

CONDUCT OF MONETARY POLICY

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

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

WEDNESDAY, FEBRUARY 10, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128 Rayburn House Office Building; Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Reuss, Gonzalez, Minish, Mitchell, Fauntroy, Neal, Patterson, LaFalce, D'Amours, Lundine, Oakar, Mattox, Vento, Barnard, Schumer, Frank, Patman, W. Coyne, Hoyer, Stanton, Wylie, Hansen, Leach, Evans of Delaware, Paul, Bethune, Shumway, Parris, McCollum, Carman, Wortley, Roukema, Lowery, J. Coyne, and Dreier.

The CHAIRMAN. The committee will come to order.

Never in its 69-year history has the Federal Reserve been the subject of so much sustained attention in the executive branch as it is today. With the possible exception of the National Security Adviser, it seems from the rank of Assistant Secretary up has had a few words of advice for Paul Volcker during the past few months, not, of course, that all the words have been the same.

On Mondays, Wednesdays, and Fridays, the Federal Reserve can do nothing right in the eyes of the administration. On Tuesdays and Thursdays the spokesmen trot out with olive branches and pronounce the Federal Reserve a full-fledged, card-carrying member of the supply side squad. On Sundays the administration's economic experts explain away the week's confusion on "Meet the Press," "Face the Nation," and the other assortment of interview shows.

For the markets, the public and Congress, it is a confusing spectacle of "he loves me, he loves me not," hardly an inspiring sight.

If Paul Volcker received strange signals from the administration during 1981, he was not alone. A year ago we were being bedazzled by Laffer curves, Stockman pronouncements and assurances that supply side prosperity was coming around the corner at breakneck speed.

Somewhere along the route to wonderland, the supply side vehicle hit some mammoth potholes, blew its tires, and it sits there today on the side street waiting for the Stockman tow service.

The result of the journey on the supply side has been the longest sustained period of back-breaking high interest rates, the longest lines of unemployed in the post-World War II period, skyrocketing business bankruptcies, and growing examples of human misery from coast to coast.

After the economic body of the Nation has been bled for a year by medieval doctors who populate the supply side shrines, one would think that a prudent man would seek a new course, a new set of policies, if not a new staff of doctors. But, no. The new budget is released and the answer is "If you disliked 1981, you will truly loathe 1982."

The fiscal year 1982 budget is constructed on a swamp of economic projections supported by no one outside the administration's immediate family—cuts in essential social programs that aren't going to be voted, interest rate estimates that are more hopeful than real, economic growth that is seen nowhere on the horizon, and pie-in-the-sky revenue sources that no one takes seriously. All this so the administration can avoid admitting to the American public that we face a deficit well over \$100 billion.

We can all wait for the summer editions of *Atlantic Monthly* to hear the true confessions.

Budget documents that vie for fiction awards don't change reality. The Nation is in deep trouble. This committee—over the protest of some—went into the field last year to learn of conditions first-hand. Human misery has been growing. The despair is there and it is despair—fear—that cuts across social, economic and political lanes. Let there be no mistake about it. We have seen it up close.

I am genuinely happy that the President has decided to follow this example and go into the countryside himself. He won't get the picture at the Republican fundraisers, but if his inner circle will let him out among the people, he will learn that while he may be liked as a person, his programs and policies are generating nothing but fear among the hardworking Americans who make up the core of this Nation.

While I sympathize with the Federal Reserve efforts to read the confused signals of this administration, it would, indeed, be simplistic—and inaccurate—to absolve the monetary policy machinery from blame.

While Paul Volcker conducts himself with a high degree of class compared to the administration's Keystone Kop search for scapegoats, the policies of the Federal Reserve have not, for the most part, deviated from those of the administration.

