Statement of Alice M. Rivlin
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before the
House Committee on Banking, Currency, and Housing
February 2, 1976

Mr. Chairman and Members of the Committee:

The passage last year of House Concurrent Resolution 133 established for the first time a direct, although limited, Congressional role in the formation of monetary policy. This new role, like the new Congressional budget procedures, increases the importance of the Congress knowing where the economy seems headed and what the effects of different fiscal and monetary policies are likely to be. Providing up-to-date, nonpartisan analyses of these issues is one of the most important objectives of the Congressional Budget Office, and one which I hope this statement will help fulfill.

The first part of the statement reviews the state of the economy as of early 1976, and concludes that signs generally point to a 5 to 7 percent rate of growth in constant-dollar GNP during 1976 and a slightly lower rate in 1977. A rate of inflation in the 5 to 7 percent range seems likely as well. Unemployment is likely to decline slowly under these conditions, with both the unemployment rate and the inflation rate remaining well above the historical averages achieved in the 1950s and 1960s.

The second part of the statement focuses more closely on the monetary aspects of the current situation. Past history tells us that the growth of the GNP is highly sensitive to monetary policy. However, there is an unusual degree of uncertainty just now over which monetary targets go with which rates of overall growth. GNP growth has been exceptionally strong relative to monetary growth in the last two quarters, and it is not clear whether this trend will continue. If it does not, there is danger that low monetary growth could slow recovery.

The final part of the statement discusses the problem of deciding on monetary policy targets at the present time. It concludes that in the present situation there is a case to be made for using an interest rate guideline as well as a monetary growth target.

I. The Current Economic Situation

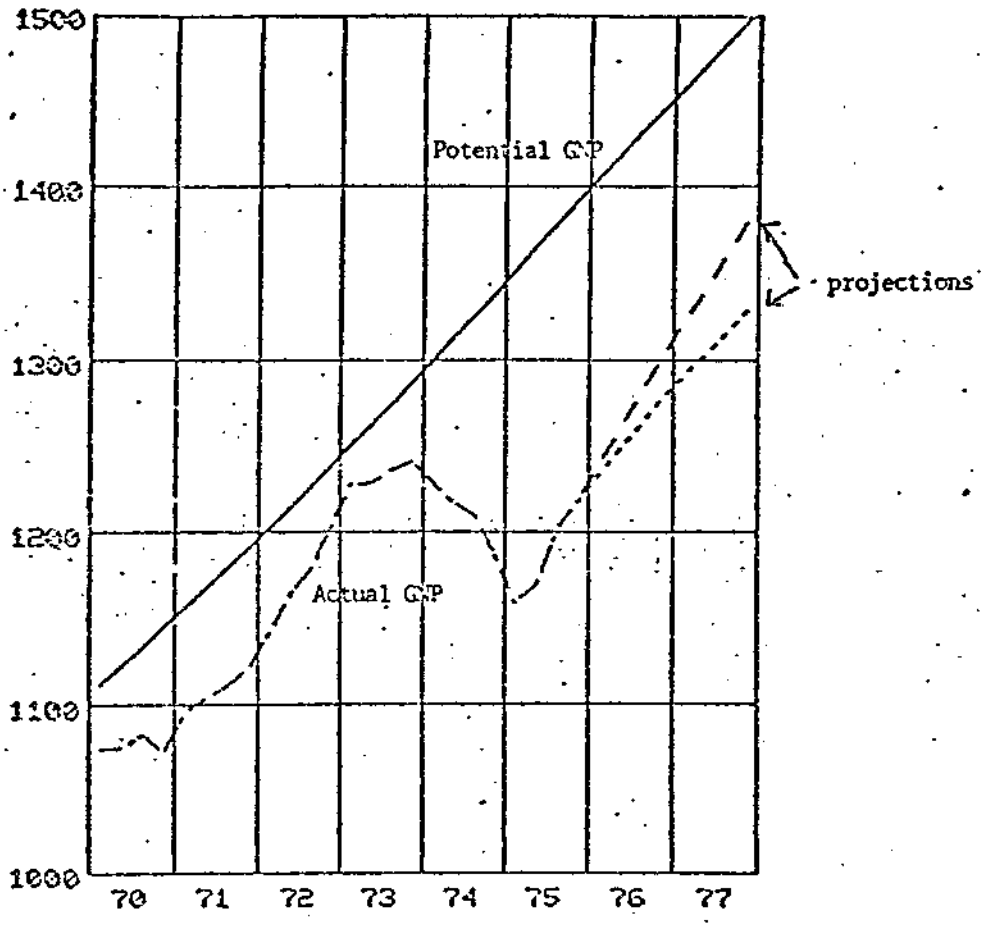
Since last spring, when the worst economic downturn since the Great Depression hit its low point, economic recovery ha proceeded in two phases. At first, production rose very rapidly as businesses shifted from massive inventory liquidation to a slow rate of liquidation. Later in the year more

