

CONDUCT OF MONETARY POLICY
(Pursuant to the Full Employment and
Balanced Growth Act of 1978, P.L. 95-523)

HEARINGS
BEFORE THE
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

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FEBRUARY 26 AND MARCH 5, 1985

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CONDUCT OF MONETARY POLICY

TUESDAY, FEBRUARY 26, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:10 a.m. in room 2128 of the Rayburn House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Subcommittee members present: Chairman Fauntroy; Representatives Neal, Cooper, Carper, Erdreich, McCollum, Hiler, Leach, Bartlett, and Chandler.

Full committee members present: Vento, Schumer, Frank, Wylie, McKinney, Wortley, McCandless, Grotberg, Kolbe, and McMillan.

Chairman FAUNTROY. The subcommittee will come to order.

Today, we hold the first of this committee's semiannual hearings on the conduct of monetary policy held pursuant to the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. Our witness today is the Honorable Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve System, who will testify on the Federal Reserve's Monetary Policy Report to the Congress.

We are holding these hearings at a time when almost everything seems to be going right in the economy, and yet large and dark clouds loom over our prosperity. On the bright side, we have experienced a very strong recovery from the recession of 3 years ago and a sizable decline in unemployment. We are now well into the expansion stage of the economic cycle, but inflation remains at the lowest rate we have seen in nearly 20 years. However, on the negative side, the unemployment rate remains above 7 percent, and more than 8 million Americans remain without jobs. Also looming over the economy is the remarkably high value of the dollar in foreign exchange markets and the related deterioration in the U.S. balance of trade, to the point that the United States last year imported \$105 billion more in merchandise than we exported.

While we are pleased with the strong gains the economy has shown, we are concerned about the continuing lag in employment and the worsening trade imbalances. Monetary policy is not, of course, the only instrument of economic policy that bears on these issues. We have heard in numerous hearings of the role that fiscal policies, especially our enormous budget deficits, have played in keeping real interest rates high, distorting the recovery, raising the value of the dollar, and crowding out production and employment in our manufacturing and agricultural sectors. Almost all of us, therefore, recognize the importance of restructuring our fiscal poli-

cies, although it would help if the President gave as much priority to reducing the deficits as he does to preserving his defense build-up and his tax cuts.

Still, monetary policy, with or without proper fiscal policies, will greatly influence what happens to unemployment and inflation this year, and what happens to the value of the dollar and the balance of trade. I have asked Chairman Volcker to address these issues in his testimony and it is these issues that I would like to focus upon in this and future hearings. Inasmuch as money and credit targets are tools of policy implementation and not ends in and of themselves, I am more interested in the Federal Reserve's assumptions about the economy than the monetary aggregates themselves. Recent history has taught us that those targets are, justifiably, rather flexible.

I know, for example, that the Federal Reserve considers low inflation to be a primary objective. But, is the current 7 percent unemployment rate an acceptable price for maintaining a 3- to 4-percent inflation rate? What will the Fed do and what can the Fed do to bring down unemployment without reigniting inflation? What guidance should we in the Congress generally, and in this committee particularly, provide as to the relative weight which ought to be given to one or another of these two objectives? What rate of economic growth and level of unemployment can be sustained at stable prices, given the likely labor and commodity market conditions and productivity trends? What can monetary policy do to help reduce the value of the dollar and ease the trade deficit without generating a dangerous swing to an undervalued currency? What do these exchange rates and trade conditions portend for employment and employment policies, as well as for inflation? Should monetary policy even be concerned with the dollar's value? It is these and related questions that I hope we can discuss in these hearings, so that when we write our report, commenting upon these policies, we will provide genuine and constructive guidance for the Congress and for the Federal Reserve.

Chairman Volcker, we are honored, as always, to have you before the subcommittee. I know that you will take my questions and my inquiries in the spirit that I have given them: not as accusations or attempts to fix blame, but as serious efforts at a dialog between this committee and the Federal Reserve. We are trying to convey to you our concerns to learn what is possible, what is not, and what is counterproductive; and to discover together the kinds of economic policies that will bring about what we all want: full employment with stable prices.

[The letter of invitation to Chairman Volcker to testify and the notice of the subcommittee hearings follow:]

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA,
CHAIRMAN

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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

WASHINGTON, DC 20515

January 16, 1985

The Honorable Paul A. Volcker
Chairman
The Board of Governors of
the Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D. C. 20551

Dear Paul:

At the request of the Chairman of the Full Committee on Banking, Finance and Urban Affairs, the Subcommittee on Domestic Monetary Policy will hold hearings on the conduct of monetary policy and the Federal Reserve's Monetary Policy Report to Congress made pursuant to the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978.

I would like you to testify on the Report and related issues at a hearing to be held on Tuesday, February 26, 1985, at 10:00 A.M. in Room 2128 of the Rayburn House Office Building.

As provided by the Full Employment and Balanced Growth Act of 1978, I would expect your testimony to address the outlook for the economy in 1985 and the Federal Reserve's objectives for growth of money and credit in 1985. I would also anticipate that you would discuss the performance of the economy and the growth of money and credit during 1984.

In addition, I would like your testimony to focus upon what can be done to obtain lower unemployment with price stability. As you know, the unemployment rate has fluctuated between 7.5% and 7.1% since May 1984, with only a small downward trend. Continued strong economic growth will be required to bring down unemployment, and monetary policy will, of course, be a major determinant of that growth. However, other factors such as productivity growth, the size and trend of the budget deficit, the strength of the dollar in foreign exchange markets, the trade deficit, and commodity and labor market conditions will also affect how fast and how much unemployment can fall without inflation accelerating. I would like you to discuss what the Federal Reserve can and will do to foster lower unemployment and stable prices in 1985 given these constraints.

As a part of this focus, I would therefore hope that you will address the following questions in your testimony:

1. In regard to the outlook for the economy, what rates of real growth does the Federal Reserve believe to be sustainable and noninflationary for the coming year, given productivity trends, current fiscal policy, and prospective international currency and trade conditions? What rate of unemployment would such real growth rates produce?
2. What are the prospects in 1985 for moderating the overvaluation of the dollar in foreign-exchange markets and reducing the U.S. trade deficit? What impact would a modest or a steep decline in the dollar's value have on U.S. inflation and unemployment? What emphasis will the Federal Reserve give to achieving a more sustainable value for the dollar?
3. What relative weight will the Federal Reserve in its conduct of monetary policy during 1985 give to the growth of the monetary aggregates vis-à-vis economic and financial market conditions? What relative weight will the Federal Reserve give to reducing the unemployment rate and to reducing the inflation rate?

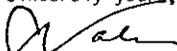
Please plan to testify before the Subcommittee on Tuesday, February 26, 1985, at 10:00 A.M. in Room 2128 of the Rayburn House Office Building. Inasmuch as these hearings will take the place of the previous Full Committee hearings on the conduct of monetary policy, please provide the Subcommittee with 150 copies of the Monetary Policy Report to Congress of the Board of Governors and 150 copies of your own testimony, so that all Members of the Full Committee as well as the Subcommittee will have copies. I would like to receive the Report in time to deliver it to Members on the day you testify before the other body. I would like to receive your testimony no later than 10:00 AM on Monday, February 25, 1985.

If there are any questions concerning this request or your testimony, please contact Howard Lee, Staff Director, at 226-7315.

I look forward to your testimony and thank you in advance for your efforts in support of our inquiry on the conduct of monetary policy.

With kindest personal regards, I am

Sincerely yours,



WALTER E. FAUNTROY
Chairman
Subcommittee on Domestic Monetary Policy

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA
CHAIRMAN

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OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

NOTICE OF SUBCOMMITTEE HEARING

TO: Members, Subcommittee on Domestic Monetary Policy
Members, Full Committee on Banking, Finance and Urban Affairs

FROM: Walter E. Fauntroy
Chairman
Subcommittee on Domestic Monetary Policy

DATE: February 19, 1985

RE: Monetary Policy Hearings
Tuesday, February 26, 1985 10:00 A.M.
Tuesday, March 5, 1985 10:00 A.M.

TUESDAY
FEBRUARY 26, 1985
10:00 A.M.

2128 RAYBURN HOB

The Humphrey-Hawkins Hearings on the Conduct of Monetary Policy will begin on Tuesday, February 26, 1985 at 10:00 A.M. in 2128 Rayburn House Office Building with the testimony of the Honorable Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve System.

In making this semi-annual report on the Conduct of Monetary Policy, Chairman Volcker has been requested to focus particularly upon what can be done to reduce unemployment while maintaining price stability. Additionally, in light of the fact that the growing trade deficit is one cause of persistent high unemployment, especially in manufacturing and agricultural sectors, the Subcommittee has also requested comment on what monetary policy might be able to do about the high interest rates and the high value of the dollar in international currency markets.

TUESDAY, MARCH 5, 1985
10:00 A.M.

2128 RAYBURN HOB

On the second day of hearings, which will be held on Tuesday, March 5, 1985 at 10:00 a.m. in 2128 Rayburn House Office Building, the Subcommittee will take testimony from four former Presidential economic advisors in assessment of the policies which the Federal Reserve will have announced at the earlier hearing. The four witnesses who will testify at that time are:

WITNESSES:

Dr. James Tobin, Professor of Economics at Yale University, was a Member of the Council of Economic Advisers under President Kennedy and Nobel Laureate in Economics in 1981.

Dr. Alan Greenspan, President of the Townsend-Greenspan Company, was Chairman of the Council of Economic Advisers under President Ford and chaired the National Commission on Social Security Reform in 1982-1983.

Dr. Charles L. Schultze, Senior Fellow at the Brookings Institution, was CEA Chairman under President Carter.

Dr. William Poole, Professor of Economics at Brown University, was a Member of the Council during President Reagan's first term.

PLEASE NOTE:

ALL MEMBERS OF THE COMMITTEE ARE WELCOME AND ARE INVITED TO ATTEND AND PARTICIPATE IN THESE HEARINGS.

Chairman FAUNTROY. Before we begin, I will yield to my colleague and friend, the ranking member of the subcommittee from the State of Florida, Mr. McCollum, for any remarks which he may wish to make at this time.

Mr. McCOLLUM. Thank you, Mr. Chairman. I am delighted to have this opportunity to be here with you today.

We have with us today the ranking member of the full committee, Mr. Wylie of Ohio. I would like, before I make my statement, to yield to him to let him make a few remarks, if I might.

Chairman FAUNTROY. Without objection.

Mr. WYLIE. Thank you very much to the gentleman from Florida for yielding for this opportunity, and thank you, Mr. Chairman, for holding these hearings today. I compliment you in that regard. I, too, want to welcome you, Chairman Volcker, to this timely hearing on monetary policy, after a too lengthy absence from this hearing room.

I think the performance of the U.S. economy, in particular, the trends of production and employment, prices and interest rates, is a source of satisfaction to all of us, I am sure. And it seems to me that you and the membership of the Federal Reserve's Open Market Committee must have made a significant contribution to this favorable outcome and should be commended for your efforts and good judgment. And I do that at this time.

Our present good fortune does not mean, however, that there are no clouds on the horizon, that all of us have been equally blessed. A major concern for policymakers, both from this body and in the administration, remains the size and growth of the Federal deficit and how best to reduce it.

While this is an issue for fiscal policy, its timely and effective resolution is of potentially great importance for the monetary authority, as you, yourself, have repeatedly pointed out.

Failure to resolve it effectively and to get us back on track toward better budgetary balance is likely to generate enormous pressure on the Federal Reserve for undue monetary expansion, particularly if large financing requirements of the Government coincide with strong private sector demand for the necessarily limited savings of the community. Yielding to such pressure could easily rekindle the fires of inflation that are still glimmering under the surface. Effective resistance to such pressure, on the other hand, could well mean higher interest rates and a measure of disinflation with widely felt ramifications, both in this country and abroad.

The general dilemma has a number of dimensions. Pressure for monetary expansion could come from representatives of export industries who believe easy money is a way to lower interest rates and thus, reduce the exchange rate of the dollar.

Sympathetic as I am, and I am sure we all are, to the difficulties of these industries, I feel that pumping up the money supply is not going to be necessarily effective in lowering interest rates, nor do I think that interest rate differentials are the only, or even the dominant, explanation of the international capital movements which account for the strength of the dollar.

Another ramification of the policy dilemma of the monetary authority, as I see it, is the still fragile financial state of many debtor

nations, although I should add that some of them appear to have made remarkable strides toward fiscal health.

Similarly, on the domestic scene, Continental Illinois appears to be making a very significant and satisfactory progress toward liquidity, and other troubled institutions are reportedly holding their own, if not improving, their positions.

Gratifying as this is, the fact remains that to regain their full financial health, a number of domestic institutions in foreign nations need a continued stable monetary climate in the United States.

So it seems to me, therefore, that the Federal Reserve, during the year ahead, and despite our present general prosperous circumstances, faces an extraordinarily delicate test of monetary management.

I look forward to your testimony and the plans you and your colleagues have for the conduct of monetary policy in 1985 and beyond, Mr. Chairman. I ask unanimous consent to revise and extend my remarks.

Chairman FAUNTROY. Without objection.

Mr. McCOLLUM. Thank you. If I might reclaim my time, I appreciate the ranking member's remarks. I will be very brief with mine in light of that.

Mr. Volcker, we are delighted that you are here, as everybody has said. We are always intrigued by what you have to say because it is of such great importance to us.

We are charged with the responsibility on this subcommittee of the oversight of the conduct of monetary policy and its effect on the economy. We are presently blessed, as has been stated, with the strongest economy and economic recovery in some 35 years. GNP grew at a rate of just a shade under 7 percent in 1984. Inflation for the last 12 months has been under 4 percent. More Americans are employed than ever before. Unemployment has decreased from record highs in 1982 to a level of 7.4 percent. And the dollar has set a new record high many times in the past few months.

However, as we commence these hearings, we realize that in order to continue this economic prosperity and obtain the long-term economic health, Congress must act swiftly, as you have admonished us so many times, to put an end to runaway Federal deficits and make fundamental changes in our tax laws to encourage greater capital formation and economic growth.

At the same time, we are mindful that a responsible and consistent monetary policy is equally important. And monetary policy is the primary concern of this subcommittee at this hearing.

While monetary policy and monetary restraint played a major role in bringing inflation under control, there are no signs that inflation is likely to reignite in the near future. And while still being mindful of the possibility, the immediate concern of monetary policy, in my judgment, should be focused elsewhere. Strong economic growth over the next few years should be a primary concern. Sustained economic growth at a level of 5 to 6 percent of GNP or better annually requires a sure and stable availability of money through America's banking system.

Furthermore, with the relative value of the dollar at all time highs and America's economy more dependent than ever on the

influx of foreign capital, monetary policy must be concerned with the potential harm that might be caused if the dollar continues to rise at an excessive rate or if the dollar fell too rapidly.

Barring the imposition of more rigid standards, the open market committee members are called upon to exercise discretion within the bounds of responsible economic principles and common sense. Since it is difficult to get any agreement on either, the difficulty of the task is fully appreciated, Mr. Chairman. And we look forward to hearing now how that task is being accomplished.

Thank you, Mr. Chairman.

Chairman FAUNTROY. Thank you, Mr. McCollum.

We will now proceed to take the testimony of our distinguished witness, the Honorable Paul A. Volcker. Mr. Chairman, we are pleased to have you.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman. We look forward to a constructive dialog on the issues.

I will not make any elaborate opening statement. I have delivered to the subcommittee a rather lengthy statement, outlining both developments last year and our plans for 1985. It is the same statement that I submitted to the Senate last week. I could summarize it very briefly by repeating what you gentlemen have already said. We have had a good deal of progress, but there are some very real problems in the economy. There are several imbalances in our budget, in our trade position, in particular, that, unless corrected I think will over time, undermine all that progress that we have made.

So far as growth in money is concerned, which is always the focus of these hearings, developments last year were generally in line with our intentions and targets, although when one looks at the broadest monetary aggregates, and particularly at the debt, you can see that it is running quite high, partly under the pressure of the Federal budget deficit. I think that, in itself, raises some warning flags for the future.

The targets that we have set forth for 1985 are very close to those that we tentatively adopted and agreed to last July. The M1 target is exactly the same—4 to 7 percent growth this year. Some small adjustments were made in some of the other targets, but the broad thrust of policy is not affected by those rather technical changes. We certainly will continue to implement policy against those guidelines we have set for ourselves in the context of what is going on in the economy, in the financial markets, and I would specifically include what is going on in foreign exchange markets in that connection, which a number of you have mentioned.

There are very clear challenges for monetary policy, as for all economic policy. That performance of the dollar which is related to enormous capital inflows, on the one hand, has helped us balance our internal financial markets—enabled us to finance the deficit and rising investment at the same time. But, inherently, it is accompanied by a growing trade deficit, which is a point of concern that, I think, illustrates the kind of problems we have.

There are some things that monetary policy can do: we certainly have an important role in sustaining demand at appropriate levels in the economy. But there are some things that monetary policy cannot do: we can't very well deal with all the sectoral problems that develop in the economy, except by contributing to a prosperous whole. I do not believe we can safely substitute money creation for savings that is inadequate to meet the demands we are placing on the economy, both through investment and deficits. If we are going to have balanced growth, we have to look toward other tools of economic policy as well.

Just a few words on the questions that you raised, Mr. Chairman, about the outlook for employment and for unemployment. Several of you have already mentioned the remarkable growth during this expansion period. Employment is up about 7 million people. Unemployment is down about 3 percent. We, in fact, have about 60 percent of the population at work, which is a very high level historically. So all those indicators after the last couple of years, certainly look favorable.

But I am also aware that reduction in unemployment came from a very high level. And when you have an unemployment rate that is currently well over 7 percent, it is certainly indicative of the fact that we have some distance to go before anyone can be satisfied. In some sense, the basic aim of policy is to promote the sustained growth of the economy and along with that, unemployment as low as practical. The forecast projections made by committee members, I would point out, look toward some modest further reductions in unemployment this year in a context of no deterioration in the inflationary picture, and perhaps some progress in the inflationary picture.

I don't think we can feel that that kind of unemployment projection is totally satisfactory or in any sense that it is the end of the road. But I would emphasize here, as I have often done before, that I think success in dealing with unemployment over a period of time—not looking at the maximum improvement in the next few months, but the best improvement over a period of time, improvement that can be sustained—must rest on a solid rock of stability in the economy, reasonable stability in financial markets and reasonable stability of prices.

We have had enough recent experience of the difficulties and pain and unemployment that results when inflation accelerates and gets out of control. And I think it's that stability side of the equation that must attract a good deal of our attention while monetary policy, as all of economic policy, is aimed at growth in employment as well.

When you look at the current unemployment picture or, indeed, the employment picture, you are inevitably struck by several characteristics. Manufacturing employment still hasn't reached the levels that it had before the last recession. I think that is one reflection of the pressures on the heavy industry sector of the economy which, in turn, go back in good part to the trade picture that we have as well.

We have alarmingly high rates of unemployment among minorities and among youth. I think in those areas, as well as, to some degree, in the manufacturing area, we face what we conveniently

call structural problems. Again, monetary policy has its part to play in creating an overall environment for growth. But I don't think that monetary policy can in and of itself, deal with all the structural problems. That requires a variety of answers, including, as you well know, those things that are very easy to talk about but very difficult to accomplish—the education of the labor force, the changing nature of the labor force, the mobility of the labor force, the discipline of the labor force, among other factors.

But as far as the general tools of policy are concerned, and specifically including monetary policy, we certainly have the strongest kind of interest in seeing this expansion continue, and continue in a way that promises further gains in the future, and promises to be sustainable.

With that much introduction, Mr. Chairman, maybe we can turn more specifically to what is on your mind.

Chairman FAUNTROY. Thank you so much, Mr. Chairman. Without objection, we will enter at this point in the record your statement, in its entirety, and the report.

[Chairman Volcker's prepared statement on behalf of the Board of Governors of the Federal Reserve System and the "Monetary Policy Report to Congress" pursuant to the full Employment and Balanced Growth Act of 1978 follow:]

Statement by

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Chairman, Board of Governors of the Federal Reserve System

I appreciate this opportunity to appear before you to present the Federal Reserve's monetary policy objectives for 1985. In accordance with the Humphrey-Hawkins Act, the semi-annual report of the Federal Reserve was transmitted to you earlier. That report reviews in detail economic developments and monetary policy in 1984, and sets forth for 1985 the plans for policy by the Federal Open Market Committee. This morning I would like to discuss the Committee's decisions and the outlook for the economy in the context of some important unfinished business facing all of us responsible for economic policy.

The Economic Setting

The familiar objective of monetary policy is to foster sustained economic growth and employment in a context of reasonable price stability. Stated so generally, that objective can hardly be challenged; it indeed encompasses the broad goals of economic stabilization policy generally.

Measured in those terms, there is clear reason for satisfaction in the performance of the economy last year. In summary, with real gross national product up by 5-1/2 percent over the year, and by about 12 percent in two years, we have enjoyed the strongest expansion since the Korean War period. On top of the gains in jobs in 1983, employment increased by over 3 million last year. The unemployment rate fell one full percentage point to 7.2 percent at year-end. Real incomes for the average American are up.

Prospects for sustained growth and productivity over time rest importantly on success in achieving and maintaining an environment of greater stability of prices and financial markets. In that light, it is encouraging that, contrary to widespread earlier expectations, the strong growth of 1984 took place without inflation increasing appreciably from the sharply reduced levels of 1982 and 1983. Specifically, the consumer price index increased around 4 percent last year, little changed from the previous two years, and prices of most goods (in contrast to services) at the wholesale and retail levels rose by less than that. While the evidence is less tangible, there are also encouraging signs that chronic expectations of future inflation have been damped.

The behavior of actual prices and nominal wages, which by some measures rose more slowly in 1984 than in 1983 despite expanding demands for labor, may in some part reflect those changes in attitude. Businessmen and workers no longer seem so preoccupied with a need to anticipate inflation in their pricing and wage decisions. And declines in bond yields after midyear seemed to reflect, to some degree, less fear of future inflation.

To be sure, a number of factors that may not be lasting have helped to hold price increases down. The continuing appreciation of the dollar and strong competition from imports have placed strong pressures on prices and wages in some manufacturing and mining industries. Widespread declines in

commodity prices cannot persist indefinitely. Unemployment is still higher than we would like to see. But it is also true that progress against inflation, as it is prolonged, can potentially feed on itself by encouraging restrained price and wage behavior.

As we start 1985, the immediate economic outlook appears reasonably favorable in these respects. Projections of Federal Open Market Committee members that I will be reviewing later in my testimony broadly parallel those of the Administration, the Congressional Budget Office, and many other observers; economic growth is expected to remain strong enough in 1985 to produce some further decline in unemployment, with little if any pickup in inflation.

But we must not be beguiled by those tranquil forecasts into any false sense of comfort that all is well. If the enormous potential of the American economy for growth and stability -- not just for 1985 but for the years beyond -- is to become reality, we need a sense of urgency, not of relaxation.

For one thing, with the general price level still rising in the neighborhood of 4 percent a year -- and with prices of services that today account for so much of the economy rising more rapidly than that -- we should not confuse evidence of progress against inflation with ultimate success. Indeed, the more favorable price expectations I noted a few moments ago

could prove fragile -- highly vulnerable to any indications that public policy is prepared to accept and accommodate to inflationary forces. That must be of particular concern in the conduct of monetary policy.

Perhaps more immediately, despite the strength of the overall expansion, some important areas of the economy are under strain and there have been recurrent international and domestic credit problems. Those strains and pressures are aggravated by underlying imbalances that, unless dealt with effectively, will undercut the long-term outlook.

One of those imbalances was highlighted by the slowdown in GNP growth we experienced in the third quarter. Such a "pause" is not an unusual feature of an expansion period. Demand does not grow smoothly, and occasional inventory imbalances will develop that require production adjustments. What was unusual last summer was that the slowing of demand growth was accompanied by a surge in imports, magnifying the effects on domestic producers. That summer import surge was reversed by year-end, but the underlying trend toward higher imports is clear. Our trade deficit increased to about \$110 billion in 1984, far higher than ever before, and the entire external current account deficit -- counting both goods and services -- has deteriorated by about \$100 billion since 1982. The sustainability of that trend, politically as well as economically, is, to say the least, questionable.

The rising trade deficit helps account for the failure of a number of important sectors to participate at all fully in the expansion. Agriculture, heavy capital equipment producers, and the metals industry, all of which face difficult structural problems in any event, are examples. They are further pressed by interest rates that, as you know, remain historically high, both in nominal terms and relative to recent inflation.

Looking abroad, growth in many industrial countries remains sluggish amid continuing high levels of unemployment, and depreciation of their currencies vis-a-vis the dollar seems to be one factor inhibiting more expansionary policies. Important developing countries are still struggling to restore stability and maintain growth while laboring under heavy debt burdens. In this interdependent world, these difficulties feed back on our own prospects.

It is no coincidence that the record external imbalance and continued high interest rates have been accompanied by large federal budget deficits -- deficits that according to projections of both the Administration and the Congressional Budget Office will only deepen in the years ahead in the absence of decisive corrective action.

Government deficits can be relatively benign and even useful in boosting incomes and purchasing power in the slough of recession and when private investment and credit demands are weak. It is also true that our growing volume of imports

over the last two years has provided an impetus for growth in other countries when other expansionary forces were weak. Moreover, the kind of obvious squeeze on, or "crowding out" of, domestic housing and investment that many anticipated as the expansion has developed has not been apparent.

We have been able to reconcile high deficits, sharply rising imports, and strong investment mainly for one reason: we have been able to attract an enormous amount of savings from abroad to supplement our own. The net capital inflow approached \$100 billion last year, and it will probably need to be still larger this year. Domestic net savings -- by individuals, businesses, and state and local governments -- are running at about \$325 billion, so the supplement from abroad adds close to a third to net savings generated internally. The net capital inflow was equivalent last year to more than half of the budget deficit.

That same inflow of funds has encouraged a very strong dollar. The strong dollar, in turn, contributes importantly to the huge and growing trade deficit. Our policy dilemma is simple but perhaps not fully understood. We cannot logically welcome the capital inflow from abroad in one breath and complain about the trade deficit in the next. They are two sides of the same coin.

We are managing to finance the deficit and maintain housing and investment expenditures with the help of imported

capital. At the same time, the exporter, those competing with imports, and the farmer are being "crowded out."

Looking ahead, the stability of our capital and money markets is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets. So far, they have been not only willing but eager to do so. But we are in a real sense living on borrowed money and time.

It is up to all of us to make constructive use of both the money and the time. In essence, that is the challenge for all of us -- for monetary and fiscal policy, and for all the other policies that can contribute to a productive, growing economy.

Monetary Policy in 1984

As you will recall, the economy was expanding particularly rapidly during the early part of 1984, and demands for money and credit -- and for bank reserves to support monetary growth -- were also strong. By early spring, data available at the time showed M1 increasing at rates well into the upper portion of its range for the year, which targeted growth at 4-8 percent.* At the same time, driven by the financing needs generated by rising levels of private spending and by the Federal Government,

*The data in this testimony for the monetary aggregates reflect recent seasonal and benchmark revisions. While the changes for the year as a whole were small, the revised data for M1 for the first half of the year are lower, and the second half higher, than reported earlier.

M3 and non-financial credit were expanding around or above the upper end of their long-term ranges.

The strong expansionary forces in the economy were reflected in some limited upward movements in interest rates in February and March, and early in the spring the Federal Reserve began to exert some additional restraint on reserves being supplied through open market operations. Consequently, depository institutions were forced to rely increasingly on borrowing at the discount window to satisfy demands for reserves. With credit demands and the economy continuing to expand strongly, and with markets concerned about the possibility that inflationary forces might reassert themselves as the period of strong expansion lengthened, interest rates moved noticeably higher in the spring. In April the Federal Reserve increased its discount rate 1/2 of a percentage point to 9 percent to bring this rate into better alignment with market rates and to discourage reserve adjustment at the discount window.

In May, a liquidity crisis developed in one of the largest commercial banks in the country, growing out of continuing concerns over weaknesses in its loan portfolio. The Federal Reserve, the FDIC, and the primary supervisor of the bank, the Comptroller of the Currency, worked closely together to support the orderly functioning of the institution while more permanent recapitalization and other elements of a long-term solution could be developed. Nonetheless, that incident, together with continuing concerns about international debt problems, for a

time contributed to uneasiness in banking markets, and interest rates on short-term private credit instruments rose appreciably above those on government securities.*

Demands for money slackened after midyear as the economic expansion slowed. Long-term interest rates began to drop from the higher levels reached in the spring as inflation concerns moderated. With the problems of the Continental Illinois Bank contained and progress made toward restructuring the debts of some important developing countries, the abnormal interest rate spreads began to narrow, but the money markets as a whole remained under some pressure. By late August and September, with M1 growth moving toward the midpoint of its range and M3 expansion slowing toward the upper end of its range, and with some evidence that economic growth had slowed, the Federal Reserve began to ease pressures on reserve positions.

That process continued through the fall, and borrowing at the discount window fell steadily from September through January. Late in the year, total and nonborrowed reserves began to grow rapidly. Short-term interest rates declined between 2-1/2 and 3-1/2 percentage points over the last four months of the year. Reacting to these declines, and to an extent facilitating them, the Federal Reserve in two half-point steps reduced the discount rate to 8 percent, the lowest level since 1978.*

*Attachments I & II summarize these and related developments, and the Federal Reserve response, more fully.

Several additional factors influenced judgments about the appropriate degree of easing of reserve positions during the fall. The dollar remained exceptionally strong in foreign exchange markets, potentially increasing pressures on some sectors of the American economy and a source of growing concern among some of our trading partners experiencing depreciating currencies vis-a-vis the dollar. At the same time, relatively favorable incoming data about prices and wages tended to allay concerns about actual and potential inflationary pressures. In fact, prices of many sensitive commodities were falling appreciably. In these circumstances, reserves could be provided more liberally, and growth in the money supply more actively supported without providing a basis for a destructive rise in inflation expectations.

The fall in interest rates and the more generous provision of reserves in the context of some increases in economic activity led to a rather strong revival of M1 and M2 growth around year-end, bringing both aggregates relatively close to the mid-points of their respective ranges. As monetary and credit growth continued at a relatively rapid pace into January, the easing process came to an end.

Unlike the pattern during much of 1982 and 1983, when M1 grew more rapidly than nominal GNP (that is "velocity" slowed), the income velocity of M1 rose 4 percent last year. That is broadly in line with cyclical experience in the past, taking

into account both the pattern of interest rate movements and income growth. M2 velocity also increased, rising around 1-1/2 percent following two yearly declines.

These developments provide some support for the view that velocity trends over time, as well as cyclical changes for these aggregates, may be returning to patterns more along the lines of earlier experience. In contrast, in 1982 and 1983, during a period of rapid transition to deregulation of deposit interest rates and substantial economic uncertainty, those earlier patterns had been disrupted and velocity had declined appreciably.

The rise in M3 and credit during 1984 exceeded expectations at the start of the year, and both measures exceeded by a considerable margin the upper limits of their ranges over the year as a whole. In fact, credit increased at its most rapid pace over the entire post-World War II period, both in absolute terms and relative to nominal GNP. Debt growth of this magnitude would appear to be much faster than consistent with the long-run health of our economy and financial system. It reflects to some degree the imbalances in our economy I emphasized earlier.

For example, the budget deficit led to expansion of federal debt of 16 percent, an unprecedented rate of growth in the second year of a business cycle. The growth of the debt of non-federal sectors, at nearly 13 percent, also was

high relative to past experience. A portion of this growth in private debt -- perhaps around 1-1/2 percentage points -- can be attributed to a huge volume of mergers, leveraged buyouts, and stock repurchases by businesses which had the effect of substituting debt for equity. Despite some sizable sales of new stock, non-financial corporations on balance retired about \$70 billion of stock last year.

Whatever the circumstances and justification for the particular companies involved, a financial structure that tends toward more debt (and shorter debt) relative to equity becomes more vulnerable over time. More cash flow must be dedicated to debt servicing, exposure to short-run increases in interest rates is magnified, and cushions against adverse economic or financial developments are reduced. These are factors that prudent lending institutions should take into account in evaluating new credits, and reports suggest that some banks did in fact review their policies toward mergers and leveraged buyout financing as the year wore on.

While the effect cannot be isolated, the rapid growth of debt relative to GNP may also reflect the fact that domestic spending increased appreciably faster than domestic production, which is what the GNP measures. A new machine, for instance, will require financing, whether purchased at home or abroad, and sharply increasing amounts of capital equipment have in fact been imported. As I indicated earlier,

directly or indirectly, that financing may be supplied from abroad, alleviating the pressures on our market. But the debt burden inevitably rests with the borrower.

Monetary Policy in 1985

At its meeting last week the FOMC agreed to some small changes in some of the ranges for the monetary and debt aggregates tentatively set out last July. The modifications are in response to analysis of information now available and do not represent any change in policy intentions. As shown on the attached table, for M1, the Committee reaffirmed the lower tentative range it adopted last July of 4 to 7 percent growth from the fourth quarter of 1984 to the fourth quarter of 1985. M2 is targeted to grow between 6 and 9 percent, the same range as used in 1984. The upper end of that range was increased by 1/2 percent from the tentative range for 1985 set in July. That small adjustment reflects a technical judgment -- based on assessment of recent developments -- that M2 could expand more in line with income growth this year, in keeping with the historic record of little trend growth in its velocity.

The upper end of the new M3 range of 6 - 9 1/2 percent was also set 1/2 percent higher than tentatively agreed in July. The associated monitoring range for credit was set at 9 to 12 percent, a percentage point above the 1984 range. Adjustments in both target ranges still contemplate a considerable slowing in these two aggregates from what actually occurred

in 1984. Even so, credit growth, fueled in part by the budget deficit, is expected to be quite strong, significantly exceeding the rate of expansion of GNP for the third consecutive year.

The Committee does not anticipate that growth of debt within the targeted range would necessarily pose significant new risks for the economy or the financial system in the year immediately ahead. However, a healthy financial structure will in time require more restraint on borrowing relative to the economic growth that, in the last analysis, provides the wherewithal to service the debt. One continuing problem in that respect is the extent to which the current tax structure tends to favor debt rather than equity financing, a point addressed in the Administration's reform proposals.

The ranges for growth in money and credit are expected by FOMC members and non-voting Reserve Bank Presidents to support another year of satisfactory economic expansion without an acceleration of inflation. Forecasts of real GNP growth centered around rates of 3-1/2 to 4 percent from the fourth quarter of 1984 to the fourth quarter of 1985 -- rates anticipated to be sufficient to reduce the unemployment rate to around 6-3/4 to 7 percent by year-end. Inflation, as measured by the GNP deflator, was expected most frequently to be in a range of 3-1/2 to 4 percent over the year, about the same rate as prevailed in 1984.*

*These projections, now regularly set out in our Humphrey-Hawkins Reports, should not be interpreted as indicating "targets" for real growth or inflation in the short or longer run. As discussed in Attachment III, the Committee does not target a specific long-range growth path for the economy.

In view of the necessarily tenuous nature of any judgment about the outlook for exchange rates, FOMC members in preparing their projections assumed that the dollar would fluctuate in a range encompassing its level of recent months. They also assumed that the federal budget deficit would be reduced significantly in fiscal 1986 relative to base line projections, a development that would help damp both interest rate and inflationary expectations. Obviously, those assumptions suggest some of the important risks inherent in the outlook.

As I indicated in discussing 1984 developments, we entered 1985 with the various monetary aggregates growing relatively rapidly. The targets for this year take, as usual, the actual average for the fourth quarter of the previous year as a starting point (or "base"). Consequently, we are starting the year with the levels of the aggregates above the target ranges as they have been conventionally illustrated -- that is by so-called "cones" starting at a point late the previous year and widening through the current year. (See Charts I to IV.)

That conventional and widely used "picture" is essentially arbitrary. Interpreted rigidly (and wrongly), the narrowness of a cone in the early part of the year -- literally narrower than some weekly fluctuations in the money supply -- would attach policy importance to levels or movements in the various aggregates that in fact have no significance.

We have sometimes considered, and others have suggested, a better "pictorial" approach would be to illustrate the targets

by a different (but also necessarily arbitrary) convention -- parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period, as shown in the charts attached. The target range is then portrayed as maintaining the same width throughout the year. The current levels of the aggregates, as you can see on the charts, are within such parallel lines.*

As a matter of economics and policy, rather than graphics, the Committee is not disturbed by the present level of M1 and M2 relative to its intentions for the year. It contemplates that, as the year progresses, growth will slow consistent with the target ranges.

Consistent with that approach, as I indicated earlier, the progressive process of easing reserve positions undertaken in the latter part of 1984 ended. The provision of reserves through open market operations is currently being conducted a bit more cautiously to guard against inadvertent "overshoots" in supplying reserves. Any further change in approach will, as always, depend upon assessments of the trend of monetary growth in the period ahead, evaluated in the context of the flow of information on the economy, on prices, and on domestic credit and exchange markets.

The annual target ranges for M1 and M2 assume that trends in velocity are returning to a more normal and predictable

*Attachment IV addresses the different but related questions of the appropriate "base" used in setting and illustrating targeted growth ranges.

pattern. However, there is some analysis that suggests the trend of velocity over time may be a little lower than the trend of 3 percent or so characteristic of much of the postwar period when interest rates were trending higher. Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee anticipates that those aggregates might end the year in the upper part of their ranges. The lower part of the M1 range would be consistent with greater cyclical growth in velocity than now thought likely. As usual, these ranges will be reviewed at mid-year, in accordance with Humphrey-Hawkins Act procedures.

The Challenge Ahead

The approach toward monetary policy that I have outlined for 1985 is designed to promote, as best we can, our common objectives of sustained growth and stability. We can build on the strong progress of 1983 and 1984. There is forward momentum in the economy. The public at large seems to sense a greater degree of control over inflation than for many a year -- and I sense some chance of further progress toward price stability this year even as the economy grows.

Happily, despite the strength of the economic advance and the financing of a huge deficit, interest rates are today little above those of two years ago. The threats of financial dislocation growing out of the debt problems of much of the

developing world, or from more purely domestic financial pressures, have been well contained. Points of strain will, without doubt, require continuing attention this year. But, in the context of a healthy economy, they are capable of resolution.

By encouraging appropriate growth in money and credit, in discharging our supervisory responsibilities, in performing when necessary the essential functions of lender of last resort, and in our general surveillance of the financial system, the Federal Reserve can help build on that progress. We aim to do so.

But it is equally important to understand clearly what monetary policy and the Federal Reserve cannot do.

The progress against inflation, the strength of the dollar and the competition from abroad, and some margins (if diminishing) of capacity and manpower have provided a certain degree of flexibility in the conduct of monetary policy. But that limited flexibility would be abused at our collective peril. Credibility in the effort to deal with inflation is a precious thing. The lesson here and abroad, now and through history, is that, once a sense of price stability is lost, it can be restored only with pain and suffering.

The Federal Reserve can theoretically run the modern equivalent of the printing press -- we can create more money. But more money is not the same as correcting the gross imbalance

between our ability to generate real savings and the demands for those savings posed by housing, by investment and by the federal deficit.

To create money beyond that needed to sustain orderly growth would be to invite renewed inflation -- damaging incentives to save in the process. In contrast, to encourage savings from income would be to provide more of the real resources we need for future growth -- and it would help spur productivity and reduce price pressures in the process.

If that route isn't open to us -- and as a practical matter we probably can't do much right now to change ingrained savings behavior -- then the only constructive alternative is to attack the problem from the other side of the ledger by reducing the federal deficit.

For the time being, capital from abroad has been readily available to close the growing gap between our domestic savings and the demands upon them, moderating pressures on interest rates. Indeed, the money attracted partly by perceptions of our strength has come so freely we have an exceptionally strong dollar. But that same strong dollar contributes to a massive trade deficit that strains key sectors of industry and our agriculture, aggravating structural problems.

No doubt bad monetary policy could drive the dollar down -- a monetary policy that aroused inflationary expectations, undermined confidence, and drove away foreign capital.

But then, how would we finance our investment and our budget deficit?

Nor is the process of money creation adapted to relieving particular sectoral strains within our economy. We can and will, in our administration of the discount window and in our actions as lender of last resort, protect the essential financial fabric by supporting credit-worthy depository institutions faced with extraordinary needs.

But the evident problems of particular sectors, in the last analysis, will yield only to measures that support their efficiency and broaden their markets. That in itself is a large agenda, for government and those involved alike. And the process will be much easier if we at the same time address the basic imbalance between our capacity to save and our need to invest and to finance the government that I have emphasized today.

Conclusion

I fully appreciate the difficulties of the decisions before you as you collectively approach those excruciating budgetary choices. As you do so, I know that you are aware of the priority that progressive reduction of the deficit deserves. That, indeed, would provide the most fundamental kind of reassurance that growth can be sustained in an environment of greater stability.

For our part, in the conduct of monetary policy, we in the Federal Reserve will be sensitive to both the opportunities and the dangers before us. We believe the approach I have outlined with respect to the monetary targets and our implementation of policy sensibly reflects and balances the concerns I am sure we share.

Chart 1

M1 Target Ranges and Actual

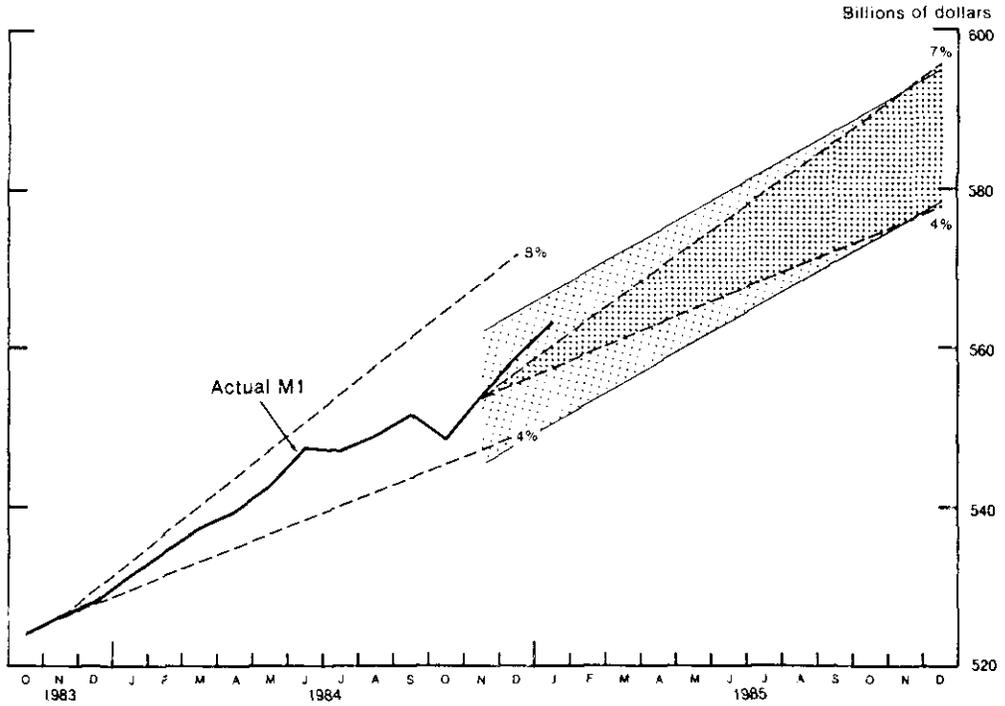


Chart 2

M2 Target Ranges and Actual

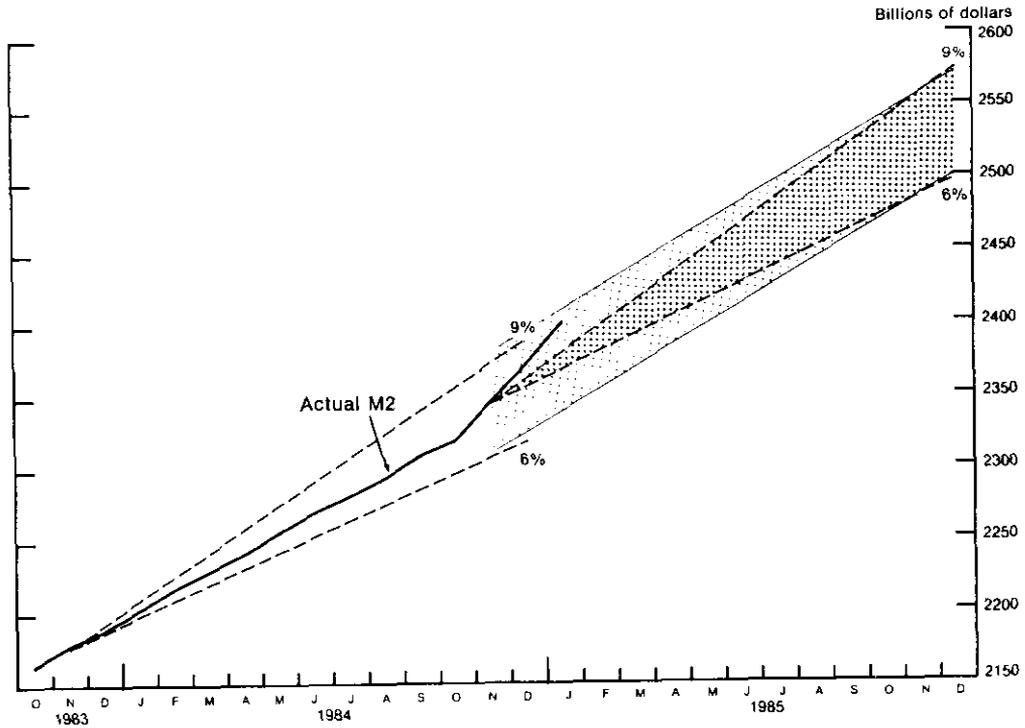


Chart 3

M3 Target Ranges and Actual

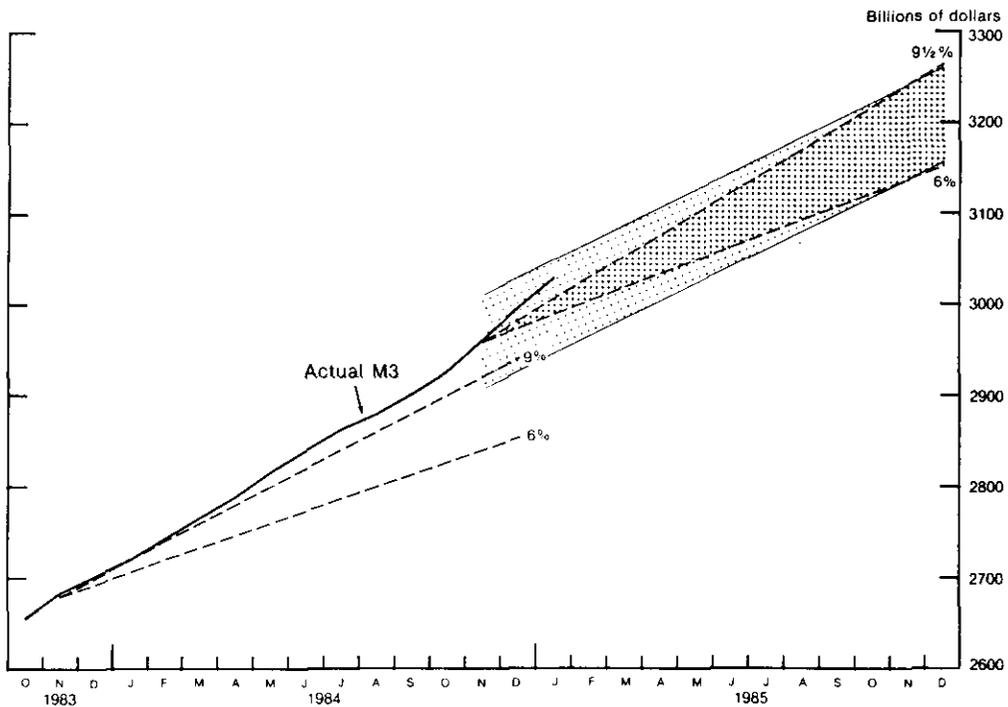
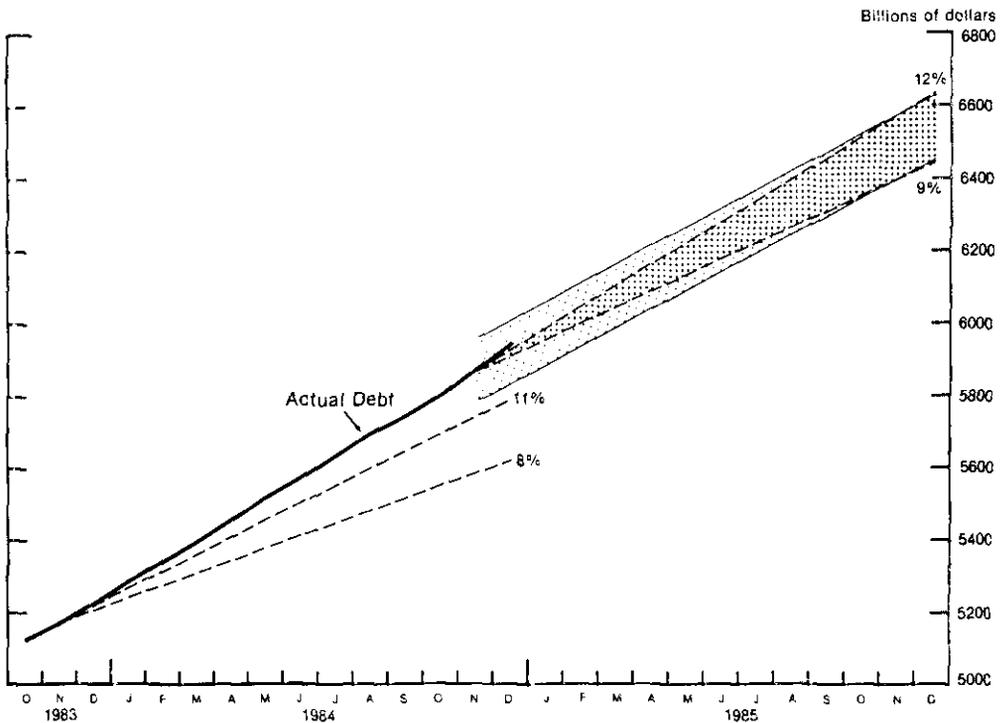


Chart 4

Debt Monitoring Ranges and Actual



Attachment I
The Implications for Monetary Policy of the Near Failure
of the Continental Illinois Bank

The condition of the Continental Illinois Bank -- the seventh largest in the United States at the beginning of 1984 -- had been a matter of concern to regulatory authorities and market participants for some time, particularly after the failure of the Penn Square Bank in the middle of 1982 brought to light large loan losses and weaknesses in credit policy. Continuing profit and loan problems culminated in rumors of possible impending failure and a liquidity crisis in May 1984, involving withdrawal or failure to renew billions of dollars of deposits in the bank over a few days.

The FDIC, the Federal Reserve, and the Comptroller of the Currency, with the cooperation of a group of major banks, developed arrangements to provide temporary capital and liquidity support pending more permanent solutions and reorganization. The Federal Reserve -- acting as lender of last resort -- provided large amounts of funds through the discount window to maintain the bank's liquidity. That lending rose irregularly from around \$3 billion during most of May to a peak of more than \$7 billion in August. During the autumn the amount of outstanding loans declined to much reduced levels.

Provision of funds through the discount window has the effect of expanding total bank reserves, and unless otherwise offset, the lending to the bank would have had the effect of

expanding the money supply well beyond targeted ranges. To maintain consistency of reserve provision with FOMC intentions, essentially equivalent amounts of reserves were absorbed by open market operations. While the large borrowings necessarily involved some added technical difficulties and uncertainties in the conduct of open market operations, the Committee was able to achieve its reserve objectives.

At the same time, however, the liquidity crisis of Continental Illinois Bank, particularly in an environment in which international debt and other credit problems were attracting attention, generated concern about possible threats to the stability of other financial institutions. As a result, interest rates on banking liabilities rose appreciably relative to interest rates on Treasury securities during the spring. More cautious funding and lending policies by a number of banks appeared to have some effect on maintaining short-term interest rates at higher levels than might otherwise have been the case.

The extraordinary concerns in the marketplace dissipated as the year wore on, reflecting some sense of progress in dealing with both the international debt situation and points of domestic financial strain. Strong liquidity pressures at one of the largest savings and loan organizations during the late summer and fall, requiring sizable liquidity support by the Federal Home Loan Bank System, had lesser effects on market attitudes.

The experience of 1984, together with supervisory efforts and the strong continuing pressures on some sectors of the economy have underscored for depository institutions the importance of adequate capital and prudent lending policies, and other means of assessing and controlling risk. Substantial efforts have been made by many of the larger banking organizations to increase capital ratios and to review credit standards. In time, in the environment of a growing economy, these efforts should be reflected in stronger institutions and a reinforced banking system.

Attachment II
The International Debt Situation in 1984

At times during 1984, concerns about the external debt problems of key borrowing countries continued to be an important factor affecting attitudes in financial markets. As the year began, markets had substantial doubts about the viability of the Brazilian *adjustment program*, the programs of the new Venezuelan and Argentine governments were unknown, and there was some sense of weariness among the borrowing countries and their creditors. Tensions were aggravated by increases in dollar interest rates in the spring and early summer.

Subsequently, concerns in financial markets receded somewhat as interest rates moved lower, clear progress was recorded in narrowing some countries' external imbalances, and plans for long-term debt restructuring were developed for some of the largest borrowers.

The improvements in external accounts in Mexico and Venezuela in Latin America, and in Yugoslavia and Hungary in Eastern Europe, produced current account surpluses last year. Brazil's current account deficit was essentially eliminated, and a number of other countries had reduced deficits.

This progress was facilitated in many cases by significant increases in exports, particularly to the United States, and in most cases was accompanied by a recovery -- or at least a slower rate of decline -- of imports. Such developments,

coupled with continued moderate capital inflows, contributed to sizable increases in the international reserves of many of these countries and to the prospects of reduced demands for extraordinary external financing in the future. At the same time, most of those countries managed to achieve domestic growth.

Against this background, several of the major borrowing countries were able to move on to a second phase in their adjustment and financing programs. One important initiative, when warranted by progress in adjustment, has been planning for longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico and Venezuela; serious negotiations have begun with Brazil and Yugoslavia; and the financing package prepared for Argentina contains some longer-term elements.

However, it is also evident from developments in 1984 and the first months of 1985 that the process of adjustment which began in 1982 is far from complete, particularly on the internal side. Financial markets will remain sensitive to indications of progress or the lack thereof. Cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required. The need for imaginative and constructive solutions to the problems faced by individual countries is not over.

Attachment III
Targeting Real Growth

Questions sometimes arise as to whether the Committee's forecasts for real GNP growth or prices are in the nature of short-run targets toward which the Federal Reserve "fine tunes" policy, or whether the Committee has preconceptions about just how rapidly the economy can and should grow over the medium or longer run.

The answer to those questions is no. Monetary policy is, of course, broadly directed toward sustaining the growth process in a non-inflationary environment. But the Committee as a group has no preconceived notion as to just how rapid growth *can or should be over a particular period of time*, without straining our resources or giving rise to price pressures and imbalances that would make it ultimately unsustainable.

Our capacity for growth over time depends on such variables as the trends in productivity, in the labor force, in incentives to save and invest, and in other factors over which monetary policy has essentially no direct or long-run influence. There are other policies, public and private, quite outside the purview of monetary policy that will influence both our growth potential and actual growth paths over time. There are debates in and outside the Federal Reserve as to some of these factors that affect economic growth, but annual monetary targets and operational decisions do not, and need not, rest on such assumptions for the long run.

For instance, the Committee would presumably welcome faster growth than predicted for 1985 if that proved consistent with moderating inflationary forces, and indeed, less inflation than anticipated would tend to encourage greater growth, consistent with our monetary targets. Indeed, the relationship between money and economic growth at any point in time is sufficiently loose that many other factors bear upon actual performance.

In sum, policies are periodically reassessed in light of incoming information about prices, output, exchange rates and other variables bearing on our growth potential and prospects for inflation. In practice there is sufficient flexibility in our targeting procedures to accommodate information that might suggest greater or lesser growth potential over time.

Attachment IV
The Base for Monetary Target Ranges

Some questions have been raised concerning the "base" used by the Open Market Committee in deciding on targets for the monetary and credit aggregates for the calendar year. Consistent with the Humphrey-Hawkins Act procedures, the Committee's target ranges are specified each February as a range of growth from the fourth quarter of the previous calendar year to the fourth quarter of the current calendar year.

The convention that is usually used, is that the beginning point -- or "base" from which growth is measured -- is taken to be the fourth quarter average growth of a particular monetary or credit aggregate. Other "bases" could be used and occasionally have been used -- if the conventional base period is seriously distorted, by institutional change or otherwise.

During its recent meeting the Committee, as it has from time to time, discussed the issue of the desirability of choosing a base for 1985 for one or more of the aggregates other than the conventional one. It concluded that none of the fourth quarter averages for the targeted aggregates were distorted in a manner that strongly suggested the desirability of departing from the usual convention, and that such a departure might indeed confuse communication of the Committee's intentions. It also noted that the average level of both M1 and M2

during the fourth quarter of 1984 was reasonably close to the mid-point of the previous year's range, an alternative base suggested by some. M3 and credit ran significantly above the 1984 ranges. Rebasings those aggregates at the mid-point of the 1984 ranges would thus have implied a wrenching adjustment in the levels of those aggregates, a result that would be contrary to the Committee's intentions. Essentially, such a change would have implied a substantial tightening to bring the growth of those aggregates into the new ranges, or, alternatively, a specification of ranges of growth for 1985 that would have been extraordinarily high and quite out of keeping with longer range intentions.

More broadly, a decision to regularly target growth from the mid-point of a previous year's range would seem to imply the continuing validity of a judgment made a year earlier that the mid-point of a previous range is in some sense a uniquely "correct" level of a monetary aggregate. The Committee does not share such a conviction. Instead, it believes that the appropriate trend of each aggregate needs to be judged in the light of evidence as to velocity changes and other factors as they emerge over time.

In setting targets for any year, the Committee is, of course, aware of the base level of the aggregate. Adjustments in the new target ranges themselves, or in the conduct of policy within those ranges, can take account of any modest distortions in the base. Such considerations are reflected in the discussion of policy in the testimony.

Growth Ranges for the Aggregates for 1984
in Comparison with Actual Growth
(QIV to QIV)

	<u>Percent Increases</u>	
	<u>Ranges</u>	<u>Actual Growth</u>
M1	4 to 8	5.2
M2	6 to 9	7.7
M3	6 to 9	10.5
Domestic Nonfinancial Debt	8 to 11	13.4

Growth Ranges for the Aggregates Adopted for 1985
in Comparison with Tentative Ranges and Those for 1984
(QIV to QIV)

	<u>Percent Increases</u>		
	<u>Adopted Ranges for 1985</u>	<u>Tentative Ranges for 1985 Set in Mid-1984</u>	<u>Ranges for 1984</u>
M1	4 to 7	4 to 7	4 to 8
M2	6 to 9	6 to 8-1/2	6 to 9
M3	6 to 9-1/2	6 to 9	6 to 9
Domestic Non- financial Debt	9 to 12	8 to 11	8 to 11



Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 20, 1985

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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Section 1: The Outlook for the Economy in 1985

Nineteen eighty-four was another year of substantial economic growth in the United States. Production and employment gains were large, making the expansion of the past two years--with growth in real gross national product averaging 6 percent per annum--the strongest cyclical upswing since the early 1950s. Moreover, continued vigor of the economy was accompanied by signs of some further lowering of inflationary expectations. Aggregate price measures rose around 4 percent last year, about the same as during the two preceding years. While prices of services continued to rise by 5 to 6 percent, prices of many goods were relatively flat, and underlying wage trends seemed to be moderating.

Economic growth had been extraordinarily rapid in the first half of 1984, and then slowed abruptly around midyear. Although some slowing in growth was widely anticipated, the abruptness of the change raised some question about the *continuing strength of expansionary forces*. However, during the last few months of the year, output and employment were clearly rising, though at a more moderate pace than earlier in the year.

The strong gains in overall activity during the year drew attention away from a number of continuing problems, but those problems are nonetheless real and serious. The overall rate of unemployment is still uncomfortably high and the joblessness among certain groups--for example, teenagers and blacks--remains well above the average. Sectors of the economy facing intense competition from abroad, such as agriculture and certain mining and manufacturing industries, have not participated in the rapid economic expansion overall, and have been under strong financial stress. Strains also remain evident among financial institutions: a number of depository institutions have experienced

a deterioration of the quality of their loan portfolios, and the earnings of thrift institutions remain constrained by low-yielding assets accumulated in earlier years.

While it has not been an impediment to economic expansion to date, growth in credit has been exceptionally rapid and many households and businesses have accumulated substantial indebtedness, often in short-term or variable-rate forms that make them especially vulnerable to unexpected economic developments. Also, despite the impetus from strong U.S. demand, growth in economic activity has been limited in a number of important industrialized countries, and many developing countries, in Latin America and elsewhere, are still struggling to restore satisfactory growth. While progress was made in stabilizing the external finances of some of the largest of those countries, that progress can only be secure in the context of greater stability in their own economies and of sustained growth in the industrialized world.

Many of the problems afflicting particular industries have causes and complications that at least in part must be dealt with in direct and specific ways. But it is also evident that the enormous imbalances in our federal fiscal posture and in our trade and current account position have aggravated the problems and made constructive solutions much more difficult. In an expanding economy requiring more private credit, the need to finance the large federal deficits has contributed to the pressures that have held real interest rates at historically high levels. The failure to deal with budgetary deficits also has sustained doubts in the minds of the public about the ability of the government to continue to curb inflation over the long run.

The large federal deficits are mirrored in our external imbalance. Many foreign investors have been attracted to the comparatively high real rates of return offered on dollar-denominated assets, and U.S. lending abroad has been reduced. Other forces stimulating capital inflows have been at work as well, including political and economic uncertainties in other countries and the relative stability and vigor of our economy. The shift in capital flows has supplemented domestic saving and helped finance the federal government deficit and private investment. But, at the same time, the strong demand for the dollar has driven its value on foreign exchange markets to extremely high levels. As the dollar has appreciated, the demand for our exports has suffered and our purchases of imported goods have increased dramatically, resulting in strong competitive pressures on the manufacturing, mining, and agriculture sectors and leading to calls for protectionist measures. Moreover, the capital inflows lead to mounting financial claims of foreigners that the nation must be prepared to deal with in future years, through reduced imports or increased exports, in either case lowering domestic consumption.

The Economic Projections of the FOMC

Notwithstanding the risks associated with the domestic and international problems just outlined, the weight of the evidence points to reasonably favorable near-term prospects for aggregate economic performance. In recent months, personal income growth has been strong, reflecting continuing substantial gains in employment and helping to support consumer spending. Overbuilding of multifamily residential units and offices in some parts of the country may pose questions about the outlook in these areas, but the lower

interest rates that developed over recent months suggest that single-family homebuilding may strengthen. Surveys of businesses indicate plans for continued growth in plant and equipment spending in the coming months, though at a slower pace than last year; meanwhile, some imbalances in business inventories that developed during 1984 appear to be well along in the process of correction, and in some sectors inventories are quite lean relative to sales. Many states and localities are experiencing an improvement in their finances, which portends further support to the expansion from that sector. And, at the federal level, there continues to be a strongly stimulative thrust from fiscal policy.

The smallest increases in nominal wages and compensation in more than a decade have been accompanied by an improvement in productivity and downward pressures on energy and commodity prices. These developments help support the possibilities of continuing restraint in price increases. Also, in the context of an economy expanding at a sustainable rate, they are consistent with continuing growth in average real income.

Taking account of the above factors, the members of the Federal Open Market Committee (as well as Federal Reserve Bank Presidents who are not at present FOMC members) now foresee the probable continuation of the economic expansion through its third year, although at a more moderate pace than in the first two years. The central tendency of the members' forecasts indicates the probability of an increase in real GNP of between 3-1/2 and 4 percent this year. The unemployment rate is expected to decline in 1985 to a level of between 6-3/4 and 7 percent by the fourth quarter. At the same time, most members expect general measures of price inflation to remain close to recent trends.

Economic Projections for 1985

	FOMC Members and other FRB Presidents		Adminis- tration	CBO
	Range	Central tendency		
Change, fourth quarter to fourth quarter (%)				
Nominal GNP	7 to 8-1/2	7-1/2 to 8	8.5	7.7
Real GNP	3-1/4 to 4-1/4	3-1/2 to 4	4.0	3.4
GNP deflator	3 to 4-3/4	3-1/2 to 4	4.3	4.2
Average unemployment rate in the fourth quarter (%)	6-1/2 to 7-1/4	6-3/4 to 7	6.9	7.0

When considering the general outlook for 1985, members of the FOMC recognized that persisting problems could become aggravated for particular sectors of the economy, and that there are risks for the economy as a whole. Clearly, there is growing distress in many farm communities. Incomes from farming have been low, land prices are falling, and many producers face heavy debt burdens. In the household and business sectors, higher levels of indebtedness are unlikely to forestall further gains in spending, but unless moderated, they would in time add to financial pressures.

Favorable price performance has been encouraged by the strength of the dollar in the exchange markets. A sharp and large reversal of that strength could be reflected in at least temporarily stronger inflationary pressures. Greater confidence in prospects for price stability is, of course, dependent over time on suitably restrained growth in the money supply, and that necessary approach, and more moderate real interest rates, would be facilitated by effective action to reduce substantially the size of federal budget deficits in the upcoming and subsequent fiscal years. Action to

restore balance in the government's fiscal position is important to the achievement of an environment conducive to stable, strong economic growth. In their forecasts, the Committee members assumed that the exchange rate would remain within the range of recent months and that effective fiscal action is in prospect.

The "central tendency" forecast of the FOMC members is broadly consistent with that of the Administration, as indicated in the Economic Report of the President, and that of the Congressional Budget Office. The Administration's projections for both real GNP growth and inflation do fall, however, toward the upper part of the ranges of Committee members' forecasts, while the CBO's estimate of real growth is a bit lower than the FOMC central tendency range.

Section 2: The Federal Reserve's Objectives for Money and Credit in 1985

At its meeting of February 12-13, the FOMC set monetary and credit growth ranges for 1985 designed to be consistent with further sustainable economic growth and progress toward reasonable price stability over time. Specifically, the Committee (1) set a growth range for M1 of 4 to 7 percent from the fourth quarter of 1984 through the fourth quarter of 1985, the same as that tentatively selected last July; (2) established target ranges of 6 to 9 percent and 6 to 9-1/2 percent for M2 and M3, respectively, one-half percentage point higher at the upper end of the range than tentatively set in July; and (3) set an associated monitoring range of 9 to 12 percent for the debt of domestic nonfinancial sectors, one percentage point higher than tentatively indicated. The upper end of the range for M1 is one percentage point below that of 1984, and the range for M2 is the same as last year's. The upper end of the target range for M3 is slightly above that for last year. That increase, as well as the upward adjustment in the associated monitoring range for the debt of domestic nonfinancial sectors, reflects analysis of developments during 1984 suggesting that growth somewhat greater than anticipated earlier may be consistent with Committee objectives for the year. Expansion within these ranges would represent a significant deceleration in the actual growth of M3 and debt from the experience of last year when the target ranges were exceeded.

In formulating these objectives, the Committee assumed that no new statutory or regulatory developments would be enacted that would appreciably influence the behavior of the monetary and credit aggregates in 1985. Although at the beginning of the year the minimum denomination of super NOW

and money market deposit accounts was reduced from \$2,500 to \$1,000, to date the promotional activity accompanying this change has been minor, and it appears that M1 and M2 have not been affected significantly.

On average, the behavior of M1 velocity--nominal GNP divided by the money stock--during 1984 was broadly consistent with previous cyclical patterns. Together with other evidence, this development suggests that the factors responsible for the highly unusual velocity behavior over 1982 and early 1983 have receded.

Nonetheless, a range of uncertainty inevitably remains about the trend of M1 relative to nominal GNP in light of recent deposit deregulation and other financial innovations that have affected the funding policies of banks and the cash management practices of the public. On balance, it appears likely that the process of deposit deregulation will lead to a trend rate of increase in the velocity of M1 that may be somewhat lower than in the post-World War II period as a whole. However, in view of the multiplicity of changes in financial instruments and practices that influence the behavior of all the monetary measures, interpretation of all the aggregates will continue to be made within the context of the outlook for economic activity, inflationary pressures, and conditions in domestic and international financial markets, including the strength of credit demands.

The new 4-to-7 percent target range for M1 encompasses growth in M1 consistent with velocity expansion over the coming year approximating that of last year, and also higher M1 growth that would be needed should velocity grow at a rate approximating the reduced trend suggested above. The movements in velocity during 1984 occurred in a context of moderate increases in interest

rates over much of the year; however, velocity has slowed substantially in recent months in the context of an appreciable rise in money growth and following declines in interest rates. In all the circumstances, a somewhat higher rate of money growth than implied by straight line projections from the fourth quarter 1984 base to the targets for the fourth quarter of 1985 may be appropriate early in the year, but growth of M1 would be expected to slow, and velocity growth to rise, as the current adjustments are completed. Thus, as the year progresses, growth of M1 would be expected to move gradually toward and into the FOMC's target range. Depending upon developments with respect to velocity and price behavior, growth in M1 and the other monetary aggregates in the upper parts of their ranges may be appropriate over the year as a whole. Those developments will, of course, be closely monitored over the year.

Like M1, growth of M2 and M3 have been particularly strong in recent months, reflecting the unusually favorable yield spreads in favor of monetary assets that emerged temporarily toward the end of last year; open market interest rates dropped more swiftly than rates offered by depository institutions on retail deposits and returns on money market mutual funds. In addition, M3 growth has reflected substantial issuance of large CDs by thrift institutions to support their lending in mortgage and consumer loan markets.

Growth of the broader monetary aggregates is influenced, as well, by the pattern of international capital inflows associated with the huge current account deficit. Domestic banks may continue to borrow sizable amounts of Eurodollar funds from their foreign branches and unaffiliated foreign banks; such borrowings are not included in the measured monetary

aggregates. By reducing the need for funding through other managed liabilities included in M2 and M3, these inflows tend to restrain measured monetary growth in relation to growth of bank credit and credit generally. Moreover, many domestic borrowers, including the federal government and private corporations, may continue to tap overseas securities markets directly, reducing the need for credit expansion by U.S. intermediaries.

Given the federal budget deficit as projected by the Administration for 1985--as well as a likely expansion of spending by domestic sectors in excess of nominal GNP growth, as part of that spending flows abroad--the Committee contemplates that domestic nonfinancial debt may continue to increase more rapidly than nominal GNP. Still, actual growth of debt in 1985 should be markedly less than in 1984, as nominal GNP growth and overall credit demands moderate. Growth within the debt range for 1985 assumes also a slowing in credit for mergers, leveraged buyouts, and other financial restructuring. Such credit led to some erosion in corporate equity cushions last year, and a more cautious approach is anticipated this year.

The outlook for financial conditions generally is again expected to be affected importantly by current and prospective federal budget deficits, which will remain enormous in comparison with experience in previous economic expansions. This massive federal borrowing will compete for available domestic savings with the strong private credit demands accompanying further growth of economic activity, keeping interest rates and exchange rates higher than they otherwise would be. Such relatively high interest rates and exchange rates limit expansion in those sectors that are most sensitive to the cost of credit and impair the competitive positions of domestic import-competing and export industries. Decisive and credible actions to reduce federal budget

deficits would have favorable effects on investors' expectations and help to lower interest rates, especially longer-term rates, even before these reductions become fully effective. Such actions would work to relieve the imbalances and strains within the economy, contribute to further abatement of inflationary expectations, and so reinforce the prospects for continued growth and stability.

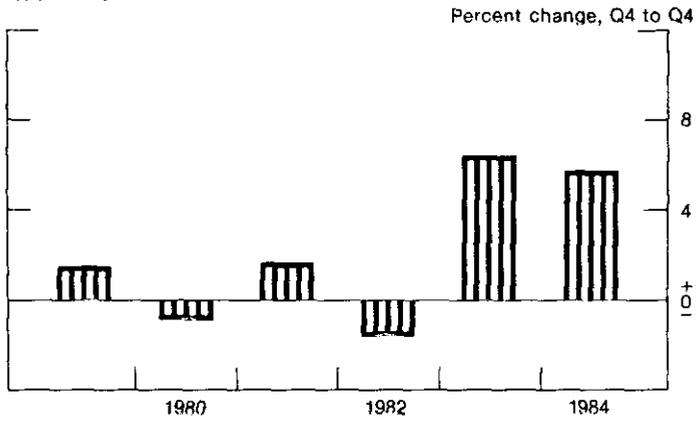
Section 3: The Performance of the Economy in 1984

The economy recorded major gains in 1984, with the real gross national product up 5-1/2 percent and the unemployment rate down more than 1 percentage point over the year. The growth in output and employment was exceptionally strong in comparison with experience in other post-Korean War expansions. But even more striking, in terms of its departure from past norms, was the extraordinary rise in domestic spending, which again appreciably outstripped growth in domestic production. Over the course of the year such spending rose about 6-3/4 percent in real terms. Consumers and businesses purchased greatly increased quantities of imported goods, whose relative prices were lowered by the appreciation of the dollar in exchange markets, and the U.S. trade deficit reached record proportions.

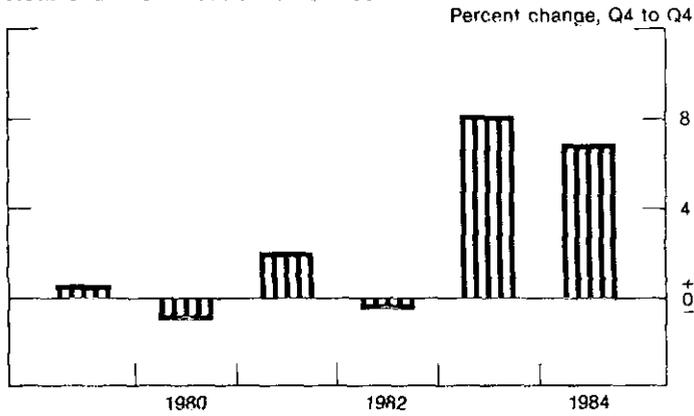
Last year's economic gains were achieved without a pickup in inflationary pressures, in part owing to the rise in the exchange value of the dollar. Aggregate indexes of prices rose about 4 percent or less, similar to rates of inflation recorded in 1983. Ample availability of industrial capacity here and abroad helped to contain price increases. Labor cost pressures also were limited, as wage increases actually were slightly lower than a year earlier. Labor markets continued to reflect the still considerable unemployment in the economy as well as the adjustments of wages in some sectors to the realities of forces associated with deregulation and foreign competition. Wage changes also reflected the favorable feedback effect of lower inflation on anticipatory or catch-up pay demands.

