

# CONDUCT OF MONETARY POLICY

(Report of the Federal Reserve Board pursuant to the  
Full Employment and Balanced Growth Act of 1978,  
P.L. 95-523.)

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## HEARING

BEFORE THE

SUBCOMMITTEE ON  
DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND  
URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE-HUNDREDTH CONGRESS

FIRST SESSION

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JULY 21, 1987  
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# REVIEW THE SEMIANNUAL REPORT OF THE FEDERAL RESERVE BOARD ON MONETARY POLICY

Tuesday, July 21, 1987

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

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Barnard, McCollum, Roth, Leach, and Wortley.

Also present: Representatives Schumer and Olin.

Mr. NEAL. I'd like to call the subcommittee to order at this time. This morning we meet to hear testimony on the semiannual report of the Federal Reserve Board on the conduct of monetary policy. This is a historic moment—the last time Chairman Volcker will deliver this report. It is also the final time Paul Volcker will appear before us as Chairman of the Federal Reserve to discuss monetary policy, though I certainly hope that Mr. Volcker will be able to give us his views from time to time as a private citizen.

For 8 years Chairman Volcker has dominated the conduct of monetary policy in the United States. When he took office in 1979 inflation was raging ahead at record rates. He leaves office shortly after the United States has completed its 4th year of strong economic growth and recorded its lowest rate of inflation in 20 years. His is a record of accomplishment of historical dimensions. I must say I think that he is the major hero of our time, a real hero of our time. His accomplishments have enormously improved economic conditions in our country.

After Chairman Volcker completes his prepared testimony on this particular monetary policy report, I'd like to ask the Chairman to reflect on the broad course of monetary policy over the last decade and try to answer essentially one question: How can we preserve this legacy? What can we do to control inflation while allowing the economy to grow at its full potential?

In answering that question, I hope that we will get a clearer understanding of the true nature of inflation. I think that we are living under some myths these days concerning inflation, and I hope that these hearings will at least help to set the record straight on that question.

(1)

Mr. Chairman, I want to thank you again for all that you have done for our country over the last several years. Before you proceed I would like to ask if other members have any opening comments.

Mr. Roth?

Mr. ROTH. Thank you, Mr. Chairman. I want to compliment you for holding these hearings and to associate myself with your remarks concerning Mr. Volcker. If there is anyone most responsible for getting our economic house in order, it's been the Chairman of the Federal Reserve. We appreciate all he's done for this country.

George Washington delivered a farewell address as have so many other famous people who have served in our Government. I hope that this morning Chairman Volcker will deliver his parting words to the Nation and tell us what we in the Congress have to do to balance the budget.

We have a saying in Wisconsin: talk's cheap but it costs money to buy whiskey. This morning we want to hear it straight from the Chairman what steps are needed to balance the budget because if there is any one issue the American people are concerned about, it's our runaway budget deficits.

So I'm delighted to be here this morning and to listen to the Chairman's message to us.

Thank you, Mr. Chairman.

Mr. NEAL. I thank the gentleman.

I noticed that in this morning's Washington Post the notice of this hearing announcing Chairman Volcker's testimony said he would be testifying on fiscal policy. Even though I think we are here to discuss monetary policy with him, I find that his advice usually includes a little on fiscal policy.

Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman. I just want to take one minute to say Mr. Volcker how much I've enjoyed working with him the past 8 years. Needless to say, I feel like he's done a tremendous job as Chairman of the Federal Reserve not only in the inflation success that we've had and that he's had, but also in I think sort of settling the international debt situation. I think his participation in that, his strength, his influence has meant much in keeping us in a stable condition there with our very, very sensitive debt situation, and possibly I think this morning, Mr. Chairman, if it's in order, I'd like for him to address how he feels that this is being handled by some of the banks that seemingly now are willing to increase their reserves to offset some of the debts that are owed to them, and whether or not he thinks this is in good order.

But not only this, Mr. Chairman, but in all your leadership, we are very much, tremendously indebted to you and we hate to see you go and wish for you every happiness and success in your future endeavors.

Mr. NEAL. Mr. Olin of Virginia is not a member of our committee, but I would like to welcome him this morning. Jim, would you like to make any opening remarks?

Mr. OLIN. Thank you, Mr. Chairman. I appreciate the opportunity to sit with the committee. I've heard the Chairman speak a

number of times since I've been in Congress. I'm here today to hear what he has to say again.

I have always been impressed with the degree of stability that Chairman Volcker brings to almost any situation, and also I have appreciated the openness, the candor, and the willingness to participate. I hope that in his new role, whatever it may be, that he will still be as accessible to the Congress as he has been before.

Thank you, Mr. Chairman.

Mr. NEAL. Thank you.

Mr. Chairman, your entire statement will be made part of the record. We would like to ask you to proceed as you will.

#### **STATEMENT OF PAUL A VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. VOLCKER. Thank you, Mr. Chairman and gentlemen. I appreciate those very generous words and I appreciate this last opportunity to appear before you as Chairman of the Federal Reserve Board. You have the official report of the Board of Governors before you, and I will try to be blessedly brief in touching upon some of the main points.

As you know, the economy has continued to grow this year, carrying the expansion well into its 5th year. At the same time, however, the inflation rate has accelerated appreciably relative to the low rate prevailing in 1986.

A change in that direction had been widely anticipated in response to the rebound in oil prices and the depreciation of the dollar. Nevertheless, the size and pervasiveness of the price increases—which have included many non-energy materials as well as services—affected the psychology and expectations in financial markets, particularly in April and early May. Recurring concerns about the dollar internationally also at times affected the mood of domestic markets, and interest rates rose rather sharply for a time.

Through the early part of the year, Federal Reserve operations placed minimal pressure on bank reserve positions. As reported earlier, however, beginning in late April definite but modest steps were taken to increase reserve pressures somewhat. Perceptions of that action appeared to help calm concerns about the future course of the dollar and inflation.

Most interest rates, long and short term, have retraced part of the earlier rise. However, long-term interest rates and prices of sensitive commodities, some of which had been deeply depressed, remain well above their levels of earlier this year.

The approach of the Federal Reserve toward the provision of reserves has not changed since May. However, growth in the various monetary aggregates slowed further in the second quarter. A reduction in the rate of growth of those aggregates from the relatively high levels of 1986 had been both anticipated and desired by the Federal Open Market Committee, as reported to you in February. However, it is also true that, with institutional and market developments importantly affecting the relationships between the various measures of money and the variables we ultimately care about, judgments about the appropriate growth of the aggregates have

become both more difficult and more dependent on prevailing economic and market circumstances.

For that reason, the committee did not set forth a particular target range for M1 this year in February. That judgment was reaffirmed at the meeting earlier this month. M2 is currently running below, and M3 around, the lower ends of their 5.5 to 8.5 percent ranges established in February. The committee decided not to change those ranges for 1987. In doing so, however, there was agreement that, depending on further evidence with respect to emerging trends in economic activity, inflation, and domestic and international financial markets, actual growth around the lower ends of those ranges may well remain appropriate.

In judging appropriate monetary growth during the course of the year, or from year to year, account needs to be taken of the apparent increase in the sensitivity of demands for money and for money-like assets to absolute and relative changes in market interest rates. Interest rates administered by institutions, especially those on transactions accounts, tend to lag market rates both when interest rates are rising and when they are falling. At the same time, the cost and effort involved in shifting funds between types of accounts, or into and out of market instruments, has greatly diminished. Experience suggests that, as a result of these factors, demand deposits, NOW accounts, and money market deposit accounts all tend to grow relatively slowly, if at all, when market interest rates are rising, as during the second quarter, but much faster than normally as market rates fall, as during much of 1985 and 1986. Those differences in growth rates in money will tend to be reflected in inverse movements in the velocity—that is, the measured rate of turnover—of money rather than commensurate changes in economic activity or prices.

That sensitivity of velocity to changes in interest rates makes it more difficult to judge the appropriate rate of monetary growth, particularly over periods as short as a quarter or a year, and impossible without reference to the stream of available evidence on economic activity, prices, and other factors. This year, too, concerns about the international performance of the dollar have at times had a significant bearing on operational decisions. Specifically, the tightening of reserve availability in the spring was related in substantial part to the desirability, in the light of the substantial cumulative depreciation over the previous 2 years and other economic policy undertakings here and abroad, of maintaining reasonable stability in the external value of the dollar. That judgment is, as you know, shared with the administration and the finance ministers and central bank governors of other leading industrialized countries.

Looking ahead to 1988, the Open Market Committee decided tentatively to reduce the target ranges for M2 and M3 by  $\frac{1}{2}$  percent to 5 to 8 percent. While recognizing the inevitable range of uncertainty I referred to earlier, some reduction in the target ranges clearly appeared appropriate in recognition of the importance of assuring that the temporary bulge in price increases foreseen for this year not, in fact, become a base for a renewed inflationary process. The appropriate range for 1988 will, of course, again be reviewed with care at the start of the year.

More broadly, policy has to be judged against progress toward the more basic goals of growth and stability, and it seems to me fatuous to think that the first could long be sustained without the latter. At the same time, now and for some years ahead, we will need to work to narrow and ultimately correct the large imbalances in our internal and external economic positions—adjustments that necessarily have implications for the policies and prospects of other countries as well. What is at issue is whether we can make those necessary adjustments while sustaining progress toward the broader goals.

In some areas, developments in the past 6 months have been encouraging:

The evidence by now is pretty clear that in real terms our trade balance is improving, even in the face of continuing sluggish growth, high unemployment, and excess capacity abroad.

While growth in domestic consumption has slowed—one essential part of the adjustment process—the expansion of domestic output and employment has been well maintained, and unemployment, at close to 6 percent, has dropped to the lowest level in this decade. Manufacturing has picked up and prospects for business investment may be improving.

Helped by some large unanticipated capital gains tax receipts, this year's budget deficit will apparently be driven even below earlier expectations, and thus very substantially below the Fiscal 1986 level.

Internationally, leading nations are not only agreed upon the desirability of greater exchange rate stability, but appear to be working more effectively to that end.

In another area demanding a high level of international cooperation, the basic approach for dealing with the international debt problems has continued to be implemented with substantial success despite doubts and challenges from several sides.

Of central importance, there has been continuing evidence of restraint and discipline on costs and wages in much of the American industry, offering the prospect of lower rates of inflation in the months ahead. Over time, that must be an absolutely essential element in maintaining our international competitiveness as well as in restoring domestic stability after the bulge in prices this year.

At the same time, it would be nonsense for me to claim that all is safely and securely on the path. The remaining dangers, risks, and problems are apparent.

Even the otherwise satisfying fall in the unemployment rate this year implicitly has a discouraging aspect. Outside of manufacturing, the statistics suggest productivity growth is quite dismal—so slow, in fact, that I cannot dismiss the thought that the reported statistics may partly reflect measurement error.

But no error of measurement can entirely explain away that our private saving, in historical or in international context, remains so low, or that our Federal deficit remains so large, or that we, the putative leader of the western world, are so dependent on other people's capital. Despite the better news on this year's Federal deficit, some projections of future deficits, assuming current programs, are being raised rather than reduced, and the political impasse over doing something about it apparently remains. In the circum-



stances, the Gramm-Rudman-Hollings targets are threatening to become pie in the sky.

The already slow growth in other industrialized countries appears to have slowed further this year, working against the adjustments needed in trade and current account positions among Japan, western Europe, and the United States. And, in that environment the dangers of protectionist trade legislation and a breakdown in the servicing of international debts are enlarged.

For all those reasons and more, my very able successor, and the Federal Reserve generally, will have challenge aplenty. But I, as I have spelled out earlier, would like to think there is something upon which to build as well.

Finally, Mr. Chairman, I would like to acknowledge specifically the usefulness from my standpoint of these regular semiannual hearings on monetary policy.

You and I are both conscious of the special position of the Federal Reserve System within the overall framework of government. The long terms of members of the Board of Governors, the participation of the Regional Federal Reserve Banks in the policy process, our budgetary autonomy, and the professionalism of our staff are all designed to provide some insulation in deciding upon money creation against partisan or passing political pressures.

In our system of government, however, insulation cannot be equated to isolation, and particularly isolation from reporting and accountability to the Congress and to the public. These hearings are an important element in that discipline. I have welcomed the opportunity that they have provided for us to consult with the Congress and to explain our purposes, our approaches, and our problems in dealing with a complicated and changing economic environment.

And I want to express my appreciation as well for the many courtesies you have extended me personally over these past 8 years.

Thank you, Mr. Chairman.

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

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Chairman, I want to return just for a moment to the question that seems important to me concerning the essential nature of inflation. To tell you the truth, I have difficulty in expressing this without sounding terribly partisan, and while I hope what I say will not be read only in that light, I understand if it is taken that way. To me it boils down to this: we have a situation now where, as I said in my opening statement, it is clear we are currently experiencing the lowest level of inflation in some time. We are prone in this country to inflation. It is not outside the realm of possibility that at a future date we will again reinflate this economy. In fact, I think that is a grave danger that we currently face. If I had to bet on it, that's exactly what I would bet—that Government officials will find inflation as a very convenient way to deal with this enormous debt that we have piled up in the last several years.

The rate of inflation has been brought down and the Reagan Administration takes credit for it. In fact, it is the major accomplishment, they say, of their tenure. It is what they and other Republi-

cans generally mention over and over again as their major accomplishment. I ask this question: what has it been that they have done that has brought down the rate of inflation? I have asked that question of many witnesses. I have studied the record myself, and, frankly, I can only find one answer to that question and the answer is that they reappointed Paul Volcker to head up the Federal Reserve System.

I raised this issue at earlier hearings of this committee, and a Republican friend of mine said, "Well, no, that isn't all. That's not quite fair. They encouraged Chairman Volcker to engage in this tough fight against inflation." Well, that is correct; they did, and I want to say fairly that a number of folks in the Administration from time to time did encourage Chairman Volcker to pursue this fight against inflation. But, I would point out that there were many times when folks in the Administration were very critical of the Federal Reserve. There are numerous examples of that. They certainly, even on that subject, did not speak with one voice.

I know it sounds partisan, but let us say 5 or 10 years from now we are experiencing another round of inflation and we say: back in the early 1980s the American economy had a high rate of inflation. Let us go back and look and see what they did to solve this problem? President Reagan, one of the most popular Presidents we ever had, said he led in the fight against inflation. What were his policies that brought inflation under control? Was it more than doubling the national debt? Is that what brought down inflation? Was it creating the biggest trade deficit in our Nation's history? Was it making us a debtor Nation that brought down the rate of inflation? Was it creating the conditions that brought about the lowest rate of savings in this country since we began measuring the savings rate? Was it the highest level of spending in peacetime that we have ever experienced? Was it running up—almost doubling—the military budget? Was that what brought down the rate of inflation? Or, was it doing things that reduced our level of productivity?

I will tell you frankly I find no correct answer in any of those except one thing: we had a Federal Reserve System that was determined to break the back of inflation, and they did that under the leadership of Paul Volcker. I hope that the record is clear, that we do not live with the mythology that somehow all of these other policies—doubling the debt, lowering savings, creating a trade deficit—had something to do with it. They did not. Inflation, I am convinced, is essentially a monetary phenomena, and if you want to break its back, you must limit money growth. If you want to create it, pump out more money.

While I am certainly not a doctrinaire monetarist, I do think that monetarist economists help us understand this phenomenon maybe better than any of our other economic thinkers. I think certainly we owe them a debt of gratitude.

Mr. Chairman, while I do not expect you to get into any kind of partisan debate—I am certainly not asking for that and you are far above it—I would like you to comment on how you understand inflation. Do you agree that it is essentially a monetary phenomenon? Do you think there is some way to deal with inflation if it begins again in this country without limiting money growth? It is

that kind of question I would like you to comment on in general, if you would, Mr. Chairman.

Mr. VOLCKER. Well, you ask a very large question, as you know, Mr. Chairman, that we could discuss all morning, and I will be very brief.

I think in an immediate sense it is fair and appropriate to say inflation is a monetary phenomenon by its nature. But you really have to look beyond that statement and say: why, given that it's a monetary phenomenon, do people act in such a way as to produce the monetary conditions that produce the inflation? I think that gets you into much further ranging questions about a tendency of human beings to reach and overreach to the end of their capacity and beyond their capacity, and they overreach what the economy can do in terms of growth and performance without inflation, which ultimately damages the growth and performance they're looking for. You see that develop in the budgetary process. You see it develop elsewhere in the private as well as public sector of the economy.

You are left with the premise—and I think we would agree upon this without being at all partisan—that control of the money and credit creation process is and must be an ultimate guard upon the inflationary temptations that exist endemically. That's what the Federal Reserve is all about in its constitutional structure, with a small "c", within Government.

I think it is terribly important to preserve that if you are going to have any chance of dealing with this inflationary tendency that you describe and that I think has been a recurrent malaise of our political life as well as elsewhere.

Mr. NEAL. Is there any recommendation that you have to help strengthen our ability to resist these inflationary pressures?

Mr. VOLCKER. I don't know as I have any institutional recommendations. My recommendation certainly would be to preserve what you have in that respect. Obviously it can be improved around the edges, but I think it's very important to preserve that basic structure of independence and insulation for the monetary authority, and I don't know of anything more important than that. I think, again, that's a lesson not just for the United States, but for other nations around the world.

In terms of dealing with actual policy decisions, let me say—and it's easy to say this; hard to do—I think it is much harder to deal with inflation once it has gotten some momentum. You're not going to deal with it ordinarily without a lot of transitional hardship. Anyway, the lesson is to deal with it before it achieves momentum. I think we are in a rather critical period right now where we've had inflation going up predictably because of the change about the oil situation and because of the dollar. I think we have a chance that that will subside again and should subside again relatively soon if we can maintain restraint on the cost and wage front, which is a matter of productivity and wage and salary increases.

So far we have done well on that, on the wage and salary side. It's continued to decline actually or leveled off at the lowest level in many years. Productivity is all right in manufacturing; it looks awful in the rest of the economy, as I noted.

But if we permit the present rate of recorded inflation over the last 6 months or so to throw us off course in those basic areas, if it gets built into the cost structure, then we have a very serious problem once again. So I think it's terribly important right at this juncture to be cautious in the conduct of monetary policy and obviously all the help we can get from fiscal policy would be terribly important. Without help from fiscal policy, monetary policy is left with a very awkward job, to put it mildly, with the risk that in the attempt to be sufficiently restrictive you aggravate other elements in the economy that will lead to higher interest rates than you otherwise would have and more risks for economic activity than are really necessary.

Mr. NEAL. Would you expand a little on that. How do the deficits that we continue to run year after year impact on your ability to conduct a noninflationary monetary policy?

Mr. VOLCKER. Well, broadly I think it's a combination of two things. You run those big deficits in a context—and I have to emphasize the other side of it, as you mentioned—of a very low savings rate in this country. It's the combination of the deficits and the low savings rate that means that we cannot finance internally both the Government and the investment we need to support growth and to support productivity. That leaves us with higher interest rates than we otherwise would have and it leaves us with a big capital inflow which for the time being bridges the gap. But is not a very reliable mechanism over a period of time for bridging the gap because a continuing high level of capital inflow, in effect, has the seeds of its own destruction. You can't borrow forever, and you build a little hole for yourself as you borrow more and more because someday that's going to stop. Cumulative increases in the borrowing itself undermine the confidence over time that must lie behind the borrowing.

So you're left with a big deficit. We cannot finance investment internally—without higher interest rates. We, therefore, are left with a trade deficit and questions about the dollar in trying to reconcile the internal dilemma. It's not really reconcilable in the end in any kind of a stable way, leaving the economy more vulnerable both potentially to inflation through declines in the dollar and interruptions in business activity because of the dangers for interest rates and capital markets that are implicit in this situation.

