

Statement of Alice M. Rivlin
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before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
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Mr. Chairman, you asked me to comment this morning on two issues: current monetary policy and the coordination of monetary and fiscal policies. These topics are, of course, related to each other, since one set of questions about current monetary policy concerns the extent to which it is coordinated with fiscal policy.

The last two or three years have been an extraordinarily difficult time in which to make economic policy-- whether the instruments in question were fiscal or monetary. The economy has been suffering simultaneously from an inadequate level of economic activity, reflected in high unemployment rates, and from rapidly rising prices. Both inflation and unemployment have proved remarkably persistent. Moreover, both fiscal and monetary policies aimed at reducing unemployment carried the risk of escalating inflation, while policies aimed at restraining inflation carried the risk of choking off economic recovery and increasing unemployment. The difficulties of economic policymakers have been further compounded by the fact that some policy instruments have an impact on expectations. A large budget deficit or a rapid increase in the money supply, for example, may lead to expectations of inflation and these expectations in themselves tend to be self-fulfilling.

The dilemma for fiscal policymakers lies in choosing a combination of federal revenues and expenditures that will stimulate the economy sufficiently without escalating inflation. The dilemma for monetary policymakers has been to choose rates of expansion in the monetary aggregates slow enough to restrain inflation, but not so slow as to drive up interest rates rapidly and interfere with the recovery.

Monetary Policy

For the first two years of the recovery, from about March 1975 to March 1977, monetary policy was made easier because of unexpected developments in the velocity of money that permitted the existence of both declining interest rates and moderate growth in the supply of money. More recently, however, these fortunate circumstances have come to an end. The formulation of monetary policy for the immediate future involves difficult choices.

First two years of recovery. As may be seen in Table 1, between March 1975 and March 1977, M_1 , currency and checking accounts, grew at an average annual rate of 5.4 percent. M_2 , a broader monetary aggregate, defined as M_1 plus savings deposits

TABLE 1. RATES OF CHANGE IN MONETARY AGGREGATES
(PERCENT CHANGES, ANNUAL RATE, IN SEASONALLY ADJUSTED DATA)

<u>Period</u>	<u>Monetary Base</u>	<u>M₁</u>	<u>M₂</u>	<u>M₃</u>	<u>Real M₁</u>	<u>Real M₂</u>
<u>Ten-Year Periods:</u>						
1956 to 1966	3.2	2.5	5.3	7.0 ^{1/}	0.7	3.4
1966 to 1976	7.2	5.7	8.5	9.2	-0.1	2.6
<u>One-Year Periods:</u>						
Dec. 1970 to Dec. 1971	7.3	6.5	11.4	13.2	3.0	7.8
Dec. 1971 to Dec. 1972	8.9	9.2	11.4	13.7	5.7	7.8
Dec. 1972 to Dec. 1973	7.9	6.0	8.8	8.9	-2.7	-0.2
Dec. 1973 to Dec. 1974	9.1	4.7	7.2	6.7	-6.7	-4.4
Dec. 1974 to Dec. 1975	7.7	4.1	8.5	11.3	-2.6	1.4
Dec. 1975 to Dec. 1976	8.3	6.0	11.4	13.2	1.0	6.3
<u>Three-Month Periods:</u>						
Dec. 1976 to Mar. 1977	7.6	3.9	8.8	10.4	-5.5	-1.1
Mar. 1977 to June 1977	8.1	8.5	9.1	10.3	0.4	1.0
June 1977 to Sept. 1977	11.4	11.0	10.9	14.0	6.5	6.4
<u>Recovery Since March 1975:</u>						
Mar. 1975 to Mar. 1977	8.1	5.4	10.2	12.4	-0.8	3.7
Mar. 1977 to Oct. 1977	9.8*	10.4	10.1	12.1*	3.3*	3.6*

* March 1977 to September 1977

^{1/} 1959 to 1966.

NOTES: The monetary base consists of Federal Reserve member bank reserves and currency held by the public and nonmember banks, adjusted for reserve requirement changes and shifts in deposits, calculated by the Federal Reserve Bank of St. Louis.