Although the nation as a whole has made substantial progress in the past two years toward the goals of sustained growth and high employment

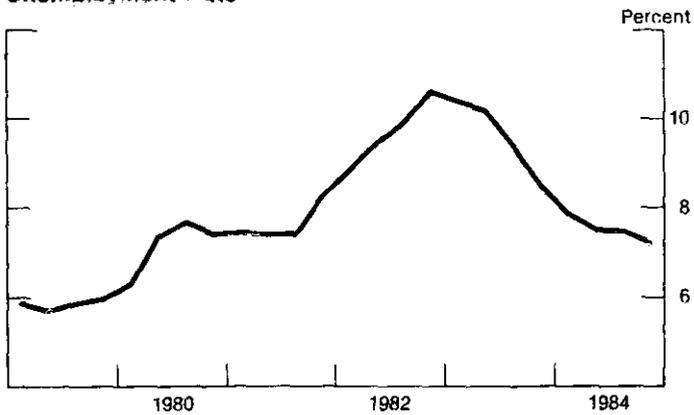
Real GNP



Real Gross Domestic Purchases



Unemployment Rate



along with price stability, important segments of the economy have continued to experience considerable difficulty. One symptom of continuing imbalances has been interest rates that, relative to the prevailing rate of inflation, have remained exceptionally high by historical standards. However, after moving upward during the first half of the year when economic expansion was especially brisk, interest rates retraced their advances in the second half of the year. At year-end, they were, on balance, a little lower.

Federal government tax and spending policies have provided substantial stimulus to aggregate demands for goods and services, but in credit markets the deficits have added strongly to the demands for funds and have been one important force keeping interest rates high. Moreover, there is general agreement that, unless legislative measures are enacted, budget deficits are likely to increase further, even in the context of a reasonably growing economy. This prospect, with its implication of continuing pressures on the supply of savings, has been a factor in the rise in the foreign exchange value of the dollar and the attendant emergence of enormous deficits in our trade and current accounts with other nations. Although, as noted above, the sharply higher value of the dollar has been an important factor in the movement toward price stability, inflationary pressures could become more apparent if the U.S. dollar were to decline sharply—a risk that could increase as fundamentally unsustainable fiscal and external postures are extended.

The Household Sector

The household sector continued to benefit last year from the economic expansion. Adjusting for inflation, the rise in disposable income

from the fourth quarter of 1983 to the fourth quarter of 1984 was 5-3/4 percent, surpassing the large gain in 1983. This strong increase in income supported a rapid rise in spending for consumer goods even as the personal saving rate rose.

Household sector outlays in this expansion have been tilted more toward durable goods than has been typical. In the 1980-82 period, a time of relatively slow income growth and high unemployment, consumers had curtailed discretionary purchases of household goods. Since the end of 1982, however, strong employment and income growth and rising consumer confidence have been translated into an appreciable restocking of household durables.

The strength of automobile purchases in 1984 was a part of this restocking process. As the stock of existing autos has aged, replacement demand has grown. Most recently, reductions in gasoline prices have lowered operating costs. Automobile sales in 1984 rose to 10-1/2 million units, the highest level since 1979. The foreign share of the market declined, owing in large part to the impact of limitations on Japanese units during a period of expanding sales. Indeed, demand for domestic autos proved to be so strong that producers had difficulty supplying many of the more popular models, even though auto companies operated some factories at near full capacity over most of the year. Total auto production was up 14 percent from the preceding year, despite brief strikes in the autumn.

Spending for new homes slowed over the course of 1984, with rising mortgage interest rates through midyear a factor reducing housing activity. However, there were some initial signs of improvement in the housing sector at year-end, associated with earlier declines in interest rates during the

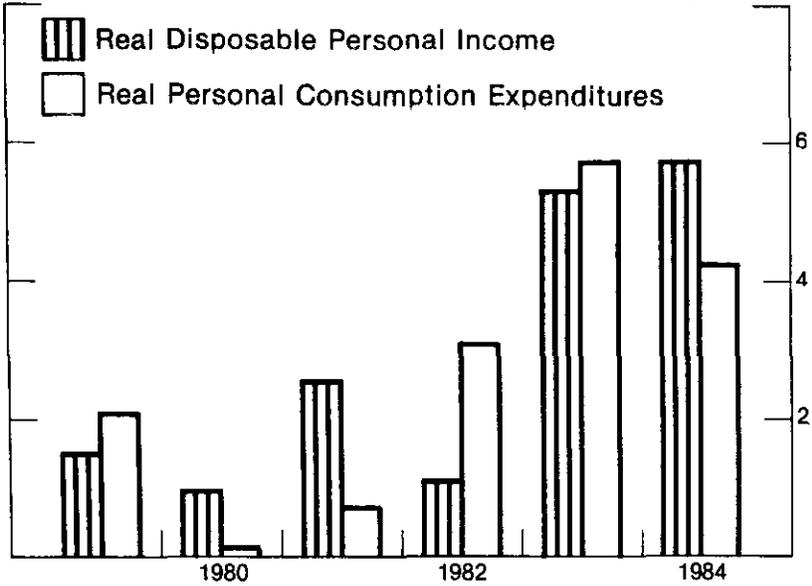
fall. From the fourth quarter of 1983 to the fourth quarter of 1984, residential construction outlays, in real terms, were up 3-1/2 percent after an extremely rapid advance in 1983. For 1984 as a whole, 1.7 million new housing units were started. This was below the peak rates in the 1970s, but a marked improvement over the performance of the first years of the 1980s, as housing demand continued to be supported by favorable demographic factors and expanding incomes. Moreover, relatively stable house prices and the growing use of adjustable-rate mortgages made home purchases more accessible for many households.

The second year of strong growth in income and spending was accompanied by significant changes in household balance sheets. Late in 1983 and in the first half of 1984, financial assets declined relative to income--owing primarily to the sluggish performance of stock prices--retracing a portion of the strong gains made earlier in the recovery. However, the subsequent rise in equity prices helped to restore household asset positions to their previous high levels, and since the turn of the year, with stock prices up sharply, asset positions have improved further. Meanwhile, growth of household indebtedness picked up noticeably last year, and consumer installment debt as a share of disposable income moved to near its previous peak in the late 1970s.

Despite the rise in indebtedness, there were few signs of increased financial stress in the household sector. The incidence of payment difficulties on consumer installment debt remained historically low and home mortgage delinquency rates were about unchanged for the year as a whole. Nonetheless, the proportion of problem loans in the home mortgage market has not receded from its recession high, and there is some special concern about future

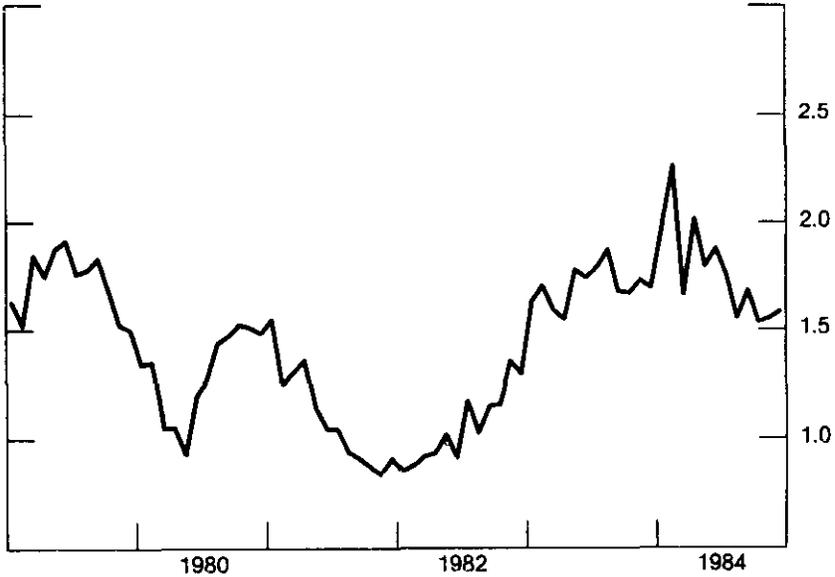
Real Personal Income And Consumption

Percent change, Q4 to Q4



Total Private Housing Starts

Annual rate, millions of units



prospects in this area owing to the added risk exposure of homeowners who took on mortgages carrying adjustable features, especially those made with sizable initial interest rate concessions. The sustained high level of mortgage loan delinquencies appears to date attributable not so much to adjustable rate loans as to a combination of still high unemployment and more stable real estate prices than some borrowers had anticipated.

The Business Sector

The increase in business spending for plant and equipment was greater in 1984 than in 1983. In fact, the rise in gross business capital outlays over these two years combined was much larger than in any other post-World War II economic expansion. Profits in the nonfinancial corporate sector were up substantially in 1984, although by year-end the level had fallen back a bit owing to the slowing in sales growth.

Growth in business fixed investment spending was strongest in the first half of the year, but continued at a double-digit pace in real terms in the second half. For the year as a whole, large gains were registered for both equipment and structures outlays. The ebullience of total spending reflected a number of factors, including the more favorable tax laws enacted in 1981, the desire to take advantage of technological advances, and the further narrowing of the margin of unused factory capacity under strong demand growth. Continued competitive pressure from foreign producers provided additional impetus for rapid modernization. At the same time, many U.S. producers of capital equipment, especially outside the "high-tech" area, did not fully benefit from this spending. Instead, foreign manufacturers captured an increasing share of capital goods purchased by U.S. firms; for

domestic equipment spending, this share--approximately 25 percent--was nearly twice that experienced in the late 1970s.

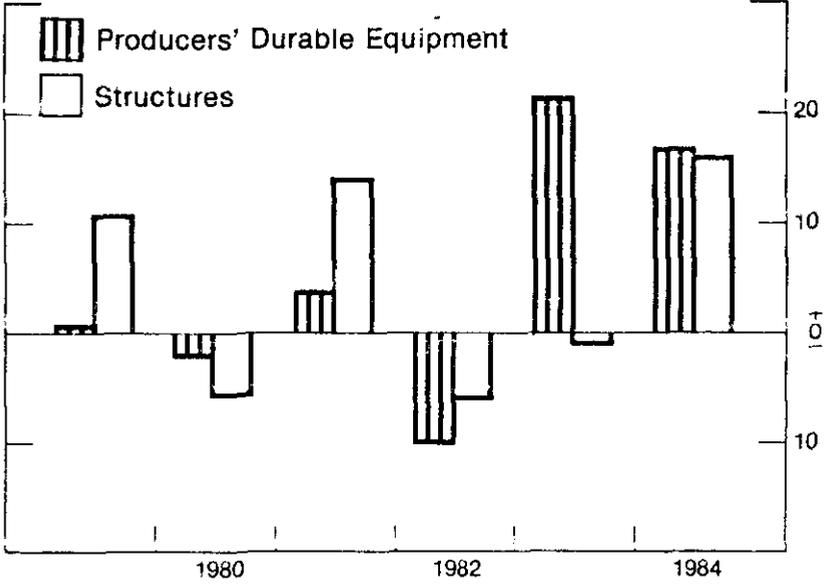
Businesses accumulated inventories in 1984 after reducing stocks in the preceding two years. In real terms, business inventories rose \$24 billion, an historically large gain. Those gains were concentrated largely in the first half of the year, alongside the rapid pace of the expansion of final demand. When sales growth slackened in the summer and autumn, businesses quickly cut back on orders and production to avoid severe imbalances.

In order to finance the combined increase in capital spending and inventory investment, businesses relied heavily on external sources of credit. Nonetheless, gross issuance of new equity weakened as stock prices declined early in the year and then failed to surpass earlier highs when they rallied in the summer. After accounting for the retirement of equity associated with merger activity and share repurchases, the net issuance of stock was decidedly negative. Shorter-term borrowing was favored by business as in the first half of 1984, as firms elected to finance mergers initially through bank loans and commercial paper, and the high level of long-term interest rates discouraged bond issuance. In the second half of the year, merger financing slowed and the decline in interest rates contributed to some movement toward longer-term debt issuance. Even so, the traditional balance sheet ratios used to assess aggregate business financial strength worsened over the year: the ratio of loans and short-term paper to total debt of nonfinancial corporations rose, as did the ratio of debt to equity.

Severe financial strains, in many cases related to the high exchange value of the dollar, persisted in some of the nation's basic

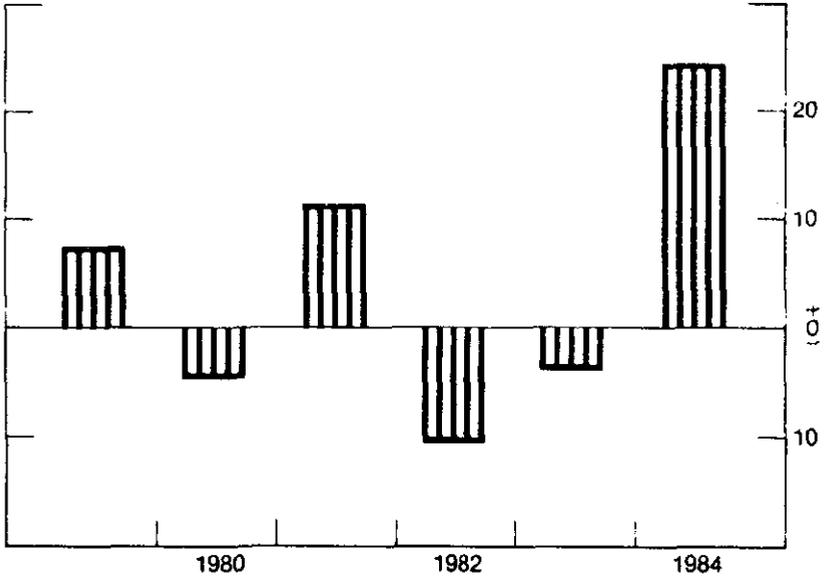
Real Business Fixed Investment

Percent change, Q4 to Q4



Change In Real Business Inventories

Annual rate, billions of 1972 dollars



industries. Farmers continued to face less favorable export conditions than in much of the previous decade, land prices fell further, on average, and farm income remained depressed. As a result, farmers with large volumes of debt remaining from the late 1970s continue to face serious debt-servicing problems. The metals, agricultural implements, and some equipment industries also continue to face significant problems.

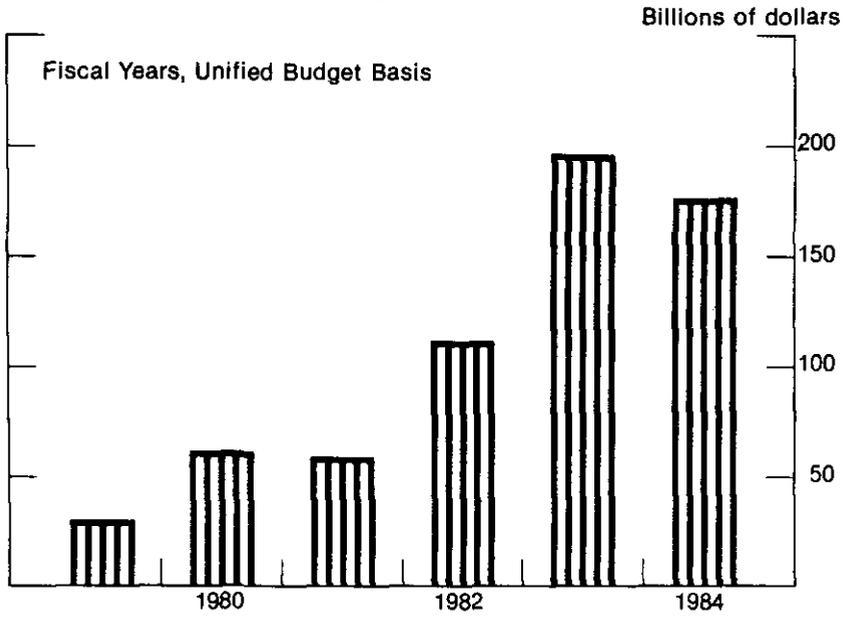
The Government Sector

The expanding economy lifted federal government receipts in 1984. At the same time, outlay growth was limited by further declines in recession related expenditures and by a drop in agricultural support payments. Nonetheless, the federal budget deficit remained enormous, more than 5 percent of GNP and larger than total domestic personal saving. Moreover, at the end of the year the deficit was again rising.

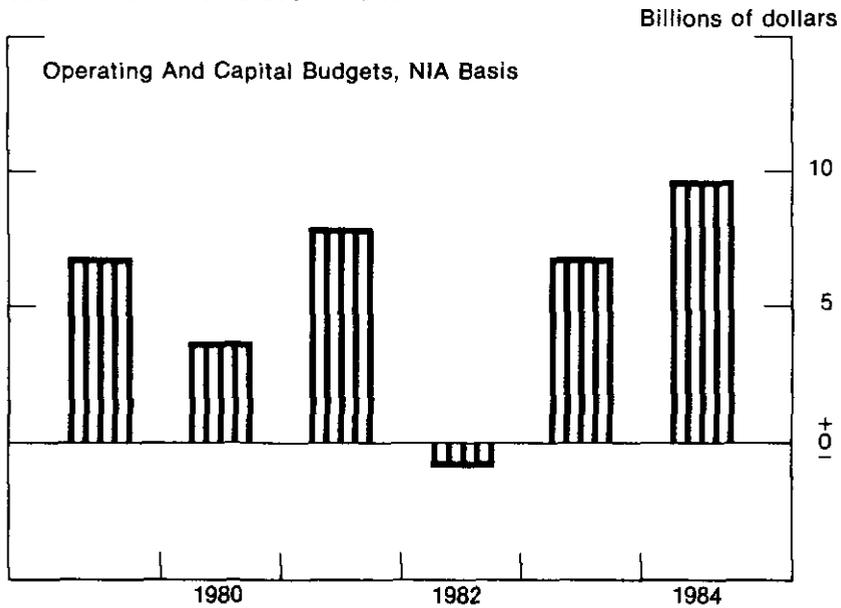
Federal government purchases of goods and services, the component of the budget that directly adds to GNP and comprises about a third of total federal outlays, rose strongly last year. Excluding changes in Commodity Credit Corporation farm inventories, federal purchases were up nearly 5-1/2 percent, after adjustment for inflation. A major thrust to federal purchases came from defense spending, which increased almost 7 percent in real terms.

At the state and local government level, real purchases of goods and services rose 3-1/2 percent in 1984, following two years of no change. The renewed growth in such spending followed an appreciable improvement in this sector's fiscal position: state and local governments experienced a sizable operating and capital surplus in 1983 and early 1984 owing to the effects of the economic recovery as well as increases in tax rates.

Federal Government Deficit



State And Local Governments



The Foreign Sector

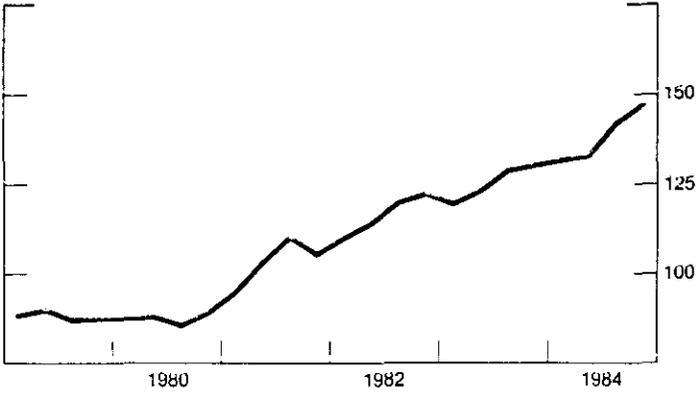
The appreciation of the dollar over the past four years directly contributed to the imbalance between exports and imports in 1984. On a trade-weighted average basis, the dollar climbed a further 12 percent during the course of the year, bringing the cumulative appreciation since the end of 1980 to about 65 percent, and the rise has continued into 1985. Part of the dollar's strength in the first half of last year may have been generated by a widening of the differential between real interest rates in the United States and real rates abroad; however, the influence of this factor appears to have been reversed in the second half of the year. The relative dynamism of the U.S. economy and success in curbing inflation helped attract capital from abroad. Conversely, relatively slow economic growth elsewhere and economic and political uncertainties in various countries also may have contributed to the dollar's appreciation throughout the year.

Notwithstanding a further weakening of the international competitive position of U.S. firms owing to the dollar's appreciation, and despite the sluggishness of foreign economies, the volume of U.S. merchandise exports increased by 9 percent in 1984. Exports to Canada, some of which are reimported after further fabrication, accounted for about a third of the rise, with Western Europe and Mexico receiving most of the remainder of the increase in exports. Economic growth in many developing nations, oil-producing as well as others, was limited by their debt servicing problems, and demand by those countries for U.S.-produced goods remained generally depressed.

The vigorous expansion of the U.S. economy and the strength of the dollar pushed the volume of merchandise imports sharply higher. Consumer

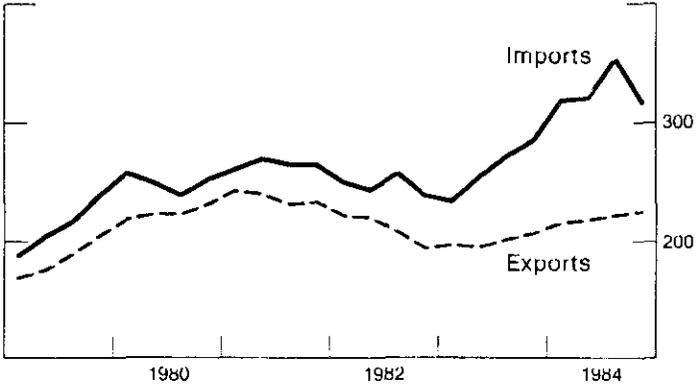
Exchange Value Of The U.S. Dollar

Index, March 1973 = 100



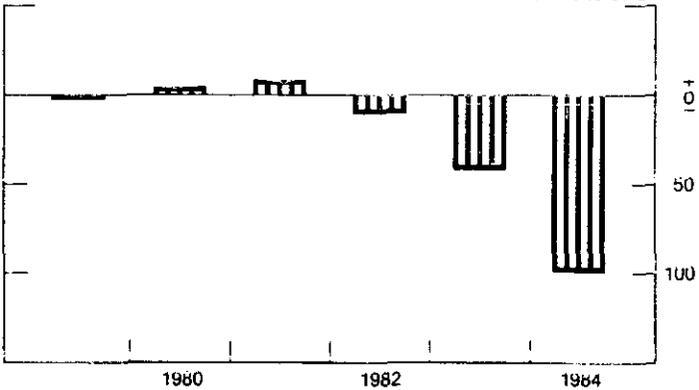
U.S. Merchandise Trade

Billions of dollars



U.S. Current Account*

Billions of dollars



* 1984 is partially estimated.

goods, materials, and capital equipment shared in the increase. The merchandise trade deficit rose to about \$110 billion. In addition to the growing trade deficit, net service receipts were reduced and the current account deficit was about \$100 billion in 1984, compared with \$42 billion in 1983.

Labor Market Developments

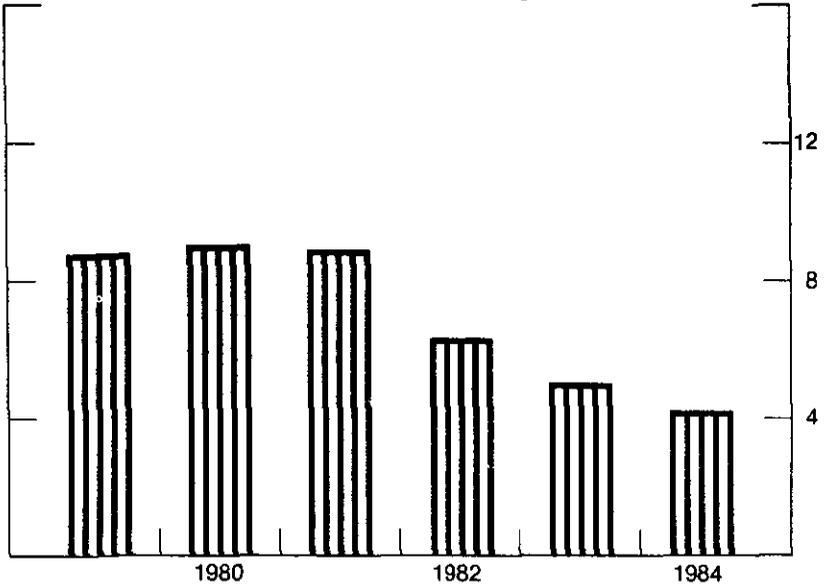
Developments in labor markets continued to be favorable during the second year of expansion. Reflecting the strength of activity and improved employment prospects, growth of the labor force picked up last year. But the number of new jobs expanded even more rapidly, and the unemployment rate was 7.2 percent in the fourth quarter, more than a percentage point below the rate at the end of 1983. Indeed, since the recession low in late 1982, nonfarm payroll employment has increased by nearly 7 million, the largest two-year gain in three decades.

In 1984, employment growth continued to be widespread across industries. The trade and service sectors each added more than one million jobs. And there was a gain in construction employment, owing in large part to a rise in nonresidential building. Government employment was up a quarter of a million, reflecting the rise in spending by state and local units. The manufacturing sector, which has borne the brunt of increased foreign competition, registered a large increase of almost three-quarter million in 1984; even so, the level of manufacturing employment remained below its pre-recession peak.

Wage developments in 1984 were more favorable to the control of inflation; even though labor market slack was reduced substantially further during the year, wage rates increased less than in 1983. The employment

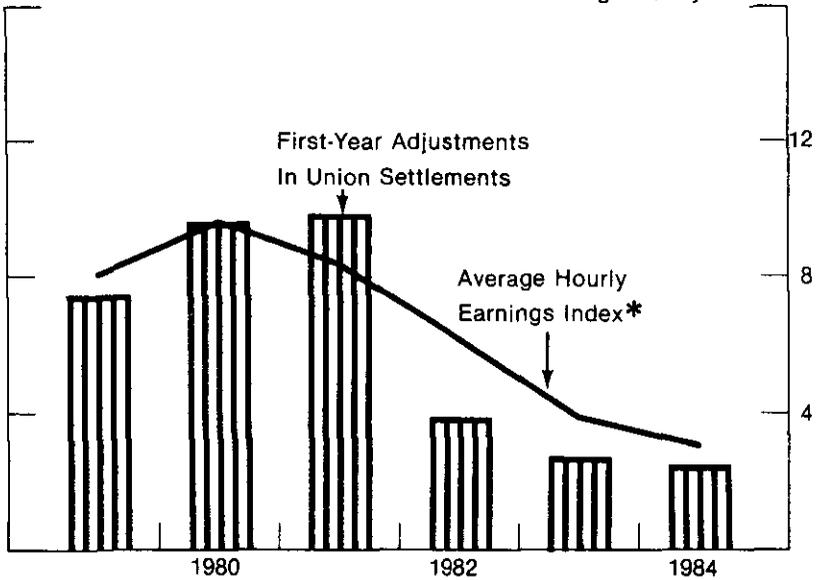
Employment Cost Index*

Percent change, December to December



Union Settlements And Aggregate Wage Change

Percent change from year earlier



* Private nonfarm business sector

cost index, a comprehensive measure of change in wages and benefits, rose just 4 percent in 1984, nearly one percentage point less than the year earlier. Moreover, major collective bargaining agreements during the year showed no acceleration in nominal wage rates, even in those industries with improved economic conditions.

These wage developments suggest that inflationary expectations continued to moderate this past year; to an increasing degree, workers and managers now appear to be focusing on improving job security and on enhancing productivity, often in an attempt to remain competitive with foreign producers. Productivity increases in 1984 were substantial in the first half of the year, when output grew rapidly, and helped keep overall cost pressures down. Over the course of the year, labor productivity increased 2-1/4 percent, partly reflecting a cyclical adjustment to higher levels of output as well as apparently some improvement in the underlying trend rate of growth from the very low pace of the 1970s. The combination of moderate compensation increases and favorable productivity developments held down cost pressures on prices; unit labor costs rose 2 percent over 1984, less than a fifth of the rate experienced in 1979 and 1980.

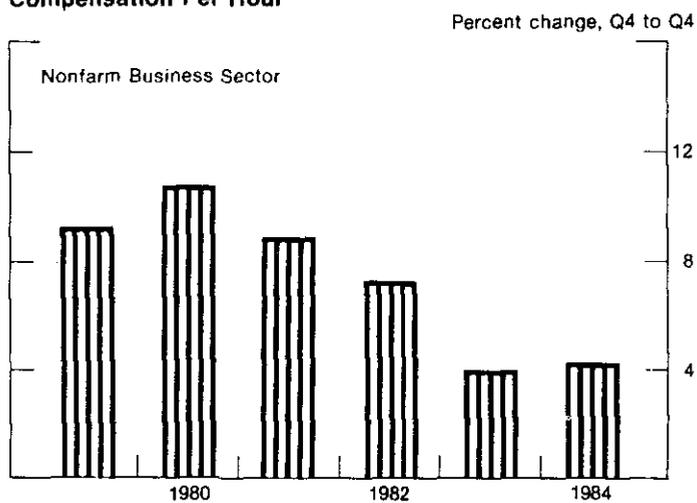
Price Developments

Over 1984, the consumer price index rose 4 percent and the implicit deflator for the gross national product 3-1/2 percent. The increases in these broad indexes represent little change from inflation rates that have prevailed since the beginning of the expansion. The producer price index for finished goods, which excludes the prices of services, rose less than 2 percent last year; basic commodity prices, which had advanced more than 30 percent early in 1983, fell during most of 1984.

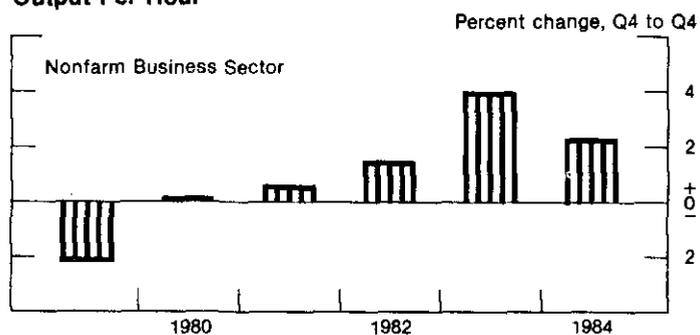
Nonfarm Payroll Employment

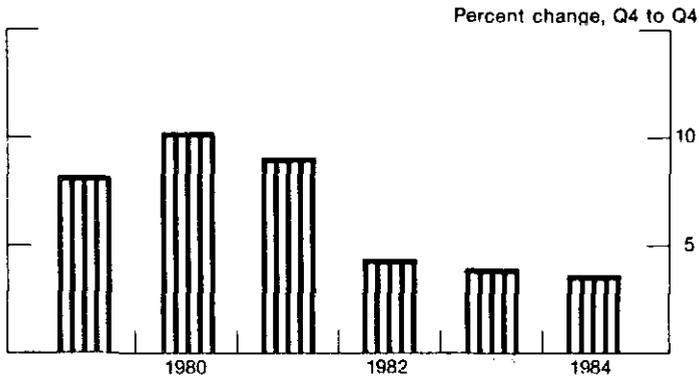
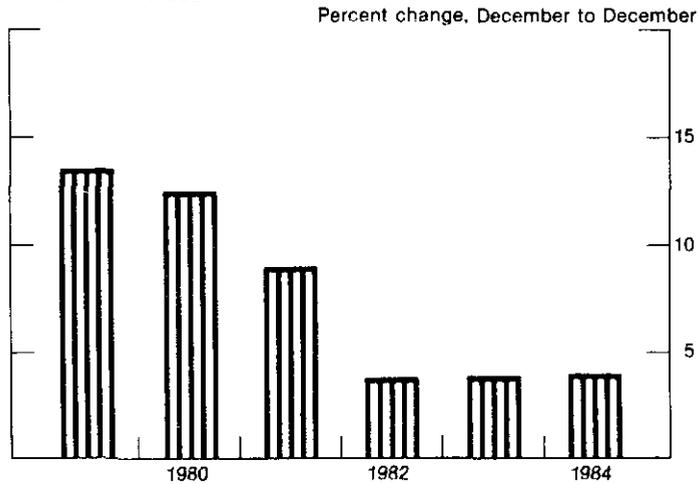
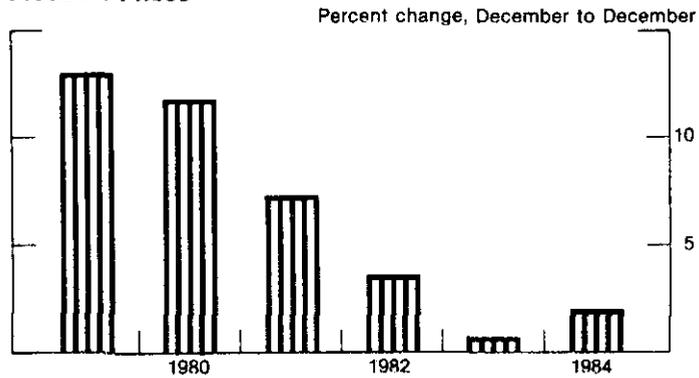


Compensation Per Hour



Output Per Hour



GNP Prices**Consumer Prices****Producer Prices**

The relative softness of demand in world-wide markets and the strength of the dollar against foreign currencies played a large role last year in holding down prices of basic commodities. Importantly, energy prices, which have been a major factor in inflation rate movements for more than a decade, moved down. The weakness of demand during the recession and early recovery period restrained energy prices in 1981 and 1982; moreover, conservation measures and additional oil production capacity in many countries have continued to relieve energy price pressures.

Food prices at the retail level rose about in line with overall prices in 1984. Early in the year, food prices jumped sharply because farm supplies were limited by the 1983 summer drought and a winter freeze. However, supplies again became plentiful as the year progressed, reflecting more favorable harvests and sagging export volume.

Apart from the food and energy areas, consumer price inflation was little changed from a year earlier. The rise in consumer goods prices slowed appreciably, owing in part to the relatively small increase in prices of imported goods, as well as the accompanying competitive pressures on domestic products. Service prices rose more rapidly over 1984 than in 1983, although the rate of inflation in the sector remained well below those recorded in the early 1980s.

Section 4: Monetary Policy and Financial Developments in 1984

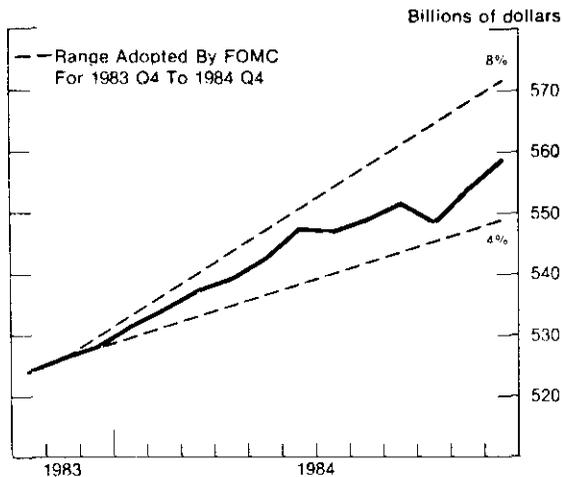
Monetary policy in 1984 aimed basically at supporting sustainable economic growth within the context of long-term progress toward price stability. The target ranges for the monetary and credit aggregates chosen by the Federal Open Market Committee last February, and reaffirmed in July, called for growth rates 1/2 to 1 percentage point below those set for 1983. Measured from the fourth quarter of 1983 to the fourth quarter of 1984, the target ranges for the monetary aggregates were 4 to 8 percent, for M1, and 6 to 9 percent, for M2 and M3. The associated monitoring range for the debt of domestic nonfinancial sectors was fixed at 8 to 11 percent.

Underlying these objectives was the Committee's expectation that the special factors distorting monetary growth rates in 1982 and 1983 would be less important in 1984, and that relationships among the monetary aggregates--particularly M1--and economic activity and inflation would be more consistent with historical trends and cyclical patterns. Portfolio adjustments associated with the previous introduction of new deposit accounts and with the steep drop in interest rates during the 1982 recession appeared to have ended. Furthermore, the economic expansion seemed to be reducing uncertainties about employment and income prospects that earlier had boosted demands for liquid precautionary balances.

Over the year, increasing evidence suggested that M1 was in fact behaving more in line with historical experience. As a result, this aggregate was given more weight in policy implementation than had been the case during the latter part of the cyclical downswing and early phase of the economic recovery. However, all of the monetary and credit measures continued to be

Ranges and Actual Money Growth

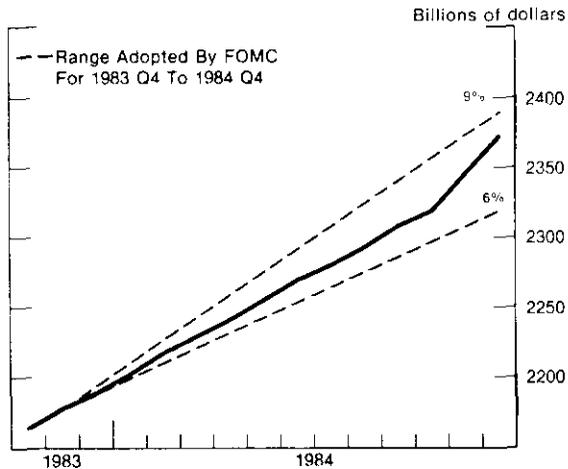
M1



Rate Of Growth

1983 Q4 To 1984 Q4
5.2 Percent

M2

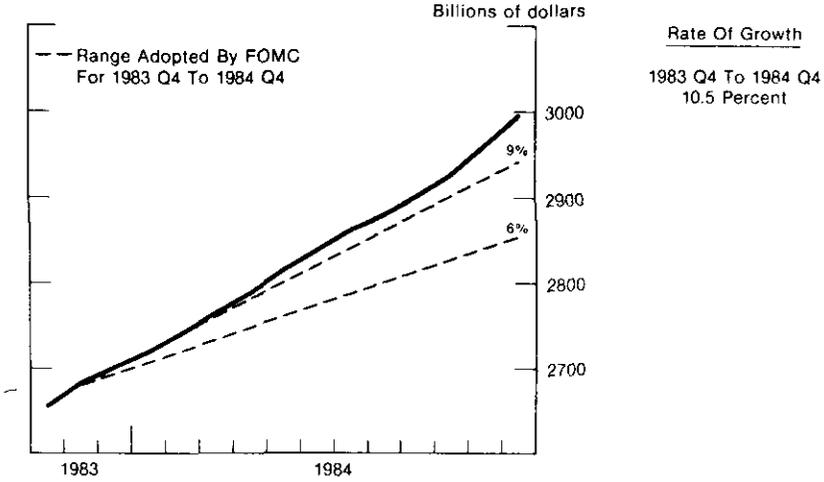


Rate Of Growth

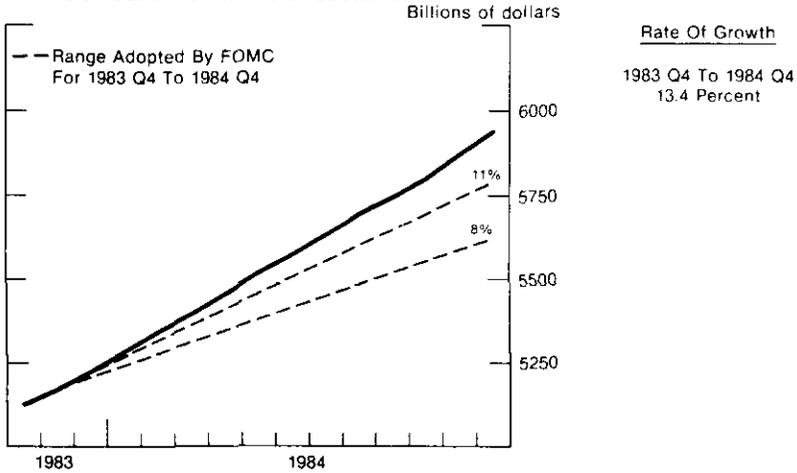
1983 Q4 To 1984 Q4
7.7 Percent

Ranges and Actual Money and Credit Growth

M3



Total Domestic Nonfinancial Sector Debt



evaluated in light of the outlook for the economy and domestic and international financial markets.

Money, Credit, and Monetary Policy

The actual growth rates of M1 and M2 over 1984 were well within the target ranges established by the Federal Reserve, with M1 expanding 5.2 percent, somewhat below the midpoint of its range, and M2 increasing 7.7 percent, a bit above its midpoint. As had been anticipated in the mid-year policy report to the Congress, growth of M3 and domestic nonfinancial debt, at 10.5 percent and 13.4 percent, respectively, exceeded their ranges.¹ The relatively wide divergence between M2 and M3 growth rates reflected mainly substantial issuance of large CDs and other managed liabilities by thrift institutions and commercial banks in the face of heavy credit demands.

Credit growth last year was the most rapid on record, and much stronger relative to GNP expansion than historical trends would suggest. An unusually large volume of mergers and related activity, including "leveraged buyouts," involving nonfinancial corporations accounted for about 1 percentage point of the growth of overall debt. Around \$75 billion of equity was liquidated in this process, with much of it replaced, at least for a time, with short-term debt. In addition, more than \$10 billion of equity was retired through corporate share repurchases, frequently in defensive maneuvers to ward off unfriendly takeover attempts.

1. The figures cited herein for the monetary aggregates are based on recent benchmark and seasonal adjustment revisions. Before those revisions, the 1984 increases were measured at 5.0 percent for M1, 7.5 percent for M2, and 10.0 percent for M3.

Even after allowance is made for the unusually large volume of merger-related borrowing, it is clear that total credit demands were exceptionally strong last year. Federal debt expansion, at more than 16 percent, was unprecedented for the second year of an economic expansion, both in absolute terms and in relation to income. Private domestic nonfinancial debt grew about 11-1/2 percent (abstracting from growth of merger-related debt issues), also faster than, but much closer to, comparable stages of previous recoveries.

The behavior of M1 velocity in 1984 was broadly consistent with past cyclical patterns. In contrast to the unusual weakness of the previous two years, over 1984 M1 velocity increased 4 percent, only a little above the average rate of growth during the second year of previous economic expansions. M2 velocity increased 1-1/2 percent, reversing two consecutive yearly declines. The strengthening of velocity over 1984 apparently reflected, in part, some unwinding of the precautionary and other motives that had swelled demands for liquid assets in 1982 and early 1983, as well as the rise of short-term interest rates in the first part of the year, and, in the case of M2, the abatement of dramatic inflows to money market deposit accounts (MMDAs) associated with the initial authorization of these accounts.

Demands for M1 balances, and for bank reserves to support deposit growth, were robust early in the year as the economy expanded rapidly. Credit demands also were very strong, and market interest rates began rising even as the Federal Reserve, through open market operations, was keeping the degree of pressure on bank reserve positions unchanged. In early spring, with credit and money demands continuing unabated,¹ and with economic growth continuing

1. Annual seasonal and benchmark revisions to the monetary aggregates subsequently lowered somewhat the growth of M1 in the first half of 1984 relative to what was estimated during the period.

GROWTH OF MONEY AND CREDIT¹
 Percentage changes

Period	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter to fourth quarter				
1979	7.5	8.1	10.3	12.1
1980	7.5	9.0	9.6	9.6
1981	5.1 (2.5) ²	9.3	12.4	10.0
1982	8.8	9.1	10.0	9.1
1983	10.4	12.2	10.0	10.8
1984	5.2	7.7	10.5	13.4
Quarterly growth rates				
1984-Q1	6.2	7.2	9.2	12.9
Q2	6.5	7.1	10.5	13.1
Q3	4.5	6.9	9.5	12.7
Q4	3.4	9.0	11.0	12.7

1. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions made in February 1985.

2. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

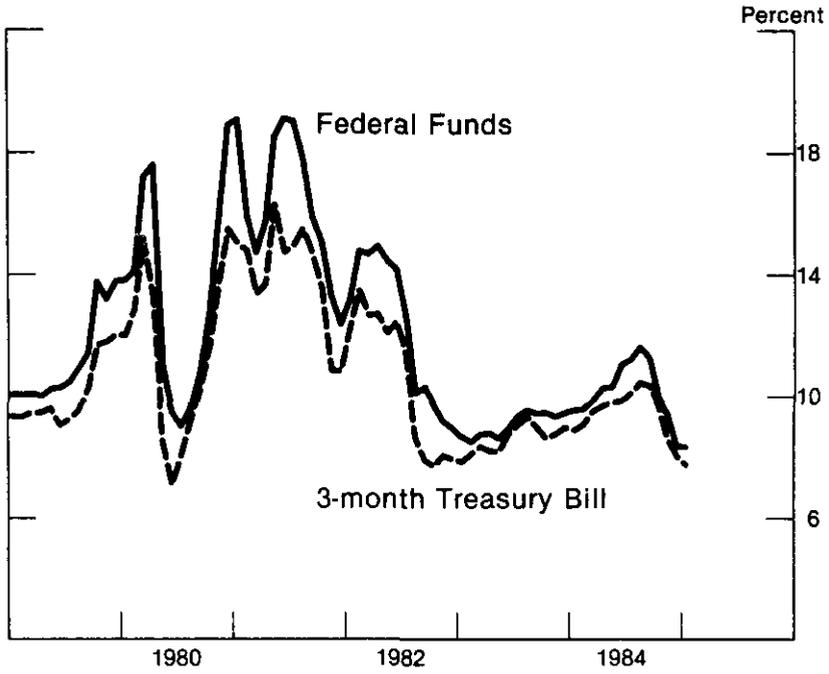
at an extraordinary pace, the FOMC adopted a somewhat more restraining posture toward supplying reserves, and both short- and long-term interest rates rose further as banks relied more heavily on discount window credit to meet their reserve needs. Borrowing for adjustment and seasonal purposes increased to around \$1 billion in March and April after averaging about \$650 million during the first two months of the year. In April, the discount rate was raised 1/2 percentage point, to 9 percent, to bring this rate into better alignment with short-term market rates.

Despite the absence of any further tightening of reserve availability by the Federal Reserve, pressures on private short-term interest rates intensified around early May in reaction to the well-publicized liquidity problems of Continental Illinois Bank.¹ Uncertainties related to the international debt situation also added to market concerns. In this environment, quality differentials between yields on private money market instruments and Treasury securities widened substantially.

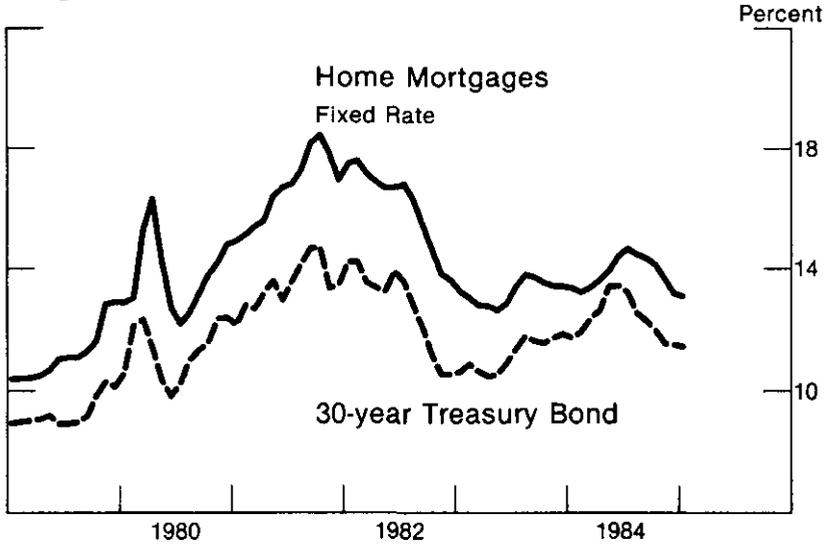
While M1 growth early in the year remained in the upper part of the FOMC's target range, M2 increased at a pace slightly below the midpoint of its range even as the economy expanded rapidly. Growth in M2 relative to income may have been damped by substantial inflows to IRA and Keogh accounts, which are excluded from the monetary aggregates. Also, as market interest rates firmed, sizable spreads developed between these rates and yields on retail deposits and money market mutual funds, likely encouraging some investors to place funds directly in credit market instruments. M3, meanwhile, pushed

1. Large discount window borrowing by Continental Illinois bank, beginning in May, was offset in terms of its impact on overall reserve supplies through open market operations.

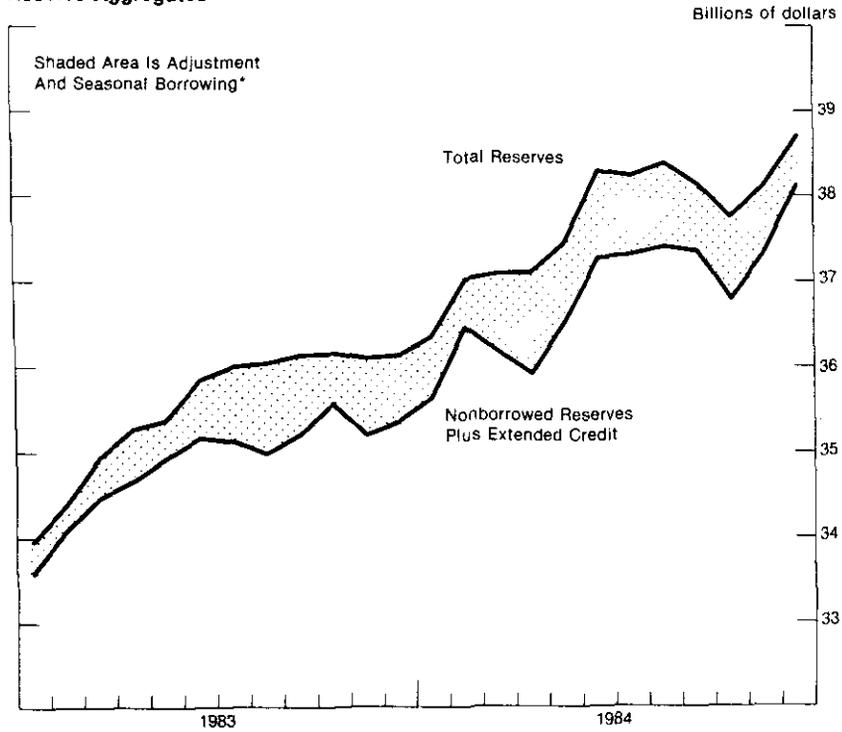
Short-term Interest Rates



Long-term Interest Rates



Reserve Aggregates



* Excludes borrowing by Continental Illinois Bank beginning in May 1984.

above its longer-run range, as banks and thrift institutions issued large CDs and other managed liabilities to accommodate rapidly rising credit demands.

After midyear, economic expansion slowed markedly, particularly during the summer, tending to reduce transactions demands for money. Growth in M3, though remaining somewhat above the upper limit of its range, also moderated as demands for short-term business credit slackened and as some banks adopted more cautious lending and funding policies in light of the strains on financial markets.

Initially, the slowing in M1 was not resisted, as it reversed a bulge that had brought M1 growth well above the midpoint of the FOMC's target range. However, by late August and early September, as evidence appeared of much slower economic growth, with financial tensions high and with the dollar rising rapidly on foreign exchange markets, the Federal Reserve moved to lessen the degree of restraint on bank reserve positions. That process continued through much of the rest of the year. Borrowing at the discount window receded, reaching levels of around \$575 million by late in 1984 and dropping further to around \$340 million, on average, during January 1985. Total reserves and nonborrowed reserves, which had shown little expansion since June, increased markedly in the final two months of the year and into early 1985.

Mirroring the easing of reserve market conditions, short-term interest rates dropped considerably from their late-summer highs. Moreover, quality spreads on various money market instruments returned to within normal ranges as the strains related to the problems of Continental Illinois Bank

remained contained and progress was made in Latin American debt negotiations. Responding to the provision of reserves and the reduced rates on alternative outlets for liquid funds, M1-type balances rose rather sharply in late 1984 and early 1985. Growth of M2 also was very rapid, as open market interest rates fell below average yields on MMDAs, small denomination time deposits, and money market mutual fund shares.

The easing in financial markets during the second half of 1984 was reflected in, and to an extent encouraged by, two successive reductions in the discount rate, first to 8-1/2 percent in November and then to 8 percent in December. By year-end, short-term interest rates were 2-1/2 to 3-1/2 percentage points lower than they had been during the summer, and 3/4 to 1-1/2 percentage points below their levels at the beginning of the year-- in some cases near their cyclical lows of early 1982.

Long-term interest rates also declined in the second half of the year, in part reflecting some moderation of inflationary expectations. But for the year as a whole, most long-term rates declined by less than 1/2 percentage point, and remained above their earlier cyclical lows. The still relatively high level of long-term rates appears to be influenced by the continuing budgetary uncertainties, current strong demands for total credit, and lingering, though lessened, fears of inflation.

Other Developments in Financial Markets

Foreign savings financed a large share of the domestic borrowing in 1984. Net inflows of capital from abroad were more than double the already advanced pace of 1983, thus supplementing domestic saving and enabling the financing of the massive federal deficits at the same time that private

investment expanded rapidly. Banks continued to intermediate substantial amounts of these inflows, and sales of Eurobonds by U.S. corporations reached record levels. Direct investment in the U.S. also was very strong, reflecting several large takeovers of domestic firms by foreign corporations.

Much of the credit market borrowing--particularly that related to merger activity--was at short term. Commercial paper debt of nonfinancial businesses surged more than 50 percent, offsetting two consecutive years of runoffs. With strong loan demands in business, real estate, and consumer areas, total loans at commercial banks grew more than 14 percent.

Given only moderate inflows to core deposits in the face of this brisk loan growth, commercial banks increased their outstanding CDs in 1984 by more than 14 percent, after having allowed a large volume of CDs to run off during 1983. Credit growth at banks was especially rapid during the first half of last year, reflecting a wave of bank-financed mergers. The bulk of the CD issuance was concentrated in this period and likely would have been even greater had not banks also borrowed heavily from their foreign offices. In the second half, loan expansion slackened appreciably, and large time deposit growth tapered off, as some earlier merger-related loans were repaid with the proceeds from issuance of commercial paper and other debt obligations and from selective sales of assets of the merged companies.

Strains on some sectors of the economy, as well as the effects of overly aggressive lending policies by some institutions, continued to be reflected in relatively high levels of non-performing and other troubled loans in a number of depository institutions. As the year wore on, there were signs of more forceful efforts to deal with these problems and their consequences. Loan loss provisions were significantly increased and steps

are being taken to correct weaknesses in credit standards. The largest bank holding companies generally improved their capital positions over the year, partly in response to supervisory guidelines to raise capital ratios. These approaches will take time to bear full fruit, and progress in strengthening balance sheets will be dependent on reasonable profitability as well as on developments external to the banking system. In that connection, the strains in agricultural areas, on heavily indebted foreign countries, and in sectors of the energy industry pose continuing challenges.

In long-term markets, municipal bond offerings achieved new highs in 1984. Tax-exempt offerings were relatively light over the first half of the year as authority to issue single-family housing revenue bonds lapsed and as the market anticipated the imposition of retroactive ceilings on issuance of industrial revenue bonds (IDBs). But volume rebounded in early summer after passage of the Deficit Reduction Act, which reauthorized housing bonds and stimulated a flood of issues toward year-end to avoid stricter rules for IDBs and student loan bonds--effective January 1, 1985. Financial and non-financial corporations also raised record amounts through bond offerings; however, the maturities of new issues tended to be much shorter than in previous years, and many offerings carried provisions that essentially transformed these obligations into short-term or variable-rate debt.

Variable-rate instruments exhibited increasing popularity within the home mortgage sector as well. Adjustable-rate mortgages (ARMs) accounted for almost two-thirds of the number of conventional first mortgages on homes at major institutional originators in 1984, up considerably from only one-quarter of such originations the previous year. Thrifts, in particular, preferred to acquire ARMs rather than fixed-rate mortgages in an attempt to

reduce their already acute exposure to interest rate risk. The widespread acceptance of ARMs by consumers was attributable partly to substantial initial rate advantages offered on ARMs compared with fixed-rate mortgages, as well as to other features that limited borrower exposure to higher future interest payments, at least for several years. Large initial rate discounts became less prevalent after the adoption of somewhat tighter standards both for purchases by federal credit agencies and for the underwriting of ARMs by private mortgage insurers. Yet, despite the shift toward ARMs during 1984, and increased consumer and business lending, the assets of thrifts remained heavily concentrated in relatively low yielding instruments.

Chairman FAUNTROY. We all agree that, in the long run, we ought to have both low inflation and low unemployment. However, in the short run, it is clear we cannot have both. In the coming year, for example, it would be great if we could reduce unemployment to 5 to 6 percent, or inflation to 2 to 3 percent, with further reductions in the years thereafter. But your projections do not show such improvement and it would probably be unrealistic to hope for them. What can we realistically achieve? It seems to me that the realistic choice this year, with some reasonable favorable developments on the deficits and on the trade fronts would be this—we could either see a reduction of inflation to, say, the 3-percent range, at the cost of continued unemployment at, say, the 7 percent range, or we could see a reduction in unemployment to somewhere around 6 to 6½ percent, at the cost of continued inflation at or about the 4 percent rate that we have today.

My question, Mr. Chairman, is which of these choices is the Fed trying to achieve through its monetary policy? My reading of your testimony suggests that you are aiming at the second choice. But the improvement in projected unemployment is so modest, that you could be trying for the first.

Mr. VOLCKER. I think our actual numbers are somewhat between your choices. I don't know whether I would accept fully the realism of your choices—whether it is really possible to achieve in combination some of the numbers that you suggested. But I don't know that for sure.

I would look at it perhaps in a somewhat more qualitative way. I don't think that we can just look at numbers in isolation for a particular year and say what is achievable in 1985. I would be very interested in what is implied in terms of the directions and the threats, as well as the benefits, let's say, toward the end of that year, with one of those extreme protections or another.

If we drove for, in some sense, maximum reduction in unemployment this year, you presumably would increase the money supply further and increase the liquidity of the economy. You might or might not be successful in the space of 12 months let us say, in getting the unemployment rate lower than you otherwise would have it in that particular period. But would you end up with the kind of forces at work in the economy that immediately jeopardized the outlook in 1986 or 1987; would you end up with unemployment a bit lower in 1985, but with a much more threatening situation as you looked out into the future?

When one approaches problems with that kind of tradeoff set of mind, the risk has been, historically that one pushes for maximum growth in unemployment in the short run at the risk of inflation and you set up, inadvertently, forces in the economy that end up with more inflation and more unemployment. It may not be true in year 1, but it would be true in year 2, 3, and 4. I think that is the history of the 1970's.

We have projections here for a year, but we try to keep a longer term perspective in mind. It is in that context that I think the importance of keeping one very clear eye on the inflationary forces in the economy, actual and potential, is extremely important.

Chairman FAUNTROY. Let me try to be a bit more specific. What would it take in your view to get unemployment down to, say, 5 or

6 percent during the next 2 or 3 years? If we mandated that as a goal for monetary and fiscal policy, what would be the risks?

Mr. VOLCKER. One kind of answer I could give you is that those chances—let's say to get to 6 percent—are going to be maximized over a time period of 2 or 3 years to the degree that we are successful on the price side. Let me, for purposes of discussion, assume that monetary growth on the order of magnitude of our targets for this year is appropriate, and should probably be something lower than that, as time passes, to be consistent with stability. If you are given that kind of a framework, the less prices increase, the more successful we are on the inflation side, almost arithmetically, the more room you have for growth.

If you think of the money supply as setting some limits—and they are very loose limits—on nominal GNP, then it is in our interest to see that as much of that turns out to be real growth and as little as possible of it turns out to be inflation. That would be the favorable result we can get. I'm always hesitant about presenting these projections because they may imply a degree of certainty about the future that isn't possible.

We would be delighted, I am sure, if growth turned out to be higher in 1985 and unemployment lower, provided that is in a context that makes it look sustainable. Again, one important element is what's going on in terms of prices, not only currently, but prospectively.

Chairman FAUNTROY. The Board recently forwarded to the Congress a study on margin regulations which study included some legislative recommendations. What priority should we place on this?

Mr. VOLCKER. I don't think it is the most urgent matter before the Congress in terms of all the matters you have before you. We have lived with these margin regulations for a long time. I wouldn't put it high on the priority list of problems in the economy.

But with the development of new and different markets for futures and options, problems have arisen in terms of consistency and equity of margin requirements for stock and other markets. In the interest of simplifying regulations wherever possible or going back and seeing whether they are necessary, that study reflects work that has been going on, in fact, for 5 years or more within the Federal Reserve System. We have concluded that margin requirements, as they have traditionally been operated since the 1930's, are probably no longer necessary. They may be delegated. One main option is to give authority over margin requirements to self-regulatory bodies with some kind of Government oversight.

I think that suggests also that, within the context of the present arrangements and the present law, one might say the present margin requirement of about 50 percent could logically be reduced some. We have been a little hesitant about doing that for fear that it might be misconstrued as a monetary policy action, which it would not be, or construed otherwise during a period when the stock market is strong. But I think the logic is—and the board has looked at the matter as a kind of interim measure—to reduce that margin requirement from the 50-percent level that it's been at for many, many years.

Chairman FAUNTROY. I am tempted to have you discuss a concern which I have on the trend in mergers and acquisitions, but I am going to resist that temptation and yield now to the distinguished ranking member for his questions.

Mr. McCOLLUM. Thank you, Mr. Chairman.

Mr. Volcker, for the past couple of years when you have testified, I've inquired about the factors that the members of the open market committee use in making judgments to loosen or tighten the money supply Two or three years ago, you responded that the M's were being distorted because of the money market factors and other things and that besides the M's and the ranges that had been adopted by the committee, you were looking at price baskets and maybe unemployment and several other factors.

Last year, as I recall, you expressed confidence in the M's again and the money supply as a guiding standard of major concern and—

Mr. VOLCKER. Relative confidence.

Mr. McCOLLUM. Relatively. But you indicated that very little or no emphasis was being placed on other factors like price commodities and so on during that testimony.

I am curious—over this past few meetings of the monetary open market committee, what factors the members are looking at, if any, besides the range of the M's. Are they looking at price baskets? I noticed in your report, the growth of debt has been of concern. Or is the primary focus still on the ranges, the target ranges, of the M's, in making the decisions to loosen or tighten?

Mr. VOLCKER. Let me try to be careful in answering because, whatever I say, I find it sometimes gets interpreted in a manner that I don't fully recognize. I do not recall deemphasizing other factors last year. I do think that we feel that so-called velocity movements may be more normal than they were, let's say, in 1982 and the early part of 1983, anyway. In that sense, we have somewhat more confidence in setting out targets and feeling that they are appropriate.

But we allow a margin for flexibility within those targets, as you well know. In conducting policy we do look at the targets in the context of other indicators. I don't think we have mechanical indicators like, let's say, a basket of commodities, or some arithmetic, mathematical kind of rule that we try to weigh into our decisions.

But if you ask are commodity price movements, for instance, a very interesting piece of evidence that is brought to the table to show the degree of inflationary or disinflationary forces in the economy, they certainly are.

One element that has, I think necessarily and appropriately, attracted increasing discussion and weight in our decisions within the general context of appropriate monetary growth is what has been going on externally, particularly with the exchange rate. That certainly affects our judgments currently as to how to conduct monetary policy, within the general framework of the monetary targets that have been set out.

Mr. McCOLLUM. Well, now, you have got the monetary targets listed in your report and, in addition, you have got target ranges for what is referred to as domestic nonfinancial debt, I suppose technically.

Mr. VOLCKER. Yes.

Mr. MCCOLLUM. It appears that in 1984, the target ranges for the debt were exceeded by quite a bit.

Mr. VOLCKER. That is correct.

Mr. MCCOLLUM. The actual growth of debt was quite a bit more.

Mr. VOLCKER. That is correct.

Mr. MCCOLLUM. In your testimony, you have indicated that with regard to setting the new targets and raising them slightly on debt, that even so, you say credit growth, fuelled in part by budget deficit, is expected to be quite strong, significantly exceeding the rate of expansion of GNP for the third consecutive year. The committee does not anticipate the growth of debt within the targeted range would necessarily pose significant new risks in the immediate year ahead.

But you go on to say that a healthy financial structure will in time require more restraint on borrowing relative to the economic growth that, in the last analysis, provides the wherewithall to service the debt.

Am I reading correctly into this that if the debt continues to grow at this kind of excessive rate, that the open market committee is going to, despite the fact that the M's may be in line at the time, put more reliance on this debt factor?

Is that what we're to expect or anticipate and there may be more tightening as a result of that?

Mr. VOLCKER. I think that that may be overstating it, that is in the sense of looking at that one variable. I think that that is one that tends to go in that direction, frankly. If we are looking at nothing but the monetary numbers and the debt number—and if the debt continued to rise very rapidly—this would weight, let's say, toward the lower part of the ranges of monetary growth, all else equal. All else isn't equal, I quickly say, and we do look at the other indicators that I just mentioned.

Mr. MCCOLLUM. And one of them is the question of the value of the dollar abroad; is that correct?

Mr. VOLCKER. Yes. Of course, we look broadly and inevitably make the best assessment we can of what the economy itself is doing in the broadest sense. What are the growth patterns in the economy? How sustainable do they appear to be? What is the degree of momentum in the economy?

You can get fooled in that analysis: monetary policy is not just a process of trying to assess and fine-tune what's going on in economic growth; quite the contrary.

You certainly look at that.

Mr. MCCOLLUM. But the emphasis, Mr. Chairman, still is on the M's. That is still the target, the primary emphasis.

Is that correct?

Mr. VOLCKER. That is the point of departure, I think.

Mr. MCCOLLUM. Thank you. Thank you very much.

Chairman FAUNTROY. Thank you, and I yield now to the gentleman from North Carolina, Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman Volcker, we are now operating under an economic plan that has doubled the national debt in about 4 years and, if unchanged, will triple the national debt within another 4 or 5 years.

I have to ask a broad sort of question. There are several parts to the question. In a very broad way, what is going to happen to the economy if we don't change this economic plan that we are following? And what will the pressures be on the Fed to pump out excessive amounts of money? As I understand from what I can read in the popular press about the supply side argument these days, I think it sort of boils down to the fact that these deficits don't really matter and that we will grow our way out of them. And in any case, if we don't, it's the fault of the Federal Reserve System; that is, because the Federal Reserve System is not pumping out enough money.

I don't mean to be unfair to the supply-side argument, but that is the way I read it and if I am correct I very much disagree. I think if the Fed does again start to engage in excessive money creation, inflation will be sure to follow and it does appear to me that the pressures on you are going to be very strong to do just that if we don't get our fiscal policy in order. Would you comment on these points?

Mr. VOLCKER. As to what happens if nothing's done about the deficit, I don't think that anybody can creditably give you a very precise scenario. I think you can look at what has been happening and raise, to me, unanswerable questions.

What has been happening is that we have been managing to finance this deficit, along with rising housing and private investment, with the help of an increasing net flow of capital from abroad, which has now reached about 2½ percent of the GNP. That 2½ percent of the GNP happens to supplement our net domestic savings on an order of magnitude of something like a third. It is a very significant quantity. We save something less than 9 percent net of our GNP domestically, and now we're supplementing it by 2¾ percent from abroad. That has not meant low interest rates in the United States, but it certainly kept them lower than they otherwise would have been and permitted the private economy at home to move ahead consistent with this deficit, contrary to many expectations a year or so ago.

The other side of the coin necessarily is that huge and rising trade deficit which reached more than \$100 billion last year and looks like it's still trending higher. That creates a severe distortion in the economy in and of itself. It helps depress the manufacturing sector of the economy. But looking ahead, I think you have to ask yourself, is that sustainable? And I would answer, "No."

I don't know how long it's sustainable. We have had a number of developments going on that have helped to track this capital, including relatively high interest rates. It contains the seeds of its own destruction, if nothing else. The more you borrow, at some point people are going to become a little suspicious and they are not going to be so willing to put money in the United States. The dollar can't go up forever, and fear that the dollar will go down in itself would tend to shut off that capital inflow.

Ask yourself what happens when that day comes? We no longer have this crutch from abroad to support our domestic financial markets. Then the squeeze comes back on the internal markets, accompanied perhaps by a rapidly falling dollar reversing the recent, or at least part of the recent rise, which gives you both pressures

on our domestic market and inflationary pressures at the same time.

One pressure at that point in time might well be what you suggest; that somehow, we in the Federal Reserve must solve that problem by creating more money. But creating more money isn't the same as creating more savings. Money, as you point out, will, in the end, create inflation. More savings do the opposite; they release real resources for investment, for the Government deficit, if we have one, for the improvement in the trade balance, offsetting the decline in the capital inflow. If you don't get the increased savings, you have got a real problem, and I don't think there is any reasonable prospect that you can expect savings to jump up conveniently. The savings rate has been quite steady within a channel for many, many decades. It reflects some very deep propensities and habits of American individuals and businesses.

That's not a very happy prospect, to say the least. It is a prospect that will both undermine the progress on inflation and the progress of the economy itself. The prudent way to prepare for that is, I think, by doing what we constructively can do, which is reduce the demands from the budget deficit. If that's not done, I think this rather high risk, bleak scenario is there. I can't predict the timing, and I can't predict just how it would come about. Looking at the shape of the American economy now, with those huge trade deficits, I think you have to sense that you're not in a fully sustainable position.

Mr. NEAL. I would like to followup, if I can. Again, I quite agree with you. I don't see what would drive foreign capital from our shores at this point, either. I mean, the economy is booming right along and interest rates are certainly attractive. But I have this uncomfortable, uneasy feeling that precisely what you suggest could happen.

Mr. VOLCKER. I well understand your uneasiness and every day brings it closer. But we've had a remarkable performance in the past year, with rather strong increases in capital inflows—net capital inflows.

If you look at what's been happening in the last 3 years or so, a large part of that net increase is in reduced growth in the outflow, particularly by banks. They are not lending abroad the way they were before. So, it is not just that our economy has been attracting a lot more money. It has been attracting some more money from abroad. But we are not sending it out at the rate of speed that we were. The sending-out side has pretty much come to a halt.

What we are doing is living off the continuing inflow, which has been expanding and using all that money at home instead of recycling it, as was the case earlier—recycling all of it, sometimes more than all of it, to the rest of the world. There is less attraction for bank lending abroad, for obvious reasons.

Mr. NEAL. It seems to me that if we don't take this deficit situation seriously, we are going to do enormous damage to the overwhelming majority of the people in this country. And a less painful way to deal with it would be to cut spending and increase some taxes as a part of a plan to deal with it, and the pain of that to the economy at large and to individual people will be much less than it

will than if we continue to ignore the problem. Would you agree or disagree with that?

Mr. VOLCKER. I certainly agree that taking action now to deal with what seems to me so evident a problem—even though, on the surface, it is obscured by the general prosperity of the economy—is what is called for. That is the only prudent, reasonable approach. How you go about that, of course, is a very controversial matter and it involves many considerations outside the strictly economic.

I have often said that if you are looking at this purely as an economist—you forget about national security and you forget about Social Security and forget about all those considerations—you look at it purely from an economic standpoint, the question is: How do you reduce that budget deficit with minimum impact on incentives? Maybe maximizing some incentives, giving maximum scope for the private economy and the growth of investment. You attack it from the expenditure side. I think that's what the economics call for. That's excluding all these other objectives. You have got to reconcile all those other objectives and, in the last analysis, if you can't do it on the spending side, then you have to look to the revenue side.

Chairman FAUNTROY. Thank you. Mr. Wylie?

Mr. WYLIE. Thank you very much, Mr. Chairman. May I say that I am not one of those who is quite that sanguine, quite as sanguine as some of the economists who feel that we don't have to worry about the Federal budget deficit, that with proper incentives from the Fed, that the economy will grow fast enough that we can grow our way out of it. So, I was glad to hear what you had to say in response to Mr. Neal's question.

Something that has been a concern of mine, Mr. Chairman, is the haphazard way in which the delivery of financial services has been developing in this country. I think it has some ramifications on the conduct of monetary policy and is therefore an appropriate question for this hearing, because I think a stable financial system would help you in the conduct of your job.

But may I ask you for the record today, Chairman Volcker, about the need for, and the urgency of congressional action on banking regulation-deregulation issues which were left over from last year.

Mr. VOLCKER. Let me say as flatly as I can, I find the present situation totally unsatisfactory and disturbing from a variety of viewpoints. You mentioned that it could impinge upon monetary policy. It certainly will impinge, in some respects, on the safety and soundness of the system. Most broadly and clearly, you are dealing here with the appropriate evolution of the banking system and financial system generally. What kind of a system do you want to see? What we have is a circus going on of every bank lawyer in the country, and I guess more lawyers want to become bank lawyers—

Mr. WYLIE. Yes.

Mr. VOLCKER [continuing]. Reexamining every law that is on the books to see what sunshine is seeping through gaps in particular pieces of legislative language and how they can move in new and different directions and directions that, by common assumption, the legislation prohibited in the first place.

You see it in the nonbank bank area, a so-called loophole whereby the basic congressional policies to separate commerce and banking can be violated. You see it in the interstate area, where ingenious theories are advanced as to how banks can move across State lines against what was thought to be the doctrine of banking law. You see a great rush by the States to provide all sorts of powers for their financial institutions, banks and savings and loans, certainly not consistent with any interpretation of what Federal policy has been in the past.

If Congress doesn't move, the world is going to move. The world is moving. The question is whether it is moving in directions that you would like to see or that anyone would like to see in terms of taking a comprehensive view of the system. It is moving by default and it is moving in awkward ways through peculiar channels because it has got to move around the obstacles of present law.

It seems quite evident to me that if you want to exert any influence over this process, you had better move to legislation; that is urgently needed. I know that you have introduced legislation that constructively deals with some aspects of this.

Mr. WYLIE. Yes.

Mr. VOLCKER. Maybe I ought to put it this way: Congress is acting by not acting, because the world out there is moving. If you want to exert some public policy direction over this movement, now is the time to do it. I will tell you, we, as regulators, as one set of regulators, are constantly put in a position of interpreting constitutional issues these days; we are, in effect, whatever way we act, making banking policy. We would like some instructions from the Congress about which way you want us to go, because we don't think that we should be doing this through interpretations of out-moded, existing law.

That is not at all to say that some of the directions in which events are moving are not constructive. Take the interstate issue. I think that there ought to be some liberalization there. But forcing it through some peculiar channels of doubtful legality seems to me to have nothing to be said for it.

Mr. WYLIE. I think I appreciate your encouragement and admonition that Congress should act fairly early on to establish some better guidelines in the delivery of financial services. As you stated a little earlier, Mr. Chairman, this country has been incurring enormous deficits in its trade with its foreign partners. How is it that the U.S. locomotive and its importation of foreign goods has not been more effective in generating more of a recovery, particularly in the countries of Western Europe?

Mr. VOLCKER. I think the premise of your question, and I think it's quite proper a premise, is that what stimulus we have seen abroad—and we have seen some growth abroad—has been in considerable part directly related to the fact that they have such favorable export markets in the United States currently. That has been constructive. Your question is why don't they have a little bit more home-grown growth.

Mr. WYLIE. Yes.