Mr. NEAL. Thank you. Mr. Roth?

Mr. ROTH. Thank you, Mr. Chairman.

Chairman Volcker, back in my district, I have a group of financial experts, including bankers, savings and loan professionals, credit union people, and the like that give me advice on legislation before Congress. In our last meeting in April, we took a vote on whether or not Paul Volcker should stay on as Federal Reserve Board Chairman. All 40 voted for Paul Volcker to stay on the job. That is quite an endorsement from the people back home of your reputation.

The chairman of our committee asked a very interesting question. Stating that he doesn't want to be overly partisan the chairman asks, how did we get inflation down? Under President Carter, inflation was at 12.6 percent. The middle class, the people on a

fixed income, senior citizens were financially being wiped out. Then we got it down to less than 3 percent.

Mr. Chairman, perhaps my good friends on the other side of the aisle have never heard of a word called "Reaganomics." I think that's done a lot to get inflation under control.

The No. 1 issue on Capitol Hill is this issue of the huge twin deficits. Mr. Chairman—realistically Congress is not going to cut spending significantly. Take for example the \$87.5 billion highway bill. The President asked us to sustain his veto so that we could cut out some of the waste. But Congress didn't go along with it.

We had a \$50 million bill for the homeless. Congress jacked it up to  $\frac{3}{4}$  of a billion dollars. These examples demonstrate that Congress is not serious about reining in spending.

So what are we going to do to get these deficits under control? Should we opt for a line item veto? Do we need a balanced budget amendment? Do we take a Gramm-Rudman approach that will force Congress to make these cuts? What do you think?

Mr. VOLCKER. Well, I think in a sense if I take your premise that spending isn't going to be cut, you've answered the question: you'd better increase taxes or whatever you euphemistically want to call them. If you are going to spend 23 percent of the GNP, or thereabouts—and you tell me that can't go down—if I have that premise, and we are collecting 19.5 percent, or something like that, you only leave me one way to close the gap. Now I wouldn't myself be that pessimistic. I have always said—I don't know how many years before this committee and others—that to deal with this deficit from an economic standpoint, it would be preferable to attack it on the spending end. But to the extent you can't do that, then you have to look at taxes. I would hope you could do something on the spending end.

You ask about mechanisms. I think the item veto is a good idea myself, looked at from this point of view; I have doubts about a balanced budget amendment for a variety of reasons. Sometimes you get so frustrated, you look for some gimmick. I think that's kind of a gimmick to rescue you, but I really haven't got all that much faith in it.

If you're really looking at something in the way of procedures, while I like the idea of an item veto, I think that might be important in giving the Executive a fairer shot at keeping expenditures restrained; I don't see that as the answer to the whole problem. I think that's improbable. If you really wanted to change procedures—you tell me you can't reduce expenditures—maybe you ought to require more than a majority vote to make expenditures. I know the President had the opposite proposal—to require more than a majority vote to increase taxes. That doesn't strike me as our problem. You say the problem is spending too much.

Mr. ROTH. So you would probably advocate legislation requiring more than a majority vote to increase spending?

Mr. VOLCKER. I don't predict that as being very likely, but if I really got discouraged and accepted your premise that under the present procedures you can't ever reduce spending, you have to look at something.

Mr. ROTH. Well, Mr. Volcker, believe me, I would like to see us cut spending. But I've been here the same amount of years that you

have, 8 years, and I have not seen this Congress cut spending in anything. That is why I've come to a fairly pessimistic conclusion about the capacity of Congress to act decisively in this area.

Mr. VOLCKER. Well, the rate of growth has slowed, I think it's fair to say, Mr. Roth.

Mr. ROTH. I'm sorry?

Mr. VOLCKER. The rate of growth has slowed, and I suppose, looked at over a period of time, what's important in determining whether you need a tax increase or not is the rate of spending relative to the GNP, and that doesn't require an absolute cut in expenditures. It does require a leveling of expenditures, but I just think the logic of the situation you describe is that you have to look at the revenue side and that raises the question of which revenues you can look at that have the least effect on incentives and the least deleterious effects on the economy in other respects.

Mr. ROTH. Well, if Congress won't cut spending, it doesn't necessarily mean that you have to go to a tax increase. Maybe a forcing mechanism is the approach that we need. That's why I was asking about the idea of a balanced budget amendment, the line item veto, and, as you had mentioned, a requirement of more than a majority vote to increase spending. I think that's what we need.

If Congress doesn't have the will, then perhaps we have to have a forcing mechanism.

Mr. VOLCKER. Well, you need a mechanism, I suppose, but in the end you have to cut. The mechanism doesn't substitute for the cut. It's a way of getting cuts maybe. What are you going to cut? Are you going to cut defense? General government has been cut and there isn't enough general government left to satisfy the deficit problem. Are you going to cut social security? Are you going to cut other entitlements? Those are very hard decisions. But you can't duck them by a mechanism.

Mr. ROTH. Mr. Chairman, just one more question dealing with private debt.

The private debt in this country has been growing by leaps and bounds. What is your prognosis for that?

Mr. VOLCKER. Well, the rate of growth, fortunately—after a number of years of growing, as you say, by leaps and bounds—at least is slowing a bit. It's maybe still leaping, but it is no longer bounding. But it's gotten very high, and I don't much like it because I think it makes the financial system more fragile.

One of the ironies of this situation is we have now had one of the longest business expansions on record during peacetime, but the quality of credit apparently has not been improving. If anything, it's been getting worse by most measures right through the present date, which raises obvious questions about the vulnerability of the economy and the financial system in particular when we run into less fair weather than we've had recently, which is inevitable at some point.

Yet, there seem to be incentives built into the marketplace at this point for reducing equity and increasing debt. I would not have thought that that was what the doctor ordered in some broad sense for the health of the American economy, but that is what's going on—at a somewhat slower pace this year than last year.

Mr. ROTH. Mr. Chairman, I'd like to follow up, but I recognize that we have only so much time. So, just very quickly I would like to ask your opinion about a very important bill before Congress dealing with the recapitalization of FSLIC and a number of other important issues. If Congress doesn't change that bill from its present form, do you think the President should veto it?

Mr. VOLCKER. No, and I think that bill has parts of it that I would prefer not to see, but overall in the real world I think it is a constructive piece of legislation. I think something has to be done about FSLIC, and this is the obvious vehicle that is on the table.

I think something should be done about the non-bank bank question which we've talked about a long time, and this doesn't have the ideal approach, but it has a workable approach. Other parts of the bill I am less happy about, but they do not seem to me at this stage so damaging as to undercut the value of the bill, even the necessity of the bill as a whole. I don't know how we can just leave this situation, either in the immediate sense of the problems of the FSLIC hanging indefinitely, or in the more fundamental sense of that basic division between banking and commerce that the Congress has not dealt with very effectively, if I may say so, for some years. This is your chance to deal with it, lay down a marker, and to forego that chance seems to me would be very unfortunate.

Mr. ROTH. Thank you, Mr. Chairman.

Mr. NEAL. Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Chairman, everyone talks about the fact that we're going into the 5th year of the economy growing. Sometimes you move forward when you just stumble. You can stumble forward. I just get the impression that this growth that we are continuing to have is not necessarily a growth that's caused by real economic growth as much as it is just a stumbling measure. We seem to be stumbling forward. Isn't some of that caused by the great deficits that we're having today?

Mr. VOLCKER. Well, I think that's right. Let me put that in a little perspective. I think there is some impression of a kind of stumbling expansion. When one looks back—and it's been stumbling in the common impression for some years—at the decline in unemployment and the rise in employment that's taken place, you wonder whether it may look a little awkward, but it has been functioning reasonably well overall. In fact, there appears not to have been a lot more room for a lot more rapid growth, given what's been going on with employment and unemployment.

I think you can also say that for the past 6 months, or maybe more, the composition of the growth has turned in a healthier direction. That's related to the question that you asked about deficits, in terms of the budget deficit and, I think, also the trade deficit.

In real terms at least, we seem to be making progress in dealing with the external deficit. I don't think we can do that and sustain that without dealing with the internal deficit. Of course, for this year anyway, we have made some movement in that direction.

I think at least in embryonic form we can see some movement in a healthier direction in terms of the composition and the sustain-

ability of the advance. If we can continue that for a while, some of this stumbling character that you referred to may yield.

Mr. BARNARD. It appears to me like a sirana just before he's getting ready to fall on his face.

Mr. VOLCKER. Well, I don't agree with that. I think there are obviously distortions and imbalances in the economy—

Mr. BARNARD. But when you look at it from the standpoint—

Mr. VOLCKER. Which create problems, but I—

Mr. BARNARD. We talk about it, though, we talk about productivity—it's not at all up to the level that we want it to be. The jobs that we agree are created are not manufacturing jobs on the whole; they're more service-oriented jobs.

So this leads me to further identify that what we are doing is just the momentum that we have seems to be caused by the fact that it is just before getting ready to tumble. Now I hope that's not true.

Mr. VOLCKER. Well, I hope it's not true, too. Again, I don't want to minimize the very large imbalances in the economy, but I don't have the feeling of the kind of inevitability of stumble that you suggest that might be associated with a different kind of distortion: strong inflationary movement, big inventory accumulation, great pressures on capacity. That's typically the kind of thing that has brought expansion to an end in the past. We don't have that. We have a different kind of distortion today.

Mr. BARNARD. What about consumer—

Mr. VOLCKER. In some ways it's a more serious kind.

Mr. BARNARD. What about consumer debt?

Mr. VOLCKER. Consumer debt is high and rising. That's another part of this debt problem. Again, that is rising somewhat more slowly this year, but we have a lot of consumer assets, too. But, clearly, another way of looking at it is that very low consumer savings rate is not a source of strength. I don't think there is any doubt about that. It does contribute to the financial vulnerability of the economy.

I don't want to suggest that there are not real problems in the economy because there are. I don't have the feeling of an inevitable stumble. I have the feeling of a very large challenge in continuing to work against these big imbalances.

We can begin to see some progress in the past 6 to 12 months. You have to capitalize and continue that progress or we will stumble.

One way of looking at our problem is can we make enough progress, give the impression of enough sustained progress in the needed direction, particularly on those deficits, that you maintain the confidence that's going to be necessary for both financial markets and the dollar to maintain some kind of equilibrium during this difficult period.

Mr. BARNARD. Mr. Chairman, on page 3 when you talk about the fact that the range of M1 has not changed and very modestly we changed M2 and M3, does this mean that the FED has really achieved a real science in the finetuning of the economy at this point, so there is not going to be any major gyrations up or down?

Mr. VOLCKER. No. I don't think you can promise that, and I don't think you can promise that particularly when we have those large



imbalances and distortions in the economy that we've just been talking about that arise from other directions. It would be an illusion to think that monetary policy has both some insight and power through that one tool of manipulating the money supply that can deal with all distortions in the economy and all pressures in the economy from whatever direction. It simply cannot do so in any repetitive, competent way over a period of time. You need help from other directions as well.

Mr. BARNARD. What would have happened if—what would you think would have happened if the FED had made a different decision and that M1 had been lowered, M2 and M3 had been lowered? Do you think that that would have contributed to more inflation at this point?

Mr. VOLCKER. Well, we haven't got an M1 target at this point. We didn't change that idea of not having a target for the time being. M1 has been running much lower. If we had, in fact, reduced the M2 and M3 targets this year—in my opinion that was certainly an option and an option that had some attractions—I think it would have recognized what has happened.

But you asked me whether it would make much difference. I don't think it would make much difference. The committee discussed that and concluded that it hadn't changed these M2 and M3 targets in the middle of the year before and it would just as soon keep them as a benchmark. But specifically the committee said to itself, as I said in this statement, that it is quite prepared under present conditions to see M2 and M3 in fact turn out this year to be at the low end of the range or around the low end of the range, maybe even a little below it, given conditions that exist. So that is another way it could have met that situation, by actually reducing the range somewhat. It chose not to reduce the range, but to make a rather explicit statement to that effect.

Mr. BARNARD. I guess you think I'm the prophet of doom this morning, but I think that sometimes we don't look at this thing in the reality that's really there.

Back on page 10 of your testimony this morning—you begin on page 8 by talking about all these great things that are happening, and I was very encouraged to read all of that, and then I turn over here to page 9. Then you say, "At the same time, it would be nonsense for me to claim that all is safely and securely on path." Then we talk about that productivity growth is dismal. On over to page 10 it talks about the "projections of future deficits assuming current programs" being raised, and so forth, is a problem. And then we get down to, "The already slow growth in other industrialized countries appears to have slowed further this year, working against the adjustments needed in trade and current account," and so forth and so on.

Well, if we're not going to get any particular help from Japan and western Europe as far as the worldwide economic growth is concerned, why aren't we looking at a probably modest but a real worldwide recession?

Mr. VOLCKER. I think the possibility of that depends a lot upon what happens in the United States. If this particular environment that I describe, relatively slow growth in Japan and western Europe, persisted and if we had some kind of a downturn in the

United States, I think the risk of that happening would be appreciable.

So what does one judge from that? It underscores the urgency of those countries' growth rate picking up. While the statement that I make here I believe is accurate, I haven't lost hope entirely that from now on the prospects may improve in both Japan and in western Europe. If we avoid a recession here ourselves, obviously the spectre that you describe isn't going to happen.

Mr. BARNARD. Mr. Volcker. I would like to ask a couple more questions and then I'll stick around. But I would like to address one question that has come up this morning, and that is we need a mechanism to control spending. We have a mechanism. It's the already opportunity to veto appropriation bills. I've been here 11 years, and of the last 8 years I don't recall that we've had a lot of appropriation bills that have been vetoed that I could have voted to sustain the President's veto. So we do have a mechanism.

Mr. NEAL. I would like to ask the indulgence of Mr. Wortley for a moment. Mr. Roth tells me he has to leave in a few minutes. I would like to make some comments and then I will yield to my friend from New York?

Mr. WORTLEY. Certainly.

Mr. NEAL. I want to engage my friend from Wisconsin for just a moment in the presence of our distinguished witness this morning. I made these comments earlier about the cause of inflation, and so on. Mr. Roth responded. He said, "Well, I understand it." He said, "We've lowered inflation because of something called 'Reaganonics'." Frankly, that is precisely the myth that I would like to do all I can to dispel. I would like to ask my friend, either now or some other time, to tell me what is it in Reaganonics that has lowered the rate of inflation?

Before I yield to him for that purpose, I would like to mention another myth that we seem to be living with these days. Frankly, I think our distinguished witness may share in it. That is that somehow Republican, or in this particular case President Reagan, policy is for lower spending than is the policy of the Congress. Or, to put it in more clearly partisan terms, that somehow the Republican policy is for lower spending while Democratic policy is for higher spending. That is not accurate at all. The fact of the matter is that this President has sought and gotten dramatically increased spending in the area of defense. He is requesting dramatic increases in spending for foreign aid and dramatic increases in spending for interest on the national debt, to the point that we have now had a whole new Federal program—new interest on new national debt that is larger than all the welfare programs put together. This is a whole new Federal Government program, a permanent program, that has been instituted in the last few years.

It is true that the Democrats want more spending for education, for aid to the homeless for social security; for a number of other domestic programs as Mr. Roth pointed out. That is true. The Democrats want more spending for some programs and less for others; Republicans want more spending for interest on the national debt, foreign aid, and military spending. The reason I want to include our distinguished witness this morning is because he has recommended a line item budget veto. I think the predictable con-

sequence of that for this President would be to go in and veto aid to the homeless, education, and so on, and then be able to blackmail Congressmen who would not go along with him. But look at the long-term consequence of that: what if we were to elect someone like Walter Mondale in the future. Would you have liked for him to have had the power to go into the budget and veto, let us say, on his own, the B-1 bomber. I do not think the Chairman of the Federal Reserve has an opinion on that, but, my friend from Wisconsin, would you like to give him the power to go in and veto a lot of defense programs, if that was his wish?

I think, Mr. Chairman, there are two major myths that we are living with today. One is that somehow the Republicans are for lower spending and, two—and this is the major myth that we will pay a dear price for if we don't deal with it—that somehow Reaganomics is responsible for bringing down the rate of inflation. I think that is a very dangerous myth.

I would like to yield to my friend from Wisconsin to tell me what it is in Reaganomics that has lowered the rate of inflation.

Mr. ROTH. Of course, I would like to yield to the Chairman of the Federal Reserve. I am sure he could answer the question much better than I could.

Mr. NEAL. I do not think so. [Laughter.]

Mr. VOLCKER. I think I'll leave that one to you, Mr. Roth.

Mr. ROTH. But, you see, I don't look at Reaganomics as a myth. I look at Reaganomics as a reality, an economic reality.

Mr. NEAL. But what did it do to lower inflation? That is the question.

Mr. ROTH. Mr. Chairman, you and Mr. Barnard—and I see Mr. Schumer has now arrived—are the three most imminently qualified and most astute Members in the Congress on economic policy.

Realize that we had interest rates at 21.5 percent under President Carter and now they're down to about 8 percent for the prime rate. We had inflation at 12.6 percent; now it's less than 3 percent. We have 113 million people employed in the United States today. The Chairman of the FED told us the answer to your question. He used the word called "psychology" in his testimony. Inflation is a function of expectations for the future. People have trust in this Administration and that's why Reaganomics works.

Incidentally, Mr. Barnard left the impression that we have all kinds of appropriations bills going to the President's desk. Now I must be Rip Van Winkle or something because I haven't seen many appropriations bills going to the President. We almost always have continuing resolutions.

Mr. BARNARD. He could veto those.

Mr. ROTH. He can veto those, but then he is forced to shut down the Government because we have waited to send it to him until the last hour before the Government's scheduled to be shut down. So we really don't give the President the veto option.

But I appreciate the chairman calling on me. I have one question that I would like to ask our witness—

Mr. NEAL. Would the gentleman yield to me just one moment before that? Is the gentleman saying that he will not answer this question or that it is psychology? What psychology is it? Is it the voodoo economics? [Laughter.]

Mr. ROTH. It is a psychology called trust and confidence in the people in Government.

Mr. NEAL. So that is what brought down the rate of inflation?

Mr. ROTH. Well, that's one of them. We have a man before us, the Chairman of the Federal Reserve, who did a great deal to bring down inflation—because the American people have confidence in you, Mr. Volcker, and the people in the financial institutions have confidence in you, and that's one of the reasons. Yes, I believe that to be the case.

Mr. Chairman, there's a very important issue emerging in this country as far as foreign bank loans are concerned. We know that in many parts of the Third World, the banking industry has a dismal record in loans. You can spell it with a capital "T." We see what's happening in Latin America, and so on.

Yesterday there was a lead editorial in The Wall Street Journal talking about the banks now being mesmerized by the Eastern Bloc and the Soviet Union. Evidently, banks are now putting a great deal of emphasis on loaning more money to the Eastern Bloc and the Soviet Union. Do you think that's a wise idea?

Mr. VOLCKER. Well, I'm not aware that the volume of that lending has approached a level that from bank supervisory grounds at this point would trouble me relative to the other problems we have, anyway. But certainly I would agree that, given the experience that the banks are going through not simply with international lending, but with a lot of domestic lending, I hope they look at new loan commitments of that sort with due care and be amply compensated for the risks involved.

Mr. ROTH. Well, there's another issue here beyond commercial considerations. We spend some \$289 billion for defense now. If western commercial-banks, including American banks are making huge loans to the Eastern Bloc and the Soviet Union, aren't they in effect helping to underwrite the Soviet empire and the Soviet defense industry?

