

CONDUCT OF MONETARY POLICY

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

Wednesday, February 25, 1987

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

The subcommittee met at 11:15 a.m. in room 2220, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Chairman Neal; Representatives McCollum and Saxton. Chairman NEAL. The subcommittee will come to order.

Today we hold the first of this committee's semiannual hearings on the conduct of monetary policy, pursuant to the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. In that act, Congress declared it to be the continuing policy and responsibility of the Federal Government to use all practicable means to promote full employment and production, increased real income, balanced growth, and a balanced Federal budget.

It is now almost 10 years since the act was passed, but its goals remain as elusive as ever. The Federal Reserve, in its current report to Congress, as required under the act, has set forth its targets and objectives for the coming year. To help us evaluate those objectives and oversee the conduct of monetary policy, I have invited a distinguished panel of expert witnesses, and asked them to assess the current thrust of monetary policy. Tomorrow we will hear from Chairman Volcker.

I have asked our witnesses to address themselves to the substance of monetary policy in the context of today's problems: budget deficits, trade deficits, sluggish economic growth, and exchange rate volatility. I would also like to invite them to reflect on the problem of accountability in monetary policy. Under the Humphrey-Hawkins Act the Federal Reserve is required to render this semiannual report, and to project ranges for monetary aggregates. It is also required to set its goals and targets in harmony with the economic objectives of the administration, and in harmony with the broad goals of the act itself. It is not, however, actually required to achieve monetary growth within any of its projected ranges. It is even free, according to the Fed's own interpretation of its obligations, to drop one of the aggregates, M1, altogether. The requirement that monetary policy be harmonized with the administration's objectives, or with the broad goals of the act, remains largely hortatory.

In short, the only certain consequence of this act is procedural: the rendering of the semiannual report, the appearances of the

Federal Reserve Chairman before the Banking Committees, the testimony of other witnesses, such as those here today, and the general discussion about monetary policy—in Congress, in the financial markets, and among the populace at large—associated with this process.

I certainly do not intend to belittle the process. Indeed, as chairman of this subcommittee, I want to promote discussion, analysis and oversight of monetary policy as vigorously as I can. But I am not certain we have made monetary policy, through this act and this process, as accountable or as transparent as it should be. It may be that a process of public debate and scrutiny is the most workable form of accountability we can achieve. I would like each witness to reflect a bit on this question, which we can turn to in our question and answer period.

We will now hear from each of the witnesses. Your full statement will be put into the record. Please summarize it as you will. Our fine panel this morning is comprised of Dr. Robert G. Dederick, executive vice president and chief economist, The Northern Trust Co., also former Under Secretary of Commerce for Economic Affairs from 1981 to 1983; Dr. Robert Solomon, The Brookings Institution, also former adviser to the Federal Reserve Board and Director of its Division of International Finance; Prof. Robert Eisner, Northwestern University, author of "How Real is the Federal Deficit?" and Dr. Gerald Holtham, visiting fellow, The Brookings Institution, former head of the General Economics Division of the Secretariat of the Organization for Economic Cooperation and Development. Gentlemen, thank you very much for being with us this morning. We certainly look forward to hearing your comments. If you would proceed in the order in which I read the names. Dr. Dederick.

STATEMENT OF ROBERT G. DEDERICK, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, THE NORTHERN TRUST CO., FORMER UNDER SECRETARY OF COMMERCE FOR ECONOMIC AFFAIRS (1981-83)

Mr. DEDERICK. In early 1987, the Federal Reserve finds itself faced with the following operating environment and I would emphasize five features.

First, thanks to the sharp plunge in the dollar, the Nation's trade deficit has started narrowing in volume terms, thus the business outlook appears to have strengthened somewhat, pointing to a 3 percent rise in real GNP on a fourth quarter to fourth quarter basis.

Second, nonetheless, prospects are far from certain. There are, in fact, risks on both sides of the 3 percent forecast—revolving around such unresolved issues as the financial strength of consumers, the impact of tax reform, and the prospective strength of foreign demand.

Third, inflation is moving to a significantly steeper trend path this year, perhaps 4 percent as measured by the Consumer Price Index, and the climb could be even faster now that the dollar has fallen so far.

Fourth, the same sharp fall in the dollar has raised concerns about whether foreign and domestic investors will be willing to hold dollar denominated debt instruments to the same degree as in earlier years.

Fifth, even for those of us who don't view ourselves as monetarists, the rapid growth of money and credit has raised concerns as well—in this case, whether the seeds have been sown for inflation and other financial excesses. Sometimes we wake up in the middle of the night asking ourselves are we missing something.

Clearly, then, conditions have changed greatly from a year ago. In 1986, the Federal Reserve's task was relatively simple; namely, to assure that domestic demand was adequate to prevent the economy from slipping off its slow growth path into recession. Inflation and inflation expectations were sufficiently muted, and belief in the desirability of dollar depreciation was sufficiently widespread here and abroad that the authorities could err on the side of ease with little danger of near-term adverse effects if policy proved to be unnecessarily stimulative. In other words, running room was ample.

Here in 1987, though, life is much more difficult for the monetary officials. To begin with, while the business outlook does appear to have improved, the same also appeared to be true early in 1986—incorrectly, as it turned out. Thus, monetary policy again has to be alert to the danger of near-term recession, with all its adverse implications for reasonably free trade, for the Federal budget deficit, and for financial stability here and abroad.

At a minimum, this implies that the Federal Reserve must stand ready to provide sufficient liquidity to accommodate the price increases that are going to be triggered by higher oil prices and by higher import prices. Failure to accommodate these increases would reduce aggregate real output because of wage and price inflexibilities elsewhere in the economy. At the same time, though, the monetary officials must also recognize that a policy of erring on the side of ease, as a means of avoiding recession, would carry dangers of its own this year. Unneeded ease would threaten to raise the already-heightened inflation rate—both directly and indirectly by its impact on the dollar. And even more ominous, under current circumstances, unneeded ease also could turn out to be downright counterproductive. It could worsen inflation expectations of credit market participants, thereby having a perverse effect on long-term interest rates. We already had a taste of this late last summer. And, the new danger, it could precipitate a loss of confidence in the dollar, again acting to push up interest rates.

So in sum, the Federal Reserve faces a daunting task in 1987. As usual, it has manifold goals—inflation control, satisfactory growth, and the preservation of financial stability. In contrast with experience over recent years, though, when one goal or the other clearly was dominant, in 1987 there is no obvious choice for emphasis as the year begins. And, worse, there is no obvious set of actions that will assure the achievement of the various priorities. So, in consequence, running room is extremely narrow. And that, in turn, means that the possibility of error is high—much higher than in 1986. Given this difficult operating environment, the monetary policymakers must be both flexible, avoiding any commitment to rigid

targets of any sort, and they must be cautious, avoiding abrupt movements in either direction. It is a time for discretion in the full meaning of the word.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Dederick may be found in the appendix.]

Chairman NEAL. Thank you, sir. We will hear from our next witness now.

STATEMENT OF ROBERT SOLOMON, THE BROOKINGS INSTITUTION, FORMER ADVISER TO THE FEDERAL RESERVE BOARD AND DIRECTOR OF ITS DIVISION OF INTERNATIONAL FINANCE

Mr. SOLOMON. Thank you, Mr. Chairman.

In this statement I shall focus primarily on the external aspects of the economy and on the Fed's responsibilities. In particular, I will look briefly at the outlook for the trade deficit and its relationship to the budget deficit; whether the dollar needs to depreciate more; the relevance of the economic policies and performance in other countries; and what influence exchange rates should play in the conduct of U.S. monetary policy, particularly in view of the agreement such as it is in Paris last weekend.

It was exactly 2 years ago that the dollar reached the peak of an appreciation that began in 1980. That rise in the value of the dollar was a major cause of the enormous trade deficit that we have and the subsequent depreciation of the dollar is a necessary condition for the reduction of that trade deficit.

As you know, changes in exchange rates have their effects on trade only with a lag. The trade deficit as measured in nominal terms—that is, in current dollars—has not yet turned down. At best, it may have leveled off in the fourth quarter and we don't have reliable figures yet for the full fourth quarter. But in real terms, the deficit appears to have turned down. Exports of goods and services in real terms rose faster than imports of goods and services in the fourth quarter, according to the estimates we have. So we are getting, in fact, in constant dollars, for the first time, a drop in the external deficit.

From the viewpoint of the growth of the economy, it's the deficit in real terms that matters. We can say that beginning in the last quarter of 1986 the external deficit gave a boost to growth in this economy instead of being a drag on that growth. In fact, according to the present estimates of the Commerce Department, the entire increase in real GNP in the fourth quarter was accounted for by the reduction in the real external deficit.

Now this outcome is consistent with most forecasts for the economy for 1987. They all look importantly to an improvement in the trade deficit for whatever stimulus to demand is expected in 1987.

If the real deficit diminishes this year at the same rate as in the fourth quarter, that will amount to something more than one percent of GNP. The budget deficit is also expected to go down by about that amount. Ideally, the twin deficits should continue to decrease in tandem, while the economy continues to grow.

I turn quickly now to the question: Has the dollar depreciated enough?

One approach to answering this question is to measure how much of the appreciation of 1980-85 has been reversed. On the basis of the Federal Reserve's index of the trade-weighted average value of the dollar, about four-fifths of that earlier appreciation has been reversed. The Morgan Guaranty has an index that includes many developing countries' real exchange rates along with those of the major industrial countries. According to that index, about 72 percent of the 1980-85 appreciation had been reversed as of January, and it's only slightly more now. Thus, the dollar has not yet returned to its 1980 level in either nominal or real terms. But it is necessary to go beyond simply undoing the earlier appreciation. Because of the interest to be paid on the external debt we have incurred as the result of our external deficits during this decade, we need a larger trade surplus to achieve any given goal for the current account. The additional interest and dividend payments to the rest of the world will amount to something roughly on the order of \$50 billion a year as a result of the external deficits we have had in this decade. To add \$50 billion to the trade surplus requires a significant further dollar depreciation.

On the basis of these considerations, I conclude that the dollar needs to go down further.

That additional depreciation does not have to occur immediately. The downward movement of the dollar of the past 2 years is sufficient to begin the process of reducing the deficit. And there is something to be said for giving other countries some breathing space in which to adjust their economies to the exchange rate change that has taken place thus far. But, in due course, the dollar should decline further.

Now I have a section here on policies in other countries and I will skip most of that and just put it in the record, if I may, Mr. Chairman.

The main thing I would say is that we shouldn't expect miracles from a speedup in growth in Germany and Japan, if we get a speedup in growth in Germany and Japan. That will help the U.S. trade position somewhat, but not enormously.

In any event, it seems to me our major interest in more stimulative policies in Germany and Japan should not be primarily because it affects our trade balance, but because it helps the world economy in general.

The world economy is sluggish. It needs stimulation. Investment in plant and equipment is too low in almost all countries, developed and developing. As the United States reduces its twin deficits, it will no longer be stimulating the world economy. Unless other industrial countries increase their domestic demand more, the world economy will stagnate, to the detriment of everybody. It seems to me the responsibilities of Germany and Japan ought to be looked at in that light.

I turn now to the question of monetary policy and exchange rates and once again I'll skip over a little piece I have here on explaining why exchange rates moved as they did in the first half of this decade.

The main point I make is that the movement of exchange rates downward in Europe and Japan and upward in the United States was a reflection of the fiscal policies pursued in these countries, a

movement toward fiscal ease in the United States and a move toward fiscal restraint in Europe and Japan. And the exchange rate movements were, in my view, inevitable given those fiscal policies.

Therefore, we shouldn't blame the exchange rate system. That would be blaming the messenger rather than the message.

The question is, should monetary policy be used to stabilize exchange rates? A number of proposals have been put forth to confine exchange rate variations within zones or bands. If one of these proposals were adopted, it would be necessary for the Federal Reserve to use its policy instruments to keep dollar exchange rates within the agreed range. But it could well happen that the domestic economy called for a different monetary policy. For example, if the dollar were at the lower band of a target zone now, the Fed would have to take actions to raise interest rates in the United States in order to prevent the dollar from going below its target. But the present condition of our economy does not call for higher interest rates.

The result would be that in an effort to stabilize the exchange rate, we would be destabilizing the domestic economy.

If we had a flexible fiscal policy, it could be imagined that these undesired effects on the domestic economy would be prevented by making fiscal policy more expansionary, thereby compensating for the depressive effects of higher interest rates. But fiscal policy, as you know, is far from flexible in the United States and in the other major industrial countries.

In my view, therefore, efforts to reform the exchange rate system should be preceded by a reform of fiscal policy. Only when fiscal policy can be brought into play to stabilize the economy on a desirable growth path should we even consider proposals that would divert monetary policy from its primary goal.

Just a word or two if I may add it on the Group of Five or Group of Six agreement last weekend in Paris, which I didn't get a chance to put in because of the snow storm on Monday.

Basically, my view of that agreement is that it provides a pause in the dollar depreciation during which other countries will have some time to adopt domestic measures that will permit them to offset the depressive effects on their economies of decreasing trade surpluses.

I wouldn't regard it as any more than a pause and I see nothing wrong with such a pause. The exchange rate adjustment has been a big shock to Japan in particular and a smaller but still significant shock to Germany, and one can hope that those countries will adopt policies that make it possible for them to offset those effects.

I will repeat my major point, though. In time, additional dollar depreciation will be needed.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Solomon may be found in the appendix.]

Chairman NEAL. Thank you very much.

Prof. Robert Eisner.

**STATEMENT OF ROBERT EISNER, PROFESSOR OF ECONOMICS,
NORTHWESTERN UNIVERSITY**

Mr. EISNER. Thank you, Mr. Chairman. It is a pleasure to be here. I will leave my statement for the record and proceed a bit briefly from the heart.

I welcome the chairman's introductory remarks pointing out the goals of the Humphrey-Hawkins Act, the Full Employment and Balanced Growth Act of 1978, which have all too often and too seriously been ignored—been ignored by the administration, been ignored by the Fed, and I must say largely ignored by the Congress.

The most important aspect of that law, in my view, and I think in the view of those that pushed its passage, was the goal of full employment, having this country make use of all of its resources, of labor and of capital. That goal is not being met and is not being met in part because of an absurd fiscal policy in which the Congress is put in straitjackets by the Gramm-Rudman Act, but it is also not being met because of a timid and frequently misguided monetary policy.

The fact is that we currently have 6.7 percent unemployed, 8 million people fully without work, large numbers of others discouraged workers who have quit looking or who are partially unemployed for economic reasons, as we put it. Our growth is a mere 2 percent, hardly over that. Business investment has slackened. Yet we still frequently see people talking about monetary policy in terms of fighting the last war. They tell us of the risks of inflation and that we have to guard against that.

Inflation at the moment is largely dead. I'm not going to say it won't come up some, but the whole notion that inflation has been due to overly expansive monetary policy or too much government spending is simply foreign from the truth.

The major inflation we had in the late 1970s and into the 1980s was overwhelmingly a supply shock inflation due to the tremendous increases in oil prices. With the collapse of those oil prices, the inflation collapsed—the collapse accelerated, to be true, by the very severe recession that we had in 1981-82.

Now the topics suggested by the chairman I think are well chosen. There is a basic interrelation between monetary policy, the budget deficit and the trade deficit. Unfortunately, the interrelations are misconstrued and we are overwhelmed by a kind of a conventional wisdom and oft-repeated rhetoric.

On budget deficits, they are too large currently in terms of what an appropriate overall policy would be, but what too many people ignore is that budget deficits can be too small as well as too large, and that budget deficits in fact generally tend to stimulate the economy. Indeed, in my book referred to in the introduction, I point out—and there are some charts taken in the prepared statement that you can see—clearly show that real structural budget deficits correctly measured, adjusted for inflation, have been associated with increases in gross national product.

The bigger the deficit, the bigger the subsequent growth in GNP.

Of course, our theory tells us that bigger deficits mean that the public is not having to pay taxes. It is accumulating wealth in the form of government debt and therefore consumes more. And the

argument is frequently made that the big budget deficits have contributed to consumption, but in that way have injured investment and have put a burden on future generations.

That, in fact, is false. The larger budget deficits have been associated not only with more consumption but with increases in investment as well. In fact, the increases in investment have been even more dramatic and larger in amount than the increases in consumption.

And the reason for that is not hard to find. Businesses will invest when they find that they can use the additional capital to produce goods that they can sell. And they can't sell their goods if consumers are not buying them. So increased consumption generally, in an economy in slack, leads to more investment.

Now given that, we have to examine monetary policy in the context of what is being perpetrated or pushed in fiscal policy. Everybody talks about trying to reduce the deficit with apparently an amazing forgetfulness of the implications of deficits for the economy and the fact that the purposes of the Congress, the administration and the Fed should not be any magic numbers on the deficit, but a prosperous economy.

If we are to reduce the deficit not only to the absurd Gramm-Rudman target with phony accounting, but even by any significant amount, we have to reckon that in this economy which is not overheated, which shows no signs of being over-heated—in this economy, that means we would have a reduction of the rate of growth, perhaps a real downturn in output, and increase in unemployment.

The answer, then, is if we are to reduce the deficit, we must have an easier monetary policy and indeed a much easier monetary policy. We need an easier monetary policy in order to get from 6.7 percent unemployment down to 6, let alone to 5, to 4, to the Humphrey-Hawkins targets which are just ignored. If we are to reduce the deficit and have a greater fiscal drag, then we need a still easier monetary policy. I have numbers in the prepared statement which I offer really more for illustration, although they come out of the statistical analysis, but I certainly don't want them to be taken that seriously, which suggest that for every percentage point that you reduce the deficit as a ratio of gross national product, you should be thinking in terms of increasing the monetary base by about 4.5 percent. Again, I offer those numbers just as talking points.

The basic point is there is a tradeoff. The tighter your fiscal policy, the easier your monetary policy is going to have to be if you take seriously the goals of a prosperous economy with high employment.

Now, fortunately, an easier monetary policy at this point will achieve a number of goals. It will reduce the Federal budget deficit, as it's measured: in the first place, because an easier monetary policy will lower interest rates. By lowering interest rates, it will lower the rather major component of the deficit which relates to Treasury interest payments.

In the second place, an easier monetary policy will tend to lower the value of the dollar, and as Dr. Solomon has pointed out very well, the huge trade deficit is related overwhelmingly to the huge runup of the value of the dollar and is being corrected and will be

corrected by a reduction in the value of the dollar. So easier monetary policy will lower the value of the dollar. In fact, you can put it in very simple terms. The value of the dollar, the price of the dollar, like almost everything else, is a matter of supply and demand. If we supply more dollars, the price of the dollar will go down. That will stimulate exports. Stimulating exports, of course, will reduce the trade deficit, will reduce the pressure for protectionism, which I know so much of the Congress feels, and will also stimulate gross national product, as Dr. Solomon has pointed out, and that then will further reduce the budget deficit because you will have more tax revenues coming in from a more prosperous economy.

So an easier monetary policy will lower the budget deficit directly by reducing interest payments. It will lower it indirectly very powerfully both by stimulating exports and also, as I have not yet mentioned, by stimulating business investment, which perhaps is not as responsive to interest rates as some make out but certainly should be expected to be greater if we have lower interest rates, which would come from an easier monetary policy.

Now that really is the substance of my argument. I might just throw out another point or two since I have focused a good bit on the budget deficit and I guess have provoked before various committees and elsewhere considerable attention to some of these issues.

The Congress, unfortunately, like so much of the public, is mesmerized on a false issue. We talk of balancing the budget, not recognizing that what you want is a balanced economy. And the way to start to look at the budget problem, which is then going to be related to your monetary policy, is that a balanced situation, aside from concentrating on the balance of the economy itself, really implies not an equality between government expenditures and government tax revenues, but rather, a balance between the debt of the country and its income.

Any individual would look at a mortgage debt of \$50,000 he had a few years ago or 20 years ago let's say, when his income was \$20,000, and say that was maybe pretty substantial. Well, if his debt is up to \$100,000 now and he has an income of \$50,000 or \$60,000, his debt is really less of a burden. Indeed, the same thing is true for the Federal Government.

The way to look at the debt then, and the deficit, is to say, is the debt becoming a greater ratio of gross national product than it was? In fact, under the Reagan administration, with the Reagan administration, we have had a huge increase in the debt as a ratio of gross national product, but the answer to that is not then to balance the budget or even have a \$108 billion phony Gramm-Rudman target.

If the economy is growing at 6 percent a year, as is occurring and is forecast, stop and think what this means. The current Federal debt is running about \$2200 billion. The gross national product will be running in round numbers, let's say, \$4400 billion. Now that means that debt is half of gross national product. A balance would mean, don't let the debt grow faster than gross national product as a rule of thumb. You should adjust that further for the state of the economy.

For the debt to grow no faster than the gross national product implies then that the debt would grow at 6 percent. So, for example, if the gross national product is now \$4400 billion, which is twice the debt, if the gross national product rose at 6 percent, that would take it to \$4664 billion. Then the debt can grow by 6 percent to \$2332 billion, and still be no more than half of gross national product.

But now think, if the debt grows from \$2200 billion to \$2332 billion, that is a growth of \$132 billion in the debt. You will accomplish the growth in the debt of \$132 billion by a deficit of \$132 billion. The arithmetic is that simple. And yet people have repeatedly ignored it and apparently are afraid to face the electorate and say, "We voted for a budget deficit."

Budget deficits are the way of the world. There's hardly any private business that doesn't run a budget deficit. Every large corporation—I have in my book and in other testimony figures on IBM, General Motors—they all have their debt increasing at a considerably faster rate than the Federal Government, but they, of course, don't call it a deficit because they have appropriate accounting, which the Federal Government doesn't have.

In any event then, that is the story. Given the pressure to reduce the budget deficit, it is all the more important that we must have a very stimulative monetary policy to compensate for that fiscal drag and, indeed, it would be desirable to permit some orderly reduction of the deficit so that we have a more balanced economy in total.

I thank you.

[The prepared statement of Mr. Eisner may be found in the appendix.]

Chairman NEAL. Thank you very much.

Dr. Holtham.

STATEMENT OF GERALD HOLTHAM, VISITING FELLOW, THE BROOKINGS INSTITUTION, FORMER HEAD OF THE GENERAL ECONOMICS DIVISION OF THE SECRETARIAT OF THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT

Mr. HOLTHAM. Thank you, Mr. Chairman. I, too, would like to say how pleased I am to be here.

In summarizing the statement that I enter into the record, I will try very much to relate it to the themes that some of the other witnesses have touched upon or raised.

First of all, I am very sympathetic to the remark that Dr. Dederick made that we have here a situation of a number of objectives which policy is trying to achieve: the maintenance of growth and high employment, the control of inflation, and the reduction of the external imbalance. It is very difficult to say anything sensible about what a single instrument—monetary policy—ought to do about the three objectives without saying something about what the other elements in the background are—what fiscal policy is doing and what indeed are the policies in other countries. Because as people are becoming increasingly aware, even the United States, the world's largest and most important economy cannot really be viewed in isolation. So I would like to say a few words about the outlook as I see it, to give you a kind of wish list for a set of ideal

policies, and then to come back and talk about what monetary policy might do if other policies do not change, as I think they should.

As to the outlook, I find myself again in substantial agreement with the remarks that have been made by Dr. Dederick on the outlook for output and inflation. There are considerable risks on the output side. We do not quite know how the consumers are going to respond, but it is the case that there is a substantial boost now coming through from the swing in the current balance of exports and imports at constant prices. And that could contribute in 1987 a good one percentage point to the growth of the economy. Furthermore, the best estimates we have suggest that what has happened already to the dollar could contribute a further 1 percent to growth in 1988.

Thus you have the prospect of substantial support to demand coming from the swing in the trade account and it is also the case that, as people have said, the outlook for inflation is for some inevitable acceleration. I would like to stress that growth outlook because the external deficit has attracted considerable attention in the United States. What tends to get looked at is the deficit at current prices, and it would not surprise me if you did not see that this year in 1987 at current prices there is very little change at all in the external deficit. You could find yourself looking at numbers for 1987 only a few billion dollars different from the ones you looked at in 1986. That is not clear, but it is quite possible. And that may be taken as evidence that the decline of the exchange rate is ineffective in influencing the external position of the United States and that, in turn, may be taken as an argument for protectionist measures to try and do the job.

But I think if you look underneath those current price numbers you see that at constant prices there is a substantial swing and, in my view, it would be misguided to pick this particular moment, when much of the impetus to growth in the United States will be coming from trade, to indulge in protectionist measures on any substantial scale. That is not to say that there are not severe problems on the horizon and I would identify two which policy has to be concerned with.

The first one is that while the deficit should decline through 1987 and 1988, it is very unlikely that the decline in the dollar we have seen up to now will be sufficient to remove the external imbalance that the United States currently has. Indeed, at current prices, you may not get down below \$70 or \$80 billion, which if I have taken the temperature of the water right, would be considered too high by many people.

So I am thoroughly in accord with the remarks of Bob Solomon who says that at some point the dollar probably has to decline further. I do not think that it is possible to foresee growth rates in the United States and abroad such that this external imbalance will be removed at the current exchange rate. That is the first problem.

The second problem is that if the United States does see a further decline of the dollar and not only does the deficit fall through 1987 and 1988 but goes on falling to the end of the decade and toward a position of external balance. That would impart a tremendous contractionary impetus to the rest of the world economy. Not

all foreign administrations seem to be really aware of the extent of this and they are not taking up to now the kind of measures that would be needed to offset the contractionary impulse which must come through the United States reducing its own external imbalance.

To resolve these problems a whole coordinated set of policies would be needed. That set would include obviously a role for U.S. monetary policy but it cannot be seen in isolation.

Chairman NEAL. I am sorry. What did you say about monetary policy?

Mr. HOLTHAM. Well, if you could get foreign governments to acknowledge more than they have done so far the need for a stimulus to their own economies, and if the commitment of the administration to reducing the budget deficit were regarded more widely as more credible than it is currently regarded—because I think people think that the main problem is just about to come in getting any further substantial reduction in the deficit—then I think that the appropriate role for monetary policy would in supporting the level of activity in the United States and being consistent with a further decline of the dollar. In other words, I would think in that situation an accommodative or expansionary monetary policy would be appropriate.

However, there are two big “ifs” in there and it is far from clear to me that either of those things is bound to happen. And, if they do not, I think that it is much more difficult to see precisely what monetary policy ought to do. For example, suppose that the dollar were falling and that the current account were on course to being balanced. That would impart a stimulus to the U.S. economy equal to about 3 percent of GNP over the course of, let us say, 4 or 5 years. That is a very substantial stimulus and it would probably put you back into an inflationary situation if there were no further correction in the fiscal deficit.

So I come out with Mr. Solomon in thinking that the ideal situation is for the external deficit and the budget deficit to decline in tandem and if that is happening, then monetary policy can indeed be accommodative. If that is not happening, then monetary policy has to balance the risks of inflation, owing to a rapid fall of the exchange rate, against the risks of inadequate activity in the United States. And I think that, as Dr. Dederick said, is rather hard to give a very strong steer in that situation.

Finally, in response to your remarks about the accountability of monetary policy, it seems to me that it would be quite inappropriate, at the present time, for the Federal Reserve to get very hung up on monetary aggregates. There are two risks here. If there were a strong and stable relationship between the monetary aggregate and the growth of nominal income in the economy, then you might be able to get by with just using money as the one indicator for your stance of policy, but it has been a long time since that was true, if it was ever true. It is therefore quite reasonable, it seems to me, for the Federal Reserve, in attempting to fix its policy, to look at a much broader range of indicators as to the way the economy is moving than just the monetary aggregates.

Now some people would tell you that that runs a risk because by the time other indicators start to show that inflation is picking up

it might be rather late and you might then have to change policy more brusquely than you would have done if you had just tracked the targeted monetary aggregate all the way through. Well, there is such a risk I suppose, but equally there is a risk if you just look at the monetary aggregate and ignore what is happening in the economy. You can drive yourself into a recession doing that if the demand for money has increased and I think it is fairly clear that if people had been tracking aggregates over the last 2 or 3 years in a religious way that is exactly what would have happened. So I think that the pragmatism of the Federal Reserve in looking at a whole range of indicators is the appropriate approach at the present time.

Thank you.

[The prepared statement of Mr. Holtham may be found in the appendix.]

Chairman NEAL. I thank all of our fine witnesses for joining us this morning and helping enlighten us with your thoughts.

In the popular press, we often read that a main accomplishment for which the Reagan administration takes credit has been bringing down the rate of inflation. In fact, the main accomplishment of the Reagan administration is normally credited with bringing down the rate of inflation and certainly they are very happy to take credit for that and, as I say, I think most of the press attributes that accomplishment to the Reagan administration. Do you agree? And if you do, for the benefit of future policymakers who might be faced with another round of inflation to deal with, what would you say it was that the Reagan administration did or led in doing that brought down the rate of inflation? Was it more than doubling the national debt? Was it increasing the trade deficit? Was it increasing Federal spending? Was it reducing taxes? Just what was it? I am serious. I have arrived at an answer for myself, but I would certainly like to hear what you all have to say about this.

Mr. DEDERICK. I would like to answer that if I may.

Mr. SOLOMON. I suspect we would all like to answer that.

Mr. DEDERICK. But that's why I spoke first, Bob.

Mr. EISNER. You may get four different answers.

Chairman NEAL. Well, I suspect that I may.

Mr. DEDERICK. I think it's the accomplishment of the administration and the Congress. I think they both deserve credit and the credit comes in giving the Federal Reserve the support which was required for it to pursue its anti-inflationary policy for such a long sustained period in the face of a lot of pressures to do otherwise.

We pursued a stern monetary policy throughout 1981 and deep into 1982, at a time when there was growing pressure to give ground. The Federal Reserve didn't. Clearly, the administration was not trying to force it away from that. They were giving tacit support at a minimum and that also I think must have been true of the Congress.

The Federal Reserve tightened again to a degree in early 1983 when the economy appeared to be running an extremely rapid growth, raising inflation expectations again, and again there was no criticism of a profound nature. There was in fact implicit support.

So I think the basic thing is the Federal Reserve was allowed to do its thing and the political authorities, whether they be in the administration or the Congress, permitted them to do that. So that's where the credit lies.

Mr. SOLOMON. Well, I would just put it slightly differently, although what I say will not be at strong odds with what you just heard from Dr. Dederick.

I would say it's a combination of the Federal Reserve and the administration with the support of the Congress, but primarily I think Paul Volcker is responsible for the lower rate of inflation, not the administration. Maybe Paul Volcker and the Fed overdid the monetary restraint in 1982 and a number of people thought so at the time.

Nevertheless, two things happened in the early 1980s. One, we had a deep recession in 1982 with high unemployment, which had a lot to do with cooling down the inflation. But the combination of the large budget deficit, which was certainly a product of the Reagan administration with the agreement of the Congress, and that monetary policy that the Fed was producing gave us the very high dollar. And that high dollar also contributed to the diminishing of inflation.

So the combination of high unemployment, low capacity utilization, and an appreciating dollar are the proximate causes for the lower inflation, and you have to attribute them to both the Fed and budget policies it seems to me.

Mr. EISNER. I would not give the Reagan administration credit for reducing the inflation and I say that not out of partisanship in this instance, although I am not necessarily nonpartisan. I have criticized the Carter administration policies and others.

The drop in the inflation has overwhelmingly been due to the collapse in oil prices. The inflation I think has been widely misunderstood in this country and perhaps in much of the world as due again, as it has been perhaps decades ago, to excess spending such as one has in war or to a misguided monetary policy.

The inflation we had came from a tremendous increase in oil prices, in energy prices, a supply shock. When the oil prices stopped going up and turned down, the inflation went down. It's curious that neither of my colleagues has mentioned the fact that inflation has gone down worldwide. Are we giving Mr. Volcker credit for that?

What did happen in this country, which I think was a serious mistake, was that the effort to combat inflation was aided and abetted and accelerated by the tight monetary policy and a misunderstood tight fiscal policy. We had budget deficits that we thought were large. In fact, when you took into account the effect of inflation on the value of the debt, as I pointed out, these so-called budget deficits were really surpluses.

So it is true, as both Dr. Dederick and Dr. Solomon have pointed out, that we had a set of policies to try to combat the inflation. What they came out to then was a tremendous overkill which gave us the worst recession we have had since the Great Depression and we had unemployment at 10.7 percent. We helped drag down the rest of the world with our recession and I, therefore, see no basis for giving credit to the Reagan administration for accelerating a

fall in inflation which would have come anyway because of the drop in supply prices, the drop in the prices of the things we are buying. And to the extent the inflation was further eased, as it was by the recession and by the high value of the dollar to which Dr. Solomon has referred, it came at a tremendous cost to the American economy and to the American people.

I think the lesson is that for goodness sakes let us stop fighting inflation at the expense of the economy. The way to fight inflation generally is to fight for competition, to stop protectionism, to force people to take their lumps, to stop worrying about fighting inflation and trying to keep up farm prices and cut down production. To say you are fighting inflation, but insist that we can't buy cheap foreign goods, that's where the government does all the damage on inflation. And by its regulations, by permitting imperfections in competition and indeed encouraging monopolistic, oligopolistic practices.

To fight inflation as it has been done by putting the economy through the wringer is the wrong way, and I dread the possibility that we have not learned a lesson and may yet try that again.

Mr. HOLTHAM. Well, it is certainly true that inflation picked up in all Western countries in 1973-74 with the oil price increase, but oil prices did not go on rising through the 1970s. They went up in 1973-74 and then they stayed high. Now when that happened at the time of the Korean war, we had a big spike in inflation and then it fell back again. I think what shocked a lot of people was that the inflation did not fall back in the 1970s. Inflation was running at around 7 percent or more, rising close to 10 percent, in the United States right through the 1970s.

So that while there was certainly an initial impetus to inflation, it then showed a certain life of its own. It had momentum. I think there was a very general fear among the Western administrations—not just the United States—when we had a second oil price increase in the beginning of the 1980s. They were afraid that we would have another ratcheting up of inflation which would run permanently faster even when oil prices stopped rising. That was why very generally policies were followed of a highly restrictive kind. You get what you pay for. We had a very dreadful recession, but inflation fell.

Now we still have to this day in the United States, and in other countries, very high unemployment and the lower level of inflation has been bought at the cost of that unemployment. There is no question of that in my mind, but that is I think what happened.

Now it is true that oil prices have subsequently fallen, as have all commodity prices, but part of the reason they have fallen too is because of the depressed state of demand in the world. So it is not just nominal wage increases that have been pulled back by very tight policies, but it is also oil prices that have been pulled back by very tight policies. So I think you have to say that the tight policies followed in this country by the Federal Reserve and in other countries, both fiscal and monetary, are largely responsible for the fall in inflation.

On the exchange rate, I would like to inject one thought, which is that, to some extent, you did not cure inflation there, you borrowed a cure and now you must pay it back. Because the dollar

was driven up import prices were reduced in dollar terms and there was a drag on inflation for that reason. But the dollar cannot stay up there because if it does you get a ballooning external deficit. So, as we have already seen, the dollar has come down, and that is bound to reaccelerate inflation to some extent.

I do not think you are going to go back to 10 percent inflation or anything like that, but there will be an inevitable increase in inflation now in the United States because to some extent you did not really cure it, you had a little bonus there from the exchange rate which now has to be repaid.

Chairman NEAL. I understand your argument, three of the four of you attribute much of the reduction in inflation to monetary policy under the leadership of Paul Volcker. So I guess President Reagan's key role in this was accepting President Carter's decision to appoint Paul Volcker to the Federal Reserve Board in 1979.

Mr. SOLOMON. And reappointing him.

Chairman NEAL. And reappointing him. The reason it does seem to me important that we answer the question is that I think it would be very possible for someone to look back a few years from now when we have another round of inflation and say, "I know just the ticket. We will double the debt again and so on." I hope that is not the case.

If three of the four of you attribute the reduction in inflation to a reduction in the rate of growth in the money supply, would it not be likely that with the current rapid runup in the rate of growth in the money supply that we would experience another round of inflation down the road a bit? I mean, if reducing money growth cures inflation why would not increasing money growth cause inflation to increase?

Mr. DEDERICK. Sir, I don't attribute it to the slow growth of the money stock. I attribute it to the rise in interest rates. The slow growth in the money stock was a means of contributing to those higher interest rates, but basically that's what the Federal Reserve was proceeding to push and we had a dramatic rise in interest rates and that is what really brought the inflation to its knees.

Now interest rates have not plunged. We are not dealing, despite the rapid growth of the monetary aggregates as officially calculated now, with a very low interest rate structure, particularly in real terms. So I don't think that if one looks at it from the point of view of interest rates that we are putting a great deal of worrisome stimulus into the economy.

Mr. EISNER. I do agree with Dr. Dederick on that. I think that's very important and one must not be mesmerized by money supply figures.

I was always skeptical of how good a measure of the impact on the economy you could get from them. The financial system as you must all know is very complicated and very subtle and if you tend to simply look at one aspect of the money supply, control that, you find, for example, that if there's a shortage of M1 available, as there was for a long time, banks and other institutions find ways of extending credit that don't affect M1.

Of course, now with deregulation and with the huge changes in financial markets, the particular measures—M1 especially—are very bad guides. I think you have to look at the economy and, as

Dr. Dederick says, a good place to start in terms of monetary matters is the interest rates, and real interest rates, as best you can gauge them in particular. But even those are not the bottom line.

The question is, where is the economy? And to say that we are in danger of accelerating inflation when we still have 6.7 percent unemployment, the excess capacity we have, the slumping investment, as I suggest in my formal statement, is again fighting the last war.

Chairman NEAL. I believe we should look at full employment as a major goal. I have come to think that inflation is probably the worst enemy of full employment. Just look at our history. You go through a period of pumping up the economy and increasing the level of employment in the economy, but ultimately it seems to me history shows—not only in our country but in other countries around the world—that it all comes to a screeching halt some day, unless you are willing to let the inflation go unchecked and, of course, that brings its own great dangers. But if at some point a government decides to stop a rapid rise in inflation, then economic activity slows rather dramatically in some cases and people lose their jobs. People are out of work. So the rate of unemployment rises. It would seem to me that if the goal is full employment, and I think it is an important goal, that goal is best served by making sure that we do not reflate the economy.

Mr. EISNER. I would respectfully disagree, sir. I believe that the confusion in some people's minds relates not so much to the impact of inflation as the efforts to combat the inflation, which I suggest are not—

Chairman NEAL. That is what I said— if you let it go unchecked.

Mr. EISNER. Well, it depends on what's causing the inflation. And I believe the misconception is that the inflation has generally been due to too much spending or too easy a money supply. That has not generally been the fact. I talk of fighting the last war. The fact is, in our kind of economy—I'm not going to take some underdeveloped country where they just print money madly—our economy has suffered from inflationary pressures due to excess demand exclusively in wartime, for understandable reasons. Whatever some wild-eyed spenders might say they want, the government has not been going mad on spending and the money supply had not been increasing enormously except where there was a war or a war situation.

The relationship between inflation and unemployment, most economists have pointed out, is I'm afraid the opposite. That is, the things that will tend to reduce unemployment can contribute to inflation because you reduce unemployment generally, aside from certain structural unemployment, by getting people to buy the goods that producers can sell. You get people to buy goods, producers to produce these goods will have to hire workers, and that way you reduce unemployment. So it takes more demand.

Now it is obviously true that a business faced by people rushing to buy may have some incentive to raise prices, but in the competitive situation, unless we do have a great shortage which again is going to be occurring in a war situation, you don't have to worry about big runups in prices simply because you have a more prosperous economy. And to accept the argument that you have to cut

demand to cut inflation is an argument which simply gives up. It gives up on Humphrey-Hawkins. It gives up on the notion of a prosperous economy. It means you are going to say, "Yes, we can keep prices down. If Chrysler and General Motors and Ford can't sell their cars, they are going to have to start giving price concessions. They may lay off a lot of workers, but we have to fight inflation at all costs." That's what you are going to get.

Mr. SOLOMON. I think you uncovered some differences among us. I don't think I fully go along with what Bob Eisner just said. Instead of arguing with him, let me try to address myself to the issue as you posed it.

It seems to me the relevant question is not whether inflation is theoretically possible—I think all of us, including Bob Eisner, would admit that inflation is theoretically possible. He would see it only with what he calls excess demand, very strong demand. He has seen that only in wartime in the United States. I think I have seen it a little bit in peacetime as well, but not all that often.

Nevertheless, the issue for the moment it seems to me is—and I assume you are mainly concerned with current policy over the next year or two—the issue for the moment is, is there a danger that demand will rise fast enough, however stimulated—whether it be by the money supply or low interest rates—to worsen inflation beyond what is tolerable? Everybody knows the inflation rate of the last year or two, particularly the past year, has been below the underlying rate because of the fall in oil prices. With the increase again in oil prices and the depreciation of the dollar, we are going back to our underlying rate of inflation which is probably 4 percent, something like that. That's inevitable. I read Paul Volcker's statement to the Senate last week and you'll probably hear that again tomorrow. I read him to say that we have to accept that underlying rate of inflation. We don't want it to go up from where it is, but we have to accept that.

The issue, therefore, do we see anything in the picture that's going to cause demand to rise enough to raise that underlying inflation rate? I guess I would say at the moment I certainly don't.

Mr. DEDERICK. Well, let me comment briefly. I, too, am going to associate myself with Bob Solomon's remarks. I disagree with Professor Eisner's interpretation of what has gone on in the past. I don't think the oil price increases came out of a vacuum. I think they were the product of an inflationary environment in each case that had developed. I think there was excess demand that began with the Vietnam war. And then after that showed signs of fading, there was encouragement in the early 1970s for strong growth for various reasons, and then in the latter part of the 1970s there was a fear of recession and we constantly erred on the side of ease and basically what we had was a 15-year period of erring on the side of ease and we paid for it with a rising inflation rate in which the oil price played a part, but as I say, they would not have been the size they were if they were not occurring in that sort of environment.

Now the question now is, as Bob Solomon says, we do seem to have an underlying inflation rate of 4 percent, but there is a part of this which is coming from the drop in the dollar. If we were to have an expansive monetary policy, almost certainly the dollar would go down still further, and not in the controlled way in which

I think everybody here suspects it will have to over a period of years, but much more rapidly than that, and we could quickly get more inflation.

We could begin to feed it into the system through rising import prices because now margins have narrowed considerably abroad. We are going to have a somewhat more hospitable economy to increases in prices. It's not a question now that one can go all out because we still have some domestic unemployment.

In the end, I very much agree with you, Mr. Chairman, that if we are going to hold down average unemployment over a period of years, we have to be moderate. We cannot pursue a policy of aggressive stimulation with an effort to bring down the unemployment rate every little notch. We have done that again and again over the years and we paid the price, and this is something I very much want to avoid, something very much the Federal Reserve obviously wants to avoid, and I would very much encourage a policy designed to avoid that.

Chairman NEAL. Thank you very much. I would like to yield to Mr. McCollum.

Mr. McCOLLUM. Thank you very much, Mr. Chairman.

I want to formally welcome the witnesses and apologize in public for not being here when you started, but I did come up before and I think you understand where most of us were.

Mr. Eisner, you have raised some interesting points and some of which your colleagues have disagreed with and others, but I am aware that you have done a lot of study in the area of deficits and questions of monetary aggregates and growth and so on. I would like to get to a base concept to understand what you feel is the natural state of unemployment.

What is really full employment today in today's world? The reason I ask that question is because it seems to me that your views have validity within the context of that in terms of arguing that real growth and structural deficits and monetary aggregate growth and so on is acceptable to encourage investment and growth in the economy as long as we have less than a full employment economy. But the problem I see is that 6.7 percent is a debatable point. How much room do we have in there? At what point will the increases in monetary aggregates or increases in deficits be detrimental when employment reaches what level?

