significantly distort growth in the broader aggregates, in contrast to the experience in the early part of this year.

With greater growth in real (and nominal) GNP than anticipated earlier—but in the context of moderating inflation—actual growth in M2 and M3 may reasonably be higher in the ranges than thought likely earlier.

The FOMC also agreed that principal weight would continue to be placed on the broader monetary aggregates in the implementation of monetary policy, in view of the continuing uncertainties that attach to the behavior and trend of M1 over time.

Monitoring M1 and Debt

Recent evidence suggests that the declines in the velocity of M1 may be abating. The income velocity of M1 declined only modestly in the second quarter of this year. The upward impact on M1 demand of earlier interest rate declines has faded and, given the sizable buildup in liquid balances that has taken place, it seems probable that some pick-up in the

velocity of M1 will develop over the quarters ahead, in closer conformance with cyclical and secular patterns of earlier years. Whether any rise in velocity would be as strong as in earlier decades of the post-World War II period remains uncertain.

Taking account of the various uncertainties, for the purpose of monitoring M1 behavior, the Committee established the growth range shown below (annual rate) for the period from the second quarter to the fourth quarter of this year. The decision to establish a new base (the second quarter) for monitoring M1 reflected a judgment that the rapid growth over the past several quarters should be treated as a one-time phenomenon, neither to be retraced or long extended. The monitoring range for M1 tentatively established for the period from the fourth quarter of 1983 to the fourth quarter of 1984 is also shown below. These ranges anticipate no further decline in the velocity of M1 during a period of relatively strong growth in economic activity and allow for the likelihood of some rebound in velocity.

M1 growth would be expected to move lower in these ranges as and if velocity strengthens.

The Committee reaffirmed the previously announced range for monitoring domestic financial debt in 1983, and reduced the range by $\frac{1}{2}$ percentage point for 1984.

The Outlook for the Economy

When the year began, an economic expansion was underway, but it was widely expected that the recovery, at least in its initial phases, would be significantly less rapid than the average postwar cyclical upswing.

By the second quarter, however, the recovery had gained vigor and was following in most respects a typical cyclical pattern. Advances in residential construction were exceptionally large during the first half, and there were sustained increases in consumer spending, particularly for durable goods. Businesses continued to liquidate inventories at a rapid pace through the first quarter, but then apparently began rebuilding stocks in the second quarter as final demands strengthened. Employment gains became

Ranges of Broader Aggregates, 1983 and 1984¹

	1983 Range	1983 Actual ²	1984 Tentative ²	Base Levels ²
	Percent	Percent	Percent	Billions of Dollars Seasonally Adjusted
M2	7-10	9.1	6½-9½	2060.4
M3	6½-9½	9.6	6-9	2366.6

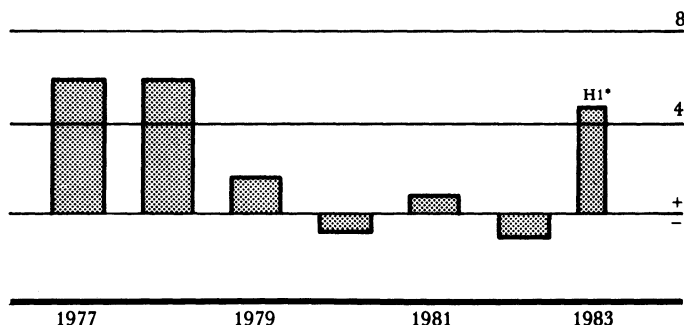
Monitoring Ranges for M1 and Debt, 1983 and 1984¹

	1983 1st Half	1983 2nd Half	1983 Actual ²	1984 Tentative ²	Base Levels ²
	Percent	Percent	Percent	Percent	Billions of Dollars Seasonally Adjusted
M1	4-8	5-9 ³	13.9	4-8	473.6
Total Domestic Nonfinancial Debt	8½-11½	No Change	10.6	8-11	4750.0

Real GNP

1972 Dollars

Change from end of previous period, annual rate, percent



*Data for 1983-H1 are based partly on advance projections from the Commerce Department.

substantial as the recovery gathered speed, and the unemployment rate in June—while still high historically—was three-quarters of a percent below the earlier peak.

Given the momentum of the recovery—and the added stimulus of another reduction in personal taxes at midyear—there is a strong likelihood that real GNP will continue growing at a healthy pace through the second half of 1983. Gains in employment and output have generated sizable increases in income, which in turn are laying the groundwork for further advances in consumer spending. And, business spending on equipment appears to be turning up. The cumulative forces of economic expansion thus appear to be well established.

Real GNP growth in the second half as a whole may not match the rapid second-quarter pace, which partly reflected the sharp swing in inventory positions. In addition, given the level of housing starts

reached in the second quarter, and with mortgage interest rates no longer falling, outlays for residential construction seem unlikely to continue rising at the extraordinary pace of early 1983. The foreign sector, too, will be exerting a restraining influence on growth of output in the United States, owing to a strong dollar, relatively slow growth in the other industrial nations, and financial difficulties besetting many developing countries.

