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Mr Turnbull

US MONETARY POLICY

SUMMARY

1. IN A STATEMENT TO THE SENATE BANKING COMMITTEE, VOLCKER ANNOUNCED THE GROWTH RANGES FOR M3 AND THE DEBT AGGREGATE FOR 1985 HAD BEEN RAISED COMPARED TO THEIR 1984 LEVELS. VOLCKER STATED THAT THE PROGRESSIVE EASING OF MONETARY POLICY HAD NOW ENDED. VOLCKER WARNED OF THE RISKS OF THE US ECONOMY'S GROWING DEPENDENCE ON FOREIGN CAPITAL. HE AGAIN URGED CUTS IN THE BUDGET DEFICIT FOR FY 86 OF SOME DOLLARS 50 BN.

DETAIL

2. FEDERAL RESERVE CHAIRMAN VOLCKER TESTIFIED BEFORE THE SENATE BANKING COMMITTEE TODAY. HE ANNOUNCED SMALL INCREASES TO THE GROWTH RANGES FOR M2, M3 AND THE CREDIT AGGREGATE FOR 1985 COMPARED TO THE RANGES WHICH HAD BEEN PROVISIONALLY SET FOR 1985 LAST JULY, BUT ADDED THAT THEY DID NOT REPRESENT ANY CHANGE IN POLICY INTENTIONS. THE NEW RANGES AND PERFORMANCE IN 1984 (FROM A FOURTH QUARTER BASE) ARE AS FOLLOWS:-

	RANGES FOR 1985	RANGES FOR 1984	ACTUAL GROWTH IN 1984
	(	PERCENT GROWTH	)
M1	4-7	4-8	5.2
M2	6-9	6-9	7.7
M3	6-9.5	6-9	10.5
DOMESTIC NON-FINANCIAL DEBT	9-12	8-11	13.4

3. VOLCKER STATED THAT GROWTH OF MONEY AND CREDIT OF THIS ORDER WOULD SUPPORT ANOTHER YEAR OF SATISFACTORY ECONOMIC EXPANSION WITHOUT AN ACCELERATION OF INFLATION. IT WAS CONSISTENT WITH THE FEDERAL OPEN MARKET COMMITTEES (FOMC) FORECAST FOR 1985 OF GROWTH OF NOMINAL AND REAL GNP GROWTH CENTERED AROUND 7.5-8.0 PERCENT AND 3.5-4.0 PERCENT RESPECTIVELY (FOURTH QUARTER ON FOURTH QUARTER), INFLATION AT 3.5-4.0 PERCENT AND UNEMPLOYMENT FALLING TO 6.75-8.0 PERCENT BY THE YEAR END. THIS FORECAST IS SIMILAR TO THAT OF BOTH THE ADMINISTRATION AND THE CBO.

4. WITH STRONG GROWTH OF THE MONEY SUPPLY AT PRESENT, VOLCKER ACKNOWLEDGED THAT ALL THE AGGREGATES WOULD START ABOVE THE TARGET RANGES, BUT WAS CONFIDENT THAT GROWTH ESPECIALLY FOR M1 AND M2, WOULD SLOW DURING THE YEAR CONSISTENT WITH THE GROWTH RANGES. THE RANGES FOR M1 AND M2 ASSUME A RETURN TO A MORE NORMAL AND PREDICTABLE PATH OF VELOCITY: THE RANGE FOR M1 IS JUDGED SUFFICIENTLY WIDE

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SHOULD VELOCITY GROWTH FALL SLIGHTLY BELOW TREND. THE NEW RANGES FOR THE BROADER AGGREGATES, ALTHOUGH RAISED, ASSUME A CONSIDERABLE SLOWING IN THE GROWTH OF BOTH M3 AND THE DEBT AGGREGATE. VOLCKER WARNED OF THE IMPLICATIONS OF CONTINUED STRONG GROWTH OF THE DEBT AGGREGATE, WHICH HE ARGUED PARTLY REFLECTED THE TAX STRUCTURE WHICH FAVOURED DEBT RATHER THAN EQUITY FINANCING.