Mr. EISNER. Yes, I appreciate the question is appropriate. I will say at first and acknowledge I am an extremist on this subject. I take the 4 percent unemployment target we had years ago as a good one. I have pointed out that in the 1960s we had an unemployment rate down to 3 percent and even somewhat below for some months, and for a while people began saying, well, that figure has to be adjusted because we now have more women coming into the labor force and we expect more of them to be unemployed and more blacks coming up from the South and we expect them to be unemployed, and more youth and we expect them to be unemployed. I never bought those arguments.

But in any event, those arguments are turned around. Women are now no longer unemployed in any larger proportions than men. The youth figures are changing. We are getting an aging labor force again. And so my own extreme view would be to keep aiming

at least for 4 percent, but I should quickly get myself off the limb by saying that I think most of my colleagues agree that maybe it is not 4 percent, maybe even it is not 5 percent, although I think many of them might go for that as a full employment target. It is certainly not 6.7 percent.

I think what has happened, very unfortunately, in all of the argument is, in a way, like the defense budget. You know, you get way, way up, and then the argument is, well, should we get it still further up. And the public has—a lot of my colleagues have seen unemployment rates rise and have sort of given up. They said, well, it's gotten so high, I guess we can't any longer aim very low. I see nothing in the economy that has changed that. We have had low unemployment rates in the past. We can have them again. I would dispute Dr. Dederick's argument that we have followed an easy policy and made every effort to reduce unemployment.

That is simply not the fact. The Congress and the Federal Reserve have not been aiming particularly to reduce unemployment. It is questionable that we have ever followed a serious policy of aggressively fighting unemployment. The economy has had its ups and downs, and sometimes it is worse and sometimes it is better.

Mr. McCOLLUM. Your view would be that you have got a lot of latitude in here, because you think that there is a much lower real employment figure, and therefore, the expansion of the monetary base and aggregates and the question of the whole issue of deficits, all that can grow a lot more before we have problems, but we don't have what you think is even—

Mr. EISNER. I should say, if I can't persuade you that we have a lot of room, I think there would be widespread agreement there still is room, and I don't think any of my colleagues here are likely to dispute that.

Mr. McCOLLUM. I would to, if I could ask each of the colleagues, just briefly, without getting into a lot of the reasoning, to tell us what you think the targets—maybe starting with Dr. Dederick—would be for full employment or for natural state, as some call it, of unemployment.

Mr. DEDERICK. Well, I would just say, I don't think there can be any one number, any one year. One has to do this over a period of time, but I would say now that the basic target we should be seeking is somewhere around 6 percent.

Mr. McCOLLUM. Dr. Solomon.

Mr. SOLOMON. I would like to make two points if I may. One, I think the rate at which you can expect to have unemployment without inflation has come down from where it was a couple of years ago. That is consistent with what Bob Dederick just said. I won't give you a specific number. I don't know what it is, but certainly lower than what we have now.

And if I may add, I think that one should look, not only at unemployment but at the degree of capacity utilization. Now that is ample at the moment, but as a general matter, that's equally important. You can imagine the situation in which we have a lot of unemployment, but investment has been so low for so long that we don't have much unutilized capacity, and in those circumstances an increase in demand could set off that inflation even with high unemployment, and you can conceive of the opposite situation.

So I suggest one look at capacity utilization as well as unemployment.

Mr. McCOLLUM. Well, we are not at the present time, in your judgment at a critical point on any of those counts.

Mr. SOLOMON. No, I don't think so.

Mr. McCOLLUM. So we can still expand the aggregates, the monetary base without running into a worry about that.

The money supply, basically, can continue to expand.

Mr. SOLOMON. Right.

Mr. McCOLLUM. Dr. Holtham, what do you think?

Mr. HOLTHAM. I would substantially agree with that. I would also be a bit leery at giving you a precise number for the so-called natural employment rate. There are people around who will give you numbers, based on the behavior of the labor market and the way that wage claims have gone in recent history, but I think it is fairly widely acknowledged that the natural employment rate would be less than 6.7 percent, certainly.

I do not think there is any immediate danger of inflation flaring up because of excess demand in the labor market, which would enable our workers to put in for higher and higher nominal wage claims. The most likely source of inflation is the one that has been referred to, namely that there is a severe weakening of confidence in the dollar, which leads to a very fast decline in the dollar and a rapid rise in import prices. And then, of course, people in work will want their wages to keep pace, so you get some feeding through into wages from those import price increases, even though there is no excess demand in the labor market.

Mr. McCOLLUM. If I can change the scope of the inquiry just briefly. Professor Eisner, Chairman Volcker has raised, in past hearings, where I have been, concern over the type of spending that we have and whether steps of spending or otherwise. It seems to me when we start talking about our deficits and Federal spending, in that regard, it becomes even more important.

Do you see a distinction between productive investment, spending by the Federal Government and the so-called consumer nonproductive spending? In other words, whether we are buying things that have tangible life or whether we are spending the money in ways that don't net any long-term investment, as a businessman would look at it?

Mr. EISNER. Yes. I think that is a very important distinction. I would argue that it would be important to have a capital budget in the Federal Government, so we could keep track of this, and so the Congress could be well aware. A lot of the talk of reducing the deficit is that we have to reduce it to eliminate the burden on future generations of the debt or to encourage investment, private investment. The fact is that a lot of the talk of reducing the deficit is, for example, reducing expenditures for education, which would be an investment in human capital, and it does make a big difference, if you are going to—what government expenditures are for, not necessarily in terms of the impact and aggregate demand. I mean a dollar is a dollar, if it is spent, but if you spend for current services, you are getting current services. If you spend for things that provide productive capacity in the future, roads, bridges, education, health, that makes a big difference.

Mr. McCOLLUM. Does the panel generally agree with that? Is that essentially what everybody would agree that we would be better off if we were spending and that problems are going to—if you are go to spend on the Federal level, spending on more productive things, and as long as we are deficit spending, we may get into trouble, if we continue to spend more for nonproductive consumer items?

Mr. SOLOMON. I think it is important from the viewpoint that Bob Eisner mentioned, and it does make a difference to the future, whether we have capital stock in the future to meet our needs, but even productive investment by the Federal Government can be excessive in any given situation and create excess demand and one has to recognize that as well. We are not in that situation at the moment, but it is conceivable. So productive investment isn't all—one cannot say, as long as it is productive investment let it go. Even there you may at times have to have limits. Not at the moment.

Mr. McCOLLUM. Dr. Holtham.

Mr. HOLTHAM. I think the distinction is a correct one, and it is a valid one, but the dramatic thing about the United States at the moment is that the Federal Government's excess of investment over revenue—or expenditure over revenue, part of which is investment, apparently is greater than the net saving of the private sector. So in effect, you are borrowing abroad to finance these expenditures, however worthwhile they may be. You have to pay a certain rate of interest on those borrowings. So a live issue is: is the rate of return on these expenditures greater than what you are having to pay foreigners for the money. If the answer is yes, well, then fine. If it is no, even though the expenditures are, in some sense, productive and worthwhile, then you should think twice about it.

Mr. McCOLLUM. Well, I know Chairman Volcker once put an equation on the board and said it was full of variables, so we shouldn't take it literally, but he put an equation on the board and said our trade deficits were proportion directly to our own domestic deficits, and in some senses, I guess you are talking about the financing, and that is what he was talking about, of our deficits abroad in some sense of the word.

Mr. Chairman, I could continue, but I think in all fairness, we have a colleague, and I would like to yield at this time.

Chairman NEAL. Mr. Saxton.

Mr. SAXTON. Thank you, Mr. Chairman, and let me express my regrets for not being here to hear your opening statements as well, but another subcommittee of this full committee was in a long debate, and both Mr. McCollum and I were there.

Let me ask a question about our twin deficits and direct it to Dr. Holtham at the outset, and then perhaps other members of the panel might comment as well.

When I came into the room, we were discussing the relationship between the trade deficit and inflation and other economic factors, and I would like to suggest and get your reactions as to whether or not this is a credible argument.

I would like to suggest that there is a very strong relationship between our Federal budget deficit and our trade deficit, in terms

of what might happen in the future, if we don't attack these twin problems in a logical way together. I would suggest that in attacking the trade deficit, as Congress seems likely to do, without attacking or doing something substantial in a meaningful way about our budget deficit, that there could be a tremendous adverse affect on interest rates, and I say that for this reason. I think we all know that we have financed substantially our Federal deficit by borrowing from foreign sources, and if we are to pass a law or a series of laws in Congress to attack our trade deficit, doesn't that have an adverse effect on how we finance our budget deficit, and if it has an adverse effect in essentially shrinking the money supply that we have to work with to borrow, doesn't that have the effect of forcing interest rates upward?

Mr. HOLTHAM. Well, I can see the reasoning which underlies that argumentation. If you pass laws that restrict the size of current account, then you cannot be importing so many goods net. More goods have to be produced in the United States, and the capital inflow into the United States will be less, because that has to balance the current account. So you must have greater demands on production and on finance in this country. In that situation there could be some increase in the level of activity in this country and perhaps in the level of inflation in this country and on the rate of interest in this country.

All of those things might well go up. But the thing that frightens me about this scenario is simply what the effect would be abroad and how foreign countries would respond to such legislation. I think we could see a severe breakdown in the existing trade system. And as I remarked earlier, the United States is now in a position where much of its growth in the next 2 years, predictably, will come from trade. The dollar has gone down. Exports at constant prices will be growing faster than imports at constant prices, and that is a big source of growth. So it seems to me that it is shooting yourself in the foot at this point to try and restrict that process just at the time when it might be doing you some good.

Mr. SAXTON. Excuse me. I don't want to argue that point with you. In fact, I agree with you. If I can be a bit parochial just for a moment. In New Jersey, which is my home State, we have somewhere in the neighborhood of 1000 foreign companies who have their center of activity for this country in my State. As a matter of fact, I am pleased and proud to have them there. And I agree that the most drastic effect that we might have is on the world economy, if we go in the wrong direction.

What I was trying to do was to determine whether or not the argument that I made is a valid one, and whether or not we might not only upset the worldwide economy, in terms of other countries, but whether or not that type of potential action on the part of the Congress could, in fact, affect our own economy, with a rather dramatic increase in interest rates.

Mr. HOLTHAM. It is possible, for the reasons that I said earlier, that that could happen. The great imponderable, though, is the way that foreign investors would respond to such measures. They could take the view, that the United States was going to get its current balance in order by main force so the dollar did not need to go down any more. In effect, tariffs or other measures could be viewed

as a substitute for further depreciation. Foreign investors might then think they could afford to lend to the United States and not worry about further declines in the dollar. If they took that attitude, well, then, the supply of capital would not dry up and finance for the remaining deficits would not be a problem.

But it is quite conceivable that foreign investors could take the opposite view. They could say: "what the dickens is going on here. The United States is trying to close itself up. It is import controls now or tariffs. It could be capital controls next." And then foreign investors might get very uncertain about investing in the United States. They could pull money out driving up inflation rates. If that were to happen, then the effects that you point to could indeed happen very strongly.

I think it is rather difficult to gauge how the financial markets would respond to any protectionist initiative. I think it is pretty likely that they would not like it.

Mr. SAXTON. May I ask the other members of the panel to respond?

Mr. EISNER. Yes. I believe that certainly—particularly this committee—but people, generally, should recognize that the main ability to supply credit and funds is precisely coming from the Federal Reserve, and while it true that foreign investment in this country tends to somewhat hold down interest rates here, if you are concerned about that, the direct thing to do is to make sure that the Federal Reserve makes enough funds available and makes it possible for banks to lend more.

The relationship between the budget deficit and the trade deficit—Mr. McCollum alluded to Chairman Volcker's remarks on that as well—is a rather curious one, in that the bigger budget deficit does contribute to a trade deficit, but it contributes to it essentially by making our imports greater, because it enables us to spend more, since we are not paying so much in taxes.

The protectionism will have a curious counter effect, largely ignored. It will not, I think, have that much effect on interest rates. What it is going to have the effect of doing is reducing the supply of dollars abroad, because we are not importing as much. Therefore, we won't be supplying as many dollars abroad. That will, in fact, tend to make the dollar more expensive, and as it makes it more expensive, it will simply tend to counteract the action of your protectionism. So what you are going to get is, if you protect certain goods, you will then tend to make the dollar more expensive and make it more difficult on those goods that are not being protected or on export markets in general.

But again, on the credit question that you raised, Mr. Saxton, the issue, I think, should be directly faced. If there is a shortage of credit. If you are worried about interest rates, you have got power, to the extent you can influence the Federal Reserve, or the Federal Reserve certainly has the power to ease interest rates.

Mr. SAXTON. Thank you.

Mr. SOLOMON. I am not sure I fully understand the question, Mr. Saxton. I assume you are starting with some action by Congress that restricts imports; is that correct?

Mr. SAXTON. That is correct.

Mr. SOLOMON. Okay. Well, I am inclined to agree with what Professor Eisner just said, that that might well not restrict imports in total, but just the imports to which those specific actions were directed, or if you had some across-the-board restriction on imports like an import surcharge, I think the exchange rate would react to that, and offset that as well. But I wouldn't assume that congressional action either on specific products or even across-the-board would lead to a reduction in imports. And if that doesn't happen, then the rest of it doesn't follow either.

Mr. SAXTON. Thank you.

Mr. DEDERICK. Well, I would just add the point that, of course, protectionism can't occur in a vacuum. And if we were to take such a step, in order to reduce our trade deficit, I think the foreign reaction would be just almost overwhelming. It would be extremely negative. And we could be almost certain that any goals we had would backfire on us.

Mr. SAXTON. Thank you very much.

In your judgment, how important is the loss of U.S. technical marketing competitiveness in relation to other factors that affect our trade deficits, such as the overvalued dollar and its reduction more recently?

Mr. DEDERICK. Well, I would say these are all part of the whole, really. You can't really differentiate among them. One of the reasons why the dollar is overvalued is because we aren't, perhaps, as competitive as we might be. But competitiveness is a hard term, and in the end you are competitive if you have the right exchange rate, and then you don't worry about competitiveness.

The basis of the problem is that our productivity growth has been relatively slow compared with other nations. There are many explanations for this, none of which is completely accepted.

We are not entirely clear as to why, but surely, we would all be better off, we and others, if this were a more productive nation. So steps that can be taken to improve our productivity, and that is the way I prefer to think of it, not our competitiveness, would be desirable and steps are needed, given our very discouraging performance over these last few years.

Mr. SOLOMON. Well, competitiveness, I find difficult to apply the term to an economy as a whole. You can apply it to specific products and even specific industries more readily, in my mind, than to the whole economy.

The major reason we have lost competitiveness in recent years is because the exchange rate went up. The usual word is buzz word, but competitiveness has become so much of a buzz word that buzz word has become a buzz word. [Laughter.]

It seems to me competitiveness is a matter of price and quality, and to a large degree, we have lost competitiveness, because our prices have gone up to the rest of the world as the dollar appreciated.

Something may have happened to quality as well. People talk about quality of American cars versus Japanese cars, and I am sure there is something to that point. I also gather there has been some improvement in the quality of American products.

Mr. SAXTON. May I interrupt you on that point. This is only a personal theory. I have a theory that there is probably something

to that argument, but I also have a theory that there is more on the minds of the American people, in terms of perception of the quality argument than really exists in the quality argument.

Would you agree with that? In other words, we think we have got the notion that foreign products are superior, far superior to American products. You know we are all interested in making sure our car starts when we turn the key, because the last thing I want to have in the morning, when I am leaving New Jersey to come to Washington is to have the doggone thing not start. I have an American car—but someone in my position might say, well, I am willing to pay a couple thousand dollars more for a foreign made automobile, because it is more likely to start in the morning, and that notion that there is a far superior quality out there, if you buy foreign, I suspect is an exaggerated perception of the real world.

Would you tend to agree with that?

Mr. SOLOMON. I don't have any trouble agreeing that is exaggerated. I suspect there is something to it or there was something to it, and it is probably moving the other way now. Yes, I agree it is exaggerated. There are fads in these matters. If you go back as far as I go, which is a long time, back in the early post-World War II years, when I was a young man around here, nobody's quality came anywhere near close to that of the United States. And everybody was worried that the rest of the world would have a dollar shortage forever, because nobody could compete with us.

Well, that was exaggerated, and perhaps we now have an exaggeration on the other side.

Mr. EISNER. Yes, I largely agree, but overwhelmingly competitiveness relates to the value of the dollar. And we just had such a tremendous run up over the 1980s, 80 percent from 1980. I don't know how anybody could look elsewhere for the problem.

On the matter of productivity, Dr. Dederick put it well. It is important to increase productivity for its own sake, but I have just been looking at the latest report of the Council of Economic Advisers, the Economic Report of the President, and they have impressive figures indicating that in manufacturing we have had substantial increases in productivity. Our overall productivity figures seem to be dragged down by the service industries for whatever the explanation. But that then would not have that much to do with trade. So I think there is virtually nothing meaningful to be attributed to our trade deficit in terms of productivity. It is a matter of what has happened to the value of the dollar and the way to correct it, therefore, is direct.

Mr. HOLTHAM. I certainly agree with that. I think you can explain the whole of the trade deficit in terms of two factors. One is the rise of the dollar and the other is the fact that demand growth in the United States, while it may have been too low to assure full employment, was growing much faster in the 1980's, from 1982 onward anyway, than it was in other countries. U.S. domestic demand grew at about 8 percent, price-adjusted, in 1984, and while it slowed down thereafter, it was still going faster than your main competitors. So however depressed you think this economy was, it was not half so depressed as the others. And that was helping to suck in the imports. So I think it is the combination of different

rates of capacity utilization, and the growth of demand here and abroad and the rise of the dollar, that substantially did this.

I do not think that any secular or structural worsening of American competitiveness is particularly important over a four-five year period, in causing the current imbalance. Over a 20-year period, there is no question, I think, that the relative industrial position of the United States has declined. I come from a country where the same thing happened 100 years ago. So maybe that is rather difficult to reverse, but I do not think that kind of longrun structural factor has much to do with the current much shorter-run problem of the current imbalance.

Mr. SAXTON. Thank you. Thank you, Mr. Chairman.

Chairman NEAL. Thank you, sir.

Dr. Holtham, in your written statement, you express a good deal of pessimism concerning the Group of Five Paris agreement. You say that it "abandons any hope of removing the trade deficit." I take it to mean that if we comply with this agreement, that the Fed would have to tighten the monetary aggregates. Our government is in the process, I guess, of tightening on the fiscal side and the combination of those two could lead us into a recession. Is that what you are saying?

Mr. HOLTHAM. That is substantially correct, Mr. Chairman. The position that I take seems to be the one which is common on this panel, that you cannot envisage the trade deficit closing without the dollar falling further. I do not know any more than anyone else exactly what to make of this agreement. There is certainly some game playing going on; perhaps they are trying to fool the market. But on the face of it, the agreement says that the United States is committed to maintaining the dollar at its current level. If they do that, the only way that the deficit can be reduced is, if the relative rates of growth in the United States and abroad were to change in a very substantial way. Therefore, either U.S. growth has to slow down, or foreign growth has to accelerate, or you are stuck with the current trade deficit as far as the eye can see.

Now it is true that the other countries made some noises about being oriented toward having faster expansion, but that was just words and there is nothing in the agreement that I can see, which makes it likely that they are going to do anything like enough to get very much faster growth. That was the origin of my somewhat pessimistic remarks on the subject. It is quite possible that the next time there is a crisis in the exchange market, and if the dollar comes under pressure, that the Federal Reserve will not, in fact, attempt to defend the exchange rate by increasing interest rates. Yet if that is so, one wonders just what the content of the agreement actually is.

Chairman NEAL. I would like for others to also comment on this. Would you also add to your comments whether or not you think that our participation in a agreement to keep the dollar at its current level is a good idea? You have all indicated essentially, if we are going to reduce the trade deficit, the dollar needs to fall. Well, why stop it here?

Mr. EISNER. I agree with the thrust of your question and the previous comment. I think the dollar should fall further. I wonder, though, if there isn't something which, in Mr. Baker's mind, is

lurking here, and that is, that if we continue to force down the dollar, we, in fact, are pressuring foreign countries to stimulate their economies, which is all to the good, because if we force down the dollar, we make it difficult for them to keep their economies going by exporting to the United States. They rather have to keep their economies going by lower their interest rates, by fiscal stimulus.

So the two go hand in hand, and I don't know what game is being played, as suggested, and what is really lurking behind the scenes. Perhaps what Mr. Baker has in mind—I saw Mr. Darmon on television, and he seemed rather, I thought, interestingly vague on this—is that perhaps you keep the dollar stabilized by getting the foreign countries to stimulate their economies sufficiently. And that is not a bad idea, though I think the dollar should go down further, in any event. But the two go hand in hand, pushing the dollar down or letting it go down, almost forces foreign countries, if they have any sense, to stimulate their own economies.

Mr. SOLOMON. Well, we all agree that the dollar has to go down further to close the trade deficit, as Gerry Holtham says. And it seems to me, Secretary Baker and Chairman Volcker must understand that too, if such intelligent people as those in this room do. The question is, then, what did they agree to in Paris. The only way I can rationalize what they agreed in Paris is that they recognize that the degree of exchange rate adjustment that we have had in the past 2 years is rather big, and that it is a shock to Japan in particular and to a lesser degree to Germany as well.

They don't want a recession in Japan and Germany. It takes a while for policies to change in these countries, and what they are doing is giving them a little time, a little breathing space, a pause, during which they can adjust their policies and increase their domestic demand and in due course, then, the dollar will go down further. I am imputing that view to Secretary Baker and Chairman Volcker, and without that view, I don't know how to understand or explain what they did.

Chairman NEAL. But they have not said anything like that.

Mr. SOLOMON. Well, they are not likely to say it. I don't think one could expect them to say that publicly, if that is in their mind. I am not sure it is. I hope it is, but I don't expect them to acknowledge it.

Chairman NEAL. But if it is not, what do you think?

Mr. SOLOMON. If it is not, I think they have made a mistake.

Mr. DEDERICK. Let me—I think very clearly it is in their mind. In my testimony referring to monetary policy, I said abrupt moves in any direction would be dangerous in current circumstances. The same is true of the dollar. And I am very close to the market. I spend a fair portion of my day with traders, and believe me, in the early part of this year, the dollar was going down the chute rather rapidly, and it was viewed as a one-way run by the trading fraternity, and there was a genuine possibility that we could have, if not a free fall, something not far from it, and this is very dangerous situation, as I mentioned in my testimony, both for us and for other countries. And I think that the whole issue here is to do these things in a controlled way, and while we can say the dollar needs to go down to resolve a problem, it doesn't have to do it all in

January or February of 1987. We have a considerable period of time. We are already going to have beneficial effects from what is happening today.

And what we need is a cooling off period, so that the markets can recognize that they are not dealing with a one-way street, so that the dangers of a free fall can be curbed for a while, and also in order that the foreign nations who, just as the United States, take a while to change their policies, be given time to change their policies. We don't change ours overnight, and they don't change theirs overnight.

If you look at the statement, there was a clause that we have basically agreed that the dollar is at an appropriate level, given the other conditions of the statement—and those were that steps would be taken abroad to stimulate their economies.

So I view it as part of a process. There will be further steps to come, when the time becomes appropriate to take those further steps.

Mr. HOLTHAM. Just two remarks, Mr. Chairman. Suppose, what Messrs. Backer and Volcker are doing is what Bob Solomon says they are doing. I think that is all right as a strategy as long as the market is persuaded that this is a reasonable exchange rate just because the governments have said so. But if the market does not take that view, if it says, "Oh we have been listening to Solomon and Eisner and other people, and we think the dollar is going to depreciate another 20 percent" and starts to speculate on that basis, the issue is what happens then? The dangerous element to me is, that either the United States will have to abrogate the agreement, which is very bad—I think it is bad to enter into agreements you do not mean to keep— or else, the Fed will have to increase interest rates in order to defend this exchange rate. And the United States does not want really to do either of those things.

So to me that is the slightly unsettling aspect of it. It is fine if they get away with it. It is fine if the mere announcement has an effect on the dollar, but if the market tests that announcement, then I think you have some difficulty, unless the other countries have agreed, in that circumstance to do a lot more than they have let on. If the Deutsche Bundesbank is prepared to slash its interest rates to the bone when that happens, maybe we are all right, but from what I know, that would be a very surprising thing.

Chairman NEAL. You are suggesting a rather unusual view that people who trade in the market actually look at some fundamentals, instead of listening to public officials. A bizarre notion.

I have been amazed at all the recent speculation in the dollar. Today all it takes to change the value of the dollar on currency markets, where there are hundreds of billions of dollars traded in a very short period of time, is for Secretary Baker to make a pronouncement or someone else to say something and, therefore, talk the dollar down. It seem to me that that is absolute nonsense.

Mr. SOLOMON. I don't think it is even true. [Laughter.]

Chairman NEAL. Again, it is something that is reported in the press very often, the same way it is reported that President Reagan brought down the rate of inflation.

Mr. SOLOMON. Well, as you know, that doesn't make it true, the fact that it is reported.

Chairman NEAL. No. But I think it is part of the popular mythology. It seems to me that we might make better public policy if we made it on the basis of some empirical evidence and not mythology. I think we are living with a lot and making a lot of public policy based on mythology. That is my point.

Mr. SOLOMON. Mr. Chairman, I think there have been some fundamentals involved here. Sure, Secretary Baker has had a lot to say since the beginning of the year, and you are right, the press has assumed he was talking down the dollar, but as I have written elsewhere, in a piece in the Journal of Commerce— I would be glad to provide it if you would like to have it—there are three objective reasons why the dollar declined during the month of January. And almost all of the decline occurred in January. It has been stable since the end of the month. Three reasons that have absolutely nothing to do with what I call open mouth policy, that is, talk by officials.

So I think the market was responding to fundamentals. Now on top of those fundamentals, you had some talk, and if people want to attribute it to the talk rather than the fundamentals, that is what they will do, but they are not necessarily correct in doing that.

Mr. EISNER. I think the fundamentals do point to a decline in the dollar, but what we should remember is that while no country can keep its currency up very well, because to do that it has to have foreign reserves, any country can drive its currency down simply by in effect printing its own money, either throwing it out or, for that matter, buying foreign exchange with it.

I would suggest that there seems to be a common view that there is something bad about a free fall of the dollar. I would suggest that there is perhaps at least as great a danger in trying to attempt a controlled fall. In the first place, as just pointed out, the markets will tend to see that and will anticipate, but if one consequence of their anticipation is that if the dollar is falling gradually, that is exactly what will disrupt capital markets, because people are not going to want to buy dollars, invest in the United States, if the dollar is going down. The expectations are not necessarily "rational expectations," but investors in the market are not idiots, and they are rational.

If they form the notion that the dollar is going to come down gradually, then they don't want to invest in dollar securities. It is like jumping into the water. Don't go in an inch at a time. If the dollar should go down, it should go down right away.

Now I appreciate that foreign countries maybe don't adjust their policies fast enough, but maybe that will force them to adjust more rapidly, and I don't see any great virtue in dragging this out.

There is a question of how far the dollar should fall, and we do have to recognize that there are lagged effects, and we will get some benefit from the amount the dollar has already fallen. Some benefits are still to come. But I see no particular virtue in trying to hold back the adjustment.

Chairman NEAL. Thank you. Mr. McCollum.

Mr. MCCOLLUM. I have a question based on interpretation of the current law that we are going to be having Chairman Volcker talk about tomorrow, Humphrey-Hawkins. You know, Senators Prox-

mire and Sarbanes seem to have the impression, at least it was reported widely in the press that they did, the other day, that the law requires the Fed to report to Congress the M1 targets, along with the other monetary aggregate targets M2 and M3 and so on, specifically, rather than merely money supply targets, as interpreted and defined by the Fed.

Dr. Solomon, if I could perhaps start with you, who is right in this affair? How do you interpret the law?

Mr. SOLOMON. I am not a lawyer, and I don't have a legal opinion on that subject, sir. I have other opinions on the subject, not based on the law, just on the basis of what I know about monetary policy, and the fact that I spent a significant portion of my life at the Federal Reserve.

It seems to me that whatever the interpretation of the law is, what the Fed has done is absolutely wise and proper. I think it would have been a mistake, given what has happened to M1, given all the institutional and structural changes that have operated on M1, as Bob Dederick pointed out in his testimony and as Chairman Volcker brings out in his statement in the Senate last week, and presumably tomorrow, I think there are very sound reasons to have set it aside for now. I hope it is legal to have done so.

Mr. McCOLLUM. Does anybody else want to comment on that? I am not going to belabor the point, particularly.

Mr. EISNER. I agree.

Mr. McCOLLUM. I have got a question that hasn't been raised today, and I am a little bit surprised it hasn't been.

To what extent is the debt situation of the lesser developing countries and their problem of servicing, which is obviously in the newspapers—it has been chronic, but for the last day or two, Brazil, particularly there. To what extent is this a consideration in setting, or should it be a consideration the setting of our domestic monetary policy?

Dr. Solomon, would you care to comment on that?

Mr. SOLOMON. Well, that is a good question, a very tough question to answer. It is fortunate that at the moment, as we have already brought out here in response to earlier questions, there isn't any strong reason for the Fed to tighten up in any event. One doesn't have to say that they have to refrain from tightening so as not to hurt Brazil, Mexico and Argentina and so on. But some people might carry your question further and say, well, if these countries are in trouble, maybe the Fed should be doing something to reduce interest rates even further, and that would become somewhat more controversial.

It is a tail wagging the dog sort of problem. Some people think that the Fed eased its policy in 1982, because of the Mexican debt crisis. That is not my interpretation. I find it hard to believe that the Fed would change monetary policy substantially with given monetary policy effects on the economy, because developing countries are in trouble. It would try to find some other means to assist.

Mr. McCOLLUM. So if you were sitting in an open market committee and getting your advice out, you would certainly say, we ought to be talking about this, but you would have a very difficult time at this point being persuaded that there is a method or a course that would be prudent to take, in terms of our monetary

policy, to impact that. It would be very hard to foresee how you could, through the monetary policies of our country, affect that debt situation, favorably, without otherwise, in some way, harming our own economy.

Isn't that essentially what you are saying?

Mr. SOLOMON. It is essentially what I am saying, that there may be circumstances in which what we do to help our own economy is also helpful to them. And if our economy happens to need some stimulus, that will clearly also be helpful to developing countries, because our imports will grow faster.

Mr. McCOLLUM. Everybody here today, we have all been concentrating on the value of the dollar, which I guess, is you think about it, the interest rate question and the money supply, it is really all interrelated. It is one thing. Trade comes into the picture, and we have talked about the deficit there and the factors that, I think that, Dr. Holtham, you outlined one, two, three. There seems to be to be a fourth one besides our own deficit, which we can debate as to whether that impacts it or not, to what degree, and that is this lesser developing country debt, and maybe that is something we haven't talked about or you haven't mentioned, because it is not something that we can get a handle on through our monetary policy. But it occurs to me that without having a viable group of trading partners south of the border down in Central and South America, that alone is a big factor in our trade deficits, being as large as they are, isn't it, Dr. Solomon?

Mr. SOLOMON. Yes. There is no question that they are an important part of the explanation for the increase in the trade deficit—not the major one, but an important one in the debt crisis and the cut in imports by developing countries, particularly those in Latin America. Correct.

Now I would just say this, and I don't want to monopolize things here on the panel. What we have talked about, particularly the policies that we have said are needed in other industrial countries, and the combined policies of all the industrial countries are actually crucial for the welfare and the exports and the debt service capacity of the developing countries. I say in my testimony that the world economy is sluggish, and it needs some stimulus. The United States is the one that provided that stimulus since 1982. We are now backing off from that as our trade deficit starts down, and the slack needs to be taken up, I think. This is one of the reasons why it is quite appropriate for Mr. Baker and Mr. Volcker to be putting pressure on Germany and Japan and even other industrial countries to adopt more expansionary policies, and that is of vital importance to the developing countries, as well.

Mr. McCOLLUM. When you say adopt more expansionary policies, you are talking about lowering their interest rates and—

Mr. SOLOMON. And cutting their taxes or doing something to have a less restrictive fiscal policy. At the moment, Japan—just to take one example—despite the Baker-Miyazawa agreement of last October, which was, in a sense, a predecessor to what happened in Paris this last weekend, the Japanese Government introduced a budget for the fiscal year that begins April 1, which is more restrictive than the previous year's budget. They are tightening fiscal policy in Japan. Well, I mean, that simply—

Mr. McCOLLUM. It doesn't make sense, does it?

Mr. SOLOMON[continuing].—it is not very helpful either to the Japanese economy or to the rest of the world.

Mr. McCOLLUM. I don't want to keep anybody else from commenting on it. I think it is kind of your specialty area to ask about, so I did it, but if anyone else wants to jump, please do.

Mr. DEDERICK. I would like to make just two points. I fully agree with everything Bob Solomon said, but when it comes to the LDC problem, I think the Fed does have two roles. One it has played very skillfully so far, as sort of a broker, primarily through Paul Volcker, and not just the Federal Reserve but also the Treasury, bringing the various parties to the table and encouraging them to reach an agreement. This is very important, because of the respect and the role which these institutions have.

The other thing is, of course, as I said in my statement, that one of the Federal Reserve's roles must be the preservation of monetary stability, financial stability, and clearly, if there were to be any shock that would emerge from this, any effects on financial institutions of any sort, it would be incumbent upon the Federal Reserve to see that these shocks did not spread. We have had these before, and the Federal Reserve has been extremely successful in containing them. This would be its responsibility again.

Mr. McCOLLUM. Thank you very much. Mr. Chairman, I believe I have asked my questions.

Chairman NEAL. Thank you, sir.

I am not sure I quite understood, Mr. Eisner. You said that there was some action we could take—and that is what I missed, that would essentially force the Japanese and the Germans to expand their economies.

Mr. EISNER. Yes, our driving down the value of the dollar makes our imports more expensive.

Chairman NEAL. When you say "drive down the value of the dollar," you actually mean expand the money supply?

Mr. EISNER. Well, we do it, essentially, yes, by expanding the money supply or making clear that we are not going to be contractionary again. I think one reason the market pays so much attention to what is said is that, you know, words imply what can be done. So we may not even have to act very much, if we make it clear that we are ready to drive the dollar down, to increase the money supply, that would have some effect. But I would not wait on that.

The point I was making simply is that by lowering the value of the dollar, we discourage—make our imports more expensive, it means we make it difficult for foreigners to export to us. And to the extent their exports to us are reduced, they have to look for other ways to keep their economy going, and they will be pressured to stimulate their economies.

Mr. DEDERICK. I would like to add one thing to that, if I can, Mr. Chairman.

I don't want to leave the impression that at least I think that our problem is the result of actions or inaction on the part of foreigners. Surely, they can help. Their economies have not been growing rapidly, and they have high unemployment rates. It would be to our benefit and to the world's benefit, if they felt they could

grow more rapidly, given their internal constraints. They do have them. It is not the case that we have constraints and the other countries not. So it is still very much incumbent upon the United States to have a balanced economy, to bring down its budget deficit, to pursue proper policies to improve our productivity, to, in other words, have our own house in order.

If we try to solve this by telling others that our problem is your fault, it is not going to work.

Chairman NEAL. I certainly am inclined to agree with that. It seems to me that we have created most—maybe even 80 or 90 percent—of the problem ourselves. I don't know exactly what percent of it. Would you all agree with that?

Mr. SOLOMON. Well, I don't know. I am not going to argue about the 80 or the 90. It is certainly not 100, Mr. Chairman. By the problem, you mean the trade imbalance, I assume.

Chairman NEAL. Yes, the budget imbalance, as well as, the trade imbalance.

Mr. SOLOMON. I wouldn't attribute the budget imbalance, not very much of it, to the rest of the world, but the trade imbalance, I would not attribute 100 percent to what the United States has done. I think it is important to remember that while we have, indeed, had a big increase in the budget deficit since 1980, which is a good part of the explanation for the increase in the trade deficit, Germany and Japan and other industrial countries have done just the opposite. They have tightened their fiscal policies and that tightening has been just as large, relative to the size of their economies as the easing of fiscal policy has been here.

So it has been complementary. And I think one has to look at what has happened at the world economy. They have surpluses; we have a trade deficit.

Are we responsible totally for their trade surpluses, or are their policies also partly responsible for their trade surpluses? So I would say it is not 100 percent, and whether your 80 percent is right, I don't know. Maybe it is only 50 percent. I think the important point is that what has happened to the world in recent years is a result of the interactions of the economies of the major industrial countries and not just the result of the actions of one particular country.

Mr. EISNER. I think there are differences to be expressed. We keep talking of slow growth, generally. I think my colleagues have in mind, essentially, Western Europe, but where we have had our biggest deficits has been—in country by country—has been with Japan, which has had a very substantial rate of growth over the years. Indeed, by my adjustments of deficits, Japan has had large budget deficits at the government level.

The Japanese have also, as far as I know—and Dr. Solomon and the rest may have more accurate information—has been free to try to keep the value of the dollar high. And as I say, you can do that. You can always make your currency cheaper by buying foreign currency with your own.

So again, you have got a problem of a value of the currency, which has the greatest to do with all this.

Chairman NEAL. Dr. Holtham.

Mr. HOLTHAM. Thank you. I think it is quite true that the policies of other countries have been restrictionary in the 1980s, and to an extent that is quite hard to defend given what is happening in the world economy. The Japanese and German Governments, for example, at the beginning of the 1980s had budget deficits which were about 4 percent of their GNP. They have both reduced the deficit down to something like 1 percent of GNP or even a fraction less. And now if you excluded interest payments, they would both be in surplus. That is the kind of fiscal correction that they have put in place over the same years that the United States has been expanding its budget deficit. If you say that they can now afford a fiscal expansion, they reply: "why do we want to end up like the United States? Wouldn't the outcome simply be, if we were to have a fiscal expansion, we would end up with a burst of growth, and then nothing, and a big deficit on our hands?"

The other thing that concerns them too is that they are much more—at least the Germans—concerned about inflation in the world economy. And I think for that reason, it would be much easier to get an agreement with them to do something constructive, if they had more confidence in the resolve of the U.S. administration to really put its budget deficit on a declining path. It is certainly true to that some extent, you can force them into a monetary expansion by having your own monetary expansion, because the monetary expansion here tends to push the dollar down. They try and stop that. They try to hold the D mark down, which means they have to print money too, and they tend to lose control of their own money supply, to the extent that they are trying to resist moving to the exchange range.

You can do that to them, and they are aware that that is happening, and they fiercely resent it. And in that situation, it is very difficult to get them to agree to any fiscal measure. My interpretation is, it would be easier for the United States to get a meaningful agreement with Japan and Germany if there were some carrot as well as some stick. If the United States were able to say it had a credible plan for getting the deficit on a declining track with measures, that were visibly likely to succeed, in that situation there would be a greater chance of them reciprocating with expansionary measures of their own.

Mr. EISNER. Yes. Quickly, there is a divergence within all of these countries. I think the battle in this country is mirrored elsewhere. That is between people who seem most worried about inflation and people who are concerned most about economic growth. I detect throughout the world a bias, I would call it, in the banking community, to minimize the danger of inflation, whatever the costs on growth—that is an overstatement. But this is true in every country. And I think it is to our interests to encourage growth in this country and to encourage those in other countries who would grow, and not, as Dr. Solomon suggested, grow simply by trying to export, as Japan does, at the expense—in some sense, at the expense of others.

There are two ways to grow. One is simply to make your export industries grow, and the other is to have a balanced growth of the entire economy.

I don't think we should be reluctant, both to emphasize growth in our country and insist that other countries emphasize growth as well.

Chairman NEAL. When you say you insist on other country growth, it seems to me we have been trying to get them to do that, but they resist. I don't know how to force it—

Mr. EISNER. Well, I think it has been suggested, and I suggested, and again, it was just suggested by my colleague, that you force it by following an easier monetary policy here. With all those consequences, they are going to be forced to go along to some extent.

Chairman NEAL. If you think, at least at some level, that the results are more inflationary, you certainly pay a price for it. You do not seem to agree with that, and I don't think we are going to settle that matter here this morning, but I am sure that that is on the minds—it would be on my mind, and I would guess it is on the minds of other policymakers also.

Back to the employment question. I have not seen regional employment figures lately, but I believe that with recent demographic changes, it may not be too long into the future before we start experiencing labor shortages in parts of this country. It is an interesting scenario—something we ought follow pretty carefully, I believe.

Mr. McCOLLUM. I have no more questions, but I have enjoyed it very much today. It has been informative. I look forward to hearing from you gentlemen in the future. I am sure we will.

Chairman NEAL. I want to thank each of you as well. Thank you very much, and please stay in touch with us. Any thoughts you have as time goes on, please bring them to us.

The subcommittee is adjourned.

[Whereupon, at 1:20 p.m., the hearing was adjourned to reconvene on Thursday, February 26, 1987 at 10 a.m.]

A P P E N D I X

STATEMENT OF ROBERT G. DEDERICK
EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST
THE NORTHERN TRUST COMPANY
BEFORE THE
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
of the
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
February 25, 1987

Mr. Chairman, I appreciate the opportunity to testify on the economic outlook and its implications for monetary policy.

For the past 2 1/2 years, the United States economy has been in what might be called a suspended business cycle. After racing ahead rapidly over the prior 1 1/2 years, the business cycle clock suddenly stopped in mid-1984 - far short of midnight, fortunately - and, as yet, it has shown no decisive indications of restarting. Thanks to the debilitating effects of the (until recently) rapidly rising trade deficit, the expansion hasn't been able to maintain a full head of steam and thereby pave the way for its own demise. And, thanks to the long-sustained ease of fiscal policy - and, after a lag - a supportive monetary policy as well - it hasn't run out of steam even given the trade deficit. The economy has just chugged along - or muddled through, to use the preferred cliché. Growth has been at an average annual rate of about 2 1/2%, a pace that, judging by the course of the unemployment rate, has been perhaps a shade faster than the economy's (disappointingly low) "potential" growth path - the expansion pace at which unemployment remains basically unchanged.

Viewed in a favorable - and by no means unrealistic - light, the economy has had the famous soft landing that postwar policymakers regularly have sought and just as regularly have failed to achieve. Less favorably, though, the soft landing occurred well short of the runway, i.e., at a level of unemployment that is inappropriately high for any sustained period. Further progress must be made.

As of early 1987, the economy's behavior continues to be "uncyclical". Nonetheless, some noteworthy changes have occurred - changes that have significant policy implications.

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First, signs have emerged suggesting that the cyclical clock is about to start running again this year. To be sure, domestic final demand - which has been the engine of growth ever since the expansion first began at the end of 1982 - shows distinct signs of tiring. The consumer is overspent in relation to his/her income; the homebuilder is bedeviled by steep vacancy rates in multi-family housing and by tax reform; the businessman is discouraged by excess capacity and, again, by tax reform; and the government spender - at all levels, but especially the Federal - is constrained by budgetary pressures. More positively, though, the sharp plunge of the dollar - in real terms, at least 20% on a trade-weighted basis against our important trading competitors - finally has begun to produce a narrowing of the mammoth trade deficit in volume terms. What has been a drag on the economy is becoming a stimulus. What's more, the stimulus will be both direct - primarily in the form of more vigorous exports and more restrained imports of manufactured goods - and indirect - via the resultant encouragement to increased inventory accumulation by manufacturers. With a mini-inventory correction having occurred throughout 1986, manufacturers' stock accumulation is ripe for a pickup. All in all, then, the best bet - not to be confused with a sure bet - is that the economy's expansion pace will quicken a bit this year - to perhaps an average of 3% on a fourth quarter to fourth quarter basis. Unemployment should decline slightly in consequence.