M₁, M₂, and M₃ data are from the Board of Governors of the Federal Reserve System.

M₁ consists of currency plus demand deposits.

M₂ consists of M₁ plus savings deposits at commercial banks.

M₃ consists of M₂ plus deposits at mutual savings banks, savings and loan associations, and credit unions.

Real M₁ and M₂ are derived by deflating current-dollar values using the Consumer Price Index of the Department of Labor, Bureau of Labor Statistics.

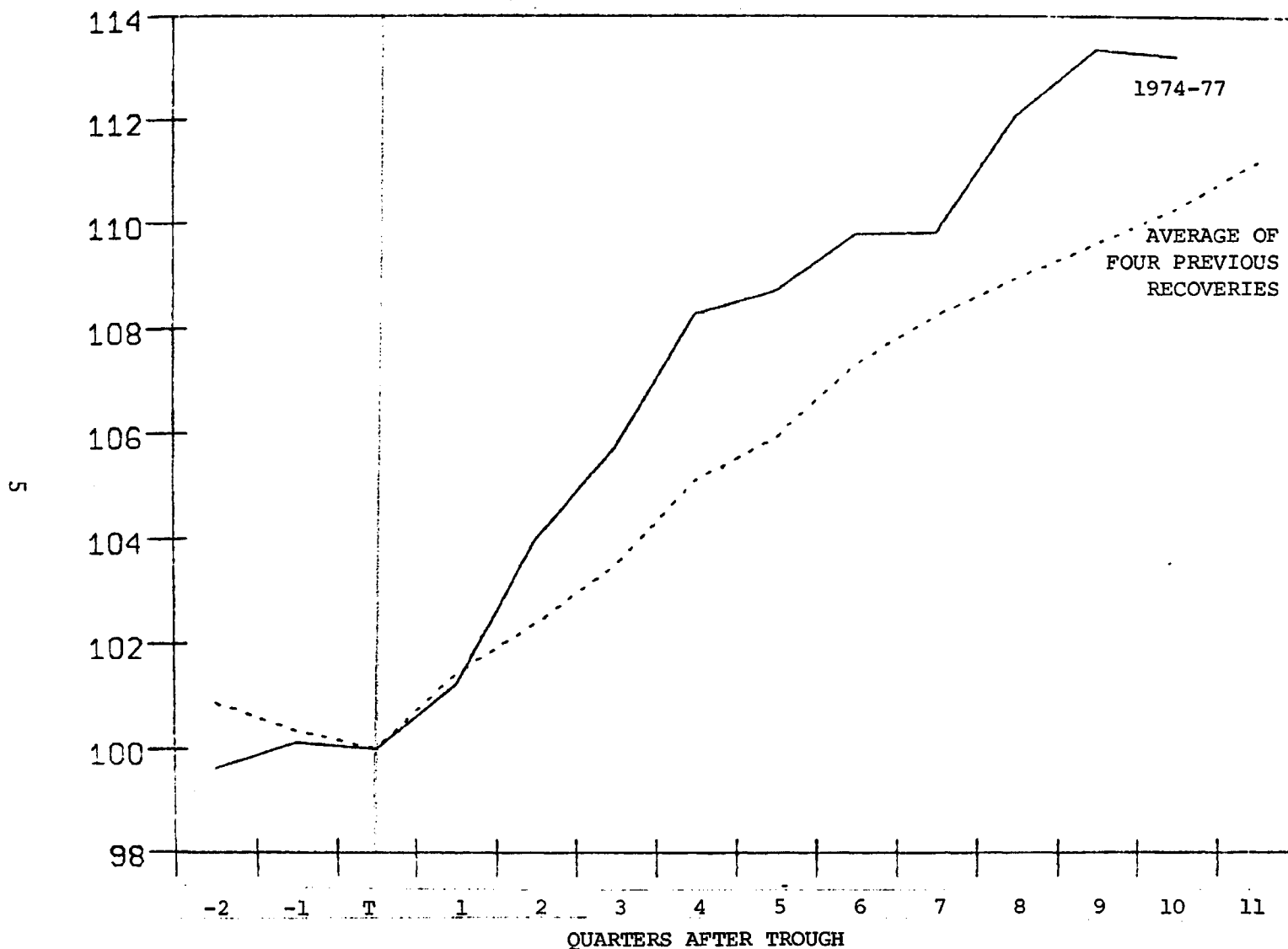
at commercial banks, grew at an average annual rate of 10.2 percent. These were fairly moderate rates of growth given the high unemployment rates throughout the period and the rapid rise in prices generated to a large extent by the aftermath of the oil shock and poor harvests of 1973-1974. Monetary policy was clearly anti-inflationary in the first two years of the recovery, since money growth did not fully accommodate the increase in prices. As shown in Table 1, M_1 adjusted for inflation did not increase during this period and the increase in M_2 adjusted for inflation averaged only 3.7 percent.