Employment is likely to continue expanding as the recovery in output progresses, with gradual declines in the unemployment rate. However, if past experience is any guide, the strengthening economy will itself prompt more job-seekers to enter the labor force, thereby reinforcing the inertia of the unemployment rate. Consequently, unemployment will remain high, relative to the earlier postwar period, for some time.

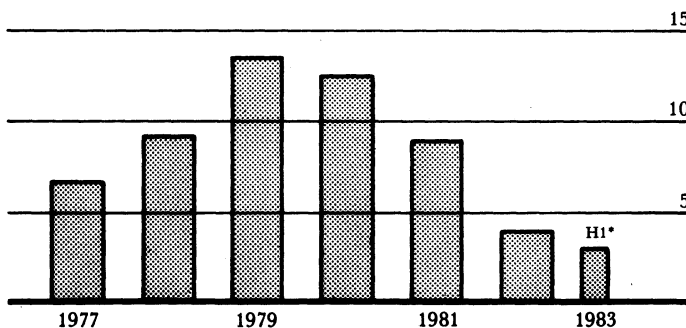
Inflation Outlook

The near-term outlook for inflation continues to be reasonably favorable. Wage pressures have moderated further into 1983, productivity is improv-

Consumer Prices

1972 Dollars

Change from end of previous period, percent



*Price changes for 1983-H1 are based on data for the December to May period.

ing, and the continued strength of the dollar is limiting increases in the prices of imported goods.

At the same time that the general trend of price increase is still slowing, there are indications that some of the cyclical influences that helped reduce inflation during the recession have waned. With demands for goods and services strengthening, price discounting is diminishing; and the downward pressures on prices and wages in some markets will lessen as orders and labor demand rise. Such developments are to some extent inevitable. What is of critical importance is that these cyclical influences not impair more lasting progress toward reduction in the underlying rate of inflation, as reflected in the interactions of wages, productivity, and costs.

Recently, the concerns on that score have been heightened somewhat by several factors. Preliminary indications are that growth in nominal GNP exceeded 11 percent in the second quarter. That high rate of spending growth is a welcome development insofar as it has come about in the context of accelerated real output growth and moderating prices. However, growth in some measures of money and credit also has been relatively large recently, and growth in *nominal* spending at the present rate over a sustained period would suggest renewed inflationary pressures.

The vigor of the private economy at midyear also has underscored the potential problems associated with federal budget deficits that will remain massive in the years ahead, unless there are decisive actions to reduce expenditures or—absent such action—to increase revenues. Prospects for interest rates are

Economic Projections for 1983 and 1984

		FOMC Members		Administration
1983		Range	Central Tendency	
Percent change, fourth quarter to fourth quarter:	Nominal GNP	9¼ to 10¾	9¾ to 10	10.4
	Real GNP	4¾ to 6	5 to 5¾	5.5
	Implicit deflator for GNP	4 to 5¼	4¼ to 4¾	4.6
Average level in the fourth quarter, percent:				
	Unemployment Rate	9 to 9¾	About 9½	9.6
1984		Range	Central Tendency	
Percent change, fourth quarter to fourth quarter:	Nominal GNP	7 to 10¼	9 to 10	9.7
	Real GNP	3 to 5	4 to 4½	4.5
	Implicit deflator for GNP	3¾ to 6½	4¼ to 5	5.0
Average level in the fourth quarter, percent:				
	Unemployment Rate	8¾ to 9¼	8¾ to 8¾	8.6

related to a number of factors, including importantly the actual and perceived trend in inflation. In 1982, when the economy was mired in recession and the inflation rate was falling, record-large government deficits were consistent with declining interest rates. However, should public credit demands remain at or near record highs while private credit demands are expanding rapidly in response to rising business activity, the outlook for interest rates would clearly be affected.

While most members of the Federal Open Market Committee are relatively optimistic about the prospects for maintaining economic growth and containing inflation over the next year and a half, they also are mindful of potential difficulties that could disrupt the outlook and cause the nation's economic performance to be less favorable than is now expected. There is, as already noted, the prospect that federal budget deficits will remain extremely large into the

indefinite future; as the private recovery lengthens, the dangers associated with those deficits are likely to increase, posing a threat to both the inflation outlook and the sustainability of a balanced expansion.

There also are some broader risks, not specifically related to the budget, that some of the progress against inflation could be reversed as the private economy strengthens. The persistence of inflationary expectations is evident both in recent surveys of private opinion and in the behavior of financial markets, in which borrowers remain willing to pay high nominal rates of return on long-term debt instruments. As the recovery progresses, wage and price developments will need to be monitored with great care to make sure that these still-present expectations of inflation are not undergirding a new round of acceleration in actual wage and price increases.

More generally, the United States has become much more integrated into the world economy than it was a decade ago, and our economic fortunes have become closely linked with those of other nations. Because of those close linkages, the economic difficulties of many foreign nations, particularly the serious financial problems still plaguing many developing countries, could affect this nation's economic performance in the period ahead.

Footnotes

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

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

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

Total Domestic Nonfinancial Sector Debt is outstanding debt of domestic governmental units (federal, state and local), households and nonfinancial businesses.

2. Base Period for Aggregates:

For M1—Fourth Quarter 1982.

For M2—Average of February–March 1983.

For M3—Fourth Quarter 1982.

For Debt—December 1982.

