ISSUES AND ANSWERS

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GUEST:

PAUL A. VOLCKER - Chairman,
Federal Reserve Board

INTERVIEWED BY:

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MR. CLARK: Mr. Volcker, welcome to ISSUES AND ANSWERS.

You and the Federal Reserve Board began drawing some heavy political fire this week as banks raised their prime interest rates on to 15 percent and beyond. Your critics say that you are pushing too hard in trying to stop inflation, that you could push the country into a very serious recession.

Are you worried either by recession or by the political fire?

MR. VOLCKER: Well, let me say, first of all, Mr. Clark, that I think the actions we took on October 6 are far from great political fire. We generally accept it as a responsible and necessary set of actions; and I was very gratified by the amount of support that was indicated at the time.

We are in a very difficult economic situation, but I would not, in terms of a possible recession, which has been discussed for months, trace that to our particular actions. The situation we had was rising inflation, speculation, a weak dollar.

We are in a better position to deal with the adjustments that lie ahead, and some difficult adjustments may lie ahead, with the kind of actions we took. I certainly believe that.

MR. CLARK: Tomorrow is the 50th anniversary of the stock market crash of 1929 that began the Great Depression. We built a lot of fail-safe systems into the economy since then, to assure that it can't happen again; but with all of the countries' and the world's current economic problems, do you ever worry that maybe it could happen again?

MR. VOLCKER: I don't worry about a repeat of the 1929 kind of thing. We have -- you know, it is wonderful for the media to have a 50th anniversary, but that kind of thing isn't going to happen again. We have protections in our financial system; we have protections in our economic policy. Situations are different. We have a difficult situation and I don't want to underestimate that, but the coincidence of 1929 is not really relevant.

MR. CORDTZ: When you talk about that, most people would agree, I think, that the stock market couldn't crash the way it did back then, but a lot of people do seem to be concerned that we may be headed for a long period of -- if not recession or depression, at least such slow economic growth that we are going to have unemployment problems and the like. Does that concern you?

MR. VOLCKER: A lot of things about the economy concern me, and very basically. Look, in this country we are used to having a three percent productivity growth, and that is what really brings a higher standard of living in the end. But that productivity growth has slowed down in the last 10 or 15 years. In the last year we have had no growth in productivity at all. We have actually had a decline. That is a serious underlying problem for this economy. It is nothing that is directly susceptible to monetary policy.

But as we move ahead, we want to create conditions in this country where we can grow again, and I think we can. But we have had a decade of moving in the wrong direction.

MR. CORDTZ: You recently made a public appearance at which you spoke the unspeakable and said that the American people, the average American has to look forward to a period of decline in his living standards?

MR. VOLCKER: That is corrected;I never said look forward to. The point I was making is the one I just made: When we have declining productivity, and now we have the additional complication of higher oil prices which are in effect a tax coming from abroad, and indeed just in the past year that tax amounts to something like one percent of our GNP; but we are producing less. In fact, producing less per capita. We have more people at work than ever before, but we are producing less per capita. That means the average worker has less income, inevitably.

Now we look ahead. We want to correct that. Now, it is not going to be easy over a period of time, and I think people do have to recognize that when productivity is declining, when energy prices are increasing so rapidly, there is no way you can increase your standard of living in the nation as a whole just by asking for higher wages or higher prices. You can try to out raise the other fellow, but collectively we cannot consume more than we are producing.

MR. CLARK: You said a couple of minutes ago that you got some strong political support. Now, some three weeks ago when the Fed initiated its get-tough policies -- and you did get a lot of support at that time -- but this last week that political fire we spoke of began to intensify in Washington, and let me cite some instances: The Democratic leader of the House, Jim Wright, called your tight-money policies an open invitation to disaster. The Chairman of the House Banking Committee, Henry Reuss, warned that you have let interest rates go too high in this three-week span. And Labor Secretary Marshall warned that interest rates are a very inefficient way to deal with inflation.

Is this sort of political pressure going to force the Fed to trim its sails?

MR. VOLCKER: We are set up, of course, deliberately, with a certain amount of insulation from political pressure. Our job is to make the best judgment we can and as to what is necessary in the area of monetary policy, what is most desirable for the economy. And I think that the reason that Congress in its wisdom for 50 years has maintained this certain degree of insulation or independence is that we just can't look at what happens next month or the next two months, or three months; we are looking at what makes the best conditions, the best probability of getting a base for growth and a productivity back in this economy over a period of time: and that is always the problem., looking with a little perspective ahead, because sometimes what appears to be best for the next month or two really, quite clearly, is not best when one enlarges his horizons.