5. ON MONETARY POLICY VOLCKER SAID THAT THE PROGRESSIVE EASING OF RESERVE CONDITIONS HAD COME TO AN END AND OPEN MARKET OPERATIONS WERE BEING CONDUCTED MORE CAUTIOUSLY. (SEPARATELY THE RECENTLY RELEASED MINUTES OF THE FOMC'S DECEMBER MEETING SHOWED THAT THE FOMC VOTED TO EASE POLICY FURTHER AT THAT TIME). REFERRING TO THE DECISIONS TO EASE POLICY IN LATE 1984 VOLCKER SAID THAT BOTH THE STRENGTH OF THE DOLLAR AND THE SUCCESS IN LOWERING INFLATION WERE CONTRIBUTING FACTORS.

6. DURING HIS STATEMENT VOLCKER STRESSED THE LINK BETWEEN TRADE AND BUDGET DEFICITS, ARGUING THAT HIGH DEFICITS, RISING IMPORTS AND STRONG INVESTMENT HAD BEEN RECONCILED BY A GROWING VOLUME OF NET CAPITAL INFLOWS, AMOUNTING TO NEARLY DOLLARS 100 BN IN 1984. VOLCKER STATED THAT QUOTE THE STABILITY OF OUR CAPITAL AND MONEY MARKET IS NOW DEPENDENT AS NEVER BEFORE ON THE WILLINGNESS OF FOREIGNERS TO CONTINUE TO PLACE GROWING AMOUNTS OF MONEY IN OUR MARKETS QUOTE AND UNQUOTE WE ARE IN A REAL SENSE LIVING ON BORROWED MONEY AND TIME UNQUOTE. THE RESULTING STRENGTH OF THE DOLLAR HAD CAUSED IMBALANCES WITHIN THE ECONOMY, ESPECIALLY AMONG EXPORTERS AND FARMERS. AS ON PREVIOUS OCCASIONS, VOLCKER URGED THE CONGRESS TO LOWER THE BUDGET DEFICIT. IN RESPONSE TO A QUESTION VOLCKER REPEATED HIS VIEW THAT THE DEFICIT FOR FY 86 SHOULD BE CUT BY SOME DOLLARS 50 BN.

7. VOLCKER WELCOMED THE REDUCTION IN INFLATION AND A PROBABLY DECLINE IN INFLATIONARY EXPECTATIONS. BUT HE WARNED THAT SOME OF THOSE FACTORS CONTRIBUTING TO THE DECLINE IN INFLATION MIGHT NOT BE LASTING. IN ADDITION VOLCKER STRESSED ON SEVERAL OCCASIONS HIS FIRM RESOLVE NOT TO SUCCUMB TO ANY POTENTIAL PRESSURES TO MONETIZE THE DEBT. IN RESPONSE TO A QUESTION VOLCKER ACKNOWLEDGED THESE MIGHT ARISE IF THERE WERE ONLY MODEST CUTS IN THE DEFICIT. BUT AN EXPANSIONARY MONETARY POLICY UNDER THESE CONDITIONS WOULD LOWER GROWTH AND RAISE INFLATION.

8. IN RESPONSE TO FURTHER QUESTIONS VOLCKER SAID SEVERAL FACTORS WERE RESPONSIBLE FOR THE STRENGTH OF THE DOLLAR INCLUDING US INTEREST RATES AND FAVOURABLE GROWTH PROSPECTS. TO DATE INTERVENTION IN FOREIGN EXCHANGE MARKETS HAD BEEN LIMITED AND WAS ONLY UNDERTAKEN WHEN BOTH THE TREASURY AND THE FEDERAL RESERVE AGREED IT WOULD BE DESIRABLE.