Figures for “1983 Actual” are measured from base period through June 1983. Tentative ranges for M1, M2 and M3 1984 are measured from the fourth quarter of 1983 to the fourth quarter of 1984; debt is measured from December 1983 to December 1984.

3. Base period is QII 1983.

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

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

I welcome this opportunity to discuss Federal Reserve monetary policy with the Banking Committee in the context of current and prospective economic conditions and other policies at home and abroad. You have before you the Midyear Monetary Policy Report to the Congress prepared in accordance with the Humphrey-Hawkins Act. This morning, I will highlight or expand upon some aspects of that Report and deal with certain further questions raised by your Chairman.

Course of the Recovery

We meet at a time when economic activity is plainly advancing at a rate of speed significantly faster than we, the Administration, the Congress, and most other observers thought likely at the start of the year. Over the past six or seven months of expansion, output has risen about as fast as in the average postwar recovery, more than 1 million more people are employed, and the unemployment rate has dropped by nearly a percentage point from its peak.

The very sizable gain in the Gross National Product during the second quarter in substantial part

reflected a cessation of inventory liquidation—and perhaps small accumulations—by business. That is not unusual in the early stages of expansion, and does not necessarily suggest continuing gains at the same rate of speed. But it is also evident that domestic final sales and incomes are now increasing fairly rapidly, that the midyear tax cut has released further purchasing power, and that consumer and business confidence has improved. Consequently, strong forward momentum has carried into the third quarter, and potentially beyond.

The expansion so far has been accompanied by remarkably good price performance. Finished producer prices were essentially unchanged over the first half of 1983, and consumer prices were up at a rate of only 3 percent through May and by about 3½ percent over the last twelve months. Perhaps more significant for the future, the rate of nominal wage increase—at about a 4 percent annual rate—is now at its lowest level since the mid-1960's, while average *real* wages, as in 1982, are rising. That pattern has been assisted by sizable productivity gains.

In all these respects, we are clearly “doing better.” Yet, even as the economy has expanded and the inflation record has remained good, widespread forebodings remain evident for the future. Those concerns are understandable and justified so long as some major policy issues—issues that I emphasized in my testimony to you earlier in the year—remain unresolved. Indeed, the very speed and vigor of the recovery in its early stages has increased the urgency of facing up to those problems.

I have repeatedly expressed the view that we have come much of the way toward setting the stage for a long-sustained period of recovery, characterized by greater growth in productivity and real incomes and by much greater price stability. Responsible and prudent monetary policies must be one important element in making that vision a reality. But it would be an illusion to think that monetary policy alone can do the job, and before turning to monetary policy in detail, I want to touch again upon some crucially important aspects of the environment in which monetary policy must be conducted.

The Budgetary Situation

I am aware of the enormous effort in the Congress over recent months to shape a responsible budgetary resolution—indeed to preserve an orderly budgetary process. But the concrete results of that effort to date appear ambiguous at best, measured against the challenge of reducing the growing structural deficits embedded in the current budgetary outlook.

The current fiscal year is likely to see a budget deficit—not counting Treasury or other market financing of off-budget credit programs—of some \$200 billion, or about 6½ percent of the GNP. Forecasts of future years necessarily entail judgments about Congressional action yet to be taken as well as economic factors. Should Congress fail to implement the expenditure restraints as well as the revenue increases contemplated in the recent Budget Resolution—and doubt has been expressed on that point within the Congress itself—deficits appear likely to remain close to \$200 billion for several years, even taking account of economic growth at the higher rates now projected. The hard fact remains that, as economic growth generates income and revenues to reduce the “cyclical” element in the deficit, the “underlying” or “structural” position of the budget will deteriorate without greater effort to reduce spending or increase revenues from that incorporated in existing programs. We would be left with the prospect that Federal financing would absorb through and beyond the mid-1980’s a portion of our savings potential without precedent during a period of economic growth.

That outlook raises a fundamental question about the consistency of the budget outlook with the kind of economy we want. That is particularly the case with respect to such heavy users of credit as housing and business investment. To put the issue pointedly, the government will be financed, but others will be squeezed out in the process.

While that threat has been widely recognized, there has also been a comfortable assumption that

the problem would not become urgent until 1985 or beyond. That might be true in the context of a rather slowly growing economy. But the speed of the current economic advance certainly brings the day of reckoning in financial markets earlier. In the second quarter, total nonfederal credit demands were already increasing substantially, even though *business* demands were essentially unchanged at a relatively low level. Potential credit market pressures have been ameliorated by a growing inflow of foreign capital, but a net capital inflow can be maintained only at the expense of a deep trade deficit. Banks have been sizable buyers of government securities during the early stages of recovery while business demands for credit have been relatively slack. But there has also been some tendency for overall measures of money, liquidity, and credit to rise recently at rates that, if long sustained, would be inconsistent with continuing or even consolidating progress toward price stability.

All of this, to my mind, points up the urgency of further action to reduce the budgetary deficit to make room for the credit needed to support growth in the private economy. Left unattended, the situation remains the most important single hazard to the sustained and balanced recovery we want.