Mr. VOLCKER. And that is a question that I have asked myself repeatedly over this period of time. I think we have to recognize, psychologically and otherwise, a situation in which the Unmed

States is attracting so much of their capital, which is reflected in a depreciating exchange rate for those countries vis-a-vis the dollar, is a factor inhibiting them in some instances, rightly or wrongly, from applying more stimulus at home.

More broadly, they have all been struggling with inflationary problems inherited from the past. They have all—I speak generally—place a lot of priority on bringing down inflation with very considerable success, even in the face of depreciating currencies. Our success in inflation is made easier by the fact that we have an appreciating currency. They have, at least vis-a-vis the dollar, a depreciating currency. That's made it more difficult. But they've had a high measure of success. They have fairly uniformly thought their budgetary deficits were too big as a structural matter, so they have been making great efforts to reduce their budgetary deficits and, in the process, there hasn't been much stimulus. Monetary policy is certainly affected by the condition of their currency.

They have been trying to reduce budgetary deficits. They have a capital outflow, so they haven't been operating, I think it's fair to say, in the most favorable environment. Nonetheless, I think your question is a very relevant one, and it does seem to me that there are opportunities in some of those countries, particularly the countries with the strongest external positions—Japan, Germany, to some extent—perhaps to take some stimulating action, perhaps by way of reducing taxes. Some of them have some plans for reducing taxes. The question arises, could they be speeded up?

They have a certain amount of preoccupation with structural problems in their labor market. I don't think there's any question to the extent they can deal with those, work on those, get a more flexible economy, they will be assisted. Those measures take some time. I don't think they offer any immediate remedy.

So we are left with a situation where the prospects for growth in most of the industrialized world is reasonable, if you just look at the percentage growth numbers. But those percentage growth numbers by and large are not big enough to reduce unemployment levels that average much higher than our unemployment levels now—historically, very high levels of unemployment.

Mr. WYLIE. Thank you. Thank you, Mr. Chairman.

Chairman FAUNTROY. The time of the gentleman has expired.

Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman. I would like to welcome Chairman Volcker as well and I appreciate hearing your testimony, getting a chance to ask you a few questions.

Probably the most publicized economic circumstance of the last couple of weeks has been the farm crisis. I have heard figures mentioned as high as \$150 to \$180 billion of liabilities out there in the farm sector. I have heard talk from the farm credit system that there could be circumstances under which they would not be able to survive economically. How would you categorize the threat of a real farm crisis? Most farm debt, as I understand it, is not Farmers Home; it's commercially financed by banks and other institutions. Assuming the worst happened, how close do you think we are from a farm crisis? How serious do you think it would be? What impact do you think it would have?

Mr. VOLCKER. For many farmers, it is a crisis. I don't think there is any question about that. They are under enormous financial pressure and strain, if they are heavily indebted. It's almost as simple as that. Let me put it that way, because the value of the asset is going down—if they went into this period with a debt ratio of upward of 50 percent, it is very hard to service that debt without simply borrowing more money and driving the ratios still higher and digging yourself in a deeper hole. A certain important fringe of farmers was heavily indebted, is heavily indebted, and is under extreme pressure. The numbers that come to my mind are about \$200 billion of agricultural debt, of which the farm credit system has something short of \$80 billion. Their assets may be close to \$80 billion, but their debt holdings are less than that, as I recall it.

The Farmers Home Administration, which, of course, is a Government agency, has, I think, something on the order of \$40 billion. The actual commercial debt in the banking system is by comparison only between \$40 billion and \$50 billion. Life insurance companies, individuals, and others, hold the remainder. Obviously, this is a threat to some rural banks that have heavy exposure in this area; it is a very serious problem, not only for those banks, but potentially for the communities that they serve.

I do not believe that this necessarily sows the seeds of a more general banking problem. These are mostly small rural banks that are pretty much fully insured by the nature of their business—as far as the depositors are concerned. In many cases, even if the bank failed, other banking resources would be developed in those communities. That may not be the case in some of the smaller communities where it becomes a community problem if the bank goes out of business.

We are in the very fortunate position that these rural banks, historically, have been among our strongest. They are well capitalized. They have been profitable right up until now, more profitable in relation to their assets than the bigger banks. They will experience some pressures and, undoubtedly, there will be some failures, as there were last year. But they do come into this period with a substantial financial cushion. And I think the same thing can be said about the farm credit system which has a high capital ratio.

The weakest loans tend to be the ones—and this is a matter of degree—in the Farmers Home Administration, which, of course, is a Government agency. However, it doesn't raise the same problems of financial threat that would be present in the private markets.

Mr. COOPER. Well, I hope, certainly, that the situation does not turn out to be one that spreads and can be confined to isolated, smaller banks. And I hope also, as you point out, that the smaller banks do have adequate capitalization.

The second question—regarding full employment. When I was in school, not too long ago, we were taught that full employment was 3 or 4 percent. Today, it seems to be substantially higher than that, and I can understand that. I just want to know, from a theoretical standpoint, what structural changes do you think have taken place in the American economy that might mean that for the foreseeable future, that full employment would be at the level of 5 or 6 percent?

Mr. VOLCKER. I think the changes that many analysts have pointed to in the past, perhaps most particularly during the 1970's, was the enormous growth in participation of women in the labor force. Also during that period there was enormous growth in the labor force and in the population, which meant a lot of young people who tend to have, at that stage, less permanent attraction to jobs, and more movement, more difficulty in getting jobs in the short run. There were some rather basic demographic forces at work in the 1970's that most people think were pushing up what I might call the natural rate of unemployment.

Some of those forces may be reversing themselves. It may be that during the decade of the 1980's, the analysis that suggested that reasonable full employment used to be 4 percent, has now risen to 6, to 6½—I suppose some people might say 6 to 7—may be going back down in the other direction. I haven't got any fixed and firm view about that. I think that is something that we find out over a period of time by experience.

Chairman FAUNTROY. Thank you.

Mr. COOPER. Thank you, Mr. Chairman.

Chairman FAUNTROY. Mr. Hiler?

Mr. HILER. Thank you, Mr. Chairman. Chairman Volcker, I think it was maybe when you testified before the other body's Banking Committee, that you indicated that the easing of money which had started in the fourth quarter of last year—

Mr. VOLCKER. It started in the third quarter. I interpreted it as less pressure on bank reserve positions.

Mr. HILER. Starting during the third quarter, that less pressure was going to—those instructions were going to be changed possibly to maintaining the current pressure and basically to stop the easing, but maintain the current pressure.

Mr. VOLCKER. I would repeat what I said last week. That is not the equivalent of tightening.

Mr. HILER. Without saying whether that is tightening or loosening, what caused you to make this determination? I mean, what was it that you saw, that the Board saw, that you felt justified—

Mr. VOLCKER. Let me cite several of them. One, quite clearly, in terms of taking the monetary targets as a basic point of departure, is that since November, the money supply in all its measures, and debt as well, has been rising rapidly, at a rate that, if sustained—that's a big if, but if it were sustained—would produce results over a longer period of time well in excess of our targets. The committee has not been alarmed, if that's the right word, as I said last week, by the current level of the various M's. But the trajectory has certainly been a fairly rapid increase in recent months.

At the same time, I think if one looked at the broad economic indicators, there was some evidence of renewed strength—greater growth in the economy—so you were not dealing, it appeared, against a weakening economic situation.

One factor that I think has gone in the opposite direction through this period has been the performance of the dollar in the exchange markets. That has been a moderating influence on any tendency to go in the other direction, which we haven't done.

Mr. HILER. So that if I can try to extrapolate from what you said, that it was the appearance that the economy was growing a little

bit better and that the growth rate of M1 in the period of the last part of the year had been picking up steam and—

Mr. VOLCKER. I would say all the M's; yes.

Mr. HILER. All the M's, and taken over a year, that the M's growth rate higher.

I am curious. The M1 growth for the year was 5.2 percent. So that when you took the 12 months overall, that is all that it went up. There were periods there where—in fact, I think for the last 6 months, M1 has only gone up about 3.2 percent or so, hasn't it?

Mr. VOLCKER. You could probably find some 6-month period. However, if you began at the beginning of the year, there was never any time that it was that low, but you can probably find the 6-month period during the year; yes.

Mr. HILER. Well, I was thinking that the last economic indicators book from the Joint Economic Committee indicated that the last 6 months have been in the low 3 percents for M1 growth.

Mr. VOLCKER. I don't recall the exact figure. But if you took June as a starting point, which is a relatively high number, there was basically no growth or very little growth for 4 months, following a high figure. That is right.

Mr. HILER. What impact does—in other words, when the Board meets and they look at things like what is happening with commodity prices to include metals and gold and other metals, look at land prices, what impact do the falling commodity prices, falling land values, have on the determination of the proper M1 or where to try to hit within the target of the M's, so that you come up with the sustainable, however you might define that level of growth, consistent with some stability?

Mr. VOLCKER. I don't honestly think I can answer that question in a really satisfactory way, because you are asking me to read the minds of 12 members of the FOMC and how they weigh this kind of thing. I am puzzled about that myself sometimes.

Mr. HILER. Since we are not in on the meeting and hear about it quite late after the meeting takes place, you are the best one we have to ask.

Mr. VOLCKER. I will try and answer, but I will tell you, I can't answer you with great precision. There is no equation and no formula out there, and I am sure different people do weigh it differently. In general terms, the kind of events that you recite—falling commodity prices, falling land prices, and so forth—I interpret them, anyway, as reducing short-term risk of a reignition of inflationary forces and as a sign that attitudes, behavior patterns, expectations are changing, and that's got favorable, as well as other aspects to it.

So, if you just look at that, that is not so much, although it could affect intelligent people's thinking, but I would think it affects less the kind of targets for the year that are set in a longer term perspective than it does the tactical decisions, the implementing decisions within the year as to how much to restrain or ease at any particular moment in time.

Mr. HILER. If I might just conclude, Mr. Chairman, my time has expired. So that maybe you could answer in a word, yes or no. Then it would be the Board's opinion that the commodity prices,

land prices, et cetera, fall not due to aspects of monetary policy, but extraneous to monetary policy—

Mr. VOLCKER. No; I don't think that is an either/or. They certainly react to monetary policy as well. They certainly do.

Mr. HILER. Thank you.

Chairman FAUNTROY. Thank you. Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman. Welcome back to this subcommittee, Mr. Chairman.

I'd like to just start off by saying that recently, in his State of the Union Message, President Reagan seemed to signal that he was in favor of the notion of tax reform, tax reform that would promote economic growth, presumably lowering unemployment, presumably reducing Federal budget deficits. Subsequent to that speech, in an interview with the Wall Street Journal, he also apparently signaled that he didn't really understand that part of the Treasury tax proposal that called for increasing taxes on businesses, while lowering, generally lowering taxes for individuals. We understand he is not a real detail man. [Laughter.]

I don't know what your reputation is as a detail man or not, but I want to just ask you some questions, if you don't mind, about Treasury tax proposals, particularly those that relate to capital accumulation, some aspects of the proposals that deal with changes in investment tax credit and ACRS and capital gains. Have you had an opportunity to think through any of those proposals and how they may or may not affect our economic expansion? Is that the kind of tax reform that you believe is likely to lead to stronger economic growth?

Mr. VOLCKER. I certainly have not looked at those in detail. I don't consider myself a tax expert particularly. It is clearly out of my area of responsibility, so I'm not going to give you a very full answer. I can say that the general thrust of the tax reform effort to broaden the base and lower the rate seems to me desirable. There is only one point of detail, if it is detail, that I would comment on from the standpoint of my responsibilities, and that is I do not like all this movement toward indexing. I think that that has unfavorable connotations for long-term policy. A lot of countries have gotten themselves into an immense amount of difficulty by thinking that they can cure problems by indexing things instead of by dealing with the basic inflationary problem.

As a matter of general philosophy, I would rather adopt economic policies that provide some reasonable assurance we are not going to have inflation; that is, that we not go running around trying to index everything.

Mr. CARPER. All right. Thank you. A couple of my colleagues have already talked about the strong dollar and what that does with regard to our ability to export and to sell abroad. Some of us believe that large budget deficits have an effect on strengthening the dollar. There are other factors that also affect or lead to the overvalued dollar. Could you just assess for us in your own judgment what are the factors that have led to the overvaluing of the dollar and maybe set them in some kind of priority? And finally, if I could just add, which of those do you think we in the Congress can and should do something about?

Mr. VOLCKER. I think the answer to the last part of your question is quite clear. To the first part of your question, I can only answer that there must be a great many factors at work. The classic factors of what your current account is doing and what your trade balance is doing I don't think are absent, but certainly the movement in the market is quite contrary in direction to what you would normally expect from a weakening trade balance in the short run.

The other factor that is typically cited and that you can measure is interest rates. Our interest rates are relatively high in nominal terms and in real terms and that undoubtedly helps attract capital and keeps American capital here, as well as attracts capital from abroad. But that also, I would think, is clearly not the only factor at work, and it may not even be the absolutely dominant factor during this period. We had some very substantial declines in nominal interest rates at least during the fall and the early part of the winter. And, during that period, the dollar on balance continued to rise.

I think there is a sense that because of the stability of the American economy, because of our political stability, because of the apparent opportunity for profits, flexibility, there is a lot of emphasis recently now placed upon the United States as a good place to have your money or your capital in real form.

But I think I have to emphasize also that everything is relative in this business, and there's a certain amount of pessimism about prospects elsewhere. That could change, consistent with the same prospects in the United States that would tend to shift these flows. Certainly, the absence of bank lending abroad, on balance, in any real size, is a reflection of distress in other parts of the world, as much as anything else.

You raised the budgetary question in this context. I would say it is against the background of a good deal of confidence and growth in the United States where the budgetary deficit, by helping to keep pressure on our interest rates and our financial markets, has contributed to the capital inflow. And the capital inflow, in turn, has helped to finance that budgetary deficit. There is kind of a symbiosis between the two; they live off each other. Unfortunately, I think the end of that road is not a very pretty picture, as I discussed earlier with Mr. Neal.

You asked me what the Congress can do constructively. You can do various things to get the dollar down. We could run a bad monetary policy, an inflationary monetary policy. That will get the dollar down, quicker than anything else, maybe, but it's not a very constructive action. I could imagine some actions that you would take that would not be very constructive, and because they were considered destructive, the dollar would go down. The question is what constructive things you can do. What is consistent with the health and growth of our own economy? And the answer to that seems to me crystal clear: you can deal with that budgetary problem.

Mr. CARPER. Thank you very much. My time has expired.

Chairman FAUNTROY. Thank you. Mr. Leach.

Mr. LEACH. Mr. Chairman, last week, in your conversations with the Senate and the President's press conference, some comments

were made that have been widely reputed to have caused the dollar to go up.

Would you care to say anything this morning to cause the dollar to go down? [Laughter.]

Mr. VOLCKER. It's certainly risen a lot, and the danger of all markets is that what rises excessively at some point may fall.

Mr. LEACH. I understand. Let me comment a bit parochially from my State of Iowa's perspective.

You mentioned earlier, and I think a little bit glibly, that lower monetary growth may be consistent with stability. I'm not sure that's true for all of America, and it's certainly not true in the heartland. I mean, we know that a lower monetary growth has caused the value of the dollar to rise, if one assumes the value of the dollar is determined by supply and demand and as the dollar goes up, the price of corn and soybeans goes down, as occurred precisely last week. And for other relationships, the price of hogs and cattle are going down as well.

One of the offshoots of monetary policy, as well as the fiscal policy, that is pro-import and anti-export, is that it has been very good for the large money center banks that have lent abroad because the only way they can be paid back is if other countries are able to export more than they import.

I would stress that the problem in rural America is very much like that of a developing country, and that if one were to look at Iowa today, one would be looking at a State that should be seen as part of the Third World. The terms of trade have turned against us.

Our banking system is in chaos. The farm credit system is about to reach comparable chaos. And the only way that we are going to be able to bailout our banks, bailout the farm credit system, is if we increase the return on investment to American farmers. That means, in essence, to bring stability to an Iowa farm economy. It very likely means to have a little more stretch in monetary policy.

So the question I would have is is the Federal Reserve Board prepared in its policies to be as sympathetic in looking at a State like Iowa as a Third World problem as it has in looking at Third World problems? You know, 80 years ago a great midwestern populist suggested that the rural heartland was being nailed to a cross of gold. And I'm not sure that today, we are not seeing our farmers nailed to a cross of the inflated dollar.

Mr. VOLCKER. I think it is considerably more complicated than that, if I may say so, Mr. Leach. First of all, you commented that the borrowing countries have to, in a sense, export their way out of the problem. There is a lot to that. I agree with that. But to avoid any misunderstanding, in terms of our own trade position, increasing exports from those countries count for a relatively tiny proportion of our problem. The overwhelming rise in imports has been from countries that are not underdeveloped, countries like Japan, Canada, and Western Europe. That is where the disequilibrium is so great.

Mr. LEACH. I share that perspective and that is precisely why one brings dramatically into question whether the Federal Reserve Board is correct in assuming that stability will be enhanced by lower monetary growth, which I think I am reflecting precisely—

Mr. VOLCKER. Let me get to that question and the awkwardness of our position. You can have as much monetary growth as is consistent with a trend toward stability in our economy. If we violate that precept, then you might get a declining dollar in the short run, but you are not going to get lower interest rates. You then have to ask yourself how we can finance this budget deficit?

Now taking your question, if we do nothing but ease money, in effect. Suppose we no longer get this capital inflow from abroad precisely because foreigners think the Federal Reserve is now embarked upon a more inflationary policy. You might argue that that environment would help farmers in Iowa. It is not going to help the homebuilder or the homebuyer or those looking to make investments in areas of the economy that are already under strain. It would simply reshuffle the problems from one sector to another sector. That is why I do not think that that problem is susceptible to any easy or, I might say, difficult monetary measure taken in and of itself. You would have quite a different situation if, at the same time, we were operating in a direction to reduce those demands from the budgetary side, but that is not the situation that we have.

Mr. LEACH. Well, I share your concerns. But one of the things—there isn't terrific economic consensus on this issue—a number of economists are arguing that a little greater monetary expansion will lower, not increase, interest rates.

Mr. VOLCKER. Since the beginning of time, a lot of people have argued that inflation is the solution for every problem. But I think we have learned a pretty hard lesson on that score recently.

Mr. LEACH. Well, I hear what you are saying to some extent. But I would also share that what is good for some parts of the economy is not good for all. And one of our problems right now is equity today.

Mr. VOLCKER. I do not disagree with that point. You can always debate, at least marginally, whether the policy should be tighter or easier. I accept that point, too. But I would simply urge that the unevenness in impact is very real and extreme in the economy at present. I do not for 1 minute minimize those problems in the farm sector. They are very great—and basically stem from some imbalances in policy. You have to come back, I think, to the imbalance in the deficit. I do not know how the problems can be cured without curing that underlying imbalance. That is the basic thrust of my statement submitted this morning.

Mr. LEACH. Well, I will not prolong this, other to say that I think most members of this committee are in sympathy with your issue on the deficit and we accept that, although it's unclear that lowering the deficit necessarily will cause the United States to become a less attractive place for foreign investment. It could become the very reverse.

Mr. VOLCKER. I cannot predict the market. The dollar has obviously gotten quite high. But you could tell me that if suddenly the deficit was reduced, people might have an added dollop or more of confidence—maybe more than a dollop—and that the short-run impact might be to send the dollar higher. I would say then that I think that is not the way the basic economic forces operate over a

period of time and, at that point, your question about monetary policy becomes much more relevant.

I can't respond to that situation because of the basic underlying imbalance that will shift the problem from one sector to another and that would have been taken care of if you did enough.

Mr. LEACH. I appreciate your comments.

Mr. VOLCKER. You have quite a different setting.

Mr. LEACH. I would only conclude by saying, we are going to deal with a farm bill in the next few days in the Congress. It is of trivial consequence compared to what you decide at the Federal Reserve Board. And all I am suggesting is that we from the farm States are hopeful for a great deal of concern reflected in Federal Reserve Board decisionmaking.

Thank you.

Chairman FAUNTROY. The time of the gentleman has expired.

Mr. Erdreich.

Mr. ERDREICH. Thank you, Mr. Chairman. Chairman Volcker, I appreciate your appearing before us again. I am trying to get some perspective on where we are to get some idea of what we should be doing. Would you give me some guidance as to what, in your view, are the specific policies enacted by Congress over the last 3 or 4 years that have been a driving force toward the recovery that we are now experiencing?

Mr. VOLCKER. I suppose I would have to say that, while it reflected no single act, or even deliberate act, on the part of the Congress, that deficit pours out a lot of purchasing power. When you start in the middle of a recession, it gives some driving force to the economy. Carried into the prosperity phase of a cycle, it gives rise to very considerable distortions in the economy.

Mr. ERDREICH. So you are saying that if you look back over the last 3 or 4 years, the major activity of Congress in producing these huge deficits is what has pulled us into recovery?

Mr. VOLCKER. That is not the only factor.

Mr. ERDREICH. Is that the major one, though?

Mr. VOLCKER. It is a factor. There are natural forces in the economy. I hesitate to give monetary policy credit, but it has been performing during this period, too.

Mr. ERDREICH. Correct, however, I am just looking for legislative acts of this Congress over the past few years.

Mr. VOLCKER. Correct.

Mr. ERDREICH. I would agree that monetary policy has been a part of that force, and it is why we are where we are today in 1985. I am trying to get some sense, though, of what you would suggest that Congress should do as far as legislative action to assure continued recovery beyond what, I agree is the necessity to push the deficit down. Are there any other specific acts that you would urge that we proceed upon besides the deficit reduction as legislative acts of this Congress?

Mr. VOLCKER. Certain things, I must confess, and let me take the opportunity to say them, come to mind as to what you should not be doing, such as yielding to protectionist pressures. That is another kind of short-run response you can make to this basic imbalance. But I think it would be totally counterproductive over a period of time.

I think what you can do to work toward improving incentives in the economy and improving efficiency in the economy. Both are always helpful. It works over a longer period of time. The tax reform proposals go in that direction. I think that they can be of assistance in a very basic way toward a stronger economy in the future.

I don't think the economy needs any other actions I can suggest. Compared to reducing the deficit and dealing with some of these basic tax issues, I think other suggestions pale in significance in terms of impact on the growth and health of the economy over a period of time.

Mr. ERDREICH. Last year, you told us that foreign capital in-flows would be about \$80 billion. What was the actual amount last year, and what are your expectations this year?

Mr. VOLCKER. I probably expected \$80 billion last year. It turned out to be \$100. I suppose our expectation on the present trajectory would be somewhat above that. I don't have any particular figure in mind. It is still rising.

Mr. ERDREICH. So that would be better than half.

Mr. VOLCKER. What you are running into now, even if the trade balance stabilized, and I do not think it has yet, is that you will begin paying the interest on all the debts that we incurred last year. Thus the current account will get worse faster than the trade account gets worse, and it is the current account that's the measure of the overall capital inflow. So you are at \$100 billion and moving higher.

Mr. ERDREICH. Do you expect that that will then finance about half our deficit?

Mr. VOLCKER. If you just offset one against the other, yes.

Mr. ERDREICH. Do you also expect the value of the dollar to stay about at its current level this year?

Mr. VOLCKER. I have no particular expectation on that score. Any expectation I had a year ago would have been wrong, and I will not make any prediction this year. It has gotten very high, as you know.

Mr. ERDREICH. All right. Thank you, Mr. Chairman.

Thank you, Mr. Chairman.

Chairman FAUNTROY. Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman. Chairman Volcker, you have alluded throughout your testimony to the foreign investment and the \$100 billion that came in last year. I would like to focus on that and, again, your opinion of what potential is there for that foreign investment to diminish or go away; in other words, for that figure to become perhaps even a negative. And, if it did trend in that direction, what would be the result of that occurring to our economy?

Mr. VOLCKER. Let me distinguish between two events, if you will. The incentive to put money in the United States could in time prove to be quite fragile because, it is dependent, probably encouraged in part, by expectations of a strong dollar. If those expectations change, if something arises either in the United States or abroad to change the relative assessments of where it is best to put your money, this thing could change rapidly. And, if the dollar began declining, expectations would run against you. We do, obvi-

ously, operate from a position of considerable strength. There is a good deal of confidence in the United States. I also would not expect in the foreseeable future conditions where our banks or others will begin investing large amounts abroad again, as they did during the 1970's, which is part of the reason the net inflow is so large.

But when you ask about actually slowing down the capital inflow or actually turning negative, let me say we cannot do that in the short run. The only way we can export capital is by running a current account surplus. That is the only way that we can finance, on balance, the capital outflow. People might try to take their money out, but, on balance, they cannot unless they are also willing to take our goods. And it takes a while for the trade balance to change. Even in the most favorable circumstances, it changes rather sluggishly. So, in effect, we are hostage to or hooked on foreign capital for a while. When you ask about the motivations to send in the foreign capital, you are really raising a question as to what is the price? What is the price in terms of the exchange rate and what is the price in terms of the interest rate?

Quite clearly, it seems to me, one of the hazards we are running, is that if those motivations changed importantly and we didn't so easily get the increasing amounts of foreign capital that we are going to need, the impact on interest rates could be quite decided and then the pressures come back on the domestic market and you get the squeezing and the crowding out that people feared on domestic investment. That is precisely the risk.

Mr. CHANDLER. That was the answer I was interested in and I very much agree.

Now, you stated earlier that there tends to be a disincentive because of the lack of confidence abroad. Yet, you said that some of those governments are taking steps to turn that situation around. Also, if the United States does deal decisively with its deficit, that would, in effect, have downward pressure on the strength of the dollar. Then does that, in a sense, create this disincentive to invest here that you referred to? Or are we chasing our tail here?

Mr. VOLCKER. But that is in a quite different setting, ideally. It would be wonderful if things worked out that smoothly. However, if you had reduced demands on our internal market from a reduction in the budget deficit, moving along more or less in line with reduced capital inflow and a stronger trade position, a reduced trade deficit, then you do not have these adverse implications for the domestic financial market because you are relieving the pressures on the one side as they are being potentially increased on the other side. That is precisely my argument. That is why I urge that you get prepared for this situation.

Mr. CHANDLER. So that the bottom line is, deal with that deficit or face higher interest rates, or depend upon an increasing flow annually of this—

Mr. VOLCKER. Precisely. And I cannot predict when that flow might stop. But in the best circumstances, it is an aggravation of what we have now. The economy looks all right in some overall sense, but it's increasingly dependent upon foreign capital inflows, which is the same thing you are saying: bigger trade deficits with

increased strains on all those sectors of the economy that are related to trade, including agriculture.

Mr. CHANDLER. Yes. At some point it's going to go "sproing."

Mr. VOLCKER. It will not if we took the right actions.

Mr. CHANDLER. But without it, it is going to say "sproing." Gee, I wish you'd let me get quoted there, Mr. Chairman, saying "sproing."

Mr. VOLCKER. "Sprawling" was the word you used?

Mr. CHANDLER. "Sproing," like a spring going— sproooooiinnngggg. [Laughter.]

Mr. VOLCKER. It's an increasingly uncomfortable situation. We are putting ourselves at unnecessary risk, in my judgment.

Chairman FAUNTROY. Thank you, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman. I want to ask you if you would address some of the criticisms that have been leveled at your work. There have been some gains, but there also are some critics.

Recently, within the last year, we were told that the Federal Reserve Board's destabilizing actions have to stop and that we need coordination between fiscal and monetary policy, timely information about Fed decisions, and an end to the uncertainties people face in obtaining money and credit. Does that seem to you a fair criticism? What can we do about it?

Mr. VOLCKER. It is a little too general for me to respond. Which aspect would you like me to address?

Mr. FRANK. I am reading from the Republican platform from 1984 on which President Reagan ran. So it is a little hard for me to supply more specifics. Perhaps my colleagues on the other side who also ran on that can give you some of those specifics.

[The "Text of the 1984 Republican Party Platform on Monetary Policy" under unanimous consent by the subcommittee was inserted in the record by Congressman Frank at this point:]

Text of 1984 Republican Party Platform

Following is the text of the 1984 Republican Party platform, as adopted Aug. 21 at the party's national convention in Dallas (Story, p. 2076).

PREAMBLE

This year, the American people will choose between two diametrically opposed visions of what America should be.

The Republican Party looks at our people and sees a new dawn of the American spirit.

The Democratic Party looks at our nation and sees the twilight of the American soul.

Republicans affirm that now, as throughout history, the spiritual and intellectual genius of the American people will create a better nation and maintain a just peace. To Republicans, creativity and growth are imperatives for a new era of opportunity for all.

The Republican Party's vision of America's future, the heart of our 1984 Platform, begins with a basic premise:

From freedom comes opportunity, from opportunity comes growth, from growth comes progress.

This is not some abstract formula. It is the vibrant, beating heart of the American experience. No matter how complex our problems, no matter how difficult our tasks, it is *freedom* that inspires and guides the American Dream.

If exercising freedom on freedom and it dies — then securing freedom at home and around the world, is one of the most important endeavors a free people can undertake.

Thus, the title of our Platform, "America's Future, Free and Secure," is more than a summary of our Platform's message. It is the essence.

The Democratic Party's understanding of this "It thinks" of country has passed its peak. It offers Americans redistribution instead of expansion, contraction instead of growth, and despair instead of hope. In foreign policy, it asserts the rhetoric of freedom, but in practice it follows a policy of withdrawal and isolation.

The Democratic Party, in its 1984 Platform has tried to appropriate the optimism and vision that marked the 1980 Republican Platform.

Rhetorical pilfering of Republican ideals cannot disguise one of history's major ironies: the party whose 1982 standard-

bearer told the American people, as president, that all we have to fear is fear itself has itself become the party of fear.

Today we declare ourselves the Party of Hope — not for some but for all.

It has been said that mercy must have a house; heart, and not a human face. We agree. Democrats measure social programs in terms of government activity alone. But the divine command to help our neighbor is directed to each individual and not to a bureaucratic machine. Not every problem cries out for a federal solution.

We must help the poor escape poverty by building an economy which creates more jobs, the greatest poverty fighter of them all. Not to help the poor is to abandon them and demean our society, but to help the poor without offering them a chance to escape poverty is ultimately to degrade us all.

The great tasks of compassion must be accomplished both by people who care and by policies which foster economic growth to enhance all human development.

In all these areas, at home and abroad, Ronald Reagan has demonstrated the boldness of vision, the optimism for our future, and the confidence in the American people that can transform human lives and the life of a nation. That is what we expect from a President who, wounded by an assassin, walked his way into a hospital and cheerfully assured the world that he and his country would not be deterred from their destiny.

His example has shaped the 1984 Republican Platform, given it meaning and inspired its vision. We stand with President Reagan and with Vice President Bush to make it a reality.

ECONOMIC FREEDOM AND PROSPERITY

Monetary Policy

Our 1984 Platform promised to bring inflation under control. We did it. This cruellest tax — hitting hardest at the poor, the aged, and those on fixed incomes — raged up to 13.3 percent under Carter-Mondale. We have brought it down to about 4 percent and we strive for lower levels.

The effects of our program have been dramatic. Real, after-tax incomes are rising. Food prices are stable. Interest rates have fallen dramatically, leading to a resurgence in home building, auto purchases, and capital investment.

Just as our tax policy has only laid the groundwork for a new era of prosperity, reducing inflation is only the first step in restoring a stable currency. A dollar now should be worth a dollar in the future. This allows real economic growth without inflation and is the primary goal of our monetary policy.

The Federal Reserve Board's destabilizing actions must therefore stop. We need coordination between fiscal and monetary policy, timely information about Fed decisions, and an end to the uncertainties people face in obtaining money and credit. The Gold Standard may be a useful mechanism for realizing the Federal Reserve's determination to adopt monetary policies needed to sustain price stability.

Domestically, a stable dollar will mean lower interest rates, rising real wages, guaranteed value for retirement and education savings, growth of assets through productive investment, affordable housing, and greater job security.

Internationally, a stable dollar will mean stable exchange rates, protection for contract prices, commodity prices which change only when real production changes, greater resources devoted to job creating investment, less protectionist pressure, and increased trade and income for all nations.

Mr. FRANK. We do have a situation where the Republican platform says that your destabilizing actions have to stop you and your colleagues. It says that we don't have coordination between fiscal and monetary policy. We don't have timely information about your decisions. And we have too many uncertainties that people face in obtaining money and credit. It seems to me that that's a criticism from a fairly substantial source and we ought to get some response to it.

Mr. VOLCKER. You all understand I did not write the platform. I'm not an expert on—

Mr. FRANK. No, I understand that. But you realize, objective rules—

Mr. VOLCKER [continuing]. The exegesis of what it means.

Mr. FRANK. Objective rules—we don't only have to ask you about things you said.

Mr. VOLCKER. I understand. But I would like to understand the question. We'd better take it up in parts. What is part No. 1?

Mr. FRANK. Is this the first time you have addressed this? I mean, the Republican national platform on which the President runs makes this solemn statement in August and it is now February of the following year.

It seems to me that I would have expected, frankly, a little more attention. I know party platforms are not holy writ, but they ain't chopped liver, either. I think you ought to pay a little attention to them. The first part is that your destabilizing actions must therefore stop.

Have you stopped destabilizing our economy? [Laughter.]

Mr. VOLCKER. I have to deny the premise. [Laughter.]

Mr. FRANK. Let me ask you in general, and I'm disappointed, frankly, that you are not going to join this issue. It is a serious issue. We have the President's party. They are in office making some fairly substantial criticisms. Some of those have continued. You are aware that there have been criticisms.

I think we may be having a situation where some people want to have their cake and eat it, too. They want to take credit for a tight monetary policy having reduced inflation, but they want to blame that same tight monetary policy because there are other problems. Those are questions that I think ought to be addressed.

Mr. VOLCKER. I will try to address it, but I address it with some trepidation, not knowing quite what you refer to.

Destabilizing—there has been a lot of criticism. It is a rather hoary old question about stabilizing the money supply month to month or quarter to quarter. The money supply was actually fairly stable last year. We have a relatively stable money supply relative to foreign countries. I do not, myself, think that stabilizing the money supply from month to month or quarter to quarter is the be-all and end-all of policy. Indeed, I think that could produce an un-stabilized economy, and I'm interested in stabilizing the economy more than I am in the money supply. Is that an answer to that question?

Mr. FRANK. I think it's a reasonable answer, although, again, I am a little puzzled that you seem to think that somehow you are surprised to be asked to respond to some fairly fundamental criti-

cism. Have you asked some of the people over there what they are worried about?

Let me put another one because the answer probably is no. There have been criticisms voiced publicly—I assume you have heard *some of them privately from some people in the administration*—that you have been too tight in the monetary policy at various parts of the year.

Your own Vice Chairman, Mr. Martin, has indicated some of that. I wonder if you would care to respond to that.

Let me just ask you a specific question. Is it your impression that the administration, specifically the President, has been supportive of *your monetary policy actions in these past couple of years*? Have there been a series of—and have there been any disagreements and what were they?

Mr. VOLCKER. Obviously, there is some disagreement. But if you ask me, broadly, are they supportive of the general thrust of the policy—

Mr. FRANK. No, I didn't ask you broadly because you don't like broadly. I asked you specifically.

Mr. VOLCKER. Specifically, I'm aware that criticisms have been made from time to time. You are aware of them, too.

Mr. FRANK. Yes. Well, you have only read them? Have people not communicated them to you privately?

I mean, we read in the paper suggestions, assertions, that monetary policy has been too tight, that the slowdown last year that we had—

Mr. VOLCKER. In fairness to me, and maybe to them, a lot of the articles I have read in the newspapers has been a concern that it might be, rather than it has been.

Mr. FRANK. So you have not been told by the President, the Secretary of the Treasury, past or present, or Mr. Sprinkle or other major economic officials of the administration that you have been too tight and that the slowdown was in part caused by excessively tight monetary policy? No one has communicated that to you directly?

Mr. VOLCKER. I am not going to discuss all my conversations with the President. But I would think, basically, the answer to that before the event is "No."

Mr. FRANK. So that representations we have had, I would infer from that, that some of these slowdowns weren't, therefore, because you were out there independently doing monetary policy, are inaccurate. I think that's an important point because we get people—

Mr. VOLCKER. You get a different question as to whether people looking backward have a different view.

Mr. FRANK. Oh, all right. Well, then, let me ask you a different question. Have they after-the-fact told you that you made some mistakes and did they on those occasions differ from your own analysis? Obviously, people make mistakes after the fact.

Mr. VOLCKER. I do not think as directly as that.

Mr. FRANK. OK. So that neither prospectively, nor retrospectively—

Mr. VOLCKER. You have read the statements in the paper, apparently, as much as I have.

Mr. FRANK. Mr. Volcker, if all I wanted to do was read the paper, I would be at my office right now. I mean, I'm asking you to comment on these things.

Mr. VOLCKER. I read the papers, too. We both read the papers and that is our common ground, then, as to what they said about our policy.

Mr. FRANK. Well, all I can say, Mr. Chairman, is I am worried Will Rogers wasn't around if I just wanted somebody who all he knew was what he read in the papers. I suppose we might have had him to ask as a witness.

I am disappointed, Mr. Volcker. There is a political point here, but there's also a substantive point. We have gotten suggestions, and more than suggestions, from the platform and elsewhere, that there are some differences between the administration and yourself on monetary policy. I think they ought to be discussed. I think your refusal to discuss them by saying, well, read the papers, isn't helpful.

Mr. VOLCKER. I think you have to be a little more specific. I think there are differences in views in the administration as to what monetary policy should be.

Mr. FRANK. I couldn't have been more specific when I asked you about the President, the Secretary of the Treasury, Mr. Sprinkle. And what you told me was, well, you're not going to discuss your conversations. I could read it in the papers.

I mean, if I am too specific, that is no good. If I am too general, that is no good. So I give up. I am out of categories. How can you expect me to ask you questions?

[Pause.]

Chairman FAUNTROY. The time of the gentleman has expired.

Mr. FRANK. Thank you.

Chairman FAUNTROY. Mr. McCandless.

Mr. McCANDLESS. Thank you, Mr. Chairman.

Mr. Volcker, I would like to shift gears for a minute, if I may, into another subject area—the mechanics of the banking, savings and loan industry from Chairman Volcker's point of view of the Federal Reserve Board.

Do you see some things here in the area of, priority areas of policy change that we here in the Congress should be looking at as far as the mechanics of the industry are concerned?

Mr. VOLCKER. Yes.

Mr. McCANDLESS. And if so, could you share some of those with us?

Mr. VOLCKER. I think there are a series of issues that the Congress began to deal with last year that are still very much relevant and we so urgently need congressional guidance. We need guidance on this question of the loopholes that I touched upon a bit earlier with Mr. Wylie, the nonbank bank issue, for one. We clearly need some action there. It is not just a question of the banks, it is of the thrifts, too; a similar problem exists there.

We urgently need, I think, some guidance about where the balance of Federal and State authority is, where we have so many States going out providing very wide-ranging authorities. Indeed, at the extreme, saying a banking institution can do virtually any-

thing, or a thrift institution can do virtually anything; what is public policy there?

We clearly need movement on the interstate banking area and the powers area. It was among those developed last year. I think it's a logical and necessary complement to some of these other problems and needed legislation.

There is a very sizable agenda that I think urgently needs action, because, as I said earlier, probably before you came in, that action is taking place. The only question is whether it's going to be through loopholes, as lawyers find their way through it, through uncoordinated regulatory decisions, or whether it's going to reflect some cohesive sense of congressional direction. That is what's lacking now.

Mr. McCANDLESS. There appears to be, at least in my part of the country, a proliferation of institutions, both banking and savings and loan, new charters which bring about obvious things, such as eager management, higher interest payouts, easier loan policy, from the Federal Reserve point of view. Do you find this to be a problem?

Mr. VOLCKER. Sometimes, I find it to be a particular problem if there is a proliferation of semibanks or nonbanks, or whatever, that are operated outside the general framework of banking regulation and violate what I have always taken to be some basic precepts of public policy. I think a mere variety of financial institutions can be a good thing if they come within some general framework of appropriate regulation and surveillance.

Mr. McCANDLESS. Are enough regulations on the book currently, in your opinion, to address this?

Mr. VOLCKER. We have got lots of regulations. The question is whether—

Mr. McCANDLESS. Policy, then. Policy, rather than regulation.

Mr. VOLCKER. I think we need some policy decisions. There is a great deal of confusion out there as to what will be allowed in the future. People are going now where they think they can go, rather than within present law, which may be outmoded. That law needs to be liberalized in some instances. But it is very hard to defend what is going on now—that is institutions going through the cracks rather than doing what makes sense from the standpoint of either the private markets or public policy. Private markets are motivated to go where they can go or think they can go legally. Some very novel interpretations of established banking policy are put forward.

Mr. McCANDLESS. And finally, Mr. Chairman, if I may, I would like to ask your opinion on how you think this foreign loan portfolio is maturing on a scale of 1 to 10.

Mr. VOLCKER. Is one good or bad?

Mr. McCANDLESS. 10 is a 10.

Mr. VOLCKER. 10 means it is all solved?

Mr. McCANDLESS. Yes.

[Pause.]

Mr. VOLCKER. Six or seven, I don't know. There is progress both in the sense of improvement in the economic conditions and balance of payments of the borrowing countries. It was very heartening. There is progress in the sense of negotiation of some long-term restructuring agreements that I think are very positive. But I

think it would be a mistake to say that that progress last year means the problem is behind us.

We have had some developments recently that illustrate very vividly that the problem is not behind us, that there are still many difficulties that could arise before I would be willing to give this a 9 or a 10, in the sense that you don't have to worry about it. It is going to be a continuing concern for these countries to achieve and be able to achieve—not only economically, but in a stable political context—a sustained pattern of growth and external equilibrium that you have to achieve in the end to put this problem behind us. There is a lot of short-term progress but a lot of long-term effort is still going to be required.

Mr. McCANDLESS. Thank you, Mr. Chairman.

Chairman FAUNTROY. The time of the gentleman has expired.

Mr. McCANDLESS. Thank you, Mr. Chairman.

Chairman FAUNTROY. Thank you. Before yielding to Mr. Vento, a member of the full committee, I yield for a unanimous-consent request.

Mr. FRANK. Mr. Chairman, thank you. I ask unanimous consent that the text of the Republican platform from 1984 on monetary policy be inserted in the record at the point at which I raised my questions. I am sure that none of my colleagues on the other side object to enshrining their party platform in the record of the hearing.

Mr. HILER. Will the gentleman yield?

Mr. FRANK. I will yield to the gentleman.

Mr. HILER. Will that be as a dissenting view or a supplemental view?

Mr. FRANK. It will simply be as an illustration to the public.

Chairman FAUNTROY. Without objection, so ordered.

[The text of the Republican platform from 1984 on "Monetary Policy," under unanimous consent by Congress Frank may be found of p. 111.]

Chairman FAUNTROY. The gentleman from Minnesota, Mr. Vento, is recognized.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Volcker, the dollar value increases that have been going on obviously are causing serious difficulties. Do you have any plan to meet with your central bank counterparts in other parts of the world in the next weeks or months to address this particular concern?

I note that there has been some intervention. I think in the past you have said that if there is a disorderly and unstable situation, that that would necessitate involvement.

Is this disorderly and unstable? What are you going to do with regard to dollar imbalance, if anything?

Mr. VOLCKER. I cannot tell you precisely what we are going to do. Do I have any special meetings scheduled or contemplated? The way I interpret your question, the answer is "no." But do we meet from time to time? Are we in frequent contact on the telephone? The answer is "yes." There is no shortage of ability to get together.

Mr. VENTO. Have recent actions been coordinated with you or have you been aware of recent actions—

Mr. VOLCKER. Yes.

Mr. VENTO [continuing]. To try and buoy up the various currencies?

Mr. VOLCKER. Yes.

Mr. VENTO. Have you got any reactions to those initiatives or efforts? Have they been helpful or harmful?

Mr. VOLCKER. The proof of the pudding is in the eating. I cannot say whether there has been any dramatic success from recent actions. I think there is a question of whether actions were taken forcefully enough, including any interventionary actions.

Mr. VENTO. Did you discourage? Encourage? How would you characterize your response or advice to those that said they were going to take action? Did you take any action yourself or recommend that the Treasury of the United States take any action?

Mr. VOLCKER. From time to time; yes.

Mr. VENTO. You have recommended that the Treasury take action? You have encouraged the action of other central bankers?

Mr. VOLCKER. You said recommended that Treasury take action. I do not know what action you are thinking of. There are two kinds of action that other countries have taken. Some of them have taken policy actions in the sense of monetary policy or other kinds of policy. And there has been intervention in exchange markets.

Mr. VENTO. I am thinking of intervention. I am not thinking of their basic economic programs.

Mr. VOLCKER. I am not sure that they are separable because I think intervention can be a useful tool at times. It certainly is a tool, in my opinion, that ought to be in our armory for use on suitable occasions. At the same time, I do not think intervention is likely to be the answer to these problems standing alone. It has to complement more basic actions and more basic directions.

Mr. VENTO. What happens if there is some decline in the value of the dollar, or rather, you know, almost as dramatic an increase in value or decrease in value as there has been increase in value with regards to the import question and inflation, Mr. Volcker?

Mr. VOLCKER. I think some decline in the dollar would be of no concern in that sense. The dollar has gone up very rapidly recently. If we retrace those grounds, I do not think that is a source of any disturbance. In the long run, it would moderate the adverse impact of this higher dollar in our trade position. If it began moving beyond reversing recent movements, it depends upon the rapidity of the move. It also depends upon the surrounding circumstances, including that question of the deficit that we discussed earlier. But that is one of the risks in the outlook for inflation; I do not think there is any question about that. I know the FOMC members, in setting forth their projections this year, for instance, decided, rather arbitrarily, to say, "We'll assume no important change in the dollar one way or another in making these projections."

Mr. VENTO. They are already wrong.

Mr. VOLCKER. And particularly on the inflation side.

Mr. VENTO. They are already wrong.

Mr. VOLCKER. They are already wrong on the up side. That is right.

Mr. VENTO. On the up side; yes.

Mr. VOLCKER. I think they were probably more worried at that time about the down side.

Mr. VENTO. Doesn't this indicate, especially in this short period of time, a certain amount of volatility that is unacceptable from a standpoint of our economy?

If this were to continue, this particular trend, over the next few months in terms of driving up the dollar, it seems like they're saying there's no ceiling in sight. Isn't this really going to necessitate a different response to intervention here, I assume in coordination with other central bankers and coordination with the—

Mr. VOLCKER. I think that is a question that is constantly reviewed. I do not like what has been going on in the markets and the volatility or necessarily the direction at this point. If I knew an easy answer to it, I would either apply it or recommend it.

Mr. VENTO. I don't think there are any easy answers. I don't think an easy answer is the deficit or changes in the economy. I think this thing is getting out of hand and I'm concerned about it. I want to express that particular concern to you, and I realize the answer—

Mr. VOLCKER. I understand the concern.

Mr. VENTO. You talked about the banks and the problem with Continental Illinois and its liquidity problems. Can you give me any answer to the question of quantifiably, how much money is being raised now on a liquidity basis every day by U.S. banks in the international marketplace?

Mr. VOLCKER. I cannot give you a figure offhand, but it is a very large amount.

Mr. VENTO. What is the effect of that in the dollar imbalance question, Mr. Chairman? Do you attribute or ascribe any problems to the liquidity issue and the money being raised—

Mr. VOLCKER. It is related in the sense that banks go to the international market to raise money as a matter of course. They will press that money-raising process more strongly the more they need money at home, the higher interest rates are at home. In that sense, it is certainly related to the overall imbalance on our markets at home, where we have an excess of demand relative to savings. Banks raising money abroad is part of the process by which we balance out the internal economy. So, there is that underlying relationship.

Mr. VENTO. I would like for the record an answer, the quantifiable one, and I guess that one brief question is do you think that the tradeoff in terms of the higher interest rates has been a good tradeoff in terms of our economy? Is that a good tradeoff, the higher interest rates and deficit issue?

Mr. VOLCKER. It is a tradeoff that we have been forced to live with. It is not desirable in the sense that I would rather have a different result, the lower deficit and lower interest rates. I think that that would be much more desirable in terms of the sustainable growth of the economy.

Chairman FAUNTROY. Thank you. The gentleman from Connecticut, Mr. McKinney, a member of the full committee.

Mr. MCKINNEY. Thank you, Mr. Chairman. I just want to apologize to the chairman. I had to be at another hearing. Since I wasn't here, I certainly don't want to take up his time. I also want to congratulate him on doing what I consider an absolutely superlative job.

Mr. VOLCKER. Thank you.

Chairman FAUNTROY. Thank you. In that regard, as we prepare to go to a second round, we did note, Mr. Chairman, that during the Humphreys-Hawkins hearing in the other body, Senator Proxmire expressed the hope that you would remain as Chairman for the full duration of your term. Inasmuch as you have not given any indication of your intentions, despite the various press comments from time to time, I would like to express a similar hope—that you will serve your full term. While we have made much progress in our economy, there is still much work to be done and many hopes to be fulfilled and needs to be met. Thus I encourage you to continue to take this challenge and remain at your post.

Mr. VOLCKER. Thank you, Mr. Chairman. I wonder whether I could maybe give you an even more apropos quotation that Senator Proxmire had at that hearing when he quoted Disraeli. You may appreciate it at this point in the hearing: “The thing that has driven more men mad than love is the currency question.”

Chairman FAUNTROY. I see. Mr. Schumer.

Mr. SCHUMER. Thank you very much, Mr. Chairman. I can tell you, Mr. Chairman, that love has driven me far more crazy than the currency question. [Laughter.]

Mr. VOLCKER. I see where your priorities are. [Laughter.]

Mr. SCHUMER. I hope so. [Laughter.]

I am not saying which has made me happier or sadder in my life. [Laughter.]

In any case, I have two questions. Before I do, I would just like to add my sentiments to those of Chairman Fauntroy. I think you’ve been an outstanding Chairman. I hope you will stay on. I think much of the credit that is given to 1600 Pennsylvania Avenue for this economic recovery belongs over at the Federal Reserve Board, not where it is being given.

I have two questions. The President has put us in an almost impossible position here in Congress, sticking to his increase in defense spending, which we know will be dropped some, insisting that COLA’s for social security be given, and then saying that we can reduce the deficit by totally eliminating some programs, which you and I know is politically nothing short of a joke because it just won’t happen. That leads me to the conclusion that if we are going to reduce the deficit by \$50 billion, which is the number that you have stated is required and all of us seek to do, we are going to have to have some kind of revenue increase, because we just will not eliminate the 17 or 18 major programs that the President has proposed. So our choice is really to increase revenues or reduce the deficit by less.

If that were the only choice available to us, decrease the deficit by approximately \$30 billion or decrease the deficit by \$50 billion with, say, \$20 billion in revenues from an oil import tax or a corporate minimum tax, which would you prefer? I am not asking which taxes, but just the overall.

Mr. VOLCKER. I do not want to be pinned down on precise arithmetic, but I have expressed for many years the opinion—and I did it again this morning—that the more you can do on spending, the better from an economic standpoint. Do it all on the spending side.

If you can't do it on the spending side and do some minimum mass, then I think you have got to turn to the revenue side.

I don't want to get into a discussion of particular revenues, but to the extent that it can be done in a way that least hampers incentives, I think the better off you will be. I also think the present tax structure, the present income tax structure, in particular, is very heavily strained with its relatively high marginal rates and lots of exemptions and all the rest. It's hard to put more pressure on that structure in its present form. That, I suppose, introduces the relevance of tax reform.

Mr. SCHUMER. What would you think, without commenting whether you're for it or against it, but just giving us some parameters to judge against, something like a 25-percent minimum tax on all gross income for all individuals, all corporations whose income was above \$100,000?

Mr. VOLCKER. I simply don't have the competence to—

Mr. SCHUMER. Fine. I didn't think you would. The second area of questions is IMF. In today's New York Times, there was a headline stating: "Rekindling Is Seen of Latin Debt Crisis."

It leads me to two questions. First, do you think that the debt crisis is being rekindled? Do you think we have major problems ahead of us because of the failure of the banks to agree to the plans that have been offered and, it seems, the bucking by some of the Third World countries of the type of austerity demanded by the IMF. Even Mexico, which is in the best shape, has undergone a pretty severe recession, and may say they don't want to retrench any longer.

Mr. VOLCKER. Mexico is growing again, which is a very favorable development, and I think Mexico will reach agreement on this third year IMF program and that restructuring will go through.

But you ask, is the problem being rekindled? I would prefer not to use the word, "rekindled" because it was never out. I don't know whether the word, "crisis" is appropriate—

Mr. SCHUMER. There was a headline a few weeks ago that said—

Mr. VOLCKER. There have been fluctuations of opinion and commentary about this, but the problem has persisted. There has been some real progress. But a feeling of euphoria that the problem was over was never justified. We see some evidence of that now in a number of Latin American countries where they still have a real struggle in restoring the kind of domestic stability and equilibrium that is necessary, even to support the progress they made in the past.

There has been dramatic progress in Brazil externally. There has been very considerable progress, I think, in improving the flexibility of their internal economy, pricing policies, reduction in the budgetary deficit, for a period of time. At the same time, inflation has been rising. So long as that is the case, there's going to be a feeling of uncertainty about the permanence of some of this improvement. For example, Argentina is still at a much earlier stage than these other countries and is clearly having difficulties in decisively moving through stage 1, so to speak, that Mexico and Brazil have been through.

Mr. SCHUMER. The amendment that we passed to the IMF bill last year and all the other parts of the legislation, have basically been short-run solutions. Do you think it is about time that people like yourself, who I think deserve more of the credit than anybody else for seeing that this crisis hasn't blown up out of proportion, start looking at long-range plans. Don't you think that before the countries balk, if some of the little and then medium-size banks start balking, that we ought to have some long-range plan? What if the banks start saying that they don't want to put up more money to repay themselves?

Mr. VOLCKER. I have no particular problem with what the banks have been doing. You have problems with individual banks sometimes that are not in the cooperative spirit in arranging some of these programs. They tend to be isolated instances.

When one looks more broadly at the financing side, I think a great deal of progress has been made, at least conceptually. None of them is fully in effect yet, but I think some of them will be shortly, in truly long-term restructurings at reduced spread. It seems to be directly along the lines of the approach that you were so strong in urging. I think there has been a good deal of progress on that side. When you look toward longer run solutions, I would like to think that we are doing that all the time. But it depends, basically, I think, on those countries getting their own economic policies in shape so that, in fact, they can look forward to sustained growth consistent with much reduced external needs for funds.

They ought to be able to do that at that stage against the background of a long-term restructuring so that they have a basis for planning ahead with some knowledge of what the external requirement is. I think that side of the process has gone pretty well in the past year.

Chairman FAUNTROY. Thank you.

Mr. SCHUMER. Thank you, Mr. Chairman. I appreciate your letting non-subcommittee members ask questions.

Chairman FAUNTROY. Certainly. We invited all of the committee members and I am pleased at the number of members of the full committee who have joined us or will be joining us for the remainder of this hearing. Thank you.

Mr. Chairman, on another subject, as you know, I have been concerned for some time with some of the trends in mergers and acquisitions, especially where it does not appear that the mergers result in improved efficiency or financial strengths. More recently, a trend has developed where various high-yielding, but unrated, notes or securities are used to finance some of these takeovers. Is this a healthy trend, in your view? Shouldn't financial institutions exercise some greater care in accepting these securities and in financing mergers or buyouts generally?

Mr. VOLCKER. All these mergers are different and have different justifications and different financial characteristics. But to respond to your question, I have had some concern that in the midst of this process, insufficient attention may be paid to maintaining a strong financial structure, both from the standpoint of the surviving business and, more directly from my concerns, the point of view of the stability and strength of the financial institutions making the loans. My sense is, while it is very hard to judge in any specifics,

that in the course of the last 12 months or so, there has been a somewhat more cautious approach by banking institutions, at least toward the dimensions of this financing, not just in mergers, but even more directly, in terms of so-called leveraged buy-outs and other restructurings of existing companies, where it has become quite the fashion in a number of cases to substitute debt for equity.

This development has been important enough so that you can see it very apparently in the gross figures for both debt and equity. We had net retirement of equity last year by American corporations of something on the order of \$70 billion, if I recall the figure correctly. There was some issuance of equity, of course. It suggests how much was retired. The other side of that is debt/equity ratios that get thinner, increasing when one looks at the overall shape of the financial system, its vulnerability to uncertainties, the inevitable vicissitudes of fortune.

Chairman FAUNTROY. According to your economic projections, you assume that the Federal budget deficit would be reduced significantly in fiscal year 1986 relative to the baseline projections. I wonder what would be the effect of your projections if there is little or no deficit reduction?

Mr. VOLCKER. I think it would increase the risk of the projection. I can't respond in quantitative terms. The presumption was that action would be taken, as you said, to reduce the deficit in 1986. That is beyond a period, except for one quarter, that's even covered by these projections.

The assumption was that the climate of financial markets might be favorably affected, or at least not unfavorably affected by the failure to take action. If there is no action, I simply think it increases the risk during this period of some of the contingencies that I was talking about earlier, about the permanence of the capital inflow, the possible consequences for domestic interest rates and the rest. The impact has to be expectational and psychological this year and, therefore, not definable.

Chairman FAUNTROY. If reducing the deficit would be so advantageous, why is it that inflation and unemployment would show so little improvement in your projections.

Mr. VOLCKER. Again, I suppose everything is relative. But I think most people would assess those as rather favorable projections, some reasonably substantial economic growth in the third year of expansion and no backtracking on the inflation progress and maybe some improvement on the inflationary picture—it doesn't look too bad for the third year of expansion.

Chairman FAUNTROY. Mr. Salomon, who is now the former president of the New York Federal Reserve, said in a recent article, and I quote him, "The case can also be made that in the short-run, at least, the economic restraint exerted by actions to reduce the deficit should be actively offset by speeding up the money growth." Do you agree with his statement and do you view the open market as—

Mr. VOLCKER. I have to ask "speeded up" from where in the first instance. It has been pretty fast recently. But I would not make that presumption *ex ante*. I could imagine circumstances in which that might be appropriate.

Chairman FAUNTROY. You also said that the open market projections for the economy assume a stable, but high exchange rate for the dollar and substantial reductions of the deficit. Are these two assumptions consistent? For example, I believe the Fed's position has been that a substantial reduction in the deficit would help bring down the exchange rates of the dollar.

Mr. VOLCKER. Right. Over time, yes.

Chairman FAUNTROY. Are you saying that reducing the deficit will not moderate the dollar's value, but simply—

Mr. VOLCKER. I think you may be reading a little bit too much into that assumption. The assumption about the dollar I think was simply an arbitrary assumption. It said there was an important movement that could have a significant impact on prices. Let us make a common assumption, and the most neutral assumption in some sense was saying, let us assume it is roughly in the area that it has been in recent months. I don't think it was meant to convey any economic policy content, or any judgment about the effects of deficits or the absence of deficit reduction action. It was an arbitrary assumption.

Chairman FAUNTROY. Am I correct in my interpretations that the M1 aggregate has been returned to its former place as the first-among-equals for the committee?

Mr. VOLCKER. I think it often gets interpreted that way, but there has not been any formal action by the FOMC in that respect.

Chairman FAUNTROY. In the report, there is quite a bit of discussion about the M1 velocity, including a projection that M1 velocity growth would be likely to be somewhat lower than the—

Mr. VOLCKER. The current growth, yes.

Chairman FAUNTROY. For this reason, it is suggested that the growth, and I am quoting you now, "growth in M1 and other monetary aggregates in the upper parts of their ranges may be appropriate over the year as a whole." Does this mean that the committee will be paying careful attention to the nominal GNP growth relative to M1 growth and adjusting M1 growth as appropriate for the desired path of outgrowth?

Mr. VOLCKER. We certainly look at real growth and the prospects thereof and we certainly look at price trends. You put those together and you are looking at the nominal GNP, but we do not have a particular target for the nominal GNP. As you know, our projections came out with the nominal GNP on the order of 7½ to 8 percent in the central tendency. If you had monetary growth in the upper half of our 4 to 7 percent range, to look at M1, say the 6½-percent area, that would be consistent with very little growth in velocity over the year as a whole.

Chairman FAUNTROY. I know that in the past, you objected to proposals that the Federal Open Market Committee specify its objectives for nominal and GNP growth on the grounds that the Fed has too little influence over the growth of such objectives to be meaningful. I would, however, note that the growth of nominal GNP from the fourth quarter of 1983 to the fourth quarter of 1984 was 9.3 percent, almost precisely in the middle of the central tendency of the Federal Open Market Committee's projections for growth of 9 to 10 percent made in February of 1984.

Not only that, but we—

Mr. VOLCKER. I think we did worse in July, didn't we?

Chairman FAUNTROY. You certainly did.

Mr. VOLCKER. It looked all right in our February projection. We should have stuck with it.

Chairman FAUNTROY. Based on the record, either the Fed has been pretty lucky in your forecasts or it has had a greater degree of influence on the nominal GNP growth than you have admitted. I wonder which it is.

Mr. VOLCKER. I don't think you would find that result in all earlier years. But I suppose, looking at the average, if we are reasonably on course on money supply and, there are not unusual developments with respect to velocity, you are going to find it falling within some general range close to our projection. I prefer to look at it as separate projections of real growth in prices because I think a lot depends upon the composition. Contrary to the expectations we put down here, if one could imagine that we had a much better inflation performance than that central tendency suggested, it is not necessarily true that you would want to have the same nominal GNP growth, or vice versa. Indeed, as I said earlier, that might be a circumstance in which the total climate would suggest that you could have more real growth, but I would not attach any particular importance to hitting that particular target for nominal GNP growth.

Chairman FAUNTROY. Thank you. My time has expired. I yield to the gentleman from Florida, Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Mr. Volcker, the target ranges that you have given to us in the back of the statement that you have delivered today indicate a couple of different ways of looking at target ranges. In fact, you alluded to them in your statement—the cone method, supposedly, or the parallel or the band method.

Mr. VOLCKER. Right.

Mr. MCCOLLUM. Some concern has been expressed to me about the results of following the two different methods and how they might vary in terms of the monetary policy. If you follow the cone method, you are following a pretty strict system.

Mr. VOLCKER. Certainly in the early part of the year. However, there is not a substantial difference in the latter part of the year.

Mr. MCCOLLUM. Right. But if you did follow the cone method more severely, rather than allowing things to go on for a while and then changing course, what would that do to the economy? In other words, do you believe this wider latitude is necessary?

Mr. VOLCKER. Let me comment first that we have conventionally drawn these cones, and it has always aggravated me because they are very narrow at the beginning of the year. If you interpreted them literally, you would have to follow a very strict policy, as you put it. It would be a policy which is beyond our capacity—to keep money within that narrow a cone in the early part of the year. In fact, we have not done that. But you get a lot of commentary as to whether we are in or outside that precise cone.

Maybe the best answer is some compromise between the two. I think this chart is another reasonable way of looking at it. It doesn't show that same implied, but maybe wrong, discomfort of being outside the cone.

You ask what the consequences would be of following that very strict policy within the cone? One of the difficulties is it is different in the first part of the year than in the second part of the year when the cone is wider. You would be following a more rigid monetary targeting approach, as I say; I think, in fact, beyond our capacity. But you would have to be willing to give total priority to hitting, or trying to hit, a rather precise monetary number. You only have leeway of \$3 or \$4 billion even now within that cone. That is less than the fluctuation in some weekly figures. You are not going to hit it every week. But if you were absolutely bound and determined to try to keep the monthly figure, let's say, within the cones, you would have to discard any other consideration in the implementation of policy in the short run.

Mr. McCOLLUM. Well, you would be adjusting every time you met as a committee and then maybe some on the telephone, too; right?

Mr. VOLCKER. You would probably change your procedure. In our present procedure, we would have to have some method of meeting very frequently to change pressures on reserve positions.

Mr. McCOLLUM. What impact would that have, for example, on the fluctuation of interest rates?

Mr. VOLCKER. Extreme.

Mr. McCOLLUM. So they would really fluctuate.

Mr. VOLCKER. Yes.

Mr. McCOLLUM. One other question I have related to the targeting. You have targeted the M1 growth at 4 to 7 percent as a range for this coming year. And you have indicated, at least the committee members apparently feel, that the estimated real GNP growth will be in the area of 3½ to 4 percent. Obviously, the real GNP growth is a very important part of any consideration of money policy. I am sure you would agree.

Mr. VOLCKER. Correct.

Mr. McCOLLUM. If this growth is at the higher end of that range or perhaps even exceeds the 4 percent this coming year, would you feel that the committee would revisit the targets?

Mr. VOLCKER. No, I don't think that those projections are set forth as targets. And I could well conceive, hypothetically, of a situation in which you got more real growth and everybody would be quite happy and it would be quite consistent with these monetary targets. That was not the best guess of FOMC members. But if things developed in a favorable way during the year, that is quite possible.

Mr. McCOLLUM. So if you had a better real growth, that would not necessarily—in fact, it wouldn't—encourage the open market committee members to reexamine the targets and maybe making them broader—

Mr. VOLCKER. Not necessarily. We always reserve the right to look at the targets and change them, and circumstances could arise in which that would be appropriate. But suppose you were getting more real growth. You were getting growth above 4 percent, maybe even comfortably above 4 percent. The price situation was developing very well. The monetary growth was more or less on target. Let me throw in another one: the Congress has acted on the budget and the outlook there looks better. There is nothing that is going to make you uncomfortable about that situation. We are certainly not

going to tighten up on the targets when everything is going well, under that set of circumstances.

Mr. McCOLLUM. What about loosening up on them if everything is going that well? Would that help bring interest rates down at that point and not inflate?

Mr. VOLCKER. I don't know. If things are going all that well, we might just leave them alone. [Laughter.]

Don't interfere with paradise. You could imagine circumstances in which you would want to change the targets. Let us take the same assumptions, but growth is doing not very well, velocity really seems to be declining; if we are wrong in our judgment about velocity, interest rates are high, then I think those are the circumstances in which you might think about raising the targets.

Mr. McCOLLUM. Thank you, Mr. Volcker.

Mr. Chairman, I yield.

Chairman FAUNTROY. Thank you, Mr. Leach.

Mr. LEACH. Some say that one of the problems, with Congress is that people get elected and break their campaign promises, and that is what is wrong with the system. But I have found around here that the problem is we keep our promises; that is, that we don't rethink when we should rethink. Maybe the Fed ought to give as much attention to defending America's trade position as is given to defending the value of the dollar.

One of the problems in the Farm Credit Administration is the possibility that the farm credit system bonds may come under pressure in the weeks or months ahead. And let me just ask, specifically, in that regard, is there any indication that the Fed might buy farm credit system bonds in order to keep their price lower?

Mr. VOLCKER. We hold some Farm Credit Administration bonds now. We were able to buy them. Let me emphasize that I have seen no signs in the marketplace of the kind of strain you alluded to currently with respect to the farm credit system. I should also say that the Federal Reserve has authority to lend to elements in the farm credit system.

Mr. LEACH. You are absolutely correct. At least as of last week there has been no evidence of gain in the bond selling end of it. And in terms of the portfolio management, I think, frankly, as we look at the next several weeks, we are going to have a donnybrook around March 1 that could indicate a great many more problems in agricultural lending in general.

And as we look at Congress' response—and traditionally, I think the monetary authorities look to Congress for response first—it should be stressed that what is being discussed in terms of helping farmers both on the Senate and House sides is still a wave in the ocean. It is not very significant.

Therefore, the underlying problems in agricultural lending are great. And, beyond that, if we look at the prices which farmers are going to get on returns for the products they have produced, they don't lend any particular confidence that they will be able to pay back their loans if all that is done is put out more credit.

Mr. VOLCKER. If they are far enough in debt, I agree with that, and I think that is the heart of the problem.

Mr. LEACH. Well, there are discrepancies, obviously. A given percentage of farmers have virtually no debt and another percentage

have higher. We are looking at conflicts between young and old, to a degree, a large and small, although those discrepancies aren't quite as significant as might be suspected because about the same number of large farmers are in difficulty as small farmers.

But it is a situation that we in the Midwest are very concerned about and in addition just simply basic American manufacturing is obviously in enormous jeopardy. I look around my area of the country and Caterpillar is moving jobs to Korea and France and Scotland, as is Tenneco. And we are looking at the prospect of a country that doesn't make anything.

In this regard, I think people historically have lent different weights to different factors in economic growth. But I would suspect that if there is any change in factors that the Fed should be considering at this time, it should certainly be our trade competitiveness.

It's pretty clear that Congress is going to look at other kinds of solutions to our trade deficit problem that might be even less acceptable, whether they be protectionism, whether they be some sort of arbitrariness that may be introduced into the economy.

And one of the attractive aspects of the value of the dollar issue is that it isn't as discriminatory as other types of responses in the sense that with protectionist legislation, one has to make one decision for automobiles and another decision for corn, and another decision for textiles.

And if we just had a more reasonable dollar relationship, a lot of inefficiency that would be introduced into the economy by specific exceptions, I think, won't have to be dealt with.

Mr. VOLCKER. If I can respond, I agree with virtually everything you are saying except the applied remedy. Where I see that we are stuck is that the economy as a whole is dependent upon a strong capital inflow to balance our accounts. That has produced a strong dollar, and your part of the economy has gotten squeezed from two directions. I don't think there is any question about it. Monetary policy is just a tool that can affect the overall environment. It cannot be directed toward your particular sector. We are forced to ask the question, if we did that, let's say, and took your applied advice as to somehow getting the dollar down—I presume by a much easier monetary policy—would we inadvertently, presumably—but I suppose with foreknowledge, simply be transferring that problem elsewhere, because the basic imbalance is not one we can deal with with monetary policy?

I think, in time, we can make it worse. But you are just feeling the effects of this huge imbalance we have in our trade accounts, which I think is inextricably related to the huge imbalance we have in our budgetary accounts, and there's nothing that can be papered over by monetary policy.

Mr. LEACH. Well, I don't think there is massive disagreement on Congress' responsibility. I am not at all sure though that the type of policy that is currently being run puts the kind of pressure on Congress that I think might have been perceived to be the case 2 or 3 years ago. In addition we have the new assessment that the reverse effect might occur, that with a reduction in the deficit, we might cause more dollar inflow rather than less, which is exactly

the opposite of what everyone was assuming until very, very recently.

Beyond that, it looks as if we are approaching a structural change of rather dramatic significance. If this country can't manufacture anything that's competitive of large size, if our rural economy is flat on its back for as long as we can see, that means the next 4 or 5 years, we are looking at a country that's going to have a very different composition in the very near future.

Mr. VOLCKER. I do not disagree with that, but there are sectors of the economy, as you know, that are doing very well. The whole service sector is booming away; the defense sector is doing very well; high-tech areas are doing just fine. Overall, the economy is doing well. It is unbalanced and you have got the wrong end of the imbalance. I am not arguing there are not modifications of policy that you can legitimately debate. We have been giving more weight to the international situation. You can argue with whether we give enough. But I do not think we can dramatically change the situation by our own tools, given—and it's a rather basic point—that it is not in the interest of the economy as a whole and is not even in the interest of the farm sector, in my opinion, to go back to an inflationary environment. That's what got them into trouble in the first place.

Mr. LEACH. Let me just conclude that for 20 years, the Fed and the Treasury have welcomed foreign investment in debt instruments, and that certainly has kept some interest rate costs down. On the other hand, it has served as probably the single most effective vehicle for other countries, particularly Japan, to devalue their currencies. The question arises as we look at this, do we want to rethink the relative importance of these factors.

On the one hand there are obvious pluses in keeping interest rates down, but on the other, there are obvious minuses about lack of ability to compete internationally. It could well be that this is a time for very serious reassessment of Fed policies. I am not sure that old-line reasoning is particularly relevant at this time. And if we don't do some new reasoning, the only thing that's obvious is that, structurally, this country is going to become a service-oriented economy in which nobody does anything for anyone else except rub their back. What about our capacity to compete in international trade and our capacity to maintain a strong country? And economy?

Mr. VOLCKER. I think you raise some very real problems and my answer that I do not think monetary policy can answer them all is not very satisfactory, because I think they are very real problems.

Chairman FAUNTROY. I thank the gentleman.

Chairman Volcker, there are a number of questions which members of the committee would like to have you answer, and I am going to submit them to you in writing and would appreciate a timely response.

Mr. VOLCKER. We will answer as soon as possible.

Chairman FAUNTROY. I yield now to the ranking minority member, who will close the hearing out with a question.

Mr. MCCOLLUM. Thank you.

Chairman Volcker, earlier my colleague from Massachusetts was doing what I call flyspecking the administration's criticism of the

Fed. One of the criticisms a few years ago was with respect to the accounting procedures, and I know you have done some changing in that, measuring the money supply growth by now using the so-called contemporaneous accounting procedure.

Could you tell us how this is going, how it's working out?

Mr. VOLCKER. Plus and minus. I think, mechanically, it is working all right. I have sensed it has been accompanied by somewhat more volatility in interest rates in the very short run. I'm talking about the Federal funds rate over the course of a 2-week period, and since that sometimes bears back on the rest of the environment and the markets in the pretty shortrun prospectus, you probably have a little more volatility with it than without it.

There is a lot of speculation the market would accommodate to this in a way you would have smoother interest rates, or at least as smooth in the very short run. I do not see much evidence of that. They tend to bid strongly in the first part of a reserve period and have excess in the latter part or vice versa, without any systematic pattern. But there are quite a lot of fluctuations. We not only made the reserve requirement period more nearly contemporaneous, but we lengthened it from 1 week to 2 weeks, and maybe it's that lengthening that gives the result that I mentioned.

Mr. McCOLLUM. Do you anticipate continuing the current procedure for the foreseeable future, or there plans to adjust them or change them?

Mr. VOLCKER. It is difficult to change these, and we wouldn't foresee changing them. There are certain costs involved in making the change. I should say we are not using a technique of monetary technology. We do not use a technique which would maximize the potential effectiveness of the contemporary reserve requirement in keeping the money supply stable. That's not the same as keeping interest rates stable.

Mr. McCOLLUM. Right.

Mr. VOLCKER. So one could argue if the objective is stability of the money supply, and that is the prime objective, we ought to change our techniques. I alluded to that earlier by saying if we really wanted to stay in that cone, we have to change the techniques, and contemporaneous reserve accounting would make it easier to adopt a different technique; theoretically it remains to be seen, like the interest rate question. Theoretically, it would make the money supply respond a little more quickly to what actions we take, if we used a different technique. But we have not been using that technique, because we didn't think it was necessary or desirable under all circumstances.

Mr. McCOLLUM. Chairman Volcker, in closing out the hearings from my end of it, I just want to commend you for your personal involvement and truly studious conduct of monetary policy.

I think we would all be a lot more restless in our sleep, if we didn't have your balanced experience and analytical thinking at the helm.

Mr. VOLCKER. Thank you very much. We will keep trying. The answers are not easy, but we will keep at it for a while.

Chairman FAUNTROY. Thank you, Mr. Chairman. We appreciate your candid and straightforward answers to many of the questions the members have raised with you. I hope you will take note of the

fact that there seems to be unanimous agreement on both sides of the aisle here that we would like to see you complete your term.