COMMENT

9. THE UPWARD REVISION TO THE RANGES FOR THE BROADER AGGREGATES APPEARS TO REFLECT A RECOGNITION THAT CREDIT GROWTH WILL CONTINUE

TO BE STRONG IN 1985, PARTLY REFLECTING THE SIZE OF THE BUDGET DEFICIT, EVEN THOUGH THE FOMC FORECAST ASSUMES A SUBSTANTIAL CUT IN THE DEFICIT FOR FY 86. THE EASING OF MONETARY POLICY HAS NOW ENDED, BUT THE GROWTH OF THE MONETARY AGGREGATES IS LIKELY TO REMAIN STRONG OVER THE NEXT FEW WEEKS. IN THE FEDERAL RESERVE'S SEPARATE MONETARY POLICY REPORT TO CONGRESS, IT IS STATED THAT DURING THE YEAR M1 WOULD BE EXPECTED TO MOVE GRADUALLY TOWARDS AND INTO ITS TARGET RANGE. IN RESPONSE TO QUESTIONS AS TO WHETHER HE WOULD SERVE HIS FULL TERM, VOLCKER WAS, AS USUAL, NON-COMMITAL. BUT HE MADE IT CLEAR THAT MONETARY POLICY WOULD REMAIN ANTI-INFLATIONARY AS LONG AS HE WAS CHAIRMAN OF THE FEDERAL RESERVE.

10. COPIES OF VOLCKER'S STATEMENT AND THE FED'S MONETARY REPORT TO CONGRESS FOLLOW BY BAG.

11. FCO PLEASE ADVANCE TO SHIELDS (HMT), BROADBENT (EA), TAIT (ERD) AND GREEN (BANK).

WRIGHT

(ADVANCED AS REQUESTED)

FINANCIAL
NAD

COPIES TO:
MR SHIELDS, TREASURY
MR GREEN, BANK OF ENGLAND

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Testimony of the Honorable
James A. Baker, III
Secretary of the Treasury
Before the Senate Appropriations Committee
February 19, 1985

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss our fiscal affairs and the tasks that lie ahead. The economy has done very well in the past year and the outlook for the future is promising. But we are faced with the need to reduce what has become an excessive rate of Federal spending. Because of that Federal spending, the prospective budget deficits that would develop in the absence of any offsetting action are far too large for our long-run economic health. We must place the Federal budget deficit on a declining path and keep it there. With your help and a bipartisan Congressional effort, I am sure that meaningful reductions in the growth of Federal spending can be achieved. Legislative action along the lines recommended in the President's Budget proposals will provide a fiscal framework within which the economy can continue to prosper.

These past four years have been marked by truly dramatic improvement in the performance of the U. S. economy. Four years ago, it was the increasingly held belief that we had lost the ability to control our economic destiny -- that inflation was out of control, that dwindling availability of natural resources would put a cap on growth; and, most worrisome of all, we were told that we had lost the innovative spirit that had propelled this economy to world leadership.

Now, confidence in our ability to meet the challenges of the future is being restored by the implementation of an economic program designed specifically to:

-- bring inflation under control,

-- free markets from the burden of unnecessary government interference,

-- restore incentives for productivity and growth,

-- and, thereby, increase opportunity for all.

That program has been remarkably successful by almost every measure of economic performance.

-- Real growth for 1984 was the highest since 1951. During the first two years of the current expansion, at a 6.0 percent annual rate, real growth has been the strongest for any expansion since the economy pulled out of the strike-depressed recession trough of late-1949 into the Korean War boom.

-- Growth of real business capital spending during this expansion has far outpaced gains during any previous postwar recovery.

-- Our economy has shown itself to be a remarkable job-creating machine. Spurred by formation of new business and by technological innovation, more than 7.3 million jobs have been created during this recovery and expansion.

-- And even as the economy has shown this remarkable growth, inflation has stayed under control. For each of the past three years, it has not exceeded 4%. Last year, as measured by the GNP deflator, it was the lowest since 1967. And the trends of wages, oil prices, and world raw material prices all remain favorable.

I have made a promise to myself that I know I may not be able to keep. But I shall try. While I will of course contribute to the development of economic forecasts that we use for purposes of planning and analysis, I shall try to resist the temptation to offer specific, detailed, numerical economic forecasts of my own.