The International Dimension

The pressures on our capacity to finance *both* rising private credit demands and a huge budgetary deficit have, as I just noted, been one factor inducing a growing net capital inflow. One short-term consequence is lower domestic interest rates than might otherwise be necessary, and maintenance of extraor-

dinary strength of the dollar at a time of rising trade and current account deficits. But the sustainability of those trends can be questioned. The picture of the largest and strongest economy in the world relying, in a capital-short world, on large inflows of funds to finance, directly or indirectly, internal budget deficits is not an inviting one for the future. The implication would be a persistently weak trade position, instability in the international financial system and exchange rates, and lack of balance in our recovery.

More immediately, the pressing debt problems of much of the developing world—centered in, but not confined to, Latin America—remain a clear threat to financial stability. In the period since we last discussed these issues, the strains have been successfully contained, but by no means resolved. To be sure, there are clear signs of progress with necessary economic adjustment in some instances—notably in Mexico. Within the past week, Brazil—which, along with Mexico, is the largest debtor—has taken forceful and encouraging domestic actions that should provide a base for renewed IMF support and for added private financing. But “normalcy” has plainly not returned.

Confidence and market-oriented financing patterns cannot be fully restored without sustained growth among the industrialized countries, so that the debtors can earn their way with greater exports. Lower interest rates will be important as well. But that process will take time. Meanwhile, failure to provide the IMF—which is the international institution at the center of the adjustment and financing

process—with adequate resources to do its job would deal a devastating blow to the extraordinary cooperative effort that has been marshaled to manage the situation, with potentially severe consequences for the U.S. financial system as well as the developing world. Early action by the House on the Administration’s request in this matter is thus one key element in a program to sustain recovery.

Wage-Price Trends

I touched earlier on the relatively favorable wage-price-productivity trends of the past year. We are now approaching a new test—whether those trends can be extended into and through a period of recovery. Today, orders are rising, businesses are hiring, layoffs are sharply diminished, and profits are improving. After the inflationary experience of the 1970’s, the temptation could arise to revert to what some might consider “normal” behavior—to anticipate inflation, to return to wage increases characteristic of the earlier decade, to fatten profit margins as fast as possible by raising prices in a stronger market rather than relying on volume increases. But pressed collectively, the irony would be that such behavior, by inciting doubts about the inflationary outlook and affecting interest rates, would impair prospects for continued growth in *real* wages, in profits, and in employment.

We and other industrialized countries have had little success in dealing with that threat through so-called “incomes policies.” But government policy can make a powerful contribution toward moderation through two avenues: first, by making evident in its fiscal and monetary management that inflationary pressures will continue to be contained, and second, by insisting upon open, competitive markets.

In that respect, open markets internationally serve our continuing basic interest in spurring efficiency and competition. Virtually every country has made compromises with protectionism during the period of recession. With growth underway, it is time not only to halt but to reverse that trend to help sustain expansion and the gains against inflation.

Moreover, as the economy grows stronger, I hope we will seriously turn more of our attention to the many purely domestic inhibitions to competition, and to reducing the artificial supports for prices and costs in some industries. All too often, they work at cross purposes to the needs of the economy as a whole.

Monetary Policy in 1983 and Beyond

This setting of gratifying immediate progress, yet evident looming threats, has provided the environment for decisions with respect to monetary policy. As you are well aware, interest rates dropped sharply during the second half of 1982 as the recession continued, and, with inflation subsiding, reserve pressures on the banking system were relaxed. Growth in money and credit has been, quite plainly, adequate to support growth in economic activity—indeed more growth in the first half of 1983 than had been generally anticipated.

During much of the period after mid-1982, institutional change, as well as adjustments by liquid asset holders to the sharp drop in interest rates, to declining inflation, and to the uncertainties of the recession, appeared to be affecting one or another of the monetary aggregates. In particular, the behavior of M1 in relation to economic activity and the nominal GNP has raised questions about whether the patterns in velocity established earlier in the postwar period might be changing, cyclically or on a trend basis. For that reason, less emphasis has been placed on that aggregate in policy implementation. For a time, the enthusiastic reception of the public to—and aggressive marketing by depositary institutions of—the new ceiling-free Money Market Deposit Accounts plainly affected growth in M2. Consequently, the target base for 1983 for that aggregate was set at the February and March average, rather than the fourth quarter of 1982, to avoid most of those distortions. More broadly, given the

questions about interpreting some of the monetary and credit aggregates, judgments as to the appropriate degree of pressure on bank reserve positions have been conditioned by available evidence about trends in economic and financial conditions, prices (including sensitive commodity prices), exchange rates, and other factors.

Through most of the first half of the year, as the economy picked up speed, the broader monetary and credit aggregates moved consistently with the ranges set in February. At the same time, trends in overall price indices were relatively favorable, and sensitive commodity prices, after an increase from cyclically depressed levels early in the year, appeared to be leveling off in the second quarter. The continuing exceptional strength of the dollar in foreign exchange markets and the international financial strains did not point in the direction of restraint. In all these circumstances, a broadly accommodative approach with respect to bank reserves appeared appropriate, despite much higher growth in M1—alone among the targeted aggregates—than anticipated.