moderate growth set in; sales, production, and employment continued to rise but the extra impetus provided by the inventory turn-around was absent. Because the rise in employment was accompanied by a rise in the number of persons seeking work, the unemployment rate declined only slowly, remaining at 8.3 percent in December.

The rate of inflation dropped significantly during the recession, partly because of the economic slack, but mostly because of favorable developments in food and fuel markets. Even after this improvement, however, the rate of inflation remained high compared to its average over the last two decades. At the end of the year, declines in food prices led to some favorable reports on inflation. The inflation rate for nonfood prices, however, remained in the range of 5 to 7 percent per year.

The most likely course of the economy in the near future is a continuation of moderate growth, with constant-dollar GNP rising in the 5 to 7 percent range in 1976 and perhaps in the 4 to 6 percent range in 1977. This pattern of recovery is illustrated in Chart 1. This chart shows not only actual constant-dollar GNP but also a measure of "potential GNP" which continues to grow as the labor force and the

CHART 1--ACTUAL AND POTENTIAL GNP
(billions of 1972 dollars, seasonally adjusted annual rate)



NOTES: Potential GNP converted from 1958 dollars and projected to 1977 by CBO. Growth in potential GNP is estimated at 4 percent per year through 1975 and 3.75 percent thereafter; the lower growth rate takes account of low levels of capital investment in 1975 and 1976. Potential GNP was associated with an unemployment rate of 4 percent of the labor force in mid-1955.

capital stock grow. The actual economy has not achieved this full potential since the late 1960s. The projections shown in the chart are based on three assumptions:

1. a rate of monetary growth of 7 percent per year in demand deposits plus currency, close to the upper end of Chairman Burns' announced target for 1975-76;

2. a federal budget at current policy levels -- that is, a budget that continues present tax laws and outlay programs, including adjustments for inflation, but with no new initiatives or cutbacks or changes in efficiency; and

3. changes in food and fuel prices at about the same rate as overall inflation.

Government spending will not be a major contributor to growth. A continuation of present programs and tax laws into fiscal year 1977 -- that is, a "current policy" budget-- implies only a slight constant-dollar increase in government spending. As for state and local governments, the change from growth to stability in school population, the rise in cost due to inflation, and the reduction in revenues due to the recession have all markedly slowed up the trend in constant-dollar state and local spending. The widely publicized financial problems of New York may have reinforced weaker spending trends. Whatever the cause, voters rejected a far larger proportion of state and local bond issues in 1975 than they had in 1973 and 1974, and this development will further retard the growth in state and local spending.

The budget proposed by the Administration is below a current policy budget, with declining constant-dollar spending during late 1976 and throughout 1977 only partly offset by reductions in taxes below current (1975) law. The $394 billion in outlays proposed by the Administration for fiscal year 1977 is 7 percent below the $422 billion which we estimate to be the fiscal 1977 cost of continuing the policies embodied in the Second Concurrent Resolution on the Budget. Our analysis of the economic impact of the President's budget suggests that it would lead to a real growth rate at the low end of the 5 to 7 percent range, with an eventual small reduction in the inflation rate. Administration economists are somewhat more optimistic about the overall growth implied in the President's budget.

In contrast to government spending, housing is likely to be a source of growth. Housing starts have followed a jagged upward path since their low point in the first quarter of 1975. As long as short-term market interest rates remain well below interest rates available in savings institutions, flows of funds into thrift institutions should continue and housing starts should continue on a generally rising trend. A three-month Treasury bill rate above 6.5 to 7.0 percent could retard housing growth; but recently the bill rate has been two percentage points below that danger zone. A moderate

rise in short-term interest rates during 1976 and 1977 is, therefore, consistent with continuing housing recovery. A sharp rise might not be.