Mr. VOLCKER. Well, you get into some question in this area about what is an appropriate concern, I think, of a private financial institution as opposed to the Government. If we or you are seriously concerned about the consistency of such lending with national security purposes, then I think you may have the responsibility for saying so and giving the banks some guidance, and then they ought to follow that policy. But in the absence of the Congress or the Administration taking that position, I think there is a limit as to how much a bank can arrogate to itself, in effect, in making foreign policy, or should.

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

Thank you, Mr. Chairman.

Mr. NEAL. Mr. Wortley?

Mr. WORTLEY. Thank you, Mr. Chairman.

Chairman Volcker, you are and will be viewed as the man most responsible for taming the runaway inflation that plagued this Nation when you began your term of office. You had the vision to perceive destabilizing inflation as the most serious threat to our economy, and indeed to our political system. You had the managerial skills to provide a unified FED position on this issue. I'd say that your contribution to stabilizing an erratic economy and get-

ting the United States on a growth course is perhaps unparalleled in our Nation's history. Both the Congress and this Administration and the American people are grateful to you. Well done, my friend.

Mr. VOLCKER. Thank you, sir.

Mr. WORTLEY. You're going to be missed over there in the FED, I can assure you. We'll miss you coming up here on the Hill. We're particularly going to miss those big, fat smoke rings that you blew at us from time to time when we asked you intimidating questions.

I'd just like to take one moment if I could respond to my chairman. With all due respect to Mr. Volcker—and I think he's done a tremendous job on the economy—the Chairman didn't have anything to do with creating an oil glut in this country. The Chairman did not cut the rate of taxes in this country, and I would remind my chairman that it was his colleagues on that side of the aisle who used to bash Mr. Volcker because of his monetary policies. I'm sure the Chairman remembers that on many, many occasions when we had overflow crowds in this chamber listening to the Democrats bash him and the Federal Reserve Board.

But, at any rate, I have two or three questions this morning I'd like to ask you, Mr. Chairman. What do you see as the short-term prospects on our Third World debt crisis? How does it look for the debtor countries, and how does it look for the U.S. banks? Will the lesser-developed nations have to look perhaps to the IMF, to the World Bank, and the International Development Bank for future credit? Do you think our banks are going to be willing to go along with extending lines of credit?

Mr. VOLCKER. Well, I have supported—and I continue to support—the broad program that goes under the general name of the "Baker Plan." That involves all the elements that you describe. It certainly involves active participation of the World Bank and the Regional Development Banks and the IMF. It certainly looks to the banks to continue to provide some flow of financing, and it looks to the borrowing countries to conduct themselves and adopt the economic programs that are necessary to support growth at home and to provide confidence to the lenders.

It also assumes a reasonably favorable world economic environment. When one looks at all these areas, there all questions in all of them. The world economic environment has not been as favorable as we had hoped and assumed. Nonetheless, the economy worldwide has continued to grow, so it hasn't been moving 180 degrees in the other direction, either. It hasn't been as buoyant as one would like to see, which has created some difficulty.

When you look at the area of international institutions—and I would want to put in the strongest statement I could make here—that in the midst of all the budget cutting, there are obviously good things to spend money on and things that have less priority, and I fear that support by the United States, as the leading country in the world, the leading economic power, the leading political power, with the most at stake, we have an obligation to support the World Bank, to support the Regional Financial Institutions, to support the IMF. That support, frankly, is in jeopardy because of this budgetary situation and other causes. I think that is an exceedingly dangerous situation in the light of the immediate debt situation, but it is exceedingly debilitating, I think, and counterproductive in terms

of American leadership in the world over a longer period of time. It is simply destructive of the role, it seems to me, this country should and must play if we're going to have satisfactory economic relationships and be able to have our ideas prevail on a worldwide basis. So I want to say I think that's important in terms of the debt strategy.

So far as the banks are concerned, there's no doubt a lot of restlessness. That restlessness is reflected in some of this recent move toward very large reserving. One cannot object to reserving. I'm not going to object to conservative accounting practices by banks. One would wish perhaps that didn't come about quite so dramatically and could have come about more gradually over a period of time.

But, in any event, I think it is very important that the banks not withdraw from the process. What is encouraging is that after these dramatic reserving moves, the banks—certainly the major banks; there is a question among some of the smaller ones—but the major banks have continued to state but, more important than stating, in fact to follow through with participation in loan programs to Argentina most recently, but also cleaning up programs in the Philippines, Venezuela, elsewhere.

There is an important test case going on right now with a country that has not rescheduled its debts, Columbia, that has maintained servicing of its debts, has maintained some kind of access to the markets. They are in the market now for a sizable loan. Will that loan be funded? It is a very important test—and we have these almost monthly—of the continuation of the strategy.

My conclusion overall is that the strategy, with strains and difficulties, is still working and it's important to continue to work with the cooperation of all these parties, not least including obviously what those countries themselves do.

The really big test at the moment, as you know, is Brazil where interest payments, at least to private creditors, have been suspended for some time. They have had difficulties in their internal economic program. They have now once again a very high rate of inflation, but most recently have also announced measures that seem to me in an appropriate and constructive direction for dealing with their internal problems, measures developed in Brazil itself.

Now some of those have not been laid out in great detail or specificity yet, but, as they are, I would hope that that program can command international support and then, in commanding international support, provide a basis for resuming more normal financing. That is the biggest country in Latin America. It's the country with the biggest debts, and what happens in Brazil is going to say a lot about what happens in this total situation in the months and years ahead.

Mr. WORTLEY. Reversing the situation, Mr. Chairman, there seems to be a considerable concern among some about the penetration of foreign banks into the U.S. marketplace. The Japanese in particular have made some substantial strides in the last year or so. Do you have any concerns about the penetration of foreign banks into the American marketplace and perhaps unfair loan policies, trade practices?

Mr. VOLCKER. I don't have any basic concerns about what's been going on. So far I think it's generally been in the direction of making more credit available, at a time when we need credit from abroad, and improving the competitive position in the markets. I think there is one area that is of concern, and it gets into the question of whether this is done on fair and equitable terms.

Are some of these banks from some of these countries, in effect, able to price services in a way that isn't sustainable by American banks or banks from other countries that may have more stringent capital or other requirements? I think we have to be careful about that, and a particular, most prominent sore point is relative capital requirements of banks around the world and whether they both are adequate from the safety and soundness point of view and provide reasonable equality of competitive opportunity. Both of those things are important because if you have unevenness of competitive opportunity, it's hard to maintain the requirements at levels that may be necessary for safety and soundness reasons.

There have been initiatives taken by the United States and others in the past couple of years to speed up the tortuous process of trying to get more international consistency in this area, and we've made quite a lot of progress in the past year. We have a basic agreement with the next biggest country in terms of international banking, the British, on a consistent set of capital standards. We have not applied that yet because there is now the opportunity for a much wider area of agreement with both the Common Market and with Japan, both critically important. Getting that agreement holds up the whole process as kind of a trade of speed for comprehensiveness here, but I have real hopes that by the end of the year, say, there will be a rather comprehensive international agreement that we and others would find satisfactory that would help deal importantly with one aspect of the question you raise, as to whether this competition does give us problems, whether it's fair and equitable.

Mr. WORTLEY. Thank you.

Before the chairman just shuts me off, may I ask for just one quickie answer to my last question?

I've been very interested and concerned about the area of international money laundering, and I had requested the FED—although I know you are not officially a member of the Central Bankers Group that meets pretty regularly in Europe, although we play a major role even though we are not official members, only observers.

Do you see any progress being made in the area of money laundering?

Mr. VOLCKER. Well, it's a difficult area for us in the United States and even more so internationally. We have brought the question to their attention, as you know. I think we have at least gotten their attention a little bit, but I don't expect any magical results over a short period. I just don't think that is possible. But we will continue to work with them and, yes, I think there is a basis for cooperation in this area.

Mr. WORTLEY. Thank you again, Mr. Chairman, for your answers and everything you've done for this economy these past several years.

Thank you.

Mr. NEAL. Mr. Chairman, we have heard a couple of rather novel ideas concerning how inflation has been brought under control. Mr. Roth has suggested it was because of confidence, and Mr. Wortley suggested it was because of the tax cut. I wonder if you could quantify how much you think each of these two policies have contributed to the fight against inflation.

Mr. VOLCKER. I don't think I'm much on the econometrics of those particular situations, but let me say one thing in connection with confidence, Mr. Chairman. I do think that the inflationary process can develop a momentum of its own. It kind of proceeds from lack of confidence about whether measures will be taken to deal with inflation. When you have it going the other way, as we have had in recent years, a lot depends upon whether there is, indeed, confidence that an environment will be maintained where you don't have to worry about inflation.

I think we are a long ways from having achieved that degree of confidence, but we're making progress in that direction. That in itself helps to explain the remarkably good performance we have on wages, let's say from this point of view.

Mr. NEAL. I couldn't agree with you more, but again, should we not be pretty precise about that? You are talking about confidence based on—

Mr. VOLCKER. Performance.

Mr. NEAL. Some performance. You are not talking about some ethereal quality that results from a few nice speeches, as I understand it. You are talking about confidence based on policy, as I understand what you are saying.

Mr. VOLCKER. I am talking largely about confidence based upon policy and performance, and that's the only way we are going to get it after we went through what we did.

I would also like to think—and it helps—if you can have confidence based upon, let's say, institutional arrangements. I don't want to bore you with this story all the time but I think the kind of general institutional structure that the Federal Reserve has is important. It is an important element in maintaining the possibility, anyway, of that kind of confidence.

Mr. NEAL. I couldn't agree with you more.

Mr. VOLCKER. If the Federal Reserve doesn't perform, the institutional structure isn't going to do any good.

Mr. NEAL. I agree. To make sure that we are being as precise as we can, is it not the policy in which we can have confidence, which we had confidence, concerning lowering the rate of inflation one of restraint concerning money growth?

Mr. VOLCKER. Yes, I think that's an element in it. However difficult that has been to judge appropriately recently, as your own report, I think, which is a very interesting report, demonstrated in its release just a few days ago.

Mr. NEAL. At the conclusion of our report on the threat of inflation we make 10 recommendations, the last one of which I would like to read and have you comment on, if I can. It says: "The impact of deregulation on velocity rendered monetary growth more difficult to assess." as you have essentially just said, "But relationships between money and economic activity did not become com-



pletely random. The Federal Reserve should make every effort to analyze these new relationships with the intention of exploiting them to control monetary growth. In particular, the Federal Reserve should analyze and publish a report on the Treasury's contention that M1-A remains a useful indicator and should be given a prominent role in the conduct of monetary policy." I mention that specifically in light of the fact that you have not this year decided to target M1.

Mr. VOLCKER. Right.

Mr. NEAL. Do you not think it would be useful for the Federal Reserve Board to take seriously this recommendation on the part of the Treasury?

Mr. VOLCKER. Well, I would agree fully with your recommendation that you make generally. We've got to look at all these things continuously and intensively, and certainly I would consider that that is part of the continuing responsibility of the Federal Reserve—to do just that, and I think we are.

Within that, I certainly think we ought to look at the so-called M1-A situation. I don't—I must report in that connection, having looked at it—have the same degree of faith that that's going to provide an uncontaminated relationship between money and GNP that some of the Treasury analysis may seem to state.

Mr. NEAL. Yes, I agree.

Mr. VOLCKER. But I think we have to look at that.

Mr. NEAL. Thank you Mr. Chairman. Mr. McCollum, the ranking minority Member of our subcommittee.

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

I apologize for being late this morning, Chairman Volcker, for your last appearance before us, which I regret it's your last appearance. We have enjoyed many years now—it's hard for me to think in those concepts, terms—of seeing you here and being able to talk about the important work that the Federal Reserve has done.

I was over in the Iran Select Committee this morning with Admiral Poindexter, and I don't think the two ships are at all the same. I am glad to be over here talking about other subjects right now.

Mr. VOLCKER. Just so I'm not here under false pretenses, I think I have an open invitation from the chairman of this committee to reappear next week.

Mr. MCCOLLUM. Well, keep coming back. Whether you're Chairman or not, you have an open invitation from the vice chairman, in any event, to come back any time.

I'd like to make one comment because I know a lot of discussion has been going on around here about inflation and all. I don't think there's any question this Nation owes Paul Volcker and the Federal Reserve that you've led a debt of gratitude for the pressures that you have put into the system to let us bring down inflation. There's a lot of debate about who contributed what to that. I think there's no question that the Federal Reserve, under your leadership, was the primary moving force to bring down inflation.

But I also think the question of confidence we were talking about is pretty important, and I think the President of the United States, Ronald Reagan, gave you a lot of confidence and a vote of confidence, and the American public did, that allowed this to take place and has allowed the continued growth of this economy to occur in a

pretty steady pattern since the blip that came about about that time.

I don't really think the finger pointing is appropriate. I think credit goes to everybody in this case. I don't think that we need to play politics with the policies that you have been involved with.

I think we should pay respect, and that's what I'm doing, and I think most of us are doing, this morning.

Would you describe for us, Mr. Volcker, what you see as the immediate and pressing agenda of the Federal Reserve as you step down as Chairman? What's the next Chairman going to face most arduously?

Mr. VOLCKER. Well, he faces a whole series of things, I'm afraid. The continuing challenge of fostering stability and an environment in which growth can be sustained is always there. I do think, as I suggested earlier, that's at a particularly critical juncture now when we've had a kind of burst of prices, more or less expected, related to the oil and the external situation.

It's one thing having a temporary resurgence of that sort for 6 months or so. Now do we relapse back to a lower rate of inflation, which we think is important, or does that get built into wages, built into expectations, built into undermining the confidence of which you were speaking? I think that's going to be an issue in the next 6 to 12 months.

Mr. McCOLLUM. Let me interrupt right there and ask this question. I was going to ask you about it, anyway. Is \$22 a barrel sustained over a period of time sufficient, in your opinion, to cause us to have serious pressure problems on inflation?

Mr. VOLCKER. Well, it would be another blip, anyway, on top of what we've had. I don't think \$22 in itself should throw us off course. I think that would be a lame excuse for a resurgence of a continuing inflationary problem, although it would make the handling of this problem that I just described a little more difficult. Obviously \$22 is going to be more difficult to handle because it means another I don't know how many cents at the gasoline pump and in home fuel, or whatever else goes into the price indices. But does it make it impossible? No.

Mr. McCOLLUM. Well, if it goes up to \$30 a barrel, we've got real problems then?

Mr. VOLCKER. That would make it a lot more difficult and create a lot of dislocations.

Mr. McCOLLUM. So we ought to worry about—

Mr. VOLCKER. And whether it goes up to \$30 or not is not independent of what the Federal Reserve and other people are doing to deal with the inflation problem. You are obviously much more likely to go up to \$30 in a burst if there is feeling that we are losing control over the basic inflationary situation than if there is not. So this gets to be a circular process.

Mr. McCOLLUM. You don't see that loss of confidence or that feeling right now, do you? I don't.

Mr. VOLCKER. I do not right now, but we've had too much experience at losing it in the past to be anything but very cautious as we look to the future.

Mr. McCOLLUM. So we should keep our eye on the \$22 a barrel and we should worry about it, but we shouldn't expect that alone to be—

Mr. VOLCKER. Not that alone, no.

Mr. McCOLLUM. The trigger factor for some inflationary spiral?

Mr. VOLCKER. No, no.

Mr. McCOLLUM. Please go ahead. I interrupted you. I had asked you for the pressing agenda that you—

Mr. VOLCKER. Well, we were on inflation. There is a continuing problem—and I won't repeat all I just said about the international debt situation, but that is going to take clearly continuing attention. I wish that international debt situation were not accompanied by continuing strains, pressures, and questions in the internal debt situation, but that would be contrary to fact. There are a lot of institutional strains that exist. The FSLIC is one aspect which is not directly under the surveillance of the Federal Reserve but, nonetheless, affects the environment in which the Federal Reserve and the Board and the new Chairman must act. So there are clearly problems from that direction.

If one projects one's concerns a little further into the future, I think we are at the critical point—I hope we are—in reviewing and deciding upon the basic legislative structure, the basic institutional structure that's going to govern banking and related businesses in the United States.

You know, everyone up here knows, that that institutional structure is outdated, outmoded, being abused both by events and by lawyers finding ways around existing restrictions. We just urgently, and we have for some years in my opinion, need a comprehensive review of that structure. Right now I think we have the opportunity. I happen to think that the legislation before the Congress now will assist that process.

Mr. McCOLLUM. Do you mean what's gone through the Conference Committee, the Banking Committee—

Mr. VOLCKER. Yes.

Mr. McCOLLUM. This bill?

Mr. VOLCKER. Yes, that bill at least moves some direction toward dealing with the immediate emergency with respect to FSLIC and the savings and loans. Also, in my judgment—and I feel this quite strongly—it will help the Congress to deal with the more continuing, fundamental issues.

Mr. McCOLLUM. There's been a debate, Mr. Chairman, down at the White House about whether the President should veto that bill or sign it. Do you have a recommendation for him?

Mr. VOLCKER. Well, that question just arose. Consistent with what I'm saying is I think that bill overall, although there are sections in it that I do not like, overall I think it is constructive. I think it is being fought very hard by certain people that have an interest in exploiting some loopholes in the present banking picture, and they want to get their exploitation further grounded in growth of their particular nonbanks or whatever over the next year or so, but I think that's precisely the reason that adds to the urgency of passing the bill, not vetoing it.

Mr. McCOLLUM. You were doing an agenda, and I interrupted. Is that—

Mr. VOLCKER. Well, I've got at least four items in this agenda. Undoubtedly, there are more, but there are three rather pressing, continuing issues, beginning with the fundamental Federal Reserve responsibility of monetary policy and ending with, I think, a unique challenge to really get to work on this basic structural area.

Mr. McCOLLUM. Let me change the subject slightly. The FED discount rate has been at about 5 percent—it has been 5.5 percent—excuse me—for some time. Its spread below the Federal funds rate has been widening. Would you describe for us the circumstances under which this rate might be changed? I'm not asking you for a prediction or anything like that. Just what are the circumstances under which the 5.5 percent discount rate might be changed?

Mr. VOLCKER. In approaching that question, you always, at the margin at least, have some room for substituting a discount rate change for open market operations or vice versa if you're either easing or tightening at the margin. I would approach an answer to your question by noting that during the spring we debated and considered very actively whether to change the discount rate in an upward direction at the time when we were tightening a bit in the provision of reserves. We did choose initially to restrict reserve provisions somewhat. We held, in effect, a discount rate which maybe carries a little noisier message to the public at large, although it's not necessarily more important. You simply get a clearer announcement. We held that in reserve and decided it was not necessarily desirable in the end, given that we had taken the other action.

We could have chosen, I think conceptually, to have increased the discount rate and tightened up less in terms of open market provision and gotten more or less the same result. In any event, we decided to go ahead with a more restrained reserve provision and then, as we followed events at that time, decided a discount rate change on top of that was not needed or desirable.

Now we were in a situation then, as you recall, when the dollar was giving us some problems and was threatening to move lower; that it was upsetting psychology and interacting with concerns about the cause of inflation. It was in that environment and in the context of a continuing expansion of economic activity, and particularly rather considerable declines in the unemployment rate. So in that environment I think that was a relevant debate and relevant consideration, as we did in the end tighten somewhat.

Those are the circumstances in which obviously I presume that the Federal Reserve might want to consider a discount rate change in the future, if that particular set of circumstances arose again. If you have got a different set of circumstances, you consider the opposite.

Mr. McCOLLUM. The different set being?

Mr. VOLCKER. You've got the dollar stronger at the moment. If you had indications that the increase in commodity prices was subsiding, that other indications of inflation were dissipating, and perhaps a rate of growth in the economy, just to bring in all the considerations more slowly, you would have a different kind of environment. Then, again, you'd have the choice, if you wanted to move, whether you moved by open market operations or the discount rate, given, as you noted, that market rates are a fair amount above the discount rate at present.