Moderate growth in M_1 during the first two years of recovery was generally--and quite unexpectedly--accompanied by declining or stable interest rates and an unusually rapid rise in the income velocity of M_1 . This is shown in Charts I and II. For reasons that are not fully understood, the growth of M_1 balances relative to income was less than predicted on the basis of earlier experience. This decline in the demand for money permitted the Federal Reserve to maintain relatively moderate growth in M_1 during the first

CHART I

VELOCITY OF MONEY IN RECESSION AND RECOVERY

INDEXES, BUSINESS CYCLE TROUGH = 100



VELOCITY: THE RATIO OF THE CURRENT-DOLLAR VALUE OF GNP TO M_1

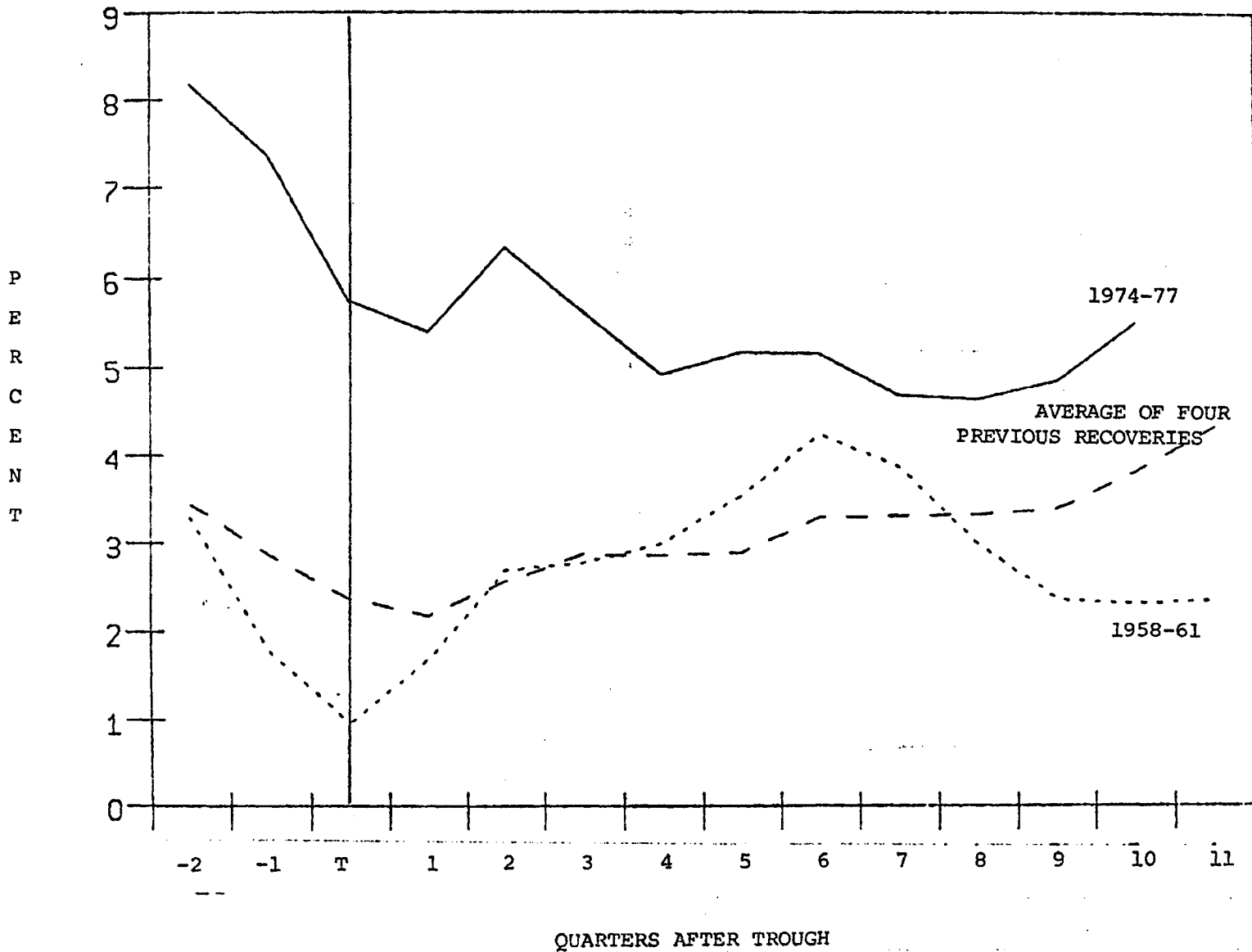
THE BUSINESS CYCLE TROUGH IS THE LAST QUARTER OF THE RECESSION, AS DESIGNATED BY THE NATIONAL BUREAU OF ECONOMIC RESEARCH