Business spending plans for plant and equipment have not yet shown signs of vigorous recovery. The U.S. Department of Commerce survey released in early January, in fact, suggested capital spending growth no greater than the likely rise in capital goods prices in 1976. This latest survey was more pessimistic than earlier Commerce and McGraw-Hill surveys, and other capital goods indicators suggest that the earlier surveys may prove to be accurate. In any case, business capital spending cannot be counted on as a major source of growth until late 1976, if then. If recovery proceeds at a 5 to 7 percent rate in 1976, then a more substantial contribution from capital spending is likely in 1977. As in the case of housing, however, the state of credit markets can make a big difference in what to expect in 1977.

Consumer spending and inventory investment respond very sensitively to current economic conditions. If growth continues, these types of spending are likely to continue to rise as well. An extra impetus on the part of consumers could come from a decline in the saving rate, which has been at exceptionally high levels in recent quarters. Credit

markets, especially the stock market, can also influence consumption behavior. Inventory investment made its major contribution to recovery in the second half of 1975, when it turned around from an annual rate of reduction of $30 billion in the second quarter to no change in the fourth quarter. It could make a more moderate and gradual contribution to growth if recovery continues in 1976 and 1977.

Achievement of a 5 to 7 percent growth rate in 1976 and slightly less in 1977 should bring some improvement in the unemployment rate but not a decline to anything like the levels of the 1950s and 1960s. The unemployment rate seems likely to remain above 7 percent all during 1976 and to remain above 6.5 percent even as late as the end of 1977.

Since economists have had a poor record of forecasting prices in recent years, any statement about future inflation is subject to an especially high degree of uncertainty. Expectations are an important part of the problem in inflation forecasting. Wage contracts are heavily influenced by expectation of future changes in the cost of living and pricing decisions are heavily influenced by expectations about future changes in the cost of labor and materials. It is very difficult even to measure, let alone to predict, the course of expecta-

tions. Probably it is these expectations, as well as a continued catching up with past cost increases, that are currently keeping the rate of inflation as high as it is. The slack in the economy, apart from some short-term effects in depressing productivity, is helping to reduce inflation somewhat. But even the extraordinarily high unemployment of 1975 has not slowed down wage increases greatly. Probably a continuation of the recent 5 to 7 percent inflation rate into 1976 and 1977 is the most likely accompaniment to the moderate growth projections described earlier and shown in Chart 1.

II. The Role of Monetary Policy

One key assumption underlying the above projections is growth in the money supply -- demand deposits and currency -- at about a 7 percent annual rate, near the upper end of the range announced in response to last year's concurrent resolution on monetary policy. We have used three statistical models of the economy -- one "monetarist" model, one "Keynesian" model, and one eclectic model -- to estimate how much difference it would make if monetary growth were held to 5 percent, the low end of the range, instead of 7 percent. Although the three models do not speak with one voice about the timing and strength of monetary policy, all agree that by the end of 1977 the effects of the monetary slowdown would be large indeed.

The estimated reduction in GNP ranges from 3 to 4 percent.

The model results are shown in Table 1. For each model, the first row shows GNP (in current dollars) projected under 7 percent monetary growth. The second row shows levels of GNP projected under 5 percent monetary growth. The third row shows the percent reduction in GNP due to substituting the lower for the higher monetary path.

A 3 to 4 percent reduction in the growth of GNP in 1976-77 would initially show up mainly as lower growth in real output and hence of employment. The unemployment rate might be expected to be one percentage point or more higher than it otherwise would be by the end of 1977 under the lower monetary growth path. Since not much reduction in unemployment is expected in 1977 even under the higher monetary growth path, the models suggest that unemployment might not fall at all or perhaps even might rise under the slow path.

In later years, lower monetary growth would tend to be reflected in less inflation rather than lower output. One estimate of this later-year effect, based on a simplified wage-price model, is that by 1979-80 lower monetary growth in 1976-77 would lower the rate of inflation by 0.6 to 0.7 percentage points. In other words, if the inflation rate were 5.0 percent under the higher monetary growth path, it would