In the latter part of the second quarter, against the background of growing momentum in economic activity, monetary and credit growth showed some tendency to increase more rapidly, and M1 growth remained particularly high—higher, if sustained, than seemed consistent with long-term progress against inflation and sustained orderly recovery. In these circumstances, the Federal Open Market Com-

mittee, beginning in late May, has taken a slightly less accommodative posture toward the provision of bank reserves through open market operations, leading to some increase in borrowings at the discount window. Whether viewed from a domestic or international perspective, limited, timely and potentially reversible measures now, when the economy is expanding strongly, are clearly preferable to the risks of permitting a situation to develop that would require much more abrupt and forceful action later to deal with new inflationary pressures and a long-sustained pattern of excessive monetary and credit growth.

These steps have been accompanied by increases, ranging from $\frac{3}{4}$ to 1 percent or more, in both long- and short-term market interest rates. Apart from any monetary policy actions, these limited changes—particularly in the intermediate and longer-term areas of the market—appear also to have been influenced by larger private and government credit demands currently, as well as by expectations generated by stronger economic and monetary growth and the budgetary deficit.

Over the more distant future, balanced and sustained economic growth—with strong housing and business investment—would appear more likely to require lower rather than higher interest rates. That outcome, however, can be assured only if the progress against inflation can be consolidated and extended. In considering all these factors, the FOMC basically concluded that the prospects for sustained growth and for lower interest rates over time would be enhanced, rather than diminished, by modest and timely action to restrain excessive growth in money

and liquidity, given its inflationary potential. But I must emphasize again that the best assurance we could have that monetary policy can in fact do its part by avoiding excessive monetary growth within a framework of a growing economy and reduced interest rates over time lies not in the tools of central banking alone, but in timely fiscal action.

Ranges for M2 and M3

Looking ahead, the Committee decided that the growth ranges established early in the year for M2 and M3 during 1983 (7-10 percent and $6\frac{1}{2}$ - $9\frac{1}{2}$ percent, respectively) are still appropriate. The most recent data, while showing somewhat larger increases in June, are still within (M2), or about at the upper end (M3), of those ranges.

As anticipated, the massive shifting of funds into M2 as a result of the introduction of Money Market Deposit Accounts, and to a more limited extent into Super NOW Accounts, has abated. We assume these new accounts, and the further deregulation of time deposit interest rates scheduled for October 1, will have little impact on growth trends in the period ahead. Given the reasonably favorable trend of prices, the ranges should be consistent with more real growth than thought probable at the start of the year.

The Committee also decided to continue the associated ranges for growth in total domestic non-financial credit of $8\frac{1}{2}$ to $11\frac{1}{2}$ percent. As you know, 1983 is the first time the Committee has set a range for a broad credit aggregate, and it is not given the same weight as the broader monetary aggregates, at least while we gain experience. We are aware that, consistent with the established range, growth in credit during 1983 could exceed nominal GNP, although the long-term trend is for practically no change in the ratio of credit to income (i.e., “credit velocity” is relatively flat). Somewhat faster growth in credit is consistent with experience so far this year, and may be related to the relatively rapid expansion in Federal debt.

For 1984, the Committee tentatively looks toward a reduction of $\frac{1}{2}$ percent in each of those ranges, for M2, M3, and non-financial domestic credit. That small reduction appears appropriate and desirable, taking account of the need to sustain real growth while containing inflation. Those targets appear fully

consistent, in the light of experience, with the economic projections of the Committee (as well as those of the Administration and those underlying the Budget Resolution).

The targets are, of course, subject to review around year end. One question that arises is whether the somewhat more rapid growth in credit than nominal GNP will, or should desirably, continue, consistent with progress toward price stability and toward a more conservative pattern of private finance than characteristic of the years of inflation. Again, the pressures on aggregate debt expansion stemming from the budgetary situation are a source of concern.

Monitoring M1 and Debt

Decisions concerning appropriate targets for M1 were more difficult. As discussed further in an Appendix to this statement, the velocity of M1, whether measured as a contemporaneous or lagged relationship, has varied significantly from usual cyclical patterns, dropping more sharply and longer during the recession and failing to “snap back” as quickly. While a number of more temporary factors may have contributed, a significant part of the reason appears to be related to the fact that a major portion of the narrow “money supply” now pays interest, and the “spread” between the return available to individuals from holding M1 “money” and market rates has narrowed substantially, more than the decline in market rates itself implies. Put another way, NOW accounts, where the growth has been most rapid, are not only transaction balances, but now have a “savings” or “liquid asset” component. For a time at least, uncertainty about the financial and economic outlook, and less fear about inflation, may also have bolstered the desire to hold money.

Growth in M1—in running well above our targets for nine months—has not, however, been confined to NOW accounts alone. Moreover, there are signs that the period of velocity decline may be ending. In

looking ahead, with the economy expanding and with ample time for individuals and others to have adjusted to the rapid decline in interest rates last year, we must be alert to the possibility of a rebound in velocity along usual cyclical patterns, even though the longer-term trend may be changing.

In monitoring M1, the Committee felt that an appropriate approach would be to assess future growth from a base of the second quarter of 1983, looking toward growth close to, or below, nominal GNP. Specifically, the range was set at 5 to 9 percent for the remainder of this year, and at 1 percent lower—4 to 8 percent—for 1984. Thus, the Committee, in the light of recent developments looks toward substantially slower, but not a reversal, of M1 growth in the future. Velocity is expected to increase, although not necessarily to the extent common in earlier recoveries.