Mr. VOLCKER. Thank you.

Chairman FAUNTROY. With that, we bring to a close today's hearing on monetary policy.

[Whereupon, at 12:50 p.m., the hearing was adjourned, to reconvene at 10 a.m. on Tuesday, March 5, 1985.]

[The following written questions were submitted to Chairman Volcker by Members of the Committee on Banking, Finance and Urban Affairs with additional questions submitted by Congresswoman Marcy Kaptur. Chairman Volcker's answers are attached to the questions.]

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA,
CHAIRMAN

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DOUG BARNARD, JR., GEORGIA
CARROLL HUBBARD, JR., KENTUCKY
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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

March 4, 1985

The Honorable Paul A. Volcker
Chairman - Board of Governors
Federal Reserve System
20th and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Paul:

Following your testimony on Tuesday, February 26, 1985, Members of the Committee on Banking, Finance and Urban Affairs submitted the following questions which were not asked and for which answers would be appreciated as soon as possible:

1. Both in your statement and in the Monetary Policy Report you express considerable concern about the rapid rise of debt, not only by the Federal government, but by the private sector. You also make an elliptical remark about the Administration's tax reform proposals. I wonder if you could be clear. Are you suggesting that the Treasury Department's tax reform proposals and similar ones by Mr. Bradley and Mr. Gephardt, and Mr. Kemp and Mr. Kasten, would be beneficial in terms of reduced credit demand and lower interest rates? What are your views on the need for and value of major tax reform along these lines?
2. On page 19 of your statement, you refer to "growth of debt within its targeted range." Earlier, you had referred to a "monitoring" range for credit, which is the way in the past the FOMC had treated the debt aggregate. Is your statement a slip, or does it indicate a change in the status of the debt aggregate?
3. In an appendix to your testimony, you discuss how the ability of the economy to grow without inflation "depends on such variables as the trends in productivity, in the labor force, in incentives to save and invest, and in other factors over which monetary policy has essentially no direct or long-run influence." However, you then say that "annual monetary targets and operational decisions do not, and need not, rest on such assumptions for the long run."

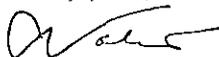
The problem of course is that, as Lord Keynes said, "in the long run we are all dead. Is it not the case that the impact of monetary policy on the economy in the short run will depend

critically upon trends in productivity, in labor force growth, and incentives to save and invest, because these factors will determine whether a given rate of money and economic growth translate into more real growth and less inflation, or less real growth and more inflation? Therefore, could you tell the Subcommittee what trend growth in productivity the FOMC is assuming? What trend growth in the labor force? Whether the incentives to save and invest will be increased or decreased by a continuation of current fiscal policies, or by adoption of the Treasury's tax reform proposals?

4. It is generally recognized that the U.S. economy must grow at an annual real growth rate of somewhere between 4.0 and 4.5% to maintain reasonably full production and employment, and even higher than those levels in order to achieve these goals when there is large economic slack. Since annual growth rates of GNP have been extremely deficient over the last 20 years (i.e., 3.2% during 1966-1969; 2.8% during 1969-1984, and only 2.1% during 1979-1984, for instance), how serious is this chronic diminution in the rate of real economic growth, in light of the fact that economic growth is the basic vehicle for creating a stable domestic and international economy?
5. When we look at the inadequate rate of growth over the last thirty years, it has been estimated by some economists that as much as 19.5 trillion 1984 dollars worth of GNP have been forfeited and more than 118 million years of unemployment, in excess of the full employment goals mandated in law, have been suffered due to inadequate growth. In view of these staggering losses in production and employment opportunity, how high of a priority does the Fed attach to the rate of real economic growth and levels of employment and unemployment?
6. When we look at the real growth rate in the non-Federally held money supply, (as opposed to the nominal rates), on an historical basis, we have had close to thirty years of little, negative or no real growth. When you add this lack of real money supply growth to the decades of less than adequate economic growth, and the large deficits in production and employment opportunities, how can current Fed policies be justified? And what defense can be given to the charge that Fed money supply policies have actually become an aggressive and patent factor in the decline of our economy?
7. If it is the Fed's position that inflation is the primary "excuse" for these past and current policies, how does the Fed a) measure the relative weight to be attached to marginal decreases in the growth rate of inflation against the weight to be attached to staggering losses in GNP and employment opportunity and b) how does the Fed explain the fact that the periods of higher real economic growth and low unemployment have been accompanied by low and declining rates of inflation, while periods of stagnation and recession have usually been marked by rising inflation?

8. It is clearly in vogue these days for virtually everyone to be urging deficit reduction. Have you considered the effect the Fed's more repressive than necessary monetary policy has had on the growth of the deficit?
9. You have stated that the deficit must be greatly reduced before it will be practical or desirable to bring about larger reductions in interest rates and larger increases in the money supply. Further, you, among some others, call most vigorously for sharp reductions in domestic spending programs as the so-called "best" way to reduce the deficits. Is it not putting the cart before the horse to say this, because is it not true that reductions in the deficit can only come about from a sustained period of GNP real growth and larger reductions in unemployment, and this can't really happen until the money supply is eased and there are appreciable reductions in interest rates?
10. How can Fed policies be changed so that the mandated goal of reaching 4% unemployment, as called for in the Full Employment and Balanced Growth Act of 1978, and 3% inflation, are attainable simultaneously?
11. In a recent New York Times article, former New York Fed President Anthony Solomon was quoted as saying that "...ideally in the long run I would like to see commercial banks permitted to do pretty much what investment banks do and vice versa." Any comment?
12. President Solomon also said in that same article "...I have a lingering feeling that it is too dangerous to live in a fully deregulated world of banking...the risks are probably too great." Any comment on this statement?
13. The President's Economic Report has suggested that rather than basing the target growth rates of the monetary aggregates on the average of the fourth quarter of the preceding year's actual growth (giving rise to base drift) the growth rate of the money supply should be measured from the mid-point of the previous year's target range. Any comment?

Sincerely yours,



Walter E. Fauntroy, Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 19, 1985

PAUL A. VOLKER
CHAIRMAN

The Honorable Walter E. Fauntroy
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Walter:

In response to your letter of March 4, I am pleased to enclose my responses to the written questions submitted in connection with the hearing held on February 26.

I hope this information will be useful to the Subcommittee. Please let me know if I can be of further assistance.

Sincerely,

A handwritten signature in cursive script that reads "Paul".

Enclosures

Question #1:

Both in your statement and in the Monetary Policy Report you express considerable concern about the rapid rise of debt, not only by the Federal government, but by the private sector. You also make an elliptical remark about the Administration's tax reform proposals. I wonder if you could be clear. Are you suggesting that the Treasury Department's tax reform proposals and similar ones by Mr. Bradley and Mr. Gephardt, and Mr. Kemp and Mr. Rosten, would be beneficial in terms of reduced credit demand and lower interest rates? What are your views on the need for and value of major tax reform along these lines?

Answer:

My remark on tax reform addresses a concern about the excessive use of debt rather than equity as a source of corporate finance. The preference for debt finance is encouraged by tax code provisions that allow the deduction of interest expense but permit no deduction for dividend payments. The Treasury tax reform proposal would provide a partial remedy to the financing bias introduced by these provisions by allowing corporations to deduct 50 percent of dividends paid to shareholders. Corporations which, as a result, relied more on equity and less on debt finance would be less vulnerable to interest rate and other economic fluctuations.

The potential impact of the Treasury plan taken as a whole, or other tax reform proposals, on credit demands and interest rates is very difficult to predict because of the broad scope and overall complexity of these plans. Individual provisions such as limits on the deductibility of interest could tend, other things equal, to lower nominal interest rates. The case for tax reform should not be seen, however, as hinging on these questions--other considerations are at least as important, if not more so. The desirability of particular reform packages needs to be assessed against the broader implications of the proposals for allocative efficiency, for the costs of compliance and administration, and for the fairness of the system.

Question #2:

On page 19 of your statement, you refer to "growth of debt within its targeted range." Earlier, you had referred to a "monitoring" range for credit, which is the way in the past the FOMC had treated the debt aggregate. Is your statement a slip, or does it indicate a change in the status of the debt aggregate?

Answer:

In the paragraph previous to the one you cited, reference was made to the "monitoring range for credit" for 1985. We have not changed the status of the debt aggregate. My reference to a "targeted range" for the debt aggregate should not be so understood.

Question #3:

In an appendix to your testimony, you discuss how the ability of the economy to grow without inflation "depends on such variables as the trends in productivity, in the labor force, in incentives to save and invest, and in other factors over which monetary policy has essentially no direct or long-run influence." However, you then say that "annual monetary targets and operational decisions do not, and need not, rest on such assumptions for the long run."

The problem of course is that, as Lord Keynes said, "in the long run we are all dead." Is it not the case that the impact of monetary policy on the economy in the short run will depend critically upon trends in productivity, in labor force growth, and incentives to save and invest, because these factors will determine whether a given rate of money and economic growth translate into more inflation? Therefore, could you tell the Subcommittee what trend growth in productivity the FOMC is assuming? What trend growth in the labor force? Whether the incentives to save and invest will be increased or decreased by a continuation of current fiscal policies, or by adoption of the Treasury's tax reform proposals?

Answer:

It is important to distinguish between longer run trends in economic variables and the actual short-run performance. They need not be, and generally are not, the same. As I indicated in Attachment III of my statement to the Banking Committee, year by year monetary policy decisions need not depend on the long-run trend growth of such factors as productivity, labor force participation, and capital formation--although clearly enough money has to be provided over time to accommodate the economy's real growth potential, after allowing for the trend in the velocity of money.

Of course, the actual short-run performance of productivity growth, labor force participation, capital formation, price and wage decisions, as well as many other structural and behavioral features of the economy will influence how the economy responds to monetary policy over the near-term. The predictions of real GNP, prices, and the unemployment rate made by members of the Open Market Committee take into account prospective near-term developments in these respects. I cannot tell you what individual Committee members assumed for each of the large numbers of nonmonetary factors that go into their forecasts. In general, it is probable that a slowing was assumed in productivity growth from the relatively rapid pace of the past two years, as normally occurs after the initial surge in growth as the economy recovers cyclically. Should more favorable productivity growth develop, and wage pressures remain low, we could see less inflation and more growth in 1985 than was projected. However, a weak productivity performance without a commensurate slowing in wage growth would exert upward pressures on prices and restrain real growth. No special effects on saving and investment incentives from the Administration's tax reform proposals were assumed in part because they are not likely to be implemented early enough to affect significantly the year 1985. It was assumed that fiscal policy was represented by the Administration's budget program, and that the financing of the budget deficit would again strain the capacity of domestically generated saving to accommodate both domestic private investment and the needs of the federal government.

Question #4:

It is generally recognized that the U.S. economy must grow at an annual real growth rate of somewhere between 4.0 and 4.5 percent to maintain reasonably full production and employment, and even higher than those levels in order to achieve these goals when there is large economic slack. Since annual growth rates of GNP have been extremely deficient over the last 20 years (i.e., 3.2 percent during 1966-69; 2.8 percent during 1969-1984, and only 2.1 percent during 1979-1984, for instance), how serious is this chronic diminution in the rate of real economic growth, in light of the fact that economic growth is the basic vehicle for creating a stable domestic and international economy?

Answer:

We can all agree that there has been a slowing in the trend real rate of growth in recent decades, but it should also be pointed out that experts in the field do not necessarily agree on the growth rate of potential GNP, differing in part on estimates of productivity growth. Indeed, the 4 to 4-1/2 percent numbers you cite tend to be high in the range of major estimates.

Setting aside the technical issue of the measurement of potential output, however, there is no doubt about the importance of achieving sustained economic growth at the nation's full potential. An expanding economy raises living standards at home and contributes to an improvement in the world economy. The critical question is how to create the conditions most likely to yield that result. Experience of the past decade has shown that sustained economic growth can best be achieved in an environment of reasonably stable prices; the slowing of real growth in the decade of the 1970's coincided, not coincidentally in my view, with a marked acceleration of inflation. But an environment of stability, while necessary to sustained growth, is not sufficient to assure that the rate of growth and productivity will return to the earlier, more rapid trend. Whether it does, or the extent to which it does, will depend on such factors as the public's preferences for saving and investment, the rate of technological innovation, attitudes of the labor force, and the organizational skills of business.

Question #5:

When we look at the inadequate rate of growth over the last thirty years, it has been estimated by some economists that as much as 19.5 trillion 1984 dollars worth of GNP have been forfeited and more than 118 million years of unemployment, in excess of the full employment goals mandated in law, have been suffered due to inadequate growth. In view of these staggering losses in production and employment opportunity, how high of a priority does the Fed attach to the rate of real economic growth and levels of employment and unemployment?

Answer:

The Federal Reserve can affect short-run movements in aggregate demand and output, but over the long run, such as the thirty-year time horizon referred to in this question, the growth of the economy depends essentially on structural and behavioral factors affecting the productive capacity of the economy that are independent of monetary policy, including the rate of productivity growth, capital formation, and technological innovation. Our policies are aimed at encouraging over time the conditions in which the economy can achieve its full growth potential and highest possible employment on a sustainable basis. We believe that can best be accomplished in an environment of stability, including reasonable price stability.

Question #6:

When we look at the real growth rate in the non-Federally held money supply, (as opposed to the nominal rates), on an historical basis, we have had close to thirty years of little, negative, or no real growth. When you add this lack of real money supply growth to the decades of less than adequate economic growth, and the large deficits in production and employment opportunities, how can current Fed policies be justified? And what defense can be given to the charge that Fed money supply policies have actually become an aggressive and potent factor in the decline of our economy.

Answer:

It needs to be understood in response to this question, that over the long-run, the Federal Reserve does not have control of the real money stock. It can control only the nominal money stock. Should it turn out that the amount of nominal money provided be more, for instance, than the public wants to hold in real terms, prices will rise--as the public attempts to buy more goods and services with the "surplus" money--and the real money stock will fall to the level that satisfies public demands.

Thus, one cannot simply conclude from a 30-year trend in real money anything about the appropriateness of past Federal Reserve policies, much less current policies as suggested in the question. In any event, over the 33-year period from 1952 to 1984, inclusive, the real money stock on average increased about 1/2 percent, about what would be expected from estimates of potential growth in real output over the period and the impact of financial innovation and other factors that tended to increase growth in velocity of money.

I do not believe that our money supply policies have become, as the question avers, an "aggressive and potent factor in the decline of our economy." The recovery and expansion following the recent recession has been the strongest of the past three decades and, with continued progress in containing inflation and assuming action to cut the federal budget deficit, may also prove to be the most enduring.

Question #7:

If it is the Fed's position that inflation is the primary "excuse" for these past and current policies, how does the Fed a) measure the relative weight to be attached to marginal decreases in the growth rate of inflation against the weight to be attached to staggering losses in GNP and employment opportunity and b) how does the Fed explain the fact that the periods of higher real economic growth and low unemployment have been accompanied by low and declining rates of inflation, while periods of stagnation and recession have usually been marked by rising inflation?

Answer:

I believe the experience of recent decades demonstrates that we cannot simply trade off inflation against unemployment. We are not, in other words, faced in practice with assessing the costs and benefits of more or less inflation vs unemployment as posed in part (a) of your question. Achievement of over-all stability, including reasonable price stability is in our view the most likely route to attaining sustainable economic growth at the nation's potential. The fact that there have been sustained periods of low growth and high inflation, as pointed out in part (b) of your question, is evidence that one cannot simply stimulate growth by adding more and more money to the economy. Depending in part on the extent of unutilized resources in the economy, there are times when additional money could lead to some increase in real growth for a while, but accelerated money expansion would, as continued, soon lead to price increases, strengthened inflationary expectations, and in the end to distortions and disturbances that retard the economy rather than encourage productive investment and growth.

Question # 8:

It is clearly in vogue these days for virtually everyone to be urging deficit reduction. Have you considered the effect the Fed's more repressive than necessary monetary policy has had on the growth of the deficit?

Answer:

We certainly do not believe that monetary policy is "more repressive than necessary," or that it is worsening the nation's basic budgetary deficits. If the economy had grown faster in the past two years, it is true that the budget deficit would have been lower. But in fact the economy grew more rapidly than in any cyclical recovery of the past three decades. Still, its rate of growth might have been even greater if so much of the spending by domestic sectors had not been made abroad. This diversion of spending to foreign sources took place because of the high exchange value of the dollar. That in turn was partly an indirect effect of the strongly expansionary fiscal policy--which by keeping interest rates here higher than they otherwise would have been, led to increased demands for dollar assets by foreigners.

In any case, the structural budget deficit--abstracting from current economic conditions--remains exceptionally large. Monetary policy cannot remedy this structural imbalance. Efforts to do so by rapid money expansion, for instance, would sooner or later lead to increased inflation and to rising interest rates. Recent Congressional Budget Office estimates show that the effect on the deficit of an increase in inflation that is matched point for point by increased interest rates--as could likely accompany a less restrained monetary policy--would be uncertain. If discretionary appropriations are not adjusted upward in step with inflation then some small improvement in the deficit would occur. However, if discretionary appropriations are adjusted for inflation then, according to CBO estimates, higher inflation and interest rates would result in a higher deficit over the 1985 to 1990 period. And the economy would also be bearing the costs and distortions of an inflation "tax."

Question #9:

You have stated that the deficit must be greatly reduced before it will be practical or desirable to bring about larger reductions in interest rates and larger increases in the money supply. Further, you, among some others, call most vigorously for sharp reductions in domestic spending programs as the so-called "best" way to reduce the deficits. Is it not putting the cart before the horse to say this, because is it not true that reductions in the deficit can only come about from a sustained period of GNP real growth and larger reductions in unemployment, and this can't really happen until the money supply is eased and there are appreciable reductions in interest rates?

Answer:

Growth is important, and we are committed to a policy of fostering an environment conducive to healthy, sustained growth. However, the consensus view seems to be that a very sizable deficit would remain even if the economy grew rapidly enough to reattain full employment in the next few years. Indeed, the Congressional Budget Office's measure of the structural deficit rises more over the 1985 to 1990 period than its estimate of the actual baseline deficit. More rapid productivity growth than has been assumed by the CBO would allow higher growth rates and a lower deficit when full employment is attained; but sizable structural deficits still would remain, if productivity growth stays within the range of our post World War II experience. I would add that monetary policy essentially has no direct influence on productivity growth trends.

I should also note that the initial sentence of the question suggests a more mechanical relationship between monetary and fiscal policy than I think exists. I do believe, however, that decisive action to reduce the deficit would help relieve the pressures holding rates up and, as such action helps to dampen inflationary expectations and forces, provide an environment with more flexibility for monetary policy.

Question #10:

How can Fed policies be changed so that the mandated goal of reaching 4 percent unemployment, as called for in the Full Employment and Balanced Growth Act of 1978, and 3 percent inflation, are attained simultaneously?

Answer:

Attainment of these two goals simultaneously in the short run probably is not possible because of structural conditions in the economy, and no change in Federal Reserve policy can alter that. It may be--and this is the view of many respected analysts--impossible to maintain an unemployment rate of 4 percent in today's economy, given the demographic characteristics of the labor force and other structural factors. Microeconomic policies may be needed to improve the skills of our workforce and increase its mobility if 4 percent unemployment is to be a realistic goal in the future.

Question #11:

In a recent New York Times article, former New York Fed President Anthony Solomon was quoted as saying that ". . . ideally in the long run I would like to see commercial banks permitted to do pretty much what investment banks do and vice versa." Any comment?

Answer:

The Board has for some time supported the view that certain changes are desirable in the current framework for separating commercial and investment banking, but it has not felt that differences between the two should be completely removed. Reasonable changes would need to be structured and implemented so as to stimulate competition for both types of financial institutions, without jeopardizing either the stability of the banking and financial system or encouraging the exploitation of potential conflicts of interests. In addition, the Board believes that such fundamental changes should be brought about by legislative action, and not by the independent actions of regulators. Given the importance of these issues, it is probably desirable that any changes be gradual and occur over the longer term.

With these ideas in mind, the Board has supported legislation to authorize bank holding companies to sponsor, control, and distribute the securities of mutual funds, as well as to underwrite and deal in municipal revenue bonds, 1-4 family residential mortgage-backed securities, and commercial paper. In addition, the Board has urged that to the extent that commercial banking powers were to be granted to investment banks, investment banks must to the same extent be subject to the rules and regulations that commercial banks operate under.

Question #12:

President Solomon said in a recent New York Times article ". . . I have a lingering feeling that it is too dangerous to live in a fully deregulated world of banking . . . the risks are probably too great." Any comment on this statement?

Answer:

Mr. Solomon was probably expressing concern with the possibility that banking organizations may expand into certain nonbank activities to such a degree that it would increase risk for the bank. This is a reasonable concern: in view of the crucial role of commercial banks as the transmission belt for monetary policy; a source of credit for most consumers and business; the primary holder of the savings and transactions accounts for the vast majority of Americans; and the key indicator, at home and abroad, of the health and soundness of the U.S. financial system.

Under the circumstances, as we move forward with deregulation with respect to the products and services banks may offer, it will be essential to move judiciously and prudently yet at the same time avoid unnecessarily constraining the opportunities for banks in new areas.

Question #13:

The President's Economic Report has suggested that rather than basing the target growth rates of the monetary aggregates on the average of the fourth quarter of the preceding year's actual growth (giving rise to base drift) the growth rate of the money supply should be measured from the mid-point of the previous year's target range. Any comment?

Answer:

This issue was discussed in Attachment IV of my statement to the Banking Committee. The convention of basing the current year's ranges on the level in the fourth quarter of the previous year is consistent with the Humphrey-Hawkins Act procedures that have been followed for some time; departures have occurred only when the conventional base level has been seriously distorted. I also noted on page IV-3 of my statement that regularly targeting growth from the mid-point of a previous year's range seems to imply that the growth from year to year at the mid-point is in some sense a uniquely correct trend for a monetary aggregate. I cannot agree that such a rigid pursuit of the mid-point, based on an earlier judgment, should be adhered to when emerging evidence on factors such as velocity shifts suggests that a deviation from the midpoint is required if the broader goals of sustainable economic growth and progress toward price stability are to be achieved.

MARCY KAPTUR
MEMBER
9TH DISTRICT OHIO



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Congress of the United States
House of Representatives
Washington, DC 20515

March 6, 1985

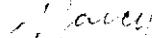
Walter E. Fauntroy, Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking
H2-j09 House Office Building, Annex 2
Washington, DC 20515

Dear Mr. Chairman:

In response to your gracious concern that Members be allowed to have all their questions regarding Federal Reserve Policy answered in a timely manner and the limited time of our recent hearings with Chairman Volcker, please find attached a number of additional questions I had for Chairman Volcker.

I would greatly appreciate it if you could include these questions in the Subcommittee's transmittal. Thank you.

Sincerely,


MARCY KAPTUR
Member of Congress

MK/pk
Encl.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 20, 1985

PAUL A. VOLKER
CHAIRMAN

The Honorable Marcy Kaptur
House of Representatives
Washington, D.C. 20515

Dear Ms. Kaptur:

In his letter of March 8, Chairman Fauntroy asked that I respond to written questions you had in connection with the Monetary Policy hearing on February 26. I am pleased to enclose my responses to your questions.

Please let me know if I can be of further assistance.

Sincerely,

A handwritten signature in cursive script, reading "Paul A. Volker".

Enclosure

cc: The Honorable Walter E. Fauntroy

Chairman Volcker's response to written questions
from Congresswoman Kaptur: (2/26/85 hearing)

Question #1: Is our "real business fixed investment" for FY 1984 (refer to page 16, graph page 18) an indication that industrial and commercial capital investment is occurring at a growing rate that will result in long-term growth? Recently in another session with Members of Congress, Mr. Volcker stated that foreign capital, which is being used to finance public and private sector borrowing, was being used primarily to finance short-term consumption, not long-term investment?

Answer: Business fixed investment has risen rapidly in the current expansion after falling sharply during the 1981-82 recession. Most observers expect some slowing in the rate of growth of capital spending this year and next. Nonetheless, the capital stock should continue to rise over the next few years, with beneficial effects on both labor productivity and potential output growth.

The recent rapid growth in investment has occurred despite very large government budget deficits, which had been expected by many observers to "crowd-out" private financing for investment. There are two reasons for this. One reason is that corporate cashflow has risen substantially in the past two years, as a result of both the 1981 business tax cuts and the strong economic recovery. The rise in cashflow has financed a good deal of the increase in investment. In addition, net foreign capital inflows have risen considerably, thus supplementing private domestic savings as a source of financing for both the deficit and private investment.

However, the funding sources that have supported investment may not continue to be as readily available in the future. As the economic expansion has matured, growth in corporate cashflow has slowed, and external financing needs of corporations have grown. Continued growth in investment therefore will require more corporate borrowing than in the past two years, leading to greater competition between government and private sector needs. An increase in the amount of foreign capital would relieve some of this pressure. However, large and growing foreign capital inflows are not sustainable and this source of funds is not a permanent solution to domestic imbalances.

If the net inflow of foreign capital were reduced, domestic saving would have to rise--current consumption would have to be cut--to finance the same amount of private investment, absent a reduction in the Federal deficit. But the prospects of such a significant rise of domestic saving in relation to income are not strong, given historical experience. Thus, a decline in the Federal deficit is the most likely source for sustaining growth of private investment at a satisfactory pace.

Question #2: Can we grow our way out of this deficit?
(page 18) Please explain based on recent trends.

Answer: I do not believe that we can grow our way out of the current federal budget deficit. The very rapid economic recovery and expansion that has occurred over the past two years has lowered the deficit from its 1983 peak of \$208 billion (on-budget plus off-budget) only to \$185 billion in 1984. The Administration projects the current services deficit to rise again this year and to remain above \$220 billion throughout the next five years. As you know, CBO's estimates of the baseline deficit are slightly lower than those of the Administration in the early years of the projection period, but rise later in the period to levels above the Administration's projections. A part, but only a relatively small part, of the difference in the later years is attributable to CBO's projection of slower growth.

Federal Reserve staff estimates suggest that one percentage point faster growth in real and nominal GNP would lower the deficit, by 1990, by a bit more than \$100 billion from the Administration's estimates, if all other key economic assumptions were the same. Such an acceleration might be associated with a more rapid rate of productivity growth, which would allow spending to expand more rapidly without incurring the danger of inflationary pressures in labor and product markets. In this regard, it should be noted that the Administration's assumptions about productivity, and the other factors

that contribute to a trend growth of output at the 4 percent rate they have incorporated in their budget calculations, tend toward the high end of ranges of many economic forecasters. Nevertheless, even sustained growth of real GNP at 5 percent over the coming five-year period would only do about half the job of closing the budget gap by 1990.

Question #3: What can be done to encourage increased "savings" by U.S. citizens?

Answer: Economists have long debated the effectiveness of special tax incentives for raising the rate of private saving. One idea that has been suggested is replacing the present income tax system with a consumption-based tax. This would tax only the proportion of income that is spent. However, economic research generally is inconclusive on the question of whether increasing the rate of return on savings actually causes individuals to save significantly more. It is therefore not certain that exempting savings from taxation would appreciably raise the overall saving rate.

Another possible way to encourage more saving would be to increase the present limits on contributions to individual retirement accounts. Again, the evidence as to whether this would increase total saving is mixed. Since IRA's were introduced in 1981, it appears that individuals generally have

shifted savings from ordinary income accounts into IRA's rather than adding new saving. However, the Treasury Department has estimated that about half of the people who invest in IRA's invest the maximum amount. It is therefore possible, although not proven, that individuals would save more if the IRA ceiling amounts were higher.

Question #4: On page 25, paragraph 1, federal and private debt expansion are discussed. Why is it that federal debt expansion of 18 percent in a second year of recovery is unusual? What is problematic about this when private domestic nonfinancial debt grew at a fairly normal historical rate?

Answer: With regard to the magnitude and impact of federal debt expansion in 1984, this growth was a postwar record for the second year of a recovery both in nominal terms, 16.9 percent, and in real terms (based on the GNP deflator), 12.8 percent. The increase was similarly unprecedented when U.S. government debt is measured in relation to income: while growth of GNP normally exceeds that of federal debt in the second year of a recovery--by about 3 percentage points, on average--last year this ordering was reversed, with federal debt expansion actually surpassing GNP growth by more than 7 percentage points. Other measures of federal borrowing, such as the federal budget deficit divided by GNP, also convey basically this same message, that federal credit demands last year were well above those in comparable periods of earlier expansions.

A major problem with heavy federal borrowing demands so late into a recovery occurs as these credit demands, together with rising private investment and credit demands accompanying the economic expansion, press against the available domestic saving. Even though growth of domestic nonfinancial debt last year was in line with past recoveries, one consequence of the contending public and private credit demands is higher interest rates than would prevail otherwise and slower expansion in those sectors most sensitive to the cost of credit. Furthermore, large prospective deficits raise market concerns about future inflationary and credit market pressures, concerns reflected in current levels of long-term interest rates that remain high relative to historical experience and to recent rates of inflation.

Relatively high U.S. interest rates, in turn, have encouraged substantial inflows of capital from abroad that, while supplementing domestic saving by a third and permitting the financing of the federal deficit and private investment, have contributed to a dramatic appreciation of the dollar on foreign exchange markets. The mirror images of these capital inflows and the appreciation of the dollar are the unprecedented deficits in our foreign trade accounts and a deterioration in the competitive positions of domestic import-competing and export sectors, in effect a "crowding-out" of domestic firms from international markets.

CONDUCT OF MONETARY POLICY

TUESDAY, MARCH 5, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2222, Rayburn House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Representatives Fauntroy, Neal, Barnard, Cooper, Carper, McCollum, Hiler, and Ridge.

Chairman FAUNTROY. The subcommittee will come to order.

This is the second day of our hearings on the conduct of monetary policy. Last week we received the testimony of the Chairman of the Federal Reserve Board. Today we will hear evaluations of the *Federal Reserve's report on monetary policy and its proposed policies* from several prominent economists.

As I noted last week, we are confronted with both evidence of great progress in the economy and signs of serious troubles either already present or looming on the horizon. As many observers have noted, this has been an unbalanced recovery. We have made remarkable progress on inflation—indeed, inflation is now at the lowest rates in the last 20 years. But the unemployment rate is still well above 7 percent—higher than the unemployment rates we have seen at the same stage in prior recoveries. Some sectors of the economy—services, defense production, high-tech manufacturing, and retailing—are booming, while other sectors—agriculture, natural resources, and traditional manufacturing—are languishing. The trade deficit is steadily worsening, driven by the continued rise in the dollar's value.

Most of us recognize that the largest threat to the economy and the major source of most of the imbalances in the recovery is the enormous budget deficits we are generating under current fiscal policies. We also accept the importance of restructuring those fiscal policies in order to bring down the deficit. But we need much greater and more flexible leadership from the President if we are to do this without creating new problems.

Still, monetary policy, with or without prudent fiscal policies, will greatly influence what happens to the economy, to inflation, and to unemployment. Monetary policy will also affect the value of *the dollar and what happens to the balance of trade*. We have heard from Mr. Volcker about what the Federal Reserve's assumptions, plans, and objectives are for monetary policy this year. Today, we will want to get some independent evaluations of those

assumptions, plans, and objectives. Are the Federal Reserve's economic projections and assumptions reasonable and realistic, given the stage of the cycle and the underlying conditions? Are the Federal Reserve's relative priorities for the reduction of unemployment and inflation appropriate? What can and should the Federal Reserve do with regard to the exchange rate of the dollar? Should the Federal Reserve be paying more attention to the monetary aggregates, or to the overall behavior of the economy?

To help us address these questions, we have assembled before us a most distinguished panel of economists. Let me welcome Dr. Alan Greenspan, president of the Townsend-Greenspan Co.; Dr. William Poole, professor of economics at Brown University; and Dr. Charles Schultze, senior fellow of the Brookings Institution and professor of economics at the University of Maryland. Dr. James Tobin, who was also scheduled to testify today, unfortunately had to cancel because of the death of a friend and colleague whose funeral is being held today. However, he has submitted a written statement, which will be included in the hearing record.

[The letter of invitation to the witnesses and the notice of the subcommittee hearing follow:]

LETTER OF INVITATION TO WITNESSES

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA,
CHAIRMAN

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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

WASHINGTON, DC 20515

January 30, 1985

At the request of the Chairman of the Committee on Banking, Finance and Urban Affairs, the Subcommittee on Domestic Monetary Policy will hold hearings on the Conduct of Monetary Policy and the Federal Reserve's Monetary Policy Report, pursuant to the Full Employment and Balanced Growth Act of 1978. In evaluating the testimony that the Subcommittee will hear from the Honorable Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System, on Tuesday, February 26, 1985, the Subcommittee will receive testimony on Tuesday, March 5, 1985, from other individuals on the Federal Reserve's Monetary Policy Report and how well the proposed policy addresses the problems that will be faced this year and in coming years.

I would like you to testify at the hearing on March 5. I would hope that in your testimony you would provide the Subcommittee with your appraisal of the outlook for the economy in 1985 compared with the Federal Reserve's projections, and with your views on the Federal Reserve's objectives for growth of money and credit in 1985. A copy of the Monetary Policy Report will be sent to you on or about February 20 to aid you in that undertaking.

Additionally, I would like you to keep in mind that the Subcommittee is particularly interested in what the Federal Reserve can do to foster lower unemployment and stable prices in 1985 and future years, given current productivity trends, unchanged fiscal policies, and likely commodity, labor, and currency market conditions. I have asked Chairman Volcker to address this issue in his testimony, and would like you to comment on his responses in your oral remarks, if not in your written statements. A copy of his testimony before this Subcommittee will be sent to you immediately after the hearing on February 26.

In preparing your written testimony, I would therefore hope that your discussion of the FOMC's economic projections and money and credit objectives for 1985 would address the following specific questions:

1. In regard to the outlook for the economy in 1985, what are the prospects for further reductions in unemployment without a reigniting of inflation? Should the Federal Reserve attach greater priority to reducing the unemployment rate in the coming year, to reducing the inflation rate, or to some combination of these objectives?

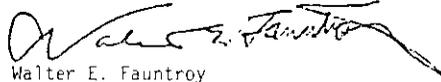
In regard to the outlook for the economy in 1985, what are the prospects for moderating the overvaluation of the dollar in foreign exchange markets, and what can and should the Federal Reserve do to help achieve such moderation? What should the posture of monetary policy be in regard to the international value of the dollar, and what role, if any, should direct Federal Reserve intervention in foreign exchange markets play to moderate the dollar's value?

In regard to the Federal Reserve's objectives for money and credit growth in 1985, what should be the relative weight given to the growth in the monetary aggregates vis-a-vis economic and financial market conditions in the FOMC's conduct of monetary policy? What specific variables do you believe the Federal Reserve should be using as targets for monetary policy?

Please plan to testify on these issues at 10:00 A.M., on Tuesday, March 5, 1985, in Room 2128 of the Rayburn House Office Building in Washington, D.C. Committee rules require that 100 copies of your written testimony be made available to the Subcommittee the day before the hearing for the use of the Subcommittee Members and staff, and for distribution to members of the press and the public who may be in attendance at the hearing. However, the Subcommittee Chairman may waive or modify this requirement if circumstances make it difficult for you to comply. If you have any questions about this or any other aspect of your testimony, please feel free to contact Howard Lee or Andrew Bartels of the Subcommittee staff at 202-226-7315.

I look forward to your testimony on March 5, and thank you in advance for your assistance to the Subcommittee.

Sincerely yours,



Walter E. Fauntroy
Chairman
Subcommittee on Domestic Monetary Policy

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA
CHAIRMAN

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WASHINGTON, DC 20515

NOTICE OF SUBCOMMITTEE HEARING

NOTICE OF ROOM CHANGE

TO: Members, Subcommittee on Domestic Monetary Policy
Members, Full Committee on Banking, Finance and Urban Affairs

FROM: Walter E. Fauntroy, Chairman
Subcommittee on Domestic Monetary Policy

DATE: March 4, 1985

RE: Continuation of Monetary Policy Hearings
Tuesday, March 5, 1985 10:00 A.M.

TUESDAY

MARCH 5, 1985

10:00 A.M.

2222 RAYBURN

The second day of hearings on the Conduct of Monetary Policy will be held on Tuesday, March 5, 1985 at 10:00 A.M. in 2222 Rayburn House Office Building. The Subcommittee will take testimony from four former Presidential economic advisors in assessment of the policies which the Federal Reserve announced at an earlier hearing. The four witnesses are:

WITNESSES:

Dr. James Tobin, Professor of Economics at Yale University, was a Member of the Council of Economic Advisers under President Kennedy and Nobel Laureate in Economics in 1981.

Dr. Alan Greenspan, President of the Townsend-Greenspan Company, was Chairman of the Council of Economic Advisers under President Ford and chaired the National Commission on Social Security Reform in 1982-1983.

Dr. Charles L. Schultze, Senior Fellow at the Brookings Institution, was CEA Chairman under President Carter.

Dr. William Poole, Professor of Economics at Brown University, was a Member of the Council during President Reagan's first term.

ALL MEMBERS OF THE COMMITTEE ARE WELCOME AND ARE INVITED TO ATTEND AND PARTICIPATE IN THESE HEARINGS.

Chairman FAUNTROY. Gentlemen, I am pleased to welcome you to this hearing. You have all served on the Council of Economic Advisers under various past and the current President. I point that out because I think it is important for everyone to know that there are still some of us in Washington who value that institution and are pleased with its continuing survival.

Before we begin, however, let me yield to my distinguished friend and ranking member of this subcommittee, Congressman McCollum of Florida, for any remarks which he may wish to raise.

Mr. McCOLLUM. Thank you, Mr. Chairman.

We are very pleased to have this panel of distinguished economists with us today to discuss the issues that are at hand on monetary policy. I think those of us on our side of the aisle understand that we are in a period of great economic growth, but we are distressed by the continuing deficits that this country has suffered, labored under for so long. We know and understand that because of foreign investment and capital that is coming into this country, this deficit has not had the impact it otherwise would have. So we are very concerned about the future in the fiscal area.

But we are equally concerned about monetary policy, especially in light of the fact that we are in somewhat uncharted water with this kind of high value of the dollar, high foreign investment and high deficits. We are looking forward to hearing from this distinguished panel in their review of monetary policy in the context of today's situation. Thank you.

Chairman FAUNTROY. I thank you. Unless the panelists have another preference, we will proceed in the order listed on the hearing notice, Dr. Greenspan first, Dr. Schultze, then Dr. Poole. Let me note that your statements, in their entirety, will be included in the record.

STATEMENT OF DR. ALAN GREENSPAN, PRESIDENT OF THE TOWNSEND-GREENSPAN & CO.

Dr. GREENSPAN. Thank you for your kind remarks, Mr. Chairman.

I would like to review briefly the economic outlook and exchange rate of the dollar and presumably leave for the question period a number of the details, which I am sure will remain unanswered.

The near-term outlook is fairly optimistic. The lack of imbalances suggests that the normal economic growth will take hold and carry us until imbalances are created. Accordingly, the FOMC's economic projections of roughly 4 percent real growth in 1985, moderate inflation at around 4 percent, and an unemployment rate below 7 percent by yearend appear reasonable. They could be accommodated by the Federal Reserve's announced monetary targets.

While such an outcome is most desirable and may have the greatest probability of any alternative scenario, it is by no means assured. There are a number of different events which might derail it, posing serious problems for the Fed. Economic expansion could prove to have greater momentum than now anticipated. Consumer buying might be stronger, and homebuilding and capital spending

more vigorous. This could generate an excessive surge of demand built on large inventory accumulation.

Such economic buoyancy generally quickens monetary growth and heightens inflation pressures. Under these circumstances, the Federal Reserve probably would be impelled to keep tightening credit, even if this eventuality produced a recession. The Fed undoubtedly would want to apply the minimum and least disruptive tightening necessary to achieve its purposes. Such judicious control of credit tightening, dampening the economy into a presumed soft landing, is not easy, however, without the benefit of hindsight.

The problem is complicated by the time which generally must elapse for the impact of Fed policy on the economy comes out of it. These time lags create a tendency to carry policy further than might in retrospect be absolutely necessary. Thus, there is a danger that initial attempts by the Fed to accommodate the accelerating expansion, so as not to endanger employment, could reignite inflationary expectations and eventually inflation itself.

The result would then inevitably be a recession, either from the inflation-induced reaction or from the anti-inflation policies adopted by the Fed or a combination of both. This problem does not appear to threaten at present. The danger of excessive monetary ease relative to the economy's requirements appears to have been allayed by the announced cessation of the policy of progressive easing preparatorily, presumably to a modest renewed tightening when and as appropriate.

Moreover, severe tightening does not appear to be contemplated or necessary at this time since the economy shows no signs of over-exuberance at the moment. The tremendous pulling back of commitments to a near hand-to-mouth basis is reflective of a virtual elimination of inflationary expectations, at least in the short term. There is, therefore, apparently little reason to accumulate inventories for potential capital gains.

The Fed is presumably keeping an eye on long-term interest rates as a gage of inflation expectations. Should these show signs of beginning to rise steeply, the Fed could be expected to respond expeditiously with policies focused more heavily on fighting inflation.

A more likely scenario is an eventual weakening of the dollar, which could develop into a speculative downturn in the exchange rate. This would, in turn, put short-term interest rates higher and stifle further economic growth. It is difficult to assess the probability of this occurring in the short term despite the indications that the current exchange rate, now probably close to 30 percent over purchasing power, is being driven by dollar demands which are unlikely to be sustained indefinitely.

History suggests that there is little that the Federal Reserve can do to nudge the foreign exchange value of the dollar lower in an orderly fashion. The attraction of the dollar as a safe haven vehicle appears to outweigh the effects of relative interest rates. As was evident late last year, lowering interest rates on dollar denominated assets, relative to those denominated in other currencies, does not necessarily cause the dollar to fall.

Moreover, should the Fed try to push U.S. interest rates down significantly to weaken the dollar, the monetary expansion which would be required to achieve this under present economic condi-

tions could intensify inflation pressures and inflation expectations. This, in turn, would raise the inflation premium in long-term interest rates causing yields to move higher.

In short, the ultimate outcome of an excessively easy monetary policy aimed at pulling down the dollar would be to raise, rather than lower, interest rates, presumably enhancing the attractiveness of the dollar on foreign exchange markets. This suggests that an overly easy money policy by the Fed might not be of much help to the dollar and could be counterproductive. If investors in the rest of the world feared inflation in the United States, this could trigger a steep decline of the dollar, as occurred in 1978 and 1979. If interest rates were not the primary determinant of a foreign exchange value of the currency, U.S. interest rates would have to climb sharply in order to attract the funds needed to cover other current account deficits. The detrimental impact on the economy is clear.

As for central bank intervention in the foreign exchange market, it too appears to have little sustained effect when there is strong movement toward currency. Such intervention may temporarily disconcert speculators and discourage speculation in the currency for a while. Resources available to central banks are limited, and repeated massive intervention simply is not feasible.

Once the markets recognize that intervention is limited, its impact on exchange values does not last very long. It then begins to take greater and more frequent intervention to achieve even that limited effect. In short, it is easier to point to techniques which will not be too effective, such as excessive monetary ease or sporadic intervention than cite the things which the Federal Reserve might do to effectively bring down the value of the dollar.

It would appear that the best thing that the Fed could do is to be patient, awaiting the emergence of market forces away from the dollar. That is likely to occur sometime this year, although it is very difficult to pinpoint the actual timeframe. The reason, basically, is that we are covering ground in the international financial markets now which I don't believe we have traversed previously.

When we observe the particular flows of funds, what comes across most clearly is that while in the early stages of the dollar rise, that is 1980 through 1982, the major force which was driving it was largely the movement of dollars in the Eurocurrency markets and the advent of a very major acceleration of dollar flows into the United States by foreigners.

Since 1982, however, a significant shift has occurred in the sense that, one, the net flow of dollars from other countries in the Eurocurrency market has stabilized, and two the flow of dollars by foreigners into the United States, while very large, has also stabilized. The only switch in the capital flows which are pushing the dollar higher is the dramatic slowdown in net investment by U.S. residents, especially banks in foreign countries. In 1982, for example, aggregative purchases of foreign assets by U.S. residents accumulated to \$111 billion, most of which was lending by U.S. commercial banks to foreigners directly, in large part Latin America, and to Europe largely through the branches of American banks also suggesting significant flows of loans to Latin America and other developing countries. With the debacle in the international credit mar-

kets initiated by the near default by Mexico, this lending contracted very sharply so that by mid 1984 it was essentially zero. Marginal evidence since, suggests there is actually liquidation going on. So what we have seen is not a significant acceleration in the purchases of dollars by foreigners, either directly in the United States or through the Eurocurrency market, but a dramatic decline in the purchases of foreign currency by U.S. residents with U.S. dollars, which obviously has the effect of essentially strengthening the dollar by weakening the demand for other currencies in terms of dollars.

That process cannot continue indefinitely. At some point we are going to find that the rate of liquidation of portfolios by U.S. commercial banks will come to a halt, and presumably some increase in lending will then ensue. At that point, the upward pressure on the dollar will come to a halt and presumably turn it downward.

It is not possible for us to make judgments as to when that will happen because we are, as I indicated earlier, tracing new ground. It is very difficult to use historical experience to determine when this particular process will take place. Nonetheless, the dollar is essentially a short-term phenomenon.

The longer term problem clearly is the budget deficit. The deepest shadow, which crosses our otherwise benevolent economic scenario, is cast by the structural aspects of that budget deficit. There can be little doubt that the markets do not expect expenditure cuts ranging up to \$100 billion or more annually by fiscal year 1988. That dimension, is a number which many budget deficit reduction programs contemplate. Should the cuts be enacted into law, currently, in a manner which is credible to the financial community, long-term interest rates are likely to fall by at least two full percentage rates with short-term rates falling even more.

Thus, even the sharp reduction in purchasing power implied by such a major contraction of the Federal deficits, that is the so-called fiscal drag, would surely be overridden by increases in effective demand generated by the market decline in interest rates and cost capital.

The economy clearly would benefit longer term if the budget problem is addressed. It is an immediate imperative as well, however, achievement of the Fed's economic projections rests upon the validity of the assumptions back of these projections. Four percent real economic growth, with inflation still at only 4 percent, assumes that interest rates will increase only modestly. This, in turn, requires some reduction in the Federal deficit as part of an ongoing Federal deficit reduction package, although I must say it does not contemplate the tremendous reductions which are involved either in the President's budget or those that are currently surfacing in the Congress.

The forecast also assumes no precipitous decline in the exchange value of the dollar and a monetary policy which successfully keeps the monetary aggregates within the Fed's targets. If any of these assumptions are not realized, the delicate balance required to achieve the projections would be in jeopardy. Appropriate monetary policy requires a weighing of the various relevant financial and economic developments, but above all, the inability to judge

the vagaries of credit demands requires stable growth rates in the monetary aggregates.

Thank you.

[Excerpts from the statement of Dr. Greenspan follow:]

Excerpts from the Testimony of Alan Greenspan*

Before The

Domestic Monetary Policy
Subcommittee
of theCommittee on Banking, Finance and Urban Affairs
House of Representatives
March 5, 1985

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While the preponderance of evidence suggests a fairly buoyant pattern of economic activity in the months immediately ahead, deep shadows hover over the longer term outlook. The recent pause in economic growth was a seemingly natural aftermath of the solid pattern of expansion during the first two years of recovery. This slowdown appears to be over, and a quickening pace of activity apparently is developing.

The improving outlook continues in the face of extraordinary strength of the U.S. dollar on foreign exchange markets. By creating price advantages for foreign-produced goods, the strong dollar has significantly increased the average share of imports to domestic demand in recent quarters. It has also diverted U.S. purchasing power to foreign producers and, at least in the simple first approximation, cost American production and jobs. But that first approximation is far from the whole story. The heavy demand for U.S. dollars has also left interest rates lower than they otherwise would have been and has clearly contributed to a lower rate of inflation. These, in turn, have reduced the sense of instability and risk associated with capital investment. It is thus unclear, on balance, how much of a job loss, if any, the strong dollar has produced.

What it has produced, without question, is a pattern of economic activity which is unique to the post World War II period and, perhaps, for a good deal of U.S. history before that. For the first time in many generations, our domestic output and employment are being significantly impacted by events which originate outside our borders.

*Dr. Greenspan is President of Townsend-Greenspan & Co., Inc.



Townsend-Greenspan & Co., Inc.

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The impact of international trends was particularly pronounced last year. The tremendous expansion in consumer expenditures, which was triggered by pent-up demand in the summer of 1983, was finally exhausted by the summer of 1984. This inevitably brought with it a slowdown in economic growth. Growth in domestic purchases in real terms, that is gross national product minus net exports, slowed from a near 9% annual rate for the first six quarters of this recovery to a less than 6% annual rate in the third quarter of 1984. But the growth rate in domestic production, that is the gross national product, fell from 7% to less than 2% annually over the comparable periods. The additional slowing of GNP growth was a reflection of a greater volume share of imported goods -- presumably ordered earlier in 1984 -- arriving on our shores in time to displace a significant amount of domestic supply, production, and employment last summer.

The marked slowing in production, coupled with the weakness in dollar-denominated international commodity prices, also created a major squeeze on profit margins which, in conjunction with the dollar translation of foreign affiliate earnings of U.S. corporations, brought the rapid acceleration of profits in the first half of 1984 to an abrupt halt by the summer. Whereas after-tax corporate profits during the first quarter of 1984 were a staggering 47% over the first quarter of 1983, it looks as though the current quarter's level of earnings will come in below those of a year ago. All of this created a tendency on the part of American business to adopt a somewhat defensive posture. The result was a dramatic contraction in purchases for inventory, and a sharp decline in the average lead time on the deliveries of materials from basic suppliers. In fact, with production materials being quoted with a lead time of only 50 days in December 1984, purchasing patterns were back to their levels of the beginning of the 1983 recovery. This is an extraordinary phenomenon since a more typical pattern is one of considerable tightening of supply two years into a business recovery, prompting slowed deliveries, spot shortages, and rising commodity prices. Whatever one may say about the end of 1984, it was characteristic more of the beginning of a business recovery than its later stages.

The reason the late 1984 pause in economic activity did not degenerate into another recession is that inventories remained exceptionally low by historical standards and capital investment was expanding. The period was scarcely describable in terms of an unsustainable boom, nor were there the clear credit stringencies which typically predate the beginnings of a recession. Thus, it was just a matter of time before the reduction of commitments -- the fall in new orders, the weakness in commodity prices, and the general compression in the timeframe of business decision-making -- would run out of room to contract. The normal forces of economic expansion would then reassert themselves and, indeed, this appears to be what is currently in progress. Real GNP growth through the first half of the current quarter seems to be tracking at something in excess of a 4% annual growth rate. This implies continuation of

the moderate inventory accumulation rate which is now apparently under way. If the inventory pace should accelerate, it is quite possible to get a much higher, say 6%, GNP growth rate for the current quarter.

Monetary policy contributed to the revitalization of the expansion. When the sluggishness in the economy became apparent last fall, the Federal Reserve responded with a marked easing in credit policy. Indeed, it reduced borrowed reserves (excluding extended credits) from a high of \$960 million last October to \$345 million in January, one of the sharpest such contractions in recent history. This was reflected in a rising ratio of seasonally adjusted nonborrowed to required reserves, which advanced from .9832 on November 7th, piercing 1.0 in the two weeks ended December 5, 1984 and remaining above 1.0 until the present. Thus, the Fed has been quite accommodative, supplying more nonborrowed reserves than required for the past three months. As a result, short-term interest rates are now approximately 300 basis points below their levels of last summer.

Accordingly, the near-term outlook is fairly optimistic. The lack of imbalances suggests that normal economic growth will take hold and carry us until imbalances are created. Accordingly, the FOMC's economic projections of roughly 4% real growth in 1985, moderate inflation at around 4%, and an unemployment rate below 7% by year-end appear reasonable. They could be accommodated by the Federal Reserve's announced monetary targets. If realized, the twin objectives of unemployment reduction and inflation containment would be attained without requiring the Fed to make crucial decisions which might jeopardize one of these aims by giving it less of a priority.

While such an outcome is most desirable, and may have the greatest probability of any alternative scenario, it is by no means assured. There are a number of different events which might derail it, posing serious problems for the Fed. The economic expansion could prove to have greater momentum than now anticipated. Consumer buying might be stronger and homebuilding and capital spending more vigorous. This could generate an excessive surge of demand built on large inventory accumulation. Such economic buoyancy generally quickens monetary growth and heightens inflation pressures. Under these circumstances, the Fed probably would be impelled to keep tightening credit even if this eventually produced a recession.

The Fed undoubtedly would want to apply the minimum and least disruptive tightening necessary to achieve its purposes. Such judicious control of credit tightening, damping the economy into a soft landing, is not easy, however, without the benefit of hindsight. The problem is complicated by the time which generally must elapse before the impact of Fed policy on the economy becomes evident. These time lags create a tendency to carry policy further than might in retrospect appear absolutely necessary. Thus, there is a danger that initial attempts by the Fed to accommodate the accelerating expansion so as not to endanger employment could

reignite inflation expectations and eventually, inflation itself. The result would then inevitably be recession, either from the inflation-induced contraction in real purchasing power, or from the anti-inflation policies adopted by the Fed, or a combination of both.

This problem does not appear to threaten at present. The danger of excessive monetary ease relative to the economy's requirements appears to have been allayed by the announced cessation of the policy of progressive easing preparatory, presumably, to a modest renewed tightening when, and as, appropriate.

Moreover, severe tightening does not appear to be contemplated or necessary at this time since the economy shows no signs of over-uberance at the moment. The tremendous pulling back of commitments to a near hand-to-mouth basis is reflective of a virtual elimination of inflationary expectations in the short-term. There is, therefore, apparently little reason to accumulate inventories for potential capital gains. The Fed is keeping an eye on long-term interest rates as a gauge of inflation expectations. Should these show signs of beginning to rise steeply, the Fed could be expected to respond expeditiously with policies focused more heavily on fighting inflation.

More likely is an eventual weakening of the dollar, which could develop into a speculative downturn in the exchange rate. This would, in turn, push short-term interest rates higher and stifle further economic growth. It is difficult to assess the probability of this occurring in the short-term, despite the indications that the current exchange rate, now probably close to 30% over purchasing power parities, is being driven by dollar demands which are unlikely to be sustained indefinitely.

History suggests that there is little that the Federal Reserve can do to nudge the foreign exchange value of the dollar lower in an orderly fashion. The attraction of the dollar as a safe haven vehicle appears to outweigh the effect of relative interest rates. As was evident late last year, lowering interest rates on dollar denominated assets relative to those denominated in other currencies does not necessarily cause the dollar to fall. Moreover, should the Fed try to push U.S. interest rates down significantly to weaken the dollar, the monetary expansion which would be required to achieve this under present economic conditions could intensify inflation pressures and inflation expectations. This, in turn, would raise the inflation premium in long-term interest rates, causing yields to move higher. In short, the ultimate outcome of an excessively easy monetary policy aimed at pulling down the dollar would be to raise, rather than lower, interest rates, presumably enhancing the attractiveness of the dollar on foreign exchange markets.

This suggests that an overly easy money policy by the Fed might not be much help to the dollar and could be counterproductive. If investors in the rest of the world feared inflation in the United States, this could trigger a steep decline in the dollar as occurred in 1978 and 1979. If interest rates are not the primary determinant of the foreign exchange value of a currency, U.S. interest rates would have to climb sharply in order to attract the funds needed to cover our current account deficit. The detrimental impact on our economy is clear.

As for central bank intervention in the foreign exchange markets, it too appears to have little sustained effect when there is strong movement towards a currency. Such intervention may temporarily disconcert speculators and discourage speculation in a currency for a while. The resources available to central banks are limited and repeated massive intervention simply is not feasible. Once the markets recognize that intervention is limited, its impact on exchange values does not last very long. It then begins to take greater and more frequent intervention to achieve even that limited effect.

In short, it is easier to point to the techniques which will not be too effective, such as excessive monetary ease or sporadic intervention, rather than cite the things which the Federal Reserve might do to effectively bring down the value of the dollar. It would appear that the best thing the Fed could do is be patient, awaiting the emergence of market forces away from the dollar.

The deepest shadow which crosses our otherwise benevolent economic scenario is cast by the structural budget deficit. Unless the laws of arithmetic are repealed, interest cost accumulation on top of \$200 billion plus deficits must inevitably crowd out private investment and economic growth. However, it is not a short-term problem. Temporary market adjustments might fend it off for several years, but the process of deterioration is inexorable.

While the strategic purpose of reducing the deficit is to prevent long-term excessive absorption of private savings and a crowding out of private investment, the short-term tactical purpose is to create, in law, a fiscal policy which the financial markets perceive as sufficiently credible to drive long-term interest rates down. There is no need for a pact with the Federal Reserve stipulating that, if Congress reduces the deficit, the Fed will ease money supply. The markets work very efficiently by themselves. If the average cynical bond trader begins to perceive that indeed a budget reduction package is not phoney, the desire to turn a profit can be counted on to drive bond prices sharply higher and long-term interest rates correspondingly lower.

There is clearly a difference, however, in the way bond traders and other participants in the world markets view a reduction in the deficit. A deficit reduction package which is heavily weighted toward tax increases is less likely to induce a marked decline in interest rates than one heavily or solely weighted in the direction

of expenditure cuts. There is the strong presumption in the financial community that an increase in tax rates could just as easily become the base for increased expenditure programs, as for reducing the deficit. The argument that the Congress has not in the past employed tax increases to finance increased expenditures is apparently unpersuasive to the financial community. The past is likely to tell us little about the future behavior of the Congress when confronted with pressures from constituencies.

It is true that Presidents and the Congress continuously cut tax rates through the 1970s as inflation pushed most taxpayers into progressively higher tax brackets. Hence, federal receipts as a percent of the GNP or of taxable incomes has remained relatively steady during the past couple of decades. It is argued, therefore, that increased tax receipts have not been the basis for financing new outlay programs. The critical consideration, however, is spending, which rose as a ratio to GNP, increasing the structural deficit. Unless the upward pressure on spending is reduced, tax increases will eventually be triggered; deficits can't increase indefinitely. In that event, taxes would be supporting increased spending programs, albeit with a time lag.

There is also clearly a difference in the way markets will react to the mix of federal budget cuts between defense and entitlement programs. Leaving the politics of entitlements and the very serious question of defense adequacy aside, so far as the economy is concerned, does it make any difference where the cuts are made?

The short answer is that it does. Entitlements: social security, Medicare, civil service, military retirement, etc., depend to a significant extent on population growth, especially among the elderly. As the base of expenditures expands, reflecting the growth in population, changes in the law today have a much larger impact on outlays ten years from now than they do, say, three years from now.

Defense, however, is another matter. A goodly part of defense expenditures are involved in building up our military asset base. Once we reach the requisite number of F-16 wings, carrier task forces, ammunition stores, etc., procurement outlays will fall back to maintenance levels, which are significantly lower in real terms than the huge budget outlays required during the period of military build-up. Hence, cuts in defense over the next three years are not translatable, as they are in entitlement programs, into very much larger cuts in the years 1990 and beyond.

Accordingly, the financial markets are surely likely to credit, on a dollar-for-dollar basis, short run cuts in entitlement programs with far more long-term anti-inflation impact than equivalent cuts in defense outlays.

There can be little doubt that the markets do not expect expenditure cuts ranging up to \$100 billion or more annually by fiscal 1988. Should they actually occur, or of more relevance should they be enacted into law currently, in a manner which is credible to the financial community, long-term interest rates are likely to fall by at least 2 full percentage points with short-term rates falling even more. Thus, even the sharp reduction in purchasing power implied by such a major contraction of the federal deficits, i.e., so-called fiscal drag, would surely be overridden by increases in effective demand generated by the marked decline in interest rates, and cost of capital.

Most immediately, homebuilding would rise quite significantly, increasing from recent levels of 1.7 million housing starts annually to well in excess of 2 million and perhaps as high as 2.2 million units annually, at least for awhile. But the more important and lasting impact would occur in the capital goods markets. The exceptionally high cost of capital which has prevailed in recent years has led to a disproportionate emphasis in investment in short-lived assets, i.e., those with quick cash payoffs. Lowered long-term interest rates would surely propel stock prices higher, and lower the cost of equity capital. The combination of lowered costs of equity and debt would increase the incentive to invest in plant and other long-lived goods. Considering the pent-up demand for long-lived investments at lower costs of capital, the expansion could go on for years. This would be especially helpful to those depressed areas of the American economy which build long-lived facilities or the materials which go into them -- steel, heavy equipment, etc.

Thus, the economy clearly would benefit longer run if the budget problem is addressed. It is an immediate imperative as well, however. Achievement of the FOMC's economic projections rests upon the validity of the assumptions back of these projections. Four percent real economic growth with inflation still at only four percent presumes that interest rates will increase only modestly. This, in turn, requires some reduction in the federal deficit as part of an ongoing federal deficit reduction package. It also assumes no precipitous decline in the exchange value of the dollar and a monetary policy which successfully keeps the monetary aggregates within the Fed's targets. If any of these assumptions are not realized, the delicate balance required to achieve the projections would be in jeopardy.

Ours is a highly complex economy, closely interrelated with economic and financial developments throughout the world. No single monetary or credit aggregate has an invariant relationship with the diverse economic and financial strands of our society. Therefore, no single monetary or credit aggregate can stand alone as the sole target of monetary policy. The various monetary and credit aggregates require monitoring and targeting, as the Fed is now doing. Moreover, the growth rates of the monetary aggregates can only be interpreted and evaluated in the context of economic and

financial conditions. Accordingly, it is not possible to specify in advance the relative weights which the Fed should assign at any given time to these diverse factors.

Since the broader monetary aggregates, such as M2 and M3, can provide the basis for transfer of deposits into transactions accounts, it is important that these broader aggregates be kept within their targets. It may be very difficult to hold down M1 if funds are beginning to be transferred into it from these other accounts. Consequently, the fact that M1 is low relative to its target must be weighed against the potential problems which could evolve if the broader aggregates remain consistently above target for a period of time.

Nevertheless, the Fed must be free to conduct monetary policy on the basis of an assessment of the forces which appear crucial at any particular time. Clearly, when the economy is faltering, it is necessary to maintain credit and monetary growth. But if the economy and money supply appear to be accelerating in an unsustainable manner, they must be reined in before a new inflation wave is generated. Appropriate monetary policy requires a weighing of the various relevant financial and economic developments. But above all, the inability to judge the vagaries of credit demands requires stable growth rates in the monetary aggregates.

Chairman FAUNTROY. We thank you, Dr. Greenspan, and we will return for questions as soon as we complete the presentations of the other panelists. We now turn to Dr. Charles Schultze. Dr. Schultze, it is a pleasure to have you here again.

STATEMENT OF CHARLES L. SCHULTZE, SENIOR FELLOW AT THE BROOKINGS INSTITUTION

Dr. SCHULTZE. Thank you, Mr. Chairman, and members of the subcommittee. I will try to abridge my formal statement liberally as I go, to save a little time.

Your letter of invitation to testify asked me to discuss a number of specific questions about the economic outlook and the monetary policy objectives for 1985, which Chairman Volcker recently presented to the committee. Let me introduce my answers to those questions that you have asked by summarizing my assessment of the Federal Reserve's basic objectives and operating techniques.

Despite all the attention still given to monetary aggregates and its semiannual reports to the Congress, the Fed, since about the middle of 1982, has not, I think, been pursuing an essentially monetarist course. You might describe the Fed as about 20 percent monetarist, or if you prefer, maybe 30 percent.

It has been pursuing, and I believe will continue to pursue, two principal objectives. It has, on occasion, modified or ignored its targets for the monetary aggregates and will do so again if necessary to meet those principal objectives. Faced with the huge and continuing pump priming stimulus from the Federal budget deficit, the Fed's first objective has been and is an anti-inflationary one—to keep a lid on the growth of national spending and output. It will do whatever it feels it has to do by way of restrained growth and bank reserves and the accompanying higher interest rate to prevent an excessively rapid economic expansion from overheating the economy and generating new inflationary pressures. Its commitment to this objective was amply shown in May of 1983 when only 5 months into the new recovery, it began to tighten monetary

policy and let interest rates move up sharply. Such an early move toward rightening was unprecedented.

The Fed, however, also, in my judgment, has no desire to see another recession. Unlike its actions in 1981, 1982, it will not deliberately put the economy through the wringer of recession in order to get inflation down further. It will, at least for the time, live with the inflation we now have. So long as inflationary pressures remain moderate, the Fed will not stand by and watch the economy go into recession. If it appears that monetary restraint has gone too far, that economic growth is slowing too much, as apparently happened late last summer, the Fed will move to ease monetary policy and lower interest rates, which it did last fall and early winter. And real interest rates are still so high, even after their decline of last fall and winter, that the Fed has very large scope to use monetary policy, if it does so responsibly and cautiously, to correct any mistake or to offset any softening in the economy.

I said that the Fed was perhaps 20, or if you want, 30 percent monetarist. It apparently doesn't pay much attention to very short-run deviations of money growth from its targets. But in the medium-run, the Fed, quite properly, does look at the combination of monetary growth rates and interest rates as a useful, although occasionally fallible current indicator of the likely strength of demand and spending in the economy.

Unexpected and sustained growth of the money stock over some months, combined with stable or rising short-term interest rates, suggests either that economic activity is accelerating or that velocity is falling below expectations. To the extent that incoming data ultimately confirmed the second hypothesis about velocity, the Fed has been willing to diverge from its money growth targets to accommodate the changed velocity. But for the interim, in deciding on the amount of bank reserves to supply, it does pay attention to sustained deviations of money supply growth from its targets.

I find the basic approach that the Fed has settled into in the last several years to be highly sensible and commendable. It has enabled the Federal Reserve reasonable economic stability and growth in an environment made very difficult by the huge structural deficits in the Federal budget.

Mr. Chairman, let me try to answer some of your specific questions. You asked about the 1985 outlook. However, short-term economic forecasting is not my bag. In any event, the economic outlook for 1985 will not solely be determined by outside events. It will be determined by the specific course that the Federal Reserve, itself, takes as the year progresses. For what it is worth, I think the prospects for the year may be a shade more optimistic than the Federal Reserve's own forecast, given the current status of policy. A fall in the dollar could give rise to higher inflation than the Fed forecasts, but unless that happens within the next 3 months or so, the time lag between the change in the exchange rate and the consequent change in prices would keep the effect in 1985 rather small.

More important than these particular forecasts, which probably aren't worth very much, is the attitude of the Federal Reserve, as expressed by Chairman Volcker. The report indicates that the Fed would do nothing to prevent the above pattern from developing.

Economic growth of the amount the Fed predicts or even a shade higher would apparently fall within the safe limits to which, under objective No. 1, the Federal Reserve is committed.

Your letter of invitation asks about the appropriate priority that the monetary authority should place on the reduction relative to reduction of inflation. Let me start with inflation. The inflation rate is now about 3.5 to 4 percent, but the rising dollar is contributing a percentage point, or probably slightly more, to that low rate. With a stable dollar, the underlying inflation rate would probably even be in the neighborhood of 4.5 to 5 percent. It has been a major accomplishment achieved at very great economic cost and human suffering to halve the underlying inflation rate from 10 to 5 percent.

At the present time I agree with the Fed's apparent willingness to live with the inflation we now have rather than to put the economy into a new period of stagnation and recession in order to pull inflation down further. On the other hand, the Nation's capacity to produce apparently continues to grow at a modest 2.5 to 3 percent a year. All of the evidence on the growth of manufacturing capacity, the expansion of the Nation's capital stock, the cyclically adjusted growth of productivity, seems to confirm that judgment. There is still some slack in the economy so that the growth of output can, for a short while, safely proceed somewhat faster than capacity is growing. But if the 4-percent forecast for GNP growth in 1985 is approximately reached, we will, by the end of the year, have used up half of the remaining spare capacity.

In terms of unemployment, it will be only one-half to three-quarters of 1 percent above the level at which unfortunately we have to begin to worry about generating new inflationary pressure. Given the human suffering and costs that are incurred during an inflation, once it gets started, and the impossibility of the Fed finetuning the economy, it would be unwise, I think, for the Fed to pursue a substantially more liberal monetary policy in 1985 than it now appears to have in mind. In short, I agree with the Fed's apparent objectives for the year, especially in the light of its demonstrated willingness to change the preannounced course of money growth if that becomes necessary, to keep the economy on the middle course between incautious expansion and unneeded stagnation.

You ask whether I think the Federal Reserve can or should redirect its monetary policy toward moderating the overvaluation of the dollar in foreign exchange markets. The essential answer to that question ought to be a resounding no. Some time ago, the Fed, quite properly, made the choice not to let the massive pump-priming stimulus from the structural budget deficit lead to excessive growth in national demand and spending.

The inevitable consequences of that decision were that other interest-sensitive activities in the economy had to be squeezed out to make room for Federal borrowing. Surprisingly, it was the trade balance that overwhelmingly got squeezed rather than domestic investment, and housing construction, and business plant and equipment. At least it was a surprise to me and most of my honest friends.

It is indeed a serious problem that the budget deficit distorts the structure of our economy so as to penalize severely the Nation's

farmers, manufacturing exporters, and import competing firms. But the Fed cannot avoid the unpleasant consequences of the budget deficit. It can only change them from one unpleasant form to another. It could sharply ease monetary policy, in my judgment, engineer for a time a large drop in short-term real interest rates, a depreciation of the dollar, and ultimately a shrinkage of the U.S. trade deficit. But the cost of such excessive expansion after a period of time would be renewed inflation, and if history is any guide, a subsequent reversal of policy leading to recession.

At the margins, the Federal Reserve may occasionally find it useful to modify its monetary policy a bit in periods when speculative fever seems to be particularly prominent in driving the dollar. But in a fundamental sense, I don't think the Federal Reserve will, or more importantly, should try to substitute the pains of inflation and subsequent recession for the less severe pains of an overvalued dollar and a large trade deficit.

The third question in your letter of invitation asked our views on the relative weight the Fed should give to various monetary aggregates vis-a-vis the financial market conditions as targets for policy. I think, Mr. Chairman, in the process of answering your earlier questions, I have already given my own views about this last one.

Finally, I would like to emphasize that the important choices about the future of the American economy must now be made not by the Federal Reserve but by the Executive and the Congress. If you do not soon act to slash the budget deficit drastically, the Fed will more and more be restricted to choosing which of several forms of economic cost it must impose upon the country. There are several alternative scenarios that might play themselves out should the budget deficit continue essentially unabated over the next several years. Each of those scenarios will pose major problems for the conduct of monetary policy. But far more important under any of them, the long-term growth, stability and vitality of the American economy will suffer severely.

The final section of my testimony, Mr. Chairman, which I will skip in the interest of brevity, goes through what I consider to be the three major scenarios that might happen with respect to the Federal Reserve's policies and actions if you don't do anything about the budget deficit. The testimony points out that in any of those scenarios, some a little more than others, but in any of the three, the Fed is put in a real bind and so is the country.

Finally, Mr. Chairman, my reading of budget numbers and political realities suggests that there is only one feasible package of deficit reductions large enough to do the job that must be done to avoid the consequences that I have spelled out. And, that is a package which attacks all the elements of the budget: reduce defense spending, cuts in Social Security benefits, and increased taxes, in addition to the cuts in other civilian programs, which the President has asked you to concentrate upon.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Schultze follows:]

Statement
of
Charles L. Schultze*
Brookings Institution
before the
Subcommittee on Domestic Monetary Policy
U. S. House of Representatives
March 5, 1985

Mr. Chairman and members of the Committee:

Your letter of invitation to testify asks me to discuss a number of specific questions about the economic outlook and the monetary policy objectives for 1985 which Chairman Volcker recently presented to this Committee. I will do so briefly. Since my views about the economic outlook and about the specific questions you have posed depend heavily on an assessment of the underlying objectives and the control techniques the Federal Reserve is now pursuing, let me start by summarizing that assessment.

Despite all the attention still given to monetary aggregates in its semi-annual reports to the Congress, the Federal Reserve, since about the middle of 1982, has not, I think, been pursuing an

* The author is a Senior Fellow at the Brookings Institution. The views set forth here are solely those of the author and do not necessarily represent the opinions of the trustees, officers, or other staff members of the Brookings Institution.

essentially monetarist course. One might correctly describe the Fed as about 20 percent monetarist. The Federal Reserve has been pursuing, and I believe will continue to pursue, two principal objectives. It has on occasion modified or ignored its targets for the monetary aggregates and it will do so again if necessary to met those principal objectives.

Faced with the huge and continuing pump-priming stimulus from the federal budget deficit, the Fed's first objective is an antiinflationary one -- to keep a lid on the growth of national spending and output. It will do whatever it feels it has to by way of restrained growth in reserves and the accompanying higher interest rates to prevent an excessively rapid economic expansion from overheating the economy and generating new inflationary pressures. The Federal Reserve's commitment to this objective was amply shown in May 1983, when only five months into the new recovery, it began to tighten monetary policy and let interest rates move up sharply. Such an early move towards tightening is unprecedented. It showed its determination again in the first half of 1984 when it engineered a 200 point rise in short-term rates to damp down an excessively rapid growth in GNP.

The Federal Reserve, however, also has no desire to see another recession. Unlike its actions in 1981-82, it will not deliberately put the economy through the wringer of recession in order to get inflation down further. It will live with the inflation we now have, as Chairman Volcker implicitly indicated in his testimony before the full House

Banking Committee on February 20, when he said that "The [1985] ranges for growth in money and credit are expected . . . to support another year of satisfactory economic expansion without an acceleration of inflation" (underlining supplied). So long as inflationary pressures remain moderate the Fed will not stand by and watch economy go into recession.

- If it appears that monetary restraint has gone too far, that economic growth is slowing too much -- as apparently happened late last summer -- the Fed will move to ease monetary policy and lower interest rates, which it did last fall and early winter.
- Real interest rates are still so high, -- even after their decline of last fall and winter -- that the Fed has very large scope to use monetary policy to correct any mistake or to offset any softening in economy; more so than usually, the Fed is now in a good position to provide counter-recessionary assistance for the economy, should that be necessary to avert a recession.

I said that the Federal Reserve was perhaps 20 percent monetarist. It apparently does not pay much attention to very short-run deviations of money growth from its targets. But in the medium run the Fed, quite properly, does look at the combination of monetary growth rates and interest rates as a useful, although occasionally fallible current indicator of the likely strength of demand and spending in the economy.

Unexpected and sustained growth of the money stock over some months combined with stable or rising short-term interest rates suggests either that economic activity is accelerating or that velocity is falling below expectations. To the extent that incoming data ultimately confirm the second hypothesis the Federal Reserve has been willing to diverge from its money growth targets to accommodate the changed velocity. But for the interim, in deciding on the amount of bank reserves to supply, it does pay attention to sustained deviations of money supply growth from its targets.