If you had a set of circumstances—if, I am talking hypothetically here—if you had a set of circumstances in which you wanted to ease, you might not choose the discount rate right off the top of the shelf because technically you've got other things to do that would bring perhaps market rates into closer alignment with the existing discount rate, but that's a point—

Mr. McCOLLUM. So you ease in other ways is what we're saying?

Mr. VOLCKER. You could ease in another way. It depends upon what kind of a signal you want to give.

Mr. McCOLLUM. One of the reasons I've asked you the question is a lot of times the public finds the Open Market Committee to be a great mystery. It really is not a mystery. You sit there and deliberate. These are factors that you go into, but they just get lost in all of these shuffles and they think the discount rate is the thing, and it is not the thing. It is a major thing, but there's a—

Mr. VOLCKER. No. Well, that is, of course, correct. If you change the discount rate, it's likely to be on the front page and people will interpret that rather directly as an easing or tightening move. That's sometimes a disadvantage; sometimes it's an advantage because if you want to convey that signal, it's a clean-cut way of doing it.

Mr. McCOLLUM. What you're saying, too, is that if you were—and, again, only hypothetical, and I'm about to give my time back here to the chairman—I just want to make sure that there's no public misconception here. If, indeed, there were to be a decision—that's an if—that a slackening of monetary policy were in order, under the present circumstances discount rate lowering would not be the first thing we'd likely to see the FED do, the Open Market Committee do. It would be more likely some other activity; is that not correct?

Mr. VOLCKER. I'm not going to be here, so I don't want to—

Mr. McCOLLUM. I know, but that's—you have other tools and you just told us that, I think. I'm just paraphrasing it.

Mr. VOLCKER. It's quite possible that it would take another form, initially at least.

Mr. McCOLLUM. All right.

Mr. VOLCKER. You could imagine circumstances in which you want to give the signaling effect of the discount rate and do it fairly promptly. It depends upon what kind of a hypothesis you want to make. It's less likely.

Mr. McCOLLUM. Well, again, Mr. Chairman, I have certainly enjoyed having you before us as Chairman of the Federal Reserve System and we look forward to having you as private citizen Volcker back here.

Mr. VOLCKER. I look forward to that as well, Mr. McCollum. Thank you.

Mr. McCOLLUM. Thank you, Mr. Chairman.

Mr. NEAL. Mr. Schumer?

Mr. SCHUMER. I thank the chairman and the Members of the subcommittee for inviting some of us not on the subcommittee but on the Banking Committee to testify.

First, I guess for the 7 years that I have been here, Mr. Chairman, you have truly been, I think, an inspiration to all of us. We'll miss you. In these days when public service seems to be knocked by

everybody, I think you're an example of what is right and what is good about public service. I would just repeat what my colleague from Florida said—I hope you'll come back and be free to give us advice in the future because your voice speaks with an authority that I think is unequaled in the future.

I was interested to hear you say that you would urge the President to sign the FSLIC bill. Could you elaborate on the possible consequences if he didn't?

Mr. VOLCKER. Well, the consequences I think flow in two directions, both of obviously unknown dimensions. The question is: what happens in a sensitive time in terms of both objective events, in terms of psychology and confidence in the savings and loan industry when it is pretty well known that at the moment FSLIC does not have large cash resources to meet demands that could be placed upon it. I think the earlier we have the assurance that those cash resources are either in hand or enroute, the better off we all will be. I think there is a strong argument not to take the risk of that not being the case. So you have that very pressing, immediate problem.

The other one is I really think there is a basic philosophical question involved in this nonbank bank issue. Is the Congress going to decide to lay down a basic rule of the game or reiterate a basic rule that's been common in this country and been accepted pretty much throughout its history—that there's going to be a basic division between banking and commerce. This is not a technical issue. It sounds very technical and everybody, including me, uses this jargon. The question is whether you want to go in the direction of big banks owned by nonfinancial companies. Is that a vision of the banking system that you want?

I think that is basically what is being brought out here. I think the sooner the Congress speaks its voice on that subject, in a sense whatever the answer may be, the better, but I have a strong opinion about what the answer should be. I think it's basically incorporated in that bill.

Now the bill has some baggage on it that I'd just as soon not see. It's got this moratorium on banking powers. I think that's unfortunate in a way, but I am also encouraged by the fact that I think the sponsors of that moratorium who kind of yielded to a lot of lobbying pressure have spoken as loudly and as affirmatively as they can that they don't want that moratorium to be extended after next year, and that they want to use this opportunity in the Senate, and hopefully in the House, for reviewing what needs to be done in the area of modernizing banking legislation.

So I hope that while I have not supported and don't like that provision, it can be a vehicle for sparking action rather than the reverse. I don't know whether it will be or not, but I've got that hope.

Mr. SCHUMER. I would agree with your analysis.

Mr. VOLCKER. There was, frankly, in the bill coming out of the House a very serious problem with some supervisory provisions. My understanding is they have been substantially improved in the conference committee, with Mr. Leach and others taking a very strong, constructive interest in that.

I think that is an area in the bill which might have justified a veto under other circumstances, but my understanding is that has

been improved substantially enough so that I hope that doesn't prove to be the roadblock in the end.

Mr. SCHUMER. Just my one comment: I think you're right about the moratorium. I don't think it will be possible to extent that moratorium again. I think it will be spur for Congress to act.

The second question I have, related to the first: I take it, then, you are not as worried as, say, Assistant Secretary Gould about the size of our banking institutions, that we have to have megabanks the size of some of the others to adequately compete, or is that a real worry? I know he is recommending, and some others, breaking down the wall between banking and commerce for that reason.

Mr. VOLCKER. Well, I'm much more concerned about the quality of our banking institutions than the size of our banking institutions. We have some very large banks. I have no doubt that they should and will grow over a period of time if they are also strong and stable. I do not think our banks have been crippled in competition from an inability to be large enough. Our banks have traditionally been leaders in international banking. In relative terms, I don't think they are as great leaders as they used to be, for obvious reasons. The American economic situation is not as strong. We are no longer big net international lenders. These banks have themselves, unfortunately, not had the strength of balance sheet and capital that promotes as aggressive international expansion as might have been the case some years ago.

Mr. SCHUMER. Related to that, two questions that I think are very important for the future: what would be your advice to your successor about preserving the independence of the Federal Reserve? You touched on the necessity to do that earlier. What would be your advice? That probably is more important than any other of these specific issues.

Mr. VOLCKER. I touched upon that several times this morning, I think before you came in and probably after you came in. I don't know how I would express my advice.

Scratch, fight, complain, whatever is necessary to try to make the point and defend it to the Congress and to the American public in terms of its importance, because I think it is a fundamental bulwark against inflation and toward the stability of not just the economy, but in some sense the country, and certainly the financial system. I don't think it is just a narrow question of inflation, although that's the center of it. I think you need a strong and independent Federal Reserve for supervisory reasons and regulatory reasons as well as for reasons of monetary policy, but certainly I think all of history suggests—not just in the United States, but elsewhere—central importance of a central bank as an institution with a reasonable degree of autonomy.

Mr. SCHUMER. One final question, with the Chairman's indulgence. It's a question I ask really for educational purposes for all of us. You've had a marvelous tenure in your 8 years. What would you regard as your greatest disappointment?

Mr. VOLCKER. I, frankly, think banking legislation comes to mind pretty quickly. It's been a disappointment over a series of years because I think it has been obvious that this area needs to be reviewed; changes need to be made to bring legislation up to date with technology and market developments. We proposed legislation

with the Treasury probably 4 or 5 years ago that I thought was quite constructive in terms of expanding the powers of bank holding companies but in an appropriate framework while maintaining the basic separation of banking and commerce. We haven't moved forward during that period of time significantly. In some respects I think we've moved backward. It has been a disappointment over an extended period of time to see little, or no, or negative movement in that particular area.

So I leave with some hope that maybe this current bill, which is far from a comprehensive bill, will serve the purpose of breaking the logjam and that a year from now my successor will not be disappointed on this score.

Mr. SCHUMER. Thank you, Mr. Chairman.

Mr. NEAL. Mr. Leach?

Mr. LEACH. Thank you, Mr. Chairman.

Well, if this is your last meeting, sir, I think it's incumbent on all of us to express our thanks. I think your career represents the highest in professional public service.

Mr. McCollum mentioned we're in the middle of the Irangate hearings. In a way you have the NSC of domestic monetary policy. I personally think there's not a job in America that has more potential for conflicts of interest and also more implications for secrecy in decisionmaking, and, therefore, there's no job in America where people of high integrity are more important. I think that you have brought that to this position.

I might also say, with regard to the great question of independence of the FED, it is inconceivable to have an independent FED unless we have independent people who have very high honor codes and backbone, and that also is reflected in your leadership. You're one of the few people that run against my own observation that, generally speaking, height is in inverse proportion to intellect, but in this case it seems not to be the case. [Laughter.]

You've been head of the FED in obviously very trying times. On the macro side, you've had high tax cuts plus high spending increases. On the micro side, in the management of the financial community, you inherited a situation where the money center banks were more overextended than in any other period in our history. Partly because of confidence in your leadership, the rest of the world has invested in this country and partly made up our deficit problem. Largely because of your leadership, the banking system has become stronger, not weaker. That is a very impressive accomplishment.

I personally think that the major scandal of our time that exists in the financial community probably relates to the thrifts. Here we have a \$900 billion system that does not have the capital requirements of the banking system. I would say, as you did observe, that having just gone over very carefully the last draft of the FSLIC bill, there have been substantial changes that have been made that will give thrift regulators comparable authority to banking regulators. I personally think that is the most important part of the bill and the most overlooked part of the bill.

Mr. VOLCKER. If I may interject I have not looked at those provisions myself directly, but I take it from your comment that you are



reasonably satisfied with them at this point, which is an important endorsement if that's true.

Mr. LEACH. What the bill included and what I considered to be the most important section, the forbearance section, initially calls for forbearance for all thrifts with less than  $\frac{1}{2}$  of 1 percent capital base and then defined the manner in which that base could be substantially negative, but at every point in which the forbearance calls are made there is a provision, a proviso, that accounting standards and the regulatory powers will be comparable to those in the banking industry. So the forbearance calls remain, but they are profoundly circumscribed.

Mr. VOLCKER. My understanding is the forbearance provisions don't apply if in the judgment of the agency the difficulties really arise from bad management rather than from external—

Mr. LEACH. That is true, but my own sense is the most important issue isn't always management; it's percentages. We have authorized an industry to exist with a negative capital base in many instances, and this will give no excuse whatsoever for any regulator to allow or countenance the growth of an industry where there is no capital base.

In addition, there is a paragraph that has been inserted that refers to the 1983 International Lending and Supervision Act in terms of capital requirements and gives the thrift regulators the power to force capital requirements comparable to the banking agencies.

Frankly, the analogy I use sometimes—and I don't mean to extend this discussion—is that if you have \$10 million, you can start a bank in California with \$120 million in deposits or a thrift with \$2 billion. Unless you have comparable capital requirements, you're going to have a skewed—that's a S-K-E-W-E-D—economy.

Anyway, one of the great theories that is at discussion about this bill and about banking in general is the question of deregulation. In theory we all understand that an economy that's too regulated is likely to become stultified. On the other hand, in the banking area it looks as if lack of attention to regulation in the early 1970s caused an extension of the international banks. Several years later, it looks like it clearly caused an overextension in the thrift industry.

One of the questions I would have is: where do you draw the line between regulation and deregulation? Is the financial community amenable to a total deregulation environment?

Mr. VOLCKER. Total deregulation, no, and I don't think the banking industry has ever been totally deregulated in this country or in other countries. There were times in our history when the State banking system was pretty totally deregulated and it didn't last very long—the days of wildcat banking.

But one of the interesting things one of my colleagues discovered recently was that in the midst of The Wealth of Nations by Adam Smith there is a rather eloquent passage that, regardless of what he says about the rest of the economy, the banking system needs a certain amount of supervision and regulation and public interest. I think that's been the perceived wisdom of not just the United States, but other countries through history by its nature. By the nature of the money creation process, by the nature of the credit

creation process, a certain amount of regulation or supervision in common interest is necessary.

The obvious problem is where to draw the line because we have a lot of unnecessary and outmoded regulation; there is no doubt about it. We want to get rid of the bad regulation and retain what's necessary, largely for safety and soundness reasons, in my opinion.

We graft a lot of other regulation onto these financial institutions simply because they're handy. They have nothing to do with the safety and soundness and economic performance of the institutions. Sometimes that's necessary, but I think we have to be a little cautious about overburdening them, because we have to have a profitable, competitively dynamic system as well. We can't ever forget that. There's no point in regulating or using as a vehicle for monetary policy a system that is so arthritic that it can't survive and that it shrinks in comparison with the rest of the financial system. We want a banking system that's large and important in the total scheme of things. Otherwise, there's no point in regulating it in some sense. That's the balance that has to be maintained. We need a profitable, dynamically active, expanding banking system, and that is one of the tests as to the wisdom of regulation.

If I may just make one other point or repeat one other point that you reminded me of, Mr. Leach, that came up in talking with Mr. Schumer. You were talking about the savings and loan industry and the weaknesses of that industry over a period of time. I have enormous respect for what Chairman Gray did and was trying to do in that area in recent years, but historically I think it's fair to say the Home Loan Bank Board System has in its regulatory area, and in part instructed by the Congress, been perhaps insufficiently independent from the industry that it regulates. While you can do a lot of regulation or deregulation that seems very favorable to the industry in the short run and they're delighted with, the net result is to drive the industry on the rocks. It's not very good from the standpoint of either the country or the industry in the long run.

I simply have a strong conviction myself that the relative independence of the Federal Reserve serves it well in a regulatory guise as well as a monetary policy guise, even though it doesn't make us the most popular bank regulator in the world.

Mr. LEACH. Well, I would concur with that. In fact, one might argue that the current state of thrift industry regulation, which has been extremely tied to Congress, may be the best argument against moving Federal regulatory powers to the Congress, which is sometimes suggested as the palliative to given sets of problems.

Let me just conclude, Mr. Chairman, with the observation that in public life there are a lot of very good public servants, but I just have grave doubts myself that we could conceivably have had 5 years of sustained economic growth if Paul Volcker had not been Chairman of the FED during that period. Thank you.

Mr. NEAL. Thank you.

Mr. Chairman, I am generally suspicious of putting much faith in formulas for conducting public policy as opposed to exercising judgment. But, there is a certain allure in some of these areas. I guess you sense it in the area of any line item veto, an area on which we disagree obviously. But there is another area. It has been

suggested over the years that we might be able to devise some kind of formula for the conduct of monetary policy to assure noninflationary growth. After your many years of working in this area, have you come to have any sympathy at all for any such idea. What is your feeling about that?

Mr. VOLCKER. Well, I do kind of conceptually. When we talk here this morning, if I were in an academic setting, I would have some sympathy for that view because I don't feel very comfortable with a situation that has had to rely as much on personal judgment as has been the case, let's say, in the past few years when we felt the relationships between money and nominal GNP and inflation and real growth were breaking down. We had many other distortions in the economic situation in the United States and worldwide. A lot of weight had to be put on what could be denigrated, anyway, as ad hoc judgment. I don't know if it was all ad hoc but it was certainly judgment.

From time to time things are going to go wrong. Judgments are fallible. If you have a rule that can command public support and provide a kind of rallying point for policy and for action, I think you're way ahead of the game. The problem is: do you have a rule that's reliable enough so you want to put that kind of weight on it?

Mr. NEAL. Correct. That is the question.

Mr. VOLCKER. That's where I fall off the trolley, so to speak, or at least for the last few years. I have not felt sufficiently confident in any rule that I could think of to want to advance it as either a legislative rule or a rule within the Federal Reserve itself to be followed with great faith, because I haven't had that degree of faith.

Now that is partly a matter of particular circumstances at a particular point in time. I think one could conceive of, for instance, an international system that would want properly to put a lot more weight on stability of exchange rates than has been the case in recent years. We put weight on that factor, I think quite rightly, now. But if one looks over the past 8 years, it was not a central purpose of policy, for a variety of reasons.

I think one could conceive of a monetary system—and I would have some sympathy for it—that put a good deal more weight on stability of exchange rates internationally for a variety of reasons, with the implication that that would be a continuing, prominent goal of monetary policy of a semi-rule kind of thought. I'm not going back to the rigidity of the gold standard, which provided a very clear, definite rule, at least in the textbooks. I don't know how clear and definite it was in practice, but certainly clearer and more definite than anything we have now. I don't think we can go anywhere near that far, but some movement in that direction may be a possibility in the future.

Mr. NEAL. I have no idea what your plans are for the future. I have every confidence that you will succeed at whatever you do. I think it would be very useful at sometime when you had the time if you could do what you might consider a definitive piece, of whatever length you think makes some sense, and I would suggest as brief as possible, on this question of inflation. What causes it? When we start to experience it, what do we do about it? I think that we are living with a lot of myths in this area. I think we have for a long time.

I keep returning to this point because there is nothing, it seems to me, more dangerous to a country than to let inflation get out of control. There is nothing more pernicious, more damaging in any way you look at it, whether you look at the short term, especially the long term, whether you look at employment or political stability or any aspect of our economic and political. There is nothing, short of war I guess, that will do more damage than inflation. Dog-gone it, we simply do not have a common understanding of it. That was expressed clearly this morning at this hearing.

Mr. VOLCKER. I don't know whether I can top your concern about inflation, Mr. Chairman. You made a very eloquent statement, which I have a lot of sympathy with. I think since it is in the end a monetary phenomenon and has something to do with the Government, I've always thought—I won't press this upon you—it even has some of the character of a moral issue.

But the difficulty is that, as you well know, a lot of analyses and certainly a lot of political instinct says what you do to preserve stability or deal with inflation has a payoff at a longer time horizon than the perceived difficulty of the measure taken in the short run. How do you deal with that apparent dichotomy?

Any standard, econometric model—ours, anybody's—says if you take action to deal with inflation today, it will have some benefits 3 years from now or 4 years from now, but whatever adverse effects it has are going to be in the next 6 months or the next 9 months. That creates a kind of insidious temptation that I guess has been with us all through human history to look at the next 9 months instead of the next 9 years, and I do think you need some institutional arrangements that help to balance that kind of scale when it comes to making a judgment or following a rule, or whatever, as to what you actually do.

Mr. NEAL. The best way to deal with it is not to let it get out of control in the first place. That is why I keep coming back to the same point. I have been on this committee for over 10 years, and I chaired this subcommittee many years ago. I have stayed on this committee over the years for this one reason that I think is so important. Clearly, I know that others differ with me on my opinion on this subject, but I have certainly come to believe—based on empirical data in our economy over the years—that, as you have just said again, inflation is essentially a monetary phenomenon. And, if you are going to control it, you must keep an eye on money growth. There are all sorts of factors that make that difficult from time to time, but, nevertheless, we must keep an eye on that.

That is why I would urge that, if you could do it, if you could let it be clear somehow that that is your opinion—whatever your opinion is, let it be clear. I know it is going to be something like this. It will be better. It will be more eloquently stated. It will carry more weight, and so on. You have done an outstanding job over the last several years bringing the rate of inflation under control. We have the opportunity now to keep it down. There are going to be enormous temptations, enormous pressures brought to bear to inflate away this debt, or we will run into a little recession at some point here. Inevitably, I think, there will be enormous pressures there to pump out the money to solve that problem. I think you are held in such high regard, your opinion is so valuable to us, that if you could

do a little something on this subject that would help guide us in the future, it would be very valuable and much appreciated.

Mr. Chairman, I want to say I certainly have appreciated the opportunity to work with you over the years. I want to say again how grateful I think the entire country should be to you, and I think they are.