Second, signs also have emerged that inflation is moving to a significantly steeper trend path this year - especially as measured by the consumer price index. To be sure, there are constraints in this area, too - notably, the persistence of widespread excess capacity in labor and product markets, the lagged effects on wages

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of last year's extraordinarily favorable inflation performance, and the large carryover of grain supplies. These dampening factors will be more than offset, though, both by the partial reversal of last year's oil price plunge and by the decline in the dollar. It continues to be true that there is no such thing as a free lunch, and the same drop in the dollar that is strengthening our trade balance is, in part, performing this feat via its effect on import prices - which, excluding petroleum, rose at an average rate of 6 1/2% in 1986. Thus, when we put the parts together in the inflation area, the best bet - a somewhat surer bet than our growth forecast - is for a rise in the consumer price index of about 4% across 1987.

Third, in the process of reversing its steep climb of the early 1980s, the dollar has lost its virtue - as in the late 1970s. Put less dramatically, the decline over the past two years - even though necessary - has proceeded to the point where it threatens to have dangerous side effects of a financial nature. In the goods markets, as Chairman Volcker has noted, there is a distinct possibility that the price raising impact of dollar declines will be much more pronounced than earlier, now that the U.S. manufacturing capacity utilization rate is rising and the profit margins of foreign producers have narrowed so sharply. In the credit markets, again as Chairman Volcker has noted, there is the danger that the demand for dollar-denominated debt instruments - on the part of both foreigners and Americans - will be curtailed in response to a loss of confidence in our currency. Given our large current account deficit - and our accompanying shortage of domestic savings - U.S. credit markets are heavily dependent on the kindness of strangers. If foreign investors take fright - or if domestic investors fear that

they will take fright - it doesn't matter; either event will suffice - the interest rate impact could be severe. And certainly the danger of either occurrence is greater now than when a drop in the dollar was widely regarded as an unequivocal virtue.

Fourth, an extraordinarily rapid increase in the narrowly defined money stock, coupled with smaller but still-historically large increases in the broader monetary and credit aggregates, inevitably has raised concern about whether the nation is being supplied with an excessive volume of liquidity - with potentially destabilizing effects on both financial markets and the real economy. Much of the upsurge in the volume of money can be explained - at least to researchers' satisfaction - by the dramatic plunge in interest rates and the decline in inflation. But, as Chairman Volcker has stated, a large unexplained residual remains. In view of this uncertainty, even those of us who have not been members of the monetarist school cannot help but wonder whether the rapid money and credit growth is trying to tell us something.

Summing up on the economy, the nation's monetary policymakers find themselves faced with the following operating environment:

1. The business outlook appears to have strengthened to a mild degree - pointing to about a 3% rise in real GNP this year.

Nonetheless, prospects are far from certain. There are, in fact, risks on both sides of the 3% forecast - revolving around such unresolved issues as the financial strength of consumers, the impact of tax reform (aggravated by our ignorance about the extent of underwithholding), and the prospective strength of demand overseas.

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The growth/inflation tradeoff is now taking place at a distinctly higher inflation level than last year, and the terms of this tradeoff may well have worsened now that the dollar has fallen so far.

The same steep fall in the dollar has raised concerns about the willingness of foreign and domestic investors to place funds in dollar denominated debt instruments, including those of the Treasury.

Rightly or wrongly, the rapid growth of money and credit has raised concerns as well - in this case whether the seeds have been sown for inflation and other financial excesses in 1987 and beyond.

Clearly, then, conditions have changed greatly from a year ago. In 1986, the Federal Reserve's task was relatively simple, namely, to assure that domestic demand was adequate to prevent the economy from slipping off its slow growth path into recession. Inflation and inflation expectations were sufficiently muted, and belief in the desirability of dollar depreciation was sufficiently widespread, that the authorities could err on the side of ease with little danger of near-term adverse effects if policy proved to be unnecessarily stimulative. Running room was ample.

Here in 1987, though, life is much more difficult for the monetary officials. To begin with, while the business outlook appears to have improved, the same also appeared to be true early in 1986 - incorrectly, as it turned out. Thus, monetary policy again must be alert to the danger of near-term recession - with all its adverse implications for reasonably free trade, for the Federal budget deficit, and for financial stability here and abroad. Just as in 1986, the nation simply cannot afford a recession under

current circumstances. At a minimum, this implies that the Federal Reserve must stand ready to provide sufficient liquidity to accommodate the price increases that will be triggered by higher oil prices (temporarily, at least) and by higher import prices. Failure to accommodate these increases would reduce aggregate real output because of wage and price inflexibilities elsewhere in the economy. At the same time, though, the monetary officials must also recognize that a policy of erring on the side of ease - as a means of avoiding recession - would carry dangers of its own this year. Unneeded ease would threaten to raise the already-heightened inflation rate - both directly, e.g., by permitting the higher oil and import prices to work their way into the wage structure, and indirectly via its impact on the dollar. Even more ominous, under current circumstances, unneeded ease also could turn out to be outright counterproductive. It could worsen inflation expectations of credit market participants, thereby having a perverse effect on long-term interest rates - we already had a taste of this late last summer - and, the new danger, it could precipitate a loss of confidence in the dollar - in this case acting to push up interest rates by discouraging investors, foreign and domestic, from placing new funds or maintaining old funds in the United States.

In sum, then, the Federal Reserve faces a daunting task in 1987. As usual, it has manifold goals - inflation control, satisfactory growth, and the preservation of financial stability. In contrast with experience over recent years, though, when one goal or the other clearly was dominant, in 1987 there is no obvious choice for emphasis as the year begins. And, worse, there is no obvious set of actions that will assure the achievement of the various priorities. In consequence, running room is extremely

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narrow. And that, in turn, means that the possibility of error is high - much higher than in 1986. Given this difficult operating environment, the monetary policymakers must be both flexible - avoiding any commitment to rigid targets of any sort - and cautious - avoiding abrupt movements in either direction. It is a time for discretion - in the full meaning of the word.

Statement of Robert Solomon^{*}
 Guest Scholar, The Brookings Institution
 before the
 Subcommittee on Domestic Monetary Policy
 of the
 House Banking Committee
 February 25, 1987

I am pleased to appear before this committee in its hearings related to the Federal Reserve's semiannual monetary policy report. In this statement I shall cover 1) the outlook for the trade deficit and its relationship to both the budget deficit and the growth of the economy, 2) whether the dollar needs to depreciate more, 3) the relevance of the economic policies and performance of other industrial countries, and 4) what influence exchange rates should play in the conduct of U.S. monetary policy, including the advisability of adopting a system of target zones.

Outlook for the Trade Deficit

It was exactly two years ago that the dollar reached the peak of an appreciation that began in 1980. That rise in the value of the dollar was a major cause of the enormous U.S. trade deficit. The subsequent depreciation of the dollar is a necessary condition for the reduction of that trade deficit.

Changes in exchange rates have their effects on trade only with a lag. The trade deficit as measured in nominal terms-- that is, in current dollars-- has at best only levelled off through the fourth quarter of 1986. But the volume of exports and imports has apparently begun to respond to the dollar depreciation. According to the Commerce Department's GNP estimates, exports of goods and services in constant dollars increased at an annual rate of 13 percent in the second half of 1986, while the volume of imports increased only 8 percent. In real terms, the deficit on goods and services

^{*}The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its officers, trustees, or other staff members.

decreased in the fourth quarter of 1986.

From the viewpoint of the growth of the economy, it is the deficit in real terms that matters. We can say that, beginning in the last quarter of 1986, the external deficit gave a boost to growth instead of being a drag on it. In fact, the entire increase in real GNP in the fourth quarter was accounted for by the reduction in the real external deficit.

This outcome is consistent with most forecasts for the economy in 1987. The outlook depends crucially on improvement in the trade balance.

If the real deficit diminishes this year at the same rate as in the fourth quarter, that will amount to somewhat more than one percent of GNP. The budget deficit is also expected to go down by about that amount. Ideally, the twin deficits will continue to decrease in tandem, while the economy continues to grow.

Has the Dollar Depreciated Enough?

One approach to answering this question is to measure how much of the appreciation of 1980-85 has been reversed. On the basis of the Federal Reserve's index of the trade-weighted average value of the dollar, about four-fifths of the earlier appreciation has been reversed. The Morgan Guaranty has an index that includes many developing countries' real exchange rates along with those of the major industrial countries. According to that index, about 72 percent of the 1980-85 appreciation had been reversed as of January. Thus the dollar has not yet returned to its 1980 level in either nominal or real terms. But it is necessary to go beyond simply undoing the earlier appreciation. Because of the interest to be paid on the external debt we have incurred as the result of our external deficits during this decade, we need a larger trade surplus to achieve any given goal for the current account.

The additional interest payments to the rest of the world will amount to about \$50 billion (assuming an increase of the net debt of \$750 billion and an interest rate of 7 percent). To add \$50 billion to the trade surplus requires a significant dollar depreciation.

On the basis of these considerations, I conclude that the dollar needs to depreciate further. This conclusion is supported by econometric studies.¹

The additional depreciation does not have to occur immediately. The downward movement of the dollar of the past two years is sufficient to begin the process of reducing the deficit. There is something to be said for giving other countries some breathing space in which to adjust their economies to the exchange-rate change that has taken place thus far. But, in due course, the dollar should decline further.

The Policies of Other Countries

As the U.S. external deficit decreases, it is inevitable that the trade balances of other countries will move in the other direction. The developing countries have little, if any, scope to incur larger trade deficits. The adjustment corresponding to the smaller U.S. deficit must therefore show up almost entirely in the accounts of other industrial countries. Germany and Japan are usually singled out in this connection, since they have the largest surpluses among industrial countries. If Germany and Japan are to experience a decrease in their surpluses without going into economic stagnation or recession, it is necessary that domestic demand expand in their economies. This is well known. I would like to make two clarifying points on this subject.

First, we should not expect miracles from a speedup in demand in

1. See, for example, Aaron and others, Economic Choices 1987, The Brookings Institution, 1986, pp.31-35.

Germany and Japan. According to an analysis by the International Monetary Fund, one percent faster growth of domestic demand in these two countries would add less than \$10 billion to U.S. exports. On the other hand, more expansive policies in these two countries, is likely to be emulated elsewhere in Europe and Asia. If many countries adopt more expansionary policies, the effect on the U.S. trade balance would be substantial.

Second, our interest in more stimulative policies abroad is not related solely to what the effect will be on our trade balance. The world economy is sluggish. It needs stimulation. Investment in plant and equipment is too low in almost all countries, developed and developing. As the United States reduces its twin deficits, it will no longer be stimulating the world economy. Unless other industrial countries increase their domestic demand more, the world economy will stagnate, to the detriment of all. The responsibilities of Germany, Japan and other industrial countries should be viewed in this light.

Monetary Policy and the Exchange Rate

The regime of floating exchange rates has come in for much criticism in recent years as the dollar soared in the first half of the present decade and fell in the past two years. The appreciation of the dollar created hardships for American exporters and for those who compete with imports. Couldn't those hardships have been avoided by stabilizing exchange rates? I shall not burden you with lengthy analysis on this issue. I shall simply state the results of that analysis, but the details are available. The main point is that macroeconomic policies were divergent among the major industrial countries. While the United States created a large budget deficit, Germany, Japan, and a number of other countries adopted restrictive fiscal policies.

It was the fiscal policies that were responsible for the development of the balance-of-payments deficit in the United States and balance-of-payments surpluses in Germany and Japan. Because of our budget deficit, we needed to absorb saving from the rest of the world. The appreciation of the dollar and the trade deficit were the means of absorbing saving from abroad. By the same token, Germany and Japan, by reducing their budget deficits, had saving to send abroad. They did that via currency depreciation and trade surpluses. In the process, they enjoyed export-led growth.

Thus the exchange-rate movements were a reflection of the fiscal policies that were pursued in the major countries.

With that background, I turn to the question whether it would be advisable to use monetary policy to stabilize exchange rates.

A number of proposals have been put forth to confine exchange-rate variations within zones or bands. If one of these proposals were adopted, it would be necessary for the Federal Reserve to use its policy instruments to keep dollar exchange rates within the agreed range. But it could well happen that the domestic economy called for a different monetary policy. For example, if the dollar were at the lower band of a target zone now, the Fed would have to take actions to raise interest rates in the United States in order to prevent the dollar from going below its target. But the present condition of our economy does not call for higher interest rates.

The result would be that in an effort to stabilize the exchange rate, we would be destabilizing the domestic economy.

If we had a flexible fiscal policy, it could be imagined that these undesired effects on the domestic economy would be prevented by making fiscal policy more expansionary, thereby compensating for the depressive effects of higher interest rates. But fiscal policy is far from flexible, in the United

States and in the other major industrial countries.

In my view therefore efforts to reform the exchange-rate system should be preceeded by a reform of fiscal policy. Only when fiscal policy can be brought into play to stabilize the economy on a desirable growth path should we consider proposals that would divert monetary policy from its primary goal.

2/24/87

Monetary Policy, The Deficit and The Economy

Prepared Statement of Robert Riser*

Committee on Banking
Subcommittee on Domestic Monetary Policy
U.S. House of Representatives
February 25, 1987

I. Introduction and Summary

Money matters. Deficits matter. They matter for the economy and they matter for each other.

Contrary to popular mythology, deficits are not all bad. Some efforts to eliminate them can be much worse.

Deficits can in fact be too small as well as too large. To know which, we have to measure them right, we have to know the state of the economy and we have to know our monetary policies.

Real, structural deficits in a less-than-full-employment economy generally contribute to economic growth, to investment and to the reduction of unemployment. Real growth in relevant monetary aggregates will also contribute to economic growth, investment and the reduction of unemployment.

Reduction of the budget deficit may tend to reduce interest rates and the value of the dollar but it will reduce the trade deficit primarily by slowing the economy. Increasing the rate of growth of monetary aggregates will reduce interest rates and the value of the dollar and reduce the trade deficit by increasing exports.

Real increases in monetary aggregates will lower our structural budget deficits by lowering interest rates and hence reducing net government interest payments. Monetary ease will further reduce the actual deficit by its effect in stimulating the economy.

The economy is sluggish. Reductions in the structural deficit will in themselves slow the economy all the more.

To lower the risk of recession, deficit reduction must be accompanied by significant monetary stimulus. The more the contemplated deficit reduction, the greater the needed monetary stimulus.

To restore optimum growth and reduce unemployment we need all the more monetary easing.

2. Budget Deficits and the Economy

Government budget deficits must equal private budget surpluses. Where the government is a debtor, the private sector -- and foreigners -- are creditors. The great bulk of government debt is owned here at home. The more we own of that debt, paradoxical as it may seem, the wealthier we feel and the more we are inclined to spend.

Deficits can then be too large if they increase private spending to the point where total spending, public and private, is more than the economy can readily produce. The result is inflation, in itself painful. Efforts to combat the inflation by tight money bring high real interest rates which in turn curb investment. Reduced investment is then the way -- and the only way -- that a real burden is put on our children and grandchildren.

If there is insufficient purchasing power or demand, from our private sector, from government and from foreigners, production, employment and our standard of living are all depressed. In such a

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situation, failing some other solution, it may well be argued that the deficit should be increased. For here a government deficit, by adding to private wealth and purchasing power, increases private demand and hence contributes to raising production and putting people back to work.

The record until recent years suggests that deficits have generally been not too large but rather too small. This becomes particularly clear when account is taken of the effects of inflation. By reducing the real value of the money and bonds held by the public, inflation acts as a tax which in a very real sense reduces the economically relevant real deficit. The inflation tax has frequently been so large as to convert our purported deficits into real surpluses.

All this and more is shown in the copy of Table 9.8 taken from my book, *How Real Is the Federal Deficit?*. It indicates, for one thing, that over the period from 1962 to 1984 each percentage point of inflation-adjusted high employment or structural deficit, measured as a ratio of GNP, was associated on the average with 1.568 percentage points more of growth in real GNP the following year. This relation may be seen graphically in Figure 8.2. A complimentary relation, showing that lesser deficits (or greater surpluses) were associated with greater increases in unemployment, is graphed in Figure 8.3.

Deficits were, as anticipated, associated with more consumption. Each percentage point of deficit, as reported in Table 9.8, was followed on the average by .642 percentage points more of consumption as a ratio of GNP. But each percentage point of deficit was also associated with 1.383 percentage points of gross private domestic investment as a ratio of GNP. The one negative element, again as might have been anticipated, is that each percentage point of deficit was associated with .399 percentage point decline in net exports as a ratio of GNP.

The economic theory of much of the last half century predicted such results. But whatever the theory, those were the facts and we had better not forget them. Inflation-adjusted real structural deficits have contributed to growth in GNP, consumption and investment, but have injured our trade balance.

3. The Role of Monetary Policy

Easier monetary policy can also stimulate the economy. As again shown in Table 9.8, in the period from 1962 to 1984, each 1 percentage point increase in the ratio of the monetary base to GNP was associated with a 7.172 percent increase in real GNP the following year. Since the monetary base runs about 5 percent of GNP, so that a 1 percentage point increase in the ratio means a 20 percent increase in the monetary base, this implies (dividing 20 by 7.172) that each 3 percent increase in the monetary base was associated with about 1 percent more in subsequent real GNP.

But each percentage point reduction in the ratio of deficit to GNP was associated with about 1.5 percent less growth in GNP. We thus have a very rough indication of a "terms of trade." For every \$30 billion that we now reduce the structural deficit — two-thirds of a percentage point reduction in the ratio of deficit to GNP — we should think in terms of a 3 percent per year added increase in the monetary base (or some comparable increase in another monetary aggregate) to compensate for the loss in fiscal stimulus.

I do not mean these particular numbers to be taken literally. The essential point is that, whatever other value people may see in deficit reduction, it does add a fiscal drag. If we are to avoid further reducing our already sluggish rate of growth or increasing our persistent unemployment, we cannot reduce the structural deficit without compensating monetary stimulus.

Fundamentally, we cannot evaluate fiscal policy and monetary policy independently of each other, and we cannot evaluate either independently of the state of the economy. In this evaluation, the foremost current fact is that unemployment remains at 6.7 percent of the civilian labor

force, with 8 million fully unemployed. Additional millions are categorized either as discouraged workers, and hence not counted as unemployed because they have given up looking for work, or as partially unemployed for economic reasons.

In this situation, reductions of the budget deficit, in themselves, can only be viewed as aggravating. By reducing purchasing power, they reduce effective demand, bring about reductions in the rate of growth of GNP, if not an actual downturn, and increase unemployment. While there is wide agreement that the current mix of fiscal policy and monetary policy is wrong, it should also be recognized that, in total, policy is not sufficiently stimulative. Therefore, any change in the mix should involve a net increase in support to the economy. If the budget deficit is to be reduced, increased stimulus from monetary policy must be sufficient both to counteract the further fiscal drag and to reduce unemployment.

4. The Trade Deficit

Monetary policy plays a critical role in the trade deficit. It is widely argued that large budget deficits have contributed to our relatively enormous trade deficit. Budget deficits, however, are an indirect factor in the trade deficit. Their reduction is a roundabout and costly cure. The direct and beneficial cure is to be found in monetary policy.

Budget deficits contribute to the trade deficit in two ways. First, by stimulating the economy they bring about more consumption and investment expenditures. Some of these expenditures are for foreign goods, thus swelling our imports. Second, given monetary policy, budget deficits by their stimulus to the economy contribute to somewhat higher interest rates. These increase the attractiveness of the dollar to foreign investors and decrease the relative attractiveness of foreign assets to American investors. The demand for the dollar increases and its cost to foreigners rises. This higher cost of the dollar to foreigners makes our exports less competitive and the corresponding cheapness of foreign currency for Americans makes imports more attractive in the United States.

Reduction in the budget deficit thus tends to reduce the trade deficit, first, by reducing our imports as it reduces our income and second, by reducing the value of the dollar, making imports more expensive and stimulating our exports. The difficulty with this way of combating the trade deficit is that to a considerable extent it throws out the baby with the bath. It reduces our expenditures on foreign goods because it reduces our total expenditures. Thus, as our economy is slowed and our income is decreased we buy fewer Toyotas, but we buy fewer Chryslers and Buicks and Fords as well.

An easier monetary policy meets the trade problem without these deficiencies. By increasing the supply of dollars, in accordance with old-fashioned laws of supply and demand we reduce the price of the dollar in terms of foreign currency. The increased supply of dollars at the same time reduces our interest rates. The lower interest rates not only contribute to a reduced foreign demand for the dollar which brings the dollar down in value. They also stimulate domestic investment. Thus, exports rise because of the reduced cost of the dollar and investment is increased because of lower interest rates. These two factors both contribute to a more prosperous American economy. That then reduces the domestic budget deficit as higher incomes raise tax revenues and at least certain kinds of government expenditures, such as those for unemployment benefits, decline.

It is hence folly to focus on budget deficit reduction as a method of meeting our real trade deficit problem. The appropriate solution is easier monetary policy, which will both reduce and ultimately, if carried far enough, eliminate the trade deficit, while at the same time bringing about a more prosperous economy and reducing the budget deficit.

It has, of course, been argued that in the last year we have had very substantial declines in the value of the dollar and the trade deficit remains. There are two answers to this. First, it is well

established in economic theory and fact that changes in the exchange rate react on the trade deficit with a considerable lag. Indeed economists refer to this as the "J" curve, indicating that in response to a fall in the exchange rate the trade deficit may even initially worsen, following the contours of the letter "J," before improving. But further, there is good reason to believe that we have not yet had sufficient reduction in the value of the dollar. It has not to this point declined significantly against the currency of some of our trading partners. And in general, the dollar is still considerably more expensive to foreigners than it was in 1980. This is, again, a fairly simple matter of economic arithmetic. If the prices of American goods to foreigners are elevated because the dollar is expensive, we lose our "competitiveness," which means simply that we are priced out of foreign markets.

5. Monetary Policy and Budget Deficits

Much current discussion of budget deficits is carried on in an eerie vacuum, ignoring both the state of the economy and monetary policy. The Grand-Rudman deficit targets, including that of a "balanced budget" in 1991, are a disaster in the making, regardless of monetary policy. They ignore the state of the economy. They ignore the oddities of federal accounting which fail to distinguish between capital and current expenditures and fail to adjust properly for inflation. If they were to be implemented -- without asset sales and other phoney accounting tricks -- they could spell a major recession, high unemployment and the creation of a huge real burden for future generations by devastating reductions in private and public investment.

No decisions on deficit reduction can be made properly, however, independently of monetary policy. As I have suggested above, without some understanding as to easing of monetary policy, given the current state of the economy, probably no deficit reduction at all is in order at this time. To the extent that we want deficit reduction, and we should in terms of a desirable fiscal-monetary mix which would not unduly prejudice investment, we must have a guarantee of a major stimulus for monetary policy. Otherwise, we shall have the worst of all worlds. Tightening fiscal policy will reduce consumption, slow the economy, and thus reduce investment as well. If the deficit is reduced by cuts in public investment in education, health, research and our general infrastructure of roads, bridges, harbors, airports, and in protection of our natural resources in the land, water and air, the future cost will be all the greater.

The critical need, therefore, is a significantly stimulative monetary policy which will foster the movement of the economy toward full employment and maximum utilization of its existing resources. The reductions in interest rates consequent upon monetary expansion will in themselves reduce interest costs to the Treasury and hence reduce the deficit. The expanded economy will reduce the deficit all the more.

It is widely argued that one must be cautious in monetary policy because monetary stimulus will rekindle inflation. This is a misreading of recent economic history as well as a misapplication of economic analysis. Inflation can come from excessive monetary stimulus. It can also come from excessive fiscal stimulus. Excessive stimulus, however, relates to the state of the economy. It is hard to place credence in the notion of excessive stimulus with those 8 million -- 6.7 percent of the labor force -- unemployed, a rate of growth of real GNP little over 2 percent, and declining investment. The facts bearing this out should be clear enough in recent history. Despite rapid rates of growth of the usual measures of money supply, M1 and M2, along with very large budget deficits, the rate of inflation has fallen from the double digit levels of 1981 to virtually zero in 1986. The inflation of the late 1970s and early 1980s was, indeed, never due to excess demand but rather was fully accountable to supply shocks, essentially the huge increases in oil prices of that epoch. With the subsequent decline in oil prices, as well as the accelerating effect of the 1982-83 recession, inflation collapsed.

There is hence little to fear in inflation currently from either fiscal or monetary stimulus. Stimulus brings inflation when the economy is already overheated. Unhappily, the economy is nowhere near that condition now.

Unless we have a misguided obsession, perhaps related to "fighting the last war," with minimizing the risk of future inflation regardless of the cost to the economy, the current imperative for monetary policy is clear. We must bring about maximum employment and purchasing power, indeed at least aim at the virtually forgotten Humphrey-Hawkins targets of full employment. This will make possible and desirable -- indeed will go far in itself to bringing about -- optimal reduction of budget deficits.

That by no means implies endorsement as a goal of public policy of the mischievous "balanced budget." Indeed, as I have argued elsewhere, most recently in testimony for the House Committee on the Budget and the House Committee on Ways and Means, a more appropriate baseline target would be a constant ratio of debt to GNP. With a 1987 ratio of some 50 percent, or \$2,200 billion debt to \$4,400 billion GNP, this has some dramatic implications. A 6 percent rate of growth, raising GNP by \$264 billion, means that we can accommodate a 6 percent rate of growth of debt, or \$132 billion, while keeping the debt-GNP ratio at that same 50 percent, in this case, \$2,332 billion of debt to \$4,664 billion GNP. An increase in the debt of \$132 billion means simply a deficit of \$132 billion. And in 1991, that "balanced" debt-GNP ratio means not a balanced budget but a deficit, on the basis of a projected GNP of \$6,000 billion, still growing at 6 percent, of some \$180 billion. But all this is another fiscal story.

Our conclusion for monetary policy is that it must be sufficiently expansive to drive down the value of the dollar enough to restore a reasonable equilibrium in our international balance of payments, to restore our economy to full employment, and to bring about maximum growth of our resources and output. To the extent that can be achieved, the budget deficit may and should be reduced in a manner consistent with our needs for public as well as private investment.

From Robert Eisner, *How Real is the Federal Deficit?*, New York, The Free Press, 1986

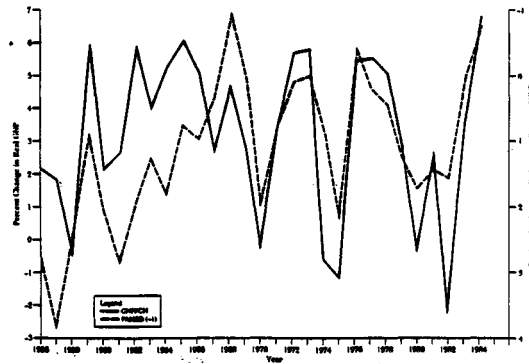


Figure 6.2 Lagged Price-Adjusted High-Employment Surplus and Change in GNP

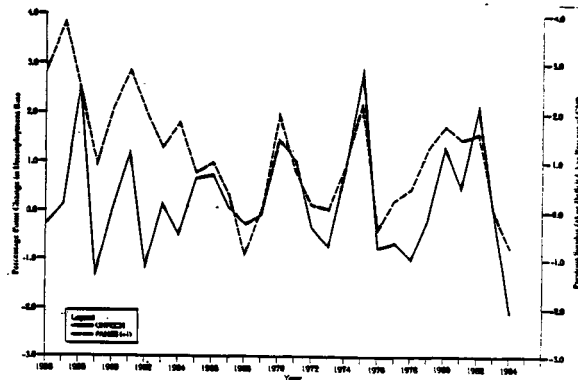


Figure 6.3 Lagged Price-Adjusted High-Employment Surplus and Change in Unemployment

TABLE 9.8 High-Employment Budgets, Changes in Monetary Base, and Changes in Components of GNP

$$\Delta COM_t = b_0 X_1 + b_{0M} X_2 + b_1 PAHES_{t-1} + b_2 \Delta MB_{t-1}$$

$X_1 = 1, X_2 = 0$ for $t = 1962, \dots, 1966$
 $X_1 = 0, X_2 = 1$ for $t = 1967, \dots, 1984$

1	(2)	(3)	(4)	(5)	(6)					
					REGRESSION COEFFICIENTS*					
					Constants		$PAHES_{t-1}$ (b_1)	ΔMB_{t-1} (b_2)	\bar{R}^2	D-W
1962-66 (b_{01})	1967-84 (b_{02})									
EQUATION	COMPONENT (COM)									
(9.28)	Consumption	3.401 (0.675)	2.339 (0.303)	-0.642 (0.263)	2.395 (1.592)	.580	1.91	.092		
(9.29)	Investment	2.613 (1.176)	1.135 (0.541)	-1.383 (0.414)	3.587 (2.411)	.570	1.99	.282		
(9.30)	Government	1.195 (0.558)	0.483 (0.270)	-0.113 (0.172)	-0.660 (0.981)	.354	1.52	.473		
(9.31)	Net exports	-1.615 (1.273)	-0.766 (1.012)	0.399 (0.137)	1.625 (0.811)	.512	1.45	.836		
(9.32)	GNP	6.208 (1.296)	3.371 (0.585)	-1.568 (0.479)	7.172 (2.830)	.735	2.03	.174		
(9.33)	Domestic demand	7.405 (1.506)	3.934 (0.675)	-2.141 (0.560)	5.149 (3.295)	.767	1.93	.155		

*Least squares with Cochrane-Orcutt, first-order autoregressive corrections; standard errors are shown in parentheses.

ΔCOM = change in component as percent of GNP

$PAHES$ = price-adjusted high-employment surplus as percent of GNP

ΔMB = real change in monetary base as percent of GNP

Statement of

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before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives

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*The views expressed in this testimony are the author's own and should not be attributed to the trustees, officers, or other staff members of the Brookings Institution.

International Aspects of United States' Monetary Policy

I. Introduction

Mr Chairman and Members of the Committee, may I say how pleased and privileged I feel to be asked to testify today on a topic of such importance. My remarks are based on the assumption that US economic policy has three objectives:

- maintenance of growth and prevention of any rise in unemployment;
- control of inflation below some critical rate;
- reduction and eventual elimination of the foreign trade deficit.

The last objective is widely regarded as requiring an improvement in "competitiveness". As far as price competitiveness is concerned, that is strongly influenced by the real exchange rate - the exchange rate corrected for changes in the relative price level in the United States and abroad. Both the exchange rate and inflation are affected by monetary policy. Other influences on competitiveness, particularly non-price competitiveness, include things like the educational level of the workforce and the rate of progress of technical innovation and productivity. Those things are not generally much affected by monetary policy and I shall not address them today.

With three broad objectives for policy, the single instrument of monetary policy is insufficient on its own to ensure a desirable outcome. To take just one example, a very loose monetary policy could, in the short run, help to sustain demand and hence growth. By lowering the nominal exchange rate it could also improve price competitiveness and help to reduce the external deficit. However, depreciation of the dollar could get out of control and, together with buoyant domestic demand, would eventually lead to a reacceleration of inflation. That would not only be undesirable in itself but would eventually threaten the other objectives as well. If monetary policy is devoted to one objective, the others will go by default; if it is forced to try and balance all three, the outcome may not be satisfactory for any of them. Monetary policy cannot and should not be considered in isolation.

The correct stance for monetary policy depends, therefore, not only on policy objectives but also on the setting of US fiscal policy and on the policies and economic performance of other countries.

I should like to proceed as follows. First, I set out what I believe is likely to happen if current policies are maintained in the United States and abroad. Second, I describe the constellations of policies that I think would be best in the current situation. That entails not only objectives for monetary policy but also for fiscal policy and foreign macroeconomic policies too. Lastly, I consider what US monetary policy can do if other policies do not adjust as they should.

II. The Outlook for 1987

I do not believe the prospects for 1987 have been substantially altered by the agreement reached in Paris last week-end between the United States and five of its largest trading partners. There may be more to the agreement than meets the eye and final judgement must await the concrete policies adopted to implement the agreement. Still, on the face of it, it is merely a nod in the right direction. The United States reaffirmed its pledge to reduce the Federal budget deficit, a pledge it has been making for a number of years; Germany and Japan both pointed to recent reductions in their discount rates and Japan promised a package of fiscal measures once its present Budget had passed the Diet. We shall have to wait and see; Japanese fiscal packages in the past have sometimes been cosmetic and the present Budget is restrictive. Germany announced it would increase the size of its tax cut scheduled for January 1988. That is a constructive move but the original tax cut (\$5.5 billion) was designed merely to offset fiscal drag and was worth about one half of one per cent of GNP; the new figure mentioned (\$8.3 billion) is below three-quarters of one per cent of GNP. Measures on this scale will make only a small contribution to growth in Germany, certainly in 1987, and will have a negligible effect in the United States. Meanwhile everyone agreed to defend an inappropriate exchange rate.

In the year ahead forecasters see continuing moderate growth of the US economy in the range $2\frac{1}{4}$ - $3\frac{1}{4}$ per cent. Unemployment should be stable or decline slightly. Unless oil and raw materials prices collapse again, which is unlikely, inflation will accelerate, perhaps to the range of $3\frac{1}{2}$ - $4\frac{1}{2}$ per cent annual rate. The acceleration will come because costs in US business are increasing faster than current inflation, which has been depressed by lower oil and raw material prices. Inflation will also be boosted because, in future, import prices will be higher reflecting the depreciation of the dollar over the past two years.

If the dollar stays, or is held, at its current level against the major currencies, and demand in other OECD countries grows at roughly the same rate as in the United States, the external deficit will show some improvement over 1986 but you may think it disappointing - only a few billion dollars. That small improvement should get larger in 1988 when the external deficit could be \$30 billion below its 1986 level.

Even that may look disappointing, leaving an external deficit well above \$100. Yet it is very important to look beyond those numbers to what is happening to exports, imports and the deficit at constant prices. Of course, the deficit at current prices is the one that makes the headlines and it shows how much the United States is borrowing abroad. Yet the volume of exports and imports at constant prices is what matters for the level of activity and employment in the United States. There is a big difference in the way the two measures of the deficit will evolve in the next two years.

The reason for the difference is the steady depreciation of the dollar since early 1985, raising import prices in dollars and making US exports more competitive in foreign currency terms. As you all know, it takes a long time for those relative price changes to affect the flows of import and export volumes. These begin to change slowly, improving the

deficit at constant prices, while the deterioration in the terms of trade causes a worsening of the deficit in current prices - the notorious J-curve. At present we have not one J-curve but a family of them, as a result of the dollar's long slide. The benefits of depreciation in 1985 are now coming through but are being masked by the price effects of depreciations in 1986 and 1987.

So while the external deficit at current prices continues to look bad, there should be an improvement this year at constant 1982 prices, of more than \$30 billion. That is what past relationships - embedded in econometric models - would predict. And, contrary to the impression you may have gained from press comment, those relationships do quite well in tracking the course of the deficit up to now. Moreover, a similar further improvement of \$30 billion or more should come through in 1988. So this year and next, the swing in the external deficit should contribute a good one per cent a year to US growth (\$38 billion in 1982 dollars is about one per cent of GNP). Indeed the improvement in the external deficit at constant prices is likely to be one of the most important sources of demand growth in the US economy. It is important to bear that in mind when looking at the ostensibly disappointing current balance numbers at current prices. It also means that it would be very misguided to introduce protectionist measures, inviting near-certain retaliation, particularly at a time when trade will be contributing to growth in US output and employment.

So far the picture might not look too bad and might suggest there is little need for substantial changes in macroeconomic policy. However, there are some dark clouds. First, while the US external balance is set to improve - at both current and constant prices - there is little or no possibility of its disappearing altogether. On present policies, the current balance should improve out to 1985 and then start to get worse again. At current prices the current-account deficit could be just above \$100 billion and even at 1982 prices it could be around \$70 billion in 1985 (See Table 1). It will then get worse for the following reason. As the trade deficit does not go away (but only falls to some \$100 billion at current prices) US external debt will continue to build up. By the end of the decade US external debt will probably amount to 20 per cent of GNP. That implies a heavy burden of interest payments to foreign creditors on the external account.

The prospect of a continuing US external deficit of that order of magnitude could result in severe intermittent pressure on the dollar with exchange and financial market instability if confidence in US financial policies weakens.

Secondly, as I pointed out, the foreseeable improvement in the external deficit at constant prices will be raising US output growth above the growth rate of US domestic demand. But the position is reversed for other countries. To the extent that the US deficit is corrected, they will experience a drag on their growth as their exports to the United States stagnate or even fall. They must expect their GNP to grow more slowly than it did in the period 1983-1986 unless domestic demand accelerates to take up the slack. No-one seriously argues that they have been growing too fast in recent years so their domestic demand should accelerate to maintain their growth. Ideally it would accelerate still more and allow their

output growth to pick up somewhat.

There has been some spontaneous acceleration of demand in Germany, due to improved terms of trade, but it does not look likely to be strong enough to maintain adequate growth. In Japan there has been no pick-up in domestic demand at all. If demand does not accelerate spontaneously in Japan and Germany then some policy stimulus is appropriate in present circumstances. The apparent agreement of the Japanese and German authorities with this proposition at the Paris meeting is a very welcome development. However, the concrete measures they have agreed to undertake remain either vague or very modest. One is left with the uncomfortable feeling that they have agreed to the minimum possible in order to induce the United States to help stabilize exchange rates and that they still do not accept the need for stimulus in their own interest.

If an improving US external deficit is accompanied by slower growth in other OECD countries, that would make it very hard for non-OECD, developing countries to find markets for their exports. That, in turn, would make it hard for them to service their debts. The example of Brazil shows how close the world debt crisis is to flaring up and shows how important it is to maintain an adequate growth of world trade - another reason to avoid protectionism. There is still a risk, only somewhat abated by the Paris agreement, of a growth recession in the OECD outside the United States.

III. Improved Policies

Policy changes are needed in the United States and abroad. The United States does not want to go on accumulating debt at the foreseeable rates, with all the uncertainty that implies for financial markets. It must put its external deficit on a declining path, not one where the path turns up again after 1985. In my view some further depreciation of the dollar will be necessary to achieve that. But depreciation alone will not be enough. To the extent that depreciation succeeds in switching consumer demand here and abroad from foreign-produced to US-produced goods, that will give a big demand boost to the US economy. It is doubtful if the economy could sustain a demand boost of \$150 billion dollars over the next few years without becoming overheated. An attempt to rectify the external deficit by depreciation alone would be highly inflationary for the US economy. In turn a resurgent US inflation would make it almost impossible to bring the trade account into balance.

So it is absolutely essential that the US fiscal deficit be reduced progressively over the rest of the decade broadly as the Gramm-Rudman-Hollings Act proposes. By lowering Federal Government credit demands, that should reduce US interest rates which could put downward pressure on the dollar. It would also free resources, enabling the US economy to respond to higher net foreign demand without inflation. Without that adjustment of fiscal policy, I do not think there is much that US monetary policy can do unaided to promote the three objectives I enumerated at the outset.

Of course, the US administration and Congress are both in principle committed to reduction of the Federal deficit. But I have to tell you that abroad that commitment is widely regarded as lacking credibility. So far defence expenditures appear to have been capped and, with the help of some

asset sales and creative accounting, deficit targets have been broadly met. The whole world is aware, however, that the difficult part is still to come - in the next year or two. It seems clear that the correction of the Federal deficit will require a political consensus for raising additional revenues. The world is waiting anxiously for some sign of this consensus to emerge. Clearly some leadership will be needed if the consensus is to be forged.

The necessary fiscal tightening in the United States and some further decline of the dollar would impart a strong contractionary influence to the world economy. In their own interests, it is essential that the most important foreign economies, Japan and Germany, monitor the situation and take whatever steps are necessary - with fiscal and monetary policy - to at least maintain their own growth rates. There are no credible supply-side reasons why the Japanese authorities should accept growth below $3\frac{1}{2}$ - 4 per cent or why the German authorities should accept growth below $2\frac{1}{2}$ - 3 per cent annually. There is no reason to believe that they would be threatened with inflation at such real growth rates.

If such policy changes were to come about, US monetary policy would not have an impossible task. It could remain sufficiently accommodating to allow further decline in the dollar - despite any monetary easing abroad. It would be necessary to accept some acceleration of inflation in the United States. The rise of the dollar and the opening up of the trade deficit suppressed inflation in the United States and the dollar's decline and the closing of the external deficit unquestionably means that some of that inflation gain must be paid back. A credible program of Federal deficit reduction, backed up by tax increases, would reduce the risk of demand inflation getting out of hand in the United States. Of course the Federal Reserve would need to monitor the economy carefully, as it always does, for signs of excess liquidity and it should take corrective action when necessary. But I would see no need for a systematic move towards restriction in those circumstances. Indeed interest rates could fall further.

To summarize: US monetary policy would ideally remain accommodating against a background of progressively tightening fiscal policy in the United States. Meanwhile important foreign economies would undertake temporarily expansionary fiscal policies with accommodatory monetary policies.

IV. Monetary Policy if other Policies Do Not Change

If there is no change in fiscal policy in the United States, the country could not afford to see the external account improving any faster than it seems likely to do at present. A faster improvement would be inflationary. Monetary policy in that situation would have to balance the objectives of external balance and growth, both requiring some further depreciation, against the objective of controlling inflation, which would be aggravated by further depreciation. That balancing act would be conducted against a background of continuing uncertainty and unease in foreign exchange markets that could erupt into a crisis at any time.

In effect, the exchange rate would become the intermediate target of US monetary policy. The dollar would be allowed to drift lower if growth

and inflation seemed sluggish and firmed up when activity and prices looked like moving vigorously. Wherever the Federal Reserve tried to position itself on that trade-off, I would see no prospect of avoiding some increase in inflation and no realistic prospect of removing the trade deficit this decade.

The Paris agreement appears to give priority to the objective of controlling inflation in the United States and reducing the risk of an exchange market crisis. It does this at the cost of abandoning any hope of removing the trade deficit without a U.S. recession. I assume the United States would not lightly agree to stabilize exchange rates in their current range without seriously meaning to abide by that undertaking. As current exchange rates and growth prospects here and abroad offer no prospect of closing the external deficit, it would not be surprising if there were speculation against the dollar in the near future. Exchange market intervention on the scale necessary to resist such speculation would need to be massive and I doubt if foreign central banks would really be prepared to accumulate US paper on the scale that would be required. US monetary policy would need to tighten, raising interest rates to defend the dollar.

If the Paris agreement sticks, therefore, US monetary policy has been substantially committed and must be devoted to defence of the dollar at around the current exchange rate. Given the prospects for slow growth abroad - not materially changed by the Paris agreement so far as I can see - the only way that the US could reduce the current balance deficit and take pressure off the dollar would be to submit to a period of slow growth and rising unemployment. This could be achieved by a fiscal contraction as foreshadowed in the Gramm-Rudman-Hollings Act. Now, however, with the Paris agreement, if lower interest rates tended to lower the dollar, the Federal Reserve would be obliged to tighten policy to defend the dollar. With both fiscal and monetary policy tightening, a US recession becomes probable.

Important foreign countries, for reasons that escape me, seem less worried by the prospect of a US recession than by the prospect of further declines in the dollar. The effect on them, however, is much the same - namely lower US imports, net, and a contractionary impulse to the world economy. What is needed in my view is a renegotiation of the Paris agreement in which the US gets its domestic political act together and is able to offer convincing plans to cut its Federal deficit. In return other countries would need to accept some further dollar depreciation - perhaps 20 per cent against the Yen and DM. They would then need to take more timely measures to stimulate their own economies in their own interests.

V. Targeting monetary aggregates

It may strike you that I have had nothing to say about the appropriate growth rate of monetary aggregates in the United States, although target growth rates for money have been one of the ways the Federal Reserve has attempted to calibrate its policy in recent years. The quantitative relationship between nominal income and monetary aggregates has broken down in the United States and in other countries. This has particularly affected the narrower aggregates such as M1.