There is growing concern about the inability of the Federal Reserve to hit targets and its consistent preoccupation with the lower reaches of targets for the basic money supply. I do not believe that the Federal Reserve, its protestations to the contrary notwithstanding, fully understands how devastating high interest rates are to the people of this Nation. There is a certain splendid isolation in this agency that prevents it from feeling the vibes of the worker, the small businessman, the homebuyer, the communities struggling to survive in a sea of high interest rates.

Both the administration and the Federal Reserve point with pride to lower inflation rates. Nothing warms the inner soul of the Federal Reserve more than its holy war against inflation. This is all well and good. No one on either side of the aisle can lay exclusive claim to their distaste for double digit inflation.

But let me remind both the administration and the Federal Reserve that in 1933 this Nation had indeed wrung inflation from the economy.

In the face of rising unemployment, some of the sideline cheers for lower inflation rates suggest that some feel that there's nothing that ails this country that a good old-fashioned Hoover-style depression wouldn't cure. Let us hope that this is not where the administration and the Federal Reserve are leading us.

Now, Mr. Chairman, we welcome you to our committee with open arms and, as you summarize your statement, I would ask you to give thought to the following two questions and respond to them at the conclusion of your summary.

No. 1, when you appeared before this committee last July, the Federal Reserve's open market committee predicted that the unemployment rate in 1981 would be between $7\frac{1}{2}$ and $8\frac{1}{4}$ percent. As you know, the actual rate in 1981 was 8.3 percent, above the Federal Open Market Committee's forecast. Now the FOMC is predicting unemployment in 1982 will be between $8\frac{1}{4}$ and $9\frac{1}{2}$ percent. Does this mean that we can expect unemployment to be approximately 10 percent in 1982?

And last year we were never certain where the Fed stood on the administration's great experiment in supply side economics. Clearly the administration's budget, tax policy and approach to the economy bears directly on your duties and the success or failure of monetary policy. I would like to know, as specifically as possible, just how realistic you feel the administration's 1982 economic policy is and how well you believe it meets the real needs of the Nation.

Frankly, we need to know your opinion now, rather than 12 months down the trail, when secondguessing will become rather epidemic, as it has just recently.

I would like to end on a pleasant note, and state that it is good to see Mr. Schultz with us this morning. I understand that this afternoon he will attend his last Federal Reserve Board meeting and subsequently he will retire to warmer climes. I want to thank him, on behalf of all the members of this committee, for his service to the Republic.

I know these have been hard times for you, but you have served well. We certainly appreciate the fact that you gave of your time during this very difficult period.

Mr. Stanton?

Mr. STANTON. Thank you very much, Mr. Chairman. I do have a prepared statement, Mr. Chairman, that I would like to issue at this time for the record, and make a few extemporaneous remarks.

[Mr. Stanton's opening statement follows:]

OPENING STATEMENT OF HON. J. WILLIAM STANTON
HEARINGS ON THE CONDUCT OF MONETARY POLICY
FEBRUARY 10, 1982

MR. CHAIRMAN -

I WOULD LIKE TO JOIN YOU IN WELCOMING OUR DISTINGUISHED WITNESS, CHAIRMAN VOLCKER, WHO IS HERE TO FULFILL THE REQUIREMENTS OF THE HUMPHREY-HAWKINS ACT OF 1978.

I BELIEVE HE HAS REASON TO BE SATISFIED WITH THE PROGRESS THAT HAS BEEN MADE IN FIGHTING INFLATION SINCE HIS PREVIOUS TESTIMONY LAST JULY.