SOURCES: GNP: BUREAU OF ECONOMIC ANALYSIS, U.S. DEPARTMENT OF COMMERCE

M_1 : BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CHART II

INTEREST RATES IN RECESSION AND RECOVERY
(3 MONTH TREASURY BILL RATES)



THE BUSINESS CYCLE TROUGH IS THE LAST QUARTER OF THE RECESSION AS DESIGNATED BY THE NATIONAL BUREAU OF ECONOMIC RESEARCH

SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

two years of recovery without driving up short-term interest rates (see Table 2). In fact, short-term rates didn't actually hit bottom until December 1976.

Relying heavily on analysis of the behavior of the real money stock, a recent Joint Economic Committee report charges that the Federal Reserve has "systematically obstructed recovery." 1/ The committee apparently believes that it is a mistake to use restrictive monetary policies to reduce inflation when that inflation is unrelated to excessive domestic aggregate demand. Such policies can do little for inflation in the short run and adversely affect economic growth and employment. I would agree that, in general, monetary policy should not attempt to offset fully a price shock such as we experiences with food and fuel. However, since interest rates declined during most of the first two years of the recovery, it hardly seems evident that the Federal Reserve was seriously obstructing economic growth. The abnormal behavior of the velocity of money

1/ The 1977 Midyear Review of the Economy, Report of The Joint Economic Committee, Congress of the United States, September 26, 1977, p. 44.

TABLE 2. RECENT INTEREST RATES

<u>Period</u>	<u>Federal Funds</u>	<u>3-Mo. Treasury Bill</u>	<u>10-Year + Treasury Bond</u>	<u>Moody's AAA Corporate Bond</u>
1974 Q ₁	9.32	7.62	6.64	7.90
1974 Q ₂	11.25	8.15	7.05	8.36
1974 Q ₃	12.09	8.19	7.27	8.99
1974 Q ₄	9.35	7.36	6.98	9.02
1975 Q ₁	6.30	5.75	6.67	8.71
1975 Q ₂	5.42	5.39	6.96	8.87
1975 Q ₃	6.16	6.33	7.08	8.91
1975 Q ₄	5.41	5.63	7.22	8.81
1976 Q ₁	4.83	4.92	6.91	8.56
1976 Q ₂	5.20	5.16	6.88	8.53
1976 Q ₃	5.28	5.15	6.78	8.46
1976 Q ₄	4.88	4.67	6.55	8.18
1977 Q ₁	4.66	4.63	7.01	8.03
1977 Q ₂	5.16	4.84	7.10	8.01
1977 Q ₃	5.82	5.50	6.97	7.95
Jan. 1977	4.61	4.62	6.68	7.96
February	4.68	4.67	7.15	8.04
March	4.69	4.60	7.20	8.10
April	4.73	4.54	7.14	8.04
May	5.35	4.96	7.17	8.05
June	5.39	5.02	6.99	7.95
July	5.42	5.19	6.97	7.94
August	5.90	5.49	7.00	7.98
September	6.14	5.81	6.94	7.92
October	6.47	6.16	7.08	8.04