The international scope of the breakdown - affecting even Germany

where the money-nominal income relationship has previously been unusually stable - suggests it may be related to lower inflation and progressively declining inflation expectations over the past several years. Another complicating factor has been financial market liberalization and the invention of new financial instruments. This has necessarily changed the demand for that group of paper assets conventionally defined as money.

The Federal Reserve has acknowledged the breakdown of the relationship between money and nominal income and has proceeded pragmatically, adjusting policy in response to a range of indicators of real growth and inflation, not just the monetary aggregates. In my judgement, the FRB has done this extremely well since 1982. If chairman Volcker had followed strict adherence to monetary targets in 1982 and 1983 he could have plunged the world into another great depression. Some monetarist economists, reluctant to abandon the familiar, have been forecasting very rapid inflation ever since on the basis of the monetary aggregates. It has not happened.

Of course excessive money creation causes inflation. No-one should dispute that. The trick is in knowing how much is "excessive". And there is no magic about it. Money injections work by raising the level of demand in the economy, initially increasing output and employment and then leading to inflation as wage settlements rise in response to a tighter labour market. In some circumstances, if money creation leads to inflationary expectations, raw material commodity prices may see a speculative boom even before excess demand bids up other prices.

That means with normal luck, the FRB will get advance warning of a resurgence of inflation. It will see activity pick up and unemployment decline so wage settlements accelerate. Commodity prices may begin to surge. When these warning signals appear, policy can be tightened. In the United States at present there is no sign of these warning signals.

Of course, it is possible that when these signs appear it may be too late to stop the inflation that is under way. Or the policy change may need to be more brutal than it would have been if taken earlier. While that risk exists, it is no greater than an opposite risk, namely the risk of causing a recession by ignoring the economic situation and targeting monetary aggregates when historical linkages between money and nominal income have loosened. Up to now the FRB has successfully balanced those risks. Had it paid more attention to the aggregates in the last year or two there could well have been a recession. I see little alternative to the FRB continuing to try to balance the risks, keeping its eye on a wider range of indicators than the money stock. I believe you should congratulate Chairman Volcker for his skill and success to date and encourage him in his pragmatism.

In conclusion, though, let me note that Chairman Volcker has more scope to be pragmatic because the markets believe in his resolve to fight inflation whenever the need arises. If his successor does not enjoy that confidence, he will have less room for manoeuvre.

TABLE 1
Projections of the External Deficit

(a) Net exports (goods and services), constant 1982 dollars (billion).

	1986	1987	1988	1989	1990	1991
Effect of 10 pc \$ Depreciation .		10	31	43	51	55
Current projection	-145	-107	-73	-69	-77	-87

(b) Current account deficit, current dollars (billion)

Effect of 10 pc \$ Depreciation .					22	
Current projection	-140	-140			-120	
Effect of Slower growth abroad -1 pc		-2	-8	-15	-24	-36
Trade balance	-146	-139	-110	-100	-110	-122

NOTES

Projections are a weighted average of econometric model projections submitted to a recent conference at the Brookings Institution, adjusted for recent exchange-rate changes. The projections are strictly conditional on fixed assumptions that do not necessarily represent the views of institutions maintaining the models. Key assumptions were: growth of 3 per cent a year in the United States and Europe, 3.5 per cent in Japan and in less developed countries; average inflation rate 3.5 per cent in the United States and in the rest of the OECD; no change in real exchange rates from the present date.

Exchange rate effects are a weighted average of simulated responses by models to 10 per cent depreciation of dollar against the yen and EEC currencies. A depreciation of the dollar against ALL other currencies would give effects about 50 per cent larger. Note that this is a strictly PARTIAL effect showing how changes of the exchange rate influence trade volumes in case (a) and prices and volumes in case (b). Probable repercussions through output and domestic inflation are ignored.

Five models took part in the exercise and their projections were weighted according to how well they tracked history in the period 1980-85.



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Economics Division

February 19, 1987

FIGURE 1

Monetary Aggregates -- M1

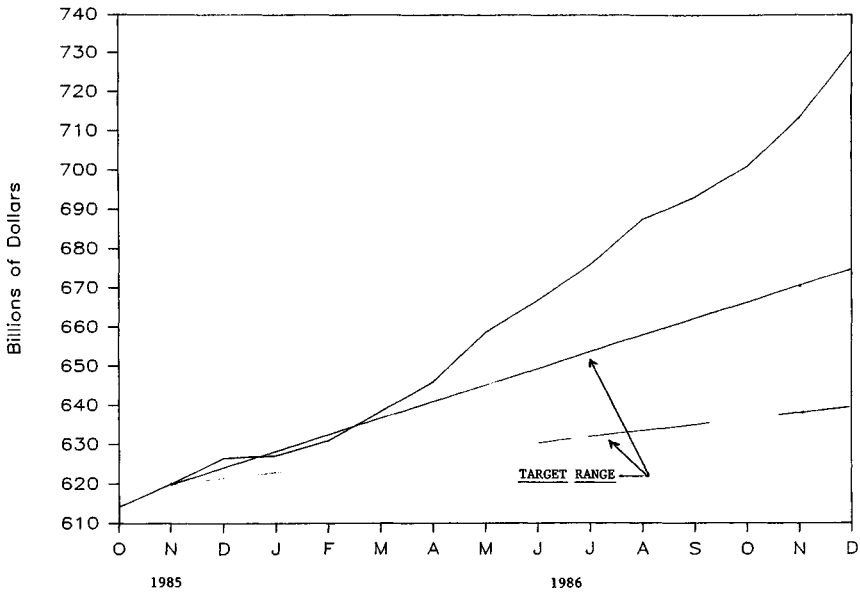


FIGURE 2

Monetary Aggregates -- M2

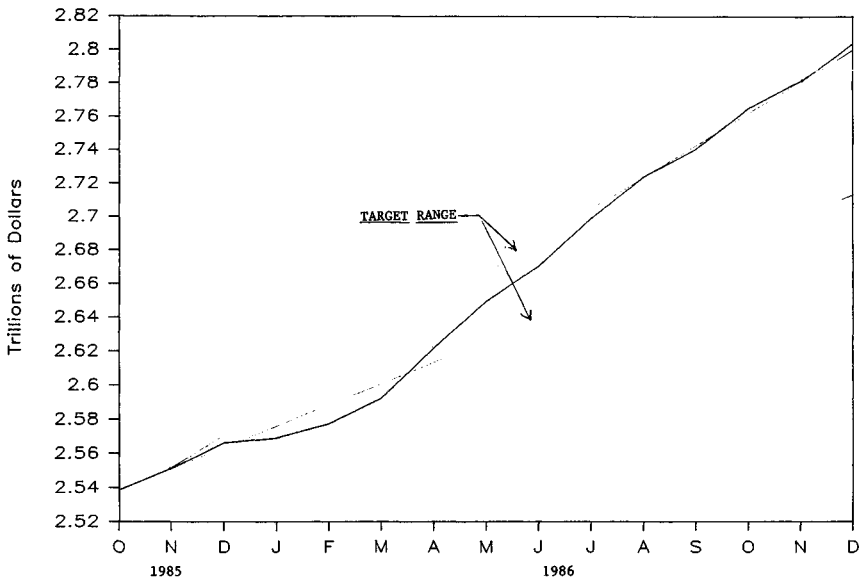


FIGURE 3

Monetary Aggregates — M3

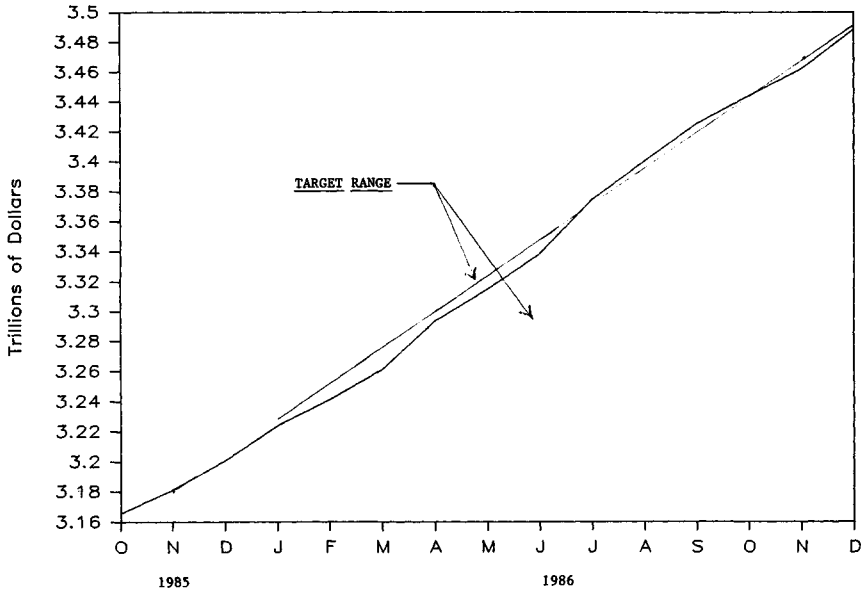


FIGURE 4

M1 And Its Components

Annualized Rates of Change

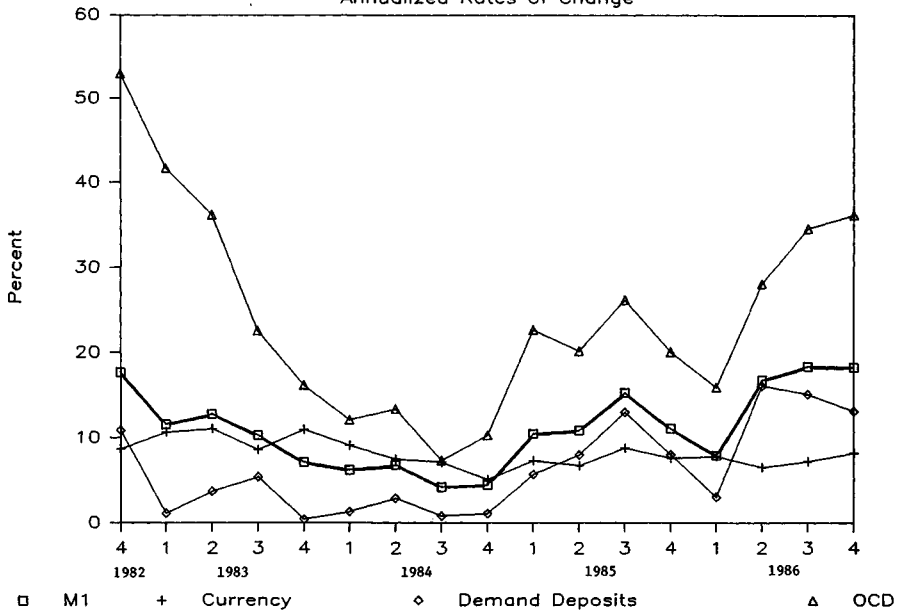


FIGURE 5

M2 And Its Components

Annualized Rates of Change

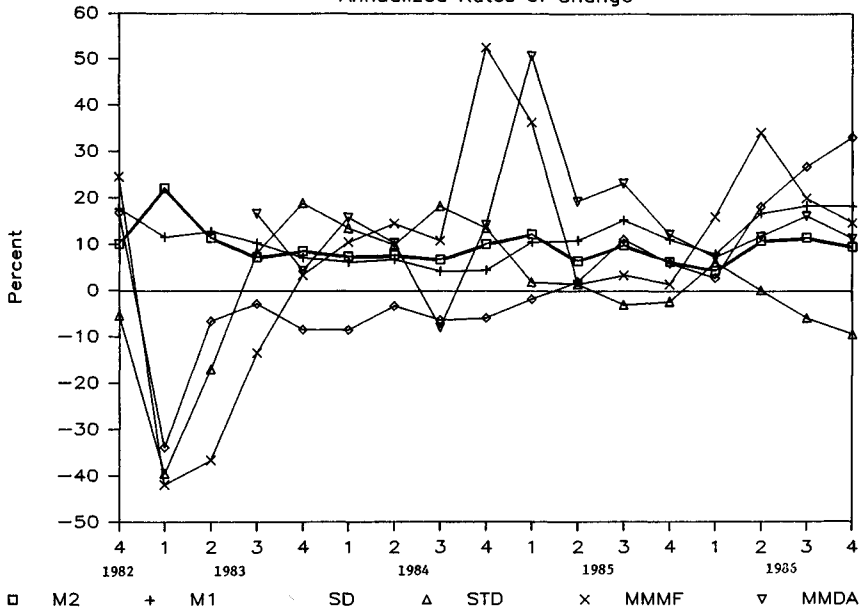


FIGURE 6

M2 And Its Components

Annualized Rates of Change



FIGURE 7

Unit 10 Components Annualized Rate of Change

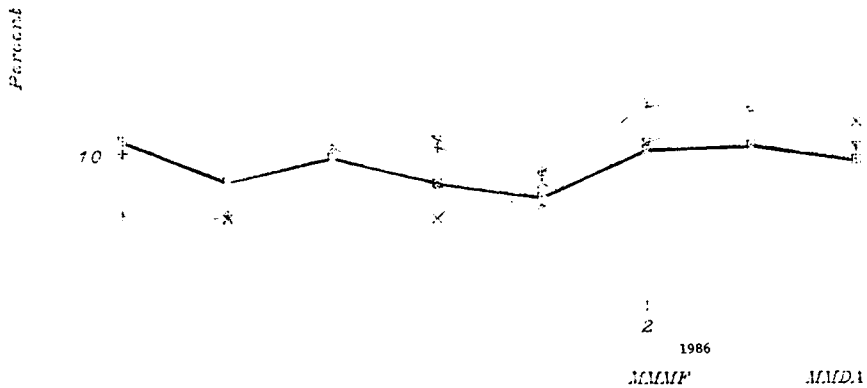
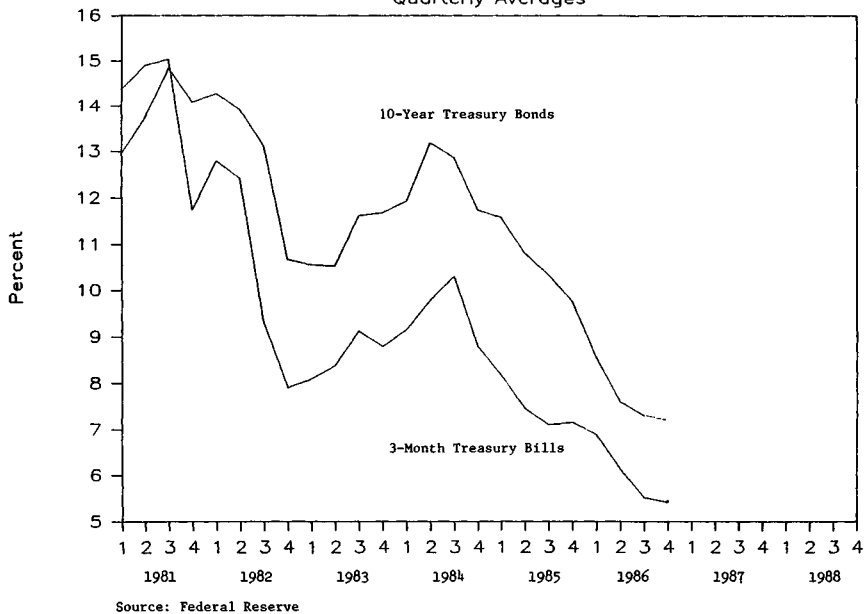


FIGURE 8

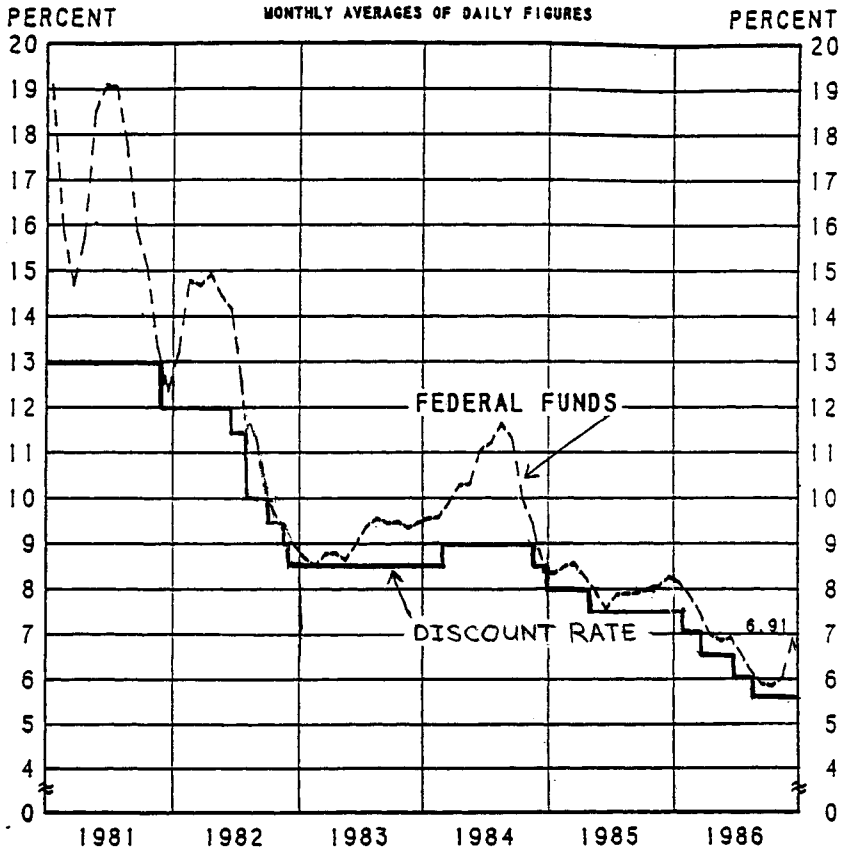
Selected Interest Rates Quarterly Averages



Source: Federal Reserve

FIGURE 9

FEDERAL FUNDS RATE AND THE DISCOUNT RATE



LATEST DATA PLOTTED: DECEMBER

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

FIGURE 10
Dollar Exchange Rate Index
(FEDERAL RESERVE INDEX)

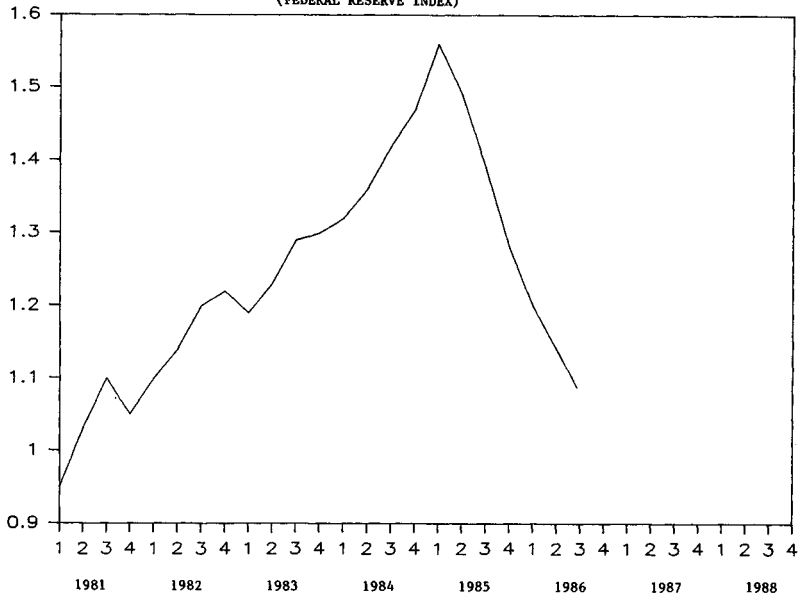


FIGURE 11
Dollar Exchange Rate Index
(MORGAN GUARANTY TRUST INDEX)

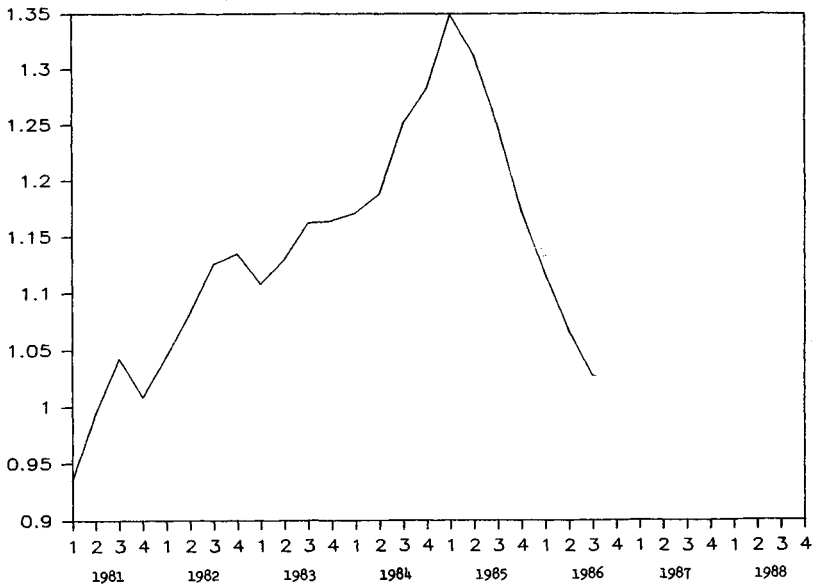


FIGURE 12

Cyclically Adjusted Budget Deficit and Current Account Deficit

73

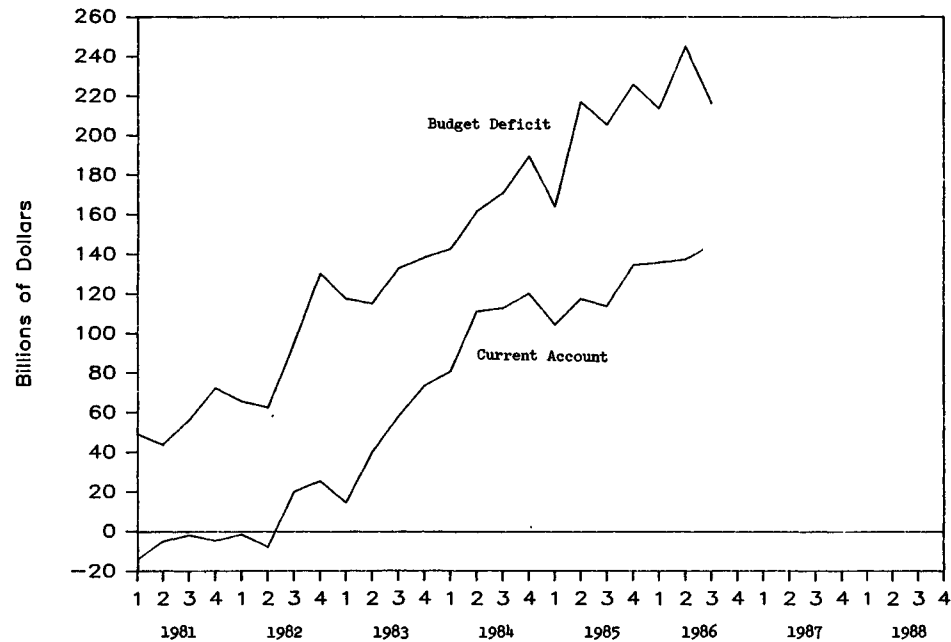
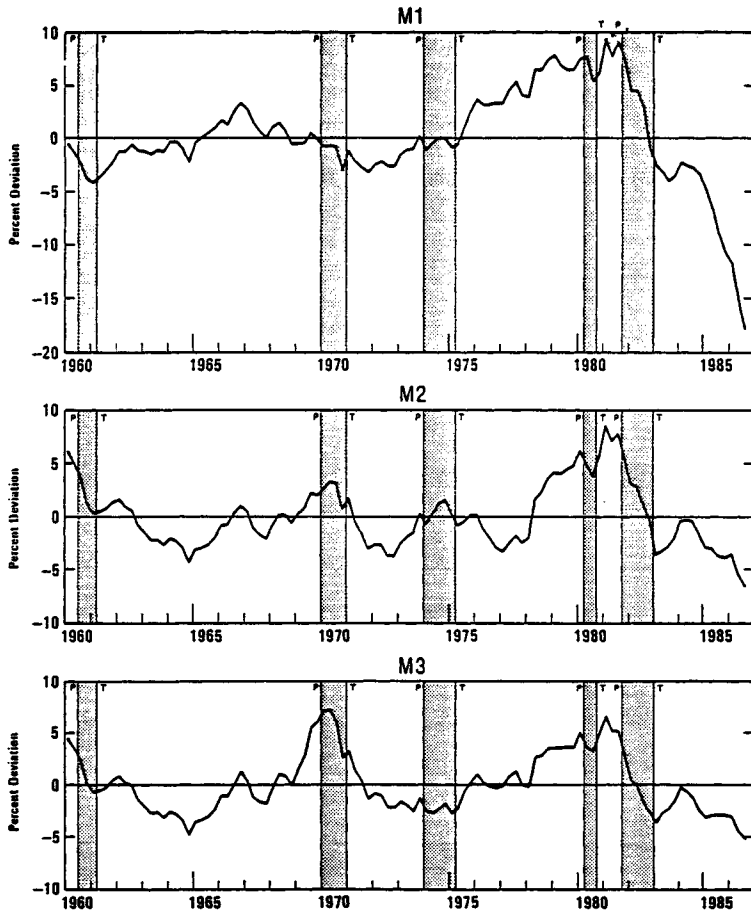


FIGURE 13

Velocity: Deviations from Trend Level



SOURCES: Congressional Budget Office; Federal Reserve Board; Department of Commerce, Bureau of Economic Analysis.

NOTE: Velocity is the ratio of GNP to money.

TABLE 1. Economic Forecasts Through 1988

	Quarters						1986	1987	1988	
	1986		1987							
	3*	4*	1	2	3	4				
I. Nominal GNP <u>a/</u>										
Wharton	6.4	2.6	6.4	7.4	8.0	8.4	5.3	6.0	8.1	
DRI	6.4	2.6	5.1	6.5	7.2	6.1	5.3	5.2	6.7	
Chase	6.4	2.6	5.4	5.8	6.3	6.0	5.3	5.0	6.1	
Administration	--	--	--	--	--	--	5.5	6.5	7.2	
II. Real GNP <u>a/</u>										
Wharton	2.8	1.7	3.0	3.4	3.7	3.9	2.5	2.8	3.6	
DRI	2.8	1.7	2.5	3.4	3.9	3.4	2.5	2.7	3.3	
Chase	2.8	1.7	2.1	2.9	2.7	2.9	2.5	2.3	2.6	
Administration	--	--	--	--	--	--	2.7	3.1	3.5	
III. GNP Deflator <u>a/</u>										
Wharton	3.6	1.0	3.2	3.9	4.1	4.4	2.7	3.1	4.3	
DRI	3.6	1.0	2.5	2.9	3.2	2.6	2.7	2.5	3.4	
Chase	3.6	1.0	3.1	2.7	3.5	3.0	2.7	2.7	3.4	
Administration	--	--	--	--	--	--	2.8	3.3	3.5	
IV. CPI-U <u>a/</u>										
Wharton	2.6	2.8	3.8	3.7	4.0	4.5	1.9	3.2	4.7	
DRI	2.6	2.8	4.7	4.5	4.1	4.1	1.9	3.5	4.3	
Chase	2.6	2.8	3.6	3.9	4.5	4.4	1.9	3.2	4.4	
Administration	--	--	--	--	--	--	1.6	3.0	3.6	
V. Unemployment Rate										
Wharton	6.9	6.8	6.8	6.8	6.7	6.6	7.0	6.7	6.3	
DRI	6.9	6.8	6.8	6.8	6.7	6.6	7.0	6.7	6.7	
Chase	6.9	6.8	6.9	6.9	6.9	6.9	7.0	6.9	6.9	
Administration	--	--	--	--	--	--	6.9	6.7	6.3	
VI. T-bill Rate <u>b/</u>										
Wharton	5.5	5.4	5.3	5.2	5.6	6.0	6.0	5.5	6.6	
DRI	5.5	5.4	5.3	5.1	5.5	6.0	6.0	5.5	5.7	
Chase	5.5	5.3	5.1	4.9	5.0	5.3	6.0	5.1	5.7	
Administration	--	--	--	--	--	--	6.0	5.4	5.6	
VII. Budget Deficit <u>c/ d/</u>										
Wharton	\$197.4	191.3	207.7	171.6	160.9	146.1	204.0	171.6	153.4	
DRI	197.4	191.2	203.3	195.1	178.8	175.4	204.0	188.2	156.2	
Chase	197.4	191.8	199.1	194.2	178.4	182.7	204.0	188.6	179.4	
Administration	--	--	--	--	--	--	--	--	--	

(Continued)

CONDUCT OF MONETARY POLICY

Thursday, February 26, 1987

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

The subcommittee met at 10 a.m. in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Chairman Neal; Representatives Barnard, Hubbard, McCollum and Saxton.

Also present: Representative David Dreier of the full committee.

Chairman NEAL. The subcommittee will come to order.

It is a pleasure to welcome our witness this morning, Paul Volcker, Chairman of the Federal Reserve Board.

I would like to say at the outset that I hold the Chairman in the highest esteem. Under his leadership, the Federal Reserve System has brought down the rate of inflation to today's much more tolerable limits. Please let me emphasize this point. Though the popular press often gives President Reagan and his policy the credit for lowering inflation, the fact is that nothing in his policy has led to this result. I have discussed this with numerous economists and in fact raised the question with our panel of economists yesterday. And, I put the question this way to anyone who thinks that Mr. Reagan's policy—Reaganomics—has been instrumental in lowering inflation. I ask these questions: "What policy has been helpful in this regard? Has it been more than doubling of the national debt? Has it been creating the biggest trade deficits in our history making us a debtor nation, cutting taxes, increasing spending, lowering the rate of savings?" The answer is always the same. The only contribution has been reappointing Paul Volcker as Chairman of the Federal Reserve Board.

So I think it is clear that under the leadership of Chairman Volcker that our country has been saved from a great calamity, that being runaway inflation.

But our job here is not to praise. In fact, Chairman Volcker receives enough of that already. He is one of the few government officials who can get widespread attention by the press for not being incompetent or violating the law. Today we need answers to some very important questions. If the Fed can halt runaway inflation by limiting money growth, can they reflate the economy with a too rapid growth in the money supply?

In my opinion, there is considerable danger of that now. Growth of all the monetary aggregates has been large and above the Fed

targets for some time. With real economic growth at the rather low rate of 2.5 percent last year, and growth of all these aggregates at high levels, isn't there a danger of more inflation returning soon?

It has recently been recommended by Chairman Volcker and Secretary Baker that the dollar has fallen enough, and that we ought to try to stabilize it at this level. Other experts tell us that the dollar must fall more if we are to see significant reductions in our trade deficit. What is the proper level for the value of the dollar today? Is this the proper level for our trade deficit?

What are the implications of Brazil's recent announcement concerning its debt payments for our banking system and for monetary policy? What is proper monetary policy for the future of our country?

These are some of the questions that we will be looking at this year. I want to say again that I am delighted that Chairman Volcker can be with us this morning. I am sure he will help us answer some of these questions, and many more that we have not yet asked.

Mr. Wylie has asked that his statement be placed into the record and I would like to do that without objection.

(The statement of Congressman Chalmers P. Wylie may be found in the appendix.)

Chairman NEAL. Do any other Members have comments? Mr. McCollum.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman. I, too, want to welcome Chairman Volcker here this morning. I have a great respect for him. I think that he is one of the true battlers for preserving the proper role of regulation in the safety and soundness of our banking system and has been, as you indicated, obviously very instrumental in the regaining of control over inflation in this country.

I would like to partially set the record straight with a modest disagreement with my chairman. Yesterday's witnesses indicated, I believe that the President did more than simply reappoint Mr. Volcker. He acquiesced—the President did and the administration—in the policies of the Federal Reserve System in that very strenuous period of bringing down the inflation rate, which was of course a tough time for all of us. But I do agree that the yeoman credit does go to Chairman Volcker and the Federal Reserve Board for that accomplishment and I certainly hope that the President will reappoint Chairman Volcker and I have written a letter indicating that to the President.

We appreciate very much what you have given us and we look forward today to hearing about the state of the monetary policy of our country and where we might expect it to be going in the near future. Thank you very much.

Chairman NEAL. Are there others who have opening comments?

Mr. HUBBARD. Mr. Chairman, I would just simply add that I, too, join my colleagues in welcoming our distinguished Chairman of the Federal Reserve Board. Chairman Volcker knows that I personally have a high regard for him and his efforts on behalf of our Federal Government on behalf of the people of our country. His message each time he appears before us is always reduce the Federal deficit and reduce Federal Government spending. I trust he will say that

today. And we don't do enough in Congress to accomplish what he challenges us to do. One major reason we still have problems is that we don't reduce Federal spending in Congress.

I, too, am hopeful that Chairman Volcker will serve a third term as Chairman of the Federal Reserve Board. It would be to the benefit of our country if he does.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, sir.

Mr. Chairman, we will put your entire statement in the record without objection. Please proceed as you will.

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

Mr. VOLCKER. Well, thank you, Mr. Chairman and gentlemen. I appreciate those comments. I don't know whether I will please you or not—I suppose so—by not reading my statement. My statement is the same as I presented to the Senate Committee last week and I would appreciate you just putting it in the record.

You have already alluded to one of our principal concerns about the threat of a resurgence of inflation. I discuss that point at some length in the statement and won't go over it in detail now, but we can get into that later.

Certainly, the various measures of the money supply and reserves went up rapidly last year. I would point out that M2 and M3 were not above their target ranges although they were just at the upper end of them.

M1 was certainly far above the tentative target we had indicated with some uncertainty earlier in the year. I might call your attention to page 18 of my prepared statement that discusses the factors that seem to us to justify generous provision of reserves and expansion in money last year.

We all know that the inflation rate was low last year, in sizable part because of a temporary fact—the collapsed oil prices. But, we have been encouraged by the fact that more basic factors signalling inflation have also been moving in a basically favorable direction.

Wage and salary costs have continued to decline in terms of rate of increase. Prices of services came down in terms of rate of increase last year. Other commodity prices were falling much of the year. The decline in long-term interest rates I think reflected to a degree greater confidence in the market itself that inflation, while still a potential problem, the underlying factors justify more optimism in that respect.

But I don't want to in any way minimize the concern about inflation. Most people, including the Open Market Committee, think there will be some bulge in prices this year, assuming the oil price remains around current levels—that's a rebound from where it was—and given the effects of the depreciation of the dollar on import prices. We do think it's terribly important that that bulge which is related to temporary external factors not be a signal or an excuse or a justification for relaxing on this front.

We don't want to see a new broad-based, cumulative, upward movement in prices and certainly that will be a factor and a key factor in developing monetary policy this year.

More generally, I might just say in terms of introduction, Mr. Chairman, that since I prepared this statement and testified last week, there has been a meeting of the major industrialized countries in Paris, as you know. I think that deliberation and that communique reinforces some of the things I have to say in my statement and are consistent with it. They certainly firmly rejected protectionism as a response to the huge imbalances that exist in the international trading arena. They express concern over too much volatility in exchange rates and raise the question—more than raise the question—whether further declines in the dollar at this point would be helpful in terms of adjusting and world economic growth.

They broadly concluded that the currencies are within ranges broadly consistent with underlying economic fundamentals, on the assumption that certain policies would be carried out here and abroad.

I think that implies, as I emphasize in my statement, that it does take a broad-based approach to deal with the imbalances. I think the dangerous imbalances in the world economy, that that approach must encompass action here and it must encompass action abroad. You well know that the United States has a special leadership role in the world economy and I think now that leadership role must be expressed in further efforts to reduce our own budget deficit. But I think, conversely, that countries with very large surpluses and that have depended upon those surpluses to support domestic growth now must turn toward other measures to support their domestic growth because they can't count and should not count on large trade surpluses. They should be declining as a counterpart of our deficit declining, and that that requires action on their part to sustain internal demand, sustain their growth, and contribute to world growth.

In general, I think we are in a period of great potential, building on 4 years of expansion, 4 years of a declining inflation rate and lower interest rates. I think we have the opportunity for a long period of further growth if we combine it with progress toward stability, but we would be blind if we didn't recognize that there are very large problems, distortions, imbalances in our economy and in the world economy.

In the United States we have been relying far too much on consumption to drive the economy, and you can do that for a while, but it's, to say the least, not healthy over a longer period of time.

We have that very large trade deficit. We are highly dependent upon an inflow of foreign capital to finance our investment needs, to finance our government deficit, in combination. That makes us vulnerable to a loss of confidence. It is another factor that emphasizes the importance of keeping inflation under control to maintain confidence and, of course, those imbalances in our economy have their counterparts abroad.

So we have some very real threats to what can be I think a very promising future and the joint responsibility of all of us is to get to work and deal with those threats so that we can realize the promising future.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Volcker may be found in the appendix.]

Chairman NEAL. Thank you, Mr. Chairman.

I am just curious. You and other of our government officials and officials of other governments recently announced your intentions concerning the value of the dollar. I am just wondering if you think those announcements are enough to stabilize the value of the dollar at this level or do you think that we will have to follow that up with some policy changes?

And if you think that some policy changes other than you often recommended one that we reduce the budget deficit, which I certainly agree with but don't see happening overnight—do you think that you will then have to tighten monetary policy or do you think that we will be intervening in foreign exchange markets?

I just wonder if you could expand on that a little bit.

Mr. VOLCKER. Well, let me make a few comments on that. I sometimes think announcements can be helpful as an indication of intentions and to the extent they express a consensus, as this one did, among the major countries, I think they are even more important. But I am also aware that the halflife of announcements without policies isn't going to be very long. And basic policy directions that are indicated in the statement I think are clear enough. They are ones that I have already alluded to: that we have to for our part deal with that budget deficit problem, and that is the only way that we can constructively reduce our dependence upon foreign capital. That's related to the trade deficit. While other countries have to maintain and enhance the momentum of their internal demand.

At any given level of exchange rates, the prospect of dealing with our deficit and their surpluses obviously will be improved to the extent that they have growing vibrant markets domestically that will in effect attract more imports into those economies. At the same time, I think we have to slow the growth in our domestic demand that's been attracting imports, among other things, into the United States, release resources and release a substantial amount of resources for exporting.

So that basic policy direction, that basic policy complementarity, is certainly basic in my mind to the judgment on exchange rates.

I don't want to say anything about intervention this morning. I think we can let events take care of that and that particular role, but I do think that in the conduct of monetary policy one of the considerations we have to take into account is the condition of international financial markets and exchange markets as well as domestic considerations because I think that those external considerations ultimately bear upon our domestic performance, both in terms of economic growth and more directly in terms of inflation.

And I note in my full statement some of the concerns that we would have under some circumstances about a declining dollar adding to inflationary pressures in the United States. Much depends upon the environment in which that might occur.

Chairman NEAL. I appreciate your comments. It has been your position and I believe our government's position for some time that the Japanese ought to expand their own domestic economy and that the Germans ought to do the same. Yet they have not done it.

It is our stated intention to reduce our budget deficit and we have not done much about that either. What is new?

Mr. VOLCKER. Well, the political problems seem to be equally difficult from both sides ironically. You would think it would be easier to take expansionary actions than—

Chairman NEAL. It is certainly easier here.

Mr. VOLCKER. Well, I suppose that has been our record. But these countries, of course, all want to defend their very good records on inflation and I think it is difficult for any country to make basic adjustments of the size that are required here and they are going to take some time and there's some hesitancy.

But one of the things that is reflected in the Paris statement, of course, are further steps and intentions by both Germany and Japan to take some particular fiscal or other actions to support growth in their economies.

So I think that was recognized by more than words. There are some commitments reflected in the statement that was released and I should also point out that, speaking of monetary policy, that both in Germany and Japan there has been a reduction in the discount rate. Japan just last week and Germany some weeks earlier.

But the implications of their monetary policies for exchange rates and for economic growth I think are reflected by action as well as by words.

Chairman NEAL. You are correct. Several weeks ago the Germans reduced their discount rate, but as I recall, they did something else to essentially sterilize the effect of that.

Mr. VOLCKER. Well, I don't think it's quite right to say they took action to offset the impact of the discount rate because particularly of exchange rate developments within Europe. There has been a lot of intervention within Europe and a very large increase in liquidity as a result in Germany. In reducing the discount rate, they did take some steps to mop up some of that liquidity that had flowed in very large volumes into Germany in earlier weeks. I think the net effect has been reflected in a decline in interest rates over that period.

Chairman NEAL. But is there anything new? What policies are we committed to? I know we said we would reduce our budget deficit. That is a fine goal, but we have been saying that for 12 years at least that I am aware of.

Mr. VOLCKER. Well, as you know, we face a Secretary of the Treasury going to a meeting of this sort, how can he commit to a reduction in the budget deficit?

Chairman NEAL. Well, he did.

Mr. VOLCKER. It depends upon what you do. So he always has that problem. He certainly expressed a very clear intention, but I think he is also conscious that in our constitutional system he cannot commit personally, or the President can't commit to a reduction in the budget deficit. The result will be a reflection of the process which involves all of you gentlemen and your colleagues.

He did express as strong intentions as I think he felt capable of in contributing to that process.

Chairman NEAL. What about the commitment of the Federal Reserve? Are you committed to use monetary policy to bring about this desired result? Is that a part of the deal?

Mr. VOLCKER. Well, there weren't any specific commitments about monetary policy in this connection.

Chairman NEAL. I guess my reading of what you are saying is that we all have good intentions, but it remains to be seen how well it is going to work.

Mr. VOLCKER. Well, obviously it remains to be seen how well it's going to work, but I think we have more than good intentions and I think we can point to a series of steps, including happily the fact that our budget deficit is going down this year and we can point to some increases in domestic growth in both Japan and Germany last year. We can point to some changes in discount rates here and abroad, some of which have been coordinated and I think broadly consistent with the intent of the statement. So I think we can point to some actions.

I think it is also fair to say that if you expect magical results in a short period of time, we are bound to be disappointed. I think this is going to take a steady, plodding effort over a period of years to bring about the very large adjustments that are necessary. In fact, maybe that's good.

Chairman NEAL. I agree with you. I also think that is good. It is inevitable. In fact, I would be much more worried if we were intending some dramatic departure.

Mr. VOLCKER. We can't make these huge adjustments in a very short period of time. Part of the problem, of course, is that if actions one way or another were taken simply to cut off very sharply the big surpluses in Germany and Japan, they undoubtedly wouldn't be able to cope with the internal economic repercussions in that short a period of time and it would depress their internal economic activity, which would not be a constructive course for the world economy or for us.

So we have to move ahead firmly, but they are going to take time and I think we can only be successful if people see that progress is being made. And if people see that progress is being made, then I think the markets in effect will give us the time. If they don't see the progress being made, then we face very difficult potentialities in the marketplace.

Chairman NEAL. I certainly agree with you. However, I have seen us, from time to time in the past, plan dramatic new events such as a big intervention or a dramatic shift in some other policy. Yet it seems to me, generally speaking, that we do not fare very well under those circumstances.

Let me change the subject just for a minute and put the question to you this way. Is there any way that you see that we can become more productive and thus competitive without increasing our domestic savings rate? My concern is this. It would seem to me we took a few small steps in last year's tax bill to nudge consumers toward more savings and less spending. We also took contradictory actions actually in the tax bill, but there were some positive ones that I hope would help with the savings rate. But I am now seeing bank ads that suggest that it is very easy to refinance homes to make consumer purchases and that the interest you pay is thus an allowable deduction under the new tax law. I have heard that some banks are going to devote up to 80 or 90 percent of their advertising budgets to promote this kind of borrowing and thus consumer

spending. It looks to me like the net result of that will be that people will start paying for cars and refrigerators and other items over 15 or 20 years, and during these long periods of time this could have a very dramatic and negative impact on our savings rate both for now and into the future. Would you have any comment on that?