I find the basic approach that the Fed has settled into in the last several years to be highly sensible and commendable. It has enabled the Federal Reserve to preserve reasonable economic stability and growth in an environment made very difficult by the huge structural deficits in the federal budget.

One way to describe the current economic scene is that, within some moderate range, monetary policy has been determining the overall level and growth of national output. The size of the budget deficit determines the *internal composition and structure of national output*. With the federal deficit equal to about 5-1/2 percent of GNP, the Federal Reserve has to squeeze out enough interest-sensitive spending to make room for federal borrowing of that amount. For the past two years it has been the foreign sector of the economy -- our export and import-competing industries -- which have mainly been squeezed. If, as, and when overseas investors become less interested in pouring

foreign saving into the United States it will then be interest-sensitive domestic activities that will have to be squeezed out. With the Fed more or less successfully targeting the overall level of demand and spending, the damage done to the nation by the huge structural budget deficits, is not so likely to come in the form of recession or inflation. Rather it will come from the distorted internal structure that the budget deficits are forcing on the economy.

Let me turn to your specific questions. You ask about the 1985 outlook. Short-term economic forecasting is not my profession. And, in any event, the economic outlook for 1985 is not solely determined by outside events. It will be determined by the specific course that Federal Reserve policy itself takes as the year progresses. For what it's worth I think the prospects for the year may be a shade more optimistic than the Federal Reserve's own forecast, given the current status of policy. Growth over the year of 4 to 4-1/2 percent, with unemployment falling to 6-1/2 to 6-3/4 percent might be a good midpoint. All of the current signs point to continued moderate inflation. Just as in the Federal Reserve's forecast a fall in the dollar could give rise to higher inflation, but unless that happens within the next three months or so, the time lag between a change in the exchange rate and the consequent change in prices would keep the effect in 1985 rather small. More important than these particular forecasts -- which are probably not worth very much -- is the attitude of the Federal Reserve as expressed by Chairman Volcker. I read him as

saying that the Fed would do nothing to prevent the above pattern from developing. Economic growth of that amount would apparently fall within the "safe" limits to which, under objective number one, the Federal Reserve is committed.¹

Your letter of invitation asks about the appropriate priority that the monetary authorities should place on the reduction of unemployment relative to the reduction of inflation. Let me start with inflation. The inflation rate is now about 3-1/2 to 4 percent. But the rising dollar is probably contributing a percentage point, or maybe a little more, to that low rate. With a stable dollar, the underlying inflation rate would probably be in the neighborhood of 4-1/2 to 5 percent. It has been a major accomplishment, achieved at very great economic cost and human suffering, to halve the underlying inflation rate from 10 to 5 percent. At the present time I agree with the Federal Reserve's

1. There is a passage in Chairman Voicker's testimony of February 20 (p. 24) where he can be read as saying the Fed is in some sense targeting a nominal GNP growth in the neighborhood of 8 percent. After saying that the trend of velocity growth in 1985 may be a "little lower" than the normal 3 percent, the Chairman went on to say, "Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee anticipates that [the] aggregates might end up in the upper part of their ranges." But over a period as long as a year, the Fed itself can control the growth of the aggregates. I take the statement to mean, therefore, that the Fed, given evidence of M1 velocity growth slowing to say, 2 percent, will deliberately grow the M1 money supply near the upper end of the target range, say 6 percent, which is consistent with an 8 percent nominal GNP growth. I do not mean the Fed can fine tune this closely. But the statement does seem to indicate that M1 growth will be adapted in the light of observed economic growth, in a way designed to move the economy towards a GNP target.

apparent willingness to live with the inflation we now have -- rather than to put the economy into a new period of stagnation or recession in order to pull inflation down further.

On the other hand, the nation's capacity to produce apparently continues to grow at a modest 2-1/2 to 3 percent per year. There is still some slack in the economy so that the growth of output can, for a short while, safely proceed somewhat faster than capacity is growing. But, if the 4 percent forecast for GNP growth in 1985 is reached, we will by the end of the year have used up half of the remaining spare capacity, and in terms of unemployment will be only 1/2 to 3/4 of a percent above the level at which, unfortunately, we have to begin worrying about generating new inflationary pressures. Given the human suffering and costs that are incurred to wring out inflation once it gets started, and the impossibility of the Fed fine-tuning the economy, it would be unwise for the Fed to pursue a substantially more liberal monetary policy in 1985 than it now appears to have in mind. In short, I agree with the Fed's apparent objectives for 1985, especially in the light of their demonstrated willingness to change the preannounced course of money growth to the extent that becomes necessary in order to keep the economy on the middle course between incautious expansion and unneeded stagnation.

You ask whether I think the Federal Reserve can or should redirect its monetary policy towards moderating the overvaluation of the dollar in foreign exchange markets? The essential answer to that question is

a resounding "No." Some time ago the Fed quite properly made the choice not to let the massive pump-priming stimulus from the structural budget deficit lead to excessive growth in demand and spending. The inevitable consequence of that decision was that other interest sensitive activities in the economy had to be squeezed out to make room for the deficit. Surprisingly, it was the trade balance that overwhelmingly got squeezed rather than domestic investment in housing construction and business plant and equipment. It is indeed a serious problem that the budget deficit distorts the structure of our economy so as to penalize severely the nation's farmers, manufacturing exporters, and import competing firms. But the Fed cannot avoid the unpleasant consequences of the budget deficit; it can only change them from one unpleasant form to another. It could sharply ease monetary policy, engineer for a time a large drop in short-term real interest rates, a depreciation of the dollar, and ultimately a shrinking of the U.S. trade deficit. But the cost of such excessive expansion, after a period of time, would be renewed inflation and, if history is any guide, a subsequent reversal of policy leading to a recession.

At the margin, the Federal Reserve may occasionally find it useful to modify its monetary policy a bit in periods when speculative fever seems to be particularly prominent in driving the dollar. Chairman Volcker told this Committee last week that the Federal Reserve may now be doing a little of this, in the sense of pursuing a slightly easier monetary policy than it would otherwise desire. But in a more

fundamental sense I do not think the Federal Reserve will or should try to substitute the pains of inflation and subsequent recession for the less severe pains of an overvalued dollar and a large trade deficit.

The third question in your letter of invitation asked our views on the relative weight that the Federal Reserve should give the various monetary aggregates vis-a-vis an array of economic and financial market conditions as targets for policy. I believe, Mr. Chairman, that in the process of answering your earlier questions I have already given my views about this last one.

Finally, I would like to emphasize that the important choices about the future of the American economy must now be made not by the Federal Reserve but by the Executive and the Congress. If budget deficits of 5 to 5-1/2 percent of GNP are allowed to continue, then -- even more than in the recent past -- the Federal Reserve will be called upon to make choices between various unwelcome forms of economic pain.

There are three alternative scenarios that describe how economic events might play themselves out over the rest of this decade, assuming no radical reductions in the budget deficit. Under the first, and possibly the most likely scenario, foreigners will eventually begin to lose some of their desire to buy dollars, as their portfolios become increasingly top heavy and risky with dollar-denominated assets. The dollar -- possibly later rather than sooner -- will begin to fall. After a lag, exports will strengthen and imports weaken. The inflow of foreign saving, which now indirectly finances over half of the U.S.

budget deficit, will start to dry up. The 5 to 5-1/2 percent of GNP which the federal government borrows will then have to be financed out of our limited domestic saving. In order to meet its primary objective of avoiding an overheated economy the Federal Reserve will, therefore, have to engineer a new surge in interest rates in order to squeeze out domestic investment in housing and business plant and equipment. No one can be sure, but recent history under financial deregulation suggests that the rise in rates might have to be very large. Yet they would only be the symptoms of underlying economic loss -- namely the long-term reduction in American economic growth that would result.

A second, less likely but still possible scenario, is that foreigners continue for a long time in the future to find dollar assets attractive, despite the cumulative increase in their holdings. After all, most of us sharply underestimated the foreign appetite for dollars over the last several years; perhaps their appetite for dollars will continue to surprise us. In this scenario foreign saving continues to supplement domestic saving in a large way. The dollar remains high; the trade balance stays huge; farmers, exporters and import competitive industries continue to suffer. But the 5 to 5-1/2 percent of GNP going to the federal budget deficit can continue to be financed at roughly current interest rates. The economic cost to the nation in this case takes the form not of reduced domestic investment and lower productivity growth, but an ever mounting foreign debt, the payment of debt service on which increasingly erodes the growth of the nation's

living standards. In one way this is the worst of all scenarios. No crisis and no surge in interest rates intervenes that might force action on the budget deficit. The day of reckoning is postponed, while, in the meantime, the eventual tax burden required to service the federal debt steadily mounts.

The third scenario, also less likely but not impossible, is a crisis scenario. Suppose that when the dollar starts to fall speculative fever takes over so that it falls not gradually but very swiftly and far. Import prices would rise steeply, and the price of import-competitive goods produced domestically would follow suit. Temporarily, at least, the U.S. inflation rate would rise significantly. In a strong economy, with low to moderate unemployment and high capacity utilization, the sharp increases in import prices might set off a new price-wage-price spiral and turn a temporary rise in inflation into a long-term one. The Federal Reserve would be faced with a dilemma -- continuing to accommodate economic growth would require validating a new inflation. Suppressing the inflation could set off a new recession. My guess is the present Fed would choose recession.

The purpose of spelling out these scenarios, Mr. Chairman, is to drive home the point I made earlier that at this juncture in history the critical choices to be made are in the hands not of the Federal Reserve but in those of the President and the Congress. If you do not soon act to slash the budget deficit drastically, the Fed will more and more be restricted to choosing which of the several forms of economic costs it will impose upon the country. A reading of budget numbers and political realities suggest in turn, Mr. Chairman, that the only feasible package of deficit reductions large enough to do the job is one which attacks all the elements of this budget -- defense spending, social security and taxes in addition to the other civilian spending programs which the President has chosen to concentrate upon.

Chairman FAUNTROY. Thank you, Dr. Schultze.
Dr. Poole.

**STATEMENT OF WILLIAM POOLE, PROFESSOR OF ECONOMICS,
BROWN UNIVERSITY**

Dr. POOLE. Thank you, Mr. Chairman, and members of the subcommittee. I am certainly delighted to be here. I must say, though, that when I took a walk after breakfast, I almost decided to call in sick and pack up my suit and go for a walk along the canal. It is such a beautiful day. But here I am anyway.

I hope you have a copy of my written statement in front of you. I will be referring to some of the charts in that statement in the course of my oral presentation.

Let me begin by just very briefly touching upon the three questions posed to me in the chairman's letter of invitation to these hearings. Then I will run through my ideas on monetary targeting with somewhat greater attention to detail.

As for the economic outlook, I believe that the administration's economic assumptions are sound. The administration, the Federal Reserve and the CBO forecasts are all quite similar. It should be emphasized, however, that we must interpret all forecasts as having a range of error attached to them. Forecast errors for both real GNP in the inflation rate average in the neighborhood of 1 to 1.5 percentage points for a four-quarter-ahead forecast. That is our experience historically.

Second, the performance of the economy will depend importantly on the future policy actions of the Federal Reserve, the administration and the Congress. It is not easy to forecast what the Government is going to do, and the discipline of economics is not of much value in improving these forecasts. To forecast the Government, it is probably better to pull out a crystal ball than a bundle of economic text books.

In relation to Federal Reserve policy toward inflation, as shown in the chart on page 2 of my statement, with a lag that has averaged about 2 years in the United States, more rapid money growth brings more rapid inflation and vice versa.

The relation between swings in money growth and the business cycle is shown on page 3 of my statement. Money growth generally declines before and during recessions. These charts, by the way, have been reproduced from this year's economic report of the President. If money growth declines gradually over time, I believe that the administration's forecast has an excellent chance of being realized, at least in broad outline. The forecast also depends on the assumption that our Federal finances are put on a sound basis. My only quarrel with the administration's outlook is that I believe that real rates of interest remain unusually high so long as the Government follows policies that support high real rates of return on new business investment. Reducing the budget deficit will help to reduce interest rates but not by a large amount, in my view.

Now, let me turn to the value of the dollar. The U.S. dollar is high, but not overvalued in any proper sense of that term. The dollar will fluctuate in value, but I do not believe that it will decline sharply under our current policies, even assuming that the

budget deficit is brought down significantly through spending reductions. However, reducing the deficit through tax increases that reduce the rate of return on new investment could well leave us with lower real interest rates and a lower dollar. Such policies would also leave us with lower investment and a lower rate of real GNP.

To those who predict that the dollar will fall if the Federal budget deficit is reduced, I raise this challenge. Find me an example from history of a country that has put its fiscal affairs in sound order and found itself with a depreciating currency.

Large-scale direct intervention in a foreign exchange market is unlikely to have much effect on the exchange rate except possibly to increase the short-term volatility of the rate. According to this morning's Washington Post, intervention by various governments last week may have amounted to about \$4 billion. Intervention of that scale continued for a year would amount to \$200 billion, and yet might only hold the dollar a few percent below where it otherwise would be. Intervention policy just doesn't look very promising.

Chairman Fautroy's third question concerned the proper role of monetary aggregates and financial conditions in Federal Reserve policy. I note first—and here I agree with Charlie Schultze, that Federal Reserve policies are not today very monetarist, especially in the short run. They are, in my view, the functional equivalent of its policies before October, 1979. The pre-1979 policies involved an explicit short-run peg to the Federal funds rate. The peg was adjusted from time to time.

Policy today involves what the Federal Reserve calls maintaining a certain degree of pressure on bank reserve positions. The reserve pressure is adjusted from time to time. But if a man or a woman from Mars dropped down here today and looked only at the data, studiously avoiding reports, speeches and testimony, that person would have a hard time distinguishing present open market policy from the policy before October 1979.

Let me now turn to monetary targeting issues. The purpose of monetary targeting is to improve the performance of the economy, to stabilize the price level, to obtain maximum employment and growth, and to foster stable and efficient financial markets. Nothing is less inherently important than green pieces of papers with numerals and nicely engraved portraits of Presidents. Money is a tool. We must be its master and not its slave. My views on monetary management reflect my best efforts to help us master money and to explain why my suggestions for policy should be helpful. I am well aware that economists have much to be humble about, and I hope my analysis will be taken in that perspective.

One issue in the design of monetary targets concerns the so-called wedge or cone, as it is sometimes called, versus the band. The chart on page 11 of my written statement, reproduced from the 1985 economic report, illustrates the difference between these two approaches.

I first advocated the band approach in a 1976 paper published in the Brookings Papers on Economic Activity. One reason for adopting this approach is illustrated nicely by the chart on page 12 of my written statement. That chart, reproduced from Chairman Volcker's recent testimony, shows that the money stock has al-

ready surged above the target wedge. At the beginning of the year, the wedge is simply too narrow to reflect the inherent fluctuations of money on a short-run basis. Rather than leave the financial markets, and the Congress, with uncertainty about exactly what the wedge means, I believe that the Federal Reserve should define its targets explicitly in terms of a band.

A second problem with the wedge approach arises when one year's target is linked to the previous year's target. Take the chart on page 12, and add one more year to it, as shown on page 13 of my statement with a chart that I drew rather crudely with a pencil and ruler, adding to the previous chart. Now, for the sake of illustration, suppose that the target range for 1986 is 4 to 7 percent growth for M^1 , the same as 1985 targets. Referring to the chart, if the money stock in late 1985 reaches point x at the end of the year, then the target wedge for 1986 will look like the upper one in that chart on page 13. Conversely, if the money stock finishes 1985 at point y , then the target wedge for 1986 will look like the lower one in the chart. The Federal Reserve's practice of basing the target for a year on the actual level of the money stock in the fourth quarter of the previous year produces this result.

The band approach, illustrated on page 14 of my written statement, shows how the two approaches differ. In the band approach, the target for 1986 will be tied to the target for 1985 and not to the actual 1985 outcome in the fourth quarter at a point like x or y . This issue is taken up in attachment 4 of Chairman Volcker's testimony.

Here is a quote: "More broadly," he said, "a decision to regularly target growth from the midpoint of a previous year's range would seem to imply that continuing validity of the judgment made a year earlier, that the midpoint of a previous range is in some sense a uniquely correct level of a monetary aggregate. The committee, meaning the FOMC, does not share such a conviction."

Am I to interpret this passage to mean that the FOMC believes that, as a normal matter, the actual level of the money stock in the fourth quarter of each year is the uniquely correct base? The Fed has often talked of the vagaries of short-run money growth and of money stock measurement and control problems. The Fed has warned us over and over again not to pay much attention to money in the short run. Why does the Fed want to base its money growth targets on what it itself views used as such a will-o'-the-wisp as the actual level of the money stock in a particular quarter?

As a matter of simple arithmetic, the wedge and band approaches could be specified in such a way year by year as to be absolutely identical, but the two specifications had different implications as to what is to be done as a normal matter. The wedge approach implies that a high or low level of the money stock in the fourth quarter of 1 year will ordinarily be built into the targets for the next year. In the band approach, the normal expectation is that a high or low level of the money stock in the fourth quarter will be reversed over the quarter of the next year.

When I wrote on this subject in 1976, I could only speculate on how the alternative systems would work because the monetary targeting announcements had only started in 1975. But now we have substantial experience with this system, as summarized in the

chart on page 15 of my written statement. Here we can see that money growth exceeded the target wedges in 1977, 1978, and 1979 as inflation became a more and more serious problem. In 1981, money came in at the bottom of the target range as the economy sank into a deep recession. The target for the recession year of 1982 was based on that low level of M^1 in the fourth quarter of 1981.

The proposal that monetary targets be stated in terms of a band is, therefore, supported by 9 years of experience with monetary targeting. The proposal is designed to provide a sound longrun monetary policy plan. Federal Reserve officials, in my view, should not come before the Congress with urgent statements of the importance of a longrun fiscal policy plan when they are unwilling, as at present, to commit themselves to a monetary policy plan extending more than 10½ months in the future.

The policy proposals discussed above have often been described as rigid and doctrinaire. Many observers believe that wise policy must be flexible policy. I am not arguing that we should, or can, enact today a monetary policy good for all time. I am instead arguing *for a policy built upon experience that is good until there is clear and convincing evidence that a different policy would be better*. That is what flexibility ought to mean. Actions based on what seems best day by day cannot be regarded as flexible policy. Unless those actions reflect some principles or standards, flexible policy is no policy at all.

Thank you.

[The prepared statement of Dr. Poole follows:]

STATEMENT
OF
WILLIAM POOLE
PROFESSOR OF ECONOMICS, BROWN UNIVERSITY

BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
U. S. HOUSE OF REPRESENTATIVES

MARCH 5, 1985

STATEMENT

Mr. Chairman, Members of the Subcommittee, I am delighted to be here this morning to discuss monetary policy and related issues. These hearings, and others like them, are a sign of the growing Congressional and public interest in monetary policy. We have come to take that interest for granted; the damage that can be done by monetary instability is obvious to everyone. Only ten years ago the potential for monetary policy to disrupt the economy was not nearly so well understood. Difficult economic conditions -- severe recession or sustained inflation -- were attributed to other causes. But everyone now knows that the Federal Reserve has the power, with one decision of the Federal Open Market Committee (FOMC), to set off a raging inflation or a deep recession. Congressional oversight of the Federal Reserve's use of its powers is one of the very most important responsibilities of this Committee and of every member of the Congress.

The first three sections of my statement are devoted to the questions posed by Chairman Fauntroy in his letter inviting me to testify at these hearings. Issues concerning the specification of money growth targets are taken up in the fourth section. In a final section I offer some observations on Congressional oversight of monetary policy.

The Economic Outlook

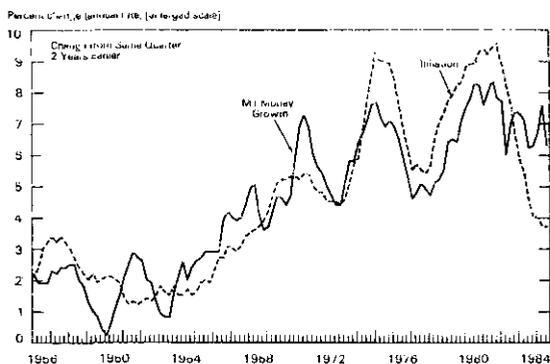
The administration's outlook for economic growth and inflation over the second half of this decade is sound and sensible. The 1985 part of this forecast path for real GNP accords quite closely with the forecasts from the Federal Reserve and the Congressional Budget Office. Most of the commentary on these forecasts has emphasized that the administration's forecast is on the high side of the others, but I am personally convinced that the administration's optimism is fully justified.

Arguing about these small forecast differences is, in any event, a waste of time. Attached to anyone's real GNP forecast over the four quarters of 1985 should be a range of error in the neighborhood of 1.0 to 1.5 percentage points. The administration's forecast should really be stated as 3.0 to 5.0 percent real growth over the four quarters of this year. The Federal Reserve's forecast might be stated as 2.75 to 4.75 percent real growth, and the CBO forecast as 2.5 to 4.5 percent real growth. What is most interesting about these forecast ranges is the extent of their overlap and not the extent of their differences. To provide a better understanding of forecast accuracy, this Committee might want to request CBO to conduct a study of the accuracy of economic forecasts.

Forecasting inflation is subject to similar hazards to forecasting real growth. Over a span of 4 quarters the inflation

forecast is subject to errors of about the same magnitude as the real GNP forecast. Over the longer run, inflation is determined primarily by the rate of money growth. To illustrate this fact, I have reproduced below a chart from the 1985 Economic Report of the President.

Money Growth and Inflation Money Growth Lagged 8 Quarters



Note: Inflation measured by change in GNP implicit price deflator, based on seasonally adjusted data.

Source: Department of Commerce and Board of Governors of the Federal Reserve System.

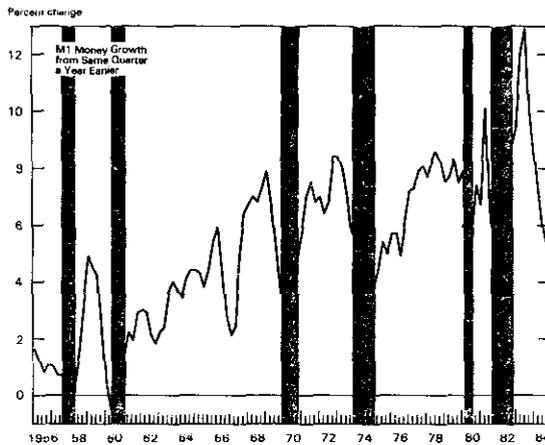
Given the close connection between monetary policy and inflation, inflation forecasting errors over the longer run are policy forecasting errors. These forecasting errors are not the fault of the forecasters. There is nothing in the traditional discipline of economics that helps economists to forecast what the Federal Reserve is going to do, or what pressures the Congress will bring on the Federal Reserve to bend its monetary policies.

What economists can say is this: if money growth falls over time, then the trend rate of inflation will also fall, although the timing and exact extent of the fall are subject to substantial prediction errors. It is up to the Federal Reserve and the Congress to determine whether that "if" clause is a factual or a counterfactual one.

Chairman Volcker, in his recent testimony, placed great weight on the importance of continuing to reduce the rate of inflation. I emphatically support that position. Inflation and our society's reaction to it were the main causes of the protracted 1981-82 recession. Looking back, the same pattern was

evident in the recessions of 1974-75, 1969-70, and 1957-58. I urge you, sometime, to review those periods of history by going to the library and pulling out microfilm for the New York Times, the Washington Post, the Wall Street Journal, and any other newspapers that might interest you. Read the news stories and, especially, the editorials to see how long into these recessions inflation was viewed as the "number one problem" for our economy. These attitudes lead to an undesirably tight monetary policy for too long into recession, dragging the economy into a far deeper slump than necessary. The chart below, also from the 1985 Economic Report, shows that money growth has typically declined before and/or during recessions.

Money Growth and the Business Cycle



Note.—Shaded areas indicate recessions (peak to trough) as defined by the National Bureau of Economic Research.

Source: Board of Governors of the Federal Reserve System (except as noted).

Our Nation cannot, however, pursue a monetary policy that is sometimes easier and never tighter. If money growth rises but is never brought down for fear of triggering or exacerbating a recession, then it is a simple matter of arithmetic that the average rate of money growth will rise over time. Under this monetary policy the rate of inflation would become higher and higher and higher. That is not a desirable policy. Nor is it one the American electorate will accept. If recessions are to be avoided by avoiding sharp decelerations of money growth, and ever-rising inflation is to be avoided by preventing an ever-rising rate of money growth, then a sustained period of higher money growth must not occur. This conclusion is a matter of logic and not of my own personal preferences.

I can emphasize my concern that we maintain a long-run policy perspective in another way. Who on this Committee remembers the state of the economy in the second quarter of 1976? Who remembers how the economy differed in the second quarter of 1977? What happened in the second quarter of 1980 that did not happen in the first quarter of 1980? My economist friends will be able to answer those questions, but few non-economists will be able to do so. Nor will they care. It doesn't matter whether the rate of inflation began to rise in the first quarter of 1977, or in the third quarter. The fact is that the rate of inflation did rise for a sustained time in the late 1970's, and the exact timing is not important. Questions about the 1985 economy should always be imbedded in a longer-term outlook.

Some economists are now forecasting a new recession to begin late this year or in 1986. There is no professional basis for such a forecast. Some base the recession forecast on the fact that by the end of this year the present business cycle expansion will be about as old as the average length of a postwar expansion. If that fact were highly relevant, then we should expect that all business cycle expansions would be of about the same length. In fact, business cycle expansions differ greatly in length.

To understand this important point, consider a simple coin-tossing analogy. We know that in repeated trials the number of heads will be about 50 percent. Suppose you are exploring the laws of probability by tossing a coin and recording the results. If you happen to see three tails in a row, should you expect heads on the next toss? The answer, of course, is "no". The coin has no memory, and each toss is independent of the previous outcomes. A business cycle expansion has about the same properties. The probability that a recession will begin in any particular quarter is independent of the length of the previous expansion, at least as a close first approximation.

I take issue with one part of the administration's economic outlook. In my view, we should expect real interest rates to remain high as long as we pursue policies that encourage economic

growth by maintaining a high rate of return on new business investment. Tax and regulatory policies, low inflation, and a healthy labor market environment free of unusual discord or an abnormally high level of strike activity all contribute to a high rate of return on new investment.

That high rate of return on investment, so long as it exists, will hold up the rate of return on competing financial assets. Under the administration's announced economic policies, business investment should continue to be profitable and the rate of return should continue to be high for the foreseeable future. Under these policies, I expect that the real rate of interest will decline only slowly. A substantial reduction in the budget deficit, which is highly desirable, will not reduce real interest rates very much if tax and other incentives to business investment remain intact.

The Value of the Dollar

The dollar is high but not "overvalued." The issue is not just a matter of semantics.

Under the Bretton Woods system of fixed exchange rates from 1945 to 1971, "overvalued" had a reasonably clear meaning. Governments intervened in the foreign exchange market to maintain the fixed exchange rates. An overvalued exchange rate was one where there was a persistent imbalance between the private demand for and supply of the currency that required governments to buy up excess supplies of the currency on a sustained basis. To maintain the overvalued exchange rate, a country had to run down its foreign exchange reserves and/or borrow abroad.

In the flexible exchange rate world in which we now live, a currency cannot be "overvalued" in the Bretton Woods sense, unless a country is intervening heavily to support its value. Today, no country is intervening heavily in the foreign exchange market to support the value of the dollar. Intervention is going in the other direction; some governments are attempting to hold the dollar down rather than hold it up.

The second sense in which the dollar might be "overvalued" is the same in which any asset might be "overvalued." A common stock, a piece of real estate, an ounce of gold, or a currency might be said to be overvalued in the sense that the speaker is predicting that the value will decline in the future. It is obvious that the average market opinion cannot be that the dollar is overvalued today. If that were the case, the value of the dollar would be lower than it is now, just as would be the price of IBM stock if the average market opinion were that it is priced too high. The dollar may fall, but there is no reason to believe that it must inevitably fall. Those who believe that the dollar must fall are making the same mistake as those who sold their "overvalued" IBM stock in 1955.

There are two basic questions concerning the high value of the dollar. The first concerns why the dollar is so high, and the second the possible public policy actions to change the value of the dollar. This second question has two parts. First, would proposed policies in fact produce the advertised results? Second, would those proposed policies be desirable considering all of their effects?

The dollar is high because of the great success of the U.S. economy over recent years compared to our foreign competitors. Let me use an analogy. Within the United States, over the last twenty years, favorable economic conditions in the sun-belt states pulled resources from the snow-belt states. Because these regions use a common currency -- the U.S. dollar -- the strength of the sun-belt could not show up in a strong currency. But if the regions of the United States had been using separate currencies, along the lines of the separate nations within the European common market, then it is highly probable that the sun-belt currency would have been strong and the snow-belt currency would have been weak.

Because the fundamental cause of the strong dollar is the strong U.S. economy, the policy option available to us that would have the largest effect on the dollar would be to do whatever is necessary to weaken the economy of the United States. The dollar will fall if we pursue inflationary policies and raise taxes on business in order to reduce the incentive to invest in new productive capital. It would be easy to add to this list of destructive policies. I know of no one who would advocate reducing the value of the dollar by pursuing such approaches.

Because the value of the dollar reflects the relative positions of the United States and foreign economies, what we should advocate is improvements in foreign economies rather than degrading the performance of our own. But while we can advocate, we cannot control the economic policies of our friends in Europe and Latin America. Those countries must find their own way. But we should insist that it is unreasonable for them to ask us to copy their own destructive policies that have led to economic stagnation and rising unemployment.

The other policy option that is frequently discussed is direct intervention in the foreign exchange markets. It is argued that we could lower the foreign currency price of the U.S. dollar through sustained purchases of foreign currencies, adding them to our international reserves.

Those who oppose this policy, as I do, do not do so for reasons of ideology, as is so often charged. This is a matter of economic science, and there is much careful empirical work to support the proposition that activist foreign exchange policies simply will not change the value of the dollar short of massive intervention.

This empirical finding depends on the assumption that foreign exchange market intervention is of the "sterilized" variety. Sterilized intervention is conducted in such a way that it does not change the rate of growth of the domestic money stock. The exchange rate might, however, be affected by truly massive sterilized intervention -- intervention amounting to scores of billions of dollars per year.

For reasons that go beyond the scope our discussions today, I believe that massive intervention would be very undesirable; all I want to do at this point is to insist to you that intervention in the neighborhood of ten to twenty billion dollars per year will have little noticeable effect on the average value of the U.S. dollar in the foreign exchange markets. This Committee might want to ask CBO for a compendium of studies on this issue.

Although limited intervention will not change the average foreign exchange value of the dollar over time, it may, as demonstrated last week, make the exchange rate less stable. To market participants, government behavior is often not very predictable. Indeed, can members of this Committee predict what the Treasury's intervention policy will be next week, or what the German Government's policy will be? It is ironic that, in the abstract, advocates of intervention argue for timely buying and selling of foreign currencies to stabilize markets and that in practice intervention often has the opposite effect, and sometimes deliberately so.

Money and Financial Conditions In Federal Reserve Policy

Having just returned to academia from Washington, I am well aware of the benefits to all policy makers of fuzzing up certain issues. While in Washington, on occasion I had no choice but to do the same. But now that I am an academic once again, my responsibility is to clarify and sharpen issues rather than the reverse.

Over the years one of the most fuzzed up elements of Federal Reserve policy has been the role of market interest rates in determining open market operations. Interest rates are politically sensitive; neither the Federal Reserve nor anyone else wants to take responsibility when interest rates rise, although I have occasionally heard political figures take credit when interest rates fall. Federal Reserve attention to "financial conditions" is simply a euphemism for Federal Reserve efforts to influence interest rates -- to make them fall when they otherwise would not, to keep them from rising as much as they otherwise would, and so on.

Over the years, and especially recently, numerous bills have been introduced in Congress that would require the Federal Reserve to target interest rates in some fashion or other. I believe that interest rate targeting is highly undesirable, and

am therefore an uncompromising opponent of such proposals. But I also believe that improved monetary policy over the long run requires improved public and Congressional understanding of what is now being done, and therefore I want to insist that the Federal Reserve is today targeting interest rates, although loosely.

A major source of confusion is that in discussing monetary policy the Federal Reserve switches back and forth between the terms "reserves" and "reserve positions". The growth of bank reserves available to meet legal reserve requirements is very closely related to the growth of the money stock, especially M1. In the short run, over several months or several quarters, reserves and money growth are essentially uncorrelated with changes in interest rates. Low reserves and money growth is sometimes associated with rising interest rates and sometimes with falling interest rates.

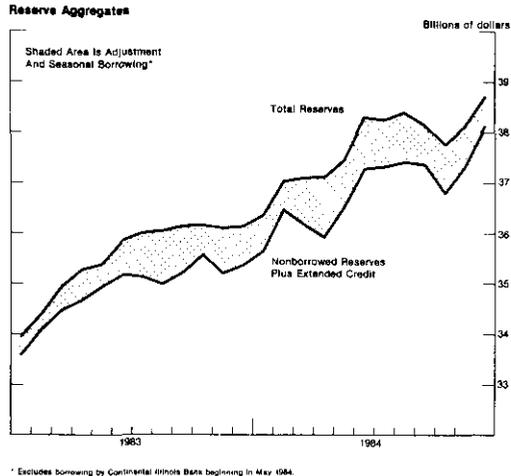
The concept of bank's "reserve position" is entirely different. A bank's reserve position is the difference between its nonborrowed reserves and its required reserves. This quantity can also be stated as the difference between a bank's excess reserves and its reserves borrowed through the Federal Reserve's discount window. When this figure is positive it is called "net free reserves" and when it is negative it is called "net borrowed reserves".

Because the reserve position is the difference between nonborrowed and required reserves, the banking system's reserve position has no necessary connection to the rate of growth of total reserves and the money stock. If money growth is rapid, required reserves growth will also be rapid. If the growth of nonborrowed reserves keeps up, then the banking system's reserve position will not change.

The banking system's reserve position, however, is closely connected to the level of market interest rates relative to the Federal Reserve's discount rate. Given the discount rate, rising market interest rates increase the incentive for banks to borrow at the discount window, and they commonly do so.

Let me now provide some illustrations of these important distinctions. On page 28 of its Monetary Policy Report the Federal Reserve says that in late August and early September of 1984 it, "moved to lessen the degree of restraint on bank reserve positions." Statements of that kind are interpreted by the Federal Reserve and by knowledgeable market participants to mean that the Federal Reserve eased interest rates down at that time. Barring temporary and anomolous blips in the data, I know of no one who would say that the Federal Reserve could "lessen the degree of restraint on bank reserve positions" at a time when money market interest rates were rising substantially. A "lesser degree of restraint" is a euphemism for "lower interest rates." In the interest of clear thinking about monetary policy issues I urge you to treat the two terms as synonymous.

Below is a chart reproduced from the Federal Reserve's Monetary Policy Report. The banking systems's reserve position is the shaded area between the two lines in the chart. Note that after the middle of 1984 total reserves fell while the reserve position "eased" -- that is, net borrowed reserves fell. This was a period when money market interest rates were falling significantly and money growth was low.



In testimony February 20, 1985, before the Senate Banking Committee, Chairman Volcker made a special point of arguing that the Federal Reserve did not target real economic growth. An attachment to his statement discusses that issue. The beginning of that attachment reads as follows: "Questions sometimes arise as to whether the Committee's forecast for real GNP growth or prices are in the nature of short-run targets toward which the Federal Reserve 'fine-tunes' policy, or whether the Committee has preconceptions about just how rapidly the economy can and should grow over the medium or longer run. The answer to those questions is no."

I believe that the Federal Reserve ought not to target real economic growth, but am less convinced than this passage suggests that it does not target real growth, at least to some extent. Consider the following two passages from that same testimony. "The strong expansionary forces in the economy were reflected in some limited upward movements in interest rates in February and March, and early in the spring the Federal Reserve began to exert some additional restraint on reserves being supplied through open market operations." (page 11) "By late August and September, with M1 growth moving toward the midpoint of its range and M3 expansion slowing toward the upper end of its range, and with

some evidence that economic growth had slowed, the Federal Reserve began to ease pressures on reserve positions." (page 13)

The juxtaposition of phrases concerning the performance of the real economy and adjustments in monetary policy in these passages, and many others, leads market observers, rightly or wrongly, to believe that monetary policy is adjusted in response to observed short-run changes in the state of the economy. It is not surprising that market speculation on Federal Reserve responses to incoming data on the strength of the economy sometimes causes interest rates to change.

Monetary Targets for 1985 and Beyond

The purpose of monetary targeting is to improve the performance of the economy -- to stabilize the price level, attain maximum employment and growth, and to foster stable and efficient financial markets. Nothing is less inherently important than green pieces of paper with numerals and nicely engraved portraits of Presidents. Money is a tool; we must be its master and not its slave.

The issue is how we can master money. Economists, government officials, and others have fought over monetary issues for centuries. The fact that we continue to fight over monetary matters, as in these hearings, demonstrates that we have not yet mastered money. We are sometimes its slave. It hurts and we resent it.

The views I present to you on monetary management reflect my best efforts to help our society master money, and to explain why my suggestions should be helpful. I am well aware that economists have much to be humble about, and I hope my analysis will be taken in that perspective.

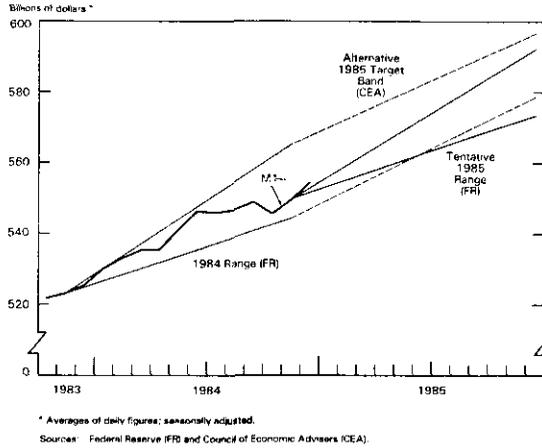
Following past practice, the Federal Reserve has announced 1985 targets for three measures of the money stock -- M1, M2, and M3. In my view, major weight should be given to M1; the other two monetary measures should be regarded as distinctly subsidiary. Indeed, I believe that the predictability of monetary policy would be improved if the Federal Reserve would confine its targets to M1. The behavior of the other monetary aggregates could be referred to in the process of justifying or explaining the M1 target. The existence of multiple targets creates unnecessary market uncertainty because the Fed may switch from one to the other.

An episode that illustrates this concern occurred in 1981. Money as measured by M1 was coming in at or below the bottom of the target growth range. In August -- which we now know was the first month of the 1981-82 recession -- the Federal Reserve switched its policy emphasis to give more weight to M2, which was coming in at the high side of its range. The effect of this change of emphasis was to alter open market operations to keep interest rates from falling as rapidly as they otherwise would have at the beginning of the recession.

I believe that a careful examination of the targeting record since 1975, counting up the successes and failures from altering the target emphasis, would yield a count of considerably more failures than successes. In designing policy for the future we should try to learn as much as we can from this experience.

A second important issue in the design of monetary targets is the "wedge" (or "cone") versus the "band." The chart below, reproduced from the 1985 Economic Report of the President, illustrates the difference between these two approaches.

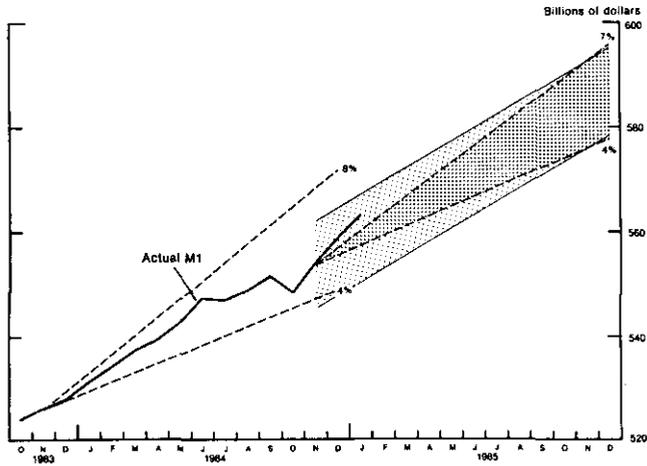
Alternative M1 Target Ranges for 1985



In his Senate Banking Committee testimony, Chairman Volcker offered the following observation on this matter. "We have sometimes considered, and others have suggested, a better 'pictorial' approach would be to illustrate the target by a different (but also necessarily arbitrary) convention -- parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period as shown in the charts attached." [Emphasis added.]

The choice between these two approaches is not arbitrary. Consider the chart offered in Chairman Volcker's testimony, shown below. A difference between the CEA chart and the Fed's chart is the choice of the base. The CEA chart is drawn with a base equal to the center of the 1984 target range whereas the Federal Reserve's traditional approach is to use the actual level of M1 in the fourth quarter of the year. In the Fed's chart the target range for 1985:IV is essentially the same under the wedge and band approaches.

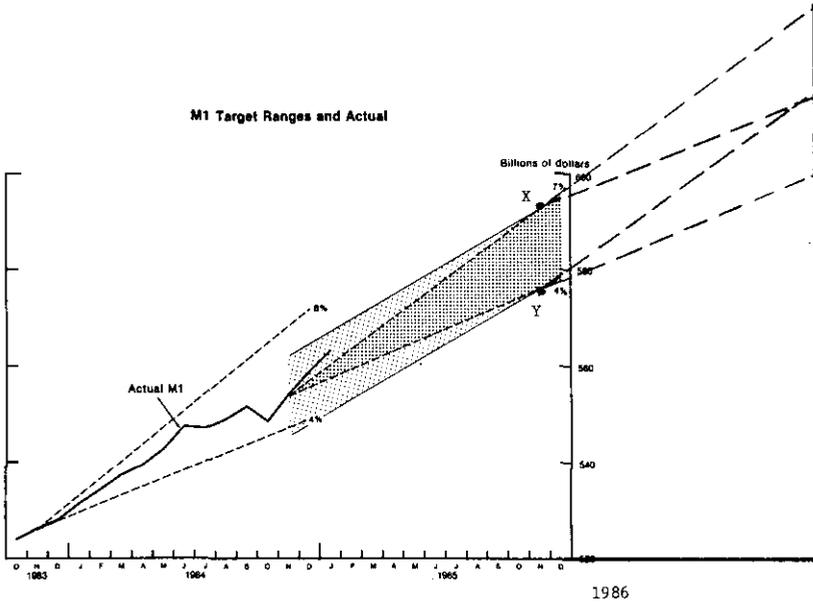
M1 Target Ranges and Actual



In the CEA chart the wedge and band, at the end of 1985, overlap to a very considerable extent, but not entirely. The reason the overlap is not complete is that the actual level of M1 in 1984:IV was slightly below the midpoint of the 1984 target range.

Now look ahead to next year. Assume, for the sake of illustration, that the 1986 target is the same as 1985.

Suppose M1 ends 1985 in either the upper part of its target range, as shown by the point marked X in the chart below, or in the lower part of the range, as shown by point Y. The 1986 target wedges from points X and Y just barely overlap at the end of 1986. Should the 1986 target range use point X or point Y as a base, or would the middle of the 1985 range be better?

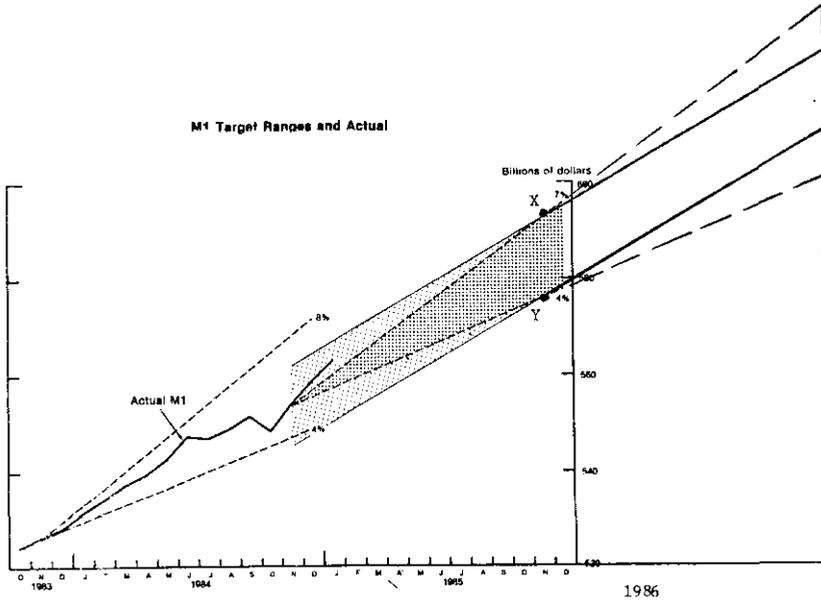


This issue is taken up in Attachment IV of Chairman Volcker's testimony. "More broadly", he says, "a decision to regularly target growth from the mid-point of a previous year's range would seem to imply the continuing validity of a judgment made a year earlier that the mid-point of a previous range is in some sense a uniquely 'correct' level of a monetary aggregate. The Committee does not share such a conviction."

Am I to interpret this passage to mean that the FOMC believes that as a normal matter the actual level of the money stock in the fourth quarter of each year is the "uniquely correct" base? The Fed has often talked of the vagaries of

short-run money growth and of money stock measurement and control problems. The Fed has warned us over and over again not to pay much attention to money in the short-run. Why does the Fed want to base its money growth targets on what it views as such a will-o'-the-wisp as the actual level of the money stock in a particular quarter?

Now, put the CEA and Fed targeting methods on the same chart, as shown below. Looking ahead to 1986, the wedge and band methods of specifying targets have major differences, and these differences are not simply "arbitrary". The Fed's procedure creates a large range of uncertainty about future monetary policy, and this range widens each year.

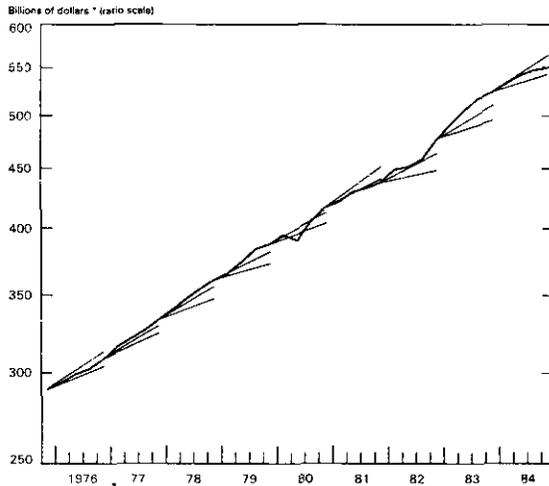


Of course, as a matter of arithmetic the 1986 targets stated according to the wedge procedure could be restated depending on whether the money stock ends 1985 at the top or the bottom of the range. Suppose M1 is at the top of its range in 1985. Would the Fed announce 1986 targets of 2.5 to 5.5 percent money growth in order to offset a high 1985 outcome of 7 percentage growth? Or, if money in 1985:IV were at the bottom of its range, would the Fed would announce a target range of 5.5 to 8.5 percent to offset a low 1985 outcome of 4 percent? I believe that the Federal

Reserve is unlikely to adjust its targets by such large amounts, fearing that it would be sending the wrong message to the markets, the voters, and their representatives in the Congress.

My concern about this needless uncertainty over the Federal Reserve's long-run policy reflects more than an academic's imagination. The chart below, reproduced from the 1985 Economic Report, shows how the Fed exceeded its targets repeatedly in the late 1970's, and each year built the overrun into the next year's target. Money growth accelerated as inflation rose. Was this a stabilizing monetary policy? In 1981 money growth fell short of the Fed's own targets, and this short-fall was built into the target range for 1982. Was this a stabilizing monetary policy as the economy sank into the deepest recession since the Great Depression? Is this the targeting procedure the Federal Reserve wants to defend?

M1 Money Stock and Federal Reserve Target Ranges



* Averages of daily figures, seasonally adjusted.

Note.—Targets are fourth quarter to fourth quarter wedges as described in the text.

Sources: Federal Reserve and Council of Economic Advisers.

The proposal that monetary targets be stated in terms of a band, with each year's band starting from the previous year's band rather than from a base level equal to whatever the actual money stock happens to be in the year's fourth quarter, is designed to provide a sound long-run monetary policy plan.

Federal Reserve officials should not come before the Congress with urgent statements of the importance of a long-run fiscal policy plan when they are unwilling to commit themselves to a monetary policy plan extending more than 10 1/2 months in the future.

The policy proposals discussed above have often been described as "rigid" and "doctrinaire." Many observers believe that "wise" policy must be "flexible" policy.

We all know, however, that flexible policy can be aimless policy. Rather than attach labels, policy proposals should be examined on their merits. The proposals I have offered are based on my analysis of where and why mistakes have been made in the past and of what might be done to avoid repeating those mistakes.

I am not arguing that we should or can enact today a monetary policy good for all time. I am arguing for a policy that is good until there is clear and convincing evidence that a different policy would be better. That is what "flexibility" ought to mean. Actions based on what seems best day by day cannot be regarded as "flexible policy." Unless actions reflect some underlying principles or standards, flexible policy is no policy at all.

Congressional Oversight of Monetary Policy

Congressional oversight of monetary policy, and indeed of government departments and agencies generally, suffers from the fact that government witnesses and outside witnesses do not appear at the same time. It is as if a defense attorney appears in court, states his case, examines his witnesses, and then takes all of them home before the plaintiff's attorney arrives. The plaintiff's attorney talks to empty chairs.

There is a sense in which outside witnesses such as myself are asked to testify in Congressional hearings in the role of "plaintiffs." All of us believe that the give and take of open debate will illuminate the issues and lead to better public policies. I am not here as a "prosecutor" to obtain a "conviction", but rather to support the Federal Reserve where I believe it is correct and to challenge it where I believe it is not. That role, I believe, could be better fulfilled if government and outside witnesses appeared together.

In the absence of such arrangements, however, I propose that the following questions be submitted to the Federal Reserve. I should like the format of the answers to consist of a first paragraph of one word -- either "yes" or "no". Additional paragraphs should explain the answer in the first paragraph.

From what we now know, and all things considered, would it have been better for the U.S. economy if growth in M1 had been one percentage point lower than it actually was in 1977, 1978, and 1979? (M1 growth should be measured from the fourth quarter of one year to the fourth quarter of the next.)

From what we now know, and all things considered, would it have been better if M1 growth in 1981 had been one percentage point higher than it actually was?

Consider a hypothetical target for M1 for the fourth quarter for 1985. Suppose the target were a dollar level that is 5.5 percent above the level in 1984:IV, and that M1 is measured on a not-seasonally-adjusted basis. If all other considerations were ignored, would it be technically possible to hit that target with an allowable error of 0.5 percent? If the answer is "no", specify the technical reasons why such a target could not be reached.

If the demand for bank borrowing through the discount window were a perfectly stable function of the difference between the federal funds rate and the discount rate, is it true that a borrowed reserves target, given the discount rate, is the exact equivalent of a federal funds rate target?

If the demand function for bank borrowing through the discount window were highly unstable and unpredictable, would success in hitting a borrowed reserves target determined by the FOMC for the intermeeting period introduce undesirable volatility in the federal funds rate?

Chairman FAUNTROY. Thank you gentlemen for your written testimony.

Let me begin by posing to any and all of you the dilemma which is uppermost in my mind, and that is the Fed's relative effort to lower inflation versus lower unemployment. So far this year, as you know, the unemployment rate has been at 7.4 percent—up, I hope temporarily from the 7.2 percent rate in the fourth quarter of 1984. The inflation rate is still at between 3 and 4 percent and has been there almost 2 years. Granted that our ultimate objective is to have both low inflation and low unemployment, what should the Fed's priorities be this year: To try to keep inflation at the current rates and push unemployment down more; to try to push inflation lower at the cost of keeping unemployment at the current rates; or simply to avoid inflation and unemployment from getting worse?

I would note that the FOMC's projections seem to suggest that it is following the first course, but those projections rest on the fairly optimistic assumption that the dollar will neither rise nor fall, and that the budget deficit will be substantially reduced. What weight should we be giving?

Dr. GREENSPAN. Well, let me start off, Mr. Chairman. I think that the presumption that there is a simple tradeoff between inflation and unemployment is misguided. I think the evidence of the last decade has clearly demonstrated that lower inflation ultimately brings lower employment if we endeavor to reduce inflation, reduce uncertainty and risk, and thereby increase the rate of capital investment and general expansion, we will find, in the context of a 2- to 3-year period, that the more we can stabilize the price level, the more we can increase the underlying growth rate in the economy and, hence, reduce the unemployment rate ultimately.

Any endeavor to engage in short-term fine tuning on either side of that presumed tradeoff, is destined to fail. So there is really only one policy. The policy which the Fed should pursue is to maintain a monetary growth rate which can, if possible, stabilize the price level. If we succeed in that, the unemployment rate will fall as low as we are likely to get for the longer term. A short-term endeavor to lower the unemployment rate can probably succeed, but only at the expense of significantly higher unemployment at a later date.

Chairman FAUNTROY. Dr. Schultze?

Dr. SCHULTZE. First, whatever you say about the long run, in the short run it is true that even though the Federal Reserve cannot forecast and predict it very well, that there is a tradeoff available. Now it isn't the kind of tradeoff the Fed can pick a target and say "We are going to hit it." But at the moment, if the Federal Reserve wanted to pursue the goal of price stability—not inflation stability but price stability—that is to get the current 3.5 to 4 percent rate of inflation down significantly further, it would have to reduce the rate of growth that is now programming for the money stock and bank reserves substantially. I don't think the Fed is going to do that. I don't think they should do it. I think that for the time being, while not trying to fine tune the economy, and not trying to do a very shortrun tradeoff, their fundamental proposition is that they will live with the rate of inflation we now have and will not deliberately put the screws tighter and tighter and tighter on the economy to pull it down further. I agree with that.

Second, they also implicitly—again without fine tuning—have decided, on the other hand, they are not going to speed up the creation of the money stock and the growth of bank reserves sufficiently to pull the rate of unemployment down except slowly. My guess is they would be quite satisfied if the money stock targets they have set forth would give them an unemployment rate falling to somewhere in the 6.75-percent range. You might quarrel a little bit but since we are now coming close to the margin of spare capacity this economy has available, thus I find it hard to quarrel with the Fed within that kind of a range. So it seems to me they are targeting properly. Given the very difficult problem of keeping the lid on this economy with that huge budget deficit, they are targeting moderate growth in the economy, slightly faster than capacity growth, consistent with rough stability in the inflation rate, given no major change in the value of the dollar.

If the dollar, all of a sudden, starts to fall out of bed, the Federal Reserve will have a real dilemma on its hands, but at the moment it seems to me what they are targeting is about right.

Chairman FAUNTROY. Dr. Poole.

Dr. POOLE. I would like to emphasize that about 14 years ago, when the inflation rate was around 4 percent, just about where we are now, we adopted comprehensive wage and price controls. Four percent inflation was regarded as being intolerable at that time. Now, many people seem to be rather relaxed about 4 percent. It seems to me that the problem is this: I would have no difficulty if I knew for sure that we could stay at 4-percent inflation. But I do not believe that that is a credible policy alternative. What are people in the markets going to say, when we get a disturbance—as will surely happen—that takes us to 5-percent inflation? Some day we are going to get an upward blip and I believe people are then going to say, “Well, if 4 percent is all right, what is wrong with 5 percent?” I do not think that that is a sound basis for long-term policy. In my view, we ought to have a steady, persistent monetary policy that is consistent with the return to full price stability over a period of years. We should not shove hard. We should not try to do it quickly, but that is where policy should be going.

Chairman FAUNTROY. I thank you. I yield to Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

There has been a lot of discussion among your testimony today, as well as others, over the value of the dollar, monetary policy and the deficits and all the interplay that goes on in them. Most of that discussion that I have heard is either centered on, or indirectly alluded to, liquidity, the availability of capital in this country, which of course would be the major factor in interest rates not being higher at the present moment, with the large deficits we have.

There have also been indications—I haven’t heard any of you discuss today—that the high dollar and the trade imbalance actually for the moment are good, in the sense that imports are almost an absolute essential part, while we follow poor fiscal policy, of keeping inflation under control. The imports are currently a major factor in the steady inflation at the present moderate level.

I would like for you to comment on that. Do you think that if we see the value of the dollar decline or perhaps, Dr. Greenspan as you described, more American banks investing abroad, loaning

abroad and so on, that at that point in time, with the trade deficit coming back in line and less imports, that inflationary expectations are likely to rise?

Dr. GREENSPAN. Mr. McCollum, the level of interest rates and the level of inflation that we currently experience would be higher with a dollar which had not been rising at the pace of recent years. As a consequence of that, I think capital investment has been higher. So while we are clearly very aware of the job losses that are occurring as a consequence of the strength of the dollar and as a result of imports displacing some competing goods in the United States, it is by no means clear to what extent, if any, the strength of the dollar has, in fact, created a net job loss as such. There is no doubt that the extraordinarily large flow of funds either by foreigners or by Americans invested in the United States has been a significant factor in creating a much more tranquil environment in the capital and financial markets than would have existed without it.

About a fourth of aggregative savings are coming in from abroad, and that is an extraordinarily large number. There can be no doubt that were that not the case, the very heavy Treasury borrowings, which are now in place and will continue indefinitely, would eventually begin to squeeze the system and create very significant problems at the Federal Reserve.

So while we may, in fact, be looking at the strong dollar as something which is creating problems, I suspect that if the dollar were to turn around and go down, the problems that would occur as a consequence would make the problems of the strong dollar rather insignificant in comparison.

Mr. MCCOLLUM. Dr. Schultze, would you care to comment on that?

Dr. SCHULTZE. I guess I would change the emphasis, but not come to a substantially different conclusion. Let me just say the same thing another way. The Federal Government is borrowing an amount now equivalent to 5 percent of GNP, and it is going to do that out to the indefinite future unless you do something about the budget deficit. After allowing for depreciation, the Nation saves 8 to 9 percent of GNP. The Federal Reserve is keeping a lid on overall economic output, letting it grow at a safe level. You have got to take that 5 to 5.5 percent from somewhere—it has got to come from somewhere. Either it comes from abroad, there is a big inflow of foreign savings, supplementing domestic savings, or if that is not available, you have got to squeeze the Federal borrowing out of savings available for domestic investment. The precious savings is diverted out of domestic deficit into financing the deficit. Neither course is costless.

The first course, namely, a large net inflow of foreign savings, preserves our own domestic investment, but at the same time we, and then our children, are going to be paying the debt service on that foreign debt, thus lowering our growth of living standards. Conversely, if you did not have the inflow of foreign savings, we would be squeezing out domestic investment, and we and our children would pay the cost by having lower domestic productivity growth in the future.

I end up where Alan does. If I have to have my choice of pains, and since I am not a farmer nor a rural banker nor an exporter, if I look at the whole national economy, I say, "Yes, you are better off to take our lumps the way we are now taking them than the way we are ultimately going to take them," because foreigners are not going to keep on pouring their savings into the United States. That is a complicated answer, but it says, "Yes," in that narrow, limited sense, the overvalued dollar is serving a purpose. Remember, however, that it is simply the lesser of various evils.

Mr. McCOLLUM. It is buying us some time for Congress to act is what you are really saying is the lesser evil.

Dr. SCHULTZE. Let me be a little bit provocative and say one of the real tragedies of this budget deficit is that we are living with it too well. We might be better off if it generated a crisis. The tragedy is there is not a tragedy. To overstate this a little bit, it took the British 50 years to become a second or third-rate economic power. It wasn't a budget deficit that did it, but by not paying attention to some very longrun gradual economic problems. Thus, I agree with Alan, but every second day I think maybe we would be better off if the foreigners weren't supporting our credit card habits.

Mr. McCOLLUM. Well, my time has expired, so I can't ask Dr. Poole the same question, but that is all right. I will yield back, Mr. Chairman.

Chairman FAUNTROY. Mr. Cooper?

Mr. COOPER. One thing here repeated so much is that our strong dollar is equivalent of a tax of 30 percent or a subsidy of 30 percent, and I have always wondered, are those two percentages additive? Is there really a 60-percent difference, or is it the equivalent of one or the other?

Dr. GREENSPAN. That percent comes from the rough calculations that the U.S. dollar in foreign exchange markets is approximately 30 percent above its so-called purchasing power parity. Purchasing power parity refers to those exchange rates that would exist relative to the dollar, if a dollar, when converted into them would buy essentially the same types of goods and quantity in any country. The problem with the calculation is that, it is very rough, and that it presupposes that the U.S. dollar is not the reserve currency for which there is constant accumulation. So the exchange rate will always, under such circumstances, be above so-called purchasing power parity.

The concept of the tax merely reflects the fact that people who are creating costs in other than U.S. dollars presumably have a cost advantage of a certain amount. Therefore, foreigners have the equivalent of their 30-percent subsidy, or we have a 30-percent tax. It is not additive. It is just different ways of looking at it. But I suspect neither is really quite correct. There is obviously a cost disadvantage to American producers. It is significantly less than the 30 percent, which is what the purchasing power parity difference suggests.

Mr. COOPER. Thank you.

I was interested in your testimony, the part you added, I think, to your text, that the problem with the strong dollar is not only the extreme confidence that other nations are placing in our currency but our lack of investment or lack of confidence, our worries over

the rural debt problems or whatever, and that one day perhaps soon that imbalance could be corrected.

I didn't understand, though, fully whether once American banks regain willingness to lend money outside this country, what effect that would have on our dollar as a currency. Would that lower the value of the dollar?

Dr. GREENSPAN. Yes; other things equal, it would do precisely that because, remember, that almost all of the lending abroad by U.S. commercial banks is converted into the local currency for purposes of business activity. In that sense it becomes a demand for deutch marks or British sterling or Swiss francs or Japanese yen in terms of U.S. dollars. That transaction thus lowers the dollar relative to those other countries. Should there be a significant increase in lending again by U.S. commercial banks abroad, that, in effect, would increase the demand for foreign currencies in terms of the U.S. dollar. That element alone would tend to suppress the dollar's exchange rate. Whether other forces might be operating in the other direction, of course, is yet unclear.

Mr. COOPER. I believe you said that in 1982 about \$110 billion is the figure for net American lending and investing overseas. About what proportion, I believe you said the lion's share was lending. About what proportion of that would be investing abroad?

Dr. GREENSPAN. Direct investment overseas in 1982 was \$119 billion, of which \$111 billion was lending by commercial banks. It is important to note, also, that when you subtract foreign investing in the United States, the net direct investment figure is negative.

Mr. COOPER. Many, myself included, have been concerned about America's turn, perhaps this month or next month, into a debtor nation, and in those days ahead when we do regain our confidence, ability to lend and invest abroad, it doesn't seem like American investing abroad will ever retake the rate at which foreigners are investing in this country. So it looks to me as if, and I would like your view on it, whether the debtor status that we are about to assume will be a fairly long-term prospect for us.

Dr. GREENSPAN. It is a prospect certainly for years immediately ahead, if for no other reason than it takes a while for the lags and the leads to work their way through the exchange rate system.

Second, the fact of the very substantial accumulation of U.S. assets by foreigners guarantees an increase of fairly substantial proportions in the net interest paid by U.S. residents to foreigners, which is an element in the current account balance which, in turn, has to be financed.

It doesn't follow, however, that we are now and forever a debtor nation in the sense that our current account will be in deficit indefinitely. Obviously, if the exchange rate were to fall quite significantly, that would, with a lag, close the trade deficit and probably create a new resurgence of our services surplus, which is rapidly diminishing. Thus I wouldn't say that there is some magic line that we cross and once crossed, creates an ability to come back. In fact, I would doubt it. This episode of our becoming a debtor nation is probably a relatively short-term affair of 5 to 7 years. Thereafter, it is quite possible, indeed probably, that the United States will fall back into current account surpluses. Whether or not it can occur for a significantly long enough time to again reverse the lines is a

good question, but we cannot say that there is certainly some structural imbalance in our trade and foreign accounts which is similar to our internal Federal budget deficit in that it creates structural problems. That does not exist for the foreign account. The only thing which is intransigent is interest payments to foreigners on the debt previously accumulated.

So I would say that it is something that is unlikely to be with us forever. Unlike the domestic budget deficit it is not in and of itself a problem. Remember that the United States, until 1914 was a debtor nation, and I don't recall that that created problems.

Mr. COOPER. Well, my time has expired.

Chairman FAUNTROY. We have the time for Dr. Schultze to respond, and then we will yield to Mr. Hiler.

Dr. SCHULTZE. I just want to add a codicil to Dr. Greenspan's answer. First, it is not simply that we are becoming a net debtor nation. We are liquidating our net asset position abroad to the term of over \$100 billion a year. That is, we are going from having net assets abroad of \$200 billion to zero, which is no better than going from zero to minus \$200 billion, and we have been doing that.

Second, when we were a debtor nation in the 19th century, we were borrowing from abroad to invest in productive assets. Now, indirectly we are borrowing from abroad to invest in the Government deficit. It pays the country which can increase its productivity through investment in productive assets to borrow from abroad. If you can borrow at 8 percent and get 10 percent return on your assets, it is good. But if you are borrowing from abroad to get zero on those assets, or whatever you think the Federal deficit is worth, it seems to me it is not a good deal. Thus I don't think it is a structural position we can't get out of, but I think there is a big difference being a net debtor nation to finance a budget deficit and being a net debtor nation to improve our own internal productive capacity.

Dr. GREENSPAN. I agree with that.

Chairman FAUNTROY. Dr. Poole.

Dr. POOLE. Let's think about saving in the United States as consisting of private saving and government saving which, of course, has been negative for some time, especially at the Federal level. So we have positive private saving and negative saving at the governmental level. We add those two together and get the total national saving. In 1984, the national saving, as a percentage of GNP, was about 15.7, compared to the 1980 figure of 16.2. So we are down about half a percentage point as a percentage of GNP. These numbers bounce around. I picked 2 years that have fairly similar unemployment rates, but you get different answers depending on how you do that. What troubles us about the foreign borrowing is, at least in part, the view that we are borrowing in order to consume, as with borrowing for the financing of the budget deficit. That is not necessarily correct because it is possible that private saving is financing the budget deficit in fact, you can't link a particular liability with a particular asset.

Now, suppose that what we are doing is borrowing abroad to increase our investment. If the foreign borrowing is increasing our productive capital and if it will have a rate of return that exceeds

the borrowing rate, then, as Dr. Schultze said, that is a good deal. If you can borrow at 8 percent and earn 10 percent, that is a profitable thing for the United States to do. The issue here is that the investment opportunities in the United States are apparently so much better than they are in so much of the rest of the world, that it does not make sense for us to send funds abroad to earn 4 percent if we can invest it at 10 percent in the United States. And, it does not make sense for anybody abroad to keep money in Europe, let's say, earning 4 percent when he can send it to the United States and earn 8 percent. So the basic cause of this capital inflow is the difference in the rate of return, which I think is very importantly related to the difference in the growth prospects, in the vigor of the economy of the United States versus the economies in Europe and Latin America. People do not get good returns when they send money abroad and, therefore, it is not sensible to send money abroad.

The key is not to reduce our own growth prospects. We could reduce our capital inflow if we were to reduce the rate of return in the United States, but that is not a sensible thing to do. The key is for the Europeans and Latin Americans to have more vigorous economies with good prospects, good rates of return. That is not under our control. We can argue the case, but we do not vote in their elections.

Chairman FAUNTROY. Thank you. Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman.

Dr. POOLE, if we start out with the proposition, that monetary policy should be conducted in such a way to achieve long-term price stability, as you have mentioned, what should we use as an indicator of inflation? What should the Fed look to to determine whether, in fact, we are attaining long-term price stability or not?

Dr. POOLE. The best thing that I know to look at is what is shown on page 2 of my prepared statement, where I have plotted M1 and the inflation rate side by side. There is a 2-year lag in this relationship. The inflation arrives a substantial time after the monetary impulse. This is the average experience in the United States. I know of no monetary measure that is a better predictor of inflation than this one. And you can see how good it is. It is not perfect, but you can see what you get out of it. It is because of this experience—and we can run these charts way back before 1956—and experience in other countries, that I am convinced that the best thing for us to do is to stabilize the rate of growth of money. The M1 definition, I think, is the best of the ones we have. We should gradually bring M1 growth down over time—not try to realize full price stability next year, but over a period of time. If we know we are headed in that direction, the financial markets know we are headed in that direction, I think it will be very constructive.

Mr. HILER. Do you have any fears today of deflation taking place?

Dr. POOLE. I think that the prospects for deflation—and by that I mean a decline in the general price level, not just declines in some prices—prospects for general deflation in the foreseeable future are, I believe, nil.

Mr. HILER. What impact do you think that the deflation that is taking place in some parts of the U.S. economy will have? Do you

have any fears about that deflation that is taking place in commodities and land?

Dr. POOLE. I would, if I were producing those commodities and owning that land.

Mr. HILER. But you see no fear except an individual fear of the loss of asset base. For the economy, you don't have a fear of that?

Dr. POOLE. No; the average price level in the United States—and it has changed over time—is made up of an enormous number of individual prices, some of which are rising and some of which are falling more or less rapidly. We have a very difficult situation in these commodity sectors which you are talking about, especially the agriculture. I think that a lot of that difficulty comes because we had an enormous change in conditions from the late 1970's to the early 1980's.

In the late 1970's, it was altogether the other way. Prices were rising, especially land prices were rising rapidly. Credit was readily available. That stipulation has flipped over in the last 5 years. Some people's expectations have been violated, and people have been put through very difficult times. I don't deny that. But it seems to me that we ought not to think about trying to regulate the rate of inflation for the economy as a whole on the basis of the very real difficulties of any particular sector of the economy.

Mr. HILER. Do you believe that and since you mentioned agriculture, but I think you could go to almost any of the metals and see the same dramatic effect—not quite as many headlines, but certainly copper, aluminum, and certainly other metals have gone down the tubes. Do you believe that the deflation that is taking place in those areas is in any way a result of monetary policy?

Dr. POOLE. This is mostly a result of the very strong dollar. These are all commodities that are traded on world markets and the strong dollar has depressed the prices in the United States expressed in dollars. What you have is that the prices abroad in the foreign countries have been rising somewhat. The prices in dollars have been falling and splitting down the middle with the exchange rate change. I think that the exchange rate is strong for the reasons that I have been talking about before because of the investment returns in the United States.

I would also mention one other thing. In the late 1970's the dollar depreciated quite clearly because of fears of inflation. That is, the markets of that kind that adjust quickly bring inflation future inflation forward into the present. I believe that part of what we have seen is that these markets have brought future good price performance up ahead in the same way. This is exactly the same proposition about what happened in the late 1970's, but going in the other direction. Thus, I don't anticipate the dollar continuing to appreciate unless we have rapid reduction in the rate of inflation. That I think is not in the cards and is not desirable as a policy goal.

Mr. HILER. I will ask this to any of the three gentlemen. How much of our current inflation today as measured by GNP price deflator, Consumer Price Index or what ever you would choose to use? How much of that inflation is still an aspect of catching up with the inflationary pressures of the seventies by maybe erratic monetary policy, rises in the price of oil? Is some of our inflation

today still a catching up of the rest of the indices of prices that are flowing through the system?

Dr. SCHULTZE. I do not think so. If you had never had inflation in the late seventies the inflation rate today would have been lower. That is, people now have come to expect—you pick your number, but let's say 4 to 5 percent inflation—and in the early sixties they were expecting 1½ percent inflation. If today they were expecting 1½ percent inflation we would have lower inflation. In that sense, maybe you are right, but in the more fundamental sense, that any significant part of inflation today represents an adjustment of long-lived processes to inflationary pressures which occurred 4, 5, or 6 years ago, I would say none of it.

Mr. HILER. Dr. Greenspan?

Dr. GREENSPAN. I agree with Charley's analysis but not his conclusion. Indeed there is an anticipatory element in the price level which affects contracts, attitudes, and activities. When in 1969-71 inflation was rising from 2 to 4 percent, increasing concern was exhibited which was why political pressure rose and a lot of people were getting nervous.

That was the reason, as Dr. Poole mentioned, we put in wage and price controls in 1971. I think we still have that residual concern, but it is gradually unwinding. It has not gone. It is still a residual reflection of the past.

Dr. SCHULTZE. To add a note of levity, I am reminded, when you asked about deflation and the probability of deflation, of a comment Pat Moynihan once made when asked a similar question. He said he put that 28th on the list of fears, the 27th being the fear of being eaten alive by piranhas. That is about where I put deflation.

Chairman. FAUNTROY. Doug Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Gentlemen, we indeed welcome you to this very interesting and important hearing this morning on monetary policy. It seems we have digressed a little bit from monetary policy to some other things, but on balance, I would presume then that you see the problems of our trade imbalance as just as important as our deficit imbalance?

Dr. SCHULTZE. I don't want to say yes or no.

Mr. BARNARD. I was hoping to catch you there.

Dr. SCHULTZE. I don't think Dr. Poole would agree, but in my judgment our deficit is important, but not solely responsible for our trade imbalance. Fundamentally our deficit and the necessity to borrow \$200 billion a year with limited supply of private savings sets in motion a whole train of events which are major factors in causing the trade deficit. Thus it isn't that one is as bad as the other, one is the cause of the other or at least an important cause.

Mr. BARNARD. Dr. Greenspan?

Dr. GREENSPAN. First, our Federal budget deficit is a far greater problem than the trade deficit which will be cured by our currency turning weak. However, which is not something I look forward to with favorable anticipation. I am more inclined to agree with Dr. Poole on this question. I am not at all convinced that the extraordinarily large credit requirements of the Federal Government is in and of itself creating a significant pull from abroad. It is certainly the case that somewhere up to but not exceeding a third of the

strength in the dollar in the last couple of years is attributable to the differential interest rates amongst the currencies, but no more than that. The substantial part is a reflection of a general change in attitudes toward the United States as a safe haven in the sense that our political and regulatory atmosphere is such that foreigners are treated essentially the same as Americans, and in a favorable way. Consequently, the Federal budget deficit is something which is not significantly affecting our trade or current account deficit. However, the internal Federal Treasury deficit is an order of magnitude owing to the nature of the problems it created, which is many times more of concern than our trade deficit.

Mr. BARNARD. But still—and I want to include you, Dr. Poole, in this—but still, as compared to our gross national product today, is our deficit that much of a problem and/or our national debt as in past history?

Dr. GREENSPAN. The answer is most certainly yes. It is a very significant problem. In fact, at a hearing last week before the Joint Economic Committee, the chairman of that committee was—I think correctly—stating that his concern was that looking out 10, 15, 20 years with these deficits, the vast proportion of our expenditures would reflect interest payments on the debt. Arithmetically it is explosive.

Mr. BARNARD. I think out of 260 deficits the interest on the debt would be 225 or something like that.

Dr. GREENSPAN. All I can say is that that particular calculation which doesn't require very detailed arithmetic, should pretty much convince us that whereas we have a problem on our international accounts, it is not a big one in relative terms. The problem of our Federal deficit is best described as scary.