in this period permitted the Federal Reserve to emphasize its anti-inflationary role without damaging the recovery.

Monetary growth since the spring of 1977. Beginning last spring, M_1 growth accelerated substantially above Federal Reserve targets. Last July, the Federal Reserve announced a 4 to 6.5 percent target for M_1 , for the year ending in the second quarter of 1978. But from March to October of this year, M_1 has increased at an annual rate of 10.4 percent. M_2 , however, did not show the same acceleration. In fact, M_2 has grown less rapidly in this period than in 1976. To reduce M_1 growth, the Federal Reserve increased the federal funds rate, the rate at which it will supply additional reserves, by nearly 2 percentage points from March to October. The Treasury bill rate and other short-term rates also rose sharply in this period.

The main question about current monetary policy is: Is the Federal Reserve acting appropriately in raising short-term interest rates in response to the recent rapid growth in M_1 ? How much further can interest rates rise without damage to recovery?

The rationale for the Fed's policy is, of course, that rapid increases in M_1 are likely to trigger

additional inflation or at least to arouse inflationary expectations that may prove self-fulfilling. But there are several reasons for caution in accepting this view.

First, month-to-month changes in M_1 have been quite erratic in 1977 and the Federal Reserve itself has indicated that these changes are not fully understood and may not be lasting. A policy closely tied to an erratic indicator is likely to be an erratic policy.

Second, M_1 appears to be giving a different signal from other indicators of inflationary pressures in the economy. Recent M_1 growth suggests an acceleration in demand that is not evident in the behavior of other monetary aggregates or in economic activity. Economic growth slowed in the third quarter of this year and advance indicators, such as business spending plans and consumer and business confidence, have been quite flat.

An additional reason for caution is that the relationship between the federal funds rate and M_1 is not at all precise. It may be that the rise of about 2 percentage points in the federal funds rate since last winter is already sufficient to slow the growth in money aggregates over time.

The recent rapid growth in M_1 appears to reflect a slowing in the growth of M_1 velocity as depositors return to keeping money balances more in line with historical experience.

CBO's economic report, Recovery With Inflation, issued last July, indicated the behavior of velocity and money growth was a major uncertainty in the outlook for real growth. ^{2/} We noted then that money aggregate targets might not be high enough to achieve the projected rate of growth in GNP, if increases in the income velocity of M_1 returned to historical patterns. That appears to be happening now. In such situations, an M_1 target is reasonable only if the Fed adjusts the target to compensate for the changed behavior of velocity. When velocity growth accelerated, the Federal Reserve did not hesitate to lower its M_1 targets. Similarly, a slowing in the growth in M_1 velocity suggests the desirability of raising M_1 targets, at least temporarily.

^{2/} Recovery With Inflation, Congressional Budget Office, July 1977.

The Federal Reserve can no longer avoid making difficult choices. If it permits M_1 to continue to increase rapidly, it may risk raising inflationary expectations. On the other hand, if the recent jump in M_1 indicates an increased demand for M_1 deposits--not to spend but to hold--the Fed runs the risk of derailing the economic recovery if it fails to raise its targets for M_1 .

Short-term interest rates are rapidly approaching levels that have caused economic activity to weaken in the past. There may already be some slowing in financial intermediation since the three-month Treasury bill rate has moved up to around 6.2 percent, well above the Regulation Q ceiling on passbook savings at S and Ls and even above the rate on saving certificates of less than one year maturity. If interest rates should move up substantially further, we may again witness severe declines in thrift accounts at mortgage lending institutions (disintermediation), a further rise in mortgage rates, and a downturn in housing activity. Over time,

business investment, which has been slow to recover, would be damaged because of higher capital costs and a depressed stock market that can do damage to both consumer and business confidence.