DESPITE THE CURRENT RECESSION AND THE ASSOCIATED POSTWAR HIGH LEVEL OF UNEMPLOYMENT, INFLATIONARY EXPECTATIONS HAVE CALMED AND THERE IS SOME EVIDENCE THAT THE UNDERLYING TREND OF COSTS IS SLOWING. LOOK AT INFLATION AS MEASURED BY ANNUAL CHANGES OF THE CPI IN RECENT YEARS. SINCE 1978 IT DECLINED AS FOLLOWS:

1979	13.3%	
1980	12.6	
1981	9.4	
1982	6.6	(ESTIMATED BY THE ADMINISTRATION)
1983	5.1	(ESTIMATED BY THE ADMINISTRATION)

THIS RECORD OF PROGRESS SHOULD BE CONSIDERED IN THE CONTEXT OF THE SOCIAL COST OF INFLATION. LAST JULY, TREASURY UNDER SECRETARY SPRINKLE OUTLINED THE RAVAGES OF INFLATION FOR THIS COMMITTEE IN THESE TERMS. ASSUME, FOR EXAMPLE, A 10% INFLATION RATE FOR THE NEXT 20 YEARS:

- THE \$3.35 MINIMUM WAGE WOULD HAVE TO RISE TO \$22.50 TO MAINTAIN ITS PURCHASING POWER;
- A \$1,000 COLLEGE TUITION WOULD SOAR TO \$6,700;
- A \$50,000 HOUSE WOULD INCREASE IN PRICE TO \$336,000;
- AN EXPECTED RETIREMENT INCOME OF \$20,000 WOULD DECLINE IN PURCHASING POWER TO \$3,000.

ALTHOUGH THERE ARE DIFFERENCES OF OPINION ON THE OPERATING TECHNIQUES OF MONETARY POLICY, THE ADMINISTRATION AND THE FEDERAL RESERVE ARE IN GENERAL AGREEMENT ABOUT THE NEED TO ACHIEVE AND MAINTAIN STABLE, NONINFLATIONARY MONEY GROWTH. IN

HIS 1983 BUDGET MESSAGE, THE PRESIDENT NOTED THAT "...THE FEDERAL RESERVE HAS TAKEN ACTION TO BRING EXCESSIVE MONEY GROWTH UNDER CONTROL...THE EXCESSIVE, UNSUSTAINABLE, AND EVENTUALLY RUINOUS GROWTH OF MONEY AND CREDIT OF THE PAST DECADE HAS BEEN CURBED."

IN ASSESSING AVAILABLE MONETARY POLICY OPTIONS WE MUST KEEP IN MIND THAT FASTER MONEY GROWTH CAUSES INTEREST RATES TO GO UP, NOT DOWN. FINANCIAL MARKETS VIEW RAPID MONEY GROWTH AS A SIGNAL THAT THE FEDERAL RESERVE IS EASING ITS POLICY AND WILLING TO ACCOMMODATE MORE INFLATION; HENCE, THEY MUST DEMAND HIGHER INTEREST RATES BECAUSE OF THE INFLATION PREMIUM. THOSE WHO CALL FOR FASTER MONEY GROWTH - NO MATTER HOW WELL INTENTIONED - WOULD ONLY WORSEN THE TWIN PROBLEMS OF HARNESSING INFLATIONARY EXPECTATIONS AND HOW TO LOWER INTEREST RATES.

ACCORDINGLY, WE MUST CONTINUE TO DECELERATE MONEY GROWTH, A STRATEGY TO WHICH THIS COMMITTEE HAS SUBSCRIBED IN THE PAST. THE NEW M1 TARGET RANGES FOR 1982 APPEAR WELL SUITED TO THIS PURPOSE. LOOKING BACK, PROGRESS WAS MADE LAST YEAR IN REDUCING MONEY GROWTH AND ESTABLISHING THE FOUNDATION FOR SUSTAINABLE, NONINFLATIONARY ECONOMIC GROWTH. IN 1981, M1 GREW AT A 5.0% RATE, BELOW THE TARGET RANGE OF 6.0% TO 8.5%.