TABLE 1--CURRENT-DOLLAR GNP UNDER DIFFERENT RATES OF MONETARY GROWTH: THREE ESTIMATES

	1976-2nd Quarter	1976 4th Quarter	1977 2nd Quarter	1977 4th Quarter
FEDERAL RESERVE BANK OF ST. LOUIS MODEL:				
7 percent growth in M_1	1619	1694	1771	1845
5 percent growth in M_1	1609	1666	1724	1779
percent differences	-0.7	-1.6	-2.6	-3.6
DATA RESOURCES, INC. MODEL:				
7 percent growth in M_1	1646	1753	1841	1936
5 percent growth in M_1	1634	1705	1776	1859
percent differences	-0.7	-2.8	-3.5	-4.0
WHARTON ECONOMETRIC MODEL:				
7 percent growth in M_1	1639	1735	1821	1911
5 percent growth in M_1	1635	1718	1782	1852
percent differences	-0.2	-1.0	-2.1	-3.1

NOTE: Estimated GNP levels in all cases are based on a "current policy" federal budget as well as the indicated monetary growth rates. For this and other reasons, the projections in the table do not necessarily correspond to any forecasts issued by the organizations responsible for constructing and maintaining the models.

be reduced to 4.3 or 4.4 percent under the lower monetary growth path.

All of these projections about the consequences of different monetary growth paths, however, must be treated with considerable skepticism. What is involved is not simply general -- and healthy -- skepticism about models of the economy and their predictions; rather, there is the more troublesome consideration that none of the models have managed to account in a satisfactory way for recent developments in money, interest rates, and income. It is important to take a direct look at these developments before drawing any conclusions about the consequences of different monetary policies.

While over a period of years rapid money growth tends to accompany rapid growth in GNP (in current dollars) and slow money growth, slow growth in GNP, over a period as short as a quarter or two the correspondence is not always close. Sudden changes in government spending or exports or imbalances in inventory-sales ratios or output-capacity ratios are among the factors which can cause GNP growth to speed up or slow down independently of what is happening to money. Often, a rise in GNP growth relative to money growth means a temporary rise in interest rates, brought on by increasing loan demands

in the face of unchanging or slowly changing supplies of bank credit. A reduction in GNP growth relative to money growth often means falling interest rates.

To compare growth rates in GNP (in current dollars) with the stock of money, a useful concept is velocity, the ratio of GNP to the stock of money. A rise in velocity means that there is more GNP per dollar of money; a fall, less GNP per dollar of money. Table 2 compares the first two quarters of the current recovery with five previous recovery periods over the last 30 years. There are two panels in the table, the top one relating to money defined as demand deposits and currency (M_1) and the bottom one relating to money defined as M_1 plus time and savings deposits, except for large certificates of deposits (M_2).

As the table shows, velocity has grown extraordinarily rapidly during the first two quarters of the current recovery. This is especially true of M_1 velocity but it is also true of M_2 velocity. If this velocity growth continues, then low monetary growth may be consistent with continued rapid recovery in GNP. If it does not continue or reverses itself, then even high monetary growth may bring a slowing of the recovery.

It is useful to look at recent changes in velocity not just in comparison to other recoveries but in comparison

TABLE 2--RATES OF GROWTH OF VELOCITY, SIX RECOVERY PERIODS

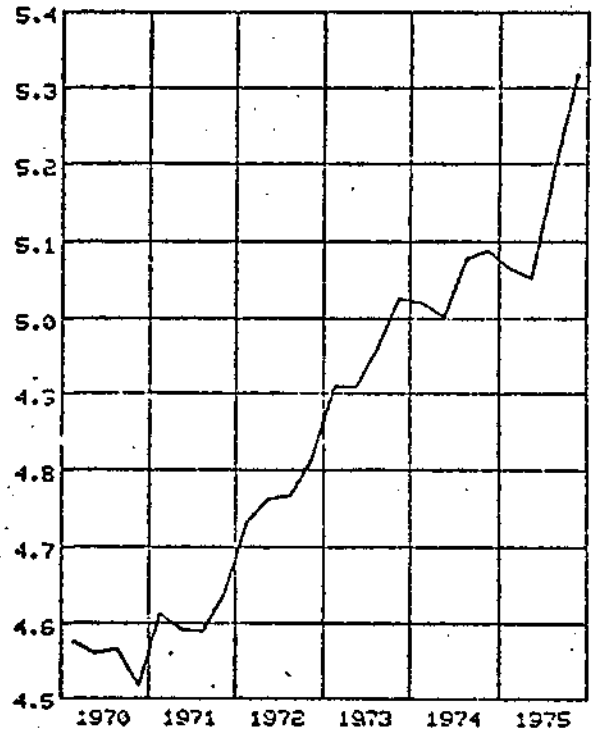
Trough Year and Quarter	Annual Rate of Growth in Velocity During Recovery			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
VELOCITY OF M_1				
1949:4	14.0	8.5	22.4	12.4
1954:2	1.1	5.6	8.9	5.9
1958:2	8.2	6.9	2.9	8.5
1961:1	5.5	4.7	6.4	6.9
1970:4	8.9	-1.8	-0.3	4.7
1975:2	11.9	9.5	--	--
VELOCITY OF M_2				
1949:4	14.6	9.2	24.2	13.7
1954:2	-0.7	5.5	9.1	5.6
1958:2	5.0	7.0	2.7	8.5
1961:1	2.9	1.8	5.3	2.4
1970:4	1.4	-5.6	-1.8	-0.2
1975:2	8.5	5.7	--	--