MR. CLARK: But are you really confident of what you refer to as that degree of insulation from policital pressures? And I ask that because of some of the confrontations your predecessors as Chairman of the Fed have had with Congress.

MR. VOLCKER: Yes, I feel confident in that. The question seems to imply that all the political comments will be on one side, and I don't think that is true at all.

MR. CLARK: Let me ask this: Do you accept the view that the Federal Reserve Board is a creature of Congress and has to bow to the will of Congress?

MR. VOLCKER: Well, it is a creature of Congress, quite deliberately set up by the Congress with this insulation of which I spoke.

Now, Congress can change the law. They haven't chosen to change that basic arrangement ever since the Federal Reserve was established, and I don't think they are going to.

MR. CORDTZ: Last week the Fed had to make the somewhat embarrassing admission that there had been a $3 billion error in the estimate of the growth of the nation's money supply and, of course, at a time like this those figures are -- great attention is being devoted to them because of what they mean for policy. Now, tomorrow your colleagues are going to be called down to Capitol Hill to appear before the House Banking Committee, and the chairman has already called that mistake inexcusable.

Was it inexcusable, and what happened?

MR. VOLCKER: Well, mistakes happen, and I am not very happy about it. I point out the mistake was not really the Federal Reserve's. We compile figures that are reported to us every week by various banks. We, unfortunately, had a bank in that particular week that reported a sizable error. We were suspicious about the figure. The bank was quizzed, some adjustments were made, we were assured the figure was correct, it was published. We later found out it to be incorrect. A very large error in that particular week. But let me make two points in that connection. I have said, my predecessors have said, other members of the Federal Reserve Board have repeatedly said, don't pay too much attention to these weekly figures. They are erratic at best, and we don't form policy on the basis of any particular week's figure. You have to look to the extent the money supply is important, at developments over a period of time. Certainly this particular misreporting which the Federal Reserve did catch -- unfortunately, after the preliminary figure was published -- and they are always revised a week later -- that particular figure did not affect -- had nothing to do with the measures on October 6 and didn't really affect our subsequent actions.

MR. CLARK: To carry this question of your political independence on to your relations with President Carter, would you back down if President Carter made it clear that your policies, as Chairman of the Fed, were in conflict with his basic economic views and policies?

MR. VOLCKER: I am not going to do that. President Carter made a statement right after our program was introduced. I was in close contact with the administration on this. It so happens the kind of problems we saw, the kind of priorities we had about inflation, and have, have been stated repeatedly to be the administration's priorities.

MR. CLARK: Let me throw a little historical perspective on this, go back about fifteen years, when William McChesney Martin, who was then head of the Fed, went eyeball-to-eyeball with Lyndon Johnson because the Federal Reserve Board at that point had raised the discount rate higher than Johnson thought it should be raised. The point that Johnson made was that the policies of the Fed should be coordinated with the overall economic and budget policies of the administration. Do you agree with that view?

MR. VOLCKER: Well, I think the answer Chairman Martin gave at that time -- I happened to see an old article a few months ago about that -- there was no basic disagreement about the objectives. The Federal Reserve is charged with the responsibility of making particular actions on the monetary side. They discharged those responsibilities. I think in retrospect; in fact, nobody would question the appropriateness of that Federal Reserve action at that time. I would hope that that would be the case in the President's --

MR. CLARK: Well, the interesting thing, to complete the historical view here, was that Mr. Martin stood up to Lyndon Johnson and did not back down. Do you expect to do the same in similar circumstances?

MR. VOLCKER: We are charged by law, Mr. Clark, with making the best judgment we can make, taking into consideration all the factors about monetary policy, and we intend to continue to discharge that responsibility.

MR. CORDTZ: Whatever the political support or non-support, obviously there has been some criticism by some economists of the Fed's policy --

MR. VOLCKER: Remarkably few.

MR. CORDTZ: One of the charges, obviously, is that higher interest rates add to inflation rather than solve it. How do you expect to bring prices down by raising the cost of money?