Mr. VOLCKER. Well, I don't think there's any doubt that there are incentives in that tax bill to transfer more borrowing to your mortgage and add second mortgages and all the rest. Whether that adds to the overall disincentives to savings, I don't know. But it's sure not any powerful incentive to save.

My broad conclusion, after looking at this and a lot of debate about savings over a period of time, is that you'd better be realistic. We have a consumer-oriented society. We are not notable for having high savings rates. We have changed tax laws and other provisions from time to time. None of it has had a very noticeable effect on the overall savings rate.

The savings rate has been going down—certainly the personal savings rate has been going down during this period of expansion. I think if you just look at our economic history and indeed look at the economic history of other countries, you have to reach a conclusion that savings rates reflect some pretty deep cultural proclivities and habits and they are not easy to change and we have a low savings rate.

I think it would be unrealistic to think you are going to change that very dramatically with tax rules. I agree with you the savings rate, in one sense, has to go up. The only realistic way I think you can bring the savings rate up, or the country is going to bring the savings rate up, is by reducing the element of dissavings, depending upon how you define this. That big element of dissavings, of course, is the Federal budget deficit. We keep coming back to that from every direction but we simply do not generate the savings in this country. And I don't think we have any realistic prospect of generating the savings in this country that will enable us to finance a budget deficit of that size on top of the investment we would like to do and on top of the housing we would like to do without relying on foreign capital.

And if we rely upon foreign capital, that's the same as saying we're going to run a trade deficit forever, and I don't think that's sustainable either. So we have to deal with it and we have to deal with it by reducing the government deficit.

One of the saddest numbers of 1986 it seems to me is that we imported more savings from abroad than the total of all the savings of all the households in the United States.

Chairman NEAL. Is this unintended consequence of the tax law serious enough for us to try to change it?

Mr. VOLCKER. Well, I don't know what its effects are on the overall savings rate. I do think it leads to a distortion in financing patterns, the one that you mentioned—that you give favored treatment to debt secured by a home. So people are going to convert consumer debt into debt secured by a home and it's probably at longer terms as it will end up than it was before. It will make the structure of home financing weaker because you're going to have more debt against a house. That creates financial vulnerabilities in

downturns or with higher interest rates that may be in some ways greater than before. It's an obvious kind of distortion when you give a different kind of tax treatment to a home—not just to a home purchaser because a home purchaser would be one thing—but to debt secured by a home. And I don't think all the consequences of that are desirable, as you suggested.

One of the dangers I suppose over time is that people will convert more of their existing debt to a home mortgage and then go out and borrow on a credit card or whatever on top of that and you end up stimulating debt creation rather than working in the direction that we would like to see it go.

Chairman NEAL. Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Chairman Volcker, we were all very pleased with what appears to be a cessation of the steep decline in the dollar's value as a result, at least in part, of the meetings last weekend in Paris and I understand from what you just said to Chairman Neal's question, that you do not understand any commitment with respect to monetary policy to have come out of that meeting on your part.

But let us assume—and let's hope it doesn't happen—but let us assume that in the next few weeks that decline in the value of the dollar and the rather steep decline we were seeing for the last several months resumes.

Would you, under those conditions, or at any stage of the game in the next few weeks, if that were to occur, would you feel obligated to recommend to the Open Market Committee a tightening of monetary policy to stem the decline of the dollar?

Mr. VOLCKER. Well, I don't think I am going to respond to a hypothetical question about the next few weeks. I think my statement did reflect the concerns that we all feel on the Open Market Committee about the implications of excessive declines in the dollar for inflation and for orderly financial markets and, indeed, for growth over time. So that would have to necessarily be a consideration in our policy deliberations.

As I said before, much depends upon what all the surrounding circumstances are.

Mr. MCCOLLUM. Well, am I correct that intervening in the sense of what we understand that term to mean can just go so far in stemming a decline of the dollar, that at some point if it were to get bad enough there would have to be a tightening of monetary policy?

Mr. VOLCKER. I don't think there is any doubt that intervention alone, running against other fundamental factors, isn't going to necessarily be effective. Monetary policy is one of those other policy instruments.

But, again, very broadly, I think the directions for fiscal policy are pretty clear. Now fiscal policy isn't something you change from week to week or month to month or even from half-year to half-year. But I think it does set a basic climate within which you're operating and could, if directed in the right way broadly, even though you can't change it in the short run, provides a basic environment that would make it easier whether through intervention or other means to stabilize the dollar.

Mr. McCOLLUM. Well, we are all concerned about doing that and I think we concur with you—those of us sitting on this panel—that we need to resolve the deficit matter and we need to get the countries abroad to lower their interest rates, stimulate their own economies, do those things that you and I want to see done. The thing that bothers me—and I am not trying to put you in a corner. I'm really trying to get a kind of understanding if my feelings are right about this—in the shorter run—the shorter run being over the next few weeks or few months—there really isn't an alternative if the dollar were to drop steeply to some kind of monetary tightening on our part to stem that flow. It may be it's a judgmental call at what point, if at all, it's ever done.

Mr. VOLCKER. It's a judgmental call and, of course, don't forget about the obvious option, which depends upon the general thrust of the world economy, I suppose, of easing policy abroad.

Mr. McCOLLUM. I have got another question. Some of the economists yesterday told us—in fact, I think all of them did—that they thought, despite the need to stem the dramatic or steep drop in the dollar, that in order for our trade deficits to come around and the world economy to be healthy that over the next several years and preferably over the next several months but perhaps not dramatically the dollar needs to fall some more.

Do you agree?

Mr. VOLCKER. I think that is a widespread view among economists of a certain persuasion that's rather popular and a lot of econometric equations under certain assumptions would point in that direction.

My own view is that it remains to be seen. Much depends upon how the world economy develops. Whether—I keep repeating it—whether fiscal policies are moving in the right complementary directions, whether we are getting a lot of growth abroad or not, whether we are in effect releasing resources for exporting. I don't think anybody knows where the exchange rate "should be" three years from now. I think the clear judgment is being expressed here, that given the very sharp declines in the dollar relative to other industrialized countries over the past two years, that we can and have found a level that ought to be tested at the very least and that further sharp declines at this point are not particularly helpful in terms of rate of speed and they may not be necessary at all. I retain a certain skepticism about some of those longer range forecasts, I think amply justified by the experience of longer range forecasts in the past.

Mr. McCOLLUM. Do I view what you are saying to us today that within the parameters of what you can see right now and not what might happen in the hypothetical world out there, that the monetary policy that we are likely to anticipate seeing forthcoming from the Federal Reserve in the near term is kind of a steady-as-you-go policy?

Mr. VOLCKER. Well, it has been that. It is up to that moment. It's been a steadily accommodative policy, I think it's fair to say, despite the declines in the dollar, given the surrounding circumstances. That has been tempered at times by concerns about the dollar, but that has been our posture.

Mr. McCOLLUM. Barring a steep decline of the dollar or something really dramatic happening, there's no reason for us on this Committee to anticipate that your Open Market Committee is likely to make a dramatic shift in either direction in the near term?

Mr. VOLCKER. Well, dramatic—many of the shifts that we make are marginal in the ordinary course of developments, but you come back, of course, to the fundamental factors of how does one assess the thrust of the domestic economy and particularly if there were emerging signs of inflationary pressure, particularly signs of inflationary pressure that weren't directly related to the recent change in oil prices and to import prices.

Mr. McCOLLUM. But you don't see those yet, do you?

Mr. VOLCKER. I think it is fair to say we have not seen them yet and we have not changed the policy. That is right.

Mr. McCOLLUM. Let me ask, if I may intervene with one other question—I don't want to dominate here too long—concerns what's happening in respect to the lesser developed countries and their obligations on this debt that's out there—Brazil particularly unilaterally not paying its interest rates.

Is that a concern that might affect monetary policy? And if so, at what point and in what way could it?

Mr. VOLCKER. Well, I don't know how much of an effect that would have on monetary policy, interpreted in the sense I think you're interpreting it—open market operations, discount rate and all the rest. Obviously, to the extent that interest rates are lower, those problems tend to be alleviated, but there are so many other things you have to take into account in the conduct of monetary policy, that can only be one limited factor in that context.

But I do think that whole set of problems obviously has potential implications for the economy and the stability of the financial system, our exports, certainly implications beyond the economic growth in Latin America, both in economic terms and in political terms. So it is a very large problem that might bear as one factor at times on monetary policy, but I think it bears much more directly, obviously, on a range of other actions that can be taken to which the government contributes toward alleviating those problems.

Our posture toward international financial institutions, what they are doing, what kind of assistance they can bring to bear, bilateral lending programs, working with both the borrowing countries and with the banks to try to get some combination of effective economic policies in those countries and get the programs adequately financed is important.

Mr. McCOLLUM. How should we view yesterday's decisions by the Argentina government with respect to their new wage and price freezes and their changes in terms of this whole process?

Mr. VOLCKER. Well, I think you ought to view those constructively. I don't want to debate particular points in the program and the role of the price freeze and all the rest. But, as you know, Argentina did introduce rather dramatic measures some time ago that I think fell in the Chairman's category of very drastic and dramatic measures, and while ordinarily they're not called for, when you have the kind of hyperinflation that Argentina had and a poorly

performing economy, that kind of shock treatment is sometimes called for and is constructive.

Now they have had renewed problems. They have had some very great achievements, but they have also had renewed problems in recent months, particularly on the inflation front. I think the set of actions that they took yesterday—not just the temporary price freeze—but the set of actions they took yesterday were designed to under-gird the basic program they had before broadly in conformance with the agreement they just reached recently with the IMF to make sure that at one and the same time they get the re-emergence of inflation under control and do that in a way that's consistent with improvements in the structure of their economy and the growth of their economy and also helps lay the groundwork for the external financing they clearly need.

So I would interpret that set of measures as a constructive and cooperative effort on their part to both improve their economy and consistent with the need for orderly external financing.

Mr. McCOLLUM. Thank you, Mr. Chairman.

Chairman NEAL. Mr. Barnard.

Mr. BARNARD. Welcome, Mr. Chairman.

Mr. Volcker, what does the Fed's own econometric model predict as far as the amount of inflation that we can expect in the next 12 to 24 months?

Mr. VOLCKER. Well, I have to tell you honestly I am not familiar with precisely with what comes out of the econometric models. It depends upon the assumptions they put into it anyway. I have enough skepticism about econometric models that I don't deliberate over the raw numbers coming out of the models.

I am very much aware of the judgment of our economic staff, one ingredient of which is all the econometric work they do with various assumptions. And while the staff judgment is not reflected in the Humphrey-Hawkins report, I think I could tell you that it's not widely inconsistent so far as inflation is concerned. They do expect some increase because of the very factors that I mentioned—the rise in import prices and the rise in the oil prices.

I think that's obviously a common expectation by most economists.

Mr. BARNARD. Well, I certainly respect that. I had understood that the Board had invested enormous amounts of resources into forecasting models over the past decade and I was wondering if they were still being utilized, and if they're not, has all of that been just a waste of time?

Mr. VOLCKER. We have a lot of models and a lot of computers and they are busily used by the people in the research department constantly. But what I am saying is what comes out of those models also gets filtered through judgment by the economists and ultimately, of course, by the Board and the Open Market Committee.

Mr. BARNARD. Mr. Chairman, as the debate here in Congress continues as to what degree the Gramm-Rudman targets should be adhered to, I would like to comment on yesterday's testimony by Mr. Robert Eisner who said, "That for every \$30 billion in reduction in the structural deficit, that we should think in terms of an addition-

al 3 percent increase per year in the monetary base or some other monetary aggregate."

In other words, if we really reduce the deficit to \$108 billion, we would require an additional increase of approximately 6 percent in the monetary base.

Would you agree with that?

Mr. VOLCKER. Well, that doesn't sound right to me, but a lot of economic models will show a movement in those directions if you look at them in the short run. An economic model will say, if you reduce the government deficit, that takes some stimulus from the economy and you can offset that, depending upon the specifications of the model—and they all differ—by a certain amount of increased monetary expansion in year one and they will all phase out over a period of years. The models all tell you if you put in too much money you will end up with too much inflation, too.

Mr. BARNARD. Well, that was the way I certainly judged the situation. I noticed yesterday that in the American Banker, Mr. Heine-mann indicated that our M1 had increased I think he said 23.8 percent in the last year.

How much more increase in M1 can we take without a significant increase in inflation?

Mr. VOLCKER. That is a judgment that we have to make. It was about 15 percent if you take it on a fourth quarter to fourth quarter basis, and that is obviously a very large increase in M1 in historical terms. It was a particularly large increase last year when you consider what was happening to inflation, the rate of growth, total nominal GNP. We had a decline in velocity—the relationship between the increase in money and the economy—of postwar record proportions anyway. And you wonder. That's out of the pattern of history.

It certainly raises the question that you raise and Mr. Heine-mann raised. The answer to that question I think can't be found in mechanics. I don't think it's going to be found in econometric equations very easily either, partly because we have new institutional developments that bear upon the response particularly of the money supply to declining interest rates, and we had sizable declines in interest rates late in 1985 and through the first half of 1986 which undoubtedly played a big part in this increase in M1.

We have to evaluate the very question that you raise meeting by meeting in effect. But we are unable to come to what we think is any reliable judgment as to what the appropriate increase in M1 is, let's say, for 1987 against the background of changed institutional setting and the other variables in the economy.

Being unable to arrive at a judgment that we felt comfortable with, of course, as you know, we didn't set forth a specific target for M1. We did make the judgment that we think all the monetary aggregates appropriately should increase significantly in 1987 than they did in 1986. And we could visualize circumstances, as I describe in my statement, where M1 should be very sharply lower in terms of rate of increase because the factor that produced the big increase this year in a certain economic setting would run in the opposite direction in another economic setting.

So I don't think you should be surprised in certain economic settings that may or may not develop to see a very sharp reduction in

the growth of M1. In other settings, it might be appropriate to be quite relaxed about it.

Mr. BARNARD. Mr. Chairman, as has been evidenced by the testimony this morning, with the high regard that all the members of Congress have for you and certainly your influence, what advice can you give us today? Should we change the Gramm-Rudman parameters? Should we stick with the Gramm-Rudman parameters and raise taxes? Should we reduce some of the ambitious programs that the administration has in defense?

What is your advice to us as to how we should approach this?

Mr. VOLCKER. Well, I had a great long discussion of this a couple of days ago with the Senate Budget Committee and, of course, the difficulty in giving you an answer is that there is a difference between a target and realization of that target and it involves not just an economic judgment. But when you are looking at targets, the question of how to motivate action, the process that's involved in getting there—as I listened to some of the discussion with the Budget Committee the other day, I had the concern that some members of the committee expressed, that if you set a higher target, a significantly higher target, and then end up missing it, either by overambitious economic projections or by certain actions that don't have much content to them but are put down on a piece of paper as meeting a target, you end up with no progress.

I don't think the economy depends quite clearly on meeting any specific arbitrary target as low as the present Gramm-Rudman target. But there is an interesting question. If you abandon that target, is that an excuse for not taking the action that is necessary to achieve a significant continuing decline in the deficit, which from an economic viewpoint that is what's necessary—not meeting that particular target, but can you achieve that goal without keeping that target in front of you?

I think that's a political question and I can see a lot of merit to keeping the target in front of you to remind yourselves of the size of the job that has to be done.

Mr. BARNARD. And I think you have stated here in testifying before this committee that any reasonable increase in taxes coming from, say, an excise source would not alter our economic position too badly. Am I wrong in that?

Mr. VOLCKER. I have always said that I think from a purely economic standpoint, forgetting about all your other responsibilities for spending programs, for defense and all the rest—viewed from an economic standpoint, doing it all on the expenditure side is better.

But I have also said that if you can't, given those other needs, do it all on the expenditure side, then I think you have to look at the revenue side, and that you could look at a variety of revenue sources and I don't think that any increase in revenues of cigar taxes is going to damage the economic health compared to the necessity of reducing the deficit.

Mr. BARNARD. Mr. Chairman, we've alluded this morning to the situation in Brazil several times. Given recent statements by Brazil that suspending interest payments on their foreign debt as well as an indication of other Latin American countries are rethinking their debt policies, I'm interested in the potential for certain LDCs

to convert at least some of their debt to equity and I understand that such conversions are permissible but only to a very limited extent.

My question is, is conversion a viable concept and could it proceed under the present Fed regulatory process or is legislation required?

Mr. VOLCKER. I think it is viable and can proceed in current regulatory framework to a degree, and it is a matter of degree. I think the major constraint on those kinds of conversions—obviously, a bank could convert debt into equity even if it itself was unable to hold the equity. It could sell the equity if it was a good investment.

I think the major constraint that tends to operate here is how much equity those countries are prepared to and can absorb in a limited period of time. That is one constraint.

Another constraint is some of these debt-equity swaps will not in fact provide financing to the country. It doesn't obviate the need for raising new money. Indeed, it may just not be neutral in that respect. It may be a subtraction from funds available to the country and this is where you get into difficulties.

Suppose a big foreign investor is planning and is going to make a sizable new investment in one of these countries and it would ordinarily bring in the money from abroad. That is net financing for that country. It's very desirable. They get more equity. They get new money to finance their deficits at the same time.

If, instead, that is financed by reducing their debt, there is no fresh money coming into the country. So they have that kind of constraint.

So I do think this is an area where you could make some useful steps. And it's useful not just as a financing device. It's useful if it encourages equity running into those countries that would not otherwise go, then you have or may have a favorable financing effect and you have a favorable effect much more broadly and maybe more significantly over time that you build up the private sector of those countries, which is very important. But I think we have to keep your mind on the limitations of the process, too.

Mr. BARNARD. Do you think that the regulatory process would be maybe liberalized a little bit to accommodate more of these debt-equity swaps?

Mr. VOLCKER. Well, I am not aware really that that's been the sticking point.

Mr. BARNARD. I think it has been.

Mr. VOLCKER. Obviously, we could look at it and if it is the sticking point, but that's not my impression and I would have to make the other obvious statement that we would not want to change the regulatory approach in a way that we thought was inconsistent with good banking practice, but within those two limitations.

Mr. BARNARD. Mr. Chairman, Gerald Holtham testified yesterday that he interprets the Paris agreement as a U.S. commitment to stabilize the current exchange rate for the dollar even if it is necessary to take a serious recession here. He also appears to believe that a recession is highly likely if we adhere to this agreement.

Naturally, I am interested in what your viewpoint is on this statement.

Mr. VOLCKER. Well, I obviously don't agree with the latter conclusion either that a recession is highly likely or that this statement would contribute to it, or the policies reflected in the statement would contribute to it.

I think on that particular point, the general view is that further sharp declines in the dollar might be dangerous at this point because of adverse repercussions from two directions really. First of all, quite directly on the economies of other countries. Both Germany and Japan, for instance, are experiencing currently in real terms a decline in their trade surpluses and it's obviously already affected to some degree the performance of their internal economies.

That's why it's so urgent they take offsetting actions to expand and stimulate their economies. But the impact on trade balance itself is negative and just in terms of the colloquy with the chairman earlier, there's a limit as to the rate of speed at which those adjustments can take place. So we want to see a decline in their trade surpluses but it has to be done in a framework that they can handle without driving themselves into recession, which in turn would reflect upon our prospects.

The other point of vulnerability is that if there is an absence of confidence in the dollar, translated into a reluctance of others to supply capital to the United States upon which we are dependent, that could be bad news for the American economy in terms of maintaining an even keel and if you drive the analysis far enough it could drive us into very difficult circumstances here and even into recession.

Obviously, it has implications for interest rates and our financial markets and we want to avoid those. And so I don't agree with the analysis that you had at all.

Chairman NEAL. Mr. Saxton.

Mr. SAXTON. Thank you, Mr. Chairman.

Chairman Volcker, it is a pleasure for me to be able to take part in this discussion with you today. One of the elements that seems to be consistent in these kinds of discussions, as they certainly were yesterday, is that there are so many factors that we all need to consider in deciding on a policy course, if you will, and they have all been mentioned here today—the world economy and what the money supply and level of it in our country means, what the budget deficit means, what the trade deficit means, what it means when perhaps foreign countries make a policy not to pay the interest that is due financial institutions—and all of those things.

But it seems to me that there is a key in terms of at least the members of this panel and other Members of Congress, and the key seems to me to be what is it that Congress is going to do to affect economic policy in our country? And as has been aptly pointed out by you, two of those key policies that Congress has dealt with, has tried to deal with and seems about to deal with again are the budget deficit and the way the budget deficit may relate to policy which may be adopted by the Congress on the trade deficit.

I am curious to know—and I asked this question yesterday—what relationship do you see between the policy that we set on the budget deficit and the policy we set on the other hand—or seem about to set—on the trade deficit, whatever that policy may be.

And, is there a relationship there that we need to be careful of in how we attack that problem, particularly in light of the fact that we appear to be very interested today in the trade deficit, and is there action there that could be detrimental to us in a general economic sense if we do it wrong?

Mr. VOLCKER. Yes. I think you open the issue very well. I think there's a very clear relationship between what you do on the budget deficit and what you do on trade policy, which we could approach from several directions.

Let me take the most extreme assumption, which I obviously am not advocating. I would oppose very strongly that you say, "Look, we have got a big trade deficit and we will take very strong protectionist measures. We've got to get rid of that trade deficit one way or another."

What would be the result? Even forgetting about the fact that others are going to retaliate and you may not end up with those results, what would be the results on the American economy even apart from that?

First of all, it's obviously going to be highly inflationary if you took that draconian action on the trade problem because we suddenly wouldn't have that flow of foreign goods that help keep our prices stable. We haven't got any immediate way of replacing all of that flow without a lot of inflationary pressures. The implication of that is, simply for that reason, interest rates would be driven up.

But look more fundamentally at the relationship with the budget deficit. If we just hypothesize that we could very rapidly eliminate the trade deficit, that is saying the same thing on a net basis as eliminating their foreign capital outflow—our inflow. You can only borrow as much as you are spending, in a sense, net overseas. And if we eliminated the trade balance, we no longer would have that \$150 billion of foreign financing.

Now what would happen if we don't have the \$150 billion of foreign financing, all else being equal? Somebody is going to get squeezed out of the domestic credit market because we haven't got enough internal savings and no prospect of changing that, as we discussed earlier—certainly in the short run. Who is going to get squeezed out of the domestic market? Well, if you have that big government deficit that has to be financed more or less of the same magnitude, you're going to put a terrible squeeze on investment in housing, for example, that isn't going to be good for the economy.

So I don't think it is possible to think in a constructive way of reducing the trade deficit without at the same time more or less parallel reducing the budget deficit to relieve the financial pressures that otherwise would arise that are now being relieved by the flow of foreign capital. So, in that sense, the problems are directly linked.

Now you can also argue, though here the relationship is less direct, that you won't improve for other reasons without dealing with the budget deficit because it's the budget deficit that helps pump up consumption and, as you pump up consumption, you draw in goods from abroad and you don't release resources that are necessary to support exporting and, therefore, many people would feel that the budget deficit is a fundamental cause of the trade problem.

Whether or not it's the cause, it surely must be dealt with as the trade deficit is dealt with.

Mr. SAXTON. If we were to take actions to reduce the trade imbalance, would it have an effect on interest rates in this country, without doing something on the budget?

Mr. VOLCKER. Without doing something on the budget, if that action was effective in a pronounced way, which is a question, but if you took such draconian action by direct controls as to reduce the trade deficit, yes, it has implications for interest rates very clearly.

Mr. SAXTON. And, of course, implications for interest rates are implications for our economy generally?

Mr. VOLCKER. Yes.

Mr. SAXTON. What do you think of the approach that we have used, talking about Gramm-Rudman? Last year our budget deficit was well over \$200 billion—\$230 billion.

Mr. VOLCKER. \$221 billion I think.

Mr. SAXTON. \$221 billion, and the projected budget deficit for this year is somewhere around \$170 billion to \$175 billion, depending on who you listen to?

Mr. VOLCKER. \$180 billion, someplace in that area.

Mr. SAXTON. Would you say that that is a significant reduction in our budget deficit? And what would you say the Gramm-Rudman targets had to do with that?

Mr. VOLCKER. I think that was a significant reduction in our budget deficit from a very high level. It was a one-year reduction and the challenge now is to keep going on that path.

Now what did the Gramm-Rudman targets have to do with it? Obviously, those projected budget deficits for this year are well above the Gramm-Rudman target, but I think the question you present, if you hadn't had the Gramm-Rudman targets in front of you, would you have done as well as you did? And I think there is obviously some room to be skeptical about that, which is what this whole debate is about setting those targets and holding them out in front of you and trying to adhere to them and you'll have a lot of slippage and it's better to have slippage from \$108 than have slippage from \$140.

Mr. SAXTON. We talked about the relationship between the budget deficit and the trade deficit or trade imbalance.

Given your position central to the financial economic condition of our country, if you had kind of a carte blanche set of powers that would let you direct the next couple of years in terms of those elements of our economic situation and problems, if you will, that we have been talking about here this morning, how would you approach from here on in a continuation of what you have been doing certainly, and what ought Congress to do to help keep our economy moving in the right direction?

Mr. VOLCKER. I think clearly the biggest single contribution you can make and the indispensable contribution you can make is keep that budget deficit on an orderly, sizable, downward course. Now you can't measure that by a precise number. As you said, it's likely to come down \$30 to \$40 billion this year. If you do another \$30 to \$40 billion next year, and I think given the confidence factor involved here, if you can do it, you have to do it in ways that provide

some basis for thinking that that's not the end of the road, that you can do more in 1989 and more in 1990. Then I think you have made the most important contribution you can make.

Mr. SAXTON. Thank you very much.

Chairman NEAL. Mr. Hubbard.

Mr. HUBBARD. Thank you again, Chairman Volcker, for being with us today. About one hour ago I mentioned that you consistently have urged Congress to reduce that Federal budget deficit. You have again today.

On page 9 of your statement you say, "Success in my mind will not be measured so much by whether we meet some pre-ordained, arbitrary target, but by whether in fact a reasonably steady downward pace in the deficit is maintained as the economy grows—maintained by measures that can be sustained year after year."

This is my seventh year in Congress, and I have advocated in the past reducing the Federal deficit. I have voted against the continuing resolutions, each one of them, that we continue to pass each year.

Many Members of Congress believe that a constitutional amendment to require a Federal balanced budget is the only solution that would cause us in fact to actually reduce the deficit enough to ever balance the budget. Many States, including my own, Kentucky, have a provision in their constitution which requires a balanced budget operation, and we live by that.

President Reagan, when he spoke to us less than a month ago, on January 27th, said, "For years, I have asked that we stop pushing onto our children the excesses of our government. What the government finally needs to do is pass a constitutional amendment that mandates a balanced budget and forces government to live within its means. States, cities and the families of America balance their budget. Why cannot we do that?"

Mr. Chairman, what are your thoughts on a constitutional amendment to require a Federal balanced budget?

Mr. VOLCKER. Well, my thoughts, frankly, are that sometimes I get frustrated enough so I begin thinking it's a good idea. I am aware that it has a great many problems. It's a very kind of arbitrary kind of thing when you know that in some economic situations the budget cannot and should not be balanced, and I also am afraid that that kind of effort doesn't solve any problem in the here and now. You are talking about constitutional amendments that will become effective years from now and you have got a lot of work to do before that happens.

Basically, I have not been a particular advocate of that approach. I would say there are other things that you could do constitutionally that make some sense.

Mr. HUBBARD. What are those?

Mr. VOLCKER. The President has also raised the question of a line item veto, which as you know many States have. That seems to make a lot of sense to me. I hate to put statistics like a balanced budget somehow—it depends on how one defines it—into the constitution, but I don't see anything the matter with putting a line-item veto into the constitution.

And I will be more radical for you. If in fact we have a chronic tendency to spend more than we are willing to tax, and that seems

to be true, maybe we ought to have a higher vote for a spending program than for an ordinary bill in the Congress.

Mr. HUBBARD. I, too, support a line item veto and to quote the President directly, just a couple of sentences on that issue, when he spoke to us on January 27th, he said, "We ask the Congress once again to give us that same tool that 43 Governors have, a line item veto so that we can carve out the boondoggles and pork that would never survive on their own."

But, of course, we continue to fail to do that.

Mr. VOLCKER. I don't want to suggest that I think a line item veto is up to the task of curing a \$170 or \$180 billion budget deficit. I think it takes a lot more than a line item veto, but it may be a useful additional disciplinary tool.

Mr. HUBBARD. Of course, I should point out as a Democrat, in fairness, that our President could present the Congress a balanced budget himself, which he has failed to do each year that he has been our President, notwithstanding his promise to do so in 1980 within 4 years to see to it that we have a balanced budget.

Chairman Volcker, major U.S. banks and their shareholders have reacted, of course, recently to the Brazilian Government's announcement last week that it will suspend payments of \$67 billion of its \$108 billion foreign debt. Actually, the banks and their shareholders have reacted with surprising calmness thus far.

Banks that have lent most heavily to Brazil and other Latin American countries have seen their stock prices drop sharply, but the reaction has been well short of panic.

Of course, we know that not everything is A-okay. While most of the affected banks have been stashing away reserves against the possibility of such a default, Brazil's action could be emulated by other nations in the region. Latin America's total debt is around \$350 billion, much of it owed to U.S. banks.

Throughout Latin America, political leaders apparently are under pressure to defy Washington or the United States, to renege on their debts, and to spurn the budget austerity that they say we preach but do not practice.

In your estimation, Mr. Chairman, is this an accurate reflection of the political atmosphere in Latin America as it relates to their willingness to cooperate with the United States banks and our government?

Mr. VOLCKER. Well, I think you overstate it in the last couple of sentences. Clearly, there are political pressures and economic pressures in those countries, and those pressures are very considerable and there is a casting around for what looks like easier solutions. But I think a responsible—I don't think in fact they are easier solutions, but may appear on the surface and politically to be so.

I think the obvious observable fact in Latin America is the degree to which those countries have broadly moved in responsible directions. That is the conclusion that the political leaders have reached there over a period of four years or more in dealing with this problem and I think there are strong incentives to continue to do so.

But we would also be blind if we didn't understand that there were pressures in the other direction.

Now Brazil has a particular problem. Other countries have suspended interest payments for a period of time and then gotten back on course. That's obviously what we would like to see happen in Brazil.

Brazil is potentially and I think demonstrably a strong country, the largest and economically strongest in Latin America. They have demonstrated ability to generate large international surpluses as well as domestic growth, but they have been off course in recent months.

What's going to be needed, first of all, is that they re-establish internally the kind of economic programs that can permit that economy to perform up to its potential, which is very large, and I think it is that step which is crucial to Brazil just for its own purposes that can also provide a basis for reorganizing their external finances.

Mr. HUBBARD. Chairman Volcker, just one more question in order to give Congressman Dreier a chance here.

You have discussed at length the debt problems of the Latin American and other developing countries, and you mention on pages 13 and 14 of your prepared remarks today that these debt problems are again at a critical stage and that in recent months the process of reaching agreement on adequately supportive and timely financing programs, whether by restructuring existing debts or by arranging what new loans are necessary, has conspicuously slowed.

Earlier this month, of course, we read that the 33 largest U.S. banks, which have over \$51.5 billion in loans outstanding to Argentina, Brazil, Mexico and Venezuela, will have to gradually write down a significant portion of their total Latin American debt.

With this in mind, would you briefly explain what you believe is the status of and the outlook for the Baker plan?

Mr. VOLCKER. Well, I don't know where you got that statement that they have to write down the value of these debts. The whole strategy of the Baker plan is that by a combination of efforts—by the countries themselves, by the banks, by international institutions—we can restore a situation in which those debts can be serviced in the normal course and will be worth the value that's on the books.

That is the aim. I think that's the aim of the borrowers as well basically. You asked for a progress report. I, in a few paragraphs, told you that I think the process has run into difficulties for a variety of reasons.

One I must mention is the growth in the industrial world that has to provide markets for the exports of these countries, while continuing, has not been quite as strong as one would like to see it. The world financial environment has not been as strong as one would like to see it from that perspective as well as from other perspectives.

I do think that there has been what I called the other day a kind of battle fatigue among the borrowers and the lenders in getting together and maintaining both the momentum of economic programs but arranging in an expeditious way mutually satisfactory financing programs.

I think there are some signs in the past days and weeks that maybe we are beginning to get through that. We are not through it yet. There are many large problems, but there seems to be some indication of renewed impetus beginning to develop and I hope that that is true and I hope that we carry through. I think that that is essential.

Certainly in looking at the Baker plan more broadly, it seems to me that the international financial institutions, particularly the World Bank, stand ready and are playing a larger role than in the past and that is highly constructive. In the case of Brazil, just to return to that particular and very large case for the moment, it would seem to me there is a sizable potential for increased World Bank lending to that country to support constructive economic programs within Brazil that would make the economy more competitive and more effective.

So I think there still is a basic joining of interests here of the kind that is reflected in the overall philosophy of the Baker plan.

Mr. HUBBARD. Thank you, Mr. Chairman. This is not a question. I would just like to conclude by complimenting you once again and say, in my opinion and in the opinion of many Americans, you have done more to reduce inflation and to cause interest rates to be as low as they are today and to bring about stability in our economy than any other person I am aware of, and we compliment you and appreciate your being with us today.

Mr. VOLCKER. Thank you very much, Congressman.

Chairman NEAL. Mr. Dreier.

Mr. DREIER. Thank you very much, Mr. Chairman.

While not a member of this subcommittee, I very much appreciate your gracious invitation to include me here this morning.

I would like to first, Chairman Volcker, get back to one of the issues that was discussed earlier and that is this two-track issue of dealing with both the trade deficit and the budget deficit.

You talked earlier about the salutary impact that the influx of foreign capital has had in this country on the budget deficit itself—

Mr. VOLCKER. Not on the deficit, but on financing.

Mr. DREIER. Exactly. On financing. What I would like to ask is, as we look at the impact that high deficits can have, do you feel that one particular aspect of the tax bill which we passed last year, that being the repeal of large parts of the Individual Retirement Accounts, the flow of those long-term dollars into the financial markets will have a negative impact on the economy?

Mr. VOLCKER. Well, somewhat reluctantly, my answer would be I would not expect that impact to be sharply adverse. We put in—

Mr. DREIER. Why do you say "somewhat reluctantly"?

Mr. VOLCKER. Because I would like to think there's something we can do to increase savings and utilize them more effectively. But I look back at the experience when those were in effect in a full-blown way and they were very popular financial devices for people in dealing with tax problems and you saw a lot of funds moving into IRA accounts. The trouble is, you couldn't see much impact on the overall savings rate, which suggests that a lot of those transfers of funds simply reflected funds that people would have saved anyway but they put them in that particular form because of the obvious tax advantages.

Mr. DREIER. What do you see as something that's on the horizon that could encourage an increase in savings?

Mr. VOLCKER. Well, I will put my point very sharply for purposes of making it. I don't see much. I don't see what you can do.

Mr. DREIER. Maybe that's one of the reasons we shouldn't have repealed the Individual Retirement Accounts.

Mr. VOLCKER. Well, except that not seeing much positive effect, I am not going to see much negative effect either. I think the basic savings habits are pretty deeply ingrained. That's what experience seems to suggest.

Let me suggest something radical. I think this would have an impact, but even then I think it would be a matter of judgment how much impact it has.

I think the whole tax system in a way is biased against savings. You tax income when you earn it. You tax it again when you have saved it and have some earnings on the savings. If you go all the way to a consumption tax and don't tax savings at all, then I think you will have done something that might make an impact. But I wouldn't want to quantify that, but that would take obviously a very radical change in the tax system.

There's another thing you can do in the tax system that may be more practical but it's been rejected time after time, but I certainly think affects the composition of savings and what it's used for, and that's the way we basically bias the tax system against equity and in favor of debt and we shouldn't be all that surprised that we see debt rising very rapidly and equity being retired.

Now there's something else you could deal with. Get rid of that bias against equity.

Mr. DREIER. Well, if you put savings and investment together, then what are your thoughts about what we did to capital gains?

Mr. VOLCKER. Well, you ran in two offsetting directions. You lowered the basic rate and then removed the special rate of capital gains.

Mr. DREIER. I should tell you, Chairman Volcker, I voted against the tax bill.

Mr. VOLCKER. I began to have the feeling that you are uneasy with some aspects of it. I think the capital gains tax I suspect would not affect one way or another very much the overall savings rate. But again, I think that is something that will affect the disposition of savings and clearly when you don't give those kinds of benefits—if I call them that—through a special capital gains tax, I think you are affecting incentives for investing in perhaps riskier areas of the economy, new and rapidly growing businesses and that kind of thing. So I think it does bear upon the type of investment you get.

Mr. DREIER. We could talk all day about the tax bill, but I would like to shift just a little bit to another issue which I think is very important and, you know, the buzz word going on around here is competitiveness and we have been talking about it for the last several months. It really started right around election time and a lot of people have carried it forward.

What I wondered, as we look at the loss of the U.S. technical and marketing competitiveness, I wondered what factor that played in

the trade deficit compared to the overvalue of the dollar that we saw over the past couple of years.

Mr. VOLCKER. Well, I don't know any way you can quantify that. I think some of these—if I may call them—pessimistic forecasts of the dollar that come out of some of these econometric equations which in effect summarize past trends and past experience—you could argue they come out that way because of other factors that have reduced our competitiveness very broadly defined. And if our competitiveness is reduced in other directions, then you have got to put more burden on the exchange rate and you get a lower exchange rate than would otherwise be necessary.

Let me put the point another way, maybe arriving at a similar conclusion. I don't think there's any doubt that wherever the exchange rate ultimately has to be in 1990 or whenever, we are in a much stronger competitive position with respect to exchange rates and overall prices now relative to industrialized countries than we were two years ago.

Now what's going to happen as we move forward? Let's say we get some response in terms of exports and we are better able to compete with imports. To what degree are we going to take advantage of that situation by more aggressive marketing efforts and particularly by keeping our costs down and our efficiency up, which I think has been going on these past few years, but it's been going on under very strong import competition.

Will we keep that productivity growth? Will we keep that restrained cost trend when suddenly the competition, because of exchange rate changes, becomes somewhat less aggressive? I think a lot hangs on the answer to that question.

To be very specific, if every time the Japanese raise their automobile prices we raise our automobile prices and that may look like a very good calculation in the short run in terms of this year's profits, it isn't very good in terms of our long-run competitiveness.

Mr. DREIER. I was really pleased with your statement at the opening of your testimony which, unfortunately, I didn't hear but I read when I got here. And you talk about something of which many of us are very proud and my friend, Mr. Hubbard, said that you are in large part responsible for the economic expansion we have seen over the past several years and I, too, believe that's the case. There are a number of other factors but I am very pleased that you point out the fact that we have had the strongest economic expansion in peacetime history.

What I would like to ask is, where do you see demand growth in the economy over the next 12 to 18 months?

Mr. VOLCKER. Where I would like to see demand growth in the economy primarily is in the export side or in the substitution for imports. I would like to see—and I think we must see—and I think the short-run future of the economy is very heavily dependent upon an improved trade picture. That is the place where we can usefully use demand stimulus, so to speak, completely consistent with dealing with these very large structural problems we have in the economy. That's the only way.

If the problem is that we have this immense international imbalance, that is where we'd better see the improvement in economic activity in dealing with the trade problem.

Now, let me point out a couple of implications of that. What I am saying is that domestic consumption has to rise more slowly. We have got to put more resources externally and less in satisfying domestic consumption.

It also means that we have to maintain that competitiveness that you spoke of while shifting a very substantial amount of resources into manufacturing industry over—it's no great problem in 1987 or 1988, but if we're going to really deal with that trade balance and we are going to change our trade balance by \$150 billion, which is what the deficit is, over a period of years we're going to have to shift a lot of resources into manufacturing and we have to maintain our competitiveness and efficiency while we do it.

Mr. DREIER. Thank you very much.

Thank you again very much, Mr. Chairman. I again appreciate your extending the invitation to those of us who aren't lucky enough to serve on your subcommittee.

Chairman NEAL. I appreciate your joining us, Mr. Dreier.

Mr. Chairman, I want to get into the FSLIC recapitalization question. I know Mr. Barnard does also. But before that, let me mention a couple of other items.

First, I would like to ask you to seriously reconsider your support for any line item veto idea. I will explain why I say that. If you look at the record over the last several years, I think that you will see that the President has actually requested more spending than the Congress has granted when you get right down to the appropriations bills and you cut through the rhetoric and all this. That is fairly typical of Presidents. Most of them do that, even though I know the public perception is that the Congress wants to spend a lot more money than Presidents want to spend. In the case of our current President, the mix has been different. He wants to spend a lot more money for military and foreign aid than the Congress wants to spend in those areas, and a lot less on domestic proposals. And so a person might say, "Well, I agree with that and I think that is just the ticket and so I want to give the President all this wonderful power to further these goals that I agree with." But remember that from time to time we elect Presidents of another party and that other President might want to spend a lot less on defense and other areas and might want to pump up a lot more money and on other projects that could cancel out what you or someone else might think are very vital defense programs.

I am sure you are very well aware the national government is not like a State government. State governments spend some money on education and roads and State highway patrol and that is pretty much it. Thus our forefathers, it seems to me, crafted a very careful balance.

If you give the line item veto to the President, you have essentially emasculated Congress, the people's House of this country. There would be little I think for Congressmen to do around here except dress up in tuxedos and go around to these lovely receptions that are so available to us. You would do another thing. You would give the President not only almost total control over spending, but you would give him almost total control over other policy. There would be this enormous temptation for a President to make deals and say to this Congressman, "Look, I want you to support me on

this thing and I will be happy not to line item veto that dam project or whatever it is in your district," and to some other Congressman he could do just the opposite.

So I think personally that there is enormous potential danger in that concept. And for that and other reasons, I would hope that you would not be a great champion of it, but, of course, that is your own business.

Mr. VOLCKER. If I may interject, I was almost inclined to say that in rebuttal that you might have enough time to act on comprehensive banking legislation from your description of lack of other duties in the Congress. I think that would be very healthy.

Mr. BARNARD. Would the gentleman yield?

Chairman NEAL. Yes.

Mr. BARNARD. Mr. Chairman, we do have sufficient time to do it now. It's just that we don't have the will.

Chairman NEAL. That is correct. There is no lack of time around here for what we want to do.

How would you characterize the priorities of your Board now? You have many responsibilities—keeping down the rate of inflation; encouraging employment and productivity; exchange rate concerns; and so on. But how does the Board order these priorities, I read comments reported in the press about what the new Fed Governors say from time to time, but I don't have an impressions of what their priorities are. Would you please help me with this? How would you characterize the priorities?

Mr. VOLCKER. I would make a couple of comments. I think we have the feeling—and I can't answer for the nuances in every individual's position—I can't answer for every individual whether it's a nuance or not—but I do think there is a general feeling that this idea that we have a tradeoff between economic growth and inflation isn't valid over any period of time and right now it may not be valid in the short run.

I do think there is a common appreciation of the dangers of reinflated inflation, if that's the right adjective to use. I think it would be entirely wrong to look upon the Board as different people having sharply different priorities, nor do I think that, speaking for myself, I don't think you can have a priority of inflation one year and growth another year and this kind of thing. They have to be treated as a whole and it seems clear to me that the economy isn't going to function very well and we're not going to have much growth over a period of time unless we keep inflation under control. And that's a constant year-in, year-out battle.

Chairman NEAL. And would you say that your fellow Board members share that view?

Mr. VOLCKER. Well, I hope so and I think so.

Chairman NEAL. There appears to me to be a great incentive in the tax bill that we passed to increase spending through the refinancing of second home mortgages. Is that a serious enough problem in your view to warrant some change? You earlier expressed some concern but you didn't really give me a yes or no answer.