to velocity movements over the last five years. The same impression of extremely rapid recent growth emerges from this comparison, as Chart 2 shows. The top panel of the chart shows that during the last five years velocity has been moving along a rising trend but that the most recent two quarters have accelerated to a steeper trend. The bottom panel of the chart converts the levels in the top to the rates of change of velocity over six-month spans and points out the recent developments even more dramatically. From the trend in this bottom panel from 1970 through early 1975, it would have been difficult to surmise that the rapidity of the recovery in GNP could have been supported by the modest rate of monetary growth we have had over the last six months. The chart, incidentally, refers to the narrowly defined money supply (M_1), but much the same impression would be gained from looking at other definitions of money.

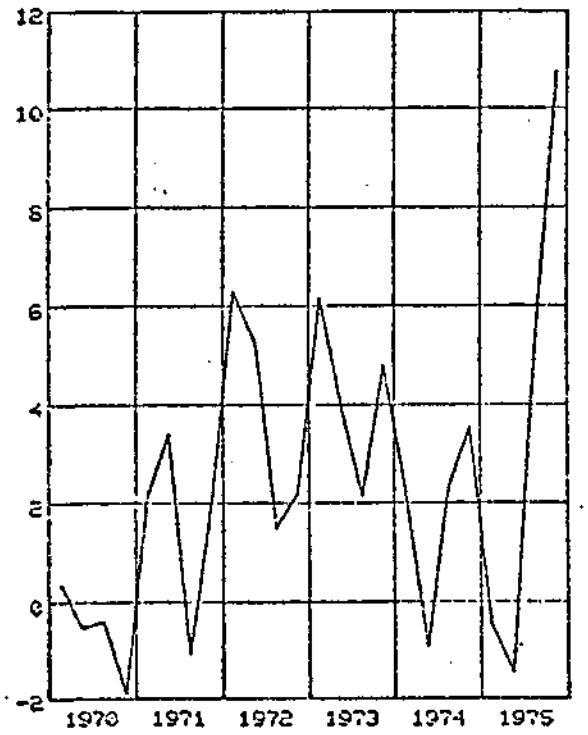
With the benefit of hindsight, it is (as always) possible to think of reasons for this recent departure from trend. Some of the possible reasons are changes in the way businesses or households handle their financial transactions. These include mechanisms for using savings accounts to pay bills, for businesses making telephone transfers between savings accounts and checking accounts, and other such institu-

Chart 2

VELOCITY OF THE MONEY STOCK
(ratio of GNP to M_1, both in current dollars, seasonally adjusted)



RATE OF CHANGE IN VELOCITY
(percent changes from 2 quarters earlier, seasonally adjusted annual rate)



tional developments, some of them only recently permitted under Federal Reserve regulations. Arguing against the significance of some of these factors is the fact that some of them imply a large-scale shift from demand deposits to time deposits, which does not show up in the recent statistics. It is also difficult to imagine that factors of this kind would account for a sudden, rather than a gradual, change in the trend of velocity. At most, these factors probably account for only a part of the recent change.

Other explanations are more short-term in character. The 1974-75 drop in GNP developed rapidly and unexpectedly and may not have had time to affect money balances; consequently, recovery did not require as much increase in money balances as rapid GNP growth normally would. Some support for this explanation is suggested by the top panel of Chart 2. Another possibility has to do with seasonal forces of the money supply which are difficult to measure and which may have been changing over the last few years. If they are involved in the movements of velocity in the last two quarters, then a return of velocity to normal could be expected quite soon in the future.