ERRATIC SWINGS IN MONEY GROWTH, HOWEVER, HAVE CONTRIBUTED TO THE UNEASINESS OF THE MONEY AND CAPITAL MARKETS. FROM JANUARY THROUGH APRIL OF 1981, M1 GREW AT A RATE OF ABOUT 14%. THIS PERIOD OF RAPID EXPANSION WAS FOLLOWED BY A SIX-MONTH PERIOD OF NO MONEY GROWTH. MONEY THEN INCREASED AT A 13% RATE DURING THE LAST TWO MONTHS OF 1981. SINCE NOVEMBER OF 1981, M1 HAS GROWN AT AN APPROXIMATE RATE OF 17%, WELL ABOVE THE 1982 TARGET RANGE. THIS RECENT, RAPID GROWTH COULD CREATE PROBLEMS IN 1982 IF NOT CAREFULLY HANDLED.

IF WE ARE SERIOUS ABOUT REAL ECONOMIC GROWTH AND STRIVING FOR FULL EMPLOYMENT, THE FEDERAL RESERVE MUST PERSIST IN ITS LONG RANGE EFFORTS TO BRING THE GROWTH OF THE MONEY SUPPLY TO AN ACCEPTABLE, NONINFLATIONARY LEVEL. THIS IS THE ONLY WAY IN WHICH THE BURDEN OF HIGH INTEREST RATES CAN BE LIFTED OFF THE SHOULDERS OF INDIVIDUAL HOUSEHOLDERS AND CREDIT-SENSITIVE BUSINESS FIRMS, STATE AND LOCAL GOVERNMENTS AND CHARITABLE INSTITUTIONS. THIS IS THE ONLY WAY TO REVIVE LONG-TERM CAPITAL INVESTMENTS TO MAKE AMERICA'S SHOPS, FARMS AND MINES MORE PRODUCTIVE.

AS FORMER FEDERAL RESERVE CHAIRMAN ARTHUR BURNS HAS NOTED, THE ANGUISH OF CENTRAL BANKING ARISES NOT SO MUCH FROM THE INABILITY TO CONTROL MONEY GROWTH, BUT RATHER FROM THE DIFFICULTIES THAT CENTRAL BANKERS HAVE IN OVERCOMING THE POLITICAL PRESSURES ASSOCIATED WITH MONEY RESTRAINT. WITH THIS THOUGHT IN MIND, WE LOOK FORWARD TO YOUR TESTIMONY TODAY.

Mr. STANTON. First, I join you in recognizing the presence here today of the Vice Chairman—the former Vice Chairman of the Board, Fred Schultz. Mr. Vice Chairman, we asked specifically that you come this morning so that we could personally and publicly thank you for the services that you have rendered to the Board and to its Chairman over the last 2½ years.

I specifically wanted to do this because, truthfully, back in the Carter administration we viewed your original announcement at that time with a little question. I remember you were serving, I think, as Speaker of the State legislature on a partisan basis in the State of Florida and so forth, and you were a good banker. But let me tell you that any doubts I had are long gone because you performed eloquently, in my opinion, and you have proved to be a great public servant. I want to personally join the Chairman in thanking you.

Second, Vice Chairman Schultz, your appearance here this morning reminds me more, really, of the independence of the Federal Reserve System that the Chairman alluded to. I say your appearance does because the Chairman, Paul Volcker, needs nobody to back him up. Like his predecessors, William McChesney Martin, and Arthur Burns, he really doesn't need anybody to defend him.

You do emphasize that the Federal Reserve Board is something that I have always been taught, since the days of Wright Patman, is an instrument of Congress and, as such, created by Congress. You are subject to Congress in that regard. I don't remember a year that we haven't had legislation introduced that is the result of high interest rates. What would they call it? The reorganization of the Federal Reserve Board or the reorganization of the Federal Reserve Act. Every year we have some legislation that comes along and goes nowhere.

I do want to emphasize that in my opinion it is regrettable that the administration, has gone public in its criticism. Everyone is entitled to do it, but my constituents back home don't really know the difference between the administration, Congress, and the Federal Reserve System. And when you see one picking on the other I just don't think it enhances any one position.

And as for those who may call for the resignation of the Chairman of the Federal Reserve System, let me say that everyone is entitled to their opinion, but it always reminds me of somebody who is used to the offense and when that is not going too well they claim the defense or somebody else is to blame.