MR. VOLCKER: Well, you know, this is always one of the most difficult things to explain to many people because it is true that interest rates enter into costs in the economy. But more basically interest rates are related to the inflationary process, itself. When inflation is going up, thirteen or fourteen percent a year as it is, if interest rates don't respond, obviously there is an enormous incentive to borrow, and there is no incentive to lend, if you are going to lose money in the lending process.

So the market, itself -- forget about the Federal Reserve -- the market, itself, pulls up interest rates in those circumstances.

If you look at the course of history in the United States, or in any country, when inflation moves over a big cycle, interest rates inevitably move over the same kind of cycle, because in a general way, they must be related to the inflation rate.

Now, what we are trying to do, and what we must do, is maintain restraint on money and credit creation, and I think history demonstrates pretty clearly that you can't have a lot of inflation with restraint on the money supply.

As inflation comes down, which is the whole object of our policy, that is, the only fundamental way to get interest rates down, and I have no hesitation in saying that the kinds of policies that we are following will bring interest rates down quicker and lower than if we took any other approach.

(Announcements)

MR. CORDTZ: Mr. Volcker, the Fed has to make policy on the basis of what it sees ahead. What do you see as the outlook for the economy over the next year or so, and how long is it going to take us to really get back to good health?

MR. VOLCKER: Well, as you know, virtually all economists, I think, in or outside of government, have been anticipating an adjustment process. They have been anticipating it, I must say, for some months, and the characteristic of the economy recently has been to maintain quite a lot of strength. But I don't, myself, take exception to the probability that some kind of adjustment lies ahead. Real incomes have been declining, the savings rate is very low, inventories in a few areas, at least, may need to go through some period of adjustment. Home-building has held up extremely well so far, relative to previous periods of expansion, but undoubtedly the mortgage market is tightening, and it could feel some effects, so there could be a combination of influences here to give us a period of adjustment. What we hope, of course, is to lay the basis during this period for a moderation of inflationary forces in the relatively short run and lay a base for dealing with inflation over a longer period of time, and it is going to take some time. That will be then a healthy situation for a continuing and resumed economic advance subsequently.

MR. CORDTZ: Charles Schultze, the Chairman of the Council of Economic Advisers, was quoted the other day as saying that the underlying fundamental inflation rate in the country is now probably eight to nine percent. Can we live with that kind of inflation rate over long period o time?

MR. VOLCKER: I don't think so, because the trouble with those kinds of inflation rates is that they don't remain stable. If you get used to an eight or nine percent inflation rate, the tendency is to speed above that, and then expectations begin running ahead of the actual price level. That was what was happening, in my judgment, in recent months, that expectations of inflation began accelerating and the expectations affect behavior and can themselves bring about a higher rate of inflation.

We began getting speculative activity in commodity markets, not just gold that was led by the gold market, the silver market, began spreading into the copper market, the zinc market. Some of the consumer spending which has been quite strong recently appears to be motivated by an idea of spending now, rather than later, because prices are going up. That basically is an unhealthy situation that creates the risk of a bigger recession later, rather than a smaller recession.

So I am not one of those who thinks we can live with a high rate of inflation, because I think it is inherently an unstable condition.

What we have to work toward over a period of time is getting back to a noninflationary situation, and that is what we intend to do.

MR. CLARK: You have pledged in the last few weeks that you wouldn't shut off the flow of credit, but isn't the flow of credit effectively being shut off for a small businessman who simply can't afford to pay interest rates of 17 or 18 percent, or for a small builder of homes who can't afford a construction loan of 20 percent on homes that he may not be able to sell because of high mortgage rates after he builds them?

MR. VOLCKER: The price at the moment is high, Mr. Clark, but we are not shutting off the flow of credit. We expect a continuing credit expansion. Credit has been expanding at an exceedingly high rate.

Now, we want to moderate that, and it must be moderated to deal with the inflationary problem. But, again, the point I would make is that these interest rates you refer to are a symptom of economic difficulties we are in; they are a symptom of the inflationary process. As we get a hold of that process, that is the best assurance we can have that the interest rates will decline, that the flow of credit can move much more smoothly than it is at present. You can't deal with that situation without dealing with the inflationary process and the kind of speculative psychology that has existed in the economy.

MR. CLARK: Chairman Reuss of the House Banking Committee seems to think the Fed needs some help in this area, and this week in warning that interest rates are too high he urged the Board to enforce its efforts to get banks to provide credit for housing for small businessmen and for farming. He offered to supply legislation from Congress if necessary -- presumably some form of credit controls.