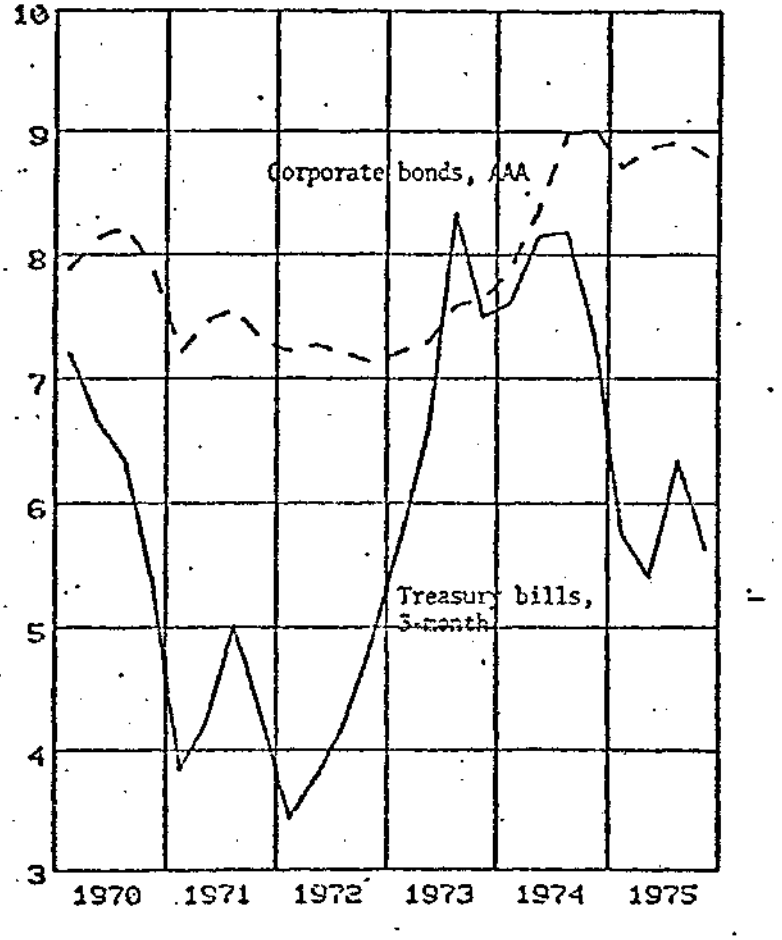
The most likely development -- but still subject to considerable uncertainty -- is that velocity growth will slow down significantly as recovery proceeds. Over the last five

recessions the average gain in velocity during the first year of recovery has been 7 percent, while in the second year of recovery the average gain has been only 4 percent.

A possible explanation which fits other periods of rapid velocity movement but does not help explain the current situation is the behavior of interest rates. High interest rates can cause businesses and households to economize on their money balances in order to benefit from higher yields available from investing in market instruments. Recently, however, interest rates have been stable or falling, as Chart 3 shows. Part of the reason for the recent behavior of interest rates may be competition of foreign interest rates, which have fallen under the impetus of the worldwide recession. Part of the explanation may lie in changing perceptions of the riskiness of municipal securities, which has led to a shift upward of municipal rates and may have caused a downward offsetting shift in other rates. Whatever the cause, the result is that interest rate movements do not help explain the willingness of the public to increase their money balances only slightly while their incomes went up a great deal.

Low interest rates, however, encourage a fast rate of recovery. Partly because of the low rates on short-term securities, savings have been flowing into thrift institutions in large amounts and have boosted recovery in housing. Stable

CHART 3--INTEREST RATES



long-term rates are a factor which should help permit a turn around in plant and equipment spending in the future. Fears that high government deficits would cause rising interest rates and in this way "crowd out" private investment have not materialized thus far, and that is one of the forces behind the strength of the recovery to date.

These recent facts about interest rates and money are of the utmost relevance in the determination of a monetary target. The faster velocity grows, the lower the monetary targets which are required to achieve any desired rate of growth in income. The models' results discussed earlier generally rest on the assumption that 1976 and 1977 will bring a somewhat smaller increase in velocity than we have observed in the recent past. This assumption is critical to reaching their conclusion that 5 percent monetary growth would greatly reduce or eliminate the short-run improvement to be expected in unemployment while producing some longer-run improvement in price trends. If the assumption about velocity is too low, it is possible that even a 5 percent rate of monetary growth could bring the kind of recovery sketched in the earlier part of this statement. If the assumption is too high, even a 7 percent growth could lead to no reduction in unemployment.