Finally, Mr. Chairman—and we will get into the details here this morning quickly with regard to the responsibility that the Fed has to us and that we have to them—there will be hard questions that have to be asked and should certainly be asked.

But in conclusion let me simply add that this independence of the Federal Reserve System is something that we will preserve. There will be no changes, I would hope, in the makeup of the Federal Reserve Board itself with regard to the way it is constituted at the present time, so that anything else discussed specifically is sheer talk. It may be good for public consumption, but in reality it will never happen.

Thank you.

The CHAIRMAN. Thank you, Mr. Stanton. The Chair has received a request from the chairman of the subcommittee with jurisdiction over the Federal Reserve Board to make an opening statement. The Chair at this time recognizes Mr. Fauntroy.

Mr. FAUNTROY. These hearings on the conduct of monetary policy are being held at a time of deep economic distress. Unemployment rates were at 8.9 percent in December of last year and will, without doubt, be even higher when the February unemployment figures are released. That is the highest rate since the last Republican recession, that of 1974-75. Unemployment has hit hardest at our young people and at our minorities. In December, 21.7 percent of the teenagers in the work force were unemployed, as were 13.7 percent of those between 20 and 24 years of age. Among minorities, 40 percent of all teenagers were unemployed and 15.1 percent of minority adult males were without jobs. Think about that—nearly 1 out of every 10 Americans who want jobs can't find them. More than 1 out of every 8 young adults and 1 out of every 7 minority Americans who want jobs cannot find them. Almost half of all black teenagers are out of work. Think about the psychological damage to individuals and to families. Think about the social consequences of broken homes and increased crime from that unemployment, and think about the personal despair and even suicides that result.

Then think about the broken promises of this administration. Think about the broken promise of supply-side economics that there would be an upsurge in prosperity and economic activity and employment if we just cut tax rates. Think about the broken promise of the social safety net after this administration reduced unemployment benefits and cut food stamps and cut welfare benefits and cut medicaid, and now is proposing even more reductions. Think about this administration's promise that the monetarist's cure for inflation would only cause, according to Treasury Under Secretary Beryl Sprinkel, "a relatively short period of * * * pain." Think about this administration's broken promise of a balanced budget, when the deficits currently projected over the next few years will add as much to the national debt as has been accumulated over the previous 200 years.

All we hear from the administration are excuses and vague hopes. The administration denies that it is responsible for the current recession and high unemployment while at the same time claims credit for the reduction in inflation. Yet the total employment is now half a million lower than a year ago and half of the drop in the CPI from its 1980 peak occurred during this administration's period of office. This administration points to the job listing in the Washington Post as a sign that there are jobs available, while at the same time it cuts funds for job training and education that would provide people with the skills needed for those jobs. This administration blithely denies that its future deficits have anything to do with the high interest rates we have been experiencing, blaming those high interest rates on volatility in the Federal Reserve's control of the money supply. This administration still insists that everything will work out in the future, despite the fact that its initial predictions for the economic growth—for interest rates, for deficits, and for employment—have so far been all wrong.

The key economic problem that we face today, I think we can all agree, is high interest rates. It was high interest rates last summer that caused our current recession and high unemployment. It is a resurgence of high interest rates over the past 2 months that will stand in the way of recovery and it is the likelihood of a recurrence of high interest rates later this year that may well lead to yet another Republican recession in 1983. So the key question we must address in these hearings today is why interest rates are high.

I think we know the reason interest rates are high. They are high because there is no confidence by the marketplace in the programs of this administration. One can debate the precise role which the Federal Reserve might play in how tight or loose the money supply ought to be, or even whether or not the Federal Reserve is using the best methodology to control the money supply. But these issues are peripheral to the fundamental falacies of this administration's economic policies of cutting taxes for the rich, cutting aid to the poor and working people, spending money on defense like a drunken sailor and then pretending that the resulting deficits do not matter if the Federal Reserve would just tighten up the money supply.