The range specified is relatively wide, but depending on further evidence with respect to velocity, either the upper or lower portion of the range could be appropriate. As this implies, M1 will be monitored closely but will not be given full weight until a closer judgment can be made about its velocity characteristics for the future. We are, of course, aware that proposals to pay interest on demand deposits could, if enacted, influence velocity trends further over time.

These targets are designed to be consistent with continuing growth in economic activity and reduced unemployment in a framework of sustained progress against inflation—and indeed are designed, insofar as monetary policy can, to contribute to those goals. The targets, by themselves, do not necessarily imply either further interest rate pressures or the reverse in the period ahead—much will depend on other fac-

tors. In particular, progress in the budget and continued success in dealing with inflation should be powerful factors reducing the historically high level of interest rates over time, to the benefit of our private economy and the world at large.

“Targeting” Other Economic Variables

The Chairman of the Committee has asked for my views on the Federal Reserve’s setting and announcing “objectives” for a variety of economic variables. As you know, the FOMC already reports its “projections” or “forecasts” for GNP, inflation, and unemployment. These projections are included with the materials I am reporting to the Committee today, as they have been at earlier hearings. I believe the practice of reporting the full range and the “central tendency” of FOMC members’ expectations about the economy may be useful in reflecting the general direction of our thinking, as well as suggesting the range of possible outcomes for economic performance in the 12 or 18 months ahead, given our monetary policy decisions and fiscal and other developments over those periods.

There is a sense in which those projections reflect a view as to what outcome should be both feasible and acceptable—given other policies and factors in the economy; otherwise monetary policy targets would presumably be changed. But I would point out that, like any other forecast, they are imperfect, and actual experience has sometimes been outside the forecast ranges.

Moreover, I believe there are strong reasons why it would be unwise to cite “objectives” for nominal or real GNP rather than “projections” or “assumptions” in these Reports.

Proposal to Cite a GNP “Objective”

The surface appeal of such a proposal is understandable. If a chosen path for GNP over a 6 to 18

month period could be achieved by monetary policy, specific objectives might appear to assist in debating and setting the appropriate course for monetary policy.

Unfortunately, the premise of that approach is not valid—certainly not in the relatively short-run. The Federal Reserve alone cannot achieve within close limits a particular GNP objective—real or nominal—it or anyone else would choose. The fact of the matter is monetary policy is not the only force determining aggregate production and income. Large swings in the spending attitudes and behavior of businesses and consumers can affect overall income levels. Fiscal policy plays an important role in determining economic activity. Within the last decade, we also have seen the effects of supply-side shocks, such as from oil price increases, on aggregate levels of activity and prices. In the last six months, even without such shocks, the economy has deviated substantially from most forecasts, and from what might have been set as an objective for the year.

The response might well be “so what”—it’s still better to have something to “shoot at.” But encouraging manipulation of the tools of monetary policy to achieve a specified short-run numerical goal could be counterproductive to the longer-term effort. Indeed, we do want a clear idea of what to “shoot at” over time—sustained, non-inflationary growth. But the channels of influence from our actions—the purchase or sale of securities in the market or a change in the discount rate—to final spending totals are complex and indirect, and operate with lags, extending over years. The attempt to “fine tune” over, say, a six-month or yearly period, toward a numerically specific, but necessarily arbitrary, short-term objective could well defeat the longer-term purpose.

Equally dangerous would be any implicit assumption, in specifying an “objective” for GNP, that monetary policy is so powerful it could be relied upon to achieve that objective whatever else happens with respect to fiscal policy or otherwise. Such an impression would be no service to the Congress or to the public at large; at worst, it would work *against* the hard choices necessary on the budget and other matters, and ultimately undermine confidence in monetary policy itself.

Some of the difficulties could, in principle, be met by specifying numerical "objectives" over a longer period of time. But, experience strongly suggests that the focus will inevitably, in a charged political atmosphere, turn to the short-run. The ability of the monetary authorities to take a considered longer view—which, after all, is a major part of the justification for a central bank insulated from partisan and passing political pressures—would be threatened. Indeed, in the end, the pressures might be intense to set the short-run "objectives" directly in the political process, with some doubt that that result would give appropriate weight to the longer-run consequences of current policy decisions.

I would remind you that we have paid a high price for permitting inflation to accelerate and become embedded in our thinking and behavior, partly because we often thought we could "buy" a little more growth at the expense of a little inflation. The consequences only became apparent over time, and we do not want to repeat that mistake.

Put another way, decisions on monetary policy should take account of a variety of incoming information on GNP or its components, and give weight to the lagged implications of its actions beyond a short-term forecast horizon. This simply can't be incorporated into annual numerical objectives.

As a practical matter, I would despair of the ability of any Federal Reserve Chairman to obtain a meaningful agreement on a single numerical "objective" among 12 strong-willed members of the FOMC in the short-run—meaningful in the sense of being taken as the anchor for immediate policy decisions. Submerging differences in the outlook in a statistical average would, I fear, be substantially less meaningful than the present approach.