If you do not feel that any change is needed now, please have some of your experts look at it and let us know why.

Mr. VOLCKER. Well, I am perfectly aware of the difficulties of reopening that tax bill and while that is not a provision in the tax

bill with which I personally am enamored, making that kind of arbitrary distinction between credit on a house and credit on something else, I am not sure that I see the short-run problem is great enough to provoke, for that reason alone, reopening of the whole debate on the tax bill.

Chairman NEAL. That was not really my question. I have a feeling—

Mr. VOLCKER. Then I misunderstood your question.

Chairman NEAL. My question was whether or not you think that it is a serious enough problem that it would be in the best interest of our country, not only for the short term but for the long term, to try to change it?

Mr. VOLCKER. If I was rewriting the tax bill, I would not have that provision in it.

Chairman NEAL. I have a feeling that the tax code will be revisited at some point this year, next year, in the near future, because there are some other little flaws in it. I could be wrong about that, I do not know for sure.

Let me put it this way. If we do get back into the tax bill, do you think that it would be desirable to take another look at second mortgage interest deduction and try to change it in some way?

Mr. VOLCKER. I think it could be. I would put it along with some of the things that Congressman Dreier mentioned, and I think one of the things that you've neglected to do that works to the disadvantage of the financial system is getting a better equilibrium between tax cost of debt and equity financing. That, I would put higher on your priority list than this problem.

Chairman NEAL. Over the years I know you have been asked this question many times in different ways. I have asked it a number of times in different ways both to you and others. Throughout last year and into this year you have stressed the importance of reducing the budget deficit. You have made it clear that you think, from an economic point of view, that it is better to reduce it by cutting spending than increasing taxes. Is it more important that we reduce the budget deficit or is it more important that we not increase taxes?

Mr. VOLCKER. You are right. That question has been put to me in many different ways on many different occasions.

Chairman NEAL. And you have given many different answers.

Mr. VOLCKER. I think you ought to attack the deficit. The best way to do that is to the maximum extent possible on the spending side, but I would throw some revenues into the package if you had to do it to get an adequate deficit reduction. I don't know how else I can answer it. I don't want to answer it as an either/or proposition.

Chairman NEAL. So You are saying that it is more important to reduce the budget deficit than it is to keep taxes at their present levels, so you would be willing to—

Mr. VOLCKER. But that doesn't mean I want to see you reduce the deficit as a matter of strong preference entirely by increasing taxes. I don't think that's the most effective way of going about it.

Chairman NEAL. I agree and I know you have said that many times. I do not think there is any doubt about your position on that. Of course, I share it. But it does seem to me that the policy-

makers in this country have said over the last 7 years that it is more important to keep taxes low than to reduce the budget deficit. That has been the policy.

Mr. VOLCKER. Well, you obviously have a rather basic problem. If you're going to continue to enact spending programs that are roughly 23 percent of the GNP and the taxes are running 19 percent of the GNP, you've got to close that gap. And if you tell me it's impossible to close it entirely by reducing spending side, then I think you inevitably have to look at the revenue side.

Chairman NEAL. Let me yield to Mr. Barnard.

Mr. BARNARD. Mr. Chairman, last fall, as you recall, we had great anxiety in the Congress about recapitalizing FSLIC and as a result we passed the FSLIC recapitalization bill.

The horror stories do not end. They keep going on and on and on and we still do not have a FSLIC bill.

The stories now are that the GAO auditors say that we need at least \$6.5 billion to even balance the books as far as FSLIC is concerned. And yet we still seem to be in this state of delay in getting it done.

Could you tell us in your opinion how critical do you think it is that we should get on with the FSLIC recapitalization bill?

Mr. VOLCKER. Well, I certainly think it's critical enough that you should get on with it. I am not as expert in that particular situation right at this moment in time as those who are directly concerned with the FSLIC, but it is clear they are going to need an injection of liquidity and capital and that is the only proposal on the table and I think—the only viable proposal on the table. It's maybe not ideal, but I don't know of any other way to approach it in the short run and I think you ought to get on with it.

Chairman NEAL. Would the gentleman yield on that point?

Mr. BARNARD. Certainly.

Chairman NEAL. On the use of the word "viable," would it be all right to ask that question now about this other approach?

Mr. BARNARD. Let me just ask this question. If I recall—and my memory may be failing—but if I recall last fall when we were having the hearings on FSLIC, it was stated in pretty definite terms that this issue was so important that it did not need to be encumbered with a lot of other controversial issues.

Would that be your position at this time?

Mr. VOLCKER. Well, there are a couple of other issues that I think are quite important that you deal with, too, and I would like to see you pass it at the same time as the FSLIC.

Mr. BARNARD. I realize that, but we are talking—

Mr. VOLCKER. I would like to see you deal with the nonbank bank issue and some powers for banks.

Mr. BARNARD. But would you agree that the nonbank bank issue is not going to cause a run on the savings and loan industry in this country?

Mr. VOLCKER. I agree it's not going to cause a run on the savings and loan industry in the country.

Mr. BARNARD. Or either the banks?

Mr. VOLCKER. Or the banks.

Mr. BARNARD. But if we get down—and we're already under the \$1.9 billion figure in FSLIC, my understanding is that they may be

just before asking for their emergency draw of the Treasury of \$750 million. Now that's getting right down to the core of the thing and now we come up with a GAO study showing that we need \$6.5 billion. It just looks like to me when we encumber that bill with the nonbank bank bill, although we need to address that—and I will agree with you there—when we encumber it with powers which is a controversial thing—in other words, if we're going to deal with the bill that has been proposed in the Senate, we will never get a FSLIC bill passed.

Mr. VOLCKER. Well, you might try.

Mr. BARNARD. Sir?

Mr. VOLCKER. You might try.

Mr. BARNARD. Well, we can't try because, Mr. Chairman, even the procedural basis will cause it to fail. When it gets to the House, it will then have joint jurisdiction of the Energy and Commerce and the Banking Committees, and when you can't get one committee to get together, how in the world are you going to get two committees together? So that's what I am saying is we need the encouragement of people like you to the Senate and the House to come up and let's get a clean FSLIC bill up and out so that we can get on with more pressing matters.

Mr. VOLCKER. Well, my problem is that there seems to be a great desire to avoid a vote on the other issues, and I think you ought to vote on all of them.

Chairman NEAL. Will the gentleman yield to me a moment on this?

Mr. BARNARD. Yes, sir.

Chairman NEAL. Mr. Volcker, you said a minute ago that the Treasury bill was the only viable solution to this. I have looked a little bit at this—

Mr. VOLCKER. Right now. This problem is going to have to come back and I suspect be revisited, but when you're looking at the immediate situation they face, I don't know any other alternative.

Chairman NEAL. Well, there is another approach on the table that originated in the U.S. League—

Mr. VOLCKER. A modification of the approach.

Chairman NEAL. That's right, a modification. It provides less money and I think anticipates that we might revisit the issue a little earlier than we would with the Treasury plan. It seems to me that there are some pretty good arguments in favor of that. First, they would have less money to spend. I have not been terribly well impressed with the way they have dealt with some of the problems facing that industry, although I do not mean to be overly critical of them. I know they have tried. It is a difficult situation.

But that approach also would give some of the savings and loans that are not badly managed or not corruptly managed that are in areas that are experiencing economic difficulties—the energy producing areas and agricultural areas and so on—a bit more time.

One of the concerns raised by the S&L folks is that the Federal Home Loan Bank Board folks might be overly anxious to close down some savings and loans that could be viable if given a little bit more time.

Mr. VOLCKER. That is not my impression. I know they say that, but that is not my impression.

Chairman NEAL. Please, I really wanted to get you to comment on the S&L industry approach. Is that not a viable approach and, if not, why not?

Mr. VOLCKER. Well, I am not familiar with the details of that approach, but my impression is that in the area of financing it doesn't provide as much assurance and at least there's a question about its viability in terms of selling the securities and so forth.

But if your concern is the length of the leash given, in effect, the volume of the funds given—

Chairman NEAL. That is part of it.

Mr. VOLCKER.—which is an important part of the concern of some people in the industry I know, that doesn't mean you have to go to that other modified technique for raising the money. You could put some kind of a cap on the so-called Treasury or Federal Home Loan Bank Board approach so that the issue could be revisited. I think they need enough money and should have enough money to deal reasonably with the problems immediately on their platter and over a couple of years. I don't think estimates of that vary by all that much.

Then you have I think it's a more philosophical question almost whether it's necessary to provide the whole amount now with assurance, looking beyond the next couple of years, as a matter of giving greater confidence and security to the industry, or whether you provide some review after a couple of years. But I think that's an issue of a different order of magnitude, so to speak, than getting enough money in there to deal with the clearly foreseeable needs over the next couple of years.

Chairman NEAL. You started to say you did not think that the idea that some of these savings and loans that are well-managed in areas experiencing difficult economic conditions could make it or what?

Mr. VOLCKER. No. I meant to say I think there are some well-managed institutions that may be experiencing difficulties from which they could recover. What I object to, from what I know—and I again don't follow this in the same degree of detail—it seems to me that the ones that they would in fact be closing up and dealing with expeditiously don't have any reasonable chance of recovering and, indeed, their continued existence drains the funds and the potential resources.

They have enough on their platter so that I don't think they're looking around for closing up institutions that may be viable. They've got enough non-viable ones to keep them busy for a couple of years.

Chairman NEAL. Our panel of economists yesterday seemed to agree that the rate of inflation for this year would be about 4 percent because of some of the reasons you mentioned earlier. Is that a number that would make sense to you?

Mr. VOLCKER. That's less than—I don't know what index they're using when they say 4 percent.

Chairman NEAL. I think they were talking about the growth in the Consumer Price Index, but I am not sure either.

Mr. VOLCKER. Well, I can give you with some precision what the committee was estimating for the GNP deflator, if I can put my hands on the right page. The estimates tend to cluster around 3 to

3.5 percent, although if you take every forecaster and every committee member it came out 2.5 to 4, with one person probably at the very top of that range.

But I think it's also true that the probability is that in 1987 the Consumer Price Index will rise more than the GNP deflator because it's more heavily weighted with the energy and import items that we know or strongly suspect will be going up.

But I think the basic point is that there are reasons—assuming the oil price stays up somewhere around the present level, that's going to work its way into the economy. It's going to impact the Consumer and other price indices now and we will be seeing numbers that reflect that. The higher import prices are a factor pushing prices up to some degree. These are quite special factors that won't last forever, but right during 1987 they are likely to push up the inflation rate.

Now that's—I don't like to see any increase in inflation, but that will not be terribly disturbing if at the same time we can reasonably conclude that what you loosely call the underlying inflation rate is not rising.

What do you look to for that? Well, you look to certainly the trend in productivity against the trend in wage increases, which in manufacturing in particular has been quite favorable recently. But wage increases are declining throughout the economy.

As I mentioned earlier, service prices, which are extremely sticky, is showing a little tendency to decline last year and if we got some further tendency of that sort, even while the prices of energy were going up, I think that would be a sign we are not disrupting the basically favorable disinflationary trend.

Are there indications of enough capacity and resources? Well, I think that's true today not just in the United States but around the world.

So I don't think I would want to interpret, and would not, an increase in prices—I hope it's less than 4 percent, and I think it would be important that it be less than 4 percent, but an increase in prices of 3 percent plus—in the 3 to 4 percent area, pretty clearly related to energy and imports, I don't think we should jump ship on in that kind of scenario and hope we can look forward and expect to look forward in 1988 and 1989 to lower rates of inflation.

Chairman NEAL. Well, I hope so, too. I would be surprised myself if that is the case, frankly.

Mr. VOLCKER. I would put it even beyond hope. That's certainly a factor in formation of monetary policy. That's what we ought to be aiming for in monetary policy.

Chairman NEAL. I could not agree more.

I was talking to someone else when you answered Mr. Dreier's question concerning what we could do positively concerning the savings rate and I missed your answer to him. My answer was "not much." I mean, I have gotten a little cynical I guess on this point. But it's not just based upon experience in the United States. If you look around the world, the Japanese have had a savings rate around 20 percent—it's come down a little—right through the post-war period. We've had a savings rate that's been low—5 or 6 percent I guess on personal savings—and it doesn't show any tendency to increase. If it shows any tendency at all, it's to decrease.

The corporate savings rate is—that fluctuates a lot cyclically, but basically it doesn't change much over a long period of years. And we've had different tax structures during that period, although in one respect the tax structure has remained the same—we penalize equity relative to debt.

But I think you're swimming against some pretty strong currents when you try to make marginal changes in tax policy anyway and expect to see a very pronounced effect in the savings rate. It just has not been our experience. It hasn't been the experience abroad either.

Chairman NEAL. But you did say something specifically about encouraging more equity and less debt I think, didn't you? Wasn't that part of your answer?

Mr. VOLCKER. Yes.

Chairman NEAL. That is the part I think I missed.

Mr. VOLCKER. Oh, yes. We've had this bias in our tax system almost ever since we've had an income tax, with a few little exceptions, where if you issue debt you get a tax deduction; if you issue equity you don't get any deduction for the dividends or for the retained earnings.

Chairman NEAL. So what do you suggest? Stop the double taxation?

Mr. VOLCKER. I would stop the double taxation.

Chairman NEAL. You said earlier in some of your testimony that you thought it was important that we make a greater investment in our manufacturing base. It seemed to me a good way to do that would be to allow a more rapid depreciation schedule—better, in fact, than investment tax credit and other tax provisions that might do it, just because it would be more even-handed across the board and for some other reasons. Actually, I put a bill in that would in fact do that—would allow very rapid write-off of investment not in real estate but in equipment. Is that a good idea?

Mr. VOLCKER. Well, Congress obviously went in the other direction in removing these kinds of incentives to that kind of investment.

Chairman NEAL. I know.

Mr. VOLCKER. And let me footnote my earlier statements about savings. If you wanted to affect the overall savings rate, I think you can do it more on the corporate side than on the individual side through these kinds of tax changes, whether it's depreciation or investment tax credit or whatever. I think there, if you make a really big change or a significant change, you might have an effect.

And you could argue that you should go in that direction, particularly against my sense that you're going to need a shift of resources to the manufacturing industry which tends to benefit from either more rapid depreciation or the investment tax credit thing.

Now there are obviously considerations on the other side which were convincing to the administration and the Congress last year and I understand those.

Chairman NEAL. Those were for revenue.

Mr. VOLCKER. Well, not just the revenues, but you want a more neutral tax system that treats all different kinds of activities the same way and there are very strong arguments in that direction.

Whether this was the best timing or whatever to do that is a question, but I think that decision has been made and—

Chairman NEAL. I do not think it has been made forever more. I do not share your view that we cannot change some of these things over time. In fact, I think we will. But the Ways and Means Committee has asked for information to try to help us determine what the costs and benefits of this would be, to try to get some estimates of what revenue gain we would get and what the cost to the Treasury would be and to try to figure if it is a reasonable tradeoff.

We have not yet gotten an answer. I am sure someone around here has received it because we dealt with those figures when we had the tax bill. Is that something that your economists could help us with a little also? If so, I would certainly welcome any thoughts you may have.

Mr. VOLCKER. Well, I would have to say our economists can help in anything, but I would also hate to bring them into this area which is not our particular expertise.

Chairman NEAL. That is no problem. We will get it somewhere.

Thank you, Mr. Chairman. You have been very patient with us. We appreciate your joining us today. Thank you, sir.

Mr. VOLCKER. Thank you.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

A P P E N D I X

OPENING STATEMENT OF THE HONORABLE CHALMERS P. WYLIE
HUMPHREY/HAWKINS HEARING
FEBRUARY 26, 1987

Thank you, Mr. Chairman. I appreciate this opportunity to welcome Chairman Volcker to our hearing.

Quite a few things have happened since your last testimony before us last July, Mr. Chairman. Many of them were good, but others have added to the challenge that you and your colleagues on the Board have to face in arriving at your policy decisions.

Thus, while the economy has been moving along at a steady, if unspectacular, rate and while we sense that certain previously depressed sectors and areas of the country have been stabilizing and may be improving, we also are under the impression that down the road there may be the threat of reaccelerating inflation and higher interest rates.

Now at the same time, the debt problem of many developing countries -- some of them in our own backyard in the Americas -- still remain unresolved. Indeed, in one important case the situation has deteriorated significantly just during the last few days. The economic condition of these debtor countries may not permit much added austerity and the potential for grave political mischief intensifies the need for a careful weighing and reconciliation of our domestic needs for price stability with the equally important objective of avoiding significant increases in interest rates and the burden of debt service for these countries. I would be much interested whether you view these two objectives -- price stability domestically and low interest rates internationally -- are compatible. If not, where do you think the priorities should lie. Finally, how do you envisage the role of the U.S. commercial banks in the resolution of what may turn out to be a major national problem for us and for those forces whom we seek to support in the developing countries.

Welcome again Mr. Volcker, I am looking forward to your testimony.

Testimony by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

February 26, 1987

I appreciate this opportunity to review once again with this Committee the conduct of monetary policy against the background of economic and financial developments here and abroad. As usual, a more detailed review of last year, of the prospective ranges for monetary and credit growth established by the Federal Open Market Committee, and of the Committee's projections for economic activity and inflation are set out in the Board's formal Humphrey-Hawkins Report delivered to you earlier. This morning, I want to concentrate on more general considerations underlying the policy approaches of the Federal Reserve. I will emphasize particularly how those approaches must fit into a broader pattern of complementary action both in the United States and in other countries if the common objective of sustained economic expansion and price stability is to be reached.

The Economic Setting

The current economic expansion -- now extending into its fifth year -- is already among the longest in peacetime

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history. It is unusual in other respects as well, including the absence of certain signs of cyclical excesses that often develop after years of expansion. For instance, inventories have been held well within past relationships to sales, and spending by manufacturers for plant and equipment has, if anything, been restrained relative to prospective needs.

While the overall rate of economic growth has been rather moderate since mid-1984, averaging about 2-1/2 percent a year, that growth has been maintained despite strong pressures on sizable sectors of the economy. Oil exploration and development activity and agricultural prices have both been heavily affected by worldwide surpluses. Commercial construction in many areas is suffering from earlier over-building. Regions of the country in which those impacts have been particularly large have thus remained relatively depressed. Difficult as those regional conditions have been, however, many of the necessary adjustments are well advanced and other areas of the economy have been moving strongly ahead.

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More importantly, both the inflation rate and interest rates, after four years of expansion, are substantially lower than when the recovery started. Homebuilding is being well maintained, and both capital and labor appear available to support further growth for some time without undue strain on resources. Certainly, conditions in financial markets, with stock prices exuberant and interest rates generally as low as at any time since the mid-1970s, appear supportive of new investment.

But if the traditional indicators of cyclical problems are largely absent, it is also evident that the economy is struggling with structural distortions and imbalances that, for us, have little precedent. Economic activity over the past two years has been supported very largely by consumption. That has been at the expense of reduced personal saving rates that, by world standards, were already chronically low. At the same time, the huge federal deficit is absorbing a disproportionate amount of our limited savings.

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For a time, we have largely escaped the adverse consequences for financial markets of that insidious combination of low saving rates and high federal deficits by drawing on capital from abroad -- the flow of which in 1986 actually exceeded all the savings by U.S. households. The other side of that coin, however, is a massive trade and current account deficit, restraining growth in manufacturing generally and incentives for the industrial investment that we will need in the years ahead.

The simple facts are that we are spending more than we produce and that we are unable to finance at home both our investment needs and the federal deficit. Those are not conditions that are sustainable for long -- not when, as at present, the influx of capital from abroad cannot be traced to a surge in productive investment.

It's not sustainable from an economic perspective to pile up foreign debts while failing to make the investment that we need both to generate growth and to earn the money to service the debts.

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It is not supportable politically, as the pressures on our industrial base are transmuted into demands for protection.

Ultimately it will not be supportable from an international perspective either, as the confidence that underlies the flow of foreign savings will be eroded.

Sooner or later, the process will stop. The only question is how.

The Broad Policy Approach

In concept, we could shut off the flow of imports by aggressive, broadbrush protectionist measures. But the result would be to drive up the rate of inflation and interest rates here, to damage growth abroad, and to invite retaliation. Instead of sustained and orderly growth, we would invite world-wide recession.

We could try to drive the dollar much lower -- or complacently sit back while the market forces produce that result. But that too would undermine the hard-won gains against inflation, and would risk dissipating the flow of

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foreign capital we, for the time being, need. The stability of financial markets would be jeopardized, and export prospects could be undercut by adverse effects on growth abroad.

Faced with similar circumstances, many smaller countries might reasonably embark upon strong austerity programs -- indeed sooner or later would be forced to undertake such programs. Large doses of fiscal and monetary restraint would be taken, risking recession in the short run, but also anticipating that exports would respond vigorously, imports would decline, and their economies would soon resume growth on a much sounder footing. But, in the context of a sluggish growth of the world economy, for the United States to take that course would entail particularly high risks and the results would be problematical at best.

There is a reasonable alternative. It is more complicated, but at the same time much more promising.

We can draw upon a combination of policy instruments to encourage the needed adjustments. Results may take time. But those results will come with greater certainty -- and they should

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be consistent with maintaining growth here and abroad, with progress toward underlying price stability, and with open markets.

That is, in fact, the course on which we are embarked. To be sure, its success will require an unusual combination of discipline, patience, and international cooperation. However, given the stakes not just for the United States but for others, I don't think there is any real choice.

Important steps have already been taken in the needed directions. Most obviously, the value of the dollar vis-a-vis the currencies of other industrialized countries has declined substantially, placing our industry in a much stronger competitive position. The volume of exports is rising, despite relatively slow growth abroad. The deterioration in the trade deficit overall appears to have been stemmed, even if clear evidence of a reversal is still lacking. Moreover, while the depreciation of the dollar inevitably carries in its train rising import prices, we have been fortunate that the initial impact on the overall price

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level was more than offset by falling oil and other commodity prices. The underlying inflation rate, measured by trends in wages relative to productivity, has continued to fall.

We have also been fortunate that the flow of capital from abroad, buoyed by the rising stock and bond markets here and by some declines in interest rates abroad, has been well maintained as the dollar depreciated. Nevertheless, as we succeed in reducing our current account deficit, the net capital inflow will decline as well. That emphasizes the critical importance of moving ahead with further reductions in the federal budget deficit which absorbs so much of our own savings.

The progress being made in that direction this year is heartening. But that can only be a start. The projected reduction of \$40 to \$50 billion this year is from a record high deficit of more than \$220 billion in fiscal 1986 -- more than 5 percent of the GNP -- and it is being assisted by some temporary factors. Progress next year will be harder.

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Success in my mind will not be measured so much by whether we meet some pre-ordained arbitrary target but by whether in fact a reasonably steady downward pace in the deficit is maintained as the economy grows -- and maintained by measures that can be sustained, year after year. Failing that, it's hard to see how a sustained decline in the trade deficit, if possible at all in the face of huge budget deficits, will bring net benefit to the economy. The clear implication would be congested capital markets, higher interest rates, strong inflationary dangers, and threats to growth.

International Consistency

Inevitably, because we loom so large in the world economy, marked improvement in our trade balance will be matched by noticeable deterioration elsewhere. Appropriately, that should take place largely in the major countries with exceptionally large surpluses -- notably Japan and Germany, both of which are now experiencing some decline in real net exports. That process cannot take place smoothly and effectively

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unless those countries and others are able to maintain a strong momentum of internal demand.

For years, those countries have been dependent for growth mainly on high and rising export surpluses. In both instances, some shift toward domestic demand was apparent in 1986, encouraged partly by some relaxation of monetary policies. That points in the needed direction. But there are also signs that their growth, overall, may be faltering, as exports have declined. At the same time, relatively high levels of unemployment and unused capacity, together with sharp appreciation of their currencies, offer substantial protection against a resurgence of inflationary pressures that they, understandably, want to avoid.

Quite obviously, the needed reorientation of economic policies -- essentially the complement of our own -- is no easier to achieve in those countries than here. Certainly, the nature and design of the needed measures will be -- indeed

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is being -- strongly debated within those countries. What is critical from a world perspective is not the precise nature of the measures or their exact timing, but that, at the end of the day, they are successful in maintaining a strong momentum of growth even as they absorb more imports from the rest of the world.

One danger is that, in the absence of stronger domestic growth, pressures will intensify for more appreciation of their currencies, undercutting further their own economic prospects. Given the size of the exchange rate adjustments already made, greater instability in that area seems neither in their interest nor ours.

Some newly industrialized countries also have clear responsibilities for contributing to a better world balance. Taiwan and Korea, in particular, have or are building external surpluses that are large even by the standards of the traditional industrial powers. Part of that reflects a strong competitive position, but both also maintain a strong wall of protectionist barriers. The very strength of their external positions points --

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in the interests of their own citizens as consumers, as well as of world equilibrium -- to the need for more forceful action to increase imports, whether by reducing tariffs, by lifting other trade restrictions or by exchange rate changes.

Success in these efforts, I must emphasize, will not necessarily or primarily be measured by changes in our own bilateral trade vis-a-vis particular countries. An open competitive trading order is by its nature multilateral, and we and others should judge equilibrium in a world-wide context.

In that connection, most of the developing world, already carrying heavy debt burdens, is in no position to revalue currencies or to absorb much higher imports (from the United States or from others) without more or less parallel increases in their exports. In recent years, however, it has been the United States that has, in fact, absorbed the great bulk of what increase in exports Latin America has had -- their exports to Europe and Japan have apparently increased little if at all.

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For us to close our markets to them now would assuredly thwart prospects for expansion, and with it the encouraging progress that has been made toward both more open, competitive economies and political democracy. What is needed instead is greater access by those countries to growing markets in Europe and Japan as well as here. The recent changes in exchange rates in the industrial world certainly provide greater incentives for exports of the developing countries to shift to Europe and Japan. At the same time, imports by the developing world from the United States have become much more price competitive than a year or two ago.

The Debt Situation

I cannot neglect emphasizing one further continuing threat to growth and financial stability involving the developing countries. Management of the debt problems of Latin America and some other developing countries is again at a critical stage. The reason is not that progress is absent. To the contrary, most of the heavily indebted countries have been growing -- if for the most

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part far below their potential -- debt burdens are tending to move lower relative to exports or other measures of capacity to pay, and new financing needs have been reduced. Perhaps most encouraging, there has been definite, if sometimes hesitant, progress toward liberalizing trade, opening markets, and reducing internal economic distortions, with the World Bank playing a particularly helpful role.

At the same time, any failure of the industrialized countries collectively to achieve a satisfactory rate of growth would clearly impair prospects for the developing countries to find the markets they need. More immediately, in recent months, the process of reaching agreement on adequately supportive and timely financing programs, whether by restructuring existing debts or by arranging what new loans are necessary, has conspicuously slowed.

In their particulars, the reasons are as varied as the complexity of the individual financing programs themselves, most of which require the agreement of hundreds of banks around the world. In some instances, policy set-backs in the borrowing countries have complicated the task. But I also suspect the

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very fact that progress has been made over the past five years -- most evidently in reducing the exposure of banks relative to capital to something like half of what it was in 1982 -- has had the unfortunate effect of dulling a sense of urgency and cooperation by some. I do not want to deny the progress. But to fail to carry through on past efforts now would plainly jeopardize much of that success and threaten new strains on the financial system.

Implications for U.S. Policy

Several key implications of all this for the United States should be clear.

First, the process of restoring external balance requires first of all that we tend to our inescapable responsibilities to deal with our budget deficit. That is not just because we are dangerously dependent on foreign savings but because progress abroad is, as a practical matter, likely to be stymied without constructive leadership from the largest and strongest nation. Should we instead resort to closing our markets, be indifferent to depreciation of our own currency, and permit inflationary

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forces to regain the upper hand, then there would be no basis for confidence in the United States. Prospects for effective complementary action abroad, or for growth for the world economy, would be dim indeed.

Second, we have to recognize that the needed adjustments will require a relative shift of financial and real resources into internationally competitive industry and away from consumption and federal deficits. Without a sharp rise in overall productivity from the one percent or so rate characteristic of most of the 1970s and 1980s -- and I see no reason to suggest that trend will change abruptly -- the recent rate of increase in consumption is simply unsustainable for long. Instead, more of our growth will need to be reflected in net exports and business investment, and less savings will be available to finance government.

Fortunately, performance with respect to productivity growth and restraint on costs in the key manufacturing sectors has been relatively strong during the period of economic expansion. That reinforces prospects for a stronger competitive

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position internationally. The challenge will be to maintain that performance in the face of a depreciated currency, higher import prices, and more sizable needs for new investment to meet domestic and export opportunities.

Finally, achieving these goals in the context of sustained growth and reasonable price stability is beyond the capacity of any single policy instrument. Quite obviously, monetary policy will have a critical role to play. In doing so, it has the potential advantage of more flexibility than other policy instruments. But there will also be a heavy premium on maintaining discipline and sound judgment amid potentially conflicting criteria.

Rapid Growth of Money and Liquidity

Throughout 1986, monetary policy accommodated a relatively rapid growth in the various monetary aggregates; the narrowly measured money supply -- M1 -- grew at a particularly rapid pace. The discount rate was reduced four times by a total of 2 percentage points, more or less in line

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with reductions in market interest rates. The degree of reserve pressures, measured by average adjustment borrowings of depository institutions from the Federal Reserve, was relatively low throughout 1986, and has remained so since.

This generous provision of reserves and expansion in money took place in, and appeared justified by, an environment of restrained economic growth and declining inflationary pressures. The latter, to be sure, was dramatically and importantly reinforced by a temporary factor -- the sudden collapse in the price of the world's most important commodity, oil. But, potentially more lasting indicators of inflationary pressure -- the rate of increase in workers' compensation and in prices of some services that respond slowly to changes in the economic environment -- were also trending downward. For much of the year, most commodity prices other than oil, measured in dollars, were falling despite the depreciation of the dollar in the exchange markets. Moreover, the sizable declines in long-term interest rates seemed to reflect some

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easing of fears of a resurgence of inflationary pressures in the future.

Nonetheless, the possibility of renewed inflation remains of concern both in the markets and within the Federal Reserve. One potential channel for renewed inflationary pressures would be an excessive fall of the dollar in the exchange markets. At times during the past year, such exchange rate considerations prompted particular caution in the conduct of policy. The timing of operational decisions with respect to the discount rate or the provision of reserves was affected; on occasion close coordination with the actions of other central banks was particularly important.

More generally, intensive analytic work during the year suggested that much of the relatively rapid growth in the various monetary aggregates was closely related (with lags) to the rather sharp declines in market interest rates late in 1985 and the early months of 1986. The responsiveness of money demand to changes in interest rates is a well established

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phenomenon. What is new in the present institutional setting is the increased sensitivity of that relationship, most particularly for M1. Today, interest rates paid on transactions accounts widely used by individuals are close to rates paid on competing financial instruments. That is because interest rates on those accounts have not declined nearly as much as market rates or those on longer-term deposit accounts. Consequently, there has been a strong incentive to transfer funds to NOW (and to some extent savings) accounts and away from other, less liquid instruments.

Demand deposits, which are largely held by businesses and pay no interest, also grew substantially more rapidly than in earlier years. In part, that was also a reflection of declining market rates; banks demanded larger balances in compensation for services provided businesses, and depositors found alternative uses of liquid balances relatively less attractive.

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Because of its composition, M1 was particularly influenced by these shifts and grew by 15 percent. That was far in excess of the target set at the start of the year (when the Federal Open Market Committee drew attention to the uncertainties surrounding that aggregate) and above any postwar historical experience as well.

Both M2 and M3 ended the year within -- but just within -- their target ranges. Even so, the increases of almost 9 percent were about as large as most earlier years, when inflation and the rate of economic growth were higher.

With inflation down and real growth moderate, these rapid increases in monetary growth meant that all measures of velocity (i.e., the ratio of nominal GNP to money) declined. That was particularly evident in the case of M1; the velocity decline of 9 percent was greater than in any year since World War II.

While velocity often moves erratically in the short run and a decline is typical of periods of falling interest rates, last year extended and amplified a pattern that has persisted

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since interest rates peaked in 1981 and 1982. The earlier post-war upward trend in M1 velocity of about 3 percent a year -- a trend established during a period of generally rising inflation and interest rates -- clearly does not provide a reasonable base for judging appropriate M1 growth today. Historically, there has been little or no trend in M2 velocity. Even so the current level is historically a bit low relative to other periods of low or declining interest rates.

All of this poses new questions in setting monetary targets to help guide the conduct of monetary policy. In the broadest terms, a levelling, and even some decline, in velocity could be welcomed as an appropriate sign of growing confidence in the value of holding money during a period of disinflation. But explanations revolving around declining interest rates and greater confidence in price stability beg the larger issue.

Not all the increases in money can be adequately explained by interest rate relationships, nor can we be certain about what interest rate is appropriate. Confidence is hard to win

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and easy to lose. We need to be conscious of the fact that the effects of excessive money creation on inflation may only be evident with lags -- possibly quite long.

As a consequence, we cannot avoid relying upon a large element of judgment in deciding what, considering all the prevailing circumstances, money growth is appropriate.

Obviously, so far as 1986 is concerned, the FOMC made the judgment that relatively strong growth in the aggregates, and particularly M1, could be accommodated consistent with the more basic objectives of orderly growth and price stability. Neither the rate of economic growth, nor the margins of available resources, nor underlying cost trends, nor the movement of sensitive commodity prices suggested money growth was setting in train renewed inflationary forces.

The continuing rapid rate of debt throughout the economy -- running far above the rate of economic growth since 1982 -- has raised one warning flag. In one sense, the enormous volume of purely financial activity, especially at year end but also at

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times earlier, reinforced other factors increasing the demand for money. But from another point of view, the ready availability of reserves and money was also a factor facilitating that same increase in financial activity.

The implicit dangers should be clear. More leveraging of corporations, aggressive lending to consumers already laboring under heavy debt burdens, and less equity in homes all increase the vulnerability of the economy to economic risk -- to higher interest rates, to recession, or to both. The fact that, after four years of expansion, many measures of credit quality are tending to deteriorate rather than improve, and that too many depository institutions are strained, should be warning enough.

Restraining more speculative uses of credit by more restrictive monetary policy is, of course, possible. But that blunt approach inevitably has implications for all credit and for the real economy as well as financial activity. It cannot substitute for prudent appreciation of the risks in highly aggressive lending by those engaged in financial markets,

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reinforced and encouraged by regulatory and supervisory approaches sensitive to the potential problems.

The Approach to 1987

In evaluating this experience, the Committee remains highly conscious of the long historical patterns that relate high rates of monetary growth over time to inflation. Consequently, in approaching 1987, it starts with the strong presumption that such growth should be moderated. Reflecting that intent, the tentative target ranges for M2 and M3 set out last July of 5-1/2 to 8-1/2 percent were reaffirmed. While those ranges are only slightly below those set a year ago, the Committee expects that the actual outcome should be much closer to the middle of the range (and near to the anticipated growth in nominal GNP), assuming interest rates prove to be more stable than in recent years.

While anticipating much slower growth than in 1986, the Committee did not set out a specific target range for M1. Given the developments of recent years, uncertainty obviously

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remains about the long-term relationship between M1 and nominal GNP. That uncertainty about the trend might be encompassed by a relatively wide target range. However, the shorter-term sensitivity of M1 currently to interest rates and other economic and financial variables realistically would require so wide a range (or tolerance for movements outside its bounds) as to provide little guidance for the FOMC's operational decisions or reliable information for the Congress or for market participants.

Instead, the Committee will monitor M1 closely in the light of other information, including whether or not changes in that aggregate tend to reinforce or negate concerns arising from movements in M2 and M3. More broadly, the appropriateness of changes in M1 will depend upon evaluation of the growth of the economy and its sustainability and the nature of any emerging price pressures. Among the important factors influencing such judgments may be the performance of the dollar in the exchange markets.

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I recognize that the success of that approach rests on good judgment and a degree of prescience. It is justified only by the fact that setting out a precise M1 target -- and weighing it heavily in policy implementation, whatever the circumstances -- would run greater risks for the economy.

I would point out that the sensitivity of M1 to interest rates and other developments will not always work in the direction of relatively high growth. To the contrary, action to reduce the rate of M1 growth, promptly and substantially, would be called for in a context of strongly rising economic activity and signs of emerging and potential price pressures, perhaps related to significant weakness of the dollar externally. In that connection, the Committee explicitly reserves the possibility, in making shorter-run operational decisions from meeting to meeting, to use M1 along with M2 and M3 as a benchmark. Conversely, lower interest rates in a context of weak growth and further progress toward reducing inflation pressures would suggest an accommodative approach toward M1 growth.

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In fact, the statistical and other signals provided about economic activity and prices seldom are unambiguous or have the same directional implications for policy. In evaluating the evidence as it does appear, the Committee will naturally be sensitive to the desirability of maintaining the forward momentum of the economy, as well as encouraging greater price stability. Quite obviously, our task in that respect will be eased to the extent fiscal policy is consistent with the needed internal and external adjustments.

Most members believe that GNP growth of 2-1/2 to 3 percent is now likely, although a few individual members have higher or lower projections. Such growth should be consistent with continuing sizable gains in employment and a slight downward tilt in the unemployment rate. Members also agree that the rate of price increase is very likely to be greater than last year, essentially because oil prices are expected to average higher and because of the virtual inevitability of higher import prices. The forecasts bunch in the 3 to 3-1/2 percent area for the GNP deflator.

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That would be about as low as in 1985 despite the special factors working toward higher prices this year.

So far as inflation is concerned, what is critical is that such a bulge in prices related to identifiable temporary external developments not be translated into a broad-based cumulative upward movement. As you well know, just such a cumulative inflationary process started in the 1960s and then extended well over a decade into the 1980s. It was eventually brought to an end, but only with great effort and at considerable cost. The scars of that experience remain.

Against that background, participants both in financial markets and in business have persistently been skeptical of prospects for lasting price stability in making investment and pricing decisions. They are bound to be alert and responsive to any sense of adverse change in the underlying inflation trend, with implications for interest rates, exchange rates, and pricing policies. The consequences for the economy would clearly be undesirable.

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In effect, neither the internal nor external setting permits thinking of trading off more inflation for more growth. Nor would inflation ease the problem of international adjustment; quite to the contrary, it would both undercut some of our competitive gains and threaten the orderly inflow of funds from abroad. The implications for caution in the conduct of monetary policy are evident.

Concluding Comments

In sum, we face, at one and the same time, most difficult and most promising economic circumstances.

They are difficult because there are obvious distortions and imbalances within our economy and internationally. Unless dealt with forcibly and effectively, those imbalances will impair both growth and price stability -- and the adverse implications will be amplified by the effects on other countries. Moreover, those imbalances will not yield to any single instrument of policy, however wisely conducted. Instead, what is required is complementary actions here and abroad -- on budgets, on monetary

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policies, and on maintaining appropriate exchange rates and an open trading order.

I know none of that is easy. Many countries are involved, and all of them have tough political decisions to make. Nor are the key decisions entirely in the hands of governmental authorities. American industry, in particular, has the challenge to build upon the efforts of recent years toward effective control of costs and greater efficiency, and to seek out and exploit the greater market opportunities that exist today. Banks around the world, despite the frustrations building over time, will need to maintain and reinforce their efforts to deal cooperatively and constructively with the pressing debt problems of their borrowers at home and abroad.

From one point of view, it may seem like a lot to ask. But equally, there is a lot to be gained.

We already have achieved a long economic expansion. We have managed to combine that with progress toward price stability -- and that progress has made possible lower interest

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rates. Financial markets more generally reflect renewed confidence. And the broad outline of policies that can preserve and extend those gains are by now well known.

To fail to act upon those policies -- to instead retreat into protectionism, to relax on inflation, to fail to deal with the deficit -- may in some ways appear to be the course of least resistance. But those are also precisely the ways by which we would turn our back to the bright promise before us.

It is only a concerted effort here and abroad that will extend and reinforce the economic expansion, consolidate the progress toward price stability, and provide the international environment in which all countries can prosper.

**For use at 10:00 a.m., E.S.T.
Thursday
February 19, 1987**

Board of Governors of the Federal Reserve System



**Monetary Policy Report to Congress
Pursuant to the
Full Employment and Balanced Growth Act of 1978**

February 19, 1987

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 19, 1987

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: Monetary Policy and the Economic Outlook for 1987

The current economic expansion in the United States has entered its fifth year, ranking it among the longest of the postwar period. While substantial imbalances and risks have emerged in the course of the expansion that must be dealt with forcefully and effectively, important groundwork also has been laid for continued growth through 1987 and beyond. Significantly, price trends thus far have remained favorable, reflecting not only the dramatic drop in crude oil prices in early 1986 but also continued restraint on labor costs in many sectors. Interest rates have moved lower and stock prices higher, reducing the cost of capital for investment and enhancing wealth. Furthermore, processes are in train that should help correct the major imbalances that have been plaguing the economy: action has been taken to cut the deficit in the federal budget, and the foreign exchange value of the dollar has moved to levels that have made U.S. firms more competitive in world markets and should help correct the imbalance in the U.S. external accounts.

While the potential for further economic progress thus appears considerable, those gains will be secured only if there is timely and constructive action by decisionmakers in the public and private sectors. Congress and the Administration must follow up the steps already taken and make basic programmatic changes that will ensure continuing movement toward budgetary balance; failure to do so would be damaging to confidence and disruptive to the financial markets. Many of our major trading partners, which have depended greatly on external surpluses to buoy their economies over the past few years, must act to open their markets more fully and to foster sustained

growth in domestic demand; without such action, prospects for world growth as well as for reducing our own trade deficit would be impaired, the risks of protectionism would rise, and prospects for the dollar would be more uncertain. And, if we are to capitalize on those trading opportunities and promote economic and financial stability at home, labor and management must avoid a return to the inflationary behavior of the past. Oil prices have firmed recently, and the sizable decline in the dollar is likely to exert upward pressure on other prices in the months ahead; the challenge is to prevent such developments from triggering a cumulative price-wage spiral.

In that context, Federal Reserve policy has a critical role to play. Monetary expansion, while adequate to support orderly economic growth, needs to be consistent with continuing progress over time in reducing the underlying rate of inflation. As the experience of recent years has demonstrated, such a policy—in part by bolstering confidence in financial markets and providing a framework of greater certainty for private decision-making—can make a substantial contribution to the maintenance of expansion and the reduction of unemployment. In the short run, a variety of factors—such as interest rate movements, regulatory changes, and institutional innovations, among others—may alter considerably the amount of funds the public wishes to hold in monetary form. Over time, however, expansion of the money stock measures clearly must moderate from recent rates if destabilizing pressures are to be avoided. The Federal Open Market Committee has established targets for 1987 with that fact in mind, but it will continue to interpret the movements in the monetary aggregates in light of developments in the economy and in domestic and international financial markets and the potential for inflationary pressures.

A Brief Review of the Past Year

Economic activity continued to expand moderately in 1986, at about the pace that has prevailed, on average, since mid-1984. This growth was sufficient to create 2-1/2 million new payroll jobs, and the unemployment rate drifted down to the area of 6-3/4 percent at year-end.

Further progress was made in 1986 toward the objective of overall price stability. Wage and price behavior continued to be influenced by the anti-inflationary thrust of policies put in place some time ago—and by the ongoing adjustment of expectations to the new environment. Thus, while the plunge in world crude oil prices contributed importantly to the sharp slowing in inflation last year, prices outside the energy area also decelerated on average. Running counter to past cyclical patterns, labor cost pressures remained subdued, with nominal wage gains across a broad range of occupations and industries continuing to move toward less inflationary rates—rates that are more consistent with trends in labor productivity.