To avoid such an outcome, the Federal Reserve could raise its M_1 targets to accommodate the slowing in velocity growth. At the same time, it could switch from the heavy emphasis on M_1 to a greater emphasis on M_2 and M_3 .

In testimony before this Committee two days ago, Chairman Burns indicated that the FOMC has not changed its M_1 target range. However, by moving the base period ahead one quarter, it appears to have decided not to compensate for the past overshoot in M_1 . At the same time, the target ranges for M_2 and M_3 have been lowered. This suggests that the Federal Reserve is not concerned that interest rates have risen too far, but is now willing to tolerate rates high enough to slow down the flow of savings to thrift institutions.

Coordination of Monetary and Fiscal Policy

The rationale for giving monetary authorities a measure of independence is that they can then keep their attention on the long-run health of the economy

and implement appropriate monetary policies without the constant necessity of responding to the short-run political pressures that influence the judgments of elected officials. If it is true that elected officials generally tend to favor a stimulative fiscal policy aimed at increasing employment even at the risk of some inflation, then the existence of an independent monetary authority can serve as a counterweight, tending to offset inflationary fiscal policy with anti-inflationary monetary policy. The danger, of course, is that this independence can be used to frustrate the well-considered policies of the Congress and the Administration.

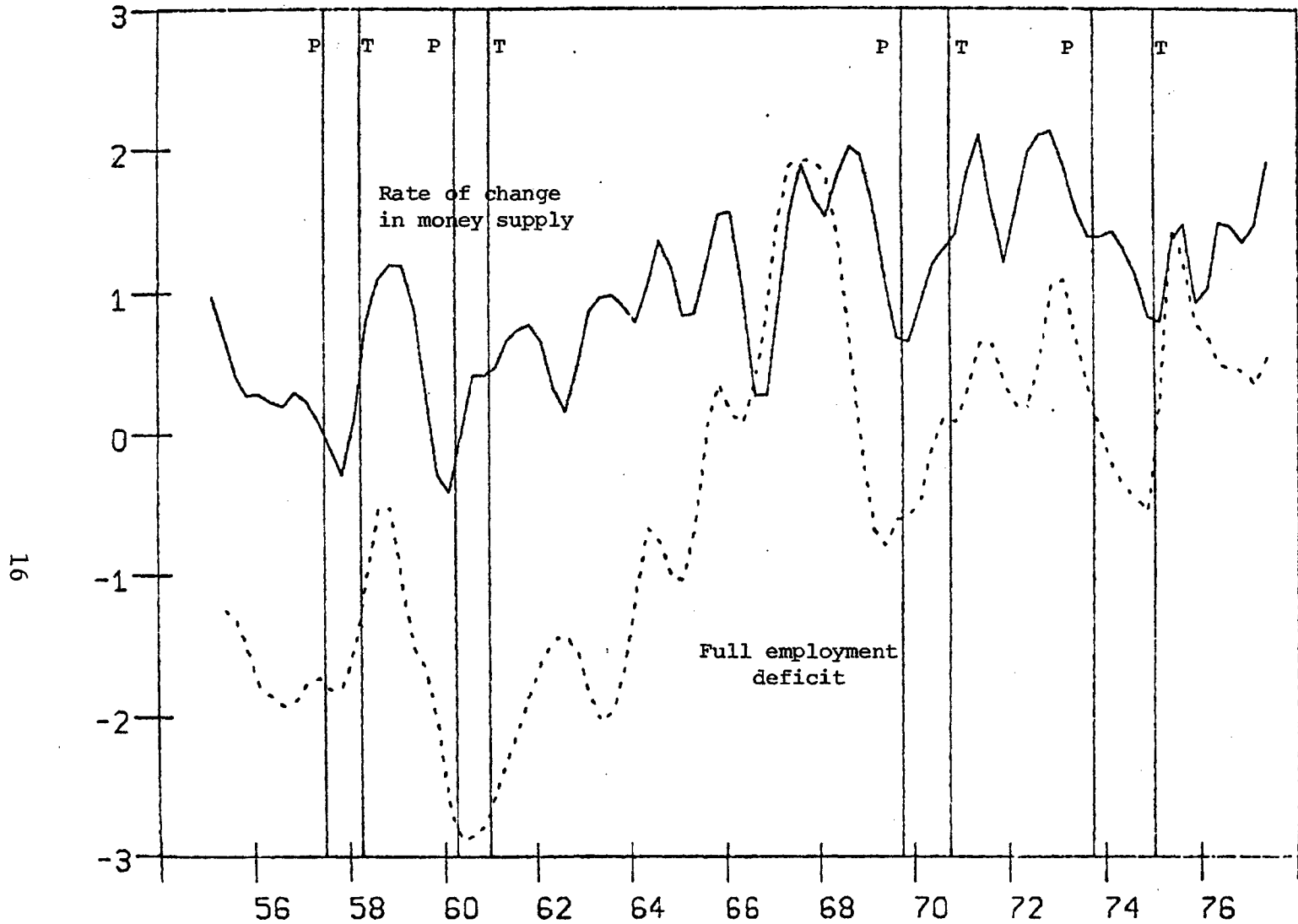
The independence of the Federal Reserve was granted by the Congress before modern concepts of stabilization policy gained wide acceptance. As the government began to pursue more active stabilization policies, the need for some form of coordination was widely recognized. Indeed, for many years the Federal Reserve and the Administration have engaged in informal discussions on economic issues. More recently, the Federal Reserve has also been required to report periodically to this Committee and the House Banking Committee on the monetary growth targets it intends to pursue.