I would like to give you a last opportunity: is there anything that you would like to say in closing? I intend to close the hearing unless my friend, Mr. Leach, wants to say anything else. So I would like to let you have the final word. Is there any parting advice?

Mr. VOLCKER. I don't think I have any particular parting advice or final word. I obviously will be leaving with some mixed feelings. I spent a large part of my life in Washington and in the Federal Reserve and in the Treasury, and I leave with the knowledge there are a lot of problems left out there. You've been concentrating on the central one. I will be watching with interest and I do hope we can remain in contact.

Mr. NEAL. I certainly hope so.

Thank you again for all that you have done for this country. There is no way that we can adequately express the gratitude for what you have done. It has not been easy and you have exercised every great quality I think in a public servant, and I want to thank you on behalf of all of us.

Mr. VOLCKER. We're now exaggerating. [Laughter.]

Mr. NEAL. The subcommittee stands adjourned subject to the call of the Chair.

[Whereupon, at 11:34 a.m., the subcommittee recessed, to reconvene at the call of the Chair.]

APPENDIX

Testimony by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance, and Urban Affairs

House of Representatives

July 21, 1987

Mr. Chairman and Members of the Committee:

I appreciate this, my last, opportunity to appear before you as Chairman of the Federal Reserve Board in connection with the semi-annual review of monetary policy. You have the official Report of the Board of Governors before you and I will be blessedly brief in touching upon some of the main points.

As you know, the economy has continued to grow this year, carrying the expansion well into its fifth year. At the same time, however, the inflation rate has accelerated appreciably relative to the low rate prevailing in 1986.

A change in that direction had been widely anticipated in response to the rebound in oil prices and the depreciation of the dollar. Nevertheless, the size and pervasiveness of the price increases -- which have included many non-energy materials as well as services -- affected the psychology and expectations in financial markets, particularly in April

and early May. Recurrent concerns about the dollar internationally also at times affected the mood of domestic markets, and interest rates rose rather sharply for a time.

Through the early part of the year, Federal Reserve operations placed minimal pressure on bank reserve positions. As reported earlier, however, beginning in late April definite but modest steps were taken to increase reserve pressures somewhat. Perceptions of that action appeared to help calm concerns about the future course of the dollar and inflation.

Most interest rates, long- and short-term, have retraced part of the earlier rise. However, long-term interest rates and prices of sensitive commodities, some of which had been deeply depressed, remain well above their levels of earlier this year.

The approach of the Federal Reserve toward the provision of reserves has not changed since May. However, growth in the



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various monetary aggregates slowed further in the second quarter. A reduction in the rate of growth of those aggregates from the relatively high levels of 1986 had been both anticipated and desired by the Federal Open Market Committee, as reported to you in February. However, it is also true that, with institutional and market developments importantly affecting the relationships between the various measures of money and the variables we ultimately care about, judgments about the appropriate growth of the aggregates have become both more difficult and more dependent on prevailing economic and market circumstances.

For that reason, the Committee did not set forth a particular target range for M1 this year in February. That judgment was reaffirmed at the meeting earlier this month. M2 is currently running below, and M3 around, the lower ends of their 5-1/2 to 8-1/2 percent ranges established in February. The Committee decided not to change those ranges for 1987. In doing so, however, there was agreement that, depending on

further evidence with respect to emerging trends in economic activity, inflation, and domestic and international financial markets, actual growth around the lower ends of those ranges may well remain appropriate.

In judging appropriate monetary growth during the course of the year, or from year to year, account needs to be taken of the apparent increase in the sensitivity of demands for money, and for money-like assets, to absolute and relative changes in market interest rates. Interest rates administered by institutions, especially those on transactions accounts, tend to lag market rates both when interest rates are rising and when they are falling (of course, no explicit interest can be paid on demand deposits). At the same time, the cost and effort involved in shifting funds between types of accounts, or into and out of market instruments, has greatly diminished. Experience suggests that, as a result of these factors, demand deposits, NOW accounts, and money market deposit accounts all tend to grow relatively slowly, if at all, when market rates

are rising (as during the second quarter) but much faster than normally as market rates fall, as during 1985 and 1986. Those differences in growth rates in money will tend to be reflected in inverse movements in the velocity (that is, the measured rate of turnover) of money rather than commensurate changes in economic activity or prices.

That sensitivity of velocity to changes in interest rates makes it more difficult to judge the appropriate rate of monetary growth -- particularly over periods as short as a quarter or a year -- and impossible without reference to the stream of available evidence on economic activity, prices, and other factors. This year, too, concerns about the international performance of the dollar have at times had a significant bearing on operational decisions. Specifically, the tightening of reserve availability in the spring was related in substantial part to the desirability, in the light of the substantial cumulative depreciation over the previous

two years and other economic policy undertakings here and abroad, of maintaining reasonable stability in the external value of the dollar. That judgment is, as you know, shared with the Administration and the finance ministers and central bank governors of other leading industrialized countries.

Looking ahead to 1988, the Open Market Committee decided tentatively to reduce the target ranges for M2 and M3 by 1/2 percent to 5-8 percent. While recognizing the inevitable range of uncertainty I referred to earlier, some reduction in the target ranges clearly appeared appropriate in recognition of the importance of assuring that the temporary bulge in price increases foreseen for this year not become a base for a renewed inflationary process. The appropriate range for 1988 will, of course, again be reviewed with care at the start of the year.

More broadly, policy has to be judged against progress toward the more basic goals of growth and stability -- and it seems to me fatuous to think the first could long be

sustained without the latter. At the same time, now and for some years ahead, we will need to work to narrow and ultimately correct the large imbalances in our internal and external economic positions -- adjustments that necessarily have implications for the policies and prospects of other countries as well. What is at issue is whether we can make those necessary adjustments while sustaining progress toward the broader goals.

In some areas, developments in the past six months have been strongly encouraging in that respect.

-- The evidence by now is pretty clear that, in real terms, our trade balance is improving, even in the face of continuing sluggish growth, high unemployment and excess capacity abroad.

-- While growth in domestic consumption has slowed -- one essential part of the adjustment process -- the expansion of domestic output and employment has been well maintained, and unemployment, at close to 6 percent,

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has dropped to the lowest level in this decade.

Manufacturing has picked up and prospects for business investment may be improving.

- Helped by some large unanticipated capital gains tax receipts, this year's budget deficit will apparently be driven even below earlier expectations, and thus very substantially below the fiscal 1986 level.
- Internationally, leading nations are not only agreed upon the desirability of greater exchange rate stability but appear to be working more effectively to that end.
- In another area demanding a high level of international cooperation, the basic approach for dealing with the international debt problems has continued to be implemented with substantial success despite doubts and challenges by some.

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Of central importance, there has been continuing evidence of restraint and discipline on costs and wages in much of American industry, offering the prospect of lower rates of inflation in the months ahead. Over time, that must be an absolutely essential element in maintaining our international competitiveness as well as in restoring domestic stability after the bulge in prices this year.

At the same time, it would be nonsense for me to claim that all is safely and securely on path. The remaining risks and problems are apparent.

Even the otherwise satisfying fall in the unemployment rate this year implicitly has a discouraging aspect. Outside of manufacturing, the statistics suggest productivity growth is quite dismal -- so slow, in fact, that I cannot dismiss the thought that the reported statistics may partly reflect measurement error.

But no error of measurement can entirely explain away that our private saving, in historical or in international context,

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remains so low, or that our federal deficit remains so large, or that we, the putative leader of the western world, are so dependent on other people's capital. Despite the better news on this year's federal deficit, some projections of future deficits assuming current programs are being raised rather than reduced and the political impasse over doing something about it apparently remains. In the circumstances, the Gramm-Rudman-Hollings targets are threatening to become pie in the sky.

The already slow growth in other industrialized countries appears to have slowed further this year, working against the adjustments needed in trade and current account positions among Japan, Western Europe and the United States. And, in that environment the dangers of protectionist trade legislation and a breakdown in the servicing of international debts are enlarged.

For all those reasons and more, my very able successor, and the Federal Reserve generally, will have challenge aplenty.



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But, I, as I have spelled out earlier, would like to think there is something upon which to build as well.

Finally, Mr. Chairman, I would like to acknowledge specifically the usefulness from my standpoint of these regular semi-annual hearings on monetary policy.

You and I are both conscious of the special position of the Federal Reserve System within the overall framework of government. The long terms of members of the Board of Governors, the participation of the Regional Federal Reserve Banks in the policy process, our budgetary autonomy, and the professionalism of our staff are all designed to provide some insulation, in deciding upon money creation, against partisan or passing political pressures.

In our system of government, however, insulation cannot be equated to isolation, and particularly isolation from reporting and accountability to the Congress and to the public.

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These hearings are an important element in that discipline.

I have welcomed the opportunity they have provided for us to consult with the Congress, and to explain our purposes, our approaches, and our problems in dealing with a complicated, changing economic environment. And I want to express my appreciation as well for the many courtesies you have extended me personally over these past eight years as we have worked together to foster economic stability and growth.

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**For use at 9:30 a.m., E.D.T.  
Tuesday  
July 21, 1987**

**Board of Governors of the Federal Reserve System**



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**Monetary Policy Report to Congress  
Pursuant to the  
Full Employment and Balanced Growth Act of 1978**

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**July 21, 1987**

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## Letter of Transmittal

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**BOARD OF GOVERNORS OF THE  
FEDERAL RESERVE SYSTEM**  
Washington, D.C., July 21, 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 and 1988

The economy expanded at a somewhat accelerated pace in the first half of 1987, and the civilian unemployment rate declined over the period to 6.1 percent in June, the lowest level in this decade. Moreover, the pattern of activity has exhibited encouraging signs that a turnaround in the trade sector is under way. An improvement in net exports in real terms appears to be providing a lift to activity in the industrial sector, offsetting slower growth of domestic spending and sustaining a moderate rise in overall domestic production. However, the process of restoring balance to the U.S. external accounts has involved a sizable increase in the prices paid for imported goods. These price increases have occurred at the same time that a rebound in world oil prices was carrying inflation rates above last year's modest pace.

Although some of the elements necessary for sustaining economic growth are now beginning to fall into place, the economic outlook continues to be clouded by a number of imbalances, risks, and uncertainties. The experience of the first half underscored, in particular, the dangers associated with a loss of market confidence in the dollar and the related potential for a rekindling of inflation expectations. The Federal Reserve, in implementing monetary policy, was sensitive to these dangers, while it continued to provide support for sustainable economic growth. During the first part of the year, growth in money and credit slowed from the rapid pace of 1986, even though pressures on the reserve positions of depository institutions remained mild. Those pressures were increased somewhat in late April and May, however, as the dollar fell sharply against other key currencies,

inflation expectations flared up, and long-term interest rates jumped to higher levels. In response to these steps, and to complementary policy actions taken abroad, the dollar has stabilized, and interest rates have retreated somewhat from their May highs.

If the nation is to achieve an orderly transition to better external balance, one marked by a minimum of financial or inflationary pressures, responsible action by many parties—in addition to the Federal Reserve—will be necessary. Further progress in reducing our federal budget deficit is essential: a failure to achieve this often-stated objective could only damage confidence in our ability to deal with our economic problems and contribute to imbalances in financial markets and the economy. In addition, satisfactory growth in the other major industrialized countries is crucial, as are efforts on all sides to maintain and improve the openness of the international marketplace. The private sector also must play a constructive role by remaining sensitive to wage and price practices that promote the international competitiveness of American business.

#### Economic and Financial Background

The economic expansion has now progressed well into its fifth year. Real GNP rose at a 4-3/4 percent annual rate in the first quarter. However, much of the increase in production reflected a rebuilding of business inventories that had been drawn down late in 1986, and real GNP appears to have increased at an appreciably more moderate pace in the second quarter. Nonetheless, growth remained strong enough to sustain a downtrend in unemployment.

Beneath these solid gains in aggregate economic activity have been welcome improvements in the fortunes of sectors that have failed to partici-

pate in the increasing prosperity of the past several years. As suggested above, the most significant development has been the emerging improvement in the nation's trade performance, which has begun to close the gap between the pace of growth in the industrial sector and the rest of the economy; indeed, some segments of manufacturing have reached relatively high levels of capacity utilization and strong profitability. Economic strains also appear to be easing in other troubled sectors. Oil-well drilling, while still at depressed levels, has turned up as a consequence of the firming of world oil prices. Agricultural income was quite high last year, although it continued to be heavily dependent on government support; farmland values seem to have stabilized, and the amount of delinquent farm loans has begun to decline.

While the external sector has been strengthening, in real terms, in recent quarters, growth in domestic demand has moderated considerably. To some extent, the slower rise in household and business purchases in the early months of this year was a reflection of the acceleration that had occurred at the end of 1986, motivated by tax considerations. However, consumers, in particular, have shown signs of less exuberance in their expenditure patterns after a period of several years in which their willingness to spend increasing proportions of their income provided considerable thrust to business activity. A moderation of domestic spending growth is, of course, a fundamental ingredient in achieving better external balance without putting excessive strains on available resources.

A key element in the recent trade developments has been the steep drop in the foreign exchange value of the dollar—almost 40 percent on a trade-weighted basis against other G-10 currencies—since early 1985. That decline,



in conjunction with notable restraint on labor costs, has greatly enhanced the competitiveness of U.S. producers in international markets. At the same time, though, the depreciation has caused prices of imported goods to increase--sharply in some cases--and exacerbated a bulge in prices coming from higher energy costs. The rise in consumer prices, averaging more than 5 percent at an annual rate over the first five months of this year, was a disturbing departure from recent experience. Moreover, as the dollar exhibited continued weakness in the early spring, and with progress toward improvement in the U.S. current account slower than many had anticipated, concerns mounted about inflation prospects. This was reflected for a time in rising prices of precious metals and other actively traded commodities, an event that only served to reinforce the inflation fears that simultaneously were unsettling U.S. securities markets.

In these circumstances, and with the economic advance evidencing reasonable momentum, the Federal Reserve in late April and May adjusted its open market operations to impose a somewhat greater, but still quite limited, degree of pressure on the reserve positions of depository institutions. This step was reassuring to the markets. Coupled with complementary actions by monetary authorities abroad and more favorable news on prices and U.S. merchandise trade flows, the firming of money market conditions contributed not only to a turnaround in the dollar on exchange markets but also to a rally in bond prices. On balance, however, short-term interest rates currently are about one-half percentage point above their levels at the time of the Board's February monetary policy report to the Congress, and long-term rates are up about a full percentage point.

The rate of growth of the money stock measures M2 and M3 has been well below that of last year and close to, or below, the lower end of the target ranges adopted in February. This has been viewed as acceptable by the Federal Open Market Committee (FOMC), given the inflation and exchange rate developments described above, as well as indications of greater than anticipated strength in the velocity of money (that is, the ratio of nominal GNP to money). M2 rose at an annual rate of only 4 percent between the fourth quarter and June, appreciably below the 5-1/2 to 8-1/2 percent growth range for the year, while M3 grew at a 5-1/4 percent rate, a shade below the lower bound of its identical range.

The marked deceleration of monetary growth, and accompanying rise in M2 and M3 velocity after two years of decline, reflected a variety of influences. Some unwinding of the buildup in balances that occurred late last year in connection with a huge volume of tax-related transactions may have been involved; tax reform also may have damped growth in money as individuals reduced their additions to deposit holdings rather than using consumer credit, on which interest is no longer fully tax-deductible. Capital constraints on the growth of bank and thrift institution assets may have limited the depositories' efforts to seek funds, an effect likely to express itself most fully at the level of M3, which encompasses a broad range of depository-institution liabilities.

But it is another factor that appeared most important, particularly in the case of M2. Changes in deposit rates have lagged changes in market rates—a behavior exhibited quite consistently in the period since most restrictions on deposit rates were removed. With market rates rising,

financial assets other than those included in M2 became relatively more attractive to the public, the opposite of developments in 1985 and 1986. This same phenomenon, reinforced by the normal downward adjustment of compensating balance requirements as rising interest rates enable banks to earn more on business demand deposits, had a marked effect on M1 growth as well, which slowed to a 10 percent annual rate between the fourth and second quarters (and a 7-3/4 percent rate between the fourth quarter and June); M1 velocity appears to have changed little in the second quarter, after more than two years of steep decline.

Reflecting in large part the diminution of the federal deficit and a slowing in state and local government borrowing, influenced by the Tax Reform Act, aggregate credit expansion in the economy has slowed noticeably this year. The debt of domestic nonfinancial sectors is estimated to have expanded at about a 9-3/4 percent annual rate through June, still high relative to the growth of nominal GNP, but less rapid than in the past several years and within the 8 to 11 percent monitoring range specified by the Federal Open Market Committee.

#### Ranges for Money and Credit Growth in 1987 and 1988

At its meeting earlier this month, the FOMC did not change the 1987 ranges for money and credit growth that it had established in February. As indicated at that time, operating decisions will continue to be made not only with due regard to the behavior of these aggregates, but also in light of evidence on emerging trends in economic activity and inflation and developments in domestic and international financial markets. At this juncture, given the actual growth achieved in the first half, it seems likely that,

absent major movements in interest rates that alter the incentives to hold monetary assets, expansion in M2 and M3 around the lower ends of their 5-1/2 to 8-1/2 percent annual ranges may well be appropriate. Indeed, should the recent tendency toward a strengthening in velocity, which has been particularly noticeable in the case of M2, persist, or if inflationary pressures appear to be mounting, some shortfall from the annual ranges might well be appropriate. With regard to the domestic debt aggregate, the FOMC anticipated that the slower pace of debt growth in the first half would continue and that the aggregate would end the year well within the 8 to 11 percent monitoring range.

Consistent with the objective of maintaining progress over time toward general price stability, while supporting sustainable growth in economic activity, the FOMC decided to adopt on a tentative basis lower growth ranges for money and credit in 1988. The target growth ranges for M2 and M3 were reduced 1/2 percentage point, to 5 to 8 percent, measured from the fourth quarter of 1987 to the fourth quarter of 1988. At the same time, the monitoring range for growth of nonfinancial sector debt also was tentatively reduced by 1/2 percentage point, to 7-1/2 to 10-1/2 percent.

Ranges of Growth for Monetary and Credit Aggregates  
(Percent change, fourth quarter to fourth quarter)

	<u>1987</u>	<u>Tentative for 1988</u>
M2	5-1/2 to 8-1/2	5 to 8
M3	5-1/2 to 8-1/2	5 to 8
Debt	8 to 11	7-1/2 to 10-1/2

The Committee noted that M1 has continued to exhibit considerable sensitivity to changes in interest rates, among other factors, as illustrated by its sharp deceleration in the first half of this year. In view of this, and the still-limited experience with the behavior of deregulated transactions accounts, the Committee decided not to set a specific target range for M1 for the second half of 1987, and no tentative range was adopted for 1988. In its policy deliberations over the remainder of the year, the FOMC will take account of M1 growth in light of the behavior of its velocity, incoming information about the economy and financial markets, and the degree of emerging price pressures.

#### Economic Projections

As noted above, the Committee believes that the monetary objectives that it has set are consistent with restraint on inflation in the context of continued moderate growth in economic activity and progress toward a sustainable external position. As is indicated in the table on the next page, the central tendency of the forecasts of Committee members and other Reserve Bank presidents is for growth in real GNP of 2-1/2 to 3 percent in 1987 and 1988. Between now and the end of next year, this pace of activity is expected to generate jobs in about sufficient number to match the expansion of the work force. Consequently, the civilian unemployment rate is not expected to change appreciably from the 6-1/4 percent average of the second quarter, although recent experience suggests that the projected growth of real GNP might lead to somewhat lower unemployment.