The economic projections underlying the budget assume continued real economic growth and a steady decline in unemployment, inflation, and interest rates.

Consistent with my promise to myself, let me say only this about the overall economic outlook. Prospects are excellent for sustained economic growth without inflation -- provided that we act promptly and responsibly to continue what we have begun. And by "we" I should emphasize that I mean to include both Houses of the Congress, as well as the Executive Branch.

There is still much unfinished business.

We must not rest with the tax rate reduction we enacted in 1981. That simply adjusted for the hyper-inflation that the economy had been experiencing before. Now we must go on, as the President has directed, to overhaul the whole tax system -- to increase fairness, simplicity, and economic growth. This element of our program is, as the President has said, of equal priority with spending control.

The printed budget document includes a number of revenue-related measures -- most of which have been submitted before. These range from tuition tax credits to enterprize zone incentives to technical provisions related to certain trust funds. The budget does not include the proposals for comprehensive overhaul of the tax system -- for, as you know, those proposals, made public on November 27, remain under review. But we believe that -- with constructive effort by all parties -- a comprehensive restructuring of the tax system could be enacted this year. And I will be having a good deal more to say about this in other contexts.

The focus of today's discussion is principally upon our printed budget, however.

Immediate steps must be taken to narrow the deficit.

Just as important as closing the deficit is the manner by which it is closed. It would be wrong to go back to our old ways of pushing up taxes, either legislatively or by bracket creep in a nonindexed system. In our view, the tax reductions of the past several years have been largely responsible for the turnaround in economic performance. This means that deficit reduction must be accomplished from the spending side.

The large deficits that we face during the remainder of the decade are due to an excessive rate of Federal spending. The American people do not feel they are undertaxed. They want government spending brought under control.

Between 1964 and 1979, Federal outlays averaged 20-1/2 percent of GNP. Now they are in the 24 to 25 percent range. Federal outlays have virtually been living a life of their own. The President's budget proposals would restrain the rate of growth of outlays below that of the economy and shrink the outlay-GNP ratio down to the 21 percent range by the end of the decade. This would leave a deficit of less than $100 billion by 1990.

The President's budget proposes a combination of freezes, reforms, user fees, program cuts and terminations that will achieve savings for fiscal year 1986 of a little more than $50 billion. This is calculated from the "baseline" path that spending would take if we did nothing. These reductions are sufficient to hold total spending on government programs -- that is, everything but debt service -- no higher in 1986 than in 1985. It is an ambitious target, but is achievable, without damaging the social safety net, or our continued defense rebuilding, or any essential government function.

Achievement of our target of $50 billion in reductions would accomplish two things. The deficit in 1986 would be about $40 billion less than in 1985. And, even more important, the actions taken this year will have an amplified effect in later years, resulting in annual savings of more than $100 billion by 1988. This will set the deficit on a declining path -- both in absolute dollars and, even more significantly, as a share of GNP. Under our economic assumptions, the deficit would drop from over 5 1/2 percent of GNP this year to less than 3 percent by 1988 -- on down to less than 1 1/2 percent by 1990. The exact percentages are not the issue; the important thing is the trend.

The deficit has been accommodated thus far without damage to the expansion, and interest rates have declined considerably. But "real" interest rates remain too high. We need monetary policies that will allow us to continue strong economic growth without inflation. Such policies will help get interest rates down further. At the same time, a firm, convincing policy of deficit reduction will also help keep us on a course to still lower interest rates -- while insuring that the Government, in financing the deficit, does not absorb such a large share of the nation's savings as to impair private productive investment.

Our budget proposal represents a "freeze" in total program spending. That is something that is easy for most to understand -- and to most, I think, it makes sense. There will, we know, be disagreements about what we propose specifically for one program or another. But we believe our specific proposals are thoroughly defensible on the merits. And we look forward to working with the Congress to develop a comprehensive package that will bring the budget under control -- by freezing overall program spending for fiscal year 1986.

With good will, we believe this can be done. We are sure it is what the American people want to be done.