III. Problems of Setting Monetary Targets

As we have seen, monetary growth targets are especially difficult to select at the present time, even if there is agreement on the desired rate of overall economic growth. Nevertheless, the Congress should have some indication of what to expect from the Federal Reserve System. As the Congress begins its new budget process, it will be particularly important to have guidelines on future monetary policies when making decisions about the budget resolutions in May and September. The problem is how to set monetary policy goals in a more meaningful way than ranges of growth in monetary totals.

A possible solution is to set targets not in terms of the rate of money growth but rather in terms of interest rates. As we have seen, the current low interest rates apparently are promoting recovery and there is every reason to believe that a sharp rise in interest rates would seriously retard recovery. It is certainly within the power of the monetary authorities to direct their operations so as to meet an interest rate target. Indeed, because of certain detailed regulations governing the setting of reserve requirements, it is probably easier to meet an interest rate target than a monetary target in the short run. It would be quite feasible, therefore, to

to select a range for some interest rate that would promote the desired rate of recovery over the next year or two and direct monetary policy toward achieving that range.

Specifying monetary policy targets in terms of interest rates is by no means a novel approach. During the second World War and until 1951 the Federal Reserve followed an explicit policy of pegging interest rates. In last year's House Concurrent Resolution 133, the House of Representatives mentioned the desirability of low long-term interest rates in the first half of 1975. In its own Open Market Committee directives, the Federal Reserve System specifies both a money and an interest rate (the Federal Funds rate) target and has more success in achieving the latter than the former.

There are, however, two weighty arguments against using an interest rate target in place of a monetary growth target. A short-run argument is that, in the face of an unrecognized change in the pace of recovery -- an unexpected boom or recession, following an interest rate target tends to make matters worse while following a monetary growth target tends to stabilize the situation. If an unexpected economic weakness were to develop in 1977, for example, it would have the effect, because of the fall off in loan demands, of reducing monetary

growth and lowering interest rates. Following an interest rate target at such a time would mean taking steps to raise interest rates back to target levels, and these steps would further reduce demands and hence further weaken the economy. Following a monetary target, on the other hand, would mean taking steps to raise the money supply back to its target level and these steps would tend to strengthen demands and counteract the unexpected economic weakness. From those times during the last 30 years when the economy has confounded the experts by unexpected strength or weakness, it seems clear in retrospect that following monetary growth targets would have promoted economic stability.

The second problem with interest rates targets arises if a target is adhered to for a long period of time. A high interest rate target -- how high it is is not possible to measure with any certainty -- will tend to require monetary restraint in greater and greater doses to achieve it and the result will be to depress the economy for perhaps an extended period. More likely perhaps, is the situation in which a low interest rate target requires larger and larger doses of money to meet it. In this case, the resulting acceleration of money can lead to a buildup of inflationary forces.

For these reasons it would probably be unwise to abandon the idea of a monetary growth target permanently and

follow an interest rate target instead. An intermediate course, which may be worth your consideration, is a target which takes account of interest rates as well as monetary growth. One way to formulate such a target would be to have a target range of monetary growth which would be followed provided that some short-term interest rate -- say the Treasury bill rate -- did not rise above some specified level. If the interest rate did rise above the specified level for some period of time, hearings and a new statement of targets would follow. Once there seemed to be more certainty about velocity movements and the demand for money, a return to unqualified monetary growth targets would be approproate.

It is not the place of the Congressional Budget Office to recommend specific targets, but rather to provide estimates of how different targets might affect the economy. At the present time, it appears that there is more uncertainty than usual about how monetary growth targets might affect the economy, and that a statement of policy involving interest rates as well as rates of monetary growth might provide more certainty. To summarize the estimates in this statement very briefly:

1. with a "current policy" budget and 7 percent growth in M_1, there is a good chance of continued recovery of output (constant-dollar GNP) at a 5 to 7 percent rate during 1976 and perhaps a slightly lower rate in 1977;

2. past experience suggests that lower monetary growth would raise interest rates for a time and slow the recovery, but recent developments do not fit the expected relationships among money, interest rates, and growth;

3. for this reason, a monetary policy target that takes account not only of money growth but also of interest rates conducive to a continuing recovery has strong appeal at the present time.