Real net exports of goods and services are expected to strengthen further while the growth of domestic demand remains relatively subdued. The

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improved competitive position of U.S. producers resulting in large part from the dollar depreciation of the past two years has only begun to be reflected in trade flows, and further improvement in the nation's external position should be realized in coming quarters. Household spending is expected to grow slowly, but stronger increases in business investment, especially in equipment, are anticipated as industrial firms respond to more favorable sales trends.

## Economic Projections for 1987 and 1988\*

	<u>FOMC Members and Other FRB Presidents</u>	
	<u>Range</u>	<u>Central Tendency</u>
	-----1987-----	
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	5-3/4 to 7-1/4	6-1/4 to 7
Real GNP	2 to 3-3/4	2-1/2 to 3
Implicit deflator for GNP	3 to 4-1/4	3-1/2 to 4
Average level in the fourth quarter, percent:		
Civilian unemployment rate	6.1 to 6.5	6.2 to 6.4
	-----1988-----	
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	5 to 8	5-3/4 to 7
Real GNP	1 to 3	2-1/2 to 3
Implicit deflator for GNP	2-1/2 to 5	3-3/4 to 4-1/4
Average level in the fourth quarter, percent:		
Civilian unemployment rate	5.9 to 6.8	6 to 6.5

\*The Administration has yet to publish its mid-session budget review, but spokesmen have indicated that earlier forecasts will be revised. As a consequence, the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

Prices, as measured by the implicit deflator for GNP, are expected to rise 3-1/2 to 4 percent over the four quarters of 1987--slightly more than the central tendency range reported to the Congress in February. For 1988, projections of the increase in the GNP deflator center on 4 percent. Assuming world oil prices are more stable, there should be no repetition of the rebound in domestic energy prices that raised the general rate of inflation earlier this year. However, the acceleration in prices of non-oil imported goods that is occurring in the wake of the decline in the foreign exchange value of the dollar likely will continue for a time to provide some impetus to inflation, even if the dollar is more stable over the period ahead, as assumed. The size of further increases in import prices resulting from the depreciation to date will depend on the aggressiveness with which foreign exporters and U.S. distributors seek to restore profit margins that have been squeezed in the past two years. The view that inflation next year will not rise significantly from the pace projected for 1987 is grounded in a belief that recognition of the potential for losses of market share and job opportunities will continue to influence wage- and price-setting behavior.

While restraint on inflation is crucial in achieving an orderly adjustment as our massive external imbalance is corrected, so too is continued progress in reducing the federal budget deficit. Inflows of foreign capital will shrink in step with the reduction in our current account deficit, and in that context excessive federal borrowing requirements, as they put pressure on financial markets, pose a threat to the ability of our economy to fund necessary private capital formation.

Finally, the members of the Committee and other Reserve Bank presidents also view the prospects for a healthy U.S., and world, economy as depending significantly on the avoidance of further protectionist measures here and abroad and on satisfactory economic growth in other major industrial countries.



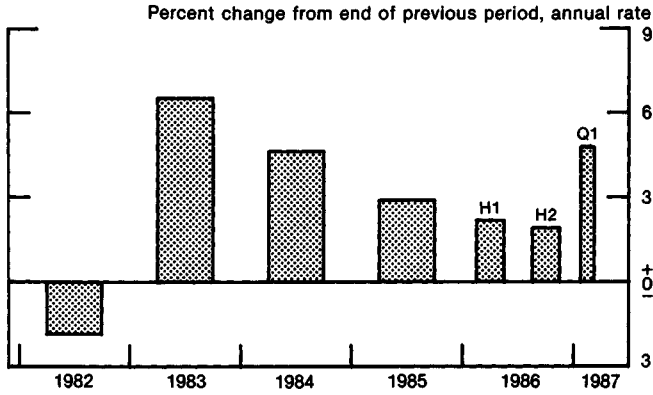
Section 2: The Performance of the Economy During the First Half of 1987

The economy continued to expand in the first half of 1987, and, in contrast to the pattern of the preceding four years, the composition of activity appeared to be moving toward a better balance between domestic spending and domestic production. The overall growth in output during the first six months of the year led to a net gain in jobs of around 1-1/4 million, a faster pace of hiring than during 1986. Moreover, the civilian unemployment rate, which had hovered close to 7 percent throughout most of last year, moved down to 6.1 percent by June.

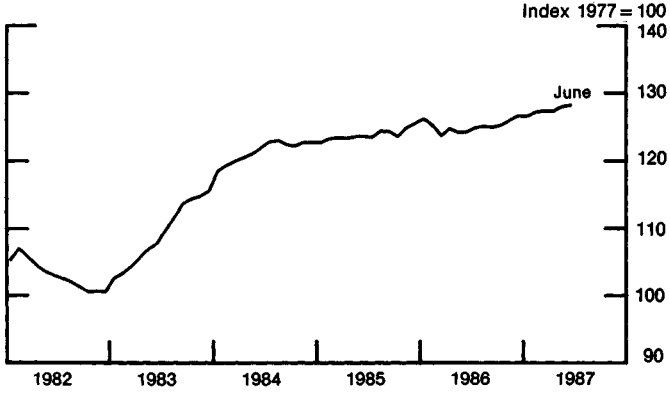
Inflation picked up early this year, with most broad indexes of prices posting increases substantially above those of the past several years. In large part, the acceleration reflected developments in oil markets, where prices have retraced part of last year's decline. But rising prices for other imported goods also began to surface at the retail level, and, at the producer level, prices paid for raw materials and other supplies clearly turned up. Wage trends, however, have remained both stable and restrained.

Higher inflation rates have been, in part, a consequence of the ongoing adjustment of the U.S. economy to a lower foreign exchange value of the dollar. Prices of non-oil imports, particularly for finished consumer goods and capital equipment, have been rising at rates in excess of domestic prices in recent quarters, damping the demand for imported goods. At the same time, goods produced in the United States have become more competitive in world markets. The volume of exports, which began to pick up noticeably in the second half of 1986, continued to expand in early 1987, although the rebound likely has been limited by slow economic growth abroad.

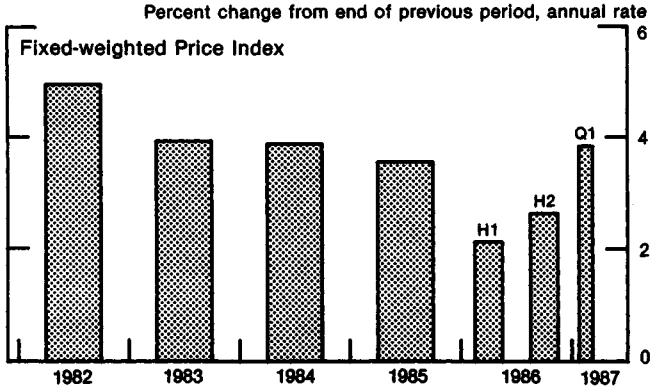
**Real GNP**



**Industrial Production**



**GNP Prices**

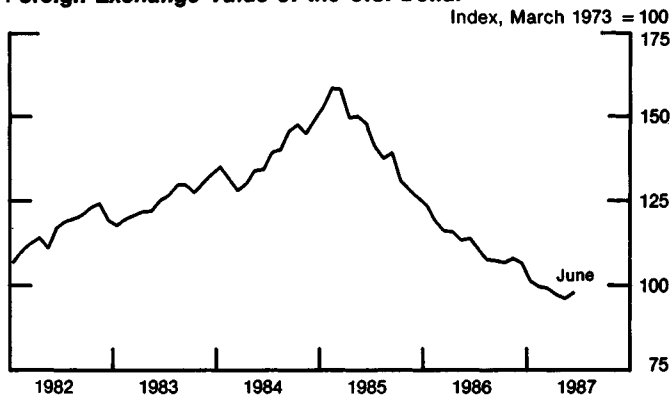


Toward the end of 1986, some manufacturing industries--notably those producing textiles, apparel, steel, chemicals, and paper--began to experience a firming in demand apparently associated with improved trade conditions. In the first six months of 1987, production of office equipment and some other high-tech capital goods as well as several categories of industrial machinery also picked up. Moreover, domestic energy output stabilized, after having been a serious drag on industrial production last year. On the whole, the pace of activity in the goods-producing sector moved back into line with the overall rise in GNP. The index of industrial production increased at a 3 percent annual rate between the third quarter of 1986 and the second quarter of 1987, after little change during the preceding year.

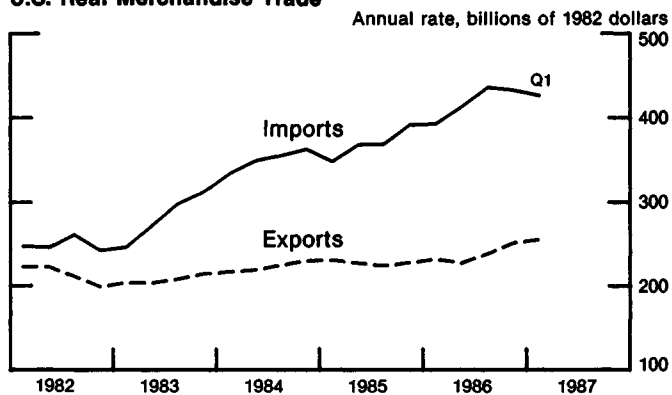
#### The External Sector

The dollar depreciated further against other major currencies in the first half of 1987, with most of the adjustment concentrated in one episode early in January and in another during a period of unsettled markets in the early spring. Since mid-May the dollar has retraced part of its recent decline, but, on a trade-weighted basis against other G-10 currencies, remains about 6 percent below its average level in December 1986, and almost 40 percent below its peak in February 1985. The underlying downward pressure on the dollar during the first half was fueled by perceptions that progress in reducing the U.S. current account deficit had been slow and by disappointment concerning prospects for policy adjustments, here and abroad, aimed at restoring better balance in the world economy. An offsetting factor until recently was the widening of interest rate differentials between the United

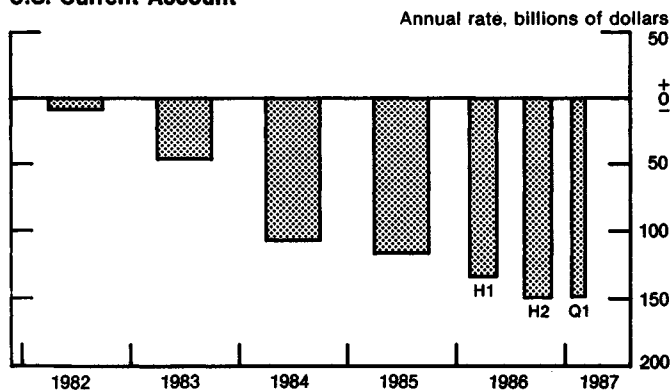
**Foreign Exchange Value of the U.S. Dollar \***



**U.S. Real Merchandise Trade**



**U.S. Current Account**



\* 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.

States and the other major industrialized countries, as rates rose in the United States while declining abroad.

The U.S. current account deficit stood at just under \$150 billion in the first quarter of 1987, little changed, in nominal terms, from the deficit in the second half of 1986. The volume of merchandise imports of goods other than oil has been about flat in recent quarters, after rising steadily for three and one-half years. Demand has leveled off for a wide range of imported industrial materials, consumer goods, and capital equipment. This adjustment, however, occurred as dollar prices for these goods began to pick up, and, thus, the value of non-oil imports has continued to edge higher. Demand for imported petroleum products dropped back early this year, but with world oil prices higher, the U.S. oil import bill stayed at about its 1986 level.

At the same time, the expansion in the volume of merchandise exports that began in mid-1986 extended into early 1987. The improvement in foreign sales has been broadly based; in particular, shipments abroad of industrial materials and capital goods, which account for the bulk of U.S. merchandise exports, both were up about 10 percent in real terms in the first quarter from the average in the first half of 1986. The volume of agricultural exports also firmed somewhat recently, as sharply reduced support prices appear to be combining with the lower dollar to boost foreign demand for some U.S. farm products.

The adjustment in the U.S. trade position to date has occurred without much impetus from economic expansion abroad. Growth of real GNP in other industrial countries averaged less than 2-1/2 percent last year; more-

over, economic activity began to slow in the second half of the year, and, at least in Europe, the weakness continued into early 1987. Export and import volumes in Europe and Japan have begun to adjust to the exchange rate movements of the past two years, cutting into the growth generated by their external sectors. While growth in domestic demand has been maintained above the rate for domestic production, it, too, has slowed and has not taken up the slack from a weak external sector.

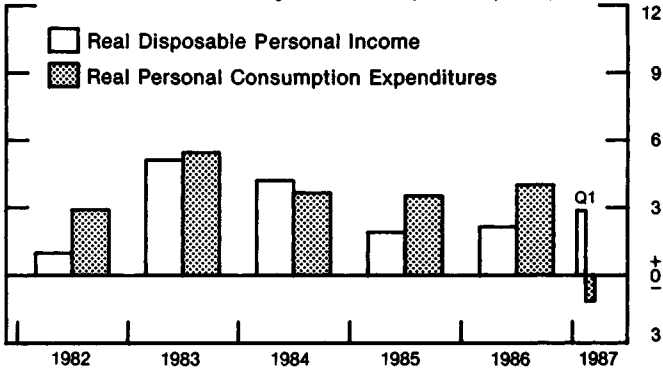
Outside of the industrial countries, average growth last year was quite uneven and, on balance, provided only a limited offset to slower economic activity in Europe and Japan. Weakness in oil markets held down OPEC growth while the newly industrialized countries in Asia continued to expand strongly. In Latin America, which is an important market for U.S exports, output rose close to 4 percent for a third year, a marked turnaround from the 1982-83 period when the onset of external financing difficulties seriously disrupted trade. Internal pressures to maintain reasonably strong growth persist in these countries; such growth could be facilitated by an improved performance of the industrial economies as a group.

#### The Household Sector

Consumer spending weakened considerably in the first half of 1987, after three years in which real gains averaged 3-3/4 percent per annum. In particular, households cut back sharply their purchases of durable goods and outlays for nondurables flattened out; spending for services, however, continued to trend up. Slower sales of new automobiles contributed importantly to the overall deceleration in consumer spending. During the first half, sales of new cars averaged 10 million units at an annual rate, down

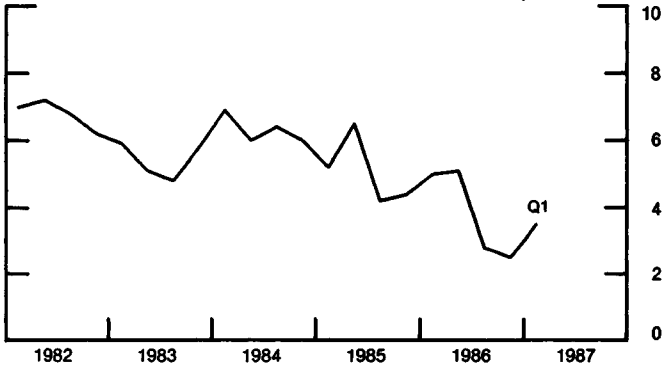
**Real Income and Consumption**

Percent change from end of previous period, annual rate



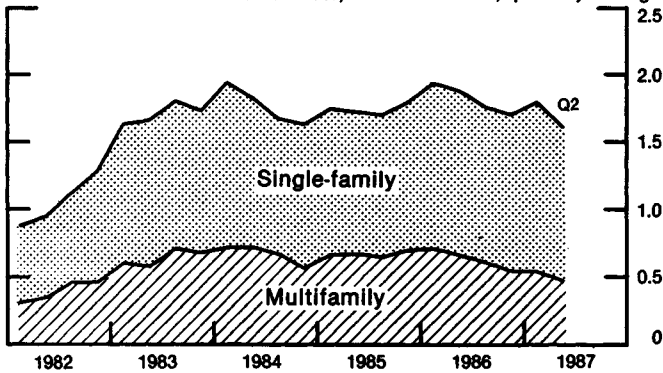
**Personal Saving Rate**

Percent of disposable income



**Private Housing Starts**

Annual rate, millions of units, quarterly average



from a record 11-1/2 million units in 1986. The slackening in demand was most noticeable for domestic makes and persisted despite the continuation of special incentive programs on a wide range of models.

The deceleration in consumer outlays, especially for durables such as motor vehicles, furniture, and home appliances, followed a period of several years during which a variety of factors were working to encourage households to increase their holdings of big-ticket items: relatively moderate increases, or even decreases, in the prices of many home goods; declines in interest rates; and pent-up demands from the period of economic weakness in the early 1980s. As those influences dissipated, and with the personal saving rate reaching an historically low level by late 1986, consumers apparently became more cautious in their buying patterns. Nonetheless, survey evidence still suggested that households' evaluations of market conditions for major purchases and of their personal finances remained generally positive.

During the first five months of 1987, growth in nominal disposable income picked up from its 1986 pace; but, with consumer prices rising more rapidly, income growth in real terms was little different from the 2 percent pace of the preceding two years. However, the aggregate balance sheet of the household sector showed further improvement early this year. Asset holdings were bolstered especially by gains in stock prices, while debt accumulation slowed. Growth of mortgage debt dropped back from the extraordinary pace of late 1986, despite the popularity of home equity loans, and growth of consumer credit dropped sharply. To some extent, the deceleration in consumer debt,



as well as the slowdown in spending on durable goods, may be a consequence of the rapid rise in household debt burdens during the past several years. In addition, the new tax law diminished the incentive to finance expenditures with installment credit. Despite the slower growth of consumer and mortgage debt, some indicators suggest that a considerable number of households still are having problems servicing existing liabilities. Although some loan delinquency rates dropped a bit, others rose in the first quarter, as did personal bankruptcies.

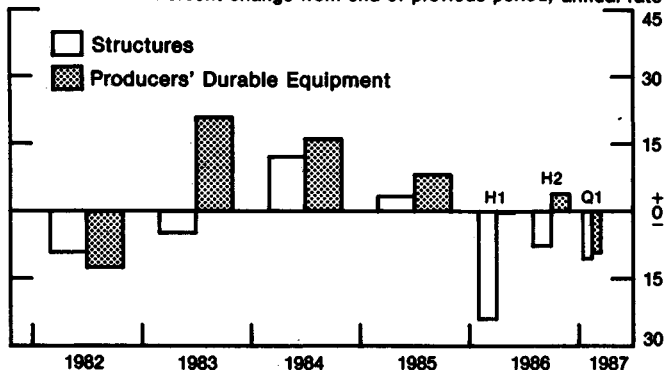
Spurred by a decline in mortgage interest rates, which reached a nine-year low at the end of March, starts of new single-family homes averaged 1-1/4 million units at an annual rate from January through April, the highest level since the late 1970s. Sales of single-family homes, which had been boosted by tax considerations at the end of 1986, also remained brisk through April. Subsequently, the backup in mortgage rates to early-1986 levels resulted in some reduction in single-family homebuilding, to around the pace that prevailed last fall. In the multifamily market, the downtrend in activity that began in early 1986 continued through the first half of 1987. In the second quarter, multifamily starts were one-third below last year's peak. Despite the adjustment thus far to overbuilding and the reduced after-tax profitability of multifamily housing investment, rental vacancy rates nationwide are still close to record highs.