Until recently, the Congress did not vote on fiscal policy explicitly. Therefore, little attention was given to the issue of conflict between monetary policy and Congressional budget actions. However, the budget procedures provided by the Congressional Budget and Impoundment Control Act of 1974 have greatly enhanced Congressional control over federal fiscal policy. Just as the Congress was previously concerned that impoundment of appropriated funds by the Administration was nullifying its actions, there now has arisen a similar concern that Congressional intentions underlying its fiscal policy decisions could be frustrated by monetary policy.

The degree to which coordination has been achieved in the past is difficult to determine unequivocally. To illustrate, Chart III compares two measures of policy, the full employment budget balance and the change in M_1 . These measures indicate that both monetary and fiscal policy have tended to become more restrictive before recessions and expansive before or during recoveries. On the surface, such simultaneous changes suggest coordination. In some cases, however, these simultaneous shifts in policy may have represented an overreaction by one party based on the unfortunate assumption that the other

CHART III

MEASURES OF MONETARY AND FISCAL POLICY
(WEIGHTED THREE-QUARTER MOVING AVERAGES)



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NOTES:

The rate of change in the money supply is the percent change in M_1 , at a quarterly (not annual) rate.

The full employment deficit is full-employment Federal spending minus full-employment Federal taxes, expressed as a percent of the current-dollar value of potential GNP. A minus value indicates a full employment surplus, which tends to restrict economic activity. Calculated by the Congressional Budget Office.

The business cycle peak (P) is the last quarter of expansion preceding the recession, and the business cycle trough (T) is the last quarter of the recession, as designated by the National Bureau of Economic Research.

would not take sufficient action. So a thorough evaluation of the record of coordination in each instance would require a much more detailed analysis, including considerable reliance on the memories of the parties involved.

Coordination between the Federal Reserve and the Administration. Even if policies are determined independently, it is clearly useful for the Administration and the Federal Reserve to exchange information on the state of the economy, views about the economic outlook, and estimates of the impact of possible policies.

There is no legal requirement that the Federal Reserve and the Administration consult each other before launching a new policy, or even that they exchange information prerequisite to coordination. Given the informality of the contacts and the natural tendency for each side to guard its own independence, it is not surprising that the degree of communication between the Federal Reserve and the Administration has varied from fairly close to almost nonexistent.