Dr. POOLE. I don't know whether the trade deficit is only 10 percent affected by the budget deficit or 90 percent. I think it is more than 10, but I don't think it is very big. I wouldn't go to the wall on that as a professional matter, but I would insist that the Congress can do something that is within its direct control, that is to reduce the budget deficit. After all, you Members passed the appropriations bills and passed the tax legislation. You don't have direct responsibility for the trade deficit, so I would say, first of all, that given the responsibilities assigned—the market by and large takes care of the trade deficit and you take care of the budget deficit.

Second, I agree that the budget deficit is a serious problem, but I would like to give equal billing to the level of Government spending. The reason I say that is that Government spending has been growing for 50 years. My view of the political processes that drives that growth is that they are extremely difficult to get hold of. If you look at the economic stagnation in Europe today, it seems to me quite clearly to be a result of bloated governments and very substantially reduced incentives for growth and employment. European governments have government spending as a share of GNP today in the 50 to 60, sometimes even the 65-percent range. They were where we are today—we are at about 35 percent for all levels of Government—only 20 years ago. The political process that is driving this growth is going to put us, I think, up where the Europeans are now in the space of a generation if we cannot control

spending. I, therefore put equal billing on spending and deficit problems.

Mr. BARNARD. Let me just ask this question realistically. Time does fleet fast.

Do you think that we ought to have a policy on our trade deficit. Should there be a Federal policy as to attacking our trade deficit, such as possibly—and of course this is coming from off the wall on this, but like an across the board tax on imports which would of course affect the deficits as well as our trade imbalance?

Dr. POOLE. We ought not to have such a policy, but in addition to that, a tax on imports would be counterproductive. If you think historically of cases where countries have imposed taxes on imports, it has been in cases when they have depreciating currencies. They impose taxes on imports to keep the currency up. If we impose taxes on imports, we are going to make our currency stronger. I don't think that is what we want to do. It is counterproductive, will lead to retaliation abroad, and interfere with the progress that the world has made towards trade liberalization since the 1930's.

Mr. BARNARD. Well, our chairman is very much concerned about inflation and monetary policy and what it has done to unemployment. Now, if we would look at our trade imbalances, we would find some very, very direct relationships to unemployment. I know in my part of the country we have got ghost towns developing all in the area of Georgia and South Carolina and North Carolina because of the textile industry. The textile industry is being taken away from us.

I have always been an advocate of free trade. I am beginning to wonder now about between free and fair trade, and that is why I am concerned about a strong policy as far as trade is concerned. I guess when I take the total aggregates in trade you may not get concerned. But when you start dividing those up in the industries and you see automobiles, textiles, and steel and other things of that kind, it is devastating.

Dr. POOLE. There are important impacts across different sectors of the economy from the strong dollar, but I come from a part of the country, New England, that was devastated, if you will, a generation ago by the textile industry moving elsewhere. It turned out in this case that it didn't move outside the country but it moved south.

Mr. BARNARD. Some folks think that is outside of the country.

Dr. POOLE. I don't. It is exactly the same as a regional issue. In one case the industry went across State boundaries and in another case it went across national boundaries, but the economics are exactly the same.

Mr. BARNARD. But we didn't have money flowing out of the country because of that.

Dr. POOLE. We had money flowing out of New England.

Mr. BARNARD. But that is different than flowing out of the country.

Dr. SCHULTZE. Mr. Chairman, Mr. Barnard, again I think I differ somewhat from my colleagues in the weight I put on it. Yes, there is a policy we ought to have about our trade deficit and that is get rid of the budget deficit. But in the other things, I think you are likely

to make matters worse. Most of the other proposals I have heard would make matters worse ultimately.

Chairman FAUNTROY. The time of the gentleman has expired. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

I would like some help from our panelists in understanding better this relationship between money, growth and inflation. I had come to think that there was a very good, predictable relationship over time, as is shown on this chart on page 2 of Dr. Poole's prepared statement. But sometime in 1982 we started having rather explosive money growth for a period of time and the rate of inflation has been coming down ever since and I don't understand it.

Maybe you can help me to understand.

Dr. SCHULTZE. We will confuse you, but we will try.

Mr. NEAL. The question is this: We had explosive money growth in 1982 and if you look at that 2-year lag, you don't find inflation soaring, you find it dropping, and I don't understand that.

Dr. POOLE. That is right. I certainly predicted that we would have rising inflation as a result of that rising money growth, from past experience. We did not get it. It appears to me that there are several reasons for it. Part of it is that I think we probably had underestimated the technical terms, the interest elasticity of the demand for money. When the interest rate came down, people decided they wanted to hold more money balances, and we had a very sharp reduction of interest rates as you know, and I don't think that was well estimated in our past relations.

Let me point out one other thing from this chart. If you look at this chart on page 2 of my prepared statement, there are periods when the inflation rate and the money growth rate run apart for a long period of time but by a relatively small amount year by year. Look at the period from roughly 1964 to 1969. There, money growth ran consistently ahead of inflation. Now, if it had run ahead all in one blip, then you might have seen something that was rather like what we have obtained now. It just took a while for inflation to catch up. The difference here was that money growth, instead of surging ahead all at once, kept creeping up. We had the same thing happen in somewhat the other direction, if you look at 1975 to 1980. There again we had inflation outrunning money growth, whereas in the late 1960's money outran inflation.

So it seems to me that what we had was simply a large divergence between the two series. The divergence ordinarily is not very great, but we have had it all at once in 1982-83. That is not a very thorough explanation.

Mr. NEAL. And over time though the relationship is good. Would you then predict as a result of that surge in money growth starting in 1982 a growing level of inflation?

Dr. POOLE. No, I think that we are unlikely to have a substantially higher inflation, provided money growth stays in the neighborhood where it is now.

Mr. NEAL. So that was a free ride? Somehow we got a free ride?

Dr. POOLE. It was a once over makeup.

Mr. NEAL. And we don't have to understand it?

Dr. POOLE. No, I think it is important to understand it, but I am saying I can't give you a precise explanation at this time.

Mr. NEAL. Can anyone?

Dr. SCHULTZE. Well, I never expected it. That is the difference. Unlike Dr. Poole, I do not believe that the association in the medium term as opposed to the very long term between money and inflation is all that good. If you look at the chart I think what you will find is that in over 28 years the really good association is for a period of about 8 to 10 years. Look back at 1956 through 1964—relatively stable inflation and fairly substantial changes in money supply. Similarly, if you look at 1968 through 1972, you do get a much closer relationship in the next 10 years. It seems to me the relationship between money growth and the consequent economic activity has particularly tended to be erratic in recent years because we are going through a period of very substantial innovations in financial institutions, new kinds of instruments, the definition of money changing, and the meaning of money changing.

Even in the past, the relationship has had periods of being erratic. Right now, it seems to me the danger of being erratic are much greater. I think the 1982-83 period was one in which the relationship between money and economic activity shifted substantially, and I think you are likely to see that again, particularly as we complete this business of new financial instruments and financial innovations. So I am not surprised because I never thought the association was that close to begin with.

Mr. NEAL. Dr. Greenspan, do you have a comment?

Dr. GREENSPAN. There is a technical problem. Money supply should relate to aggregative nominal GNP and is divided into two parts: real growth, and the growth in price level or the rate of inflation. That correlation requires a stripping out of it the long-term growth, that is the physical volume of activity. It doesn't change the correlation that much. Hence I would agree with Charley Schultze. Over the long run there is no question that unit money supply—that is money supply adjusted for the level of economic activity—and prices go hand in hand. They have as far back as our data go. It is not clear that the correlation is as close as that 2 year overlap suggest, however.

My concern is that because that 2-year overlap has been used recently as a forecast of the relationship between money and prices, and since it clearly hasn't worked, that therefore the conclusion is that inflation is not related to money. I think that inflation is fundamentally a monetary phenomenon. It is just that I don't believe it has that rigid a relationship.

Mr. NEAL. My time has expired.

Mr. COOPER. [Now presiding]. Mr. Carper, do you have any questions?

Mr. CARPER. I would like to ask questions but not at this time. Will I have an opportunity later in the hearing?

Mr. COOPER. Yes sir, I anticipate taking another round if that suits the witnesses. Mr. McCollum.

Mr. MCCOLLUM. Dr. Schultze, in your testimony you indicated that the unemployment rate might be reaching a point shortly at which we were faced with possible inflationary pressures. A few years ago the figure for full employment was 4 percent. Does your testimony indicate that we are now using a level higher than that, 6½ percent?

Dr. SCHULTZE. Yes, sir. Let me start with the obvious point that nobody wants to stake their professional reputation or any kind of reputation on a precise number. Nevertheless, I think virtually all economists who have studied the matter would say that the level of unemployment at which you begin to have to worry about pressures in the labor market and excessive wage increases is higher than it used to be. It probably never was quite as low as 4 percent. It may have been 4½ percent, but I would suggest that in the late 1970's the number probably grew into a range a little above 6 percent. For demographic reasons it is probably declining slightly so if somebody put me on the spot and said you have got to give me a number, I would say it is a little under 6 percent now. But the uncertainty is such, and the costs of reversing an inflationary mistake are so great, I would play that fairly cautiously. Once you get down in the neighborhood of 6 percent I would start to worry.

Mr. McCOLLUM. So if the Fed were to target or to try to target unemployment at some level in close proximity to that, mistakes could gravely be made in your judgment that would touch off inflation?

Dr. SCHULTZE. Well, I don't think the economy is so hair-trigger sensitive that small mistakes would do it. But conversely, having just gotten burned yes, I would play a little cautious. I wouldn't go through the roof if the Fed made a little mistake, I don't think it would kill you, but it would become more and more of a problem.

Mr. McCOLLUM. With the import-export deficits, trade deficits we talked about being what they are, why are our European allies currently not having a better recovery than they are?

Dr. Greenspan, Dr. Schultze, Dr. Poole, any of you?

Dr. GREENSPAN. Remember that a good part of the recovery that they do have is in fact attributable to our trade deficit. It is difficult to make a judgment, but I think the point that Dr. Poole made earlier, namely that they have not managed to get their internal central government finances in a shape, and that is clearly impinging upon their ability to be productive. I suspect that a goodly part of Europe's difficulties in the last 10 to 15 years is reflective of the fact that their version of entitlement programs have begun to create some fairly significant problems for their underlying vitality.

Mr. McCOLLUM. Dr. Poole, would you agree with that?

Dr. POOLE. Yes, sir. I think that there is an enormous range of policies in Europe that influence this result. Let me give a specific example. In the United Kingdom there is a clearly improving productivity performance now, but it is coming primarily from reducing labor input and not from substantial increases in manufacturing output, though their output is growing. So the unemployment rate has been rising. They have some pretty good job opportunities in the south of England but the midlands are in pretty bad shape. Why don't people move to the south? Well, one of the reasons is that they live in highly subsidized council housing—local government housing—in the midlands. The local government housing is not available in the south because there are just no units available. So, people won't move out of their highly subsidized houses when they are supported with unemployment benefits of various kinds.

There is no incentive, so you can't get labor to move where the jobs are.

Mr. McCOLLUM. They do not have the growth that otherwise we would expect.

Let me move over to one last question before my time runs out. Chairman Volcker last week in testifying before this subcommittee, indicated that he was not only concerned about public debt, but the growth of private indebtedness. As a matter of fact, in addition to the M1 charts he brought along, he brought along the private indebtedness charts and he urged us to consider the tax structure changes that might favor equity financing rather than debt financing in addition to simply getting control over the deficits.

Do you gentlemen all agree with that in general principle? Should we be doing that and is there a great concern with the growth of private indebtedness in the country today?

Dr. POOLE. If I had my way I would do away with the corporate income tax and tax corporations as if they were partnerships. That would eliminate the major incentive for corporations to finance using debt rather than equity. That is where the bias comes. It is built into the tax law.

Dr. SCHULTZE. There is another alternative. I haven't thought it through very carefully, but I think that Treasury Secretary Donald Regan's tax plan—his outgoing gift to the Nation—is a great gift if somebody would take it. It does move in the direction of reducing the penalty substantially of equity financing versus debt financing. In fact I think they were quite ingenious in getting at this problem.

Mr. McCOLLUM. Dr. Greenspan, would you care to comment?

Dr. GREENSPAN. There is a very important issue for this subcommittee in the sense the problem exists largely in the business area where ratios of short-term to long-term debt have been rising inexorably, and our equity debt ratios, until recently have not been looking terribly healthy.

What that means is that the major domestic lending of the commercial banking system reflects dealings with business institutions whose balance sheets are getting less and less viable. Since a significant part of those with better balance sheets are borrowing with commercial paper; that is, outside the commercial banking system, the commercial banking system is being left with the sludge so to speak. A goodly part of our loan problems, not only reflect the local problem loans with respect to the oil patch and for agriculture, but the general quality of loans by necessity is lower because the balance sheet ratios, and the debt burdens of the borrowers have gotten worse. That is clearly a major problem for this country.

Mr. McCOLLUM. Thank you very much. My time has expired.

Mr. COOPER. Mr. Hiler.

Mr. HILER. Thank you.

I just have a couple of quick questions here.

Gentlemen, I have this nagging fear based on 4½ years now of watching the Fed, that the Fed believes that real growth will lead to inflation and that therefore whenever real economic growth begins to go over 3 percent, which is the long-term historical average in the country, that inflationary fears of the Fed begin to be ignited and then the M1 growth is kind of clamped down.

And at the same time, I have this fear that the Fed, in its deficit bashing that it does fairly often up here on the Hill and in the media, that when it kind of puts the clamp down on monetary growth so that the real GNP does not grow by more than that 3 to 3½ percent, it becomes a self-fulfilling prophecy that that deficit then begins to climb. Do you have any comments on my fears?

Dr. POOLE. I think they are fully justified. As a general proposition, I think it is unwise for the monetary authorities to target on the rate of real growth or the level of unemployment.

In the 1970's we made mistakes over and over again anticipating the so-called natural rate of unemployment. Our estimate of the full employment level of unemployment at which we would have to worry about inflation was lower than it should have been. So we followed expansionary policies too long and then it turned out we could not get down to 4 percent unemployment but inflation started to pick up in a major way at 5-percent unemployment, and then at 5½ percent, and so forth. That process is perfectly symmetrical. It can work in exactly the opposite direction. We do not know on a professional basis where that point is, or how fast the economy can grow. Given that we don't know, I believe that the way in which we should view policy is to have sound and stable policy conditions, and let the economy go for it, to have an automatic, built-in stabilizer rather than try to have the Fed decide exactly how far the economy can go.

Mr. HILER. Dr. Greenspan.

Dr. GREENSPAN. I don't think the Fed is working on that assumption. We don't know what the growth rate is, in the underlying sense. I think the Federal Reserve is endeavoring to avoid monetary growth rate which is far in excess of our physical capacity to increase. Irrespective of where you put it, such money growth will ultimately show up in inflation. But the presumption that they believe that that number is 3 percent, I don't think is correct. The goals are supposed to create an environment for maximum economic growth. I think they are endeavoring to avoid the extremes of major monetary expansion, which would create inflation and reduce growth. Acceleration in real growth alone is not going to create a tendency on their part to clamp down. If monetary growth has moved at a pace, which in conjunction with near term possible economic growth, implies an inflation rate that is unacceptable, then I think they move against it. But I would be very cautious in interpreting their actions as being ready to put a clamp on at the point when growth goes above 3 percent or even 4 percent. I don't think that is in fact what they are trying to do.

Mr. HILER. Dr. Schultze, before I allow you to answer that, if I could just interject one question to Dr. Greenspan. I would very much like to leave this room today 100 percent confident in your answer, but I look at 1984. We had an M1 growth rate of 5.2 percent over the year. That 5.2 percent was made up of two very distinctly different segments—a growth rate of probably somewhere in the neighborhood of 7½, 8, or 9 percent in the first half, and about 3 percent in the second half.

Now, it is difficult for me to take the fact that the Fed may have clamped that M1 growth rate down to 3 percent, and at times,

lower than that, except in return for the high economic rate, real GNP growth rate in the first and second quarters.

Inflation had not changed over the course of the year. It was basically $3\frac{1}{2}$ to 4 percent, which was about a point to a point and a half less than what many of the forecasters and economists in the country were predicting. And so with inflation remaining at the point where it had been for several years, we clamped down on M1 growth and it seems to me in looking at the minutes of the Federal Reserve, which they are kind enough to give us 45 days afterward, it looked or certainly appeared that they were concerned about economic growth.

Dr. SCHULTZE. In the first place, if they were trying to do it, they sure missed because they allowed $6\frac{1}{2}$ percent growth in 1983 and about $5\frac{1}{2}$ percent growth in 1984. It seems to me that is pretty good. In fact, it is the best recovery in terms of the output growth that we have had—not by a big amount, but by enough to make it interesting.

The Fed does not so much target growth but the Fed does worry that aggregate spending in the economy will proceed, one, too fast, and second, too far; leading to producers trying to increase output, the higher factors changing their expectations, everything in a way that could set off inflation. When that increased spending gets what the Fed considers to be too fast, I think they do crack down. So far, I think it has worked quite well. I happen to agree that that is about the way they ought to do it.

I remind you again that this economy is beginning to get fairly close to the point where we are reaching what appears to be the *zone of capacity limitation*. We still have a ways to go, but we are getting close, and every indication is that the Nation's capacity to produce measured in terms of its capital stock, measured in terms of the Fed's capacity measures, measured in terms of its productivity and labor force growth—all of which are imperfect—but all of those seem to indicate that we are continuing to grow that capacity and $2\frac{1}{2}$ to 3 percent a year, and I think the Fed has to be fairly cautious. You can quibble at the margin about not letting spending get to the point where it tries to drive us through that capacity and does set off inflation both in expectations and in actuality.

Mr. HILER. My time has elapsed but if I might take about 30 seconds to conclude.

Mr. COOPER. Certainly.

Mr. HILER. With unemployment at 7.4 percent and capacity utilization in the Fed statistics at 82 percent, and prices at the farm level and metal prices depressed, and land prices with no apparent bottom in sight in some areas of the country, it is difficult for me to see where we are bumping up against, or close to bumping up against the extremes of our capacity utilization potential. But I am not an economist, so I will defer.

Mr. COOPER. Mr. Neal.

Mr. NEAL. I would like to ask you all to help me with what I think are essentially a couple of technical questions. One, what is the real savings rate in this country? I had thought it was about 6 percent of GNP. I heard Dr. Schultze use some other numbers.

Let me go ahead and ask the second question so you could all respond to both. That question is, what would bring down the value

of the dollar relative to other currencies? In looking at that question, I don't see anything that would—except bring down the budget deficit and even that would take a long time to produce results—unless we were to do something very foolish internally. There is no sensible thing that I can see that we would do at this time to bring down the value of the dollar. I can see stupid things, reinflating the economy, or putting ourselves through a deep recession or going to war, or doing other things to destroy confidence in this country, but I can't see anything sensible.

Dr. GREENSPAN. Speaking for the three of us, that we would probably agree with you on your second point.

Mr. NEAL. That there is nothing sensible that we can do?

Dr. SCHULTZE. I wouldn't agree with that.

Dr. GREENSPAN. You are talking about the budget deficit. I think he is talking about monetary policy.

Mr. NEAL. Even on that question, as I see it, if we were to bring the budget deficit down, as I hope we will, that would only inspire more confidence in our economy and would not probably bring the value of the dollar down very soon. That would attract even more dollars.

Dr. SCHULTZE. I would put much less weight than my colleagues here on confidence in savings and more weight on the fact that you can make a nice buck in the United States—you can earn a good return—if you can bring down the rate of interest responsibly. And, I think you can bring down the rate of interest responsibly by a substantial amount. I don't know exactly what it will do to the dollar. I don't know exactly what it will do to foreigner's willingness to buy dollars. I don't know exactly what it will do to the trade deficit. I do know it will push it substantially in the right direction. It will make it less attractive to invest in the United States. It is one thing to invest in the safe haven at 8 percent real growth and another thing to invest in a safe haven at 4 percent.

Mr. NEAL. But it is all a relative matter, isn't it? Where will the money go? Where else could you get this kind of return or even two points less with the kind of safety that their investors could find here?

Dr. SCHULTZE. I don't think that the rest of the world is in that bad shape—my point is, the world doesn't have sharp corners. Clearly, there is some interest rate at which we would be unattractive and I don't think that we are very attractive at interest rates of 10, 9, 7, 6, 5, or 4 percent, and then not attractive at 3. It is a curve. It is continuous and as you pull those rates down, people who are at the margin on investing in the United States are going to begin to drop out. Now, I can't tell you how many are going to drop out and how much it is going to do.

Mr. NEAL. What you are suggesting would be the sensible thing over a period of time. That is precisely what we want. We want to get the deficit down and hope the other economies in the world approve.

Dr. POOLE. You asked a question about the saving rate. The personal saving rate is in the neighborhood of 6 percent, but we have, of course, corporate saving—business saving—and then we have Government, which is generally dissaving. The net of all of those is in 1974 about 15.7 percent.

Mr. NEAL. Personal is six?

Dr. SCHULTZE. Not of GNP.

Dr. POOLE. What I did was this. Take GNP and subtract out consumption and Government expenditures. Subtracting out the expenditures that we would regard as being not saving and taking that residual as a ratio to GNP, you get about 15.7 percent.

Mr. NEAL. As net?

Dr. POOLE. Well, as gross. It is not net of depreciation allowances, that is.

Mr. NEAL. Could you run over the numbers with me one more time? Personal savings is 6 percent of GNP?

Dr. POOLE. No, it is about 6 percent of personal income.

Mr. NEAL. What percent of GNP?

Dr. POOLE. I don't know. I can make the calculations but I don't have them right here.

Dr. GREENSPAN. It is about two-thirds of that, or 4 percent.

Mr. NEAL. Four percent of GNP and 6 percent of disposable personal income after taxes?

Dr. GREENSPAN. Yes sir.

Mr. NEAL. And corporate would be roughly what.

Dr. POOLE. Well, we are talking about corporate cash flow here. I don't know. I can't tell you right off the tip of my fingers here.

[The following supplemental information was submitted on the savings rate for inclusion in the record by Dr. Poole:]

A Note on the Saving Rate

William Poole, Brown University

Before discussing the saving rate, the important distinction between gross and net product must be explained. Gross National Product is the total production of final goods and services, including production of capital goods to replace capital that is wearing out. Subtracting the capital consumption allowance from Gross National Product yields Net National Product.

For most purposes NNP is a more appropriate concept than GNP. However, economic analysis is often based on GNP because employment fluctuations, a matter of major concern, are related to GNP fluctuations and because measurement of the capital consumption allowance is subject to substantial error. (For example, I live in a 110-year old house that the national income accountants probably wrote off years ago.)

Saving is the part of national output that is not consumed. By convention, the consumed part of national output includes all personal consumption expenditures and all government expenditures as measured in the National Income and Product Accounts. This convention neglects the fact that, for example, cars and highways are not used up during the period they are built and appear, respectively, as personal consumption expenditures and government expenditures in the national accounts.

In 1984 gross saving was 15.7 percent of GNP compared to 16.2 percent in 1980. Subtracting the capital consumption allowance yields net saving -- 4.7 percent of GNP in 1984

compared to 5.1 percent in 1980.

The personal saving rate (gross) in 1984 was 6.1 percent of disposable personal income, or 4.3 percent of GNP. The corresponding figures for 1980 were 6.0 percent and 4.2 percent, respectively.

Taking all levels of government together, in 1984 government dissaving was 3.4 percent of GNP, compared to dissaving of 1.2 percent of GNP in 1980. The rise in government dissaving of 2.2 percentage points between 1980 and 1984 was mostly offset by an increase in the gross corporate saving rate amounting to 1.0 percentage points.

Gross saving, and especially net saving, fluctuates substantially from year to year. Net saving was 7.4 percent of GNP in 1979, but only 1.4 percent of GNP in the recession year of 1982. Sorting out the effects of the business cycle and the effects of government budget deficits on the saving rate is a complicated task. There is little agreement in the economics profession about these matters, and precise estimates, or even generally - accepted rough estimates, are not available.

The comparisons between the 1980 and 1984 saving rates discussed earlier do not "prove" anything, but should alert us to the possible interactions among the components of saving. On the one hand, the increase of government dissaving from 1980 to 1984 may have been partially, or even largely, offset by an increase in corporate saving. On the other hand, the increase in the corporate saving rate might have occurred in any event. Future fiscal policy actions that reduce government dissaving might

reduce both personal and corporate saving, or might not. These issues are unsettled.

The one conclusion that does seem clear is the Reagan Administration's success in increasing the national investment rate has not yet been matched by success in increasing the national saving rate, whatever may be the reason. However, it should be noted that the amount of saving has been growing rapidly during the business cycle recovery; even if the saving rate were constant, rapid growth in GNP would yield rapid growth in the amount of saving.

None of this analysis should be interpreted to imply that the present Federal budget deficit is not a problem. The extent of the effect of the deficit on the national saving rate is certainly important in assessing the overall economic effect of the deficit, but even if the effect of the deficit on the national saving rate were zero it would still be highly desirable to reduce and eventually to eliminate the budget deficit.

Mr. NEAL. Well, let me get at it one other way. The Government deficit is roughly 5 percent of GNP. I had thought, obviously incorrectly, that savings was roughly 6 percent and therefore the deficit was eating up most of our savings. How would you make me understand that a little better?

Dr. SCHULTZE. Let me try to bridge the difference in numbers. I don't have exactly the same numbers in mind, but let me start with 16 percent of GNP as the gross savings rate. It has two components: One, depreciation allowances, which at least in theory are roughly sufficient simply to keep our capital unchanged, to replace it as it wears out, and that is about 9 percent of GNP. That means our net savings is normally something like 8 percent of GNP. So your number is in the right ball park for net savings. Both are legitimate concepts.

I think if you are looking at a long term economic growth and the amount of funds available to expand the Nation's capital stock, you want to ask how much do we save net and therefore, can invest in adding to our capital stock. This means you have to have the net numbers. So Dr. Poole's 16 percent and your 8 percent are both right, but they are different concepts.

Mr. NEAL. But if you are thinking about them in terms of what is needed today to finance the deficit, is 8 percent probably the more reasonable figure to think about?

Dr. GREENSPAN. Yes, sir. The depreciation is also an optional number, which basically reflects the average age of the types of equipment purchased. As a consequence the decline in the average age of what we have been investing in in turn reflects the high cost of capital and leads to depreciation charges accelerating. It is not a fundamental economic improvement in savings. It is merely a reflection of investment processes. Since the claim of the Federal Government reflects the same net concept as that net savings figure, the lower figure is the more appropriate number to match against the Federal budget's claim on the gross national product.

Mr. NEAL. So a deficit of 5 percent and a savings rate of 8 percent are a reasonable way to think about that.

Dr. GREENSPAN. Yes sir.

Mr. NEAL. Thank you.

Mr. COOPER. Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

I apologize for arriving late. I have three subcommittees going at the same time and it is tough to cover all three.

I would like to follow up on what you were beginning to say, Dr. Schultze, in response to one of the questions. I think you were talking a little bit about the Treasury tax reform plan.

I would like to ask you, and then I am going to ask Dr. Greenspan and Dr. Poole to also comment on those aspects of the plan, particularly proposed changes in taxes on business or corporations, how they may effect, in your judgment, positively or negatively the prospect for economic expansion in this country.

The President, in his State of the Union Message talked about the need for reforming the Tax Code in a way that was consistent with economic growth. Most of us took that as a signal that he was sort of getting behind the Regan Treasury plan, but as it turns out, he apparently didn't realize that the Treasury plan increases busi-

ness taxes and lowers personal taxes. Are there any thoughts that you might share with us this afternoon?

Dr. SCHULTZE. The Treasury plan, it seems to me, affects the prospects for long-term growth in a number of ways, but let me just concentrate on two of them.

On the one hand, it does raise, as I understand it, the tax rate on business. Now, part of that is in some very special areas such as financial institutions where it significantly tightens up the taxation of banks. It also raises revenue by changing the construction loan period on various defense contracts and other things, and oil and gas depletion. If you take those out, there is still a net increase in business taxation, but it is a much smaller amount. You could say all right, on balance everything else being equal, that still tends to depress the incentive to invest, I think modestly.

On the other hand at the same time, it substantially reduces the current distortions in the Tax Code which arbitrarily favor one form of investment relative to another form of investment. The schedule of depreciation allowances combined with the investment tax credits that is now in the Tax Code, arbitrarily pushes and pulls investment in directions that economic logic would not. When you consider the fact that they are they are making the tax system much more neutral, much more even, and with less distortions, I would say that probably in the short term the plan would have only a modest penalty on investment. In the long term, it is going to improve the efficient allocation of investment and have a favorable impact on economic growth.

Combine that with the substantially lower marginal tax rates on individuals and the effect of that is positive. Don't expect miracles at all, but it is a plus from the standpoint of economic efficiency, in growth and improvement in the Nation's ability to grow, a modest amount, but that is about all we can do.

Mr. CARPER. All right, thank you, Dr. Greenspan.

Dr. GREENSPAN. It is a very difficult question to answer easily. There is no question that the simplified tax is superior to the existing Tax Code, There is also no question that you will, if you eliminate the investment tax credit and significantly increase the average depreciation lives of equipment and plant, reduce the level of capital investment in the short run. It is unclear, however, how it all comes out in the long run.

There is another issue which probably will surface in these hearings, and that is a bias that does exist in the whole taxation area relative to investment. It is something we don't think about very much because it was defined many years ago, not by the tax lawyers, or not by the Congress, but by the accountants. They stipulated that research and development expenditures be written off immediately. R&D is a long-term capital asset which increases production in the long run but is expensed immediately. Training courses which improve productivity and are a long-term investment are the same sort of thing. A large number of corporate expenditures are written off immediately, but effectively address the long term. While it is certainly true that every time you shift the depreciation schedule, you favor one investment versus another, and impose taxes on one area versus another, the ability to arrive at so-called tax neutrality I think is a will o' the wisp. We are not

going to be able to do that. Unless we eliminate the corporate tax—which I favor—we end up with some form of distortion in the investment process.

Mr. CARPER. Dr. Poole?

Dr. POOLE. The taxation of financial institutions is a major part of how the Treasury proposal would get extra tax revenues out of business. The main issue here is that banks are permitted to deduct interest on funds they borrow—let's say certificates of deposit—even if those funds are invested in tax exempt securities. You and I are not permitted to deduct such interest expenses on our own returns. I don't think the current tax treatment of banks is a sensible provision of the tax law.

As for corporate investment in general, that is the key issue, and how we approach it depends on what our basic objective is. If we would like to move our tax system toward an ideal of a well-designed income tax, then we ought to use depreciation allowances that are close to economic depreciation—that is, depreciation for tax purposes that closely reflects the actual wearing out of capital. If we want a tax system that is more oriented toward a consumption tax—that is, that does not tax saving—then if we keep the corporation tax we ought to permit expensing of investment—immediate write-off.

One of the things that we certainly should not do is to leave in the negative tax rates that now exist in some circumstances. If you look at the Treasury tax proposal you will see some tables that show negative tax rates on certain kinds of investments. There is a net tax subsidy. That is, present law provides for more rapid depreciation than expensing in some cases. The combination of the depreciation provisions and the investment tax credit lead to a net tax subsidy. That certainly should be changed.

Mr. CARPER. My time has expired again. Thank you, each one of you, for being with us this morning and sharing with us your thoughts.

Mr. COOPER. I, too, would like to add my thanks to the distinguished panel. We are indeed fortunate to have had the benefit of your testimony. As the last matter of business, I ask unanimous consent to include Dr. Tobin's remarks in the record.

[The statement of Dr. Tobin entitled "Monetary Policy in 1985" follows:]

MONETARY POLICY IN 1985

James Tobin

Statement for House Subcommittee on Domestic Monetary Policy
March 5, 1985

The Federal Reserve Monetary Policy Report of February 20, 1985 and the accompanying Statements of Chairman Volcker are important and reasonable documents. The Federal Reserve has managed our economic recovery well since 1982. Both that record and the current statements give promise that the Fed is willing and able to keep the recovery alive. One reason is that the Fed is orienting its operations to macroeconomic objectives--GNP growth, unemployment, and prices--and subordinating its targets for intermediate monetary aggregates to those objectives. Although this has been the practice of the Fed since fall 1982, it is now stated quite clearly and explicitly as policy. I find this a very encouraging development.

Mechanical monetarism seems to be dead at the Fed. The monetary aggregates, M1 and its four companions, never were economically important per se. They stood between the central bank's actual operating instruments and the ultimate objectives of monetary policy, and sometimes they got in the way. The targets were a vehicle for establishing the anti-inflation credibility of the central bank, but adherence to them became a criterion of its credibility. On occasion it was unfortunate that the Fed's inflation-fighting credentials were tied to those numerical targets.

In the first eight months of 1982, the Fed stuck to the money growth targets it had announced in February, with disastrous results for the performance of the economy. Figure 2 shows how drastically current-dollar GNP fell short of the Open Market Committee's expecta-

tions at the start of the year, and it also shows the main reason. The velocity of M1--the number of times a year the average dollar makes the circuit from one GNP purchase to another--fell far short of the assumptions implicit in the Committee's M1 growth target relative to its \$GNP projections.

In August-October 1982 Chairman Volcker and company reversed priorities, deliberately exceeded their monetary targets, made up for the velocity slowdown, and turned the economy around. (Figure 3 shows how the M1 target range was first exceeded and then lifted.) Ever since then, at least by my interpretation, the Fed has geared its operations to macroeconomic performance first and foremost, specifically to managing the recovery. The FOMC has touched the brakes when, as last spring and summer, real growth appeared too exuberant, and has eased when, as last quarter, the recovery gave signs of petering out. Now that the recovery seems to be on track again, Chairman Volcker indicates "steady as you go" and says he is content with interest rates at current levels.

Under this flexible policy interest rates have been much less volatile than in 1980-82, though they have by no means been pegged. (Figure 5). Moreover, Chairman Volcker and his colleagues have not lost their reputations as inflation-fighters, dearly earned over the three years from October 1979. Their credibility rested on firmer foundations than monetary targeting.

The current Report and Statement support my interpretation. They pay as much attention to the velocities of monetary aggregates as to their amounts. They explicitly indicate that the Fed will continue to alter growth rates of money supplies to offset velocity surprises as soon as they can be detected. Although M1 velocity has an upward

trend, its growth from quarter to quarter is quite volatile. (See Figure 4.) Indeed, as Chairman Volcker has often pointed out, the pace of technological, institutional, and regulatory change in the financial industries has made velocity more uncertain than ever.

Now the Fed has clearly accepted the fact that it is Money times Velocity that matters, MV not M by itself. Of course MV is by definition current dollar GNP ($\$GNP$). In effect, the FOMC is targeting $\$GNP$. That means that the paths of $M1$ and other aggregates will be moved within their target ranges inversely to velocity. Indeed we may infer, also from 1982-83 experience (Figure 3 again), that they will be moved outside them if necessary. The "central tendency" of the FOMC's projections of $\$GNP$ may be the true target of policy, ahead of any of the aggregates. For the year beginning in the fourth quarter 1984, that central projection is 7.5-8%. The midpoint of the $M1$ target range, 5.5%, augmented by a normal trend growth in velocity of about 3%, would more than suffice. But if velocity growth fell below 0.5%, $M1$ growth would have to exceed its 7% upper limit.

The macroeconomic objective of the Federal Reserve, the goal that has guided its management of the recovery, is, I feel sure, a "soft landing" on a track of sustainable growth at as low an unemployment rate as will not cause prices to accelerate. When the economy finally climbs back on to that track, the temporary cyclical components of recent growth will disappear and the economy will be limited to the growth in production attributable to increase in its resources and in their productivity. The Fed does not know, nor does your panel today, exactly what that sustainable growth rate is; most economists put it at 3% per year or a bit lower. The Fed does not know, nor does your

panel today, precisely what the inflation-safe unemployment rate is these days. It is quite clear that it is significantly lower than current unemployment. A consensus estimate is around 6%.

The recovery has some distance to go. The Gap between actual real GNP and Potential real GNP (estimated at 6% unemployment) appears to be about 3% as of 1984 fourth quarter. (See Figure 1a for the history of the Gap, estimated two ways, the last four years. Figure 1b shows its change quarter to quarter in recession and recovery.) To complete the recovery over two years would require real growth averaging 4.5% per year--1.5 to take up half the remaining slack plus 3 for the trend of potential GNP itself. The FOMC consensus contemplates real growth of 3.5-4% from fourth quarter 1984 to fourth quarter 1985; the other half of its \$GNP projection is for continuation of the moderate 3.5-4% inflation.

It is understandable that the Fed wants to approach its goal more slowly the closer it gets; that is the meaning of "soft landing". Still, the Fed's 1985 scenario seems over-cautious, leaving the unemployment rate at 6.75-7% and the Gap above 2% at year end. I believe 4.5% real growth would be warranted in present circumstances. I hope that the Fed will not oppose a rise in both dollar and real GNP somewhat faster than their Report projects for this year.

The Fed's adoption of velocity-adjusted money growth targeting, in effect \$GNP targeting, is welcome progress. However, rigid adherence to any dollar-denominated target can cause excessive real damage to the economy in case of supply price shocks like the two big oil price increases in the 1970s. Under \$GNP targeting, if prices rise 1% more than expected real growth must be 1% less. The one-to-one sacrifice ratio is severe, unnecessarily so if the price shock is non-

recurrent so that the extra inflation is temporary. The FOMC has not told us what it would do in such contingencies.

At this date price shocks like those of unhappy memory seem unlikely. Oil prices are moving in our favor. The main possible source of bad price news is depreciation of the dollar against other currencies, raising the dollar prices of some internationally traded goods and services. That development would reverse some of the disinflationary gains due to the amazing appreciation of the dollar these past five years. But those are gains we have to relinquish sooner or later, as we should always have known. We could not expect to hold the dollar at exchange values so far out of line with costs of production here relative to those abroad. The chances are good that dollar depreciation would not trigger a secondary wave or spiral of domestic cost and price inflation. In current labor markets wage increases and new settlements are modest. The hunger of workers and employers for jobs and market shares eroded by foreign competition should keep them moderate if and when the dollar declines.

A decline in the dollar would be a welcome development. Our present huge trade and current account deficits are untenable. Agriculture and other export and import-competing sectors are hurting badly. The longer the exchange rate adjustment is postponed the less able will these sectors be to exploit the competitive opportunities the adjustment will bring.

The dollar might fall through no action on our part, simply because investors throughout the world become saturated with dollar assets, find better opportunities in other currencies, or lose confidence in the long-run prospects of a currency tied to a large

trade deficit. It is commonly said that our interest rates would then necessarily rise. It is true that as long as the dollar was in the process of falling and was expected to fall further, investors in American assets would want interest compensation for the expected decline. That is why, contrary to common impression, a sharp and rapid decline might be preferable to a protracted gradual correction.

In any case U.S. short-term interest rates will not rise unless *the Fed wants them to*. I do not think that the Fed should automatically try to "defend" the dollar by raising interest rates. Instead, the Fed should consider whether a rise in interest rates is appropriate to its domestic macroeconomic objectives, discussed above. A depreciation of the dollar would eventually, after lags of several quarters, promote exports and retard imports. That welcome improvement in our trade balance would also be extra demand stimulus in the U.S. economy. If the economy were at the upper limit of a "soft landing" track, *the extra demand stimulus would be unwelcome*. The Fed would have to make room for higher net exports (lower net imports) by raising interest rates enough to "crowd out" an equivalent amount of domestic spending. This might be the case. However, as I noted above, the Fed's projected paths of real GNP and unemployment are cautious. We could well afford to close the Gaps faster, especially when the extra demands come to depressed sectors with unemployed labor and underutilized capacity well above the national averages.

I have referred just now to a dollar decline brought about by a shift of world portfolio preferences away from dollar assets. Another way the dollar could fall would be by deliberate changes in U.S. fiscal and monetary policies. A significant reduction in the budget deficit, by expenditure cuts or tax increases or both, would withdraw

demand stimulus from the economy. To stay on the desired GNP track, the Fed would, if I am right about its present policy stance, ease monetary policy and lower interest rates to replace the lost fiscal stimulus. The reduction in U.S. interest rates might deter capital inflows and lower the dollar against other currencies. But it might not. Our trading partners overseas might seize the opportunity to lower their interest rates too, preventing or limiting the dollar's fall. The European and Japanese economies need the stimulus of lower interest rates, and improvement in their economies would help our trade balance whether the exchange rate falls or not.

In conclusion, I welcome the Federal Reserve's adoption of a philosophy of monetary policy that places important macroeconomic objectives first. That shift has served the Fed and the nation well the last two and a half years. It is good to have it stated so clearly and explicitly as the Board and Chairman Volcker have done in their Report and statements. The recognition of the need to offset velocity shocks by compensating changes in growth of money supplies gives the present policy specific content. For 1985, the Fed is right to continue to manage the recovery toward a "soft landing" at the lowest inflation-safe unemployment rate. However, I find the Fed's 1985 scenario somewhat over-cautious. Finally, I warn against assuming, without careful consideration of the domestic macroeconomic scene, that interest rates must be allowed to rise when and if the dollar falls. Anyway, a preferable approach is to seek a decline in the dollar by a shift in our mix of fiscal and monetary policy. This depends on action by the Congress to reduce the budget deficit, and it would result in lower interest rates all over the world.

Figure 1a

The Gap in each quarter is the difference between Potential Real GNP and actual Real GNP, both in constant 1972 dollars, as percent of Potential. Potential corresponds to 6% unemployment. Unemployment-based Potential is calculated from the excess of 6% over the average of actual unemployment rates, seasonally adjusted, for the three months of the quarter. An "Okun's Law coefficient" of 2.25 is assumed; that is, Potential exceeds Actual by a percentage 2.25 times the excess unemployment. Trend-based Potential assumes that Potential and Actual were on average equal in calendar year 1978 and that Potential has grown at 0.72% per quarter since then, i.e. 2.9% year over year. The "avg" line graph in the Figure is midway between these two Gap estimates.

The unemployment-based Gap estimate was much the higher of the two at the depths of the business cycle in late 1982 and early 1983. Evidently unemployment was extraordinarily high relative to output. At the end of 1984, however, the trend-based estimate was slightly higher. If the rise in unemployment reported for January 1985 is indicative, the unemployment-based Gap will move toward the higher trend-based Gap.

The plots for 85:1-85:4 are those implied by the midpoint of the central tendency of projections of real GNP growth to 85:4 by Federal Reserve Governors and Bank Presidents, as stated in the Monetary Report to Congress of February 20, 1985. It is assumed that their projected growth rate applies evenly throughout 1985.

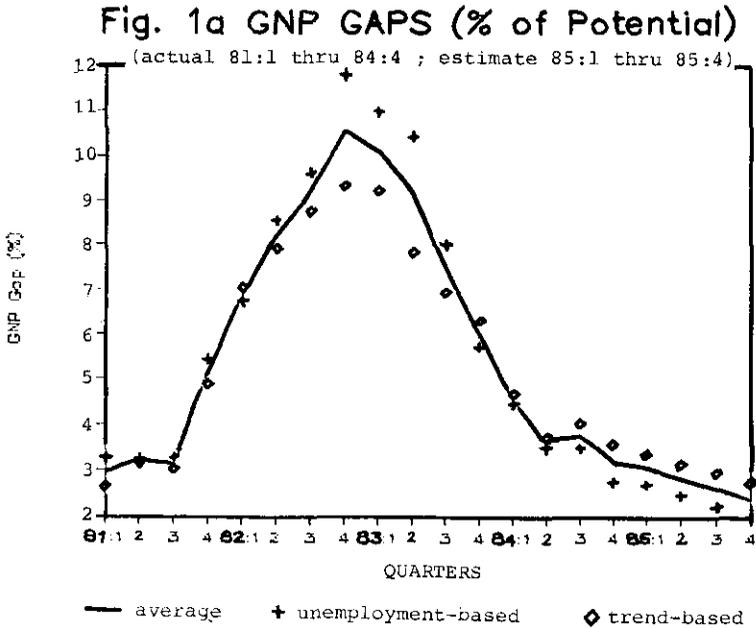


Figure 1b

The change of the "avg. Gap" of Figure 1a is the difference in percentage points between the Gap for the quarter and for the preceding quarter. The plots for 85:1-85:4 are those implied by the midpoint of the central tendency of projections of real GNP growth to 85:4 by Federal Reserve Governors and Bank Presidents, as stated in the Monetary Report to Congress of February 20, 1985. It is assumed that their projected growth rate applies evenly throughout 1985.

After the Fed's policy change took effect in 82:4 the Gap declined rapidly. The general decline in the rate of decline since then is consistent with a "soft landing" policy, as are the corrections the Fed engineered to slow down rates of Gap decline that seemed too high in the first halves of 1983 and 1984 and too low later in both years.

Fig. 1b Change in GNP GAP

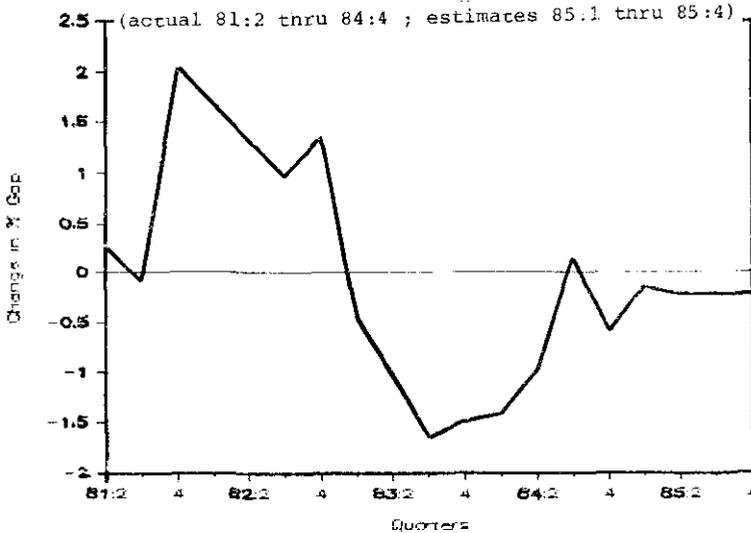


Figure 2

\$GNP surprises are excesses, negative if shortfalls, of actual \$GNP for the quarter over the \$GNP projections stated in the Monetary Policy Report to Congress. They are plotted as percentages of actual \$GNP. The midpoint of the central tendency of the Governors and Bank Presidents, or of the range when central tendency was not reported, is used. The projections are for rates of growth over years ending in the fourth quarter; these have been spread evenly over the intervening quarters. The projections are those in the February Report except for 1983:3 and 1983:4. For those two quarters the \$GNP projections implicit in the midyear Report of July 1983 were used. This was the only occasion during the period when M1 targets for the year in progress were altered. At that time both the GNP projections for the year and the monetary growth targets for the year were raised.

A velocity projection for M1 is calculated on the assumption that velocity will grow at a "normal trend" rate of 0.75% per quarter from the base period of the Fed's \$GNP projections and M1 targets for the year. The base period is always the fourth quarter of the previous year, except for the latter two quarters of 1983, for which it is the second quarter of 1983. Velocity Surprise is the difference between the "projection" so calculated and the actual velocity of the quarter, expressed in percentage of actual.

The general correlation of the two Surprises is clear, especially dramatic in the 1981-82 recession. The success of the Fed in compensating for velocity shortfalls in 1983 with higher monetary growth also is exhibited in the figure.

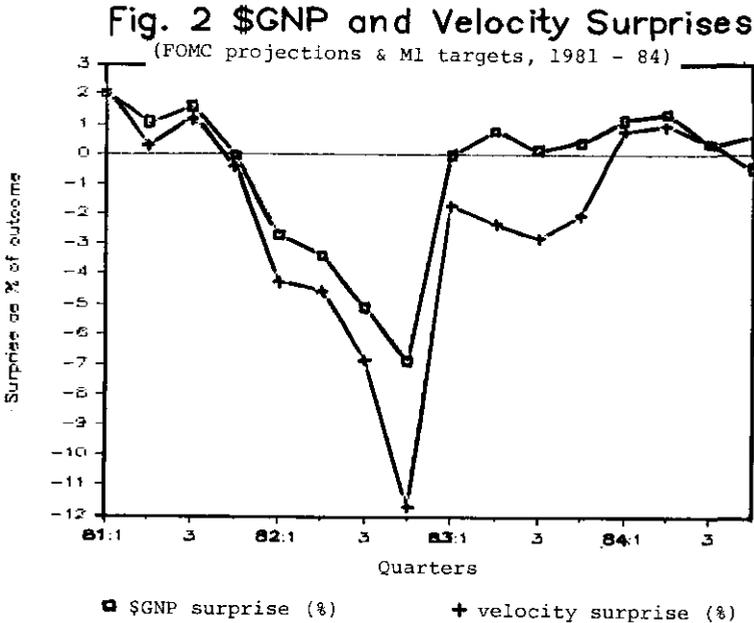


Figure 3

The quarterly history of M1, seasonally adjusted, is shown by the line graph. The upper and lower limits of the target ranges as shown are derived from the annual February Monetary Policy Reports, except that the July 1983 midyear Report is used for 83:3 and 83:4 because the monetary growth targets for the year and the base period for M1 were then revised.

The M1 growth targets and base periods, as thus announced, define M1 target ranges in absolute billions of dollars only for the coming fourth calendar quarter. The intervening target ranges must be inferred. However, the mid-range target M1 is defined for every quarter by the base M1 and the mid-range growth rate. Here it is assumed that the upper (lower) limit of the target range for M1 is above (below) the mid-range target for every quarter in the same ratio as in the fourth target quarter. This seems preferable both to the conventional "cone" and to the assumption that a limit differs from the mid-range by a constant amount of billions of dollars in each quarter of the year.

The figure shows the planned slowdown of M1 growth for 1982, as the Fed was pursuing the gradual disinflationary policy of October 1979. It also shows the decision to ignore the M1 targets, in favor of macroeconomic performance, from 82:4 and the similarly motivated upward rebasings of M1 targets, twice in 1983 and at the start of 1984. The lower 1985 targets are also shown, together with a mid-February figure for actual M1 for 85:1 close to the top of the target range.

Fig. 3 M1 targets 81-85 and history

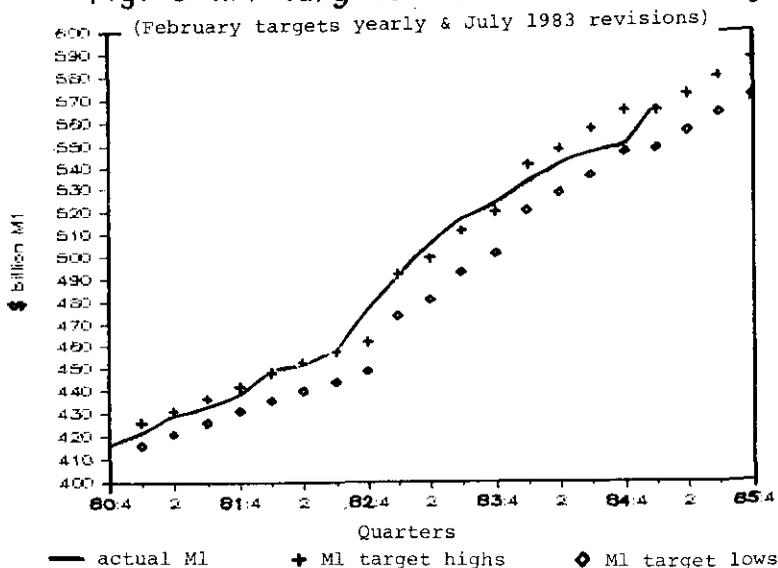


Figure 4

The figure shows the percentage change in velocity relative to the previous quarter, multiplied by four. Thus it is the change that would have occurred in a year had it continued at the same rate. It is a number comparable to the 3% a year often taken as the normal trend. The figure illustrates the volatility of velocity, which explains the Fed's current emphasis on correcting monetary targets and growth rate for perceived velocity fluctuations.

Fig. 4. % change M1 velocity 1981-1984

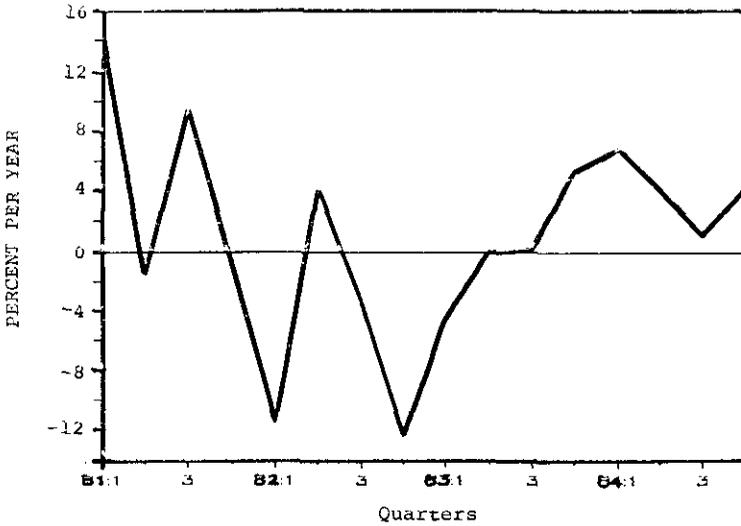
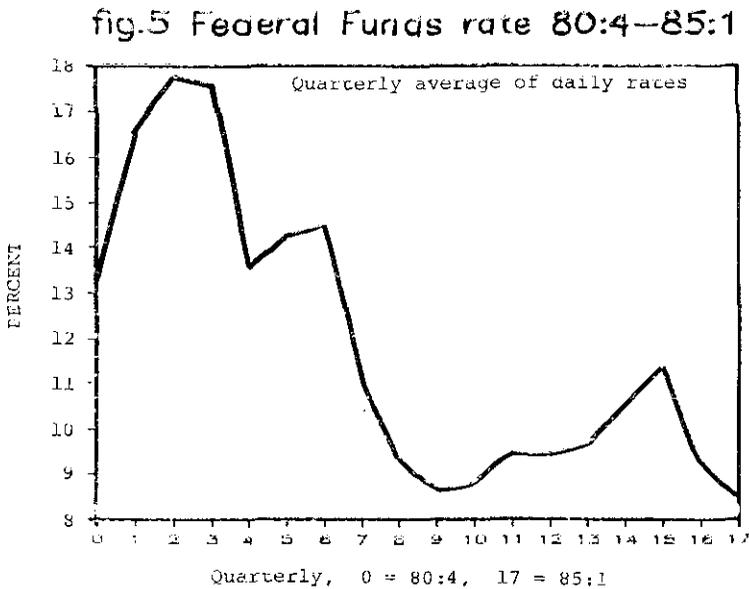


Figure 5

The average daily effective Federal Funds rate for the quarter is plotted. The dramatic effect of the Fed's policy change over quarters 7-9, 82:3, 82:4, 83:1, is clear. Likewise, the swings since then reflect the Fed's management of the speed of recovery. The point plotted for quarter 17, 85:1, is an estimate based on history through mid-February.



Mr. COOPER. If there be no objections, the hearing is adjourned.
[Whereupon, at 12:15 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

A P P E N D I X

ADDITIONAL MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

FEDERAL RESERVE press release



For Use at 4:30 p.m.

March 29, 1985

The Federal Reserve Board and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on February 12-13, 1985.

Such records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

RECORD OF POLICY ACTIONS OF THE
FEDERAL OPEN MARKET COMMITTEE

Meeting Held on February 12-13, 1985

1. Domestic policy directive

The information reviewed at this meeting suggested that the rate of economic expansion strengthened in late 1984. For the fourth quarter as a whole, growth in real gross national product picked up to an annual rate of about 4 percent, according to the preliminary estimate of the Commerce Department, from about 1-1/2 percent in the third quarter, and there was evidence of continued moderate expansion in early 1985. The pick-up in growth from the third to the fourth quarter was attributable in large part to stronger domestic final demand and a reduction in the current account deficit with foreign countries after a sharp further widening of that deficit in the third quarter. Broad measures of prices and wages generally continued to rise in 1984 at rates close to those recorded in 1983.

Industrial production increased 1.0 percent in the November-December period, offsetting the declines in the preceding two months, and preliminary indications suggested a further gain in January. The December rise was broadly based, in contrast to the increase in November, which was concentrated in the automotive category. The index of industrial capacity utilization moved up to 81.9 percent in December, but remained almost 1 percentage point below its recent high in mid-1984.

Nonfarm payroll employment, adjusted for strike activity, rose more than 300,000 further in January. The largest gain occurred at retail trade establishments, but employment growth was also strong in services

and in construction, where unseasonably mild weather boosted hiring in both December and early January. In manufacturing, employment rose moderately after a large gain in December, and the length of the workweek edged down but remained above the average level in the fourth quarter. Despite the continued rise in employment, the civilian unemployment rate increased slightly to 7.4 percent, as the civilian labor force grew substantially.

Retail sales rose 0.7 percent in January, continuing at about the same pace as the average for November and December. Much of the January rise was attributable to sales at automotive outlets. Sales of new domestic automobiles were at an annual rate of 8-1/2 million units, about 1 million units higher than the average in the fourth quarter of 1984. Stores selling primarily discretionary items such as general merchandise, apparel, furniture, and appliances registered a marked decline in sales in January, after substantial increases in the final months of 1984.

The decline in housing activity that had characterized the second half of 1984 appeared to be ending as the year drew to a close. Total private housing starts, though down about 6 percent in the fourth quarter as a whole to an annual rate below 1.6 million units, edged up in the November-December period, and sales of existing homes rose somewhat over the final two months of the year.

Business fixed investment spending continued to grow in the fourth quarter, although at a less rapid pace than in the first three

quarters of 1984. Shipments of nondefense capital goods increased moderately in the fourth quarter, and spending on nonresidential construction advanced substantially. In contrast, new orders for plant and equipment fell in December and over the fourth quarter as a whole.

Some imbalances in business inventories had developed during 1984, but businesses appeared to have made substantial progress toward attaining desired inventory levels, and in some sectors inventories relative to sales were quite lean. Investment in business inventories slowed markedly in late fall, largely in response to the earlier weakness in orders and sales. In November, stocks at all manufacturing and trade establishments were *little changed in real terms, after average monthly increases in the range of \$20 to \$25 billion at an annual rate during prior months in 1984.*

In December, the producer price index for finished goods and the consumer price index edged up 0.1 percent and 0.2 percent respectively. During 1984 the rise in producer prices was 1.8 percent, compared with 0.6 percent in 1983, while the increase of 4 percent in consumer prices was about *the same as that in the previous year. The advance in the average hourly earnings index was 3.0 percent last year, compared with 3.9 percent in 1983.*

The foreign exchange value of the dollar rose about 5-1/2 percent to a new high over the intermeeting period. After the announcement on January 17 by the G-5 Ministers of Finance and Central Bank Governors regarding coordinated intervention in exchange markets, and subsequent exchange market operations, the dollar tended to stabilize. The rise resumed in early February, apparently in association with a perception

that the outlook for economic activity in the United States was improving without signs of a strengthening in inflationary pressures. The U.S. merchandise trade deficit declined sharply in December and for the fourth quarter as a whole, primarily because imports dropped substantially from the high rate in the third quarter. Nevertheless, the trade deficit for 1984 totaled nearly \$108 billion, compared with \$61 billion in 1983.

At its meeting on December 17-18, 1984, the Committee had adopted a directive that called for some further reduction in the degree of restraint on reserve positions. The members expected that such an approach to policy implementation would be consistent with growth of M1, M2, and M3 at annual rates of around 7, 9, and 9 percent respectively during the four-month period from November to March. Given the estimated shortfall in growth of M1 for the fourth quarter relative to the Committee's expectations at the beginning of the period, the members agreed that somewhat more rapid growth would be acceptable, particularly if the faster growth occurred in the context of sluggish expansion in economic activity and continued strength of the dollar in foreign exchange markets. The Committee also indicated that greater restraint on reserve positions might be acceptable if growth in the monetary aggregates were substantially more rapid than expected and if there were indications that economic activity and inflationary pressures were strengthening significantly. The intermeeting range for the federal funds rate was set at 6 to 10 percent.

After growing little on balance since early summer, M1 expanded at estimated annual rates of about 10-1/2 and 9 percent respectively in

December and January.^{1/} M2 and M3 also expanded rapidly over the two months, rising on average at annual rates estimated to be around 14 and 13-1/2 percent respectively, considerably above the short-run objectives for the November-to-March period established at the December meeting. Relative to the Committee's longer-run objectives for the period from the fourth quarter of 1983 to the fourth quarter of 1984, M1 grew at a rate of about 5-1/4 percent, somewhat below the midpoint of its 4 to 8 percent range, and M2 increased at a rate of about 7-3/4 percent, a bit above the midpoint of its 6 to 9 percent range. M3 and domestic nonfinancial sector debt expanded at rates of about 10-1/2 and 13-1/2 percent respectively, above the Committee's ranges of 6 to 9 percent and 8 to 11 percent for the year. The rapid growth in total debt reflected very large government borrowing and strong private credit growth that was boosted in part by the unusual size of merger-related credit activity.

Over the December-January period, the average level of borrowing by depository institutions at the discount window declined on balance, despite a bulge around the year-end statement date, and both nonborrowed and total reserves expanded at very rapid rates. In the first part of the recent intermeeting interval, open market operations were directed toward achieving some further reduction in pressures on reserve positions. Adjustment plus seasonal borrowing at the discount window, after bulging around year-end, declined to the \$250 to \$300 million range over much of

^{1/} These growth rates and all subsequent data on the monetary aggregates reflect annual benchmark and seasonal factor revisions as published on February 14, 1985.

January. By the latter part of January, against the background of continued rapid growth in the monetary and credit aggregates and the relatively good performance of the economy, the easing process came to an end; reserves were provided more cautiously through open market operations, and borrowing rose somewhat, partly because of unexpectedly large demands for excess reserves. Reflecting variations in actual pressures on bank reserve positions, but in part in anticipation of an easing in pressures, the federal funds rate declined in the early part of the period from around 8-3/4 percent to the 8 to 8-1/4 percent area; subsequently it rose to around 8-1/2 percent or somewhat higher. Other short-term market interest rates generally rose somewhat on balance over the intermeeting interval, while most long-term rates were roughly unchanged or a little lower.

The staff projections presented at this meeting suggested that real GNP would grow at a moderate pace in 1985. Business fixed investment was likely to expand further during the year, and anticipated gains in real disposable income were expected to support continued sizable advances in consumption expenditures. The unemployment rate was expected to edge down over the period, and the rate of increase in prices was projected to remain close to, or slightly below, that experienced in 1984.

In the Committee's discussion of the economic situation and outlook, the members agreed that continuing expansion in business activity was a likely prospect for 1985, though at a more moderate rate than in the first two years of the current cyclical upswing. As they had at previous meetings, however, members referred to persisting problems and financial strains in various sectors of the economy that constituted

threats to the sustainability of the overall expansion, especially if substantial progress was not made toward reducing the massive deficit in the federal budget. Moreover, the high level of the dollar and large trade deficit were increasingly being reflected in pressures on some sectors of the economy. Most of the members expected about the same rate of inflation in 1985 as that experienced in 1984, assuming that the dollar exchange rate remained in the range of recent months, but some saw the odds as tilted in the direction of some modest further progress toward price stability.

At this meeting the members of the Committee and the Federal Reserve Bank presidents not currently serving as members presented specific forecasts of economic activity, the rate of unemployment, and average prices. For the period from the fourth quarter of 1984 to the fourth quarter of 1985, the forecasts for growth of real GNP centered on a range of $3\frac{1}{2}$ to 4 percent, with an overall range of $3\frac{1}{4}$ to $4\frac{1}{4}$ percent. Forecasts of the rate of inflation, as indexed by the GNP deflator, also centered on a range of $3\frac{1}{2}$ to 4 percent, and the central tendency of the forecasts for growth in nominal GNP was a range of $7\frac{1}{2}$ to 8 percent. Forecasts of the rate of unemployment in the fourth quarter of 1985 varied from $6\frac{1}{2}$ to $7\frac{1}{4}$ percent, but most of the members anticipated unemployment rates ranging from $6\frac{3}{4}$ to 7 percent. These forecasts were based on the Committee's objectives for growth in money and credit established at this meeting. The members also assumed that significant progress would be made toward reducing future deficits in the federal budget, thereby helping over the nearer term to moderate inflationary expectations and pressures on interest rates, and they assumed that the

foreign exchange value of the dollar would fluctuate within the range experienced in recent months.

While a number of members commented during the discussion that actual growth in line with the forecasts would represent a favorable development for the third year of an economic expansion, several observed that growth might well be faster, especially in the short run. This possibility was raised by current indications of appreciable strength in both consumer and business spending and an expansive fiscal policy. It was also pointed out that a large decline in the foreign exchange value of the dollar, should it occur, would tend to stimulate domestic business activity while also adding to inflationary pressures. Several members noted their concern that strong growth in spending by the private sectors in the context of a stimulative fiscal policy could lead to some inflationary pressures, particularly as the margin of unutilized productive resources diminished, with adverse consequences for interest rates and interest-sensitive sectors of the economy and ultimately for the sustainability of the expansion itself.

While the overall expansion in economic activity was currently displaying some momentum, the members also referred to the decidedly uneven participation in the expansion of different sectors of the economy or parts of the country, including adverse conditions in agriculture and in certain sectors of industry. Circumstances and problems varied from one industry or region to another, but particular concern was expressed about the damaging impact that a rising dollar internationally was having on a number of manufacturing and extractive industries and on agriculture,

with attendant financial difficulties for those sectors of the economy and related strains on the financial institutions that serviced them. Reference was also made to the overbuilding of multi-family housing and office structures in some parts of the country and to the problem loans associated with such overbuilding. Some concern was expressed about the rapid accumulation of debt by many households and businesses that rendered these borrowers more vulnerable to adverse economic developments. It was generally expected that such problems would not significantly retard overall economic expansion in the near term, but several members indicated that they were more troubled by the economic prospects for the longer run. The members agreed that the odds of prolonging the expansion would be greatly enhanced by a substantial reduction in federal budgetary deficits and the emergence of a more sustainable pattern of international transactions.

With regard to the outlook for inflation, most of the members anticipated that continuing economic expansion in line with their forecasts would probably be associated with little change in the rate of inflation during 1985. Some members were more optimistic and viewed the prospects for some decline in inflation as relatively favorable. Although the members had assumed in presenting their forecasts that the dollar would remain within its recent range of fluctuation in foreign exchange markets, they recognized that the future performance of the dollar was in fact highly uncertain.

Members who were relatively sanguine about the outlook for inflation cited the favorable trend in wages, the strong competition from abroad in many industries, the growth of productive capacity, and the widespread

efforts of businesses to improve productivity. The possibility of further declines in oil prices was also cited. The removal of quotas on imports of automobiles from Japan would also help to restrain the rise in average prices, although the extent of that effect was uncertain. Members who were less optimistic about the outlook for inflation noted that unit labor costs could be expected to be under upward pressure because productivity gains would tend to diminish as the nation continued to move toward fuller utilization of its productive resources during the third year of the current expansion. One member also raised the prospect of at least some pressures from rising commodity prices in 1985.

At this meeting the Committee reviewed the 1985 growth ranges for the monetary and credit aggregates that it had tentatively set in July 1984 within the framework of the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act). Those tentative ranges included growth -- measured from the fourth quarter of 1984 to the fourth quarter of 1985 -- of 4 to 7 percent for M1, 6 to 8-1/2 percent for M2, and 6 to 9 percent for M3. The associated range for total domestic nonfinancial debt had been provisionally set at 8 to 11 percent for 1985.

The Committee's discussion focused on whether the tentative ranges for 1985 remained appropriate in light of developments since mid-1984 and foreseeable economic and financial circumstances. There were a number of proposals for small changes in the ranges. With respect to M1, a majority of the members wanted to retain the tentative range of 4 to 7 percent, but the remaining members expressed a preference for raising the upper limit to 7-1/2 or 8 percent. In the majority view, the tentative

range provided adequate room to accommodate a desirable and sustainable rate of economic expansion and retention of that range would also serve to underscore the Committee's commitment to an anti-inflationary policy. The members who preferred a higher limit for the M1 range gave considerable emphasis to the uncertainties that surrounded both the economic outlook and the relationship between money growth and GNP. They did not necessarily disagree that the tentative range might in fact prove to be consistent with a satisfactory economic performance, but they believed that some additional leeway was desirable for use if needed.

In the course of their discussion, the members referred to evidence that the income velocity of M1 -- nominal GNP divided by the M1 stock -- seemed to be returning to a more normal or predictable pattern. Some analysis suggested that the trend growth of M1 velocity might be somewhat lower than that experienced over much of the postwar period, reflecting in part the deregulation of deposits and other financial changes in recent years and the related prospect of a slower rate of financial innovation in the future. A number of members emphasized that such a development would imply the need for M1 growth in the upper part of the Committee's tentative range. It was also noted that the lagged effects of the interest rate declines during the latter part of 1984 were likely to depress velocity growth in the first part of 1985. Other members raised the prospect that the growth in M1 velocity might not decline as much as expected from the rate experienced in 1984 and in that event growth of M1 near the upper limit of the tentative range, or above it, would have inflationary implications. The members agreed that the trend rate of increase in M1 velocity, as well as the velocity of the other monetary aggregates, remained subject to a considerable range of uncertainty, given

the still limited experience with a relatively deregulated financial environment. Under these conditions, the Committee members indicated the need to continue to judge the behavior of the monetary aggregates in light of the flow of information on business activity, inflationary pressures, and conditions in domestic credit and foreign exchange markets.

With regard to M2, most of the members indicated that they could accept an increase of 1/2 percentage point in the upper limit of the tentative range, although some expressed an initial preference for no change in the range. The small upward adjustment reflected the technical judgment, based upon an assessment of recent developments, that growth in M2 for the year could revert to its earlier pattern that was more in line with the growth in nominal GNP.

Most of the members also supported an increase of 1/2 percentage point in the upper limit of the tentative range for M3 and an increase of 1 percentage point in the provisional monitoring range for total domestic nonfinancial debt. Growth within both ranges in 1985 would represent a considerable slowing from the actual pace in 1984. Some members questioned the need for any increase in those ranges, both because of the anticipated moderation in the expansion of GNP and because the higher ranges could convey a wrong impression of the Committee's anti-inflationary policy. Nonetheless, total debt was expected to continue to grow at a faster rate than nominal GNP, reflecting further rapid expansion in the federal debt, larger than normal growth in merger and other corporate restructuring activities, and the continuing need to finance increases in spending by domestic sectors that exceeded the rise in nominal GNP, as reflected in

the expected further widening of the nation's large deficit in its external trade balance.

In the course of the Committee's discussion, consideration was given to a proposal for using the midpoint of the previous year's fourth-quarter target range, rather than the actual fourth-quarter outcome, as the base for the following year's target range. This issue had been discussed in some detail at the previous meeting of the Committee. No support was expressed in favor of such an approach, although the members recognized that in some circumstances such an alternative might be appropriate. In setting its objectives for a current year, the Committee already took into account the prior year's monetary developments and their implications for the evolving relationship between money and GNP. It was generally felt that employing the midpoint of the previous year's target range as the base for the current year's target would have the disadvantage of introducing a degree of rigidity in the decision-making process; it would impose a base that was decided upon many months before under possibly quite different circumstances. In the current situation, such problems were particularly evident for M3 and total credit whose levels at the end of 1984 were well above their long-run ranges; use of a previously targeted fourth-quarter base would therefore imply either a wrenching slowdown in actual growth for 1985 or adoption of very high target ranges for growth in 1985.

The members also noted that the levels of the monetary aggregates at the start of the year were all above the target ranges under consideration, as those ranges were conventionally illustrated, because monetary growth had been relatively rapid in late 1984 and early 1985. No member

expressed concern about this development, since it was contemplated that monetary growth would slow as the year progressed and expansion for the year as a whole would be consistent with the target ranges. With reference to the Humphrey-Hawkins testimony, the pictorial representation of the targets as "cones" would be supplemented by other lines to indicate that the Committee was not concerned about variations in money growth outside the relatively narrow portion of the cones early in the year.

At the conclusion of the Committee's discussion, a majority of the members indicated that they favored or found acceptable a policy that included retention of the tentative range for M1, increases of 1/2 percentage point in the upper limits of the tentative ranges for M2 and M3, and an increase of 1 percentage point in the provisional monitoring range for total domestic nonfinancial debt. The members indicated that it might be appropriate for growth in the aggregates to be in the upper part of their ranges for the year, depending on developments with respect to velocity and provided that inflationary pressures remained subdued. In keeping with the Committee's usual procedures under the Humphrey-Hawkins Act, the ranges would be reviewed at mid-year against the background of economic and financial developments.

The following paragraph relating to the longer-run ranges was approved:

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee

agreed at this meeting to establish ranges for monetary growth of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9-1/2 percent for M3 for the period from the fourth quarter of 1984 to the fourth quarter of 1985. The associated range for total domestic nonfinancial debt was set at 9 to 12 percent for the year 1985. The Committee agreed that growth in the monetary aggregates in the upper part of their ranges for 1985 may be appropriate, depending on developments with respect to velocity and provided that inflationary pressures remain subdued.

Votes for this action: Messrs. Volcker, Corrigan, Boykin, Gramley, Mrs. Horn, Messrs. Partee, Rice, Ms. Seger, and Mr. Balles. Votes against this action: Messrs. Boehne, Martin, and Wallich. (Mr. Balles voted as an alternate).

Messrs. Boehne and Martin dissented because they preferred a somewhat higher upper boundary for the M1 range in order to provide enough leeway, if needed, to accommodate a satisfactory rate of economic expansion. In their view, the additional leeway was desirable because of the uncertainties surrounding the outlook for velocity, and it took account of the favorable outlook for inflation and the continuing financial strains in some sectors of the economy. Mr. Boehne also noted that M1 growth in 1984 was in the lower part of the Committee's range.

Mr. Wallich dissented because he wanted to retain the ranges for the broad monetary aggregates that were tentatively adopted in July 1984. In his view those ranges provided adequate room for fostering a sustainable rate of economic expansion. They were more consistent with the Committee's long-run objective of bringing down inflation, and raising them might be misinterpreted by the market as a weakening of policy in that regard.

In the Committee's discussion of policy implementation for the weeks immediately ahead, all of the members indicated their support of an approach directed toward maintaining the reserve conditions characteristic of recent weeks. Such an approach was thought likely to be associated with reduced growth in the monetary aggregates over the balance of the first quarter, although growth for the quarter as a whole would probably exceed the Committee's longer-run ranges for the year. That approach was reinforced by the current strength of the dollar in the exchange markets and the sense that the outlook for the economy and prices did not appear to signal a need for a change.