We need to face the fact that this administration has no plan for reducing interest rates other than to blame the Federal Reserve. Essentially, they have argued that it is the volatile money supply which has led to the adoption of uncertainty premiums, in addition to inflation premiums. This is a most novel and fatuous argument. Administration officials fully know that there is no relationship between the short-run fluctuations of the money supply and inflation or to much of anything else that affects the interest rates. It is as disingenuous as their claim that they deserve credit for the lower inflation, but not the blame for the high unemployment.

The inescapable facts are that it is the prospect of large and growing deficits that produced high interest rates last year and that this administration has no credible plan for reducing those deficits. Look at the numbers. Under last year's tax rates, Federal revenues were reduced to 19 percent of GNP by 1984. Under current plans, spending for defense will equal 6 percent of GNP, social security, medicare, and retirement benefits alone will equal 7 percent of GNP, and interest payments will be close to 3 percent of GNP. That will leave only 3 percent of GNP to be spent on every other Federal program, from aid to the poor, highways, the FBI, the State Department, to the Congress, and the White House. Not only is that less than the 7 percent of GNP spent on these functions in 1981, it is less than the 6.6 percent of GNP spent in 1970 or even less than the 5.5 percent of GNP spent in 1960 at the end of the Eisenhower administration. No wonder this administration has decided that deficits are not so bad after all, and no wonder that the financial markets are so skeptical of this administration's policies. The only hope that the administration has is that there will be a rapid economic growth. But how can that take place when enormous deficits are projected that are driving interest rates up at an alarming pace?

The administration's deficit-prone fiscal policy places the Federal Reserve in a difficult position. Because this administration has no other policy for reducing inflation, if the Federal Reserve eases its

monetary policy to relieve the deficits in pressure on credit markets, that would set off fears of more inflation and drive up the inflation premium in interest rates.

I ask unanimous consent to allow me to continue for 1 minute.

The CHAIRMAN. All right. The Chair would like to hear from Mr. Volcker at some point. [Laughter.]

Mr. STANTON. I hope the chairman will take that in mind in his remarks.

Mr. FAUNTROY. All right. I will yield to the suggestion of the distinguished ranking minority member on that and simply ask that the rest of my statement be included in the record for reading by all Members.

[The full text of Mr. Fauntroy's opening statement follows:]

REMARKS OF HON. WALTER E. FAUNTROY, CHAIRMAN, SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

These hearings on the conduct of monetary policy are being held at a time of deep economic distress. Unemployment rates were at 8.9 percent in December of last year, and will without doubt be even higher when the February unemployment figures are released. That is the highest rate since the last Republican recession, that of 1974-1975. Unemployment has hit hardest at our young people and at our minorities. In December, 21.7 percent of the teenagers in the work force were unemployed, as were 13.7 percent of those between 20 and 24 years of age. Among minorities, 40 percent of all teenagers were unemployed, and 15.1 percent of minority adult males were without jobs. Think about that—nearly one out of every ten Americans who want a job are without one. More than one of every eight young adults, and one of every seven minority Americans, who want a job cannot find one. Almost half of all black teenagers are out of work. Think about the psychological damage to individuals and to families, think about the social consequences of broken homes and increased crime from that unemployment, and think about the personal despair and even suicides that result.

Then, think about the broken promises of this Administration. Think about the broken promise of supply-side economics, that there would be an immediate upsurge in prosperity, in economic activity and employment if we cut tax rates. Think about the broken promise of the social safety net, after this Administration reduced unemployment benefits, cut food stamps, cut welfare benefits, cut medicaid, and is now proposing even more reductions. Think about this Administration's promise that the monetarist's cure for inflation would only cause, according to Treasury Undersecretary Beryl Sprinkel, "a relatively short period of . . . pain." Think about this Administration's broken promise of a balanced budget, when the deficits currently projected over the next few years will add as much to the national debt as had accumulated over the previous two hundred years.