The Federal Reserve encouraged continued economic expansion last year by supplying ample reserves for the banking system and reducing the discount rate four times, by a total of 2 percentage points. A large portion of the reserves provided were to accommodate the strong demand for M1-type deposits. Last year, M1 grew in excess of 15 percent and its velocity—the ratio of nominal GNP to money—declined more than 9 percent, unprecedented during the postwar years. In part, this rapid money growth reflected the public's response to changes in interest rates, which made it more attractive to hold NOW accounts and demand deposits. However, last year's growth was well in excess of what would be expected based on past relationships among money, interest rates, and income. Growth in the broader aggregates was more

in line with past experience, taking account of interest rate movements. Both M2 and M3 expanded almost 9 percent last year, ending 1986 just within the upper bound of their annual target ranges.

In the credit markets, short-term rates of interest declined about 2 percentage points through the first three quarters of the year. Since that time, short-term rates have backed up some, first reflecting pressure around the end of the year from a huge volume of tax-related transactions and more recently from investors' response to stronger-than-anticipated economic news and concerns about weakness in the dollar. Longer-term bond rates have fallen more than 2 percentage points since the end of 1985, with most of the decline occurring in the first four months of 1986 in response to an improved inflation outlook and sluggish growth in economic activity. After mid-April, Treasury bond rates fluctuated in a relatively narrow range, but corporate and municipal bond rates trended lower—reaching the lowest levels since the late 1970s.

The declines in interest rates contributed to the vigorous pace of household spending last year by reducing borrowing costs and boosting asset values. Housing starts, which are particularly sensitive to interest rate developments, rose a bit, despite the drag of a depressed economy in regions heavily dependent on oil and agriculture. In contrast, capital spending declined over the course of the year, largely because of the sharp cutback in oil drilling; more broadly, investment was restrained by an overhang of office and other commercial space and the weak pace of activity in major segments of the manufacturing sector.

The disparity between household spending and business investment is indicative of the imbalances that characterized the U.S. economy in 1986. Indeed, economic performance throughout the current expansion has varied considerably across industries and regions of the country. In some cases, such as agriculture, special circumstances have played a role. But more fundamentally, the imbalances are rooted in the enormous—and partly related—deficits in our external accounts and in the federal budget.

Although the foreign exchange value of the dollar has fallen sharply from its peak in early 1985—at least relative to the currencies of the major industrialized countries—the nation's trade deficit deepened last year. The increased price competitiveness of U.S. producers contributed to a sizable improvement in real export growth, but the pickup was damped by the relatively slow pace of economic activity abroad. At the same time, the volume of imports continued to rise rapidly through most of last year, in part because the pass-through of the dollar depreciation into import prices was limited by the ability of foreign exporters and U.S. distributors to absorb much of the exchange rate swing in their profit margins. Also, American buyers apparently have developed strong preferences for certain foreign goods, and the newly industrialized and developing countries continued to rely disproportionately on U.S. markets. With import penetration remaining on an uptrend, domestic production continued to expand less rapidly than domestic demand.

The federal budget deficit also remains huge, despite substantial deficit-reducing actions taken by the Administration and the Congress. Official estimates suggest that the deficit for fiscal 1987 will be in the range of \$175 billion—a good deal less than the record \$221 billion figure of a year earlier but still equal to a historically high 4 percent of GNP. Further

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cuts in the federal deficit are essential, in the context of movement toward better external balance, to ensure that an adequate flow of domestic saving is available to support needed domestic investment.

Monetary Policy for 1987

As noted above, the members of the Federal Open Market Committee believe that a reduction in the growth of the money supply measures, over time, will be needed if the economy is to achieve noninflationary growth and external equilibrium. The precise timing and degree of that moderation in monetary expansion will depend on prevailing circumstances in the U.S. economy and in domestic and international financial markets. The Committee has established target ranges for M2 and M3 of 5-1/2 to 8-1/2 percent from the fourth quarter of 1986 to the fourth quarter of 1987, the same as those tentatively agreed upon in July. The ranges for M2 and M3 are one-half percentage point below those in effect for 1986, and are below the actual growth rates last year. Indeed, in an environment without the dramatic movements in interest rates of recent years, only small changes in the velocity of these aggregates would be anticipated. Accordingly, the Committee now expects growth of M2 and M3 this year to be in the middle parts of their ranges.

Ranges of Growth for Monetary and Debt Aggregates (Percent change, fourth quarter to fourth quarter)

	<u>1987</u>	<u>1986</u>
M2	5-1/2 to 8-1/2	6 to 9
M3	5-1/2 to 8-1/2	6 to 9
Debt	8 to 11	8 to 11

The FOMC elected not to establish a specific target range for M1 at this time because of uncertainties about its underlying relationship to the

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behavior of the economy and its sensitivity to a variety of economic and financial circumstances and assumptions at particular points in time. With the deregulation of deposit rates, and the attendant changes in the composition of M1, the narrow money measure has become much more responsive in the short run to changes in interest rates, and possibly to other factors affecting the portfolio decisions of households. Moreover, only with the passage of time will it become possible to assess with any precision the longer-term trend in growth of M1, under current institutional arrangements, relative to nominal GNP. Given these circumstances, the appropriateness of different rates of M1 growth cannot be assessed in isolation; rather, the movement of this aggregate necessarily will be evaluated in the light of expansion in M2 and M3, growth of the domestic economy, and emerging price pressures, which in turn are partly related to changes in the value of the dollar.

Clearly, there are circumstances in which much slower growth of M1 would be appropriate. For example, if, in the context of an expanding economy, inflationary forces appeared threatening, the dollar was exhibiting significant weakness on exchange markets, and the broader aggregates were growing rapidly, a less accommodative approach to reserve provision would be necessary. In those circumstances, monetary velocity likely would accelerate, and much slower growth of M1 would be both a natural and essential development. Conversely, it could be appropriate to accommodate, in the short run, further sizable increases in M1 in circumstances characterized by sluggish business activity and maintenance of progress toward underlying price stability and international equilibrium. As this implies, the Committee will continue to monitor M1 behavior carefully, assessing the growth of the aggregate in the context of other financial and economic developments. And,

depending on circumstances, it is possible that at some time in the year the Committee might set more specific objectives for M1.

The Committee will continue to monitor the growth of debt. Growth of domestic nonfinancial sector debt in recent years consistently has exceeded both the Committee's expectations and, more important, the expansion of income by a wide margin. This is a matter of concern, for it has resulted in potential fragilities in the nation's financial structure. Although the range for the debt measure has been kept at 8 to 11 percent, the same as in 1986, that range implies a significant slowing from the almost 13 percent pace last year—but to a rate still in excess of that expected for income. With a reduced federal deficit, borrowing by the federal government will slow. Also, new constraints imposed by tax reform legislation should reduce the presence of state and local governments in the financial markets. Borrowing by non-financial business firms is expected to grow at about the same rate as last year. Tax reform should result in some reduction in the volume of equity shares retired in connection with mergers and other corporate restructurings, but such activity—and the attendant borrowing—appears likely to remain significant, in some cases undermining the financial strength of corporations as they become more highly leveraged. Moreover, firms may have a wider gap than last year between internally generated funds and investment expenditures, owing in part to higher corporate tax bills.

Growth of household debt also is expected to be about the same as last year. Consumer installment credit clearly is decelerating, but growth of mortgage debt should be robust, reflecting both a good housing market and the substitution of home equity lines of credit for installment borrowing.

Economic Projections

The Committee believes that its monetary objectives are consistent with continued moderate growth in economic activity and a relatively modest upturn in inflation in 1987 that would be attributable almost entirely to higher import prices and a rebound in energy costs. As indicated in the table, the central tendency of the forecasts of Committee members and other Reserve Bank Presidents is for growth in real GNP of around 2-1/2 to 3 percent. Such an increase in output would be expected to generate substantial gains in employment, and the jobless rate is projected to drift down a bit over the year. Prices, as measured by the implicit deflator for GNP, are expected to rise 3 to 3-1/2 percent. It should be noted that the rise in energy and import prices likely will have a somewhat greater effect on consumer prices, so that measures such as the Consumer Price Index may rise faster than the GNP deflator--a pattern that emerged in the second half of 1986.

Economic Projections for 1987

	FOMC Members and other FRB Presidents		Adminis-	
	Range	Central Tendency	tration	CBO
Percent change, fourth quarter to fourth quarter:				
Nominal GNP	4-1/2 to 7-1/2	5-3/4 to 6-1/2	6.9	6.5
Real GNP	2 to 4	2-1/2 to 3	3.2	3.0
Implicit deflator for GNP	2-1/2 to 4	3 to 3-1/2	3.6	3.4
Average level in the fourth quarter, percent:				
Unemployment rate	6-1/2 to 6-3/4*	6-1/2 to 6-3/4*	6.5	6.6*

*Civilian unemployment rate.

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The forecasts of the Committee members and the other Reserve Bank Presidents assume that Congress will make further progress in reducing the federal budget deficit. Continuing evidence of fiscal restraint is viewed as crucial in maintaining financial conditions that are conducive to balanced growth and an improved pattern of international transactions.

In the Committee's view, orderly growth in GNP has become increasingly dependent upon a substantial improvement in real net exports. The international competitiveness of U.S. firms clearly has benefited from the decline in the dollar, and this should bolster export growth and help curb the expansion in imports. But there still is considerable uncertainty about some of the other factors affecting the external sector. In particular, the increase in exports is contingent on a satisfactory pace of economic activity abroad over time, on continued progress in handling international debt problems, and on enhanced access to foreign markets. On the import side, the improvement is predicated on a substantial rise in the relative price of foreign goods. That unfortunately carries with it some domestic inflationary risks, underscoring the need for prudent fiscal and monetary policies.

Slower growth of domestic demand is expected to release resources to the external sector in 1987. Consumer spending is projected to rise less rapidly than in 1986, given that the saving rate has fallen to an extremely low level and real income gains in 1987 are likely to be damped by rising energy and nonpetroleum import prices. And while the sharp rise in the value of financial assets should continue to buoy household spending, debt burdens remain troublesome for many families. Housing activity overall is expected to be well-maintained, even though multifamily building will be inhibited by

high vacancy rates and adverse tax changes. Nonresidential construction also will be depressed by a sizable overhang of office space; the recent firming in oil prices may well signal an end to the sharp contraction in oil drilling, but relatively little improvement seems likely at current price levels. In contrast, equipment spending by industry generally is anticipated to be supported by the continuing need to modernize and to cut costs, as well as by the improved sales prospects associated with a more positive foreign trade outlook.

The effect of the dollar depreciation on prices is likely to be felt more strongly in 1987. In addition, crude oil prices have rebounded in the past few months, reversing part of the sharp drop that occurred early last year. However, the favorable trend in wages and other costs, combined with sizable productivity gains in manufacturing, provides the opportunity for absorbing these short-run price shocks while maintaining a sense of progress toward greater underlying price stability. The Committee's projections anticipate that neither significant capacity constraints nor strong labor market pressures will develop and that domestic firms will not squander the opportunity to regain markets in a shortsighted effort to expand profit margins unduly as demand for their products increases.

The central tendency projections of real GNP and inflation are slightly lower than the forecasts of the Administration. However, given the uncertainty of economic forecasting, the differences are not significant, and, in fact, the Administration projections are well within the full range of expectations among Committee members and other Reserve Bank Presidents.

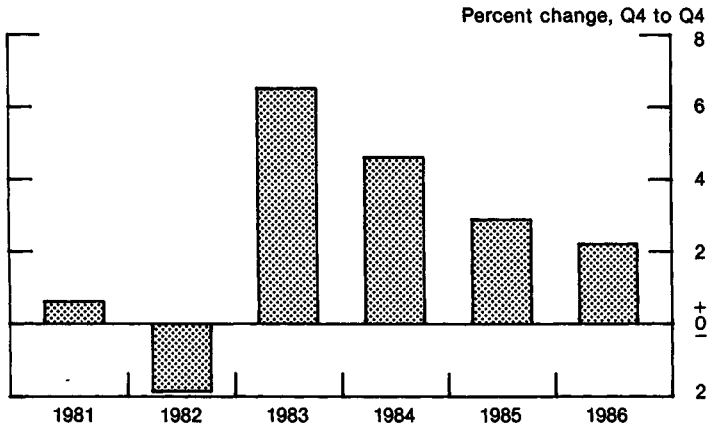
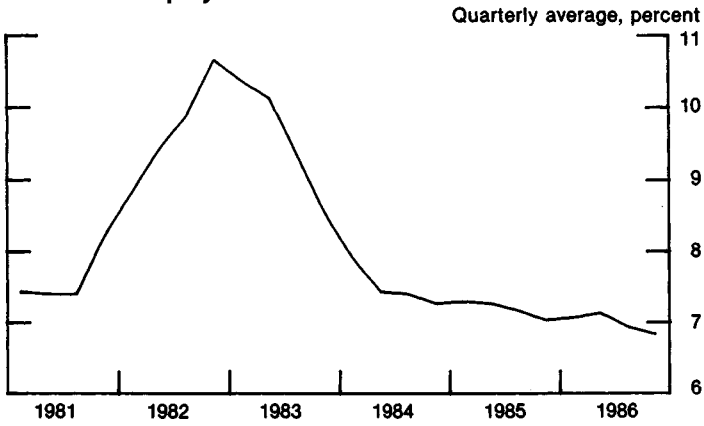
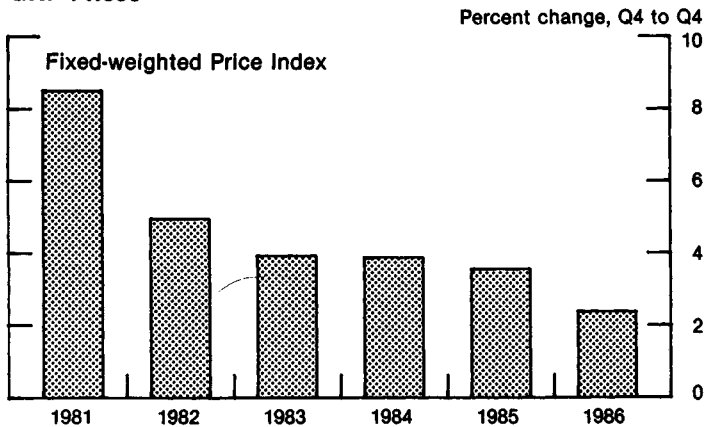
Section 2: The Performance of the Economy during the Past Year

The economy completed a fourth consecutive year of expansion in 1986, with real gross national product increasing about 2-1/4 percent. The rise in overall activity last year was similar to the gains that have been recorded, on balance, since mid-1984 and was sufficient to create 2-1/2 million new payroll jobs. The jobless rate for civilians continued to edge down and, at year-end, was 6-3/4 percent.

Inflation slowed sharply in 1986, with virtually all broad measures of price trends showing their smallest increases in many years. Although the sharpness of the deceleration owed much to specific developments in the markets for oil and other commodities, the favorable inflation performance also represented at a fundamental level the continuation of trends in wage and price behavior fostered by policies in place since the early part of the decade.

Although output continued to grow in 1986, the economy still was characterized by pronounced imbalances. These were reflected in marked disparities in economic performance across industries and regions of the country. In particular, domestic oil exploration and investment was cut back sharply, and only massive federal subsidies sustained many farm enterprises faced with sharply lower crop prices. In addition, major segments of the industrial sector continued to struggle with intense foreign competition, and relatively low rates of capacity utilization—along with a glut of office space—depressed capital spending.

The most serious imbalances continue to be in the external sector and in the federal budget—developments that are linked. Although the foreign exchange value of the dollar against the other G-10 currencies has declined

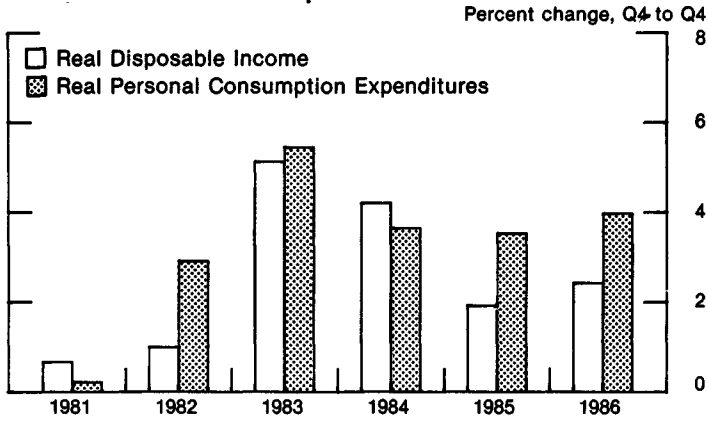
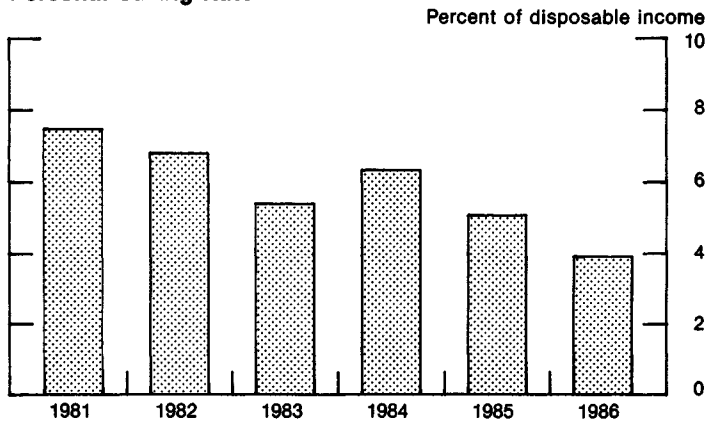
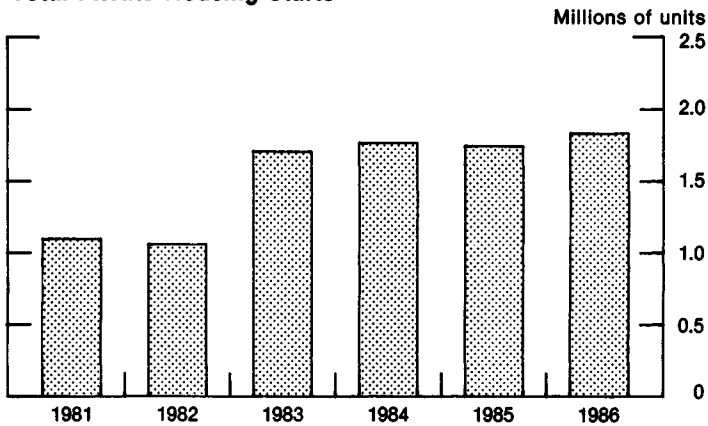
Real GNP**Civilian Unemployment Rate****GNP Prices**

roughly 40 percent over the past two years, the nation's trade balance continued to deteriorate in 1986. Growth in the volume of exports did pick up in response to the enhanced international competitiveness of U.S. firms, although the rebound was damped somewhat by the relatively slow growth of the economies of our major trading partners. However, import volumes continued to expand rapidly through most of the year, in part because much of the swing in exchange rates apparently was absorbed in the profit margins of foreign exporters and U.S. distributors, thereby limiting increases in the prices of imported goods. As a result, the current account deficit continued to widen, reaching the \$150 billion range in 1986.

The federal budget deficit also increased, hitting \$221 billion in fiscal 1986; the deficit vastly exceeded official targets, as underestimates of program costs and shortfalls in revenues offset the deficit-reducing actions taken by the Administration and the Congress. Recent estimates suggest that the deficit for fiscal year 1987 will decline to the \$175 billion neighborhood, which is a good deal less than the year earlier but considerably above the Gramm-Rudman-Hollings target of \$144 billion.

The Household Sector

The household sector was the major contributor to overall growth again last year. Consumer spending increased a robust 4 percent in real terms, even though income growth was only moderate, on average, for the second year in a row. Real disposable income soared in the first half because of the plunge in energy prices, but dropped after midyear, as wage and salary gains remained sluggish and farm and interest income declined. Consequently, the personal saving rate fell to around 4 percent, the lowest annual average in nearly 40 years.

Real Income and Consumption**Personal Saving Rate****Total Private Housing Starts**

Consumer spending has been bolstered by lower interest rates, which have reduced borrowing costs and boosted asset values. Rising stock prices alone have added several hundred billions of dollars to household wealth since late 1985. Household debt also increased further last year, in part reflecting the desire of consumers to liquify the gains in their asset values. The rise in debt was somewhat smaller than in the preceding few years, but still large enough to push measures of debt burdens to new highs. For a sizable number of families, especially in parts of the country hard hit by economic adversities, servicing these debts became more difficult, as evidenced by higher consumer loan delinquencies and charge-offs and high mortgage delinquencies.

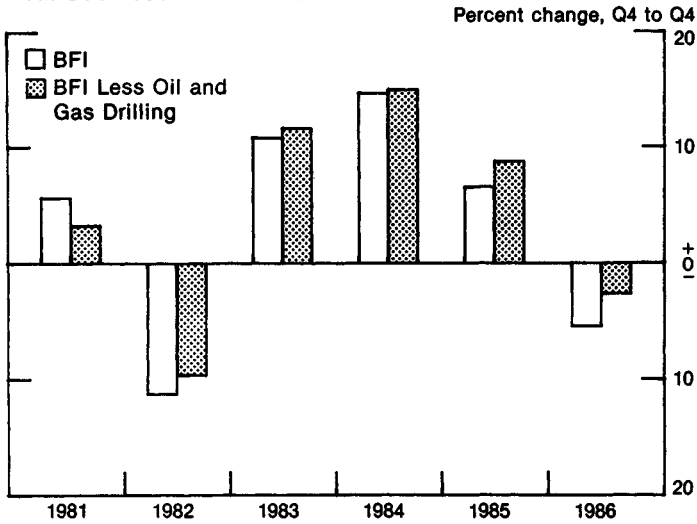
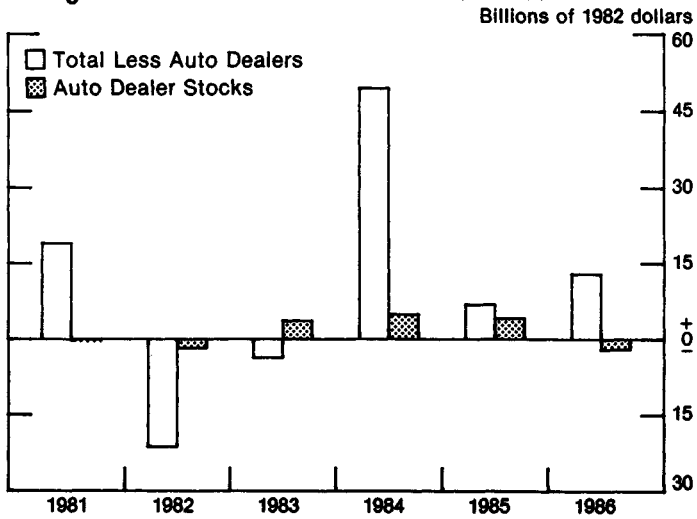
The growth in consumption last year was paced by strong gains in purchases of durable goods, while spending on nondurables and services was up at about the same rate as in the preceding few years. Within the durables category, sales of new cars rose to around 11-1/2 million units. Effective prices of new cars were held down by a series of below-market finance incentive programs for domestic makes and by the introduction of low-priced imports from Korea and Yugoslavia. At the same time, sales of Japanese and European models remained brisk, despite appreciable increases in their sticker prices. Outlays for other durables also rose substantially last year, as purchases of home electronics products advanced sharply and sales of furniture and appliances were supported in part by the robust pace of home sales in recent years.

Housing activity continued to expand in 1986. Total housing starts edged up to 1.8 million units for the year as a whole, their highest level since the late 1970s. Single-family homebuilding increased about 10 percent,

bolstered not only by a sizable decline in mortgage rates—which brought fixed-rate loan rates back to single-digits for the first time since 1978—but also by continuing favorable demographic trends. In contrast, multifamily activity dropped off considerably over the course of the year. In part, the slowdown reflected the restraining influence of record-high vacancy rates on rental units, especially in key markets in the South. In addition, several provisions of the recent tax legislation have reduced the profitability of building rental housing.

The Business Sector

Business spending on plant and equipment declined 5-1/2 percent in real terms in 1986. Much of the drop in investment was attributable to the sharp cutback in oil and gas well drilling, which fell almost 50 percent over the year. But investment outside of the energy sector also was generally lackluster, as many firms—especially in the tradeable goods sector—trimmed expansion plans in light of relatively low rates of utilization of existing capacity and continuing uncertainties about future sales trends. Investment in computers and other office machines remained on the reduced growth path that has been evident since the fading of the high-tech spending boom in 1985, reflecting in part concerns about the productivity-enhancing potential of some of these products. More broadly, transitory tax considerations also helped to depress equipment spending in 1986. In late 1985, the widely-anticipated elimination of the investment tax credit prompted many firms to accelerate spending from early 1986; although there also was some tax-related speedup of spending in late 1986, it appears to have been comparatively small. Outlays for nonresidential structures outside of the energy area, which rose extraordinarily rapidly over the first few years of the expansion,

Real Business Fixed Investment**Changes in Real Nonfarm Business Inventories**

fell in 1986. The decline in office construction, where vacancy rates have reached extraordinarily high levels, was especially sharp.

Inventory investment generally remained subdued in 1986. In an environment of sluggish orders and stable or falling prices, manufacturers continued to trim their stocks. In the retail and wholesale trade sector, inventories of goods other than automobiles increased moderately for the second year in a row; however, at year-end such stocks appeared to be roughly in line with near-term sales prospects. At auto dealers, there were sharp fluctuations in stocks, but little net change over the course of the year; drops in inventories coincided mainly with the timing of special incentive programs that pushed sales to record levels as well as with a burst in sales in December in anticipation of tax changes in 1987.

After-tax economic profits in the nonfinancial corporate sector, although at fairly high levels relative to GNP, were essentially unchanged overall from 1985 levels. There was considerable diversity in the performance of individual industries. The petroleum industry experienced a sharp drop in profits associated with the fall in oil prices. On the other hand, petroleum-using industries such as chemicals and plastics fared relatively well.

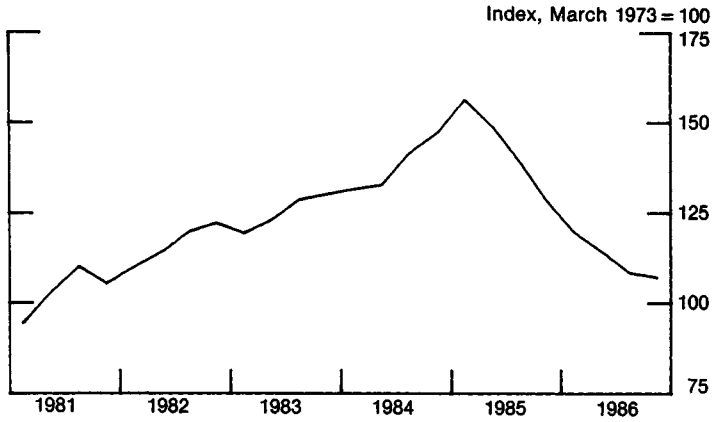
Given these movements in business investment and corporate earnings, internal funds in the aggregate were nearly sufficient to meet the basic financing needs of nonfinancial corporations. However, some firms continued to borrow heavily to fund massive retirements of equity in association with mergers, buyouts, and share repurchases. At the same time, the drop in long-term interest rates to the lowest levels in a decade afforded businesses the opportunity to improve their financial positions by selling bonds and retiring older high-coupon securities or short-term debt.

The External Sector

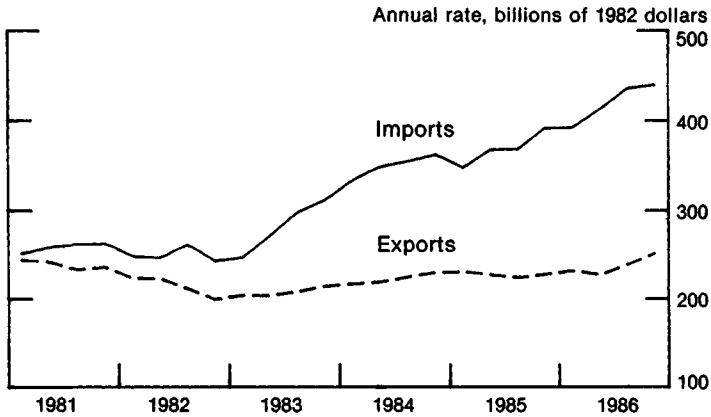
Widening U.S. trade and current account deficits have aroused deep concern because of their implications both for the orderly expansion of the domestic economy and for international financial stability. The foreign exchange value of the dollar, which had declined about 20 percent against a weighted-average of the currencies of other G-10 countries from February 1985 to December 1985, has fallen an additional 20 percent since that time. Because the U.S. inflation rate over the past two years was approximately the same as the average inflation rate in other G-10 countries, the decline in the real value of the dollar (that is, adjusted for relative inflation rates) was similar to the nominal decline. As measured by broader exchange-rate indexes, which include the currencies of major developing countries as well, the real decline in the value of the dollar was somewhat smaller, in part because some of those countries allowed their currencies to depreciate as part of an effort to improve their external positions. On such broader measures, the appreciation of the dollar in real terms through early 1985 also was smaller.

The decline in the dollar over the past year was associated with a fall in interest rates on dollar-denominated assets relative to rates on assets denominated in other currencies. Moreover, some correction of the dollar's external value was seen to be an essential element in the process of reducing over time the huge U.S. current account deficit—which widened to the \$150 billion range in 1986—and restoring better balance in the United States and world economies. The apparently muted response of the current account to the dollar's depreciation through most of 1986 contributed to sharp downward pressure on the dollar in early 1987.

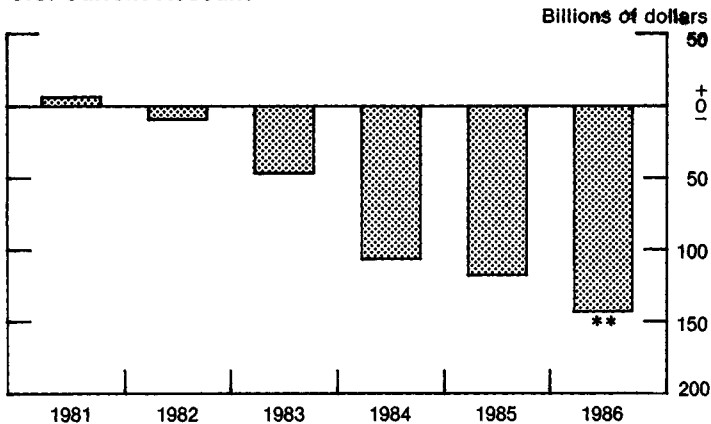
Foreign Exchange Value of the U.S. Dollar*



U.S. Real Merchandise Trade



U.S. Current Account



* Federal Reserve Index of weighted-average exchange value of U.S. dollar against currencies of other G-10 countries plus Switzerland. Weights are 1972-76 global trade of each of the 10 countries.

** Estimated

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The volume of merchandise imports rose sharply in 1986, with increases widespread across products and countries of origin. Petroleum imports surged as prices plunged and domestic production contracted, and nonpetroleum imports continued to grow at about the rapid 1985 pace. In part, the sustained strength of nonpetroleum imports reflected the relatively moderate increase to date in prices of these goods. As measured by the index compiled by the Bureau of Labor Statistics, prices of nonpetroleum imports were up 8-1/2 percent over the year, with sizable increases for products such as automobiles, other consumer goods, and some types of capital equipment. Nonetheless, the rise in the overall index was somewhat smaller than historical patterns would suggest, given the typical lags between movements in exchange rates and import prices. The weak response of import prices was attributable in part to the ability of exporters to the United States, whose profit margins had widened substantially during the period of dollar appreciation in the early 1980s, to absorb initially a large proportion of the dollar's depreciation. In some cases where prices of imported goods have risen, U.S. distributors have absorbed some of that increase. In addition, since early 1985, the dollar has appreciated in real terms relative to the currencies of Canada and some developing countries, which account for almost half of U.S. nonpetroleum imports.

Meanwhile, the volume of merchandise exports picked up last year. This improvement mainly reflected the enhanced international competitiveness of U.S. goods in foreign markets that stemmed from the decline in the dollar, as the pace of foreign economic activity generally remained sluggish. Growth last year for the major industrialized countries as a group was slower than in 1985, in part because of a pronounced deceleration in Japan, while

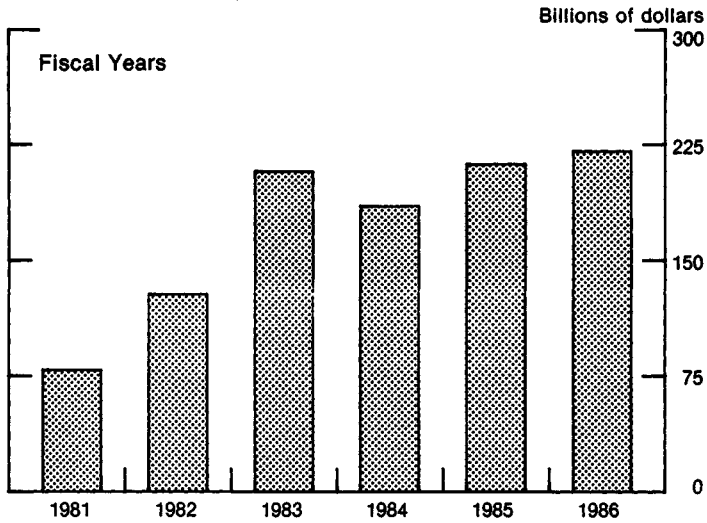
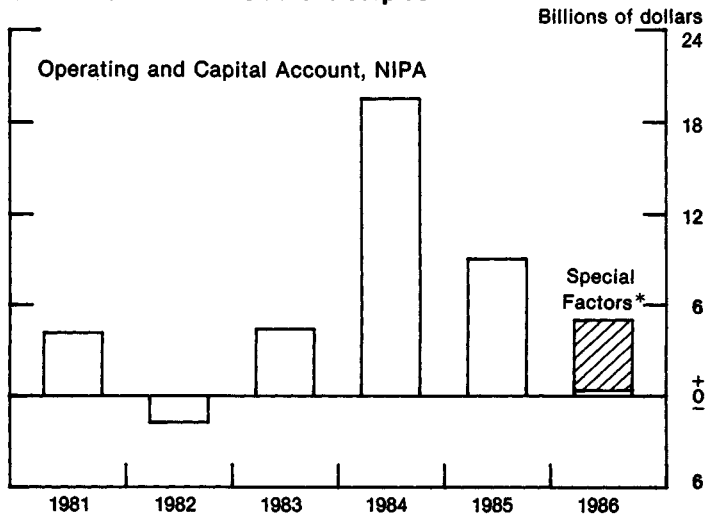
activity in many developing countries was damped by subdued growth in the industrialized world and the continuing pressures associated with the need to meet external debt-servicing obligations. Weakness in world commodity prices also has aggravated the financial difficulties of many developing nations, including oil-exporting countries.

The Government Sector

Even though the Administration and the Congress have taken significant actions in the past few years to reduce the federal budget deficit, it has remained huge. In fiscal year 1986, the fiscal imbalance hit a record \$221 billion, exceeding the previous year's figure by more than \$8 billion. Revenue growth last year was restrained by the relatively moderate rise in nominal income, while demands on a number of programs, especially in the agriculture and health areas, were strong. Although the budgetary program put in place for FY 1987 was nominally consistent with the Gramm-Rudman-Hollings deficit target of \$144 billion, the Administration and the Congressional Budget Office recently have published estimates in the \$175 billion range, equal to about 4 percent of GNP--still a high ratio historically.

Excluding changes in farm inventories held by the Commodity Credit Corporation (CCC), federal purchases of goods and services rose appreciably last year. Over the course of 1986, defense purchases in real terms grew about 7 percent, similar to the increases that have been recorded since the early 1980s. Excluding CCC purchases, real nondefense outlays, which have shown little net change in recent years, were essentially flat.

Purchases of goods and services by state and local governments rose briskly last year, mainly reflecting a surge in construction activity. An upswing in the school-age population in recent years has led to a step-up in

Federal Government Deficit**State and Local Government Surplus**

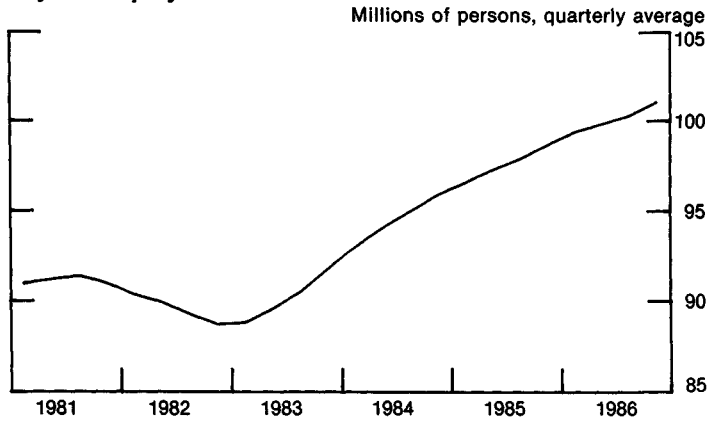
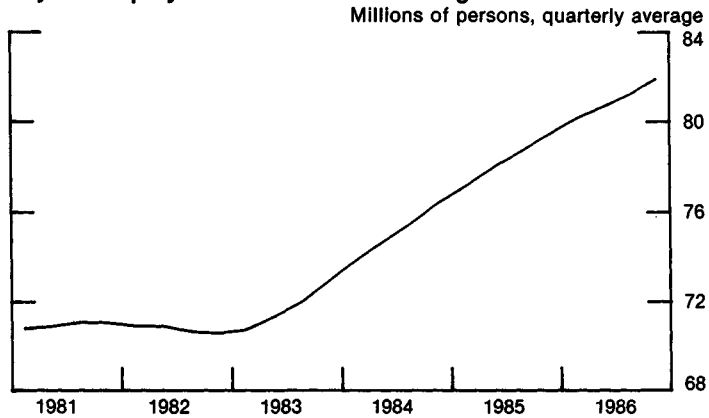
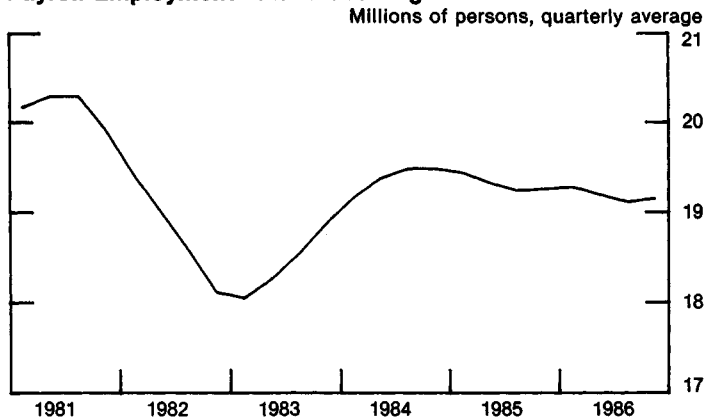
* Nonrecurring inflows resulting from settlements involving oil company overcharges, Outer Continental Shelf rents, and stripper well charges, as well as shifting of some revenue sharing payments to fiscal 1986.

school building, and numerous programs are underway to expand and improve basic infrastructure. The growth in overall outlays has been sustained despite concerns about the financial condition of the sector. Excluding some special one-time inflows--such as previously escrowed oil lease payments--the combined surplus of operating and capital accounts for the sector as a whole fell to near zero in 1986. Many states, including most of those in the energy and agricultural regions, have responded to budgetary pressures by raising taxes and cutting spending.

Labor Markets

Nonfarm payroll employment increased 2-1/2 million in 1986, about the same as the robust 1985 pace, and continued strong in January of this year. Hiring in trade and services again was quite vigorous, with especially large increases for business and health services. In contrast, manufacturing employment contracted over the first three quarters of 1986. However, factory hiring picked up in the autumn in response to an apparent firming in industrial activity. Employment gains in nondurable industries, where output has risen steadily, have been widespread in recent months; meanwhile, hiring at firms producing durable goods has remained spotty.

The growth in jobs last year slightly exceeded the rise in the labor force. As a result, the civilian unemployment rate edged down, to 6-3/4 percent at year-end. Labor force participation maintained its upward trend; women continued to enter the workforce in large numbers, in part responding to expanding job opportunities, and participation rates for adult men held steady. Overall, the number of persons employed relative to the working-age civilian population reached 61 percent--a new high.

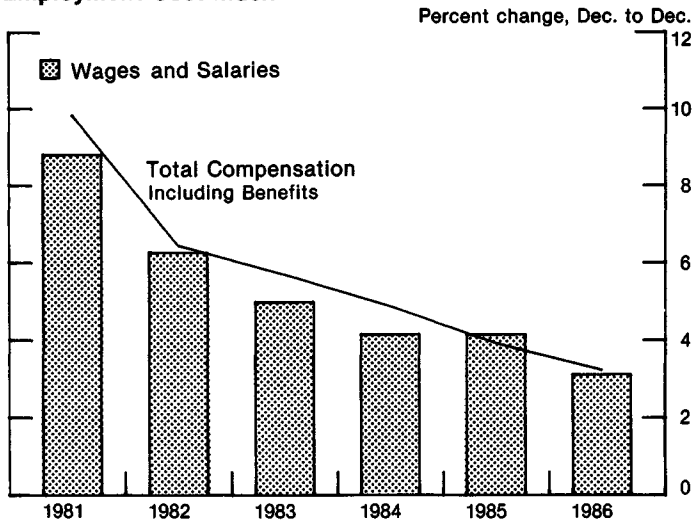
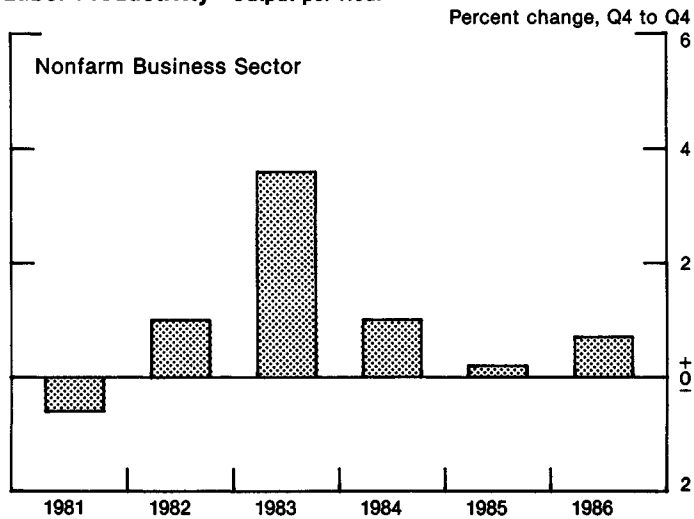
Payroll Employment—Total**Payroll Employment—Nonmanufacturing****Payroll Employment—Manufacturing**

Wages continued on a path of moderation in 1986. Hourly compensation in the nonfarm private sector, as measured by the employment cost index, rose about 3-1/4 percent, 3/4 percentage point less than in 1985. The deceleration in wages reflected the continued slack in labor markets as well as the reduction in price inflation, and was widespread across industries and occupations. In the unionized sector, wage increases have been especially small, and a number of alternative, more flexible compensation arrangements—including the substitution of lump-sum payments for general wage increases—have been adopted. Compensation for white-collar workers, although continuing to rise more rapidly than for other groups, also moderated in 1986.

Unit labor costs in the nonfarm business sector were well contained last year, given the relatively moderate increase in wages and a small advance in labor productivity. Gains in output per hour, however, have averaged less than 1 percent per year since 1984, suggesting that the underlying trend in productivity for the business sector as a whole has improved only slightly from the very low pace of the 1970s and remains well below the pace of earlier in the postwar period. In contrast, productivity in manufacturing over the past three years has increased about 3-1/2 percent per year, in part because intense foreign competition has induced many producers to modernize their factories and streamline their operations.