#### The Business Sector

Business spending on plant and equipment fell sharply in the first quarter of 1987. For equipment, the weakness was concentrated in January and followed a tax-induced bunching of purchases in late 1986. In subsequent

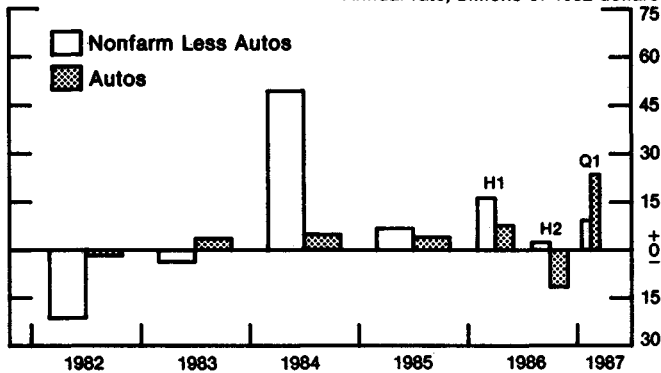
**Real Business Fixed Investment**

Percent change from end of previous period, annual rate

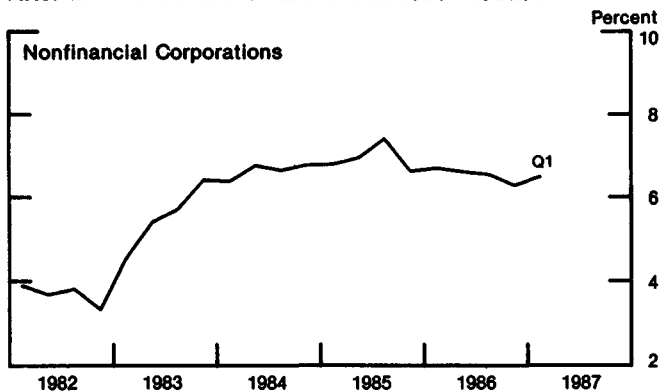


**Changes in Real Business Inventories**

Annual rate, billions of 1982 dollars



**After-tax Profit Share of Gross Domestic Product \***



\* Ratio of profits from domestic operations with inventory valuation and capital consumption adjustments to gross domestic product of nonfinancial corporate sector.

months, shipments of nondefense capital goods recovered, leaving the average level for April and May, in nominal terms, 1-3/4 percent above the third quarter of last year. New orders for nondefense capital goods also dipped at the beginning of the year, but then strengthened noticeably as bookings for aircraft and for office and computing equipment rose sharply. The recent level of orders appears consistent with a continuation in the near term of the moderate uptrend in spending on equipment that has prevailed over the past two years. According to private survey responses concerning business capital spending plans for the year as a whole, firms still intend to direct the bulk of these purchases toward modernization and cost-saving improvements in their production lines.

In contrast, the environment for expansion of plant facilities and office space is still generally unfavorable. Large amounts of vacant and underused space in both office buildings and factories began to take a toll on nonresidential construction last year. And, less favorable treatment of commercial structures under the new tax code reinforced the tendencies toward a lower level of activity in this sector. As a result, spending for commercial and industrial buildings dropped further in the first quarter of 1987, to a level about 20 percent below a year earlier. The decline in spending for these types of buildings accounted for the overall weakness in nonresidential structures early this year, in the face of an upturn in oil drilling and some increases in other categories.

A sizable swing in business inventories around the turn of this year was associated with sharp, tax-induced fluctuations in sales. The surge in consumer and business spending at the end of 1986 was met to a

considerable extent by drawing down stocks, which were then rebuilt at the beginning of this year. This spring, inventory-sales ratios generally were not indicating serious imbalances, with the notable exception of the auto industry. Domestic car makers boosted production in early 1987 in excess of slackening sales, leading to a substantial backlog of unsold cars on dealer lots. By June, a scaling back of assemblies had stemmed further accumulation, but the industry entered the summer with stocks that were quite large by historical standards.

Before-tax profits of nonfinancial corporations, which had slipped a bit relative to GNP since 1984, rose in the first quarter. After-tax profits relative to GNP were up as well, although the rise was damped by increases in corporate tax liabilities associated with the new tax law. Corporations paid out a slightly larger share of earnings as dividends in the first quarter; nonetheless, internally generated funds remained sizable relative to investment outlays.

#### The Government Sector

A substantial reduction in the federal budget deficit for fiscal year 1987 appears in train, with the most recent estimate from the Congressional Budget Office at \$161 billion, compared with \$221 billion in fiscal 1986. Growth in receipts has been extremely rapid; this reflects, in large part, a one-time surge in tax payments this April from individuals who realized capital gains last December, taking advantage of lower tax rates under the old tax code. But more fundamental progress in reducing spending growth also appears to have been made in the wake of the Gramm-Rudman-Hollings legislation. Total outlays have been rising at a rate of around 2 percent

in the current fiscal year, a marked slowing from 8 percent per year during the preceding five years. Although entitlements spending is still increasing steadily, agricultural support payments and interest outlays have leveled off. Moreover, military spending has begun to respond to reductions in defense authorizations and has slowed to about half its 1986 rate of increase. In addition, there has been continued budgetary restraint on discretionary domestic programs. On balance, these developments have held down the growth of federal purchases, which account for about a third of total federal expenditures; excluding changes in farm inventories held by the Commodity Credit Corporation, real federal purchases were little changed between the second quarter of 1986 and the first quarter of this year.

Real purchases of goods and services by state and local governments rose at a 4 percent annual rate in the first quarter of 1987, close to the brisk pace of the past several years. The growth in outlays continues to be boosted by efforts to upgrade basic infrastructures. This rise in spending has outpaced growth in receipts, however, and the sector's combined operating and capital accounts (that is, excluding social insurance funds) moved into deficit in the first quarter of this year. In many instances, a current deficit does not signal any fundamental financial problem, as capital expenditures are financed through bond issues. Nonetheless, a good many units are experiencing a degree of difficulty, with oil-producing states under the most stress. Many states are responding with plans to trim their general funds budgets; some are considering tax increases or are planning to retain the extra receipts generated by changes in federal tax laws.

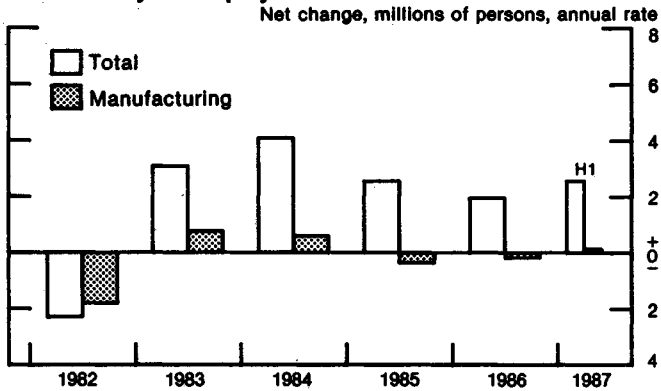
Labor Markets

Employment accelerated early in 1987, and, despite a slowing in recent months, the average monthly increase in nonfarm payroll employment of just over 200,000 so far this year exceeds the pace of hiring in 1986. The improvement in labor demand has been fairly broadly based. In manufacturing, a two-year string of cutbacks in durable goods industries ended late last year, and hiring picked up a bit in the nondurable goods sector. As a result, factory employment, overall, edged higher over the first six months of 1987. In addition, the number of jobs in oil and gas extraction stabilized after the sharp retrenchment in 1986. At the same time, the expansion of jobs in the trade, services, and finance industries, despite some recent slowing, remained sizable.

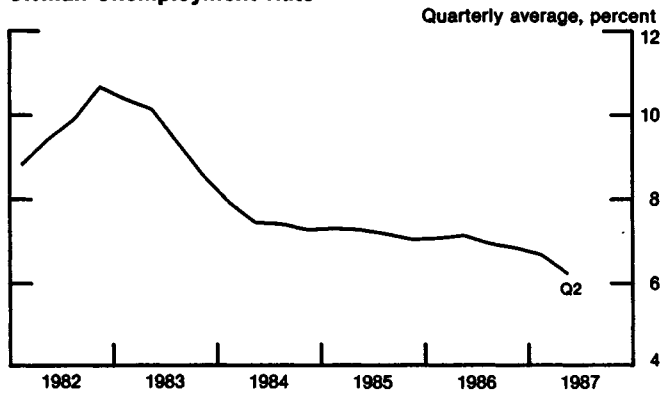
The combination of strong gains in employment and declining numbers of unemployed workers over the first half lowered the civilian jobless rate to 6-1/4 percent on average in the second quarter from just under 7 percent at the end of last year. The rate for adult men (aged 25 years and over), which had been stuck at around 5-1/2 percent from mid-1984 to late 1986, moved below 5 percent this spring; further improvement also occurred for adult women, whose unemployment rate in the past year has moved below that of their male counterparts.

Despite falling unemployment, available measures of labor compensation showed little sign of acceleration early this year. Hourly compensation, as measured by the employment cost index, rose 3.1 percent in the 12 months ending in March, the same as the year-over-year changes in the second half of 1986 and down nearly three-quarters of a percentage point from a year

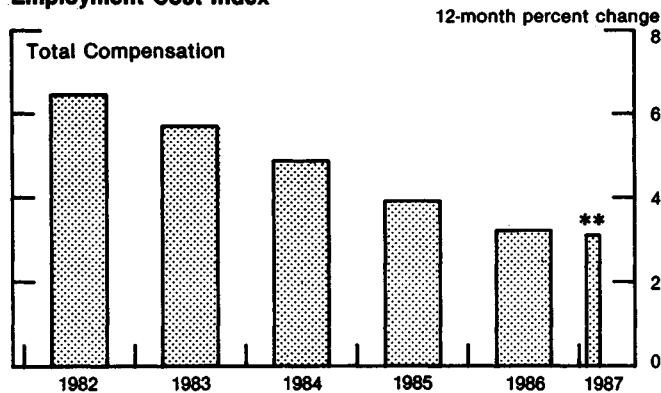
**Nonfarm Payroll Employment**



**Civilian Unemployment Rate**



**Employment Cost Index \***



\* Employment cost index for private industry, excluding farm and household workers.

\*\* Percent change from March 1986 to March 1987.

earlier. A wide gap persisted between the size of pay increases for white-collar workers and those in blue-collar occupations. Nonetheless, the slowing in wage inflation compared with a year earlier was relatively widespread by industry and occupational group. An exception is the Northeast region where wages showed no deceleration in the year ending in March and increases were still outpacing those in other parts of the country by a sizable margin.

The moderation in hourly compensation increases has been the principal factor holding down labor costs, as productivity continues to be quite sluggish. After declining in the second half of 1986, output per hour in the nonfarm business sector rebounded in the first quarter of 1987, but remained little different from its year-earlier level. Since 1984, productivity gains in the nonfarm business sector have averaged less than 1 percent per year. The trend has been much more favorable in the manufacturing sector, where firms apparently have had some success in their efforts to boost the efficiency of their production processes; indeed, productivity gains in U.S. manufacturing between 1985 and 1986 outstripped those recorded by other major industrial countries.

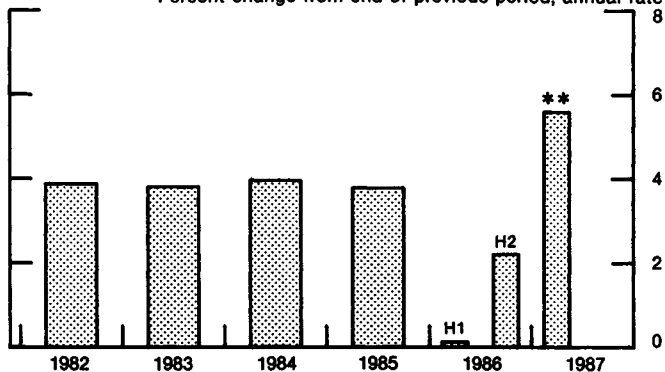
#### Price Developments

As expected, inflation rates have been higher so far this year, largely reflecting a rebound in energy prices. The GNP fixed-weighted price index, a broad measure of inflation for goods and services produced by the United States, increased at about a 4 percent annual rate in the first quarter; it had risen 2-1/2 percent during 1986. Sharper accelerations occurred in the consumer price index, which was up at a 5-1/2 percent rate over the first five months of the year, and in the producer price index for

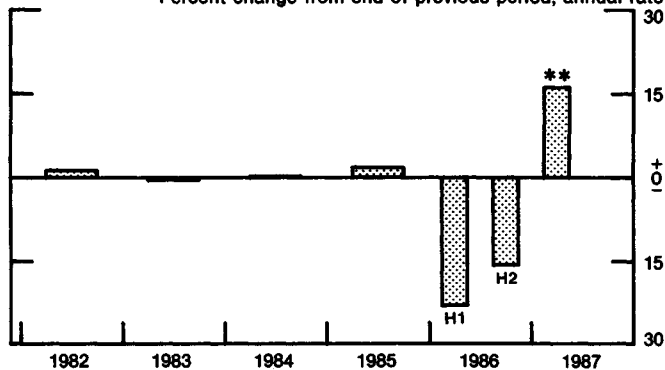


**Consumer Prices \***

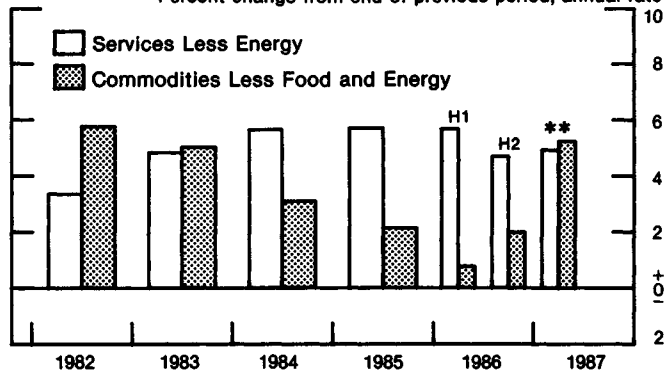
Percent change from end of previous period, annual rate

**Consumer Energy Prices \***

Percent change from end of previous period, annual rate

**Consumer Prices Excluding Food and Energy \***

Percent change from end of previous period, annual rate



\* Consumer Price Index for all urban consumers.

\*\* Percent change from December 1986 to May 1987.

finished goods, which rose at a 4-1/2 percent annual rate over the six months ended in June.

The rebound in energy prices began in January when spot prices of crude oil jumped about \$3 per barrel in response to the reductions in output to which OPEC had agreed late in December. Higher crude oil costs were quickly passed on to end-users, and by May consumer prices for gasoline and fuel oil had risen about 15 percent, retracing half of last year's decline. Spot prices of petroleum products moved up a bit further early in the summer as inventories tightened, and these increases were supported subsequently by the renewal of OPEC's agreement to control production.

In addition to the developments in energy markets, the influence of a lower value of the dollar, as well as trade restrictions, on the prices of imported goods became increasingly evident at the retail level in the first part of this year. The dockside prices of non-oil imports turned up in 1986 after several years in which stable or declining import prices had helped to restrain domestic inflation. Although price changes have varied considerably among different categories of imported goods, some of the largest increases have been reported for consumer commodities, including autos. Retail prices for a number of items with higher-than-average import proportions—such as apparel, footwear, and some other home goods—have shown markedly faster increases than during the past several years. These increases contributed to a sharp acceleration in the consumer price index for goods other than food and energy between December and May compared with 1986 while the rise in prices of nonenergy services over the same period was slightly less rapid than last year.

At the domestic producer level, prices of finished consumer goods and capital equipment other than food and energy rose at less than a 2 percent annual rate over the first six months of the year. At earlier stages of processing, however, prices of domestically produced intermediate materials other than food and energy rose at a 4 percent annual rate, after two years of essentially no change. This acceleration reflected a sharp rise in the prices of industrial chemicals and some other petroleum-related materials as well as increases in a number of other categories.

Prices of primary commodities other than petroleum also have increased so far in 1987. In the agricultural sector, crop prices have retraced part of last year's decline that occurred when farmers sold large amounts of the grain they had received from the government in lieu of cash payments. Prices of cattle and hogs also were up markedly into the spring, but, with supplies improving, cattle prices have retraced much of their advance, and hog futures prices point to declines later this year. Prices of industrial materials, with the exception of a brief period early this year, have been rising fairly steadily since the early autumn of 1986. Spot prices for precious metals have been particularly sensitive to developments in foreign exchange markets and renewed market concerns about inflation; after climbing sharply into May, they fell back a bit with the subsequent firming of the dollar.

Section 3: Monetary Policy and Financial Markets in the First Half of 1987

The Federal Open Market Committee at its meeting in February established 1987 target ranges, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5-1/2 to 8-1/2 percent for both M2 and M3. It also set a 1987 monitoring range for domestic nonfinancial debt of 8 to 11 percent. The M2 and M3 ranges represented a 1/2 percentage point reduction from last year's target ranges, and the Committee expected growth to be well within the ranges, especially in the absence of dramatic movements in interest rates. The range for debt was unchanged from 1986 but below the actual outcome in that year and other recent years; thus, the Committee anticipated that debt growth also would slow this year.

The Committee viewed a substantial slowing in money and credit growth from the rapid pace of 1986 as likely to be consistent with continuation of sustainable economic expansion and conducive to further progress over time toward reasonable price stability. Growth of M1 also was expected to moderate considerably this year. However, the Committee in February elected not to set a target range for M1 for 1987 because of the continuing uncertainties about the relationship of this aggregate to the economy. These uncertainties partly reflected the substantial sensitivity of its velocity to changes in financial conditions that had been evident in recent years, capped by a record postwar decline in the velocity of M1 over 1986. Instead, the FOMC decided to continue evaluating movements in this aggregate in light of the behavior of its velocity, the rate of economic expansion, inflationary pressures, and developments in financial markets.

Over the first half of 1987 monetary policy was conducted against a backdrop of heightened concerns about inflation, stimulated in part by substantial downward pressure on the dollar in foreign exchange markets. At the same time, growth of money and credit aggregates moderated considerably and the velocities of the broader monetary aggregates turned upward after several years of rapid money growth and falling velocities. Measured from the fourth quarter of 1986, M2 in June was below the lower end of its target growth range, while M3 was around the lower end of its range. Meanwhile, growth in M1 slowed to a 7-3/4 percent pace and debt expansion moderated to a 9-3/4 percent rate. As pressures on the dollar and inflation worries intensified in April and May, interest rates began to rise substantially, especially in long-term markets. In late April and May the Federal Reserve adopted a somewhat less accommodative stance with respect to the provision of reserves through open market operations. These actions, together with monetary easing moves by key industrial trading partners, helped to stabilize the dollar and calm inflation fears, contributing to some decline in long-term interest rates and strengthening of the dollar.

#### Money, Credit, and Monetary Policy

In its conduct of policy thus far this year, the Federal Reserve has given a good deal of weight to a number of considerations in addition to the monetary aggregates—principally recurrent episodes of heavy downward pressure on the dollar, indications from long-term securities and commodity markets of heightened inflationary expectations, and evidence that the economy continued to advance at a pace sufficient to produce rising levels of resource utilization. Under these circumstances, interest rates tended to move higher, and

**GROWTH OF MONEY AND CREDIT**  
(Percentage changes at annual rates)

Period	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter 1986 to second quarter 1987	9.9	4.5	5.3	9.8 <sup>e</sup>
Fourth quarter 1986 to June 1987	7.7	4.0	5.3	9.8 <sup>e</sup>
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) <sup>1</sup>	9.3	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	8.8	7.7	13.4
1986	15.3	8.9	8.8	13.2
Quarterly average				
1986-Q1	8.8	5.3	7.7	15.5
Q2	15.5	9.4	8.7	10.2
Q3	16.5	10.6	9.7	12.5
Q4	17.0	9.2	8.0	12.1
1987-Q1	13.1	6.3	6.3	10.4
Q2	6.4	2.5	4.1	9.0 <sup>e</sup>

<sup>e</sup>—estimated.

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

the patterns of rapid money growth and declining velocities of the last several years, when inflation and interest rates were moving down, began to be reversed. Growth of the broad aggregates remained around the lower bounds of their growth cones through most of the first half of the year, although M2 dropped well below its long-run range later in the period. Growth of both M2 and M3 was considerably below the pace of recent years, and their velocities increased. Expansion of M1 also slowed markedly, while growth of domestic nonfinancial sector debt moderated.