As you know, we adopted this year the approach of indicating the "central tendency" of Committee thinking as well as the full range of opinion. These "estimates" provide, it seems to me, a focus for debate and discussion about policy that, in the end, should be superior to an artificial process of "objective" setting that may obscure, rather than enlighten, the real dilemmas and choices.

International Coordination

Your questions, Mr. Chairman, went on to raise the issue of international coordination of monetary policy and whether or not to stabilize exchange rates multilaterally. I can deal with these important issues here only in a most summary way.

Coordination, in the broad sense of working together toward more price stability and sustained growth, is plainly desirable—indeed it must be the foundation of greater exchange rate and international financial stability in the common interest. But stated so broadly, it is clearly a goal for economic policy as a whole, not just monetary policy.

The appropriate level of interest rates or monetary growth in any country are dependent in part on the posture of other policy instruments and economic conditions specific to that country. For that reason, explicit coordination, interpreted as trying to achieve a common level of, for instance, interest rates or money growth, may be neither practical nor desirable in specific circumstances. What does seem to me desirable—and essential—is that monetary (and other) policies here and abroad be conducted with full awareness of the policy posture, and possible reactions, of others, and the international consequences. In present circumstances, we work toward that objective by informal consultations in a variety of forums with our leading trade and financial partners, recently on some occasions with the presence of the Managing Director of the IMF.

As this may imply, I believe a greater degree of exchange market stability is clearly desirable, in the interest of our own economy, but that must rest on the foundation of internal stability. In recent years, in my judgment, the priority has clearly had to lie with measures to achieve that necessary internal stability. In specific situations, particular actions

may appear to conflict with the desirability of exchange rate stability; that possibility is increased when the "mix" of fiscal and monetary policy is far from optimal, as I discussed earlier in my statement. Such "conflicts" should diminish as internal stability is more firmly established.

The idea of a more structured international system of exchange rates to enforce greater stability in the international monetary and trading system raises issues far beyond those I can deal with here. I do not believe it would be practical to move toward such a system at the present time, but neither would I dismiss such a possibility over time should we and others maintain progress toward the necessary domestic prerequisites.

Stability and Sustained Growth

In important ways, even more progress toward our continuing economic objectives has been made during the past six months than we anticipated. But it is also true—partly because economic growth has increased—that the need to deal, promptly and effectively, with the obstacles to sustained growth and stability have become more pressing. Those obstacles are well known to all of you. There is, indeed, little disagreement, conceptually, about their nature.

What has been lacking is a strong consensus about the specifics of how, in a practical way, to deal with them. There should be no assumption that

monetary policy, however conducted, can itself substitute for budgetary discipline, for open and competitive markets, for inadequate savings, or for structural financial weaknesses.

The world economy offers ample illustration of the dangers of procrastination and delay in the face of political impasse, and in the hope that problems will subside by themselves—only to be faced, in crisis circumstances, with the need for still stronger action in an atmosphere of shattered confidence. That great intangible of confidence, once lost, can only be rebuilt laboriously, step by step.

Here in the United States we have, with great effort, already gone a long way toward rebuilding the foundation for growth and stability. We are not today in crisis. The American economy—for all its difficulties—still stands as a beacon of strength and hope for all the world.

We know something of the risks and difficulties that could turn the outlook sour. But I also know that the actions necessary to make the vision of stability and sustained growth a reality are within our grasp. We have come too far, with too much effort, to fail to carry through now.

Appendix

Questions have been raised about the practicality of identifying a particular concept of money that has a stable relationship to broader economic objectives, such as economic activity, prices, and employment, and about the related issue of whether the recent "breakdown" in velocity behavior relative to historical norms is temporary or longer-lasting. Both these questions bear directly on the role of monetary aggregates in the formulation and implementation of monetary policy.

No single concept or definition of money or credit aggregates can reasonably be expected always to provide reliable signals about economic performance, or about the course of monetary policy and its relation to the nation's basic economic objectives of sustainable economic growth, high employment, and stable prices. One reason is that market innovations and regulatory changes can alter the significance of the various aggregates at different times. Usually, however, such changes take place gradually without basically altering relationships over the shorter-term. On occasion, their impact may be more sizable and abrupt, both in terms of influence on measured monetary aggregates and their relation to over-all economic performance. Definitions of the monetary aggregates can be, and have been, adapted to significant institutional changes, although all definitions of "money" necessarily involve at the margin a degree of arbitrariness. The various money and near-money assets often serve a variety of functions for their holders that cannot be precisely distinguished statistically.

Even in the absence of institutional changes in financial markets, changes in the public's desires to hold liquidity as compared with "normal" past patterns can, through impacts on velocity, alter growth rates in the aggregates that may be consistent with broader economic developments. These shifts in liquidity preference historically have occurred during periods characterized by unusual economic uncertainties associated with such developments as protracted economic weakness, fears of inflation, or instability in the financial system.

Consequently, the use of monetary and credit aggregates as guides for policy and in interpreting like-ly economic developments requires continuing judgment about the impact of emerging institutional developments and changing public preferences for money and credit demands, particularly when the economic or financial environment has changed drastically. In that context, the value of the aggregates for policy depends not so much on the "stability" of their relationships to other economic variables, but on the predictability of these relationships, taking into account structural shifts that are known to be in process. Monetary targeting is based on the presumption that structural changes will not be so rapid or so unpredictable as to undermine the usefulness of the aggregates as annual targets, although over time they may need to be adapted to ongoing behavioral changes.