All we hear from the Administration are excuses and vague hopes. The Administration denies that it is responsible for the current recession and high unemployment, while at the same time it claims credit for the reduction in inflation. Yet, total employment now is half a million lower than a year ago, and half of the drop in the CPI from its 1980 peak occurred before this Administration took office. This Administration points to the job listings in the Washington Post as a sign that there are jobs available, while at the same time it cuts funds for job training and education that would provide people with the skills needed for those jobs. This Administration blithely denies that its future deficits have anything to do with the high interest rates we have been experiencing, blaming those high rates on volatility in the Federal Reserve's control of the money supply. And this Administration still insists that everything will work out in the future, despite the fact that its initial predictions for the economic growth—for interest rates, for deficits, and for employment—have so far all been wrong.

The key economic problem that we face today, I think we can all agree, is high interest rates. It is high interest rates last summer that caused our current recession and high unemployment. It is a resurgence of high interest rates over the past two months that will stand in the way of recovery, and it is the likelihood of a recurrence of high interest rates later this year that may well lead to yet another Republican recession in 1983. So, the key question we must address in these hearings today is why interest rates are high.

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We need to face the fact that this Administration has no plan for reducing interest rates other than to blame the Federal Reserve. Essentially, they have argued that it is the volatile money supply which has led to the adoption of "uncertainty premiums" in addition to the inflation premiums. This is a most novel and fatuous argument. Administration officials know full well that there is no relationship between the short run fluctuations of the money supply and inflation, or to much of anything else that affects interest rates. It is as disingenuous as their claim that they deserve credit for lower inflation, but not blame for higher unemployment.

The inescapable facts are that it is the prospect of large and growing deficits that produced high interest rates last year, and that this Administration has no credible plan for reducing those deficits. Look at the numbers! Under last year's tax cuts, Federal revenues will be reduced to 19 percent of GNP by 1984. Under current plans, spending for defense will equal 6 percent of GNP, Social Security, Medicare, and retirement benefits alone will equal 7 percent of GNP, and interest payments will be close to 3 percent of GNP. That will leave only 3 percent of GNP to be spent on every other Federal program, from aid to the poor, highways, the FBI, the State Department, to Congress and the White House. Not only is that less than the 7 percent of GNP spent in these functions in 1981, it is less than the 6.6 percent of GNP spent in 1970, or even less than the 5.5 percent of GNP spent in 1960 at the end of the Eisenhower Administration. No wonder that this Administration has decided that deficits are not so bad after all, and no wonder that the financial markets are so skeptical of this Administration's policies. The only hope that the Administration has is that there will be rapid economic growth, but how can that take place when enormous deficits drive up interest rates or absorb all the new savings that may occur?

The Administration's deficit-prone fiscal policy places the Federal Reserve in a difficult position. Because this Administration has no other policy for reducing inflation, if the Federal Reserve eases its monetary policy to relieve the deficits' pressure on credit markets, that would set off fears of more inflation and drive up the inflation premium in interest rates. But if the Fed tightens monetary policy to maintain anti-inflation credibility, that will make credit conditions even tighter and lead to even more unemployment. However, the course that the Fed has announced today is not an acceptable way out of that dilemma. Almost every economic forecast I have seen assumes a money-growth rate of close to 6 percent if there is to be a sustained recovery this year. That rate is within last year's target range for M-1. But if the targets are lowered, as the Fed has now proposed, these same forecasts suggest that there will be a prolonged recession, a weak recovery, and yet another recession in 1983. I think the Fed could have given the economy a little more breathing room and reduced a little bit the adverse consequences of this Administration's fiscal policies it had retained last year's targets for monetary growth. Still, I recognize that there are difficulties in controlling money supply with precision, because of the increasing blurring of boundaries between transaction and savings balances. For this reason, the Subcommittee on Domestic Monetary Policy will hold hearings on March 3 and 4 on the impact of money substitutes on monetary control.