Price Developments

The fixed-weighted price index for GNP rose about 2-1/2 percent in 1986, down from an increase of 3-1/2 percent in 1985. The increase was the smallest in more than two decades. Some other popular measures of prices decelerated even more markedly. The Consumer Price Index for goods and

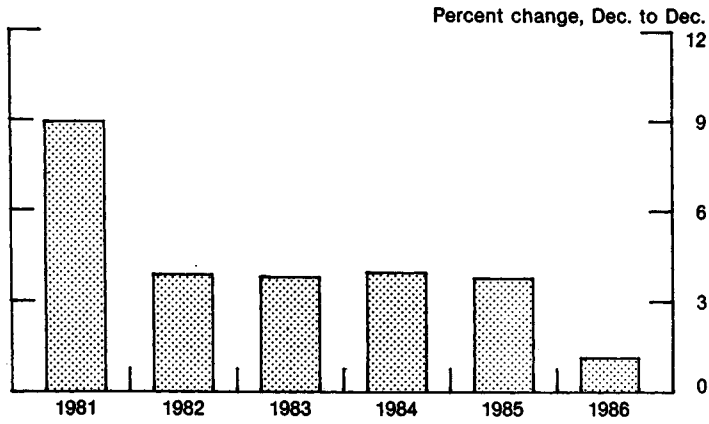
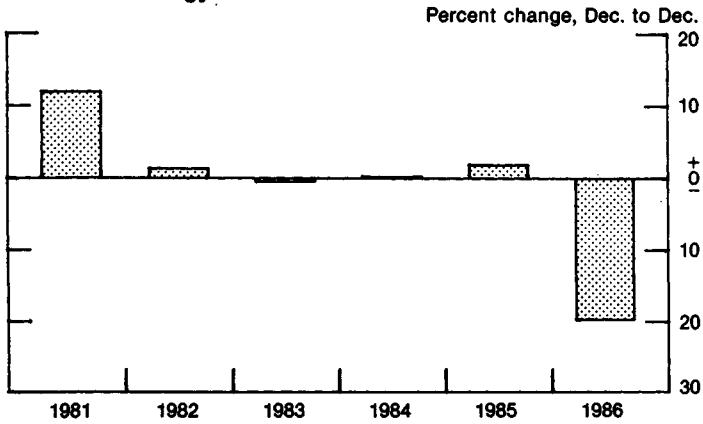
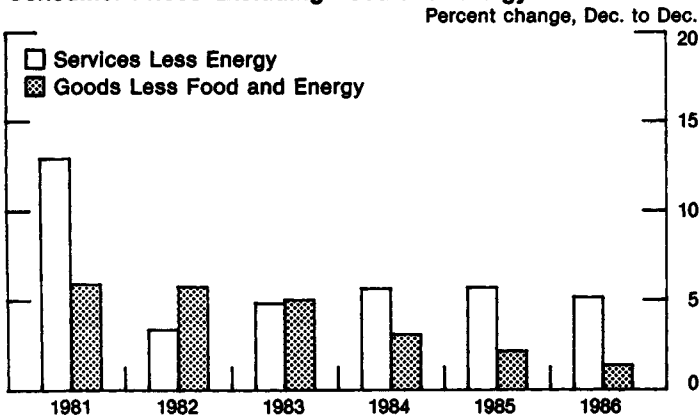
Employment Cost Index***Labor Productivity—Output per Hour**

* Private nonfarm workers.

services rose only about 1 percent, and the Producer Price Index for finished goods actually fell 2-1/2 percent.

The greater deceleration in the CPI and PPI than in the GNP price measure is a reflection of the greater importance of energy prices in those indexes. The movements in energy prices over the past year or so have been striking. World crude oil prices dropped from \$26 per barrel in late 1985 to the \$11 per barrel range around midyear; these prices trended up over the second half and recently have risen to around \$18 per barrel in the wake of the agreement on production limits reached at the OPEC meeting in late December. The drop in crude oil prices in the first half was reflected fairly rapidly in prices of gasoline and home heating oil, which fell around 30 percent over the course of the year. There also were declines in charges for electricity and natural gas, but they were much smaller than those on refined petroleum products. On balance, retail energy prices declined 20 percent last year. The effects of the recent firming in oil prices are already evident in general indexes: the PPI jumped 0.6 percent in January, owing largely to the rebound in gasoline and heating oil prices.

Price increases outside the energy area generally remained moderate in the past year. Retail food prices rose 4 percent, a bit more than in 1985, reflecting the effects of last summer's heat wave in the Southeast. However, prices of retail goods excluding food and energy continued to slow and, on balance, were up only 1-1/2 percent. The influence of the depreciating dollar on consumer goods prices was highly variable across sectors and relatively small overall. There were sizable increases in dockside prices for foreign cars and for some types of home electronic and photographic equipment, and retail prices of such goods have accelerated. But there was

Consumer Prices***Consumer Energy Prices*****Consumer Prices Excluding Food and Energy***

* Consumer Price Index for all urban consumers.

little evidence of any significant aggregate impact on other consumer goods. Prices for nonenergy services also slowed somewhat last year but still rose around 5 percent, boosted by continued large increases for medical services and higher premiums for various types of insurance.

Prices for many basic industrial commodities continued to decline over the first three quarters of 1986. Excess capacity in some basic industries and the generally abundant world supplies of many primary commodities contributed importantly to the weakness in these prices. Sluggish industrial activity in the United States and other large economies also was a factor. Prices in a number of these markets have turned up in recent months, possibly in response to the firming in U.S. industrial activity. Nonetheless, industrial commodity prices still are well below the most recent peaks reached in mid-1984.

Section 3: Monetary Policy and Financial Markets in 1986

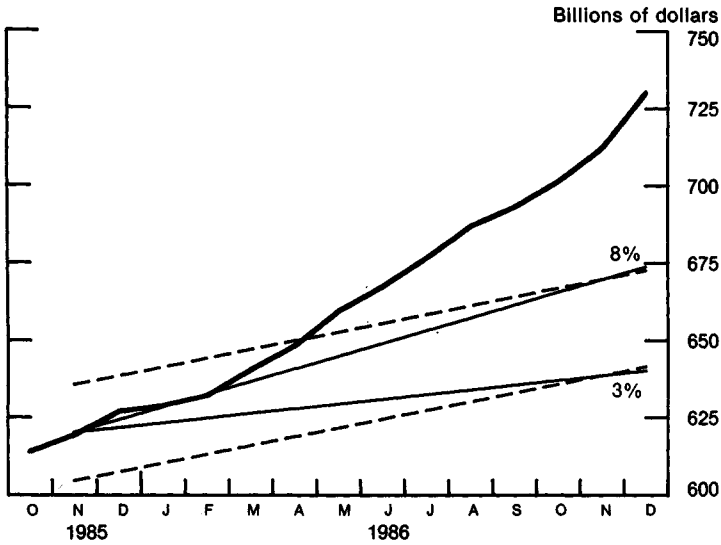
The Federal Reserve faced continuing challenges in 1986, not only in discerning the underlying trends in a complex domestic and international economic setting, but also in specifying appropriate policy actions in a financial environment marked by a rapid pace of structural change. As in previous years, and in keeping with the Full Employment and Balanced Growth Act, money and credit aggregates were used as a means of assessing and characterizing policy. At the same time, however, in targeting and interpreting these aggregates, and in reaching operational decisions with respect to the degree of reserve pressures and the discount rate, the evaluation of signals provided by a broad range of economic and financial indicators played a large role.

At its meeting in February 1986, the Federal Open Market Committee established target growth ranges, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated monitoring range for growth of domestic non-financial debt was set at 8 to 11 percent. Based on the experience of recent years, the Committee recognized that the relationship between M1 and economic activity was subject to particularly great uncertainty. Accordingly, the FOMC agreed to evaluate movements in M1 in light of their consistency with the patterns in other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures.

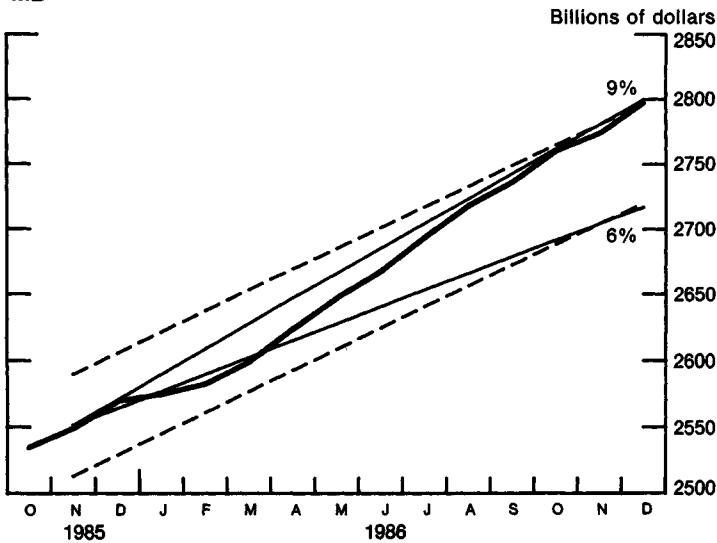
M1 was well above its annual target range at the time of the July FOMC meeting. The available evidence suggested that the rapid growth of M1 reflected shifts in portfolios toward liquid assets in the context of declining market interest rates rather than excessive money growth with potential

Ranges and Actual Money Growth

M1

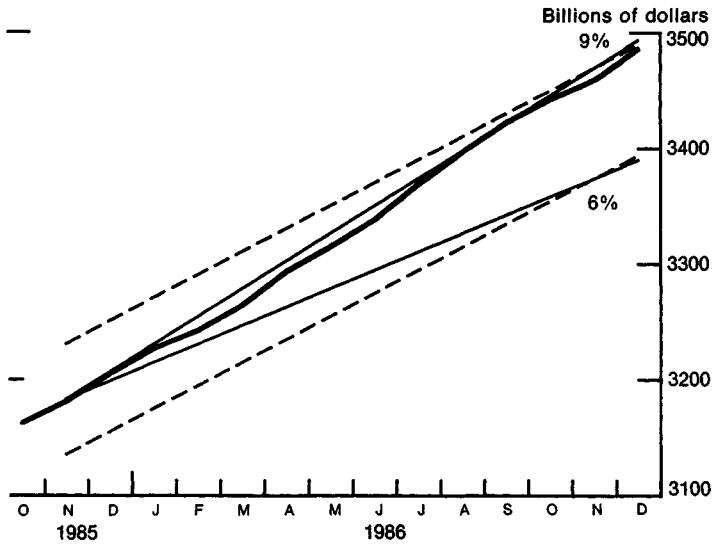


M2



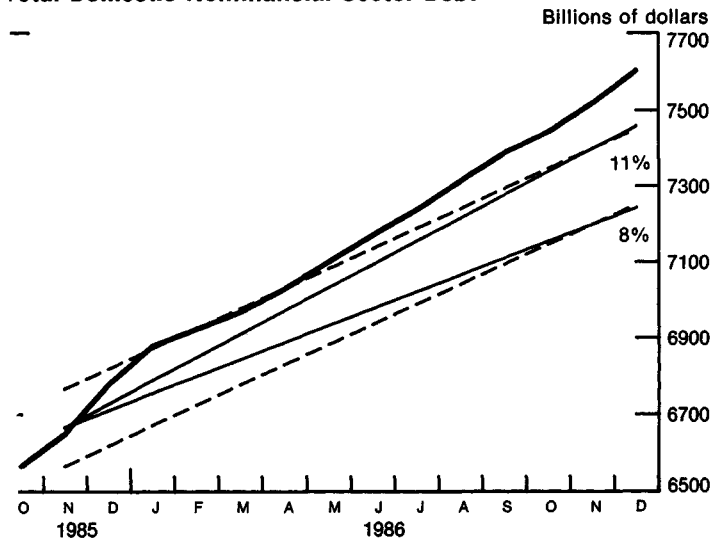
Ranges of Actual Money and Debt Growth

W3



Rate of Growth
1985 Q4 to 1986 Q4
8.8 Percent

Total Domestic Nonfinancial Sector Debt



Rate of Growth
1985 Q4 to 1986 Q4
12.9 Percent

inflationary consequence. Against this background, the Committee concluded that M1 growth above the existing range would be acceptable, provided the broader aggregates expanded within their target ranges, price pressures remained subdued, and the economy continued to expand at a moderate pace. The Committee reaffirmed the target ranges for M2 and M3 at its July meeting. Data at that time showed that both of these aggregates had expanded near the midpoints of their ranges, and Committee members felt that growth within those ranges for the year was still consistent with the overall policy objectives of reducing inflation further, promoting sustainable growth in output, and contributing to an improved pattern of international transactions. In the first half of the year, the growth of domestic nonfinancial debt exceeded both its monitoring range and the growth of nominal GNP, as it had in previous years. The Committee was concerned about the burdens and potential instabilities associated with the persistence of rapid debt growth and felt that raising the monitoring range for debt would create an inappropriate benchmark for evaluating long-term trends. As such, the existing range was maintained, but the FOMC thought that debt growth could well exceed its upper bound.

The growth of M2 quickened in the second half of the year, and M3 expanded at a somewhat faster pace as well. However, both of the broader aggregates ended the year within—although near the upper bounds of—their target ranges. The growth of M1 accelerated further in the second half of the year, resulting in a record postwar decline in velocity for 1986. The growth of nonfinancial debt slowed slightly in the second half of the year, but still exceeded its monitoring range by nearly 2 percentage points.

Pressure on reserve positions of depository institutions, as reflected in a relatively low volume of borrowing at Federal Reserve Banks,

changed little over the course of 1986. The broadly accommodative thrust of policy also was manifest in the four reductions in the discount rate between March and August. In part, the discount rate cuts were intended to keep this rate in line with the yields on short-term market instruments, but they also were taken in the context of hesitant worldwide economic growth, an improved inflation outlook, and growth of the broader monetary aggregates within their annual target ranges.

In setting monetary policy the FOMC focused considerable attention on the nation's trade deficit and the foreign exchange value of the dollar. The Committee members generally viewed the narrowing in the trade deficit as a key to achieving a sustainable and more even expansion of activity across the economy. At the same time, however, the Committee was concerned that an unduly precipitous decline of the dollar against the currencies of our major trading partners could contribute to inflationary pressures in the United States. To help limit the effect on the value of the dollar, the first reduction in the discount rate was a coordinated action with other major central banks; similarly, the reduction in April was accompanied by a cut in the Bank of Japan's discount rate.

Money, Credit, and Monetary Policy

M2 expanded almost 9 percent in 1986, placing this aggregate near the upper bound of its annual growth target. Although in recent years this aggregate has exhibited a tighter relationship with nominal GNP than M1, M2 velocity still registered a decline of 4 percent last year and reached its lowest level in decades. The build-up of M2 balances relative to income probably reflected incentives to place savings in various components of the aggregate whose offering rates were falling more slowly than market interest rates.

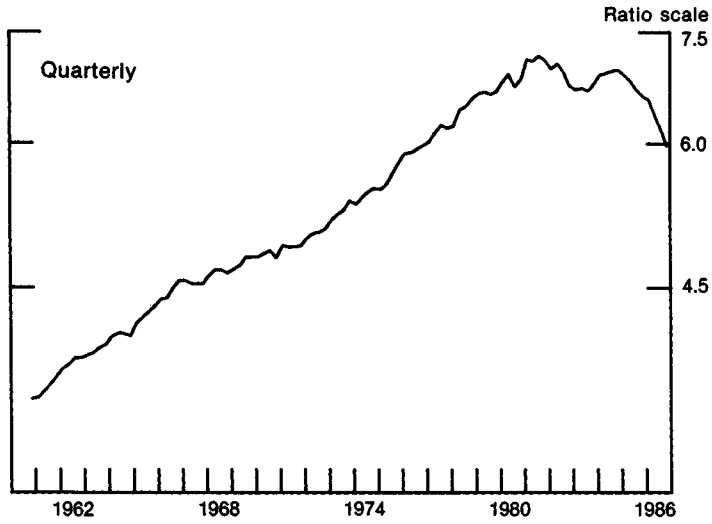
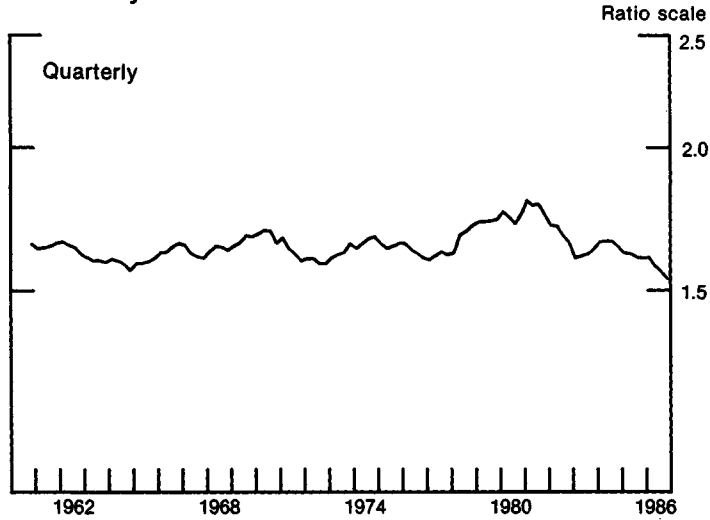
GROWTH OF MONEY AND DEBT¹
(Percentage changes)

	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter to fourth quarter				
1979	7.9	8.2	10.4	12.2
1980	7.3	8.9	9.6	9.6
1981	5.1 (2.4) ²	9.2	12.3	9.9
1982	8.6	9.1	9.9	8.9
1983	10.2	12.1	9.8	11.5
1984	5.4	7.9	10.7	13.9
1985	12.1 (12.7) ³	8.8	7.7	13.5
1986	15.2	8.9	8.8	12.9
Quarterly growth rates (annual rates)				
1986 Q1	8.8	5.3	7.7	15.4
Q2	15.5	9.4	8.7	10.3
Q3	16.5	10.6	9.7	12.0
Q4	17.0	9.0	7.8	11.5

1. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions made in February 1987.

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

3. M1 figure in parentheses is the annualized growth rate from the second to the fourth quarter of 1985.

M1 Velocity**M2 Velocity**

The slowest adjustments in rates on retail deposits last year were made in short-term accounts. Depository institutions have been reluctant to adjust savings deposit rates downward because many of these accounts have represented a stable, profitable source of funds for many years. Rates on NOW accounts also have fallen only slightly. Much larger declines were registered on time deposits, reflecting not only quicker adjustment to market rates but also the pattern of rate movements in the credit markets, where long-term rates fell much more than short-term rates in late 1985 and early 1986. The changing structure of deposit rates at banks and thrifts has led to a pronounced shift in the composition of M2: inflows to transactions deposits, savings deposits, money market deposit accounts, and money market mutual fund shares were very strong last year, while small time deposits ran off, marking the second consecutive year of zero or negative growth.

The weakness in small time deposits in 1985 and 1986 also could reflect "rate shock." As existing time deposits matured, savers with high-yielding deposits acquired several years ago were unable to reinvest the funds at comparable returns. A sizable portion of maturing deposits evidently was placed in liquid instruments in M2 while savers searched for other investment opportunities. Yield-conscious investors also may have been lured from time deposits by attractive returns on some nondeposit instruments. For example, stock and bond mutual funds grew rapidly in 1985 and 1986 after stagnating during most of the 1970s and early 1980s, and the issuance of savings bonds was strong in the summer and fall before their minimum yield was lowered from 7-1/2 to 6 percent.

M3 also ended 1986 near the upper bound of its annual range, increasing 8-3/4 percent over the year. Growth of M3 close to that of M2 is

not surprising, given that M2 constitutes four-fifths of the larger aggregate. The remaining share is dominated by large time deposits and certain other managed liabilities of depository institutions. Credit growth at banks and thrifts remained quite strong last year, but with the exception of the first quarter, the use of managed liabilities in M3 was light as growth of core deposits largely was sufficient to fund asset expansion. Large CDs expanded only 3 percent on balance in 1986, with commercial banks paying down their outstanding CDs during much of the year and thrift institutions also doing so in the fourth quarter. The weakness in CDs was widespread as institutions relied more on other managed liabilities, such as term RPs, included in M3, and advances from Federal Home Loan Banks, not included in M3.

The broad shift to liquid assets greatly affected the behavior of M1. The narrow monetary aggregate expanded more than 15 percent in 1986, marking the second consecutive year of double-digit growth. The velocity of M1 fell 9-1/2 percent last year, compared with a decline of 5-1/4 percent in 1985. Since 1981 the velocity of M1 has declined 16 percent—a remarkable development in view of its tendency to climb about 3 percent per year in the previous two decades.

Much of the rapid growth in narrow money over the past two years appeared to be related to the effects of the sharp decline in market interest rates on incentives to hold both NOW accounts and demand deposits. Since their peak in the latter part of 1984, short-term market interest rates have fallen about 5 percentage points, to their lowest levels in nine years, while NOW account rates have changed considerably less. Although more rapid money growth generally would be expected in an environment of declining rates, the expansion of M1 last year and in 1985 was in excess of what would be indicated by the historical relationships among money, interest rates, and income.

About half of the growth of M1 in both 1985 and 1986 occurred in interest-bearing checkable deposits. Because depository institutions have adjusted the rates paid on NOW accounts only sluggishly, the spreads between the rates on these deposits and those on substitutes have narrowed substantially. For example, between the first quarter of 1986, when interest rates on NOW accounts were fully deregulated, and the fourth quarter of last year, the spread between the 3-month Treasury bill rate and the average NOW account rate at commercial banks shrank from 135 basis points to 53 basis points. Similarly, the average rate on NOW accounts late last year was not far below that on 6-month small time deposits (as shown in the exhibit on the next page).

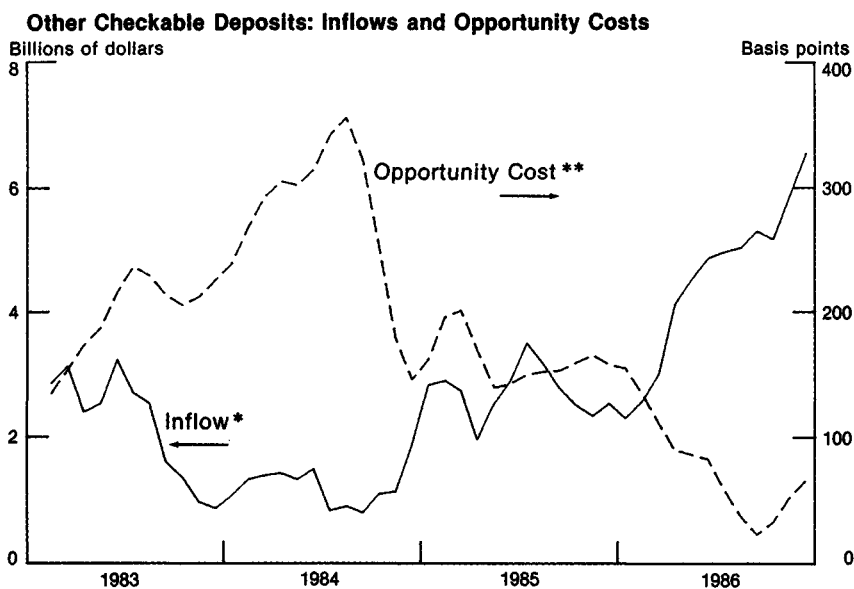
The growth of demand deposits also accelerated last year, amounting to nearly 12 percent from the fourth quarter of 1985 to the fourth quarter of 1986. As with other checkable deposits, lower short-term interest rates are an important influence on the growth of demand deposits because they reduce incentives to economize on transactions balances. Also, some demand deposits are held by business firms in exchange for services provided by banks, and these compensating balance requirements typically are enlarged as market rates decline. While these effects were important elements behind the expansion of demand deposits throughout 1986, the apparent response to declining interest rates was much larger than would be expected from historical experience.

Another element in the growth of demand deposits apparently was the large volume of financial transactions that occurred in 1986. For example, because of certain payment procedures--such as funds held in escrow accounts and transferred by officer's check rather than by wire--the massive volume of mortgage originations and prepayments last year could have influenced the

Interest Rate Spreads:
Selected Yields Less NOW Account and
Super NOW Account Rates at Commercial Banks*
 Basis points, except as noted

Account	1984	1985	1986			
	Q4	Q4	Q1	Q2	Q3	Q4
6-month small-time deposit	408 197	220 139	149	99	61	52
MMDA	360 149	157 76	96	61	27	18
3-month Treasury bill	366 155	223 142	135	86	37	53
Memo:						
NOW account rate (percent)	5.38	5.38	5.86	5.60	5.37	5.16
Super NOW account rate (percent)	7.49	6.19				

*Prior to January 1986 a regulatory distinction existed between regular NOW accounts (which had a maximum interest rate of 5 1/4 percent) and Super NOW accounts (which had no rate restriction if a minimum balance requirement was met). All rates used in calculating the spreads are annual effective yields; rates on NOW and Super NOW accounts are compounded monthly. The data in *italics* are rates on Super NOW accounts and the interest rate spreads based on these rates.



* 3-month centered moving average of monthly inflows at commercial banks and thrift institutions.

** 3-month centered moving average of the difference between the 3-month Treasury bill rate and the NOW account rate at commercial banks. The NOW account rate for periods before 1986 is an approximate measure constructed from available information on rates paid on regular and Super NOW accounts.

movement of demand deposits. In addition, a flurry of financial transactions around year-end induced in part by impending tax law changes temporarily boosted demand deposits sharply.

Domestic nonfinancial debt expanded almost 13 percent last year, a slightly slower pace than in the two previous years but still above both the Committee's monitoring range and the growth of nominal GNP.¹ Debt issuance by the state and local sector dropped off substantially from the pace set in 1985, when it was boosted by borrowing in anticipation of tax reform restrictions. In the household sector, mortgage borrowing strengthened, but a marked decrease in the expansion of consumer installment credit from the elevated rates in prior years contributed to a moderation in overall growth of household indebtedness. A continuation of corporate financial restructurings buoyed expansion of business debt, despite the maintenance of a moderate gap between capital spending and internal funds. Growth of federal sector debt remained strong.

In implementing policy in 1986, the FOMC generally accommodated through open market operations the strong demand for reserves associated with the rapid growth of transactions balances. In the context of prospects for slow growth of real economic activity, disinflationary trends in wages and prices, and growth of the broader monetary aggregates within their target ranges, four reductions in the discount rate were implemented between March and August.

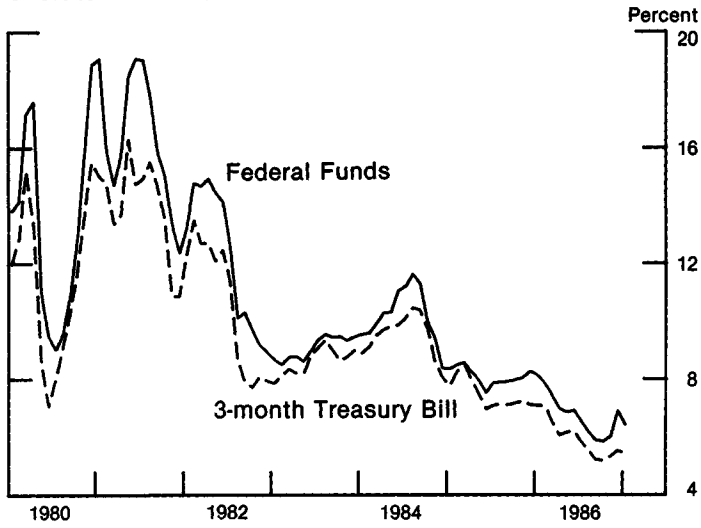
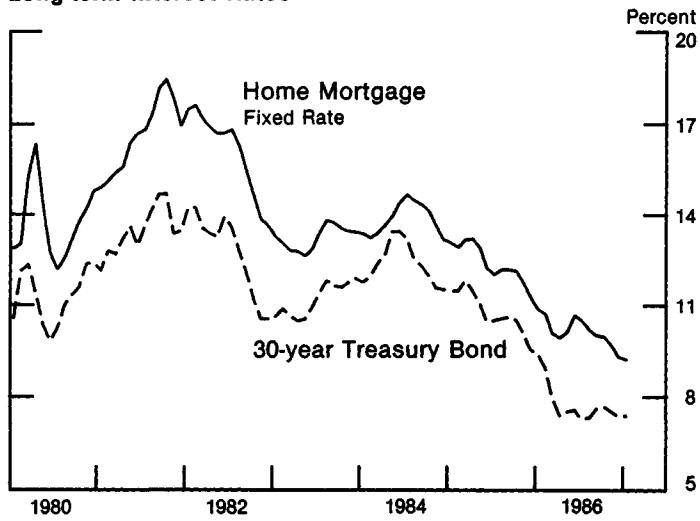
Early in the year, all the monetary aggregates slowed sharply, with M2 dropping below its annual target range. Also, evidence suggested that the

¹ When measured from the end of December to the end of December, domestic nonfinancial debt expanded 11-1/2 percent last year. The fourth-quarter to fourth-quarter growth cited in the text is higher because of the surge in debt at the end of 1985 and the arithmetical effects of quarterly averaging.

economy was growing sluggishly, and the outlook for inflation improved as oil prices fell. In this environment, market interest rates began to decline in mid-February, and the Federal Reserve reduced the discount rate 1/2 percentage point to 7 percent in early March. At the time, there was concern that unilateral action to lower interest rates might cause an excessive reaction in the foreign exchange market, where the dollar had been under downward pressure. Accordingly, the reduction was timed to correspond with similar actions by the central banks of West Germany, Japan, and several other industrialized nations.

With the economy expanding slowly and underlying price pressures continuing to moderate, interest rates fell further throughout March and into April. By mid-April, most market interest rates had reached their lowest levels since the late 1970s. At that time, the Federal Reserve instituted another reduction in the discount rate to catch up with and to ratify the declines in market rates.

After mid-April, interest rates rose for a short time as market participants focused on an upturn in oil prices, an acceleration in the growth of the monetary aggregates, and a further decline in the foreign exchange value of the dollar. By the end of June, however, a steady flow of weak statistics began to reveal anemic growth in real economic activity in the second quarter. An improvement in activity had been expected by the FOMC for the second half of the year, but the rebound now appeared likely to be less vigorous than previously anticipated and perhaps delayed because of continued disappointing movements in our trade position and the effects of pending tax reform legislation on business investment. Accordingly, shortly after the July FOMC meeting, the Board approved another half point cut in the discount rate to 6 percent.

Short-term Interest Rates**Long-term Interest Rates**

The final reduction in the discount rate last year took place after the August FOMC meeting. The last two reductions in the discount rate in 1986 were adopted without similar action by foreign central banks. Unilateral action to lower interest rates carried the risk of adding to the downward pressure on the dollar and possibly feeding a source of inflationary pressure. However, the Federal Reserve thought that prevailing economic and financial conditions warranted such a risk, realizing that the provision of reserves could be tightened through open market operations if adverse developments were to arise.

While the value of the dollar fluctuated considerably after the reduction in the discount rate in August, it showed no distinct downward movement until around year-end. Short-term interest rates declined about one percentage point over the summer months, moving either in anticipation of, or in response to, the reductions in the discount rate. Long-term rates were about unchanged on balance over the summer, but more concern about interest rate prospects developed in early fall. Economic indicators began signaling a pickup in the pace of economic activity, and rising prices of oil and precious metals, along with the potential effects of the cumulative decline in the value of the dollar, seemed to raise concerns about the outlook for inflation. Over that period and through the remainder of the year, the FOMC attempted to keep a steady degree of reserve pressure, and market interest rates fluctuated within a fairly narrow range.

Even so, short-term interest rates moved higher as the year-end approached, owing, in part, to the exceptional volume of tax-related transactions. As firms rushed to complete mergers and buyouts, and households stepped up their sales of assets to realize capital gains, the demand for

transactions balances and business loans surged. This heavy volume of financing also was reflected in unusually strong reserve demands by depository institutions. The System added reserves freely to accommodate this demand, but the pressure nevertheless showed through to short-term rates. Shortly after the turn of the year, short-term rates moved back toward their earlier levels. The dollar, however, was under substantial downward pressure in early 1987; disappointing figures on the U.S. trade deficit prompted selling of the dollar on exchange markets, and this pressure intensified with reported suggestions by some U.S. policymakers that, particularly in the absence of more growth-oriented policies abroad, further dollar depreciation might be necessary to correct the nation's external imbalance.

Other Developments in Financial Markets

As long-term interest rates declined last spring to their lowest levels in eight years, the volume of corporate bond issuance surged to record levels. Indeed, the volume of domestic corporate bonds sold last year was nearly twice the previous record set in 1985. Much of the bond issuance last year was used to refund higher-cost debt or to pay down short-term credit. With the stock market continuing to register impressive gains last year, new equity issuance also reached record levels. Of the gross proceeds from new equity issues sold last year, about 30 percent was raised by firms issuing stock in the public market for the first time.

The retirement of high-coupon bonds, the reduced dependence on short-term credit, and the issuance of new equity shares tended to improve conventional measures of corporate balance sheet strength. However, massive volumes of outstanding equity were retired through mergers, acquisitions, buyouts, and other restructurings, resulting in the third consecutive year

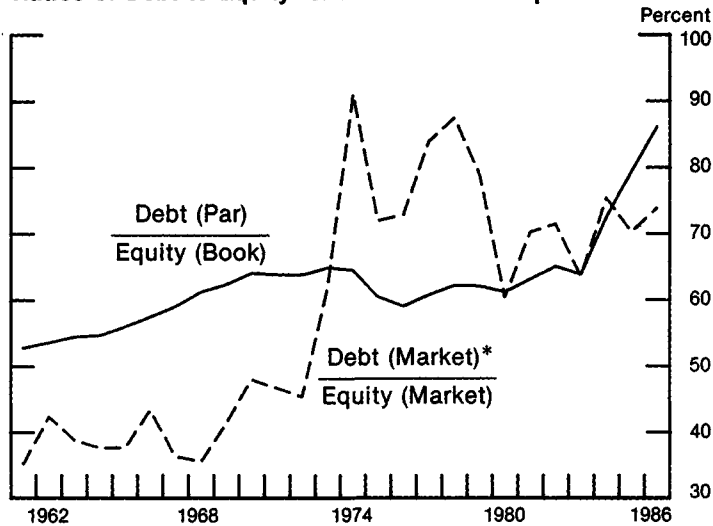
of large net equity retirements. Reflecting the financing patterns in recent years, the aggregate debt-equity ratio of nonfinancial corporations, on a "book" basis, swelled to a record level (see chart). When stated at market values, however, the robust gains in share prices have kept debt-equity ratios well below levels that generally prevailed during the 1970s. With interest rates trending down in recent years, interest-coverage ratios have crept up, suggesting that the ability of firms in the aggregate to service their debt has not deteriorated. These modest gains, however, have been achieved in relatively benign market and economic circumstances.

Because of the large paydown of equity, the ability of some corporations to weather economic shocks has waned. The weak financial structures of some firms, along with strains in certain industries, led to more than \$3 billion of corporate bond defaults in 1986, an amount that dwarfs the experience in nearly every other year of the postwar period. Concern that other firms also may have problems in meeting their financial obligations is reflected in the pace of bond downgradings, which last year totaled more than three or four times that in the late 1970s.

Firms with downgraded debt typically find their securities trading at higher interest rates in the secondary market. In general, however, quality spreads between private debt securities of different grades have been relatively stable in recent years,¹ suggesting that investors have not been alarmed at the credit quality of corporations in the aggregate and have not attempted to limit their portfolios to higher-rated issues. During the

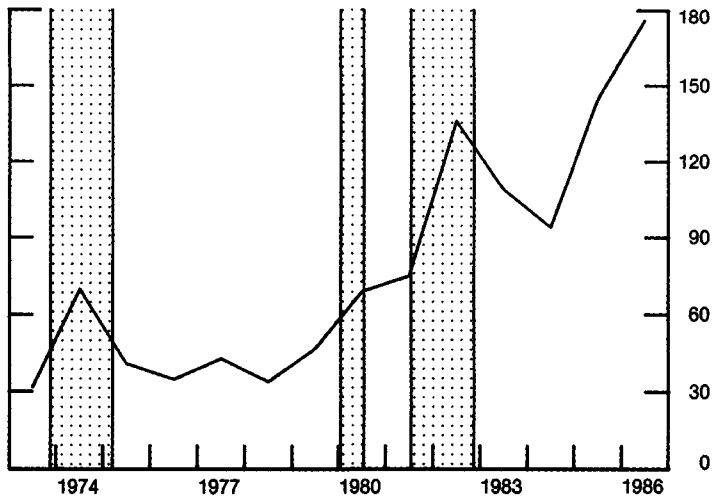
1. The interest rate spreads between investment-grade and speculative issues widened by about 50 basis points for a short time after the bankruptcy filing by LTV Corporation in July. Low-rated or unrated bonds also experienced substantial yield increases for a time later in the year, when concerns about the liquidity of that market segment surfaced in connection with the insider trading scandal; that widening has been reversed since the beginning of 1987.

Ratios of Debt to Equity for Nonfinancial Corporations



* The market value of debt is an estimate obtained by multiplying the par value of outstanding bonds by the ratio of market value to par value of bonds traded on the New York Stock Exchange; equity value is based on market prices of outstanding shares.

Number of Downgradings in Moody's Corporate Bond Ratings **



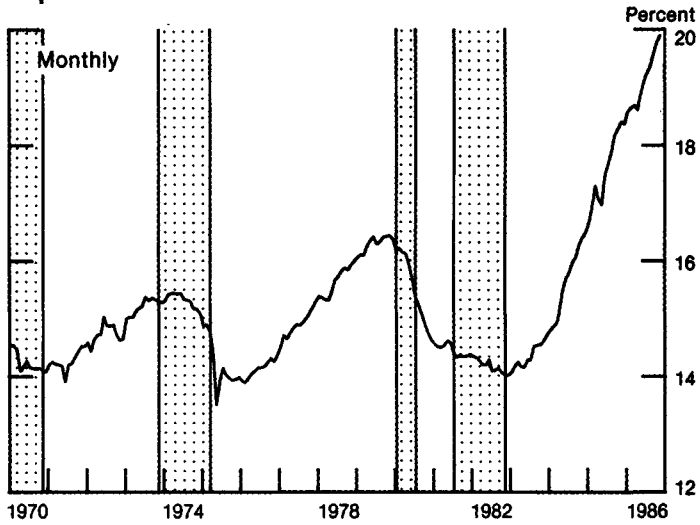
** The number of downgradings on a corporation's highest-ranking debt issues. In April 1982, Moody's increased the number of rating categories by dividing most of its major categories into three subcategories. Only downgradings from one major category to another are counted.

first half of 1986, spreads between the yields on corporate bonds and Treasury securities widened considerably, but this appeared to be related to the heavy volume of corporate issues and a revaluation of call and refunding provisions on long-term obligations. A narrowing of these spreads early in 1987 has reversed much of the earlier increase.

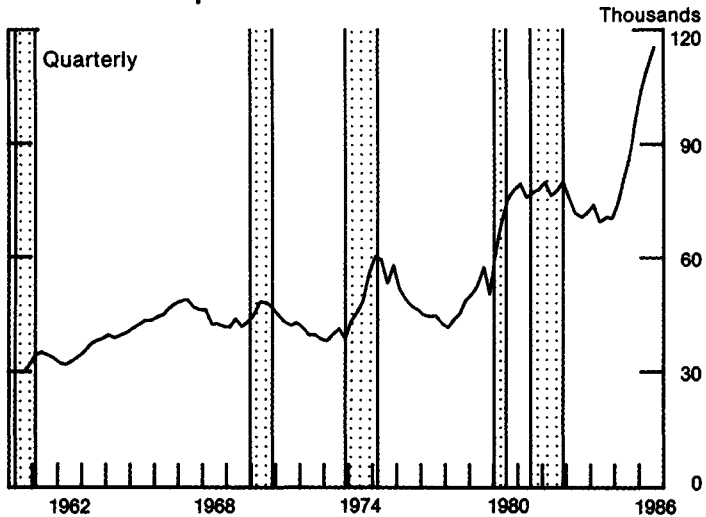
The expansion of household debt slowed last year as the growth of consumer installment credit receded to about 12 percent from the 15 to 20 percent pace of recent years. Nevertheless, installment debt continued to grow faster than income, and the ratio of such debt to income established another record (see chart, next page). With mortgage debt expanding rapidly, the ratio of overall household debt to income also reached a new high. While assets of the household sector have increased sharply in recent years, many individuals have experienced difficulty in meeting their financial commitments. The number of personal bankruptcies accelerated dramatically in 1985 and 1986, with bankruptcies last year surging well beyond the historical experience. Strains were particularly evident in the area of credit card debt, as delinquency rates on revolving balances increased appreciably. Delinquency rates on other categories of installment debt and mortgage loans fell some last year, although they were at much higher levels than in previous expansions. For some households, debt-servicing burdens were reduced last year by the re-financing of high-rate mortgages or the decline in interest payments on their adjustable-rate mortgages.

While the economy has grown continuously for more than four years, the expansion has been uneven and has left certain sectors under severe strains. The problems faced by firms in the mining, energy, agricultural, and many manufacturing industries are well known, as are those of a number of

Consumer Instalment Debt as a Percent of Disposable Personal Income



Personal Bankruptcies



heavily indebted developing countries. The difficulties in these areas are feeding through to the financial intermediaries supplying them credit. Last year, for example, 136 commercial banks failed—compared with a total of only seven in 1981. Many of these institutions had heavy credit exposures to the oil industry, while more than 40 percent of the failed banks held large amounts of agricultural loans.

The impact of the distress in the farm sector also has been severe for the Farm Credit System, the government sponsored agency that holds about 25 percent of outstanding farm debt in the United States. The losses of the banks in the System probably exceeded \$2 billion last year, largely reflecting provisions for loan losses, and the System's capital surplus soon will be exhausted if losses do not abate. The Congress last fall approved regulatory accounting procedures for the Farm Credit System that will allow the banks to report higher net income figures than generally accepted accounting principles would permit. The higher reported income may ease some of the problems within the System relating to the preservation of capital and help to justify charging borrowers more competitive rates. By themselves, however, the accounting procedures do not provide substantive relief.

The financial condition of the thrift industry as a whole has improved markedly since the early part of the decade, but the difficulties of many institutions have intensified. As interest rates fell from their elevated levels in 1981 and 1982, the average cost of funds at thrift institutions declined much more rapidly than the average yield on their assets. The industry as a whole returned to profitability in 1983, and aggregate earnings have jumped since then. Net income for the industry in 1986 probably was strong again, although it is likely to have been below that in 1985.

At the same time, asset quality problems have become increasingly important for a sizable number of these institutions. While some of these problems are associated with economically distressed regions of the country, overly aggressive investment strategies of some institutions certainly have contributed heavily. For 1986, about one-quarter of the thrift industry will report negative net income, and the long-term prospects for many of these institutions are unfavorable. Moreover, the Federal Savings and Loan Insurance Corporation has inadequate resources to manage these problems effectively.

While the many stresses and financial vulnerabilities are not amenable to correction through general monetary policy, they do influence the economic environment and represent a potentially disruptive and destabilizing element in financial markets. The Federal Reserve has been called upon to play a positive role through its regulatory and supervisory functions. For example, steps have been taken to reduce the risks associated with large payments made by wire transfer, and several proposals have been made to ensure the capital adequacy of commercial banks. Many of the financial and sectoral stresses will take considerable time to alleviate, and will require a stable monetary environment, redress of the imbalances in the nation's federal budget and international trade positions, and—importantly—prudent private behavior, encouraged as necessary by sound regulation.