Coordination and communication between the Federal Reserve and the Administration could be greatly improved without compromising the independence of the Federal

Reserve. We may be able to gain some insights by studying the experience of various foreign countries. For example, the West German system for coordination has these features:

- o The law provides that the Ministers of Finance and Economics may attend policy meetings of the central bank as non-voting members.
- o While the government's representatives have no vote, they are authorized to present the Administration's views on the economic outlook and monetary policy.
- o The government has the authority to delay for two weeks implementation of policy changes decided upon by the bank to give time for negotiation. Apparently cooperation has been very close so that it has not been necessary for the government to exercise this power.

The German central bank remains very independent and may adopt policies that the government opposes. Nevertheless, their formal system for coordination of monetary and fiscal policies appears to have resulted in a higher degree of cooperation than we have seen in the United States. An equivalent system for the United States might involve permitting the Secretary of the Treasury, the Chairman of the Council of Economic Advisers, and representatives of Congress to attend

FOMC meetings, with an opportunity to address the voting members. In addition, the Administration might be given the authority to delay Fed policy changes for a short time.

Less formal arrangements might also satisfy the requirement for an exchange of information and consultation on policy. The basic information would include: (1) forecasts for the economy under assumptions of current policy; (2) presently proposed policies; and (3) what these policies are expected to achieve, that is, the short-run goals for unemployment, inflation, and economic growth that appear to be both achievable and consistent with long-run goals of full employment and price stability. Such an exchange would not guarantee coordination, but it might lead to a narrowing of differences and improve prospects for coordination. At the same time, the independence of the Federal Reserve would be maintained.

Coordination with the Congress. The issue of coordination of monetary and fiscal policies has become more critical since the Congress adopted budget procedures that give it an active role in the area of stabilization policy. The possibility that at times Federal Reserve

and Congressional action will work at cross purposes cannot be discounted because few steps have been taken to insure coordination. In fact, the Budget Committees have had to proceed without the benefit of technical information necessary for coordination of monetary and fiscal policy. The announced money growth targets frequently do not extend to the period covered by the budget resolutions and, more important, the Committees do not know what economic goals the Fed's policies are designed to achieve. Similarly, the Federal Reserve has not had the benefit of knowing what economic goals are acceptable to the Congress.

A bill introduced by Senator Proxmire on November 3rd represents an attempt to remedy some of these deficiencies. It provides that money and credit targets be specified for the ongoing and coming fiscal year before enactment of the budget resolutions; that the Fed reveal its estimates of the level of unemployment, production, and prices for the end of these fiscal years; and that periodically the Fed be required to explain revisions in its objectives and plans. This proposal could be an important move toward improving the flow of information. It would be unfortunate, however, if the Fed

were completely tied down by previously announced targets for the fiscal year. As I indicated earlier, one of the present problems is that the Fed may be reluctant to reconsider its earlier decision to make M_1 a primary target. The Fed should not lose the flexibility to deal with changing circumstances.

An alternative might be for the Congress to use the budget resolution itself as a vehicle for articulating its own short-run economic goals and then ask the Federal Reserve to explain how its own actions relate to these goals. Budget resolutions now set out fiscal policy targets based upon a specific short-run economic forecast. This forecast has not been described as an economic goal but presumably it reflects Congress' expectations for the economy, assuming implementation of the resolution. Perhaps the Budget Committees and the Banking Committees need to consult on this issue to develop a mechanism which would encourage the Federal Reserve to adopt policies that are consistent with these Congressional expectations for the economy.

It is possible, of course, that at times a fully coordinated monetary policy would be worse than uncoordinated policies. That is an argument for retaining

the independence of the Federal Reserve, but it is not an argument for conducting policy in the dark without cooperation. A more open exchange of views on monetary and fiscal policies would encourage well-reasoned policy decisions. It would also make it easier to identify responsibility for the outcome and to evaluate procedures for adopting policies. It might also raise the level of public debate and at least demonstrate that there are no easy answers for situations like the present.