With regard to M1, the members referred to an analysis which suggested that expansion in this aggregate should moderate as the lagged effects of earlier declines in market interest rates on the demand for money balances dissipated. With respect to the outlook for the broader aggregates, the members viewed appreciably slower growth as a reasonable expectation, partly because of the prospect that inflows of funds to money market deposit accounts and to money market mutual funds would moderate as the interest paid on such accounts was brought into better alignment with short-term market rates. Indeed, evidence of such a development was already apparent with respect to money market mutual funds. Additionally, the expansion in M3 might be held down by continued moderation in the issuance of large-denomination certificates of deposit by commercial banks.

Despite the prospects for more moderate growth in the monetary aggregates, some members were concerned that such growth might not slow

sufficiently over the period ahead and that some firming of reserve conditions might be needed to foster a desirable rate of monetary expansion. They found the current approach to policy implementation appropriate for the present, but they did not want to rule out the possible need for some modest firming over the weeks ahead. Several members indicated that the degree of any firming should remain fairly limited even if money growth was above expectations for a time because they were concerned about the adverse impact that a substantial rise in market interest rates over the near term could have on the exchange market situation and on interest- or trade-sensitive sectors of the economy and ultimately on the economic expansion itself. Members concluded that evaluation of the desirability for firming should take account of the strength of the dollar in exchange markets as well as the business outlook and inflationary pressures and that any firming of reserve conditions over the weeks ahead should be undertaken in a limited and gradual manner. Accordingly, relatively rapid monetary growth would not automatically call for more reserve restraint if it occurred in the context of emerging weakness in business conditions and a strong dollar in the foreign exchange markets. The members also agreed on the possibility of some easing in reserve conditions, but in the view of at least some of the members, any potential need for easing seemed less likely, given the recent strength of the monetary aggregates and the performance of the economy.

At the conclusion of the Committee's discussion, all of the members indicated their acceptance of a directive that called for maintaining the degree of reserve pressure that had prevailed in recent weeks.

The members agreed that modest increases in reserve restraint would be sought if growth in M1 appeared to be exceeding an annual rate of about 8 percent and M2 and M3 a rate of around 10 to 11 percent during the period from December to March, particularly if such monetary expansion was associated with satisfactory growth in business activity and diminishing pressures in exchange markets. The members also agreed that lesser restraint on reserve positions would be acceptable in the event of substantially slower growth in the monetary aggregates, especially against the background of sluggish growth in economic activity and continued strength of the dollar in foreign exchange markets. It was agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 6 to 10 percent.

The following directive, embodying the Committee's longer-run ranges and its short-run operating instructions, was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that real GNP expanded at a moderate pace in the fourth quarter, reflecting some strengthening in late 1984 after several months of considerably reduced growth, and there was evidence of continued moderate expansion in early 1985. Total retail sales rose in January at about the same pace as the average for November and December, while the decline in housing starts appears to have ended. Industrial production and nonfarm payroll employment increased appreciably in the November-December period and nonfarm payroll employment rose substantially further in January. The civilian unemployment rate rose slightly in January to 7.4 percent. Information on business spending suggests less rapid expansion in outlays for fixed investment, following exceptional growth earlier; businesses also appear to have made substantial progress in adjusting

their inventories. During 1984 broad measures of prices generally increased at rates close to those recorded in 1983, and the index of average hourly earnings rose somewhat more slowly.

The foreign exchange value of the dollar against a trade-weighted average of major foreign currencies has continued to appreciate strongly since mid-December. After the announcement on January 17 by the G-5 Ministers of Finance and Central Bank Governors regarding coordinated intervention in exchange markets, and subsequent operations, the dollar's rise moderated somewhat. The merchandise trade deficit declined sharply in December and for the fourth quarter as a whole, primarily because of a large drop in imports from the high rate in the third quarter. Nevertheless, the deficit for the full year 1984 was substantially higher than in 1983.

After growing little on balance since early summer, M1 expanded at a rapid pace in late 1984 and early 1985. The broader aggregates also expanded rapidly in recent months. For the period from the fourth quarter of 1983 to the fourth quarter of 1984, M1 grew at a rate of about 5-1/4 percent, somewhat below the midpoint of the Committee's range for the year, and M2 increased at a rate of about 7-3/4 percent, a bit above the midpoint of its longer-run range. Both M3 and total domestic nonfinancial debt expanded at rates above the Committee's ranges for the year, reflecting very large government borrowing and strong private credit growth, boosted in part by the unusual size of merger-related credit activity. Short-term interest rates have risen somewhat on balance since the December meeting of the Committee, but long-term rates are about unchanged to a little lower. On December 21, the Federal Reserve approved a reduction in the discount rate from 8-1/2 to 8 percent.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at this meeting to establish ranges for monetary growth of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9-1/2 percent for M3 for the period from the fourth quarter of 1984 to the fourth quarter of 1985. The associated range for total domestic nonfinancial debt was set at 9 to 12 percent

for the year 1985. The Committee agreed that growth in the monetary aggregates in the upper part of their ranges for 1985 may be appropriate, depending on developments with respect to velocity and provided that inflationary pressures remain subdued.

The Committee understood that policy implementation would require continuing appraisal of the relationships not only among the various measures of money and credit but also between those aggregates and nominal GNP, including evaluation of conditions in domestic credit and foreign exchange markets.

In the implementation of policy for the immediate future, taking account of the progress against inflation, remaining uncertainties in the business outlook, and the strength of the dollar in the exchange markets, the Committee seeks to maintain reserve conditions characteristic of recent weeks. Should growth in M1 appear to be exceeding an annual rate of around 8 percent and M2 and M3 a rate of around 10 to 11 percent during the period from December to March, modest increases in reserve pressures would be sought, particularly if business activity is rising at a satisfactory rate and exchange market pressures diminish. Lesser restraint on reserve positions would be acceptable in the event of substantially slower growth in the monetary aggregates, particularly in the context of sluggish growth in economic activity and continued strength of the dollar in foreign exchange markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that pursuit of the monetary objectives and related reserve paths during the period before the next meeting is likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Votes for short-run operational paragraph:
Messrs. Volcker, Corrigan, Boehne, Boykin, Gramley,
Mrs. Horn, Messrs. Martin, Partee, Rice, Ms. Seger,
Messrs. Wallich and Balles. Votes against this
action: None. (Mr. Balles voted as an alternate).

2. Authorization for Domestic Open Market Operations

At this meeting the Committee voted to increase from \$4 billion to \$6 billion the limit on changes between Committee meetings in System account holdings of U.S. government and federal agency securities specified in paragraph 1(a) of the authorization for domestic open market operations, effective for the intermeeting period ending with the close of business on March 26, 1985.

Votes for this action: Messrs. Volcker, Corrigan, Boehne, Boykin, Gramley, Mrs. Horn, Messrs. Martin, Partee, Rice, Ms. Seger, Messrs. Wallich and Balles. Votes against this action: None. (Mr. Balles voted as an alternate).

This action was taken on the recommendation of the Manager for Domestic Operations. The Manager had advised that substantial net purchases of securities were likely to be necessary over the upcoming intermeeting interval in order to offset the estimated absorption of reserves stemming from technical factors including changes in currency in circulation, vault cash, and required reserves.

Some Problems and Prospects for Monetary Policy in 1985

I am delighted to have this opportunity to talk about the unfolding economic situation and how it might affect monetary policy. I want to give some indication of where I think we can be going next year, but I also want to point out some of the possible pitfalls for monetary policy. I then plan to offer some thoughts on the broader issue of how monetary policy should be structured. As you probably know, my official role in monetary policy will come to an end on January 1. But I can assure you that my interest in these issues will remain intense.

The economy has given convincing signs of slowing substantially after an unexpectedly strong first half. This slowing was badly needed. Continued expansion at the earlier pace would have begun to re-ignite inflationary tensions within a matter of months. More recently, the question has become whether the slowing has gone too far. Indeed, some have been questioning whether a new recession might be brewing.

My own sense of it is that the signs of outright weakness are likely to prove temporary. As we all know, the exact timing of consumer spending is very hard to predict. In 1984, for reasons that are hard to pinpoint, consumer spending tended to bunch heavily in the first half of the year. This was then offset by a lull in subsequent months. The result of this uneven performance was apparently some overbuilding of inventories. The more recent signs of softness in production represent efforts to correct this situation.

Remarks of Anthony M. Solomon, who retired as President of the Federal Reserve Bank of New York on January 1, 1985, to the Money Markets of New York University at the City Midway Club on November 20, 1984.

But the classic preconditions for recession just do not seem to be present. The inventory problems have been no more than minor and scattered. Consumer confidence and financial positions have remained basically strong. There are no signs of major or pervasive capacity constraints—in good part reflecting our heavy reliance on imports in this economic expansion. On the financial side, credit has continued to expand rapidly and has remained readily available. There has been nothing remotely resembling a credit crunch. The effects of the moderate run-up in interest rates earlier in 1984 seem to have been confined to some softening in housing. Now, rates have come down substantially, more than reversing the earlier advances.

Looking just at the business cycle picture in the conventional way, the prospects look good for a resumption of the expansion. To be sure, we may still see some effects from the inventory blip created by the uneven pattern of consumer spending. But in the absence of major capacity strains, and in view of the fact that overall demand appears to have slowed to a sustainable rate, 1985 could turn out to be a very satisfactory year. Real expansion could average close to or somewhat above our long-run capacity to grow. We could see some gentle further declines in the unemployment rate. The inflation story could also be very good with, at most, only a very modest acceleration from this year's low rate. Assuming no further distortions in the money measures from deregulation, such an evolution ought to be readily accommodated by something like the tentative 1985 growth ranges announced last July.

But as we all know, there are a lot of things in the

situation that have to raise questions about the applicability of conventional business cycle analysis to the prospects for 1985. Let me tick off a few of them. One is our still-high level of real interest rates. After the fact, it is easy to think of reasons why we have been able to have a strong expansion even with these levels of rates—the fiscal deficit, changes in business depreciation rules, and financial deregulation are perhaps the most obvious. But even after allowing for these factors, there remains an unexplained element in this situation. For this reason, the continued existence of relatively high rates is bound to make us less confident of any economic forecast. We simply cannot be sure that high real rates will not become more of a barrier to expansion than they have been so far.

A second difference compared with earlier postwar expansions is the persistence of some degree of financial fragility both domestically and internationally. This fragility is the residue of the late inflation, the recession and the related performance of interest rates. As the expansion has proceeded, and as vigorous efforts have been made to deal with the international debt problem, financial health has been returning. But problems do remain. They underscore the importance of sustaining the U.S. economic expansion as a condition for restoring financial health. By the same token, they could also inhibit us in using as much monetary restraint in the event that inflationary pressures returned.

A third obvious difference from the past is our record trade deficit and the extraordinary strength of the dollar—of which more in a moment.

Given the various special features of our situation, it looks even more dangerous than usual to be dogmatic about the appropriate course for policy in 1985.

A fourth unusual factor is the relative sluggishness of the economic recovery in much of the rest of the industrialized world. A related feature of this situation is the prolonged and very high levels of unemployment in many of these countries. The social implications of this situation—especially as applied to the young people—are already serious. They become progressively more serious as the problem continues. Frankly, at this point, I do not see too much basis for near-term optimism on this front. The importance of a continued, sustainable expansion in the U.S. economy is obvious in this context.

A fifth unusual factor is what might be called the "fragility of inflationary expectations." The recent infla-

tionary experience of the American people has been very uneven. First we had very high rates of inflation for several years in the late 1970s and early 1980s. Recently, inflation has been much lower and I am pleased to see that inflationary expectations also seem to have come down. But given this major transition, many people probably have a very hard time figuring out what should be regarded as "normal" as far as inflation is concerned. I would therefore guess that views about the prospects for inflation are likely to continue for some time to be unusually volatile.

If my comments on these various matters seem to add up to a plea for the exercise of a large measure of judgment, let me say at once that I plead "guilty"—guilty with an explanation, but not with an apology!

A final unusual factor is of course our fiscal situation. It is unusual in terms of the large cyclical stimulus it continues to provide us well into a business expansion. It is also unusual in terms of its structural implications for interest rates, inflationary expectations, our balance of payments, and the dollar.

Now I do not mean to imply that all these unusual features of our situation are necessarily going to be sources of trouble or that all the risks are on the downside. For example, the international debt situation has clearly been improving rather than deteriorating recently. And a general consciousness of financial fragility does have some virtues! It encourages a desire to improve balance sheets, to shun extreme risks and, in general, to avoid the kind of unrestrained and ultimately self-destructive optimism that has always been a feature of inflationary booms. Moreover, on the fiscal problem, with the election over, we can hope that serious negotiations to deal with our fiscal imbalance will bear fruit. And of course while the strong dollar is hurting our export industries it is holding down prices.

For monetary policy, the real point about these special features of our situation is that they raise doubts that the course of policy can be as smooth next year as it looks at first blush. Given the various special features of our situation, it looks even more dangerous than usual to be dogmatic about the appropriate course for policy in 1985. Even absent these special factors, we would have the normal problems in anticipating the strength of the economy and therefore the appropriate stance of policy. But that is at least a problem made familiar by long experience in dealing with the postwar business cycle. It is the special features of our situation that create the potential for unfamiliar problems.

Suppose, for example, the economy expands signif-

icantly more rapidly than capacity and price pressures re-emerge. Normally, in the context of steady money growth rates, such a development would put some upward pressure on interest rates. This would be an appropriate and constructive result in such a context. But under present conditions, the response of the economy could be very hard to judge. For example, if the resulting rise in rates led to another jump in the dollar, depressing our trade balance further, the restraint on the economy could be unusually large. In that case, even a mild rise in rates could prove a powerful offset to inflationary pressures. On the other hand, if, as some believe, only quite large jumps in interest rates have any significant effects on our deregulated economy, we would have to consider how much restraint could be tolerated in a world with significant remaining financial fragility. So either way, new factors have created new uncertainties about how policy should respond to any resurgence in inflationary pressures.

Another policy issue that could arise from the special conditions of our present situation is how to factor in movements in the dollar. I myself have long believed that our domestic monetary policy should take greater account of the performance of the dollar. Certainly there have been instances—November 1978 and October 1979 are examples—when the dollar has been an important factor in domestic monetary policy. But the performance of the dollar has generally been only a background consideration in routine month-to-month decision-making. Now, however, given the extent of the dollar's rise and given its apparent over-valuation in purchasing power and trade terms, further advances in the dollar next year might provide a valid reason for some shading towards an easier position.

Conversely, while a gradual and moderate decline in the dollar would be welcome, a sharp drop could raise other problems for domestic monetary policy. Such a sharp drop would, even without any change in monetary policy, tend to put upward pressure on our interest rates. And I could imagine circumstances where international considerations could contribute to a tightening of monetary policy.

Now just how we should respond to any of these contingencies for the dollar would of course depend on the context of domestic developments. But I suspect that the foreign exchange markets will, and should, come to play a more prominent role in our thinking about domestic monetary policy than has been true in the past.

A third policy issue created by our special circumstances could arise from significant action to reduce the deficit. Action on this front, substantial enough to convince the markets, would of course put downward pressure on interest rates. This would be true even in the context of unchanged money growth. But the case

can also be made that in the short run at least, the economic restraint exerted by actions to reduce the deficit should be actively offset by speeding up money growth. Again, this is one of these decisions that would have to be made in light of all the developments in the economy at the time.

Overall, I think it's clear there are many issues monetary policy may have to face in 1985 that could go beyond the routine. So it would be even more foolish than usual to try to tie policy rigidly to specific money growth targets set in advance. And this would be the case even if no new problems turn up with the money measures themselves. In fact, such problems have been pervasive throughout my tenure on the Open Market Committee. We of course have multiple money targets—three to be precise—and an associated total credit measure. Moreover, these multiple targets are defined in terms of ranges rather than points. The existence of multiple targets and the use of ranges, plus our ability to reset the ranges if appropriate, provides us with considerable flexibility within the targeting approach. I think this flexibility may be needed again in 1985 as it has in the past.

Fundamentally, the basic need is for the central bank to show that it can and will take the actions needed to control inflation.

If my comments on these various matters seem to add up to a plea for the exercise of a large measure of judgment, let me say at once that I plead "guilty"—guilty with an explanation, but not with an apology!

I think I understand and appreciate the arguments of those who favor some form of explicit rules to govern central bank performance. Basically, their argument is that rules are needed to protect central banks from pressures to focus on short-run problems at the expense of a long-run commitment to price stability. Monetary rules provide, it is argued, protection against an inflationary bias inherent in the political process. Moreover they can, on this view, provide a form of accountability for the central bank.

These arguments for some form of rule have appealed to some observers as long as central banking has been a subject for public discussion. The reason for the enduring appeal of this position is that the arguments clearly have some elements of validity. The case for some form of monetary rules—and against discretion and judgment—is one of those perennial philosophies that tends to re-emerge, though in changing form, from generation to generation. As a student of Henry Simon in my early days at the University of Chicago I can

personally attest to the durability of this position.

Nevertheless, a position that would rule out major elements of judgment in making monetary policy is not one that I find congenial. First, there is the problem of finding a rule that works. The most popular proposal in recent years has been to fix on some growth rate for some definition of money. But as almost everybody is now willing to concede, all of the various money measures have given us major problems in recent years. The reasons are too well known to need repetition here. Basically they involve the effects of financial innovation and deregulation. These forces have at times produced major and unpredictable aberrations in velocity. Perhaps the worst of these aberrations are behind us and we are returning to more "normal" behavior. But no one can be sure about this. In any case, the new version of "normal" is not likely to be the same as the "normal" of earlier postwar years. At this point, we just can't be sure what "normal" really is.

Leaving aside the problem of finding a rule that would "work", my own feeling is that monetary rules are really not the requirement for success in achieving reasonable price stability. The reason is that in the end, it is results that really count. Monetary targets provide necessary long-run discipline when applied with a measure of flexibility to deal with changes in velocity. But fundamentally, the basic need is for the central bank to show that it can and will take the actions needed to control inflation. If it does this, whatever the precise approach, it will acquire the credibility it needs to do the job of controlling inflation at reasonable cost.

I do think it is clearly true that financial markets, notably including the exchange market, are far more sensitive to the inflation implications of policy than they were in the past.

In my view, the Federal Reserve has in fact acquired credibility in recent years. This is not because of the performance of the money measures it targets. It is because inflation has in fact fallen sharply and because the public has become convinced of the Federal Reserve's determination to conduct an anti-inflationary policy. The key has been results, not monetary targets, let alone monetary rules.

And that is true not just in the United States. Other countries with relatively good inflation records, such as Germany, Switzerland, and Japan, pay attention to money growth and, in the case of Germany and Switzerland, set targets. But my evaluation would be that it is not monetary targets that have produced a successful record on inflation in these countries. Instead, it is the

well-earned confidence that the central bank will act overall as needed to do the job, even if it does not pursue monetary targets closely in each and every year. The success of these countries in limiting inflation has generally been reinforced by fiscal policies compatible with anti-inflationary objectives.

Now one objection to actual performance as the test of a successful anti-inflationary monetary policy might be that the price effects of policy show up only with a lag. If so, a satisfactory current price performance may not warn you of troubles lying ahead from a too expansionary policy. So, especially if the lags are long, the ill effects of such a monetary policy might become apparent only when it was too late.

I agree this could be a problem. But my feeling is that the lags have shortened a lot in recent years. The truth seems to be that the inflationary experience of the '70s and early '80s has greatly sensitized the financial markets and the public at large to any signs that monetary policy may be loosening its grip on inflation. Indeed, one school of academic economists apparently now takes it as a working assumption that all markets can more or less immediately foresee the price implications of excessive monetary growth. If this were true, an inflationary monetary policy would have immediately visible effects on actual inflation. And in this case, in turn, the inflation results of policy could be continuously monitored.

To be sure, such an extreme claim seems unjustified. But I do think it is clearly true that financial markets, notably including the exchange market, are far more sensitive to the inflation implications of policy than they were in the past. And perhaps commodity and even labor markets respond more rapidly to policy. So I suspect the problem that lags could represent for judging policy by its results is much reduced in today's world. Hence I come back to the working proposition that monetary policy can be and will be most meaningfully judged by its results rather than by adherence to some particular formula.

I think I should add that the "rules versus judgment" debate has a somewhat academic ring looked at from the point of view of working central bankers. Within the Federal Reserve, the practical issue that has really gotten attention is the degree of reliance on mechanistic as against judgmental responses to changing developments. In particular, the post-October 1979 approach allowed for a relatively mechanical response of interest rates to short-term movements in money growth—although even in this period there were clearly major elements of discretion in the process. More recently, purely mechanistic responses have been essentially eliminated.

In practical terms, what kind of monetary policy approach is going to bring about a sustained period of

rough price stability? We have to recognize that as much as we have accomplished in recent years, the problem is not yet solved. Inflation is still at levels that would have been unacceptable in earlier years. And our progress to date is partly hostage to a foreign exchange rate that will probably sooner or later move down. Further, the progress we have made continues to co-exist with levels of unemployment, both here and abroad, that are just too high to be acceptable over the longer run.

Our goal should be a peak cyclical rate of inflation in each business cycle expansion that is lower than the one we had in the previous expansion.

If we follow the usual cyclical script, moreover, price inflation will not improve further in this economic expansion. Instead, it could worsen somewhat—although the actual outcome obviously depends importantly both on the dollar and on some crucial commodity markets, notably the oil market. This suggests to me that a strategy for really defeating inflation will have to look beyond the current business cycle expansion. At the same time, I also believe there is a good chance that carried through one more full cycle, such a strategy can come close to the desired objective. Our goal should be a peak cyclical rate of inflation in each business cycle expansion that is lower than the one we had in the previous expansion. Under normal circumstances—that is, assuming no major further shocks from financial innovation and deregulation—such a strategy should imply a similar downward ratchet in the peak rates of money growth. It is this downward ratchet in money growth from one cyclical expansion to the next that should be our principal objective so far as money is concerned.

Gradual year-by-year slowing in money growth rates certainly remains a generally desirable objective. Indeed, the ideal of gradual, year-by-year reduction in monetary growth has continued to be a factor in the minds of most FOMC members in setting the annual targets. But the actual results, for all the Ms, have in fact differed substantially from this pattern. The need to take account of the various effects of deregulation on the Ms is one reason for the difference. The sharp and essentially unpredictable drop in all velocity measures in 1982 and the continuing weakness of M1 velocity over much of 1983 is another. This experience—plus my belief that we have to look at ending inflation over a multi-cycle horizon—is what leads me to a cycle-by-cycle reduction in monetary growth rates as the more critical test.

Obviously labor market issues are not part of monetary policy. But to me, the other side of a successful long-run anti-inflation strategy would have to do with the functioning of our labor markets. The level of unemployment rates consistent with nonaccelerating inflation has been too high in recent years given the social costs. If I were to name the single most important issue in domestic macro-economic policy, I would say it is the need to lower the average unemployment rate consistent with price stability. This is too large a subject to go into here. Some reasons for moderate optimism may be changing demographics and a prospective improvement in our productivity performance relative to the dismal record of the 1970s. Admittedly, however, such an improvement has not yet shown through in the figures.

What about the tactics of monetary policy? Personally I am reasonably satisfied with the approach the Federal Reserve has taken since about late 1982. At that point we set aside the approach adopted in October 1979. That approach, as I noted earlier, allowed interest rates to respond semi-automatically to deviations of money growth—especially M1—from target paths. The problem with that approach was that M1 was giving out unreasonable signals. For a brief period we tried to adopt the same general approach to an emphasis on M2. But since about the beginning of 1983 we have had what I would call a "tripartite" approach. This approach allows us to continue to take account, in a judgmental way, of the performance of money growth as before, but also of the economy itself and, indirectly, of the behavior of short-term interest rates.

I should add that you can often learn things from looking at the economy, money, and interest rates together that you could not learn from looking at each of them separately.

Each of these three elements has a legitimate role to play in decision-making. The relevance of looking directly at the performance of the economy is obvious. The broad, longer-term trend in money growth is a component of our anti-inflation strategy along the lines I have already described. And interest rates themselves clearly warrant explicit consideration for the manifold effects they have on the functioning of markets and the economy. Indeed, the intrinsic importance of interest rates becomes greater in circumstances where sharp exchange rate movements and financial fragility in credit markets are a factor.

I should add that you can often learn things from looking at the economy, money, and interest rates

together that you could not learn from looking at each of them separately. For example, if money growth is slowing down, does that mean policy is tightening? Does it mean that the economy is weakening? Or just that money demand has shifted? Looking at what interest rates are doing can help solve this puzzle and help indicate the proper course of action. For example, the sharp slowdown in M1 growth that worried some monetarists in the last half of 1983 looked considerably less significant when the continuing strength of the economy along with reasonably stable interest rates was taken into account.

On a day-to-day operational basis, our focus since early 1983 has been on bank reserve "availability", measured in terms of member bank borrowing and/or net free or net borrowed reserves (excess reserves less borrowings). Now there is a loose and shifting, but nonetheless real relationship between borrowings and the level of the Federal funds rate and other short rates for any given discount rate. So when a particular level of borrowings is sought, we have some rough range for the Federal funds rate in mind as the expected result. Of course it is possible that changes in banks' willingness to borrow at the window—due to changing levels of financial market anxiety, for example—could push the funds rate out of line with the rough range we had expected. In such a case, we could, of course, always adjust the level of borrowings we seek accordingly. Whether we would actually make such an adjustment would depend on the surrounding economic and market circumstances. It would be a judgment call.

Moreover, all recent Directives to the Open Market Desk here in New York have made the desired level of reserve availability conditional on unfolding events. In general, these Directives allow for the possibility of increasing or decreasing the levels of borrowings or net free reserves during the inter-meeting period. Such possible adjustments may, but need not, necessarily result from substantial deviations of money behavior from the expected performance as stated in the Directive. What I want to emphasize again is that such adjustments are discretionary, not automatic. The Directive language has always made it clear that any

decision to change reserve availability would be made in the context of unfolding developments in the economy and the financial markets—with the precise emphasis varying from Directive to Directive.

Now what does all this mean for interest rates? Clearly it means we have moved a substantial distance from the post-October 1979 procedures where an automatic mechanism could set in motion large and often volatile rate movements. On the other hand, we have definitely not returned to the pre-October 1979 situation where the Federal Reserve sought, usually successfully, to control the funds rate week to week with a rather high degree of precision.

Within limits, the present approach gives significant room for market forces alone to generate movements in the funds rate. I realize that this fact at times creates uncertainty about Federal Reserve intentions for those who try to read those intentions from the funds rate itself. But I think there is a lot to be said for a procedure that gives scope to market forces. Market pressures can themselves be a source of valuable information to the policymakers. Moreover, rigid interest rate targeting seems to have a built-in weakness in making policymakers too slow to act when action is needed. This was the lesson that brought about the changes of October 1979.

Now I know none of this tells you what is going to happen to interest rates next week or, for that matter, next year. But I am sure none of you really expect that from me. What I have been trying to say is that my years on the FOMC have convinced me that there is no simple formula for making monetary policy even in the easiest of times. And these last four and a half years have certainly not been the easiest of times! Nineteen eighty-five may be a relatively smooth year to negotiate. But for the reasons I have spelled out, there are plenty of grounds of suspecting it may not be. Never, I think, has the kind of generally pragmatic approach to policymaking I favor been more clearly called for than at present. Certainly I will miss not being with my colleagues in the Federal Reserve as they work on these problems next year. But I wish them the best of luck in an endeavor that is so important to all of us.

Stock Prices Rise in Active Trading On Help From Strong Bond Market

ABREAST OF THE MARKET

By BEATRICE E. GARCIA

Stock prices rose in active trading, helped along by a strong bond-market advance.

The Dow Jones Industrial Average finished 8.61 higher at 1286.11. The broader market averages also registered hefty gains: Standard & Poor's 500-stock index rose 1.94 to 181.17 and the New York Stock Exchange composite index moved up one point to 104.82. The number of Big Board advancing issues outpaced declining stocks 1,018 to 563.

Volume on the Big Board expanded to 114.1 million shares from 89.7 million traded Monday. The number of block trades of 10,000 shares or more rose to 2,157 from 1,787 Monday.

Yesterday's session started off rather quietly but on a positive note, following news of a 0.2% rise last month in the Consumer Price Index. Trading activity accelerated and the gains widened as the closely watched federal funds rate dipped below 8% for the first time in recent weeks. The industrial index showed a gain of more than 13 points at mid-afternoon before easing into the close.

Several buy programs on the Big Board added some spice to yesterday's activity and lured some investors into the market from the sidelines.

The stock market also was cheered by indications from Federal Reserve Chairman Paul Volcker yesterday that the central bank isn't about to tighten monetary policy. Last week he had told Congress the Fed's more accommodative credit policy of late 1984 had ended.

Robert Barbera, chief economist at E.F. Hutton in New York, said Mr. Volcker's testimony before a congressional committee sounded a strong note of concern about the recent strength of the U.S. dollar. Mr. Barbera believes the volatile foreign currency markets "could play a role in a more accommodative monetary policy" over the near-term.

"The stock market is looking over its shoulder at the bond market" once again, said Gerald Simmons, a vice president in the listed trading department at Smith Barney Harris Upham. He and other traders believe the stock market now is moving in lockstep with the fixed-income market. They said further gains in equity prices will depend on declines in interest rates.

While the declines in interest rates over the last two sessions were certainly welcomed, many traders said the 20% increase in short stock positions on the New York Stock Exchange in the month ended Feb. 15 were a potential source of future buying power. Keith Hertell, vice president in the institutional trading department at Drexel Burnham Lambert, said investors buying stocks to cover these short positions could be "a tremendous factor that fuels this market."

A correction yesterday in the dollar's recent sharp rise provided a boost for multinational stocks such as Eastman Kodak, International Business Machines and some of the drug issues.

IBM moved up $\frac{1}{2}$ to 134 $\frac{1}{2}$. The company has expressed concern that the strong dollar will cut into its foreign revenue during the current quarter. Since it's a bellwether stock, IBM's advance did much to encourage the rest of the market forward yesterday.

Bond Prices Register Their First Gains In Over a Week as Fed Funds Rate Falls

CREDIT MARKETS

By TOM HERLMAN
and EDWARD P. FULDESSY
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK—Bond prices rallied yesterday afternoon, registering their first gains in more than a week.

Prices of some actively traded Treasury bonds climbed a point, or around \$5 for each \$1,000 face amount. Still, prices of many issues are more than 3½ points lower than they were less than two weeks ago.

Traders were cheered yesterday by a decline in the interest rate on federal funds, which strongly influences other rates. The rate on Fed funds, which reverses that banks lend one another overnight, fell to about 7¼% late yesterday from an average of about 8¼% in recent weeks.

Also buoying the market was stronger-than-expected investor demand at the Treasury's auction of \$7.01 billion of new five-year, two-month notes. The average yield was 11.43%.

Some analysts were encouraged by testimony yesterday by Paul Volcker, chairman of the Federal Reserve Board, at a House Banking subcommittee hearing. Mr. Volcker, as usual, didn't make any specific forecast about the Fed's credit-policy plans. But several traders contended that his remarks indicated the central bank is increasingly concerned about the dollar's surge in foreign-exchange markets and thus may be even more reluctant to tighten credit conditions than it was previously.

Dollar Prompts Complaints

Many U.S. industries have complained bitterly that the dollar's sharp increase against other major currencies has eroded their competitive position in world markets. Some economists fear that continued increases in the dollar's value could slow the U.S. economic expansion and intensify international financial strains.

Mr. Volcker told the House Banking subcommittee yesterday that "I don't like what's been going on in the markets—in the volatility, or necessarily the direction." He didn't offer any specific recommendations but indicated that the dollar's strength is playing a more important role in the Fed's policy-making than previously.

"Volcker seemed to display more concern about the dollar than he did when he testified last week" at a Senate Banking committee hearing, said Rudolf Thunberg, an economist at Ried, Thunberg & Co., a New Canaan, Conn.-based investment research firm.

Analysts have been worried that the Fed would tighten credit conditions within a few months, driving up interest rates, in an effort to stem the rapid growth of the money supply. Higher rates, however, could make the dollar even more attractive to foreign investors. "The dollar's strength will mitigate the amount of tightening" that the Fed can undertake, said Donald E. Maude, chief economist of Refco Partners.

Higher Rates Expected

But Mr. Maude and others still expect higher interest rates in coming months. "I think you'll see the federal funds rate up to 9% by the end of March," Mr. Maude predicted. By midyear, the funds rate will spurt to the 10½% to 11% area, he contended.

"The next major move in rates will be up," agrees Mr. Thunberg of Ried Thunberg. Rates will climb within a few months because "a growing economy will generate increasing credit demands" from businesses and individuals at a time when the federal government will be borrowing heavily as well. Moreover, Mr. Thunberg expects that the Fed eventually will tighten credit conditions to slow money-supply growth.

Lawrence N. Leuzzi, a vice president and economist at E.F. Hutton & Co., disagrees. He expects interest rates will be "relatively stable over the next several months." He argues that the Fed's recent decision to stop easing credit has set the stage for a moderation in money-supply growth.

Furthermore, Mr. Leuzzi contended that the economic expansion isn't gaining momentum. He estimated that the gross national product, adjusted for inflation, is growing at an annual rate of 3% to 3½% in the current quarter, down from the fourth quarter's 4.9% clip. GNP is the nation's total output of goods and services.

In the credit markets yesterday, the Treasury's 11¼% bonds due 2015 closed at a price of 96 18/32, up from 96 4/32 Monday. That cut the yield to 11.66% from 11.72%. The government's 13¼% notes due 1995 rose to 97 11/32 from 97 5/32, paring the yield to 11.71% from 11.74%.

Bill Rates Slip

Treasury bill rates edged lower. The latest 13-week bill closed at 8.35% bid, down from the average rate of 8.36% set at auction Monday. The bid on the latest 26-week issue eased to 8.52% from the auction average of 8.53%.

In the municipal market, a \$240 million issue of various-purpose general obligation bonds by California sold briskly. A group led by Bank of America submitted the winning bid for the bonds at an auction yesterday and restated the bonds priced to yield 8.20% in 1986 to 8.20% in 1990, 8.20% in 1991, 8.20% in 1992, 8.20% in 1993, 8.20% in 1994, 8.20% in 1995, 8.20% in 1996, 8.20% in 1997, 8.20% in 1998, 8.20% in 1999, 8.20% in 2000, 8.20% in 2001, 8.20% in 2002, 8.20% in 2003, 8.20% in 2004, 8.20% in 2005, 8.20% in 2006, 8.20% in 2007, 8.20% in 2008, 8.20% in 2009, 8.20% in 2010, 8.20% in 2011, 8.20% in 2012, 8.20% in 2013, 8.20% in 2014, 8.20% in 2015, 8.20% in 2016, 8.20% in 2017, 8.20% in 2018, 8.20% in 2019, 8.20% in 2020, 8.20% in 2021, 8.20% in 2022, 8.20% in 2023, 8.20% in 2024, 8.20% in 2025, 8.20% in 2026, 8.20% in 2027, 8.20% in 2028, 8.20% in 2029, 8.20% in 2030, 8.20% in 2031, 8.20% in 2032, 8.20% in 2033, 8.20% in 2034, 8.20% in 2035, 8.20% in 2036, 8.20% in 2037, 8.20% in 2038, 8.20% in 2039, 8.20% in 2040, 8.20% in 2041, 8.20% in 2042, 8.20% in 2043, 8.20% in 2044, 8.20% in 2045, 8.20% in 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Dollar Eases From Highs After Remarks By Volcker on Intervention Trigger Sales

By STEPHEN GROVER

Staff Reporter of THE WALL STREET JOURNAL

The U.S. dollar fell back against major foreign currencies in panic selling after Federal Reserve Board Chairman Paul Volcker suggested that recent foreign-exchange market intervention by major central banks add other accompanying policies hadn't been forceful enough.

Less than 15 minutes after he spoke before a panel of the House Banking Committee, the dollar plunged from an interday high of more than 3.47 West German marks to about 3.39 marks. Later in the day, as traders began to focus on favorable economic indicators released in the morning, the dollar recovered some of its lost strength, settling at 3.4069 marks in late New York trading.

The favorable indicators were the 0.2% rise last month in U.S. consumer prices, indicating that inflation still was under control, and the 3.8% rise in January U.S. durable goods orders following a revised 1.9% decline in December. The December figure originally was given as a decline of 2.9%, so that the upward revision also helped the dollar. "Under normal circumstances," said Barry M. Weinstein, a vice president of BankAmerica International, New York, "the market would have bought dollars like crazy on news like this."

The dollar also was helped late in the afternoon by Alan Greenspan, who was chairman of the Council of Economic Advisers under President Gerald Ford. In testimony before the Joint Economic Committee of Congress, he said it was possible the U.S. gross national product, the nation's output of goods and services, could rise at a 6% rate in the current quarter.

Even so, the dollar settled lower across the board following its record-setting performance Monday. The British pound, for example, after having declined to less than \$1.04 in early New York trading, regained some strength, settling late in the day at \$1.0615, up from its record low of \$1.0545 Monday.

Traders said the foreign-exchange market yesterday was totally disorderly, with spreads between the dollar and the mark at one time reaching 150 points, or 1.5 pfenigs. "You can't execute a commercial order in a market like this," said James T. McGroarty, a vice president of Discount Corp. of New York. Douglas E. Hart II, an assistant vice president and manager of the corporate advisory desk of Credit Suisse in New York, said that "people wouldn't even answer their telephones. We couldn't get a price out of anyone."

The result, said Timothy F. Hurley, a first vice president of Bank of Boston, was that "it was extraordinarily difficult even to exchange \$2 million for marks, whereas normally a \$10 million transaction is executed without any difficulty."

What Mr. Volcker said doesn't appear to represent a change in administration thinking about intervention in the foreign-exchange market, said Mr. Hurley. "As I read his remarks," Mr. Hurley said, "he's saying that more intervention should be used, but not necessarily by the Fed," which has been reluctant under President Reagan to intervene except to calm disorderly markets.

"He's suggesting that other central banks haven't been as active as they could have been in the foreign-exchange market, and he's warning that if they had moved, we also would have moved."

Nonetheless, some traders criticized the apparent disparity between President Reagan's remarks last week and Mr. Volcker's testimony yesterday. Last Thursday, Mr. Reagan told a news conference that the U.S. shouldn't attempt to bring the dollar down.

"The market may even have been set up for a fall," a trader said yesterday. The fact is that the dollar advanced an astounding 4% against major foreign currencies on Monday, largely as a result of Mr. Reagan's remarks, only to fall back nearly 3% yesterday, before the dollar gradually began to recover some of its lost strength.

"With that kind of volatility," Mr. McGroarty said, "the foreign-exchange markets are breaking down. How can you expect the dollar to stabilize when the president says there's nothing you can do to stop the dollar from rising, and Volcker appears to say something much different?" He added: "The authorities have a responsibility to the foreign-exchange market."

Mr. Hurley said that, despite yesterday's correction of dollar strength, "everything's coming up roses for the U.S. currency, and we're going to see the dollar much higher than its recent levels. The reason is that we've had an economic revolution in this country, and it's been accompanied by a revolution in exchange rates."

In early trading in Tokyo Wednesday, the dollar fell against the Japanese currency to 258.92 yen from 260.33 in New York yesterday afternoon.

On the Commodity Exchange in New York, gold for delivery this month rose \$6 an ounce to \$288 an ounce, in reaction to the dollar's declines. Contracts for all deliveries amounted to a moderate 3.8 million ounces.

Gold was quoted at \$288.45 an ounce during early trading in Hong Kong Wednesday.

CURRENCY RATES			
	New York	Home Amt.	New York
	(in U.S. dollars)		Rate
British pound	1.0615	1.0625	1.0545
Canadian dollar	0.7181	0.7179	0.7145
(\$100 New York = 100 U.S. dollars)			
French franc	20.350	20.345	19.950
Japanese yen	360.33	360.35	361.30
Swiss franc	2.066	2.0710	2.0710
West German mark	3.4069	3.4070	3.4000
Based on average of late evening bid selling rates.			
Home markets: London, Toronto, Paris, Tokyo, Zurich and Frankfurt.			
GOLD PRICES			
(\$10 U.S. dollars per troy ounce)			
Comex	London PM	London AM	Comex
Feb. 26	265.75	265.75	265.00
Feb. 27	288.45	288.45	288.00
Comex based on settlement price for gold for delivery in the nearest month on Commodity Exchange in New York.			
London based on morning and afternoon price figures of five major dealers.			

Dollar Falls After Volcker Testimony

By John M. Berry
Washington Post Staff Writer

Federal Reserve Chairman Paul A. Volcker said yesterday that recent actions undertaken to stem the rapid rise of the U.S. dollar on foreign exchange markets, including intervention by central banks, have not been forceful enough.

"If the proof of the pudding is in the eating," Volcker told a House Banking subcommittee, then the efforts have failed, since the dollar has continued to rise.

However, as soon as foreign exchange markets became aware of his remarks, the dollar plunged. The dollar dropped from 3.47 to 3.39 German marks in the space of about 5 minutes.

"Now the feeling is split," said one market analyst in New York. "Some people think this is the first sign of a dollar decline and others think we will have the dollar at 3.50 marks by the weekend.

Volcker, who essentially repeated the testimony on the economy and the Fed's monetary policy plans that he gave last week to the Senate Banking Committee, also indicated that the strength of the dollar has become "a moderating influence" in the central bank's discussions about any possible tightening of its monetary policy position.

The Fed chairman noted that money supply growth has been "well in excess of our targets." Cen-

tral bank policy-makers are "not alarmed by the level of the 'M's'"—the various measures of money—but they are worried about the money supply's "trajectory."

He reiterated that the Fed stopped easing its monetary policy stance last month, but that it has not begun to tighten that policy. "The value of the dollar in foreign exchange markets . . . has been a moderating influence on going in the other direction, which we have not done," Volcker told the subcommittee.

A move toward tightening—making reserves less readily available to financial institutions—would tend to raise short-term interest rates and, all other things being equal, the value of the dollar as well, in the opinion of most analysts.

Should the currency begin to weaken, for whatever reason, Volcker said, "some decline in the dollar would not be adverse," since it has risen so strongly since the first of the year. But he warned that a larger reversal of that trend could mean higher interest rates and higher inflation.

The Fed chairman said that intervention in exchange markets "is not likely to be an answer standing alone." More fundamental policy changes, such as major progress on reducing federal budget deficits, are needed in the United States, while other countries take actions to stimulate their domestic economies.

"I don't like what's been going on in the markets, either the volatility or the direction," he declared.

Volcker said that the current situation, in which more than \$100 billion worth of foreign capital is flowing into the United States annually in excess of that being sent abroad by Americans, is an unstable and risky one. "The incentive to put money in the United States could prove quite fragile" to a shift in expectations about future inflation and interest rates, he warned.

"We are hostage to, we are hooked on, foreign capital for a while" because of the large budget and trade deficits. The price of that dependency is that "if we cannot get so easily the foreign capital we need, then interest rates will rise" and domestic credit users, such as housing and investing businesses, will get crowded out of the market. "That's the risk," he said.

Volcker said that he cannot predict when foreigners might become less willing to invest in the United States, but he added, "It's an increasingly uncomfortable situation. We are putting ourselves at risk."

After Volcker spoke to the Senate committee last week, both short- and long-term interest rates rose in the money markets. As of yesterday, they had not regained the ground lost, analysts said. The three-month Treasury bill was yielding about 8.45 percent before his testimony last week and yesterday it was at about 8.66 percent.

Volcker Implies Moves to Check Dollar Are Weak

Congressional Testimony Produces Sharp Drop On Foreign Markets

By LAURIE MCGINLEY

Staff Reporter of THE WALL STREET JOURNAL
WASHINGTON — Chairman Paul Volcker of the Federal Reserve Board suggested that efforts by the U.S. and other countries to check the dollar's recent rise should have been more forceful.

Mr. Volcker's statement produced a sharp drop in the dollar on foreign-currency markets yesterday, as traders apparently concluded that more forceful in-

Mr. Volcker's testimony initially stirred nervous currency speculators into a sharp, though short-lived, dollar-selling spree on foreign exchange cash and futures markets. It also helped bolster bond prices, which, in turn, were credited with aiding a stock market rally yesterday (see stories on pages 33, 50, 48, 63).

tervention might soon drive the dollar down. The British pound, which had been below \$1.04 during the day's trading session, bounced back to \$1.06, for example.

The Fed chief, asked at a House Banking Committee hearing about his reaction to recent efforts to intervene in the currency markets, replied, "I can't say there has been any dramatic success from recent actions. I think there is a question of whether actions were taken forcefully enough, including in the intervention area."

Criticism of Treasury Seen

Some viewed Mr. Volcker's comments as a criticism of the Treasury. Throughout the Reagan administration's first term, the Treasury adhered to a hardline, no-intervention policy.

But late last month, concerned about the soaring dollar, the Treasury agreed to join other major industrialized nations in acting more aggressively to help stabilize the foreign-exchange markets. Since then, the U.S. has intervened more regularly, but still modestly.

Fed officials contended that Mr. Volcker wasn't singling out the Treasury for criticism but merely stating the obvious: that recent attempts by the U.S. and other countries to curb the dollar's rise and bolster foreign currencies haven't been large enough, coordinated enough or sustained enough to do much good. In the U.S., the Treasury, after discussion with the Fed, makes the decision on whether to intervene in foreign-exchange markets, and the Fed carries out the decision.

The chairman didn't suggest a future course of action for government grappling with the problem of the high dollar, but he did express continued concern over market conditions.

"I don't like what's been going on in the markets—in the volatility, or necessarily the direction," he said.

While bemoaning the ineffectiveness of recent intervention efforts, Mr. Volcker reiterated his longstanding view that intervention, by itself, can't be expected to overcome basic currency and economic trends.

Strong growth and political stability make the U.S. an attractive place to invest, he said, adding that some European countries should consider cutting taxes to stimulate their economies.

No Change for Farmers

Mr. Volcker also stressed that the dollar has been an important consideration in setting domestic monetary policy. The strong dollar, he said, "has been a moderating influence on any tendency" by the central bank to tighten monetary policy, "which we haven't done."

Mr. Volcker also put farm-state lawmakers on notice that he doesn't intend to loosen monetary policy to aid the ailing agricultural economy. "We can't deal with all the sectoral problems in the economy except by producing a prosperous whole," he said.

The Fed chairman said Congress could help debt-ridden farmers by reducing the federal budget deficit which, over time, would lead to a decline in the dollar. In the short run, he acknowledged, a reduction in the deficit could actually push up the dollar, as foreign investors gain increased confidence in the U.S. economy.

As he has in the past, Mr. Volcker warned the committee that the country's

current heavy reliance on foreign capital to finance its trade and budget deficits carries the "seeds of its own destruction." Eventually, he said, foreign investors are likely to stop investing so heavily in the U.S. and interest rates will go up. "It isn't a pretty picture," he said.

Asked by committee members whether the Fed would tighten monetary policy this year if the economy grew faster than expected, Mr. Volcker said no, as long as other economic variables, such as inflation, continued to perform well.

As part of a wide-ranging discussion before the panel, Mr. Volcker renewed his call for legislation to deregulate the banking industry, warning it may be Congress's last chance to influence the evolution of the rapidly changing banking industry. And he said the Fed is considering reducing its credit, or margin, requirements on purchases of securities; currently, borrowing for stock prices is limited to 50% of the value of the stock.

This disclosure wasn't surprising; earlier this year, the Fed urged Congress to eliminate government-mandated margin requirements, saying securities exchanges should be allowed to set their own credit requirements, subject to review by government regulators.

The Fed, in a letter sent to congressional committees, said there "no longer remains justification" for limiting borrowing to 50% of the stock's value.

Dollar Plunges in Late U.S. Trading

By NICHOLAS D. KRISTOF

The dollar plummeted yesterday, leaving traders divided over whether its long march upward had stalled. "I believe the trend has been reversed," said Albert Sorin, foreign-exchange manager at the Swiss Bank Corporation. "This is the first leg of a big move. It could snowball."

Other traders were not so bold. Some expect the dollar to recover soon, though perhaps after dropping a bit more first. And even those, such as Mr. Sorin, who expect a longer downturn said the dollar probably

would touch bottom at levels that are still high by recent experience.

In Europe, before trading began in New York, the dollar rose sharply, reaching 3.47 West German marks and a \$1.039 level against the British pound. But later the dollar fell in New York, and the decline accelerated as banks scrambled to dump dollars they had accumulated.

In a few hours, the dollar lost more than 2 percent of its value. In light, nervous trading in the afternoon, the dollar recovered slightly. By the time most trading had ended in New York, the dollar was quoted at 3.40 marks and the pound at \$1.061.

The dollar tumbled after traders received reports of yesterday's testimony before Congress by Paul A. Volcker, the Federal Reserve chairman. Intervention by central banks in the currency markets, he said, may not have been forceful enough. Traders took this to mean that the Federal Reserve and other Western central banks might intervene more forcefully in the future, selling dollars to push down the exchange rate.

Last week, however, President Reagan indicated reluctance to interfere with the dollar's course.

Trading already was jittery yesterday, with many banks flush with dollars and apprehensive about whether they would be able to unload them fast enough if there were a decline. So when the dollar began to fall, traders said, many of those holding dollars tried to sell them immediately.

Traders have little idea what will happen next, they said, but even those who expect a continuing downturn said the dollar should stop before falling below the level of 3.2 or 3.3 West German marks.

And some experts said the dollar could again climb until it is trading parity with the pound.

"I think it's a correction — no more than that — but it still may have a way to go," said Larry Ryan, senior vice president and foreign-exchange manager at the European American Bank in New York. Mr. Ryan compared yesterday's dollar plunge to last Sept. 21, when market intervention by the West German central bank precipitated a sharp drop for the American currency. The dollar then gradually recovered, and a month ago it surpassed its previous peak.

"We're playing by a whole new set of rules that no one really understands," Mr. Ryan added. He and other traders cautioned that predictions were extremely risky.

"People are just following the lead, whatever it happens to be," he said. Yesterday's plunge in the dollar's exchange rate from the morning high was even more dramatic than the previous day's rise.

Among other currencies that rose yesterday in relation to the dollar, the Japanese yen ended at 260.3 to the dollar, compared with Monday's 262.5. The French franc moved to 10.42 to the dollar from 10.54, and the Swiss franc moved to 2.38 to the dollar from 2.92.

And the price of gold, which often

moves in the opposite direction as the dollar and had plunged more than \$12 an ounce on Monday, climbed about \$6 yesterday, to \$288.75.

Dollar's Action Abroad

LONDON, Feb. 26 (AP) — Despite its late drop in New York today, the dollar closed in Europe today at records against the pound, the Italian lira and the French franc, at 13-year highs against the Dutch guilder and West German mark and at a 10-year high against the Swiss franc.

The dollar was hit by profit taking in the Far East, where the markets open and close earlier than in Europe. It closed in Tokyo at 260.85 yen, down more than 2 yen from Monday's 263.05, but European trading later pushed the dollar up to 261.55 yen.

Gold bullion, which had lost \$15 an ounce in London the day before, was quoted at a late bid price of \$287.20, up from Monday's \$284. It was quoted in Zurich at \$286.50, up from \$283.50.

Foreign Exchange

TUESDAY, FEBRUARY 26, 1985

Foreign currency	Rate per unit of foreign currency	Mon. per dollar	Tue. per dollar
Argentina (Peso)	0039	0039	253.75
Australia (Dollar)	7140	2960	4065
Austria (Schilling)	0413	0413	34.18
Belgium (Franc)	0145	0144	88.80
Brazil (Cruzeiro)	0143	0143	80.00
Canada (Dollar)	00754	00754	3975.00
Denmark (Krone)	0630	0630	577
France (Franc)	0050	0050	546
Germany (Mark)	0051	0051	343
Italy (Lira)	2036	2036	1937
Japan (Yen)	2608	2608	260.85
Netherlands (Guilder)	2036	2036	1937
New Zealand (Dollar)	0417	0417	2159
Portugal (Escudo)	0054	0054	85.00
Spain (Peseta)	166	166	166
Sweden (Krona)	034	034	17.00
Switzerland (Franc)	034	034	17.00
United Kingdom (Pound)	079	079	106.50
United States (Dollar)	100	100	100
West Germany (Mark)	034	034	17.00
Yugoslavia (Dinar)	0001	0001	20.00

THE NEW YORK TIMES
WEDNESDAY, February 27, 1985

Fed Held Inhibited by Dollar Rise

Volcker Tells Of Impact on Money Policy

By ROBERT D. HERSHEY Jr.

Special to The New York Times

WASHINGTON, Feb. 26 — Paul A. Volcker, the Federal Reserve chairman, said today that the dollar's spectacular rise in world currency markets was inhibiting the central bank's conduct of monetary policy.

The implication seems to be that the Fed may be supplying more money to the economy than it would prefer, thereby eventually contributing to upward pressure on prices.

Mr. Volcker's comment, thought to be the first public acknowledgment of a predicament that analysts have discussed for many weeks, came during extensive questioning by a House subcommittee on a host of subjects that included the farm crisis, corporate takeovers and securities margin requirements.

Last week, appearing before a Senate panel, Mr. Volcker disclosed that the Federal Reserve had ended the progressively easier credit policy it pursued during the final four months of 1984.

Aggregates' Growth Noted

When Representative John P. Hiler, an Indiana Republican, today asked the reason for this, Mr. Volcker cited rapid growth in the monetary aggregates since November and "some evidence of renewed strength" in the economy.

Mr. Volcker then suggested that the central bank might have taken stronger action had it not been for the soaring dollar. The dollar, he asserted, "has been a moderating influence on any tendency to go in the other direction, which we haven't done."

But Mr. Volcker was not asked, during a hearing that lasted nearly three hours, whether the Fed would in fact have tightened credit had it not been for the dollar's strength.

It is widely assumed that a tighter monetary policy would raise American interest rates, thereby making investments in this country still more attractive to foreigners and further strengthening the dollar.

Impact on Various Sectors

The rising dollar, about which Federal Reserve officials have long expressed concern, has had adverse effects on sectors of the American economy that face competition from imports or, like agriculture, rely heavily on exports.

Mr. Volcker's prepared statement today was virtually identical to the one he gave the Senate committee last week — a major point was the dangerously high American reliance on foreign capital and the need to cut the Federal budget deficit — but the questioning included a number of additional or related subjects.

When asked, for example, why the American economy was not proving to be a better "locomotive" in pulling other countries from recession, Mr. Volcker said it was partly a matter of the United States attracting "so much of their capital."

Some nations such as West Germany and Japan, he suggested, should consider tax cuts or other "stimulative action" without which their growth would probably not be sufficient to reduce unemployment.

Mr. Volcker also said he had had "some concern" about the wave of corporate mergers that, although now somewhat abated, has burdened both the surviving companies and the institutional lenders that have financed such deals.

On yet another subject, the central bank's chief indicated that the Federal Reserve would cut securities margin requirements, which have stood at 50 percent since 1974, if such action were not likely to be misconstrued as having significance for monetary policy. The Fed recently issued a report declaring the requirements, which date from the 1930's, to be outmoded.

As for the farm situation, about which Mr. Volcker has been asked repeatedly of late, he said it was not a problem that could be solved by monetary policy. Faster money expansion, he said, would only shift the problem to some other sector of the economy, such as home building. A lower dollar, he said, would not lead to lower interest rates.

Trade and other imbalances, he added, cannot be "papered over." In fact, he said at another point, a somewhat perverse effect of achieving such a desirable goal as reducing the Federal budget deficit "might be to send the dollar higher."

Economic Scene

Leonard Silk

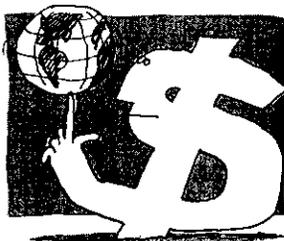
The Flight To the Dollar

AFTER soaring to record heights this week, the dollar fell back yesterday. But the soaring dollar still promises to reach new altitudes this year. Before falling and later recovering a bit in New York yesterday, it rose abroad to 3.47 against the West German mark, and some traders and analysts think it could climb to 3.6 marks or perhaps all the way up to 4 marks. And the British pound fell as low as \$1.04 before rising to \$1.06; a buck for a pound seems inconceivable to those who can remember when the pound was worth nearly \$3.

How long can the high-flying dollar stay aloft? R. T. McNamar, the former Deputy Secretary of the Treasury, suggests that, thanks to the strong inflow of foreign capital to the United States, the dollar will stay permanently strong. In a recent speech to the National Foreign Trade Council in New York, Mr. McNamar suggested that the dollar's strength, despite the record United States trade deficit, was due to the preference of investors all over the world to put their money here more than in any other country.

This preference, the result of a search for maximum, safe, after-tax returns, stems basically from the resurgence of United States economic growth. The American economy grew by 6.8 percent last year, compared with the average growth rate of 2.3 percent for the four largest European economies and the 5.6 percent growth rate of Japan. The United States growth rate has actually risen from its rate of slightly above 1 percent in 1978-80, while the other countries have been essentially flat. The persistently low European growth rates and the higher Japanese rates, according to Mr. McNamar's theory, explain why the European currencies have fallen so far against the dollar, and why the Japanese yen has declined much less.

At his news conference last week, President Rea-



Nicholas Azzari

gan embraced the economic growth theory for the dollar's rise and indicated a reluctance to intervene in currency markets in any effort to drive the dollar down. Paul A. Volcker, chairman of the Federal Reserve Board, indicated his own reluctance to intervene in the exchange markets, and speculators took this as a cue to bid the dollar higher. Yesterday, Mr. Volcker said that intervention perhaps had not been forceful enough, and traders took this to mean that action might be more forceful in the future. Without United States cooperation, it is unlikely that foreign governments can intervene on a large enough scale to force the dollar down.

Mr. McNamar contends that the steep decline in the rate of United States inflation, relative to other countries, has also helped to strengthen the dollar. The strong dollar is itself a source of disinflationary pressure. Within the United States, it curbs exports and spurs imports, giving Americans more goods to consume than they produce. Internationally, the dollar's strength is depressing commodity futures, which this week fell to a 23-month low. Gold dropped \$12.30, to \$282 an ounce on Monday, a five-and-a-half-year low, before rising yesterday.

Many economists who, a year ago, were warning of an imminent collapse of the dollar have now begun to say it may stay up for years to come. The new Morgan Economic Letter, released this week by the Morgan Guaranty Trust Company, sees "a growing perception on the part of foreigners that

the United States is a highly attractive place to lodge funds." Among the reasons for this: higher interest rates here than elsewhere, the more dynamic American economy and "the safe-haven appeal of a country that offers political stability."

"Neither the unusual funds-gathering role of American banks nor the foreign investment in the United States can be counted on indefinitely," the Morgan economists say. "But there is also little reason to expect either an imminent decline in large capital flows to this country or a major weakening in the dollar."

Many foreigners and Americans are asking these days, "Where else would you put your money?" Indeed Mr. McNamar puts heavy stress on this country's safe-haven role for capital. Investor concerns, he says, have ranged from the impact of East European debt problems on German banks to political instability and turmoil in the Middle East and the debt situation in Latin America, which in recent weeks has flared up again.

"While in some cases the fears of investors may have been exaggerated," he said, "the perception that the United States is a safe and secure place for funds is not." He contended that, relative to any other country in the world, "the United States continues to have an advantage."

But is all this new-era talk? The flight to the dollar, driving up its price, is certainly not an un-mixed blessing. It is intensifying the problems of American farmers and other exporters. It is exacerbating protectionist pressures, as producers try to offset the damages resulting from an overvalued dollar. And Mr. Volcker said yesterday that the dollar's rise was inhibiting the conduct of monetary policy, seemingly implying that the Fed might be supplying more money to the economy than it would prefer, thereby eventually contributing to upward pressure on prices.

By forcing other countries to raise interest rates as a means of preventing further declines of their currency, the soaring dollar is threatening to make a sick world economy even sicker. Yet a precipitate fall in the dollar would also destabilize the United States and other countries. We shall consider these problems, and what to do about them, in another column.

NEW YORK TIMES Sunday, March 3, 1985

Economic Scene

Leonard Silk

Fed, Reagan And the Dollar

THE soaring dollar was jolted again this week by the warning of the Federal Reserve Board's chairman, Paul A. Volcker, that there could be a "very sharp decline" in the dollar's value because market psychology could change rapidly.

Psychology obviously has a lot to do with the day-to-day course of the dollar, whose drops send interest rates up and the securities markets down. Yesterday, the dollar jumped on news that the money supply had grown faster than expected.

But the big question is whether the markets are starting to see a peaking out of the dollar resulting from fundamental changes in the economic and political climate and from the actions of the Fed, the Reagan Administration and Congress, as well as those of foreign central banks and governments.

Mr. Volcker, whether he intended to or not, knocked the bond market down and interest rates up with his Congressional testimony a week ago that the Fed had ended its progressively easier monetary policy of the last four months but had not yet decided to tighten.

This week, Mr. Volcker suggested that the markets had misinterpreted his statement. He caricatured the markets' reaction by saying they had taken "about one nanosecond" to react, implying they had misread him. In his prepared statement, the Fed chairman said on Wednesday that "we will want to provide enough money this year to sustain orderly growth in demand and output." Pressed to say what the Fed would do next, Mr. Volcker said, "I don't know what the next move is."

In confusion, the dollar again fell in response to Mr. Volcker's latest testimony, and so, a nanosecond behind, did the stock and bond markets. Confusion, which the markets abhor, was intensified by a speech given at the Brookings Institution the same day by Preston Martin, the vice chairman of the Fed and a Reagan appointee. Mr. Martin said that "somewhat faster" growth of the money supply might be needed this year because of a slowdown in velocity, the rate at which the money supply turns over.

Was Mr. Volcker actually trying to slow the growth of the money supply and Mr. Martin trying to speed it up?

In an interview yesterday, Mr. Martin sought to dispel the confusion by saying that Brookings had asked him to look ahead through 1985 and 1986, while Mr. Volcker was looking backward through the latter part of 1984. "While we eased back in August and September, we are no longer easing," the Fed's vice chairman said. The present status, he said, was that "we are neither tightening nor loosening." Essentially, he insisted, monetary policy had not changed. "We were permitting the narrowly defined monetary aggregates to grow above their cones or their targeted range," and that is still the case, he added.

Mr. Martin said M-1, consisting of currency in circulation, demand deposits, travelers' checks and other checkable deposits, "is still increasing at an annual rate of 16 percent or 16 percent plus."

"How would the markets interpret this as tightening?" he asked rhetorically. In raising interest rates in response to its expectations of future monetary policy, he said, the market was making a "self-fulfilling prophecy."

For the whole of 1985, he said, the Fed would be at or above its targets for M-1, depending on what happened to velocity. If velocity regained again, as it had in 1982, "we will be at or above 16 percent" in monetary growth.

And what did the Fed mean to do about the dollar? he was asked. "We can't have an overt policy with respect to the dollar," Mr. Martin said, supporting the Administration's position.

Mr. Volcker, however, seems less bound by the Administration's position. In recent weeks, he has given encouragement to foreign central bank intervention, which he suggested had not been on a large enough scale to move the dollar down. The Fed itself has intervened only lightly.

Under Mr. Volcker's leadership, the Fed does appear to be set on a monetary course aimed at gradually reducing the exchange rate of the dollar, which is inflicting heavy damage on American exports and import-competing industries and agriculture, increasing pressures for protectionism and threatening world trade.

Since a falling dollar could increase inflation and interest rates, the Fed faces a tough problem in its conduct of monetary policy: for if, to guard against inflation as the dollar declines, it tightens money, this would put upward pressure on interest rates. The danger is that soaring rates would check United States economic growth, intensify the debt repayment problems of third world countries and dump the world economy into recession.

The best way to offset this effect would be for the Federal budget deficit to be reduced, and Mr. Volcker has been campaigning hard for a cut of at least \$50 billion. President Reagan and Congress share that objective, but disagree on how it is to be achieved. That disagreement was dramatized this week, on one side, by the President's veto of emergency farm credit legislation, which he called "a massive new bailout that would add billions to the deficit," and, on the other side, by a vote of the Senate Budget Committee to slash \$75 billion over the next three years from Mr. Reagan's military spending plan.

A statement on the budget will aggravate the anxieties of business, the securities markets and the foreign exchange market over the outlook for the dollar, interest rates and economic growth. Such anxieties were mounting last week, as the White House, Congress and the Federal Reserve struggled to get their related acts together. The markets seemed to be betting that they could not or would not — at least not in time to prevent a worsening economic scene.

THE NEW YORK TIMES
Monday, March 4, 1985

Fed Debates a Chart's Shape

By ROBERT D. HERSHEY Jr.

Special to The New York Times
WASHINGTON, March 3 — A long-simmering and highly technical debate over the way the Federal Reserve presents its monetary targets has burst almost overnight from arcane professional journals into the high-stakes arena of practical economic policymaking.

Although it is too early to tell for sure, some analysts think the nation's central bank may be on its way to embracing a new method of defining and portraying its all-important targets for money growth, a change that proponents say will greatly enhance the nation's economic performance.

Others, however, suspect the Fed has little intention of changing its method and will use the issue this year as a smokescreen behind which it will conduct an overly expansionary policy motivated by political and economic expediency.

The issue, in the Fed's vernacular, is whether the traditional "wedges" or "cones" used by the central bank to portray its monetary targets should be supplanted by "parallel bands." This seemingly small distinction is actually quite important, for the "wedge" provides very little room for the Fed to maneuver in the early months of the year when the wedge's boundaries are extremely narrow.

The more important issue, however, is the related one called "base drift." This, in essence, is a question of determining from what point the wedges — or parallel lines — are drawn.

Although the idea has appeared in the academic literature for a decade or more, it was not until last month that the proposal to change existing practice attracted significant public attention. The challenge was contained in the annual report of the President's Council of Economic Advisers, which offered an alternative "parallel lines" approach and a strong argument for emitting this device in the battle against "drift," usually upward, in the base.

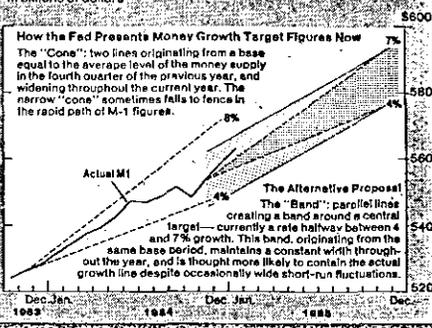
It is mostly economists of the monetarist school who support such a change. They argue that the Fed's current practice resulted in too much money creation during the late 1970's leading to an outburst of inflation. To subdue the double-digit inflation, the Fed was required to take the drastic tight-money countermeasures that caused the severe 1981-1982 recession.

The council's report attracted the attention not only of Wall Street but, also of the central bank itself. When Paul A. Volcker, chairman of the Federal Reserve, went before the Senate Banking Committee on Feb. 20 to announce the 1985 targets for money growth, his prepared statement contained four charts showing the 1985 trajectories based on both wedges and parallel lines.

Mr. Volcker was noncommittal about whether he thinks the monetarist proposal is a good idea. "We have sometimes considered," he said, "and others have suggested, a better 'pictorial' approach would be to illustrate the targets by a different, but also not necessarily arbitrary, convention." But Mr. Volcker's mere mention of it may prove to have been an important breakthrough.

Proposed Changes In Portraying Monetary Targets

In billions of dollars



According to William Poole, an author of the council's report who has since returned to being a professor at Brown University, the chief goal is to attack base drift. He maintains that not only is it important to set the proper rate of money growth — the Fed has fixed a 4 percent to 7 percent range for M-1, the narrowest of the measures, for 1985 — but to link it to the previous year's target.

A "Quality Control" Plan

"The present system codifies the mistakes into the next year's targets," Mr. Poole said in a telephone interview. He likens his proposal to the "quality control" that is practiced by any company.

Under current practice, the Fed takes the actual fourth-quarter level of the money stock as the starting point for the following year's target ranges. Mr. Poole, however, would employ, say, the midpoint of the 1984 target range in setting the range for 1985.

Drawing parallel lines from this point, supporters maintain, would not only prevent overshoots — or, as in 1981, undershoots — from being compounded, but would give the Fed more leeway in which to operate during the first few months of the year.

The Fed is aware, of course, that the "wedges" at this time of year are so confining that the entire framework can be skewed by an event no more significant than a snowstorm that shuts down airports and prevents checks from being cleared promptly. Mr. Volcker thus told Congress that he was not at all disturbed that some of the aggregates are now far above the target range, and he said that no remedial action need be taken.

The monetarists, however, argue that even if the Fed is not a slave to the targets there would be less uncertainty if the markets did not have to guess at the reasons why money growth is not being contained within the prescribed range. The Fed's credibility would be enhanced, as Professor Poole puts it, by "acting according to expectations."

Many analysts say the current economic climate seems likely to put the Fed to a severe test, one that could make the case for change particularly compelling this year.

With the dollar soaring in international currency markets and with the Federal budget deficit making huge demands on the capital markets, the Fed is already under heavy pressure to keep interest rates from rising further. In fact, numerous members of Congress, particularly those from farm areas, have pressed Mr. Volcker during the past two weeks to bring rates down.

There is now, in the view of H. Erich Heinemann, chief economist at Ladenburg, Thalmann & Company, "absolutely no constituency for monetary restraint" with the Reagan Administration "going for growth," the Fed will find it almost impossible to resist the political and economic forces pushing for an expansionary monetary policy. The adoption of parallel bands could, in such a climate, be a cover under which higher-than-targeted money growth might be pursued for some time before arousing market fears about the potential for inflation.

Whether the Fed, in fact, formally adopts the monetarist change probably will not be known until at least July, when Mr. Volcker makes his next semi-annual appearance before Congress. At that time he will give the tentative monetary targets — and the base upon which they are to be calculated — for 1986.

Higher Treasury Yields Expected

At this week's regular auction of new Treasury bills, interest rates are likely to be the highest since mid-November of last year, based on rates prevailing last week.

Late Friday, the outstanding three-month issue was bid at about 8.63 percent, while the six-month issue was 8.98 percent. Rates for both issues have climbed sharply in recent weeks. As recently as Jan. 28, three-month bills were sold at 7.76 percent, while the six-month issue averaged 7.97 percent.

Outside of the Treasury bill market where auctions are held weekly, the next three weeks promise a light schedule of new issues. Except for a one-year bill auction expected March 14 and a two-year note auction expected March 20, there are no longer-term issues coming out until the week of March 23. In the last week of the month, dealers expect a three-part package of four-year notes, seven-year notes and 20-year bonds totaling about \$17 billion.

In the tax-exempt bond market, analysts at Salomon Brothers Inc. estimate that this week's offerings

total about \$1.4 billion, including a \$300 million issue by New York City.

The following new fixed-income securities are scheduled this week:

TAXABLE

ONE DAY DURING THE WEEK

Southern California Edison, up to \$250 million of first and refunding mortgage bonds, due 2015, A/A-2/AA. Competitive.

McDermott Inc., \$150 million of floating-rate notes, due 1992, BBB/A-2/A. First Boston.

Hercules Inc., \$50 million of European currency units, due 1992, A/A-2/A. First Boston.

Mortgage Bankers Financial Corp., about \$110 million of collateralized mortgage obligations, rated AAA by Standard & Poor's. Kloder, Peabody & Co.

Thousand Trails, \$75 million of senior subordinated notes, due 1992, NR/B-2/B. Prudential-Bache Securities Inc.

Duke Power, \$125 million of first and refunding mortgage bonds, due 2015, A+/AA2/AA-. Merrill Lynch.

Alco Standard Corp., \$50 million of convertible subordinated debentures, due 2010. First Boston.

International Lease Finance, \$50 million of notes, due 1989, NR/BBB1/BBB. Dean Witter Reynolds Inc.

Ho-Med Inc., \$60 million of debentures, due 2005. Prudential-Bache.

Compaq Computer, \$50 million of convertible subordinated debentures, due 2005, rate B-1 by Moody's. L.F. Rothschild, Urnerberg, Towbin,

Federal Realty Investment Trust, \$35 million of convertible subordinated debentures, due 2015. Merrill Lynch.

Flowers Industries, \$30 million of convertible subordinated debentures, due 2005. Merrill Lynch.

Firm Fresh Inc., \$40 million of convertible subordinated debentures, due 2010. Kloder, Peabody & Co.

Source: McCarthy, Crisanti & Mattel Inc. Ratings: MCM/Moody's/Standard & Poor's.

TAX-EXEMPT

MONDAY

Arvada, Colo., \$30 million, rated A-3 by Moody's. Competitive.

TUESDAY

State of Pennsylvania, \$102 million, A/A+. Competitive.

Nashville and Davidson County Metropolitan Government, Tenn., \$39.5 million, A+/AA. Competitive.

TENTATIVE OFFERINGS DURING WEEK

Connecticut Resource Recovery Authority, \$325 million, insured by the Municipal Bond Insurance Association. First Boston.

DeKalb County, Georgia, \$42.1 million. Merrill Lynch.

Dormitory Authority of the State of New York (variable rate bonds), \$45 million. First Boston.

Missouri Higher Education Loan Authority, \$29 million. Manufacturers Hanover Trust Co.

Surge in the Money Supply Will Cause Fed to Tighten Policy, Analysts Believe

CREDIT MARKETS

By TOM HERMAN
And EDWARD P. FOLDESSEY

Staff Reporters of The Wall Street Journal
NEW YORK—The continued surge in the nation's money supply will prompt the Federal Reserve System to tighten its credit hold soon, and interest rates will climb, according to bankers and economists.

Until recently, some of these analysts believed that the U.S. dollar's strength would keep the Fed from tightening credit conditions. But money growth has been so vigorous that the Fed can't afford to delay changing policy much longer, these analysts say.

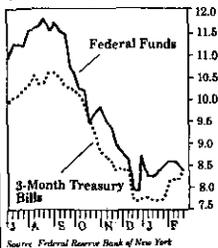
Moreover, the dollar's setback in foreign exchange trading last week gives the Fed a little more leeway in carrying out domestic policy, many economists say. Whatever the case, last Wednesday's plunge in the U.S. dollar sent bond prices tumbling, underscoring the importance of foreign-exchange developments for the U.S. credit markets.

A Weather Vane for Bonds

Bond prices recouped part of their losses late last week. But many analysts contend that investors increasingly will be watching the dollar's behavior as a weather vane for bonds. In addition to the implications for Fed policy, changes in the dollar's value could well affect the willingness of foreign investors to hold U.S. securities, they say.

"The trend in interest rates will be up," predicts Roger N. Kubarych, chief econo-

Short-Term Interest Rates (Weekly average, in percent)



Source: Federal Reserve Bank of New York

mist of the Conference Board, a business research group. "The economy is strong and money supply is growing much too fast. The Fed will take every opportunity to promote higher interest rates."

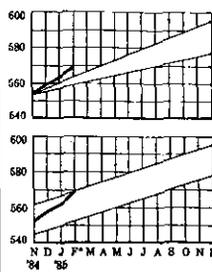
Since October, the basic money supply, known as M1, has grown at an annual rate of more than 11%, according to some estimates. The M1 measure consists of checking deposits plus cash held by the public. Because it represents funds readily available for spending, it is considered an important determinant of the economy and inflation.