For the past decade or so a series of institutional changes have affected the meaning and interpretation of the several monetary aggregates. Around the mid-1970s, various instruments and techniques began to be developed in financial markets that enabled depositors to economize on holdings of cash and to earn interest on highly liquid balances that to some extent substituted for cash. This new financial technology, abetted by legislative and regulatory changes that permitted depository institutions to compete more effectively, changed the shape of financial markets. The Federal Reserve adapted its

definitions of monetary aggregates to the emerging institutional structure.

The narrowest definition of money—M1—was designed to measure transaction balances, and thus could be expected to bear a closer, more predictable relation to aggregate spending than the broader measures, which were affected as well by attitudes toward saving and wealth. The measure of M1 was redefined a few years ago in light of institutional changes to encompass transaction-type balances held in forms other than demand deposits. In particular, interest-bearing savings accounts subject to a regulatory ceiling rate but with checkable features (such as regular NOW accounts) were included in the measure, and later such accounts that could pay a market rate were also added (super-NOW accounts). However, these accounts served broader purposes for their holders than simply facilitating transactions. They also were an attractive repository for longer-term savings. Thus, interpretation of M1 was affected, and made less certain, especially over the past year or more, by its changing character; and the weight placed on this aggregate in policy implementation was necessarily altered during such periods of transition.

Over the last several quarters, the income velocity of M1 has fallen considerably and been much weaker than experience over comparable stages of post-war business cycles would have suggested,

whether velocity is measured contemporaneously as the relationship of GNP to money in the current quarter or is measured on a lagged basis as the relationship of GNP to money one or two quarters earlier. This occurred as the share of NOW accounts in the aggregate expanded, as financial markets adjusted to lower rates of inflation, and as economic uncertainties were heightened during the recent period of economic contraction. The unusually large and sustained drop of M1 velocity may in the circumstances in large part reflect an enhanced demand for M1 that arose from the decline in inflation and the related sharp fall in market interest rates during the second half of 1982. The availability of interest-bearing NOW accounts may have made depositors even more willing to hold funds in M1-type accounts as market interest rates declined. In addition, M1 was probably boosted by heightened savings and precautionary demands. These savings demands originally manifested themselves in the contractionary phase of the current economic cycle, but apparently have to a degree continued into the expansion phase.

The “breakdown” in the pattern of the velocity of M1, in the sense of its unusual behavior during the current economic cycle, may well be abating. Its income velocity declined much less in the second quarter of this year than it had over the previous five quarters—which may suggest that velocity is beginning to move back toward a more familiar and predictable pattern of behavior. Of course, the radical change in composition of M1 over the past two and a half years—with interest-bearing NOW accounts (some subject to ceiling rates and some at market rates) presently representing about one-third of the deposits included in M1, a share that will probably grow—suggests that the pattern of M1 velocity, even after a transition period, may come to vary from what it had been in the past.

While the relatively short experience with an M1 measure that includes a prominent savings compo-

nent (NOW accounts) tends to heighten uncertainty when predicting velocity behavior, it is by no means clear that our understanding of emerging velocity trends will be so limited as to preclude reasonable estimates of the outlook for velocity. Efforts to re-estimate money demand equations in light of recent institutional developments have helped explain a considerable part of recent velocity movements, and can be expected to be of assistance in projecting velocity.

Institutional changes have also affected the broader aggregates—M2 and M3—and they have been redefined as necessary to incorporate new instruments, such as money market funds, repurchase agreements, Eurodollars, and money market deposit accounts. With the definitional coverage of broad money measures enlarged, they encompass a very wide spectrum of liquid assets, so that these measures would tend to be less distorted than M1 by financial innovations and shifts of funds among various liquidity instruments. Very large shifts of funds, as were associated with the introduction of MMDAs, could distort particular money measures for a relatively short time, as was the case particularly for M2 in early 1983.

While the velocity of M2 departed from historical norms during the past several quarters, it did so to a lesser degree than M1. During the recent downturn M2 velocity declined only somewhat more than it had in past cyclical contractions on average. Thus far in the recovery phase of the cycle, the velocity of M2 has turned upward on average (after rough allowance for the distorting influence of shifts associated with the introduction of MMDAs) within the range of experience of previous cyclical expansions.

With regard to credit, institutional developments, the process of deregulation, and the emergence of innovative financing techniques in bond and other markets have contributed to reducing the special significance of bank credit as the cutting edge of changes in credit availability. As a result, more weight has been placed on a broad measure of total credit—in particular, the aggregate debt of domestic nonfinancial sectors—for helping to track credit needs as related to the overall economy and to guide monetary policy in that respect.

In brief, several money and credit measures taken as a group, together with an updating of definitions and measurement techniques as needed, can serve, and have served, as a useful guide for monetary policy, and in the light of a long sweep of history cannot be ignored. While it is true individual aggregates from time to time may be distorted by special developments and may not readily track the performance of the economy, the presumption remains of a longer-term stability and predictability in relationships.