Do you need legislation from Congress to back up your own jawboning?

MR. VOLCKER: Definitely not, in my judgment. We are not capable in Washington in the Federal Reserve or elsewhere to make the kind of detailed judgments about what loan is a good loan or what loan is a bad loan. The attempt would only create entirely unnecessary and unfortunate uncertainty on the part of borrowers.

It is the job of banks and savings and loans and other lending institutions to make that kind of judgment as to what the need is of their individual customers; and I have indeed reminded them that in this process we hope that they will give particular attention to the needs of small business, the homebuilder and all the rest, and resist any temptation to go out in some loan that may look profitable at the moment but it is not making much contribution to the economic adjustment.

MR. CLARK: That is all a voluntary effort. Aren't you almost assuring that Congress will launch some rescue efforts of its own if, for instance, you let the housing industry to slide into serious recession?

MR. VOLCKER: Well, it depends upon what you mean by "rescue effort."

MR. CLARK: Mandatory ~~price~~ credit controls?

MR. VOLCKER: I would suggest that that is not a rescue effort, but that would only severely complicate the situation and lead to less certainty about credit availability.

Now, other actions are possible. The Home Loan Bank Board took some actions this week to relax the liquidity requirements on savings and loans. They, of course, have borrowing facilities for savings and loans. There are actions that can be taken to meet some of the particular points of strain that might otherwise be unduly burdened.

Now, that is not a question of credit controls or credit allocation. There is a marked difference between those types of actions.

MR. CORDTZ: Well, to approach this from the other side, your letter to the banks and President Carter's statements recently have suggested that we are going to make sure that housing isn't too badly affected by this; but isn't housing exactly one of the very speculative sections of the economy that needs to be deflated?

MR. VOLCKER: Housing is an area that is inherently vulnerable to this kind of process and, General, I am not just speaking of the Federal Reserve actions. The kind of inflationary situation we have. You probably saw reports that savings and loans are losing deposits in September, and savings banks have been losing deposits. That is before we took these actions. Because, as market rates rise in response to inflation, those institutions tend to be in a more vulnerable position than others. They have not been as vulnerable in this expansion as in earlier expansions, because of a variety of actions that have been taken to improve their competitive position. Those actions have been fairly successful. They can not work perfectly in a highly inflationary situation of the kind that we have had. Those institutions will again thrive as we begin to get the inflationary situation under control.

I know when I talk to savings and loan executives, quite generally they say, "My God, we are going through a tough situation now, but we recognize the only thing that is really going to make us healthy is getting this inflation under control."

MR. CLARK: One of the reasons, Mr. Volcker, that savings and loan associations have been losing money is because of the Federal Reserve Board's, we might say, notorious regulation Q which limits interest rates on regular passbook accounts to five and a half percent, and you have to have at least $10,000 to buy one of those special 6-months' certificates. The interest rates on those certificates this last week rose rather incredibly to 12.6 percent, but isn't it grossly unfair to small savers who have only a few thousand dollars to limit their interest to five and a half percent?

MR. VOLCKER: Well, there have been a lot of modifications in Regulation Q, as you know, over the past couple of years, so that savers do have access to higher rate instruments. This is under current discussion within the Congress, and I am sure that those matters are going to continue to be reviewed.

The other side of the coin is the problems that some of these institutions have in paying higher rates at this particular point in time.

MR. CLARK: But why should that problem be heaped on the small savers?

MR. VOLCKER: It should not, in a fundamental sense. There is a question of what can be done at a particular point in time.

MR. CLARK: And the answer seems to be that nothing can be done now.

MR. VOLCKER: A lot has been done.

MR. CLARK: A half percent or a quarter increase, from five and a quarter --

MR. VOLCKER: On the passbook savings account, but a lot has been done in terms of other forms of savings certificates and money market certificates.

MR. CLARK: Smaller denomination Treasury bills, but most people don't know anything about those. They don't have the sophistication --

MR. VOLCKER: Well, we have not got a perfect situation in this respect, but small savers have found a lot more opportunities in this particular episode than they found in earlier episodes, and we want to work away from those restrictions, and we want to work away from them as fast as we reasonably can.

MR. CLARK: Thank you very much, Mr. Volcker, for being with us on ISSUES AND ANSWERS.

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