If rapid money-supply growth continues, the economy might race ahead at an unsustainably rapid pace, reigniting inflationary pressures, some investment managers fear.

Paul Volcker, chairman of the Federal Reserve Board, said late last month that the Fed "isn't disturbed by the present level" of M1. The Fed is seeking 4% to 7% growth this year in M1, which now stands well above the upper limit of the cone-like figure that analysts traditionally have used to illustrate the target range.

M1 Money Targets

The Cone versus Volcker's Tunnel
(Billions of dollars, seasonally adjusted)



The Federal Reserve wants 4% to 7% growth in M1 this year. The cone on top is the traditional way the target has been depicted. But Fed Chairman Paul Volcker suggests the parallel lines, or tunnel, shown above may be preferable.

*February estimate, by Money Market Services Inc.

Mr. Volcker noted that the target range, when presented as a cone, is very narrow early in the year and that strict adherence to the target would be wrong. He suggested that the target might be better represented by two parallel lines, resembling a tunnel and drawn at an equal distance from the 5.5% midrange of the Fed's target. But M1 last month already hit the upper part of the tunnel, according to estimates of some analysts.

"Whether you use the cone or the parallel lines, recent money growth has been excessive," said Norman Robertson, senior vice president and chief economist of Mellon Bank, Pittsburgh. "If we have another week or two of strong money growth, the Fed will have to adopt a more restrictive credit stance."

William Melton, vice president and senior economist at IDS/American Express Inc., Minneapolis, agrees that the money-supply graphics aren't important at the moment. "What matters right now is that the monetary aggregates and business indicators are all telling the same story—the pace of economic activity has picked up substantially," he said. He expects "another very minor tightening move" by the Fed within a month.

Mr. Melton predicted that the interest rate on federal funds, or reserves that banks lend each other overnight, will rise to about 9% by the end of this month. The funds rate recently has hovered around 8½%. He also predicted that the yield on the Treasury's newest 30-year bond will rise to about 12½% by the end of the month from just over 11½% currently.

The Fed already has tightened its credit hold slightly, according to Mickey D. Levy, senior vice president and chief economist at Fidelity Bank, Philadelphia. As a result of a more restrictive credit policy, Mr. Levy said he expects money growth to slow down soon.

Others say the Fed hasn't changed its policy course since early this year, when it ended a series of credit-easing moves begun last fall. Some, such as Dana E. Johnson, an economist at Northern Trust Co., Chicago, predict that the Fed won't need to tighten credit because they anticipate slower money supply and economic growth soon.

Decline in Rates Predicted

Mr. Johnson looks for declines in interest rates in the months ahead. For example, he predicted that the rate on three-month Treasury bills, now about 8½%, will drop to about 8¼% over the next couple of months.

The fate of the dollar will strongly influence U.S. interest rates, some analysts say. The dollar's movements against other major currencies "are going to be an increasing source of concern for long-term investors," said Mr. Melton of IDS.

Investments by foreigners have played a major role in financing the U.S. government's huge budget deficits. This source of funds from overseas is "potentially unreliable," Mr. Melton warned. The higher the dollar rises, "the greater the possibility that foreigners may take their profits and run" once the dollar begins to slide, he added.

Mellon Bank's Mr. Robertson agreed that the bond market will be reacting to developments in the foreign-exchange markets. He said Fed officials will monitor the dollar's behavior closely in setting credit policy. "A falling dollar will enable the Fed to tighten policy, while a strong or rising dollar implies the Fed will be reluctant to adopt a more restrictive stance," he said.

In the credit markets Friday, the Treasury's 11¼% bonds due 2015 closed at a price of 95 15/32 to yield 11.8%. That compared with Thursday's close of 94 27/32, where the yield was 11.88%. The government's 11¼% notes due 1995 rose to 96 22/32 from 96 7/32, lowering the yield to 11.82% from 11.91%.

Treasury bill rates rose. The latest 13-week bill closed at 8.64% bid, up from 8.52% Thursday. The bid on the latest 26-week issue increased to 8.95% from 8.82%.

February was an extremely tough month for bond market investors, especially for those who bought long-term Treasury bonds. The price of the Treasury's 30-year bond tumbled 6.74% last month, the biggest one-month decline since an 8.49% drop in February 1980, according to Sharmin Mossavar-Rahmani, senior analyst at Ryan Financial Strategy Group, a division of Retco Partners.

KEY ASSETS AND LIABILITIES OF THE NATION'S LARGE COMMERCIAL BANKS

	Feb. 28, 1985	Change from Feb. 23, 1985
ASSETS:		
Total loans, leases and investments, gross adjusted	799,579	+ 1,570
Commercial and industrial loans	249,170	+ 1,738
Loans to depository and financial institutions	43,709	- 892
Loans to individuals	116,822	+ 46
Real estate loans	162,461	+ 30
U.S. Government securities	102,266	+ 4,517
Other securities including municipal issues	47,800	- 125
Municipal securities	28,820	- 141
LIABILITIES:		
Deposited deposits	597,491	+ 2,320
Other transaction deposits including NOW accounts	34,756	+ 109
Savings and other	400,548	+ 74
Other transaction deposits	155,620	+ 753
of \$100,000 or more		

Growth and Inflation Debated

White House, Fed at Odds

By MICHAEL QUINN

One of the thorniest issues facing economists — the relationship between money supply growth, the economy and inflation — is a matter of great debate among policy makers in the Federal Reserve Board and the Reagan Administration, who want both growth and low inflation.

"The fundamental question is how fast can the economy grow without creating pressure for more inflation," James B. Johnson, an economist at the Northern Trust Company of Chicago, said. "The Fed is always going to be more inflation-conscious than the body politic, but when the body politic changes, the Fed must make some adjustments," he added.

Since 1984 was a year of fast growth without high inflation, Mr. Johnson and other analysts agreed, the Fed has been having a harder time reminding the public and politicians about the dangers of inflation. The Fed chairman, Paul A. Volcker, is still perceived by investors and economists as a strong inflation fighter, but, in his Congressional testimony last month, he indicated that he is bending a little to accommodate the Reagan Administration's desire for fast economic growth.

Tolerate Some Growth

In past years, for example, the Federal Reserve's commitment to reducing inflation has often included statements about the need to gradually reduce money supply growth year after year. In 1985, however, Mr. Volcker said, the central bank may tolerate money supply growth in the upper part of the 4 percent to 7 percent growth target, up from 3.2 percent growth in 1984.

Mr. Volcker said faster growth could be warranted by a slowdown in velocity, or the rate at which money is turned over. But some analysts worry that faster money supply growth is not consistent with the Fed's objective of gradually reducing inflation and money supply growth.

The rise in 30-year Treasury bond yields to 11.68 percent, from about 11 percent at the end of January, cannot be attributed to fear among investors that faster money supply growth this year will bring more inflation. But the rise in bond yields so far above 11 percent, even though consumer prices have increased at a rate of 4 percent or less for the last three years, is a sign that many investors are still worried that inflation will rise again.

Further Signs

Another sign of the Fed's willingness to adjust its anti-inflationary monetary policy statements was the special attachment to Mr. Volcker's Congressional testimony titled "Targeting Real Growth."

Although economists are convinced that inflation is a development that follows from periods of excessive money supply and economic growth, Mr. Volcker said, the Fed "has no preconceived notion as to just how rapid" economic growth can be "without straining our resources or giving rise to price pressures." The Fed's forecast for 1985 of about 3 1/2 percent inflation and the same amount of real growth are not targets which the Fed tries to achieve, Mr. Volcker said.

"The controversy about real growth is a sign of the vitriolic debate between the Fed on one side and the White House and Treasury on the other," Lawrence A. Kudlow, president of Lawrence Kudlow Associates, said. "The White House accused Volcker of undermining their fast growth policies by tightening in 1984. Now, Volcker is trying to allay their fears by saying that the Fed does not base its policy on targets for economic growth."

Economic Growth

While the Fed may say it does not target economic growth, many economists are convinced that the Fed does play close attention to the rate of economic growth. When the Fed reacts to excessive economic growth it may say its actions are a response to excessive growth in money supply or credit, they said.

"I think that intuitively the Fed has some notion of what is too fast or too slow," Thomas Thomson, chief economist at Crocker National Bank, said. While Federal Reserve Governors Preston Martin and Martin Sager have suggested that real growth of 5 percent may be sustainable, Mr. Thomson said, "I think the sustainable non-inflationary growth rate is considerably less," or about 3 percent.

Mr. Kudlow warned that if Administration officials put pressure on the Fed into compromising its anti-inflation policy, the result would be higher rates in the future. "A dose of restraint by the Fed in the first half of this year will keep inflationary expectations low and open the door to lower interest rates in the second half," he said. "But a dose of ease in the first half will lead to significantly higher interest rates in the second half," Mr. Kudlow said. Too much stimulation early this year will bring higher rates as credit expands and investors anticipate an upturn in inflation and a subsequent vigorous Federal Reserve move to tighten policy.

FOREIGN EXCHANGE

EUROPE POUNCES ON THE MIGHTY DOLLAR

When currency traders finally bid up the dollar so high that they themselves got nervous, Europe's central banks saw their opportunity and pounced. Selling an estimated \$1.5 billion in a matter of hours on Feb. 27, Europe's monetary guardians pushed the dollar down a startling 17 pfennigs against the West German mark. "The central banks," says David C. Redding, vice-president at Bankers Trust Co., "are on a credibility-oubling exercise."

The impressive display of interventionist muscle scattered market players to the sidelines. Trading was so sparse that

bankers had caused the dollar to dive 5% against the mark.

The turnaround was a dramatic end to the dollar's steep February climb. The currency had sunk below the previous day's close only a couple of times during the entire month. "The runup over the last two weeks was much too much," says Horst Duseberg, executive vice-president of European American Bank. "This reaction was overdue."

But while many traders were anticipating some sort of correction to the February frenzy, it is hard to find anyone willing to bet that this is the beginning of the long-awaited decline of the dollar. In fact, the dollar is expected to rebound—and maybe rise still further. Higher U.S. interest rates are the most frequently cited reason, and, as Duseberg points out, "the underlying fundamentals still favor a strong dollar."

UNUSUAL SIGNS. Early warning signals that the dollar's stellar status was coming to an end were evident in two areas of the currency markets. The Japanese yen, which has fallen by more than 40% against the dollar since 1980, has been holding up surprisingly well over the past few weeks. While the British pound is down 8% since Feb. 4, and the mark 6.5%, the yen has declined less than 1% (chart).

The impressive performance of the Japanese economy explains the yen's strength in part, but traders also note increased intervention by the bank of Japan. "There is a clear indication that the dollar is not going to rise against the yen from now on," says the Paris-based foreign exchange manager of one large U.S. bank. "In the past days, hundreds of millions of dollars have been thrown at the dollar/yen rate."

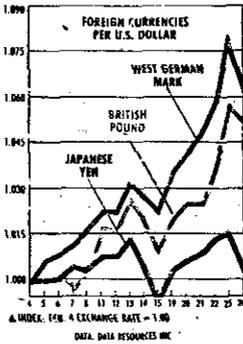
Currency traders think the Japanese authorities have become extremely concerned about the possibility of protectionist legislation coming out of the U.S. Congress (page 34). To head that off, they are trying to make sure the yen does not weaken further. "The Bank of Japan is trying to control the situation," says Friedrich W. Menzel, managing director of Citibank in Frankfurt.

Unusual shifts within the European Monetary System (EMS) also foreshadowed the likelihood of a dollar setback. Although the mark has been hitting 13-year lows against the dollar, it has actually been strengthening within the EMS at the expense of the traditionally weaker European currencies, such as the Ital-

ian lira and the Belgian franc. Traders typically position themselves within the EMS that way if they are expecting a dollar correction, since the mark is the biggest beneficiary of a tumbling buck. Indeed, the mark's resurgence within the EMS is putting such pressure on the weaker currencies that Citibank's Menzel thinks the shifts could trigger an EMS realignment in the second quarter of this year.

By Sarah Bartlett in New York, with John Templeman in Lausanne

THE STRONG DOLLAR IS FINALLY TAKING A BREATH



the spreads between the bid and ask prices on currencies widened from the normal 10 basis points to a full 100. Traders at France's nationalized banks were so disheartened that many headed home at noon.

The concerned central bank attack on the dollar followed a some loud sword-wielding by Federal Reserve Chairman Paul A. Volcker before Congress one day earlier. Testifying before the House subcommittee on domestic monetary policy, Volcker criticized the dollar's level and suggested that there was a need for more forceful central bank intervention. The Federal Reserve chairman's remarks triggered a sharp dollar decline, setting the stage nicely for the Europeans' selling action. In just 24 hours, the combined efforts of the world's central

CHART BY BARRY McDONALD/EPW

DAVID R. FRANCIS

Should the Fed be more open in its money policy?

Washington
Lawrence K. Roos called himself a "disillusioned old codger"; but Mr. Roos, retired president of the Federal Reserve Bank of St. Louis, doesn't sound like it. He speaks more like an enthusiastic reformer.

"Because we live in an open and free society in the political sense, monetary policy goals must be agreed upon by, and known to, the public," he told a recent conference held by the Cato Institute, a free-market public-policy research institute.

"And the method chosen by policymakers to achieve those goals must be clearly understood by the public. Policy actions must be easily observable, well explained, and, of course, consistent with the goals sought. And finally, it is essential that policymakers be held accountable for the achievement of their announced goals."

That may seem reasonable. But the fact is that the Federal Reserve System, the nation's central bank, is one of the most secretive of federal institutions. Its

FOMC members do not always agree on priorities, Roos says. "There were usually as many goals as there were chairs around the table."

goals are not clear to outsiders — or, for that matter, to many insiders, probably.

Most economists would agree nowadays that the Fed's monetary policy is an extremely important — if not the most important — influence on economic trends in the United States.

Tight money can prompt a recession. Loose money can encourage a boom. The level of inflation generally reflects the amount of money the Fed pumps into the economy, though only after a lag of two years or so.

In fact, it is often said that the chairman of the Fed (Paul A. Volcker at the moment) is the nation's second most powerful individual, after the president himself. Since the US has the most powerful economy in the world, accounting for about 20 percent of global output, some economists regard Mr. Volcker as No. 1 in world economic power.

What bothers Mr. Roos about all this is that not only does the Fed "love to be secretive and mysterious," but it does not set any "clear, achievable, long-range goals."

Roos was joined to a degree in his complaint by an actual Fed policymaker, Robert P. Black, president of the Federal Reserve Bank of Richmond, Va.

"It would seem to make sense," he said, "to narrow the Fed's mandate in order to reduce its need to rely heavily on discretion in conducting policy. Such a narrowing would enable the Fed to develop a cohesive strategy with clear and feasible objectives and, in my opinion, would very likely improve the quality of monetary policy over the long run."

One of the Fed's problems is that it has been assigned by Congress what might be called a "mission impossible." The Federal Reserve Act, as amended by the Humphrey-Hawkins Act of 1978, states that Federal Reserve policy should promote maximum employment, stable prices, and moderate interest rates. These goals should be pursued with due attention to production, investment, real income, productivity, international trade, and balance-of-payments equilibrium, as well as employment and prices.

Mr. Black notes, however, that Congress gives the Fed no priorities for these various objectives. Nor does it specify any time horizon over which the Fed's success is to be evaluated.

Roos termed these goals a "wish list," saying that "asking monetary policymakers to do all this is sheer nonsense . . . a total lack of understanding as to what the Federal Reserve is capable of doing."

Probably Congress itself could not agree on priorities, since such matters as unemployment and interest-rate levels are highly sensitive politically. So it dumped this hot potato on the Fed, saying, in effect, "Make the economy run perfectly."

Black doesn't like bouncing this hot potato around. "It should be obvious to anyone that a mandate which instructs the Fed, in essence, to pursue all desirable economic objectives is no basis for an effective strategy for money policy. Such a broad mandate merely transfers all of the hard strategic choices regarding priorities, time frames, and what is and what is not feasible to the Fed, which is not in a position to make them, precisely because it has no clear mandate."

He concluded: "Clearly, it puts the Fed in a Catch-22 position."

Mr. Black would like to see Congress instruct the Fed to put its top priority on price stability. He regards this as a feasible objective for Fed policy.

"The close longer-run correlation between the growth of monetary aggregates and the price level is one of the most firmly established empirical relationships in economics," he noted.

There is much less agreement, he added, on the Fed's ability to influence such variables as employment and production "in a systematic and socially beneficial way."

Frank Morris, president of the Federal Reserve branch in Boston, counters that Black's proposition for an inflation-only goal is not practical. Because fiscal policy (federal taxation and spending levels) has proved to be inflexible, monetary policy must also consider employment objectives. "Government can't take the position it doesn't have any unemployment objective," he contended in an interview in Boston.

Nonetheless, having been given a many-sided policy problem, the Fed has had difficulty itself setting priorities and goals.

Mr. Roos recalled: "Never once in my participation in meetings of the FOMC [Federal Open Market Committee, the 12-person policymaking body of the Fed] do I recall any discussion of long-range goals of economic growth or desired price levels. It was like trying to construct a house without agreeing upon an architectural design."

One difficulty is that FOMC members do not always agree on priorities when the goals are not compatible with one another. "There were usually as many goals as there were chairs around the table," Roos said.

Treasury and Federal Reserve Foreign Exchange Operations

During the six months ended in January, the dollar rose to its highest levels of the floating-rate period against the German mark and to record levels against the British pound and most other European currencies. The dollar's advance largely occurred in two steps—first around mid-September and again from early November to mid-January. In all, the dollar rose some 8 percent against the currencies of Continental Europe and 15 percent against the pound sterling. It advanced by a substantially smaller 3½ percent against the Japanese yen and by about 1 percent in terms of the Canadian dollar. In trade-weighted terms the dollar rose some 8 percent over the six-month period.

The dollar continued to rise despite a shift in the prospects for the U.S. economy and for U.S. interest rates, which began to occur in the summer. For the past couple of years, the dollar's strong performance had been associated with exceptionally vigorous U.S. economic growth, contrasting with slower recoveries elsewhere. Relatively high U.S. interest rates had also been viewed as supporting the dollar. But indications emerged in August that the U.S. expansion was slowing in the third quarter, while economic activity abroad was picking

up. Private economic forecasters tended to scale back their projections of U.S. output gains for late 1984; some even speculated that the United States might experience a growth recession in the coming quarters. At the same time, long-term U.S. interest rates were progressively declining. By early autumn, evidence accumulated that the narrowly defined monetary aggregate was no longer expanding and short-term interest rates began to fall back. By late January, interest rates on long-term U.S. government bonds had eased one and a half percentage points. Short-term interest rates had dropped even more, the decline accompanied by two half-percentage-point cuts in the Federal Reserve's discount rate to 8 percent. For the period as a whole, the rate for three-month Eurodollar deposits had declined by more than three percentage points, and interest differentials *vis-à-vis* the German mark, for example, though still favorable to the dollar, had been cut just about in half.

Under these circumstances, expectations developed that the dollar would weaken during the latter part of 1984, but these expectations failed to materialize. Each time the dollar started to move lower, it quickly recovered. The dollar was buoyed by an easing of inflationary fears in the United States that implied U.S. real interest rates were still attractive, even at lower nominal levels. Forecasts that price pressures would reappear, made when the U.S. expansion was stronger early in 1984, had not been borne out. Inflation con-

A report by Sam Y. Cross, Executive Vice President in charge of the Foreign Group at the Federal Reserve Bank of New York and Manager of Foreign Operations for the System Open Market Account. Richard F. Allard and R. Spence Hilton were primarily responsible for the drafting of this report. Assisted by Elisabeth Kiebanoff.

tinued moderate, and confidence grew that the U.S. economy might experience reasonable price stability for some time. This confidence gained support from continued declines in world commodity prices, most particularly crude petroleum.

The strength of the dollar reflected as well a continuing preference on the part of both residents and non-residents to invest in dollar-denominated assets. Since the last recession, economic growth was considerably greater in the United States than in most other industrialized countries many of which were still facing near-record levels of unemployment. The United States and its currency continued to be well-regarded on grounds of relative political stability. The flexibility of its labor and product markets compared favorably with those of other countries, some of which had been experiencing unusually protracted labor disputes. The weakness of precious metals and other commodity prices tended to underline the attractiveness of financial assets in general and of dollar assets in particular. Investors, still reacting to the credit problems of recent years, attempted to be more selective. They tended to place a greater premium on security in making investment decisions, and the dollar provided an outlet for much of these investments. Portfolio managers as well remained attracted to dollar markets. These markets seemed to provide the flexibility needed to adjust investment strategies quickly in the face of shifting interest rate expectations, and the liquidity to cover the currency exposure if the dollar should drop.

Thus, capital inflows continued to be attracted to the United States at a pace greater than needed to finance a large current account deficit at prevailing exchange rates. During the third quarter, heavy inflows came through the banking sector, as banks in the United States pulled back funds previously placed in the Eurodollar market. As inflationary expectations in the United States continued to moderate, as long-term interest rates fell, and as expectations of a decline in the dollar faded, a larger portion of the inflows subsequently took the form of portfolio investments in dollar-denominated securities. In November and December, the U.S. bond market in particular attracted attention at least partly because of relatively attractive yields and prospects for capital appreciation.

As these developments unfolded during the six months, market participants focused on the economic consequences and the possible policy implications of the dollar's continued advance. For the United States, while a strong currency helped to moderate price pressures at a time of vigorous economic growth, it imposed major strains on the U.S. competitive position. The current account deficit was building up close to \$100 billion, largely as the result of sharp increases in imports of

consumer and investment goods. For other countries, market participants noted the competitive boost being given to their exports, the leading source of stimulus to

Table 1

Federal Reserve Reciprocal Currency Arrangements

(in millions of dollars)

Institution	Amount of facility January 31, 1984
Australian National Bank	250
Norwegian Bank of Gjøvik	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	700
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements, Swiss franc-denominated	600
Other authorized European currency-units*	1,250
Total	30,100

Source 7

Net Profits (+) or Losses (-) on United States Treasury and Federal Reserve Current Foreign Exchange Operations

(in millions of dollars)

Period	Federal Reserve	United States Treasury Exchange Stabilization Fund
First quarter 1984	0	-0
Second quarter 1984	17.7	-21.4
Third quarter 1984	-0	0
Fourth quarter 1984	-0	-0
January 1985	-0	-0
Valuation gains and losses on outstanding assets and liabilities as of January 31, 1985*	\$1,890.7	- \$900.6

Data are on a value-date basis.

*Valuation gains and losses represent the increase or decrease in the dollar value of outstanding currency assets and liabilities, using end-of-period exchange rates as compared with rates of acquisition. The valuation basis reflects the dollar's appreciation since foreign currencies were acquired.

otherwise relatively modest economic recoveries. But they believed the authorities would prefer a broader-based recovery and, therefore, would seek to keep interest rates as low as possible, particularly since inflationary expectations were subdued.

Thus, market participants concluded that the authorities would be reluctant to use monetary policy to resist the dollar's rise. For a time early in the period, dealers were skeptical that even intervention would be used. But market sensitivity to intervention increased, after the Bundesbank sold dollars aggressively in the exchange market late in September, in the first of several, highly visible operations. The U.S. authorities, having intervened on one occasion earlier that month, again entered the market on four days following the Bundesbank's late September operation. Central banks of some other countries also intervened to sell dollars during late September and early October. Later in the period, when the dollar resumed its advance, market professionals again expected the authorities would try to moderate the move with intervention. Expectations of central bank resistance, along with the intervention operations that actually took place, for a time kept the dollar's rise in check.

By the turn of the year, the outlook for the U.S. economy was progressively improving. Published data revealed quicker growth in the fourth quarter for the United States than had been anticipated. Also, an accelerating expansion of monetary aggregates late in the year was seen as narrowing the scope for any further easing of U.S. monetary policy. Economic performance in several European countries, though also improving, was still viewed by market professionals as not so vigorous as to require greater monetary restraint. As sentiment toward the dollar became even more bullish early in January, the dollar's rise against all currencies gained increasing momentum. The market noted the dollar's approach to levels against the German mark where the Bundesbank had been seen intervening several months before, as well as intense selling pressure against the British pound. In a few European countries, domestic interest rates were tending to firm in response to concerns that the dollar's continued rise would eventually be reflected in increased domestic inflation.

With the approach of a scheduled meeting of G-5 finance ministers and central bank governors, market professionals anticipated that this might be an occasion for monetary authorities to plan a large and concerted exchange market operation. The officials discussed a range of international economic and financial issues. In their announcement of January 17, they reaffirmed their commitments to promote a convergence of economic performance and stressed the importance of removing

structural rigidities in their economies. They also reaffirmed the May 1983 Williamsburg agreement to undertake coordinated intervention as necessary.

After the G-5 meeting, visible foreign exchange market operations were in fact undertaken by several countries. Most central banks in Europe and the Bank of Japan operated on occasion to sell dollars during the rest of January. The U.S. authorities, in coordination with the others, also intervened on two occasions late in January to sell dollars against marks.

These operations reinforced market perceptions that the central banks were more willing to intervene than before. At the end of the month, however, market participants were still uncertain of the extent to which the authorities were prepared to intervene and of the circumstances in which the central banks would judge intervention to be appropriate or helpful. Dealers remained impressed by the steady stream of commercial and investment-related orders for dollars coming into the market. Under these circumstances the dollar steadied but did not fall back appreciably from mid-January levels.

In summary, during the six months under review, the U.S. authorities intervened in the exchange markets on seven occasions, selling dollars and buying marks in each instance. They bought \$50 million equivalent of marks on one day early in September, \$229 million on four occasions between September 24 and October 17, and \$94 million on two days late in January. The total, \$373 million equivalent of marks, was shared equally between the U.S. Treasury and the Federal Reserve.

In other operations, the Treasury Department announced on October 12 that it had joined with the Bank of Japan and the Bank of Korea in arrangements to provide short-term financing to the Central Bank of the Philippines, totaling \$80 million in support of the Philippine economic adjustment program which had been agreed upon with the management of the International Monetary Fund (IMF). The Treasury, through the Exchange Stabilization Fund (ESF), agreed to provide \$45 million, the Bank of Japan \$30 million, and the Bank of Korea \$5 million. The full amount of the facility was drawn on November 7. The drawing occurred after the Managing Director of the IMF confirmed that the IMF had received assurances of the availability of adequate financing in support of the Philippine economic adjustment program and that he had formally submitted the Philippine request for a standby arrangement to the Fund's Executive Board. The drawings were repaid on December 28, after the Philippines drew on its standby arrangement with the Fund.

On December 3, the U.S. Treasury agreed to provide a \$500 million swap facility to the Central Bank of the Argentine Republic as bridging credit in support of the

Argentine economic adjustment program, which had been agreed upon with the IMF. The full \$500 million was drawn on December 28. On that day the IMF Managing Director indicated that the IMF had assurances of adequate financing from commercial banks in support of the Argentine Government's economic program. Argentina's requests to draw on a standby arrangement and on the Compensatory Financing Facility (CFF) were then approved by the Fund's Executive Board. The drawing was repaid in the amounts of \$270 million on January 3, 1985, and \$230 million on January 15, 1985, after the Argentine Government's drawings from the IMF under the CFF and its standby arrangement, respectively.

The Federal Reserve and the ESF invest foreign currency balances acquired in the market as a result of their foreign exchange operations in a variety of instruments that yield market-related rates of return and that have a high degree of quality and liquidity. Under the authority provided by the Monetary Control Act of 1980, the Federal Reserve had invested \$870.1 million of its foreign currency holdings in securities issued by foreign governments as of January 31. In addition, the Treasury held the equivalent of \$1,573.8 million in such securities as of the end of January.

German mark

During the period under review, the mark fell 8.5 percent against the strongly rising dollar and eased relative to all other major currencies except sterling, ending the period near the bottom of the EMS. The mark's decline against the dollar was interrupted only temporarily—between late September and early November.

At the start of the period, international investors' attention was deflected to dollar-denominated securities. A rally in the U.S. bond market had just gotten underway. A much talked-about elimination of U.S. withholding tax on interest payments to non-residents was finally approaching. And talk spread that the U.S. Treasury would soon issue securities targeted especially for foreign investors. Meanwhile, the mark continued to suffer from comparison between the recoveries in Germany and in the United States. Under these circumstances, the mark was trading at DM2.9170, near 11 and a half-year lows against the dollar early in August. Its margin over other currencies within the EMS had also been significantly reduced.

After trading steadily in seasonally thin markets for several weeks, the mark again began to decline as the dollar rose early in September. As the mark's fall progressed, market participants questioned whether the German authorities would act to stop the decline. The economic justification for doing so was unclear. Additional stimulus to Germany's export sector—already the

driving force to economic recovery—was seen in the market as a welcome boost to the economy and a spur to employment. Meanwhile, depreciation was not generating any evident pickup in inflationary pressures, partly because of the weakness of world commodity prices. Moreover, market participants were unsure what policy tool the authorities might use if they chose to act against the mark's decline. The Bundesbank had emphasized before, when the mark was also declining against the dollar, that it did not intend to tighten monetary policy. As for official intervention, remarks of Bundesbank officials pointed to its limited effectiveness in resisting fundamental market trends.

In fact, the Bundesbank had been intervening regularly at the Frankfurt fixings and on occasion at other times in the open market. These operations, at least during August, just about offset interest earnings and other inflows into Germany's reserves, so that the foreign exchange reserves showed little net change from end-July's \$38 billion level. When the dollar's rise accelerated, pulling the mark rate down to DM3.1765 on September 21, the Bundesbank intervened more aggressively. Its actions, followed by other European central banks, helped the mark to bounce back up immediately. For several days thereafter, market participants were extremely wary of possible further dollar sales by the Bundesbank, and rumors of other large operations circulated widely. For the month of September, Germany's foreign exchange reserves fell \$2.7 billion.

The U.S. authorities had purchased \$50 million-equivalent of marks on one occasion early in September. After the Bundesbank's action of September 21, they purchased a total of \$135 million equivalent of marks during three days from late September to early October to counter disorderly markets. These purchases were shared equally between the Federal Reserve and the Treasury.

Immediately after the central bank interventions the mark traded generally between DM3.00 and DM3.10. In early October the mark received a further lift when the cabinet announced repeal of Germany's 25 percent withholding tax on German securities held by non-residents, retroactively to August 1, sparking renewed foreign interest in German bonds. But soon thereafter, the mark began to drift lower against the dollar and to a lesser extent most other currencies. In mid-October, when the mark was approaching the lows of September and trading at DM3.1575, the Bundesbank again intervened. The U.S. authorities also bought \$95 million-equivalent of marks on one occasion to counter a renewed outbreak of disorderly market conditions.

The mark then rallied. Market participants had become impressed that the Bundesbank and others were

Table 3

Drawings and Repayments by Foreign Central Banks under Special Swap Arrangements with the U.S. Treasury

in millions of dollars: drawings (+) or repayments (-)

	1984 II	1984 V	1985 January	Outstanding January 31 1985
Drawings on the United States Treasury				
Central Bank of the Philippines	0	{ +45 -45	0	-0-
Central Bank of the Argentine Republic	-0-	+500	{ -230 -270	-0-

Data are on a variable basis.

resisting the generalized rise of the dollar. Furthermore, the economic environment appeared to have shifted in Germany's favor since mid-summer. Statistics were released indicating that the economy had revived strongly during the summer. Exports continued to be the principal boost to output and earnings. But for the first time the export boom appeared to be spilling over to other sectors, as reflected in increased domestic new orders for capital goods. U.S. interest rates of all maturities were declining, so that the market no longer perceived the Bundesbank as having to resist a gradual decline in German rates to obtain a narrowing of adverse interest differentials to strengthen the mark. Under these circumstances, market professionals began to build up long positions in marks in the expectation that a major adjustment in the dollar-mark relationship was about to occur. The bidding for marks pushed the spot rate up 9 percent to DM2.90 in the first week in November.

But after November 7, the mark changed direction and declined as the dollar strengthened for the balance of the period under review. At first the selling of marks appeared to be dominated by corporations and others that had postponed dollar purchases required before the year-end in hopes of taking advantage of the expected rise in the mark. Before long the selling of marks broadened as expectations of a generalized decline in dollar rates diminished. Speculators in the futures markets and dealers in commercial banks liquidated much of their long mark positions by year-end. Moreover, international investors, no longer as concerned that a decline in the dollar would erode their total return on dollar-denominated securities, came back to U.S. securities markets in size. With investors attracted by the remaining interest differentials favoring the dollar and the prospect of profits as U.S. interest rates continued to decline, the dollar quickly came to overshadow the mark in the exchange markets. By January 11, the

mark had been pulled down to a record low for the floating rate period of DM3 2020.

The Bundesbank had continued to operate in the exchange markets to sell dollars. These operations contributed to a \$950 million decline in Germany's foreign exchange reserves during the three months October to December. But German authorities were also attempting to modify their money market management to ensure that German banks not have permanent recourse to large amounts of Lombard loans at the central bank and they were concerned that larger dollar sales might complicate this endeavor. Accordingly, by January, central bank money was increasingly being provided through security-based repurchase agreements, sometimes at interest rates slightly below the Bundesbank's Lombard rate. Foreign exchange market operators at times misread the central bank's actions as signaling a desire for short-term interest rates to ease. In fact, the Bundesbank had announced that its monetary growth targets for 1985 would be lower than for the previous year, at 3 to 5 percent. Bundesbank officials pointed to the impact of the mark's continued decline on import prices, thereby suggesting there was little scope for easing monetary policy. Yet the market's misinterpretation of the Bundesbank's intentions for money market rates was not fully dispelled until the Bundesbank announced it would raise the Lombard rate half a percentage point, to 6 percent, effective February 1.

In any case, by the time the mark hit its mid-January low, market attention was focused more on the rise of the dollar than the decline of the mark. Other currencies, too, were weakening sharply, most especially the pound. As a result, when market participants became aware that a G-5 meeting of finance ministers and central bank governors was to take place in Washington on January 17, they began to expect a concerted intervention operation. Between the middle of January

and the close of the period, there were joint intervention operations in which the U.S. monetary authorities purchased \$94 million-equivalent of marks. These operations, like those earlier in the period, were shared equally between the Federal Reserve and the Treasury and were conducted to resist a renewed rise in the dollar.

At the end of January the mark was above its lows, trading at DM3.1670 against the dollar. But it was 3 percent below its high reached in early November and 8½ percent below end-July levels. Germany's reserves declined a further \$821 million in January to close the period at \$34 billion.

Within the EMS, the mark's attraction as an investment vehicle for private-sector investors weakened in relation to other EMS currencies, as well as to the dollar. Economic performance and macroeconomic policies among EMS countries were showing growing convergence. Other European countries were adopting more market-oriented policies. Against this background, the persistence of wide, unfavorable interest differentials at a time when inflation differentials were narrowing and prospects for a new currency realignment were appearing remote led virtually all the EMS currencies to strengthen relative to the mark. The authorities of other EMS countries took advantage of this development to buy substantial amounts of marks in the market to add to reserves.

Sterling

At the beginning of the period under review, a five-month decline of sterling against the dollar was ending, with the currency trading around \$1.30 and between 78 and 79 according to the Bank of England's trade-weighted index. After mid-October, however, the pound became increasingly vulnerable to selling pressure, and by December it was falling across the board. The downward pressure continued in January. For the period as a whole, the pound fell 15 percent against the dollar and 9 percent in terms of the Bank of England's trade-weighted index.

In August and September, sterling traded steadily against other European currencies, even though all were declining against the dollar. The British authorities' resolve to adhere to their medium-term financial plan calling for cuts in monetary and public-sector borrowing growth had recently been reaffirmed. The Bank of England ratified a substantial increase in short-term British interest rates, that restored an interest rate advantage for the pound relative to the dollar. Although the pound declined 8½ percent against the dollar to \$1.22 as the dollar advanced generally, it did not move below 76.6 on the trade-weighted index. The overall steadiness of sterling and an apparent moderation in the

growth of British monetary aggregates permitted staged reductions in short-term sterling interest rates during August totaling 1½ percentage points. With these cuts the interest differentials favoring sterling were more than eliminated.

Notwithstanding the pound's steadier tone in the exchange markets, a number of factors undermined market confidence that the British authorities would hold to their anti-inflation policies. Britain's economy, in its third year of expansion, was showing signs of losing momentum while unemployment was still rising. No progress was being made in bringing inflation down below 5 percent or in slowing the rise of unit labor costs, by then increasing more rapidly than in other industrial countries. Meanwhile Britain's current account position was deteriorating, despite a pickup in demand in major export markets, because of a sharp jump in imports. A lengthy strike by coal miners was having an adverse effect on production, as well as the balance of payments since imported oil was being substituted for domestically-produced coal. Moreover the oil sector, which had been accounting for more than half of the economy's recent growth and had kept Britain's current account in surplus, was no longer seen as a reliable source of strength. With predictions that North Sea oil production would peak in the next couple of years, the stimulative effect of the oil sector on the economy was expected to wane. In the meantime the contribution of net oil exports to Britain's balance of payments was expected to be undercut if an apparent weakness in oil markets led to any significant drop in petroleum prices.

Britain's domestic economy and external position were thus perceived to be in precarious balance. Market participants paid close attention to any development thought capable of forcing the government to have to choose between supporting further growth and employment or dealing with pressures on prices, costs, and the exchange rate. Thus, prospects of a possible spreading of the coal miners' strike and of a reduction in oil prices set the stage for an abrupt but limited drop in the exchange rate around mid-October. Within a week, the pound slid below \$1.20 against the dollar and to 74.0 against the trade-weighted index.

For about two months, the pound then steadied. The coal miners' strike failed to widen and downward pressure on oil prices was being contained as long as OPEC discussions on ways to deal with weak oil prices continued. The pound traded within a range of 74 to 78 according to the trade-weighted index. Against the dollar it moved in line with other European currencies, rising during late October and early November before falling back below \$1.21 early in December. With the pound again trading more steadily, British short-term interest rates continued to ease largely in line with the decline

in Eurodollar rates. By mid-December, the British clearing banks had cut their base lending rates from the mid-summer highs by a total of 2½ percentage points to 9½ or 9¾ percent.

From December on, sterling began to fall sharply against all currencies, setting successive new lows in terms of both the dollar and the trade-weighted index. Selling of sterling was stimulated by the expectation that OPEC would have difficulty reaching an effective agreement on price differentials. In addition, the market's underlying concern intensified that the authorities were shifting their priorities for economic policy toward spurting output. Growth of public-sector borrowing was turning out well in excess of the government's target, only partly because of strike-related expenditures. Credit extended to the private sector also showed signs of accelerating. The monetary aggregates remained near the top of their official target ranges. Admittedly, the monetary aggregates were distorted in December by a stock issue. But market participants, interpreting the evidence at hand, concluded that the Bank of England would be reluctant to see a reversal of the interest-rate declines of the past several months even to stem a fall in the exchange rate. Market participants also came to doubt the authorities were prepared to use intervention to resist a renewed decline in sterling. Official declarations and actions suggested the authorities were willing to let the pound fall if dictated by market forces.

Under these circumstances the pound dropped steadily, falling most precipitously in mid-January when the OPEC negotiations appeared to be under particular strain. The pound touched a low against the dollar of \$1.1015 in Far Eastern trading on January 14 and of 70.6 against the trade-weighted index at the opening in London that same day. As the exchange rate fell, the authorities did not resist a rise in money market interest rates. The Bank of England at one point seized the initiative to push interest rates up further, to the levels of mid-summer. In the end, sterling interbank rates rose even more—for a total increase of 4½ percentage points to 14 percent. At that point interest rate differentials were again strongly in favor of the pound, reaching a level of 3½ percentage points for three-month deposits relative to the dollar.

Late in January, the high level of sterling interest rates made selling the pound short expensive. In addition, OPEC had demonstrated an ability to work out a limited agreement on pricing differentials, and spot oil prices firmed. Thus, the immediate pressures against the currency abated. In addition, sterling benefited from market talk of stepped-up central bank intervention following the mid-January G-5 meeting in Washington. Although the pound remained subject to sporadic pressure through the end of the month, it traded without clear direction.

The pound closed slightly above its low at \$1.1275 and 71.5 in terms of the Bank of England's trade-weighted index.

British foreign exchange reserves were little changed on balance between end-July and the end of December. Then for January, they dropped \$233 million to \$6.73 billion as of the end of the period.

On December 18, the Chancellor of the Exchequer, in reply to questions in Parliament, stated that the Bank of England would no longer request foreign monetary authorities to restrict sterling balances to working levels, thereby ending formally an agreement the government felt was no longer appropriate to the current international monetary setting. The announcement did not cause any visible impact on exchange rates at the time.

Japanese yen

Over the six-month period under review, the Japanese yen eased against the dollar but appreciated against the European currencies. A record-breaking pace of long-term capital outflows continued to be a source of downward pressure on the currency against the dollar. Outflows of Japanese resident capital were attracted in part by relatively high interest rates abroad. They also reflected the continuing diversification of financial assets by Japanese investors and increased yen lending to foreign borrowers. Meanwhile, some non-residents that had been among the largest investors in Japanese securities several years ago continued to liquidate their holdings at maturity, largely to meet payment needs. The net long-term capital outflows swamped Japan's large and growing current account surplus, which was reaching \$35 billion for the year. At times, however, favorable shifts in commercial leads and lags gave a boost to the yen against all currencies. *Vis-à-vis* the European currencies, Japan's large current account surplus and robust domestic economy was an important source of strength.

At first, the yen got some respite from the full brunt of the capital outflows that had helped to push the spot rate down to ¥246.45 by the start of the six-month period. The outflows subsided in August as foreign investment in Japanese equities resumed during a late-summer rebound in the Tokyo stock market. Also, Japanese investors slowed their net purchases of foreign securities ahead of the end of the financial half-year in September. Thus, the yen advanced to ¥242 early in August and traded steadily against the dollar at that level for several weeks.

During September and October, the yen also received a lift from a favorable swing in commercial transactions. The yen started to ease against the dollar which had become well-bid across the board. But market participants expected this weakness to be short-lived, antic-

ipating that the dollar would soon decline in response to declining U.S. interest rates. Thus, as the yen fell through the lows of late July-early August and toward the ¥250 level, Japanese exporters stepped up their selling of dollars to take advantage of the current dollar rate. Meanwhile importers postponed their currency purchases. At the same time, Japan's imports of oil slowed so that the net export balance was unusually favorable.

With these trade transactions favoring the yen and capital outflows temporarily subdued, the yen's decline against the dollar was more gradual than the decline of the European currencies during September and early October. The yen did touch a two-year low of ¥250.45 on October 17, but it gained 7 percent against the German mark to trade near a record high vis-à-vis that currency. Moreover, the yen recouped its losses against the dollar during late October when the dollar eased back. By early November the yen was again trading near the ¥240 level against the dollar and reached a high for the six-month period of ¥239.40 on November 7.

Meanwhile, the changing economic environment abroad had several implications for Japan. The slowdown of the U.S. economic expansion in the third quarter of 1984 seemed to show up almost immediately in a sharp deceleration of Japan's export growth. As a result, Japan's external position actually had a negative impact on GNP the same quarter. In addition, the decline in U.S. interest rates, widely expected to be further encouraged by cuts in the Federal Reserve's discount rate, contributed to a substantial easing of long-term interest rates in Japan. Japanese enterprises shifted their expectations about immediate financing requirements and the future costs of funds. Credit demand softened and corporate borrowing increasingly took place at shorter maturities.

Against this background, there was discussion in the fall that a reduction of the Bank of Japan's official interest rates could entail large potential benefits and low risks for the Japanese economy, given Japan's restrictive fiscal policy, low inflation, and the more restrained economic growth outlook. Bank of Japan officials were concerned, however, that any further drop in Japan's relatively low short-term rates would put further pressure on the yen exchange rate at a time when the size of Japan's current account surplus was threatening to provoke protectionist reactions in major export markets. It therefore kept its discount rate at the 5 percent level established a year earlier with the result that short-term interest rates remained steady.

As a result of these interest rate developments, the interest differentials adverse to the yen narrowed somewhat for long-term rates and declined even more

for short-term rates. But market operators began to waver in their expectations that the yen would strengthen further in response to this narrowing of interest differentials, because the dollar generally had eased relatively little from its highs of October.

Thus, the allure of the remaining interest differentials favoring the United States and of prospects of significant further capital appreciation on dollar-denominated bonds began once again to weigh on the Japanese yen. Toward the end of the year Japanese investment in foreign securities mounted. The December U.S. government issue targeted at foreign investors, as well as the offering of British Telecom shares, were well received in the Tokyo market. Thus, net capital outflows jumped up in November and December to \$5 billion and a record \$8 billion, respectively. In the year as a whole net long-term capital outflows from Japan rose to \$50 billion. At the same time, market participants noted that foreign private borrowers rushed to take advantage of the opening of the Euroyen market to them, effective December 1, to place yen issues. To the extent these issues were purchased by Japanese residents the transactions contributed to Japan's capital outflows.

Commercial leads and lags also began to shift against the Japanese yen. When expectations of a decline in the dollar faded, importers who had postponed their currency purchases came to fear that exchange rates would become even more unfavorable if they waited any longer. Meanwhile, exporters had already converted some of their foreign currency proceeds ahead of schedule.

As a result, the yen progressively weakened against the dollar, falling over 6½ percent from its early November high to ¥255.40 by the end of January. At this level it was down 3½ percent on balance during the six months, although against the major European currencies, it rose nearly 5 percent.

Throughout the six-month period the Bank of Japan intervened in the foreign exchange market in comparatively small amounts. Following the meeting of the G-5 in mid-January, the prospect of an increase in coordinated intervention made market participants wary of speculating too heavily against the yen. However, the concern was not sufficient to stem the yen's slide. In total, intervention sales of dollars offset only a fraction of Japan's interest earnings on its foreign exchange reserves, which rose \$1.6 billion over the six-month period to close at \$22½ billion.

European Monetary System

During the period under review, there was a growing convergence of economic performance among EMS countries. Recovery had spread to all. The countries showing the greatest improvement in 1984 were those

that had still been in recession during 1983. Inflation was continuing to decelerate, with the countries showing the greater declines being those with the higher inflation rates a year before. In general, current account positions were either stable or continuing to improve.

In all cases, the economic expansion proved insufficient to reduce historically high levels of unemployment. Yet fiscal and monetary policies were generally restrained. Fiscal policies were aimed at reducing the size of the government deficit relative to GNP, with actual results varying depending on the burden of unemployment compensation and interest payments on government debt. Monetary policy was generally unaccommodating. Interest rates were allowed to ease only in response to declines in other countries or to improvements in inflation and fiscal deficit control at home.

Under these circumstances, the exchange rate relationship within the EMS remained free from strain during the entire period under review. Early on, most of the EMS currencies were clustered within 1 percent of their bilateral parity rates. The only exception was the Italian lira, which started near the upper limit of the wider, 6 percent limit established for that currency. The German mark and the Dutch guilder alternated as the topmost currency within the narrow band against the Belgian franc at the bottom. During the period, the German mark and Dutch guilder fell progressively, albeit unevenly, to the lower part of the band. The two currencies fell below the Danish krone and the Irish pound by early September, dropped below the French franc late in November, and approached the bottom of the narrow band to trade below the Belgian franc by early January.

The strength of other currencies vis-a-vis the mark presented many EMS countries with opportunities and policy choices. One option, chosen by the Belgian, French, and Italian authorities, was to take advantage of the lack of pressure to build their foreign currency reserves. Prior to the period, the Belgian National Bank had been able to begin reducing its liabilities to the European Monetary Cooperation Fund (EMCF), using the proceeds of the government's external borrowings. During the six months under review, the Belgian central bank was able to continue this program, not only with proceeds of further borrowings, but also with foreign currencies acquired in the market. By the end of the period, Belgium had fully restored its European Currency Unit (ECU) position in the EMCF and increased foreign currency reserves more than \$500 million over the six months. Before the period, the French and Italian authorities had already restored their foreign currency reserves to the levels prevailing before the last EMS realignment. However, they continued to buy substantial

amounts of marks along with some other currencies.

Another option, chosen in a small way by the French and Italian authorities, was to ease some of the exchange controls imposed during earlier periods of pressure against their currencies. On December 1, the French authorities announced a partial lifting of controls on the transfer of funds abroad by individuals and corporations and permitted Economic Community institutions to float ECU-denominated bonds in the French market. On December 1, the Italian authorities announced reductions in the non-interest-bearing deposit required against residents' investment abroad and eased restrictions on foreign exchange accounts as well as on the means of payment to be used by Italians traveling abroad.

A third option was to take advantage of the relative strength of the currency to lower interest rates. In France and Belgium the authorities cautiously permitted an easing of interest rates once the foreign currency reserve position was restored and after inflation had shown clear signs of moderation. The French authorities also took advantage of moderating domestic credit demands to replace the strict guidelines on banks' credit, known as the *encadrement du credit*, with a more flexible credit control system.

But in general the authorities perceived the scope for lowering interest rates to be limited. Faster or more substantial cuts in interest rates were judged to be inappropriate in view of the remaining inflation differentials vis-a-vis Germany, the continuing need to finance a large budget deficit, or the financing requirements of a current account deficit. In both Italy and Ireland, interest rates were actually increased. The Bank of Italy temporarily raised its discount rate one percentage point to 16.5 percent in September to curb growth in bank credit that was exceeding its target range. When credit growth moderated, however, the Bank of Italy cut its discount rate back to 15.5 percent in recognition of the continuing progress in reducing inflation to below double-digit rates.

Thus, interest differentials among EMS countries remained relatively wide and did not narrow as rapidly as, for example, the inflation differentials. Residents in countries with still relatively high interest rates increased their borrowings in international markets, partly to finance domestic operations, while short-term capital movements through the banking sector also flowed to the centers with higher rates. Judging these inflows to be potentially reversible, the central banks chose to resist a substantial appreciation of their currencies within the EMS through intervention.

Against the dollar, the EMS currencies fluctuated generally in line with the German mark, weakening most of the period under review with the only major reversal

during October and November. By the end of January many of these currencies were trading at record lows against the dollar, and all were some 8 percent below end-July levels.

Although several of the EMS central banks at times intervened in dollars to limit the decline of their currencies against the dollar, total dollar sales by central banks other than the Bundesbank were moderate for the period as a whole. In any case, by end-January, the EMS central banks had purchased considerably more EMS and other currencies in the exchange market than they had sold dollars.

Swiss franc

As the period under review began, Swiss interest rates were under some upward pressure. Throughout 1984, the monetary authorities in Switzerland aimed at controlling inflation by monetary restraint, adhering to a targeted rate of growth of about 3 percent for the central bank money stock. They held to this goal even though economic recovery slowed during the second half of the year. The economic recovery, though moderate by historical standards, was sufficient to generate a modest pickup in credit demands and some increase in interest rates. In addition, domestic financial markets were somewhat unsettled by the decline of the Swiss franc from its peak in March that amounted to nearly 19 percent *vis-à-vis* the dollar and about 2 percent *vis-à-vis* the German mark by the end of July. These declines had brought the spot rate down to SF2.4745 and DM.8493 by the opening of the period.

During August the Swiss franc steadied. Although short- and long-term interest rates in Switzerland remained the lowest of any of the industrialized countries, the tightening of money market conditions in Switzerland combined with other factors to begin to reverse the decline in the Swiss franc. Interest rates in Switzerland were rising at a time when rates elsewhere were either steady or declining. Interest differentials, while still adverse *vis-à-vis* both the dollar and the German mark, narrowed. In addition, non-residents had significantly reduced their issuance of Swiss franc-denominated bonds. Also, there had been a particularly sharp drop in bond placements—and therefore in the ensuing conversion of bond proceeds into dollars—by Japanese firms whose ability to offer attractive terms on bonds with stock warrants became compromised by a poor performance of Japan's stock market during the second quarter. Nor did Swiss franc bonds offer as much prospect for capital appreciation to attract investors as did bonds denominated in currencies where interest rates were declining.

The Swiss franc therefore recovered irregularly

against the dollar to reach its high of the six-month period of SF2.3650 on August 16. The franc recovered against the German mark for somewhat longer, moving to a level below DM0.82 after mid-September.

During late September and October, when European currencies were generally fluctuating widely *vis-à-vis* the dollar, the Swiss franc moved with the German mark, but not as widely. The Swiss franc was not the focus of selling pressures prior to September 21. Thereafter, it did not benefit as much from intervention. The Swiss authorities made it clear that they did not intend to intervene aggressively in the exchange markets out of concern that they might then have to deviate substantially from their domestic monetary policy objectives. When the dollar fell back in late October, the Swiss franc was again trading close to its highs for the period against both the dollar and the mark.

Thereafter, however, the franc began to lose ground relative to both currencies. This weakness in the franc followed statistical releases confirming that inflation continued to be higher and growth lower than in Germany. Also, the franc did not benefit, as the mark did, from continuing expectations of central bank intervention. The National Bank, having kept its restrictive 3 percent target for growth of central bank money for 1985, was perceived as reluctant to add further upward pressure on domestic interest rates by intervening in the exchange markets. The franc declined more rapidly than the mark as the dollar strengthened across the board during late December and January. The franc closed the period at SF2.6830, down 8½ percent relative to the dollar for the six months.

As the franc began again to decline in late 1984, market commentators started to attribute the move at least in part to a long-term loss of the franc's international appeal. They suggested the franc might be suffering from an erosion of its "safe haven" status in the face of worldwide reductions in inflation and the perception of an increasingly fragile political environment in Europe. Some also suggested that the transactions demand for the currency had diminished to the extent that the franc has lost attractiveness as a trading vehicle. As for foreign exchange dealing, the dollar/mark relationship was volatile enough to provide sufficient profit opportunities in markets larger in size and permitting bigger transactions. As a medium for investment, the franc was being overshadowed by other currencies, most especially the dollar.

The Swiss National Bank did not intervene in the exchanges during the August-January period. Swiss reserves fluctuated as the central bank used currency swaps to adjust domestic liquidity, closing virtually unchanged from end-July levels.

Canadian dollar

Just before the period opened, the Canadian dollar had shaken off the severe selling pressures of the earlier part of the year. In mid-summer, Canadian interest rates had moved up, restoring a positive differential in favor of the Canadian dollar. With money market rates well above corresponding U.S. rates at the start of August, the cost of short Canadian dollar positions had become expensive. Thus professional selling of the currency subsided and commercial leads and lags came into better balance. Also a public debate faded over whether economic policy should give priority to reducing unemployment or dealing with inflation. The Canadian dollar rose from the historic low of Can.\$1.3368 (\$0.748) against the U.S. dollar reached in mid-July to Can.\$1.3094 (\$0.764) by early August.

During the period under review, a number of factors supported the Canadian currency which, along with the U.S. dollar, rose relative to the other major currencies. Canada's current account was in surplus, buoyed by a strong export performance. Canada's economy revived in the third quarter, catching up for slower growth earlier in the year. Meanwhile, inflation continued to moderate, falling to below 4 percent at an annual rate. In addition, a change in government at the September national elections encouraged market participants because of the new governing party's advocacy of policies to encourage foreign investment in Canada, to reduce governmental intervention in the economy, and to cut government expenditures. These ideas were reaffirmed in November when the government gave a statement to Parliament of its intended legislative program.

Yet market confidence in the Canadian dollar was not fully restored. The public debate preceding the election had left uncertain the priority any government would place between lower interest rates to stimulate the

economy and higher rates to fight inflation. By mid-winter there was also some doubt that the new government would be able to implement its program of fiscal restraint. Moreover, large corporate transactions occasionally weighed on the market for Canadian dollars at times.

Under these circumstances, the Canadian authorities moved cautiously to take advantage of the decline of U.S. interest rates to avoid an outbreak of revived pressure against the currency. Canadian interest rates at first did not decline as quickly as U.S. rates, and by mid-October the interest differentials vis-à-vis the U.S. dollar were even wider than in early August. Thereafter, Canadian interest rates did ease more in line with U.S. interest rates, maintaining the wider differentials for the balance of the six-month period.

Against this background, the Canadian dollar fluctuated without clear direction against the U.S. dollar, declining less than other currencies. On balance it declined 1 $\frac{1}{4}$ percent to Can.\$1.3258 (\$0.754) by end-January. The Canadian dollar thereby continued to appreciate against other currencies during the period under review, benefiting at least in part from high yields on Canadian assets and the currency's relative firmness against the U.S. dollar to attract sizable capital inflows from abroad.

Foreign exchange intervention by the Canadian authorities was aimed at smoothing out sharp movements in the currency. Total foreign currency reserves fell by \$1.2 billion, mostly in August and November, to stand at \$1.5 billion at the end of the period. The declines primarily reflected repayments of outstanding foreign exchange drawings made earlier in the year on the government's credit lines with Canadian and foreign banks.

THE ECONOMY

FORTUNE FORECAST DON'T COUNT INFLATION OUT

The rapid money growth that began 2½ years ago hasn't yet shown up in inflation. But that will change in 1985, says a leading monetarist, as the forces that suppressed inflation wane.

ONE OF THE major accomplishments President Reagan proudly claimed in his reelection campaign was low inflation. While the Administration blamed the recessionary rigors of 1981 and 1982 on previous economic policies and on a tightfisted Federal Reserve, it cheerfully took credit for the dramatically lower inflation rate that followed the Fed's actions. Now some in the Administration suggest that inflation has been cured and that monetary policy should be aimed at pushing the economy more rapidly toward full use of its resources.

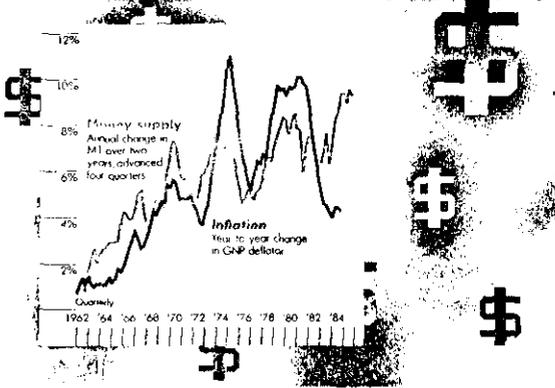
But inflation has been deferred, not cured, and stoking the economy with faster money

This guest column is by ROBERT SINCKE, a monetarist who is chief economist at the brokerage house of Bear Stearns. FORTUNE's own 18-month economic forecast will appear in the next issue.

growth would be shortsighted. Each recession in the last 20 years resulted from monetary policies designed to fight an unacceptably high level of inflation. That level has risen steadily over the past decade: a 5% rate in 1971 led to the imposition of wage and price controls, while today 5% is considered tame. The economic outlook for 1985 depends both on today's definition of an unacceptable inflation rate and on the likelihood of inflation breaching that level.

A Rise Is in the Cards

Other forces may postpone the results, but inflation eventually follows M1 growth (shown as a two-year rate to smooth fluctuations). And the trend of M1 suggests rising inflation ahead.



There are few guidelines for estimating the rate policymakers consider unacceptable, but Fed Chairman Paul Volcker has often said the U.S. should not have suffered through the 1981-82 recession only to squander the progress it has made against inflation. The rate troughed in the 3% to 4% range in 1983, and the Fed would probably like to keep cyclical pressures from increasing it by more than two percentage points. As a result, 5% to 6% would appear to be the upper end of an acceptable range for 1985. If inflation pierces the 6% level, the Fed would be likely once again to make fighting inflation a top priority, even at the risk of significantly slowing economic growth or causing a recession.

Judging by the recent course of inflation, there may not seem to be much danger of exceeding the critical level in 1985. Over the last year consumer prices and the GNP fixed-weighted price deflator, a broader measure of inflation, have increased an average of 4.2%. But a look at recent business cycles shows this performance cannot be relied upon as a harbinger of future trends.

During each of the economic recoveries of the 1970s, the rate of inflation continued to decline well into the expansion. Although the economy began to pick up in December 1970—responding to accelerating money growth—the inflation rate did not revive until July 1972, 20 months into the recovery. Similarly the economic expansion of the late 1970s began in April 1975, but the rate of inflation continued to decline into 1976, reaching a trough of 3.3% in the spring. In both instances, however, inflation accelerated markedly in later stages of the recovery, following the course of earlier rapid growth in the money supply. The message seems clear: good inflation performance early in an economic recovery does not guarantee continued low inflation into the third year of expansion.

Evidence across time and across countries indicates that inflation is a monetary phenomenon—too much money chasing too few goods and services. Monetarists argue over the appropriate definition of money, but most have come to agree that the best measure is M1, which includes currency and checking account balances. Most also agree that M1 growth leads the inflation rate by about one to two years. And the trend of monetary growth since the summer of 1982 suggests that the best inflation news is behind us. Over the next year the inflation rate should move steadily higher.

According to strict monetarist models, inflation should already be raging in the 8% to 10% range—which is what some monetarists forecast a year ago. But while M1 growth provides valuable information about the trend of inflation, the actual rate of inflation often deviates from the rate of M1 growth for long periods. Nonmonetary forces—particularly isolated shocks—can often push inflation well above or well below the trend induced by monetary growth.

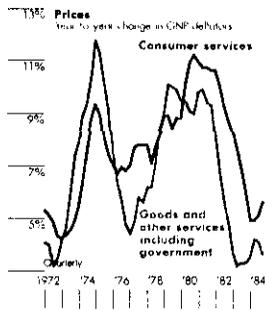
During the mid-1960s, for example, inflation remained consistently below the rate of monetary growth. The Kennedy wage and price guidelines helped keep wage demands down through the early part of the decade, along with strong capital spending and productivity growth, that restrained unit labor costs. In addition, inflation expectations moved upward slowly.

From 1974 through 1981, by contrast, the inflation rate remained consistently above the trend of monetary expansion. Wages spurred to make up for the ground lost to prior inflation; because productivity growth was poor, unit labor costs soared. Worldwide crop shortages boosted agricultural prices in 1973 and 1974, and energy prices soared after the two oil shocks. Finally, the flight from U.S. dollar-denominated assets in the late 1970s drove the dollar down and increased the cost of imports, allowing domestic manufacturers to raise their prices freely. In both periods the trend of M1 growth accurately forecast the trend of inflation, but actual changes in inflation rates departed from the trend because of a combination of nonmonetary forces.

In the first half of the 1980s a different set of nonmonetary forces came into play, and inflation is once again running consistently below a monetary-induced rate. While some of these forces are likely to remain at work for the longer run, others are temporary. The major ones:

► **DECLINING COMMODITY PRICES.** Desperately short of cash, many less developed countries (LDCs) have been pushing exports of basic materials and depressing prices—in some cases to their lowest levels in real (inflation-adjusted) terms since the Depression. The most obvious example is oil, where strong production in the face of slow demand has been putting downward pressure on prices over the last couple of years. **The LDCs' lingering debt problems could keep commodity prices weak at least through 1985.**

► **BETTER PRODUCTIVITY.** Capital spending has enjoyed an extraordinary surge in the current expansion, and during the third quar-



Services Tell the Tale

Strong dollars and weak commodity prices have kept the costs of goods down, but consumer services reflect the growth of money.

ter claimed a postwar record share of real GNP. This strong increase in capital formation against the backdrop of a slower-growing labor force suggests that the capital-labor ratio, one of the prime determinants of the trend of productivity, should keep on increasing at an above-average pace. **In 1985 productivity should grow at about the 2½% rate of the early postwar era, moderating unit labor cost pressures.**

► **ABUNDANT CROPS.** Following poor harvests in 1983, the past year produced surpluses in major agricultural commodities, pushing prices lower. While policymakers don't need to anticipate disruptive crop shortages, neither can they count on falling agricultural prices to moderate future inflation.

► **MODEST WAGE INCREASES.** The prolonged 1981-82 recession and strong import competition during the recovery convinced many workers to accept small wage increases—and even reductions. But higher demands from labor are now likely and will offset some of the productivity gains. As unemployment declines and corporate profits remain strong, **hourly compensation is likely to rise at a rate of 6% to 7% during 1985.** That would be a significant increase from the 4.4% average of the last year.

► **THE STRONG DOLLAR.** Nothing has done more to hold down inflation in recent years than the soaring dollar. Since the autumn of 1980 its trade-weighted value has risen 74%, with a dramatic 16% gain since March 1984 alone. By depressing import costs and generating strong competition for domestic pro-

ductors, the rising dollar has by most estimates reduced the reported inflation rate by one to two percentage points over the past 18 months. Recent signs of stability suggest that the dollar won't help as much in 1985—a prospect that has worried Federal Reserve officials all year.

The dollar's impact can be seen most clearly in the differences between the inflation rates for goods and for services (see chart at left). Though inflationary pressures began to mount early in 1981, the sharp rise in the value of the dollar pushed price inflation for goods back down. During the last two quarters, inflation in the non-consumer-services sector of the economy slowed to a 3% annualized pace. But inflation in the consumer-services sector, which now makes up about 30% of GNP, was unaffected by the dollar. And it has been gathering steam steadily since early 1984, just as underlying monetary growth conditions would suggest. During the last two quarters, prices of consumer services accelerated to a 6.6% rate, up from 4.7% in the prior two-quarter period.

The message of the movement in service prices is that inflation is on an upward trend. It reached its low point late in 1983 and is now following the acceleration of monetary growth that began in mid-1982. The nonmonetary factors that have held it down—factors that did not suppress the underlying rate of inflation revealed in the service sector—should diminish in importance. In 1985 inflation should rise at a rate closer to its monetary-induced rate of about 8%.

How close the actual rate is depends largely on the dollar. Assuming that the trade-weighted value of the dollar stabilizes near current levels during the next six months, **the inflation rate could pierce the critical 6% level by midyear and reach a cyclical peak of up to 7% by year-end.**

Based on a monetarist analysis, therefore, inflation is going to force some unpleasant choices on policymakers during 1985. The extraordinarily favorable combination of strong real growth and low inflation is already beginning to unravel. Growth, it now appears, could come to a halt in the first quarter and resume gradually during the second. **Over the year, real GNP growth will average 2½%.** And as price increases start to accelerate during the second-half pickup, the Federal Reserve will crank up its inflation-fighting efforts. The combination of higher inflation and monetary restraint will likely raise interest rates—particularly short-term rates—and bring an end to the economic expansion by early 1986. □

FEDERAL RESERVE press release



For immediate release

March 8, 1985

The Federal Reserve Board today announced a two-part modification in its seasonal credit program. The changes are designed to provide further assurance that small- and medium-sized agricultural banks can meet temporary liquidity requirements that might arise in accommodating the needs of their farm borrowers over the forthcoming planting and production cycle.

While the great bulk of farm banks appear to have adequate liquidity, the modifications are designed to ensure that liquidity strains do not hamper the necessary flow of credit in various local areas. The modified program to meet seasonal liquidity needs complements loan guarantee actions taken by the administration to help assure a necessary flow of credit to agriculture.

The seasonal credit program, which has been in place for many years, provides access to discount window borrowing for institutions that demonstrate recurring financing needs related to seasonal fluctuations in their deposit flows and loan demands. The program has been modified by (a) certain changes that liberalize amounts available under the regular program and (b) addition of a temporary, simplified program which may be used as an alternative.

Modification of Regular Program

The regular seasonal program requires an institution to fund a portion of the seasonal swing in its net need for funds (computed from past and projected patterns of deposit and loan variations) from its own resources before it can borrow from the Federal Reserve. The Board has reduced the amount that a bank must fund from its own liquidity.

The formula for computing this deductible has been changed from 4 to 2 percent of the first \$100 million in deposits, from 7 to 6 percent of the second \$100 million in deposits, while remaining at 10 percent of deposits over \$200 million. This change will allow a borrowing institution, especially a smaller one, to obtain a greater portion of its seasonal needs for funds from the Federal Reserve.

In addition, discount officers will be taking a more flexible approach to the administration of the seasonal credit program, particularly in judging whether there are special factors under current circumstances in the farm economy that would modify evaluation of seasonal swings based on historical data. Reserve banks will be making special efforts to acquaint depository institutions with both the regular and temporary seasonal credit facilities.

Temporary Simplified Program

The temporary simplified program will be available through September as an alternative to smaller banks actively engaged in agricultural lending and with no or limited access to the national money market. Such banks generally would have less than \$200 million in deposits and would have a ratio of loans to farmers or for farm real estate to total loans greater than 17 percent (the average for the banking system of the ratio at each bank of farm loans to total loans). Banks with loan-to-deposit ratios of 60 percent or more would be eligible.

For banks that qualify for the program, credit at the discount window would be available to fund half of their total loan growth in excess of 2 percent from a base level, either the average for February or for the two weeks just prior to submission of an application. Credit under this program may not exceed 5 percent of a bank's deposits. It is

expected that credit will be used primarily to fund loans for agricultural or agricultural-related purposes.

Exceptions under the program may be made at the discretion of a Reserve Bank for banks particularly affected by agricultural credit conditions and that lack ready access to national money markets.

As a matter of policy, borrowing under this program would be repaid as the seasonal credit needs abate. In no case should such borrowing, including renewals, be outstanding beyond February 1986.

Interest on credit advanced under the special seasonal borrowing program will be set at a rate that will remain fixed during the time that the credit is outstanding. The rate was initially set at 8-1/2 percent, a rate between the basic discount rate and the rate on extended credit that is outstanding for more than 60 days. The rate for new loans may be changed as the basic discount rate and extended credit rates are changed.

Banks may borrow under either the regular or the temporary seasonal program. They may shift between programs, but may not borrow under both at the same time.

The Board also stressed that the discount window would be available on a regular adjustment or extended credit basis where unusual demands developed in local areas as a result of the agricultural credit situation.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

Division of
Research and Statistics
March 8, 1985

Attached is the press release of March 8, 1985, announcing modifications in the Federal Reserve's seasonal credit program and also announcing a temporary simplified credit program for smaller agricultural banks.

In general, farm credit problems since 1980 have arisen from reduced creditworthiness of borrowers rather than from a lack of loanable funds at lenders. Nevertheless, some agricultural banks appear to be fairly "loaned up," and the temporary program may provide such banks with a useful source of additional loanable funds, should these banks get additional loan demands that they desire to accommodate.

Tables 1 and 2 provide data for agricultural banks that may be useful in analyses and public explanations of the new program. Table 1 indicates that most agricultural banks have ample liquidity; however, 9.9 percent (492 banks) have a loan-deposit ratio of 75 percent or higher, and 20.2 percent (1,004 banks) have a loan-deposit ratio of 70 percent or higher. These data include banks with deposits over \$200 million that generally will not be eligible for the temporary simplified program; however, these larger agricultural banks are relatively few in number, and some of them would be eligible for the regular seasonal program.

Relative net sales of federal funds, shown in Table 2, indicate that it is the banks with these relatively high loan-deposit ratios that may be experiencing liquidity strains. Because of the relatively small size of most of these banks (see average deposits in Table 2), most of them lack ready access to national money markets; therefore, their liquidity strains may be restricting their lending activity. In these circumstances, either the regular seasonal credit program or the new temporary simplified program may be a useful source of additional loanable funds.

Table 2 also shows an interesting correlation between loan-deposit ratio and the relative level of delinquent loans. On the surface, it appears that the more aggressively managed banks from the standpoint of liquidity also tended to make relatively riskier loans. However, other possible partial explanations occurred to me while writing that sentence. Please send me any insights or analyses regarding this correlation, along with any future analyses you may do regarding the new temporary program and its use.

Table 1
 Percentage distribution of agricultural banks by loan-deposit ratio at bank
 December 31

Total loans as a percentage of total deposits at bank	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Total.....	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Under 35.....	14.1	11.9	10.3	7.5	5.4	3.9	3.4	4.7	6.2	7.4	7.6	7.6
35 to 39.....	7.8	6.8	6.5	5.2	3.7	3.3	2.2	3.9	5.3	5.8	5.8	4.7
40 to 44.....	10.7	10.0	9.0	6.8	5.2	4.0	3.6	6.2	7.2	7.4	8.1	7.2
45 to 49.....	12.3	11.3	11.0	8.6	7.6	5.8	5.9	8.9	10.1	9.9	10.4	9.9
50 to 54.....	13.6	13.8	13.2	11.4	10.1	8.9	8.3	11.6	13.8	12.7	12.0	12.1
55 to 59.....	12.6	12.8	13.4	12.1	12.6	11.6	11.4	15.0	14.9	14.8	14.3	13.3
60 to 64.....	11.2	12.2	13.0	13.6	13.8	14.4	15.3	16.7	15.2	13.6	12.7	13.5
65 to 69.....	8.7	10.0	10.4	13.1	15.1	16.3	17.0	14.6	11.8	11.4	11.1	11.4
70 to 74.....	4.7	6.3	6.9	10.2	12.8	14.5	14.6	9.7	8.8	8.0	7.7	10.3
75 to 79.....	2.7	3.0	3.8	6.6	8.0	10.5	11.1	5.1	4.2	5.3	5.9	5.5
80 to 84.....	1.2	1.1	1.5	2.8	3.7	4.6	4.8	2.6	1.5	2.1	2.5	2.7
85 and over.....	.4	.6	.8	2.0	2.1	2.1	2.4	.9	1.1	1.6	1.8	1.7
Addendum: Average loan-deposit ratio (percent).....	54.4	55.6	56.3	59.8	62.5	65.0	65.3	60.7	58.7	58.4	58.2	59.3

Agricultural banks are domestically-chartered insured commercial banks with an above-average farm loan ratio on the date specified. The farm loan ratio at each bank is the ratio of total farm loans ("loans secured by farmland" plus "loans to finance agricultural production and other loans to farmers") to total loans (excluding lease financing receivables). On December 31, 1984 agricultural banks had farm loan ratios above 16.99 percent.

In calculating loan-deposit ratios, total loans include lease financing receivables.

Data for December 31, 1984, are preliminary estimates based on specially edited reports from over 99 percent of all banks, available as of March 8, 1985.

Table 2

Agricultural banks and selected data for such banks, by loan-deposit ratio at bank
December 31, 1984

Total loans as a percentage of total deposits at bank	Number of banks	Average deposits (millions of dollars)	Net sales of federal funds and RFE as percentage of assets	Total farm loans (billions of dollars)	Total delinquent loans as percentage of total loans		
					Total	Fast due and still accruing interest	Nonaccrual and renegotiated
Total.....	4,978	27	4.3	29.9	6.2	4.0	2.2
Under 35.....	379	19	8.0	.8	4.2	3.3	.9
35 to 39.....	236	23	6.6	.8	4.3	3.2	1.0
40 to 44.....	360	24	5.6	1.4	5.0	3.6	1.4
45 to 49.....	492	24	5.8	2.2	5.6	3.9	1.7
50 to 54.....	604	28	5.4	3.3	5.6	3.8	1.8
55 to 59.....	661	28	4.6	3.9	5.8	3.6	2.2
60 to 64.....	673	27	4.2	4.4	6.2	4.0	2.1
65 to 69.....	569	28	3.8	3.9	6.6	4.0	2.6
70 to 74.....	512	35	2.3	4.6	6.5	4.1	2.4
75 to 79.....	273	28	1.9	2.0	7.6	5.2	2.4
80 to 84.....	136	27	1.4	1.2	8.0	5.4	2.5
85 and over.....	83	42	-1.2	1.2	7.0	4.3	2.7

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