But that being said, there can be no question that any major solution to our economic problems will have to come from this Administration, and from changes in its economic policies. As that noted Republican and conservative Herbert Stein has said of the Administration's program, "When the captain of the cruise ship leaves New York harbor to sail north to Bermuda, one does not have to wait until ice bergs are spotted to call for a change of course."

Mr. PATMAN. Mandatory reading. [Laughter.]

Mr. FAUNTROY. Yes, mandatory reading. Let me conclude, Mr. Chairman, by echoing your words of praise for retiring Vice Chairman Schultz, who has brought an unusual dedication to his tenure on the Federal Reserve Board, who by his careful attention to detail and close working relationship of the staff of the Fed has en-

riched the public service. Thank you, Mr. Schultz. I yield back the balance of all the time you gave me. [Laughter.]

The CHAIRMAN. The Chair will assure the chairman of the subcommittee that all members will read his statement very assiduously.

At this point the Chair would like to recognize Mr. Schultz.

**STATEMENT OF HON. FREDERICK H. SCHULTZ, VICE CHAIRMAN,
BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM**

Mr. SCHULTZ. Thank you very much, Mr. Chairman. I am most appreciative of the comments that you and Congressman Stanton and Congressman Fauntroy have made. I would just note that it is easy to look good when there is good leadership, and Paul Volcker has provided that leadership.

I hope you will excuse me. I need to go chair a Board meeting. It is interesting that when I was sworn in, Chairman Miller was moving out something had occurred which required a Board meeting, so I chaired the first Board meeting that I ever attended. I am now about to chair my last Board meeting.

I will miss the Fed very much. One of the things that I will not miss is the fact that I sat between the Chairman and Governor Wallich, both of whom smoked cigars. [Laughter.]

I shall not comment on the quality of those cigars. [Laughter.]

I would, however, sincerely request that if you can keep the Chairman here long enough today I can chair the Board meeting with just half of that twosome and, therefore, only half of the cigar smoke. [Laughter.]

Thank you very much. [Applause.]

The CHAIRMAN. Mr. Barnard asks if you have any other promises that you can make us that you can keep if we can keep Mr. Volcker here long enough.

Chairman Volcker.

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

Chairman VOLCKER. I would like to proceed with my statement, Mr. Chairman, but I do want to take this opportunity to acknowledge from my point of view the enormous service that Fred Schultz has given to the Federal Reserve and to the Nation generally, and I certainly have been in a position to appreciate that more than anyone else. We are going to miss him greatly. We can only thank him for his willingness to serve during this period.

I appreciate the opportunity to meet with members of this distinguished committee today to discuss the direction of monetary policy and the prospects for the national economy. I have submitted for the record the official report from the Board in accordance with the Humphrey-Hawkins Act. I would now like to take a few minutes to underscore and amplify some of the points in that report, as well as to offer some more personal views on the problems—and equally important, the opportunities—that are before us.

As you know, the economy has been in recession for some months. The recession has some of the characteristics of earlier

downturns. But it seems to me plainly wrong to think of the current state of the economy as simply reflecting "another" recession.

Rather, we are seeing the culmination of a much longer period of unsatisfactory economic performance extending well back into the 1970's—performance marked by poor productivity, growing unemployment, much higher interest rates, and pressures on the real earnings of the average citizen and on the real profits of our businesses.

A number of factors have contributed to that deterioration in our performance, not all of them completely understood. But one pervasive element—an element particularly relevant to monetary policy—stands out: we found ourselves in the midst of the most prolonged inflation in our history, and that inflationary process had come to feed on itself. Incentives were distorted. Too much of the energy of our citizens was directed toward seeking protection from future price increases and toward speculative activity, and too little toward production. Increasingly depressed and volatile capital markets reflected the uncertainties. Effective tax rates increased as inflation carried taxpayers into higher brackets. But, in a sluggish economy, those revenues did not keep up