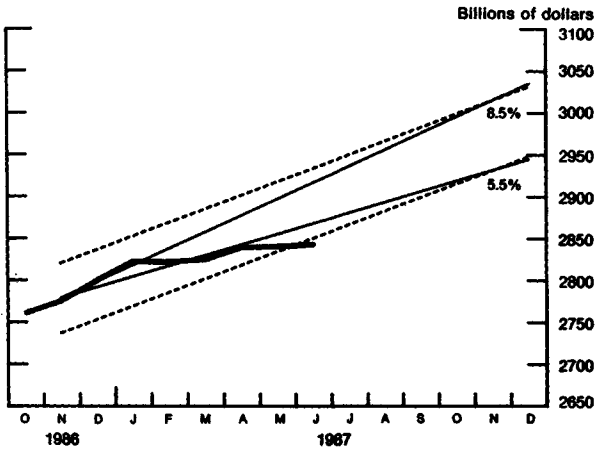
Through the early spring of this year, System open market operations were conducted to keep pressures on the reserve positions of depository institutions unchanged from last year. In January, strong credit and money demands associated with a burst of tax-related financial activity in late 1986 began to abate, and short-term interest rates eased; however, these rates remained above levels prevailing in the fall of last year.

In foreign exchange markets, the dollar had begun to decline in late December, after a period of some stability. The drop continued through January, amid market concerns about the prospects for correcting U.S. and foreign external imbalances. In late February, the statement in Paris by the ministers of finance and central bank governors of six major industrial countries that they "agreed to cooperate closely to foster stability of exchange rates around current levels," along with a discount rate cut by the Bank of Japan, seemed to stabilize the dollar for a time.

The spread between private short-term rates and Treasury bill rates widened after Brazil announced a suspension of interest payments to banks in February, and subsequently widened further as the Treasury's paydown of bills,

**Ranges and Actual Money Growth**

**M2**

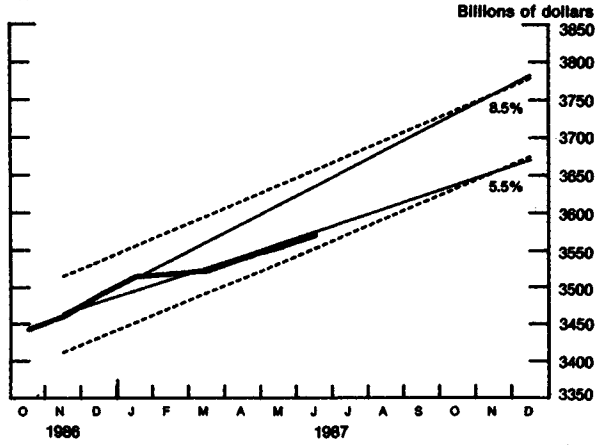


Annual Rates of Growth

1986 Q4 to 1987 Q2  
4.5 percent

1986 Q4 to June 1987  
4.0 Percent

**M3**



Annual Rates of Growth

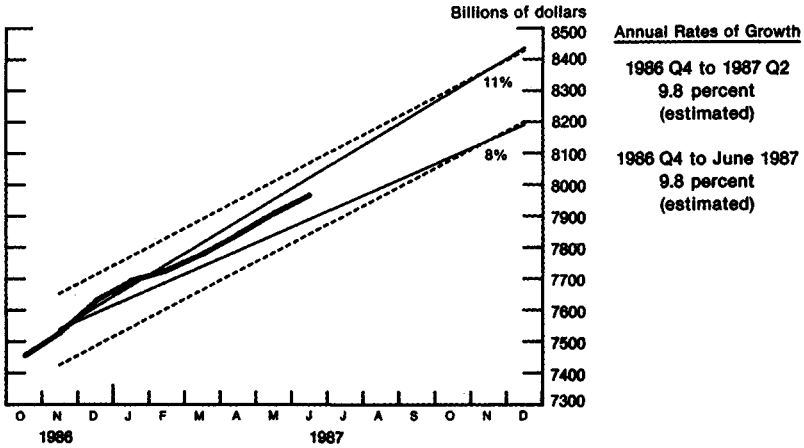
1986 Q4 to 1987 Q2  
5.3 percent

1986 Q4 to June 1987  
5.3 percent

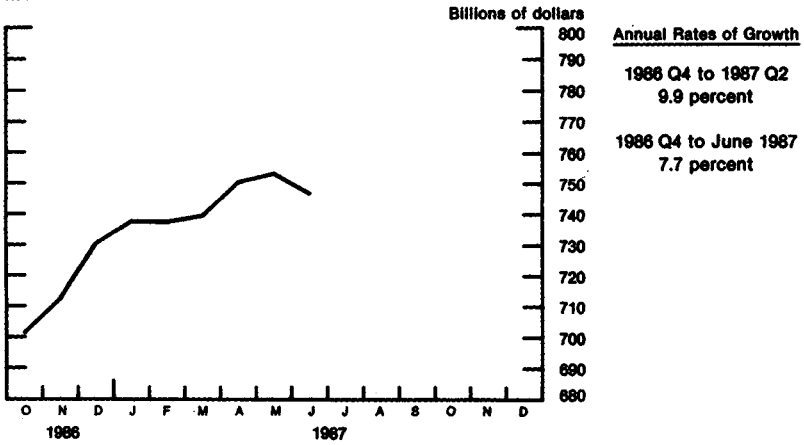


**Actual Debt and Money Growth**

**Total Domestic Nonfinancial Sector Debt**



**M1**

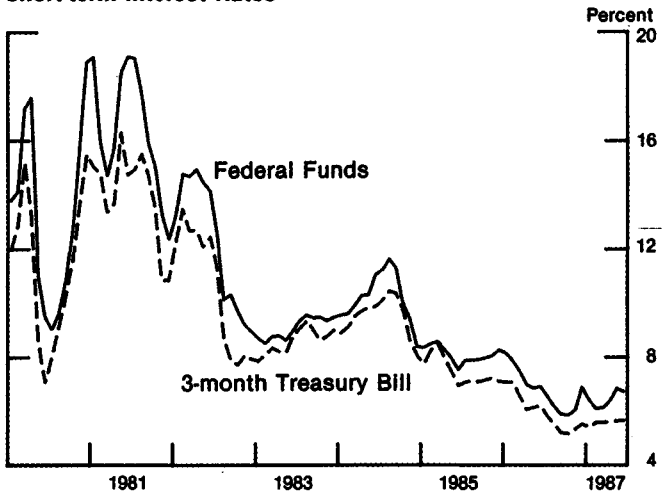


which began early in the year, picked up and foreign official institutions purchased bills with the proceeds of dollars acquired in exchange market intervention. Reflecting the somewhat higher private short-term interest rates and concomitant increases in funding costs, commercial banks raised the prime rate by 1/4 percentage point on April 1.

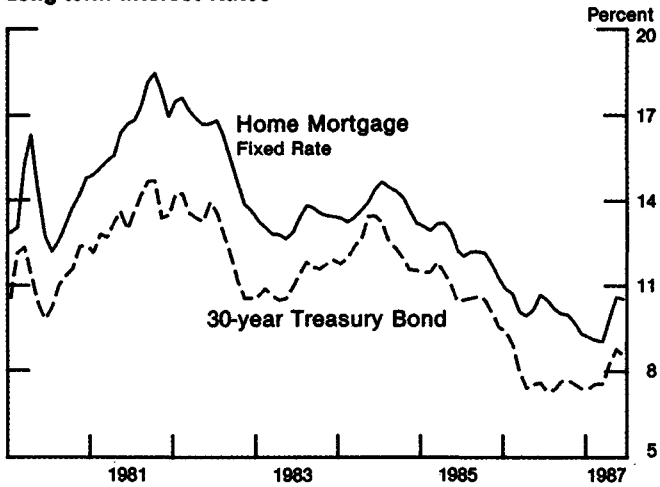
Long-term rates, which had not been much affected by the transitory credit demands of late 1986, continued to drift down in the early months of 1987, displaying little short-term volatility. The placid conditions in long-term markets were abruptly changed in late March, primarily by developments in the international sphere. Announcements of trade sanctions by the United States, persisting weakness of the dollar, and disappointing trade figures all raised questions about continuing private demands for dollar assets, prospects for inflation, and the response of monetary policy. The dollar dropped sharply in the last three weeks of March, and between late March and late April yields on 30-year government bonds rose about 1 percentage point on balance. The exchange and bond markets became highly volatile during this period, as the dollar continued to drop and inflation fears appeared to be intensified by the publication of adverse price data. Mortgage rates and yields on mortgage pass-through securities reacted very promptly to the deterioration in the bond markets and, indeed, rose more than most other long-term rates as many investors shied away from these instruments subject to substantial prepayment risk.

The effects of these developments also were evident in short-term credit markets, where rates rose in April partly in anticipation that monetary policy would have to firm to contain pressures on prices and the dollar. In

**Short-term Interest Rates**



**Long-term Interest Rates**



late April and again in May, the Federal Reserve did move to tighten the availability of nonborrowed reserves through open market operations. Short-term interest rates rose about 1/2 to 3/4 percentage point during April and May, and the prime rate was raised twice more, on May 1 and May 15, in 1/4 point increments. The System's firming actions, along with complementary moves abroad, helped to stabilize the dollar and ameliorate the concerns about the inflation outlook.

Along with some better price news and evidence of improvement in our trade deficit, this policy appeared to impart an improved tone to short-term and, especially, long-term credit markets over the latter part of May and June. Since May, most short-term rates have posted declines of 1/4 percentage point or more. Longer-term markets generally have registered greater gains, and in early July long rates were off 1/2 to 3/4 percentage point from their May highs. The dollar, meanwhile, has shown more dramatic improvement, regaining the ground it lost in April and May.

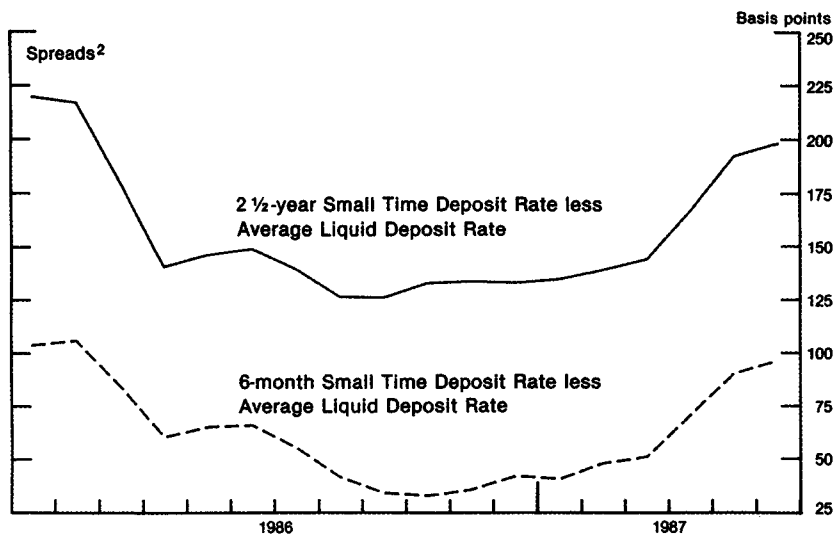
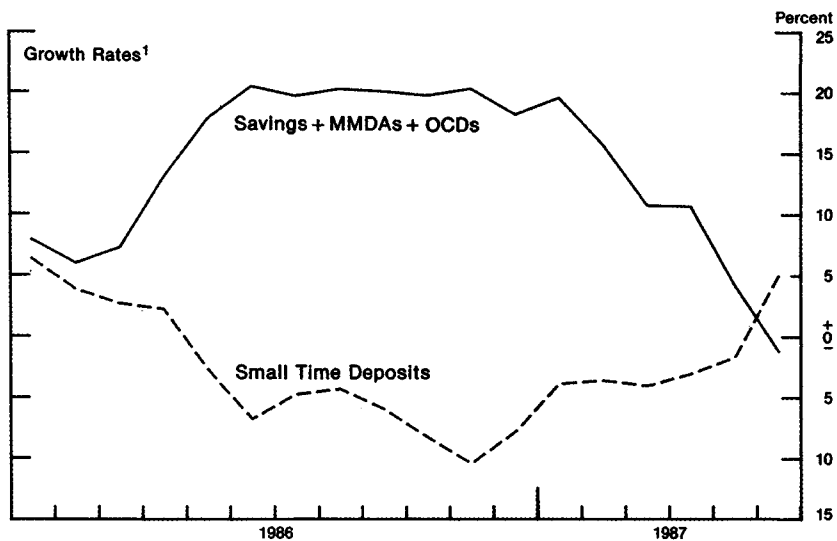
As interest incentives favoring market instruments over monetary assets became more pronounced in the first half of the year, growth of the monetary aggregates slowed. M2 decelerated in both quarters, expanding at only a 2-1/2 percent annual rate in the March to June period. In addition to the influence of rising interest rates, tax reform may have weakened the public's demand for M2 assets, particularly household-type deposits, to the extent that it induced individuals to pay down consumer debt or to finance expenditures out of liquid assets rather than with credit. The velocity of M2 is estimated to have risen in the first and second quarters after declining in 1985 and 1986.

The slowing of M2 growth was accompanied by a marked change in the composition of deposit inflows away from transactions and other highly liquid instruments and toward longer-term retail deposits. This reversal of the pattern of portfolio shifts in 1985 and 1986 occurred as rates on time deposits adjusted more promptly to rising market rates than did yields on more liquid monetary components and the deposit rate curve steepened.

Growth in transactions instruments fell in the first half to a pace not seen since 1984, the last time interest rates rose on a sustained basis. Demand deposits, along with other checkable deposits (OCDs), were boosted smartly in April as individuals prepared to pay tax liabilities, which were swollen by capital gains taken in 1986 to avoid higher rates under tax reform. On balance, however, demand deposits have exhibited no sustained strength since late last summer. Among other factors, the rise in interest rates reduced the volume of demand deposits that businesses need to hold as compensating balances for bank services. As rates on time deposits and market instruments rose, OCDs became a less attractive savings vehicle. The progressive slowing this year of OCD growth, which had averaged close to 30 percent during most of 1986, was interrupted only by the April surge. With demand deposits and OCDs both running off in June, growth in M1 for the second quarter was down to a 6-1/2 percent rate. The velocity of M1 in the second quarter is estimated to have been little changed after declining in each quarter since 1984.

Growth in other liquid balances also has been falling. Savings deposits, after expanding at around a 30 percent rate since the late summer of last year, slowed in the second quarter and advanced at only a 10 percent

### Growth of Retail Deposits and Deposit Rate Spreads



1. Based on a 2-month moving average of retail deposits at commercial banks and thrift institutions.

2. Spreads are based on rates paid at commercial banks. Average liquid deposit rate is a weighted average of OCD, MMDA and savings rates.

rate in June, and money market deposit accounts have been particularly weak this year. By contrast, small time deposits which had run off over much of last year in an environment of falling short-term rates, expanded significantly in June for the first time since April 1986. Small time deposit growth this year has been especially strong at thrift institutions, reflecting elevated offering rates and, in certain cases, shifting to deposits in denominations under \$100,000, as some of these institutions have encountered difficulties in issuing large time deposits.

Even with weak inflows to core deposits, the need among commercial banks to tap wholesale managed liabilities was limited by a moderation in demands for credit. M3 growth was further damped in the first half as banks obtained funds from sources not encompassed by the monetary aggregates, including borrowing from their foreign branches and a sharp rise in Treasury deposits. Federal Home Loan Bank advances to thrifts also were strong, although below the pace of last year. M3 growth fell below that of income in the first half and its velocity apparently rose in both quarters, the first sustained increase in three years.

Credit flows were reduced in the first half of 1987, with total domestic nonfinancial sector debt expanding at around a 9-3/4 percent annual rate, compared with rates in excess of 13 percent in each of the preceding three years. Even so, expansion of both the private and public components of the debt aggregate continued to outstrip growth of income, as generally has been the case in the 1980s.

Overall business credit demands continued to be buoyed in the first half by heavy net share retirements associated with mergers, buyouts, and

other corporate restructurings. With long-term rates subdued in the first three months of the year, firms concentrated their borrowings in bond markets and short-term business credit contracted. However, as long-term markets deteriorated in April, bond issuance abated and business credit demands focused on the commercial paper market. By June, with some improvement in long-term markets, these financing patterns reversed again as bond issuance picked up and growth of short-term business credit came to a halt.

Growth of consumer installment credit was considerably diminished during the first half. The reduced deductibility of consumer interest payments under the new tax code encouraged this development. The tax law change made use of mortgage credit relatively more attractive, and the active promotion by lenders of home equity lines of credit reinforced tendencies toward substitution. In addition to credit taken down under home equity lines, mortgage growth in the first half was maintained by heavy volumes of new and existing home sales.

Federal government credit needs in the first half were held down by unusually strong tax payments stemming from the retroactive repeal of the investment tax credit and, principally, capital gains realized late last year. The budget showed a small surplus in the April to June period, after a \$59 billion deficit in the first quarter. Net borrowing from the public nevertheless rose in the second quarter on a seasonally adjusted basis as the Treasury replenished its cash balances, which had been drawn down sharply in the initial months of the year. The Treasury ran off bills in both quarters, but continued to issue coupon securities in volume. Federal debt expanded at a 9-3/4 percent annual rate in the first half of the year, down from the pace of 1986.



Borrowing by state and local governments has fallen off this year. Issuance of municipal debt for new capital has been slowed considerably by provisions of tax reform that narrowed the definition of public-purpose debt and constrained private-purpose offerings. In addition, issuance of refunding bonds, which was strong in the first quarter, slackened after April owing to higher interest rates.

The financial system has continued to evidence strains in 1987. Indications that the agricultural sector is beginning to stabilize have emerged, with loan delinquencies declining, land prices bottoming out, and export volume firming; the failure rate among agricultural banks seems likely to have peaked. However, the Farm Credit System, the nation's largest farm lender, lost considerable sums in 1985 and 1986, and many of its units continue to struggle with troubled loan portfolios.

In addition to difficulties with agricultural loans, commercial banks have been saddled with persisting problems in their energy and developing country loan portfolios. Although some banks remain highly profitable, 19 percent lost money last year, compared with about 3 percent as the decade began; loan loss provisions were the main cause of the earnings problems. The banking system is likely to post record losses this year owing to huge reserve provisions taken by large banks primarily as a consequence of developments in the international debt area. Despite the shrinkage in the book value of shareholder equity recognized by these actions, share prices rose at many banks announcing large increases in loan loss reserves.

Net operating income before taxes for solvent thrift institutions rose last year as interest margins widened with falling market rates, and

thrifts overall have raised their ratio of net worth to total assets by taking advantage of strong stock prices to issue large volumes of equity. Nonetheless, at a significant minority of thrifts already negative net worth positions have been aggravated by continued losses. Moreover, the problems of some troubled institutions intensified this year as the real estate market in certain areas of the country remained depressed and interest rates backed up.

The difficulties of the thrift industry are mirrored in the situation of the Federal Savings and Loan Insurance Corporation. Estimates indicate that current and potential claims against the FSLIC exceed its reserves by significant amounts. With premiums levied on member institutions already at a statutory maximum, some action clearly is called for to strengthen the FSLIC and bolster its ability to deal with problem institutions. Plans currently under study by Congress would involve using retained earnings from the Federal Home Loan Banks to capitalize a financing corporation which, in turn, would issue obligations and invest the proceeds in FSLIC capital stock. At this stage, these plans call for a maximum capacity to issue debt of \$8-1/2 billion. This would be repaid over an extended period of time through FSLIC assessments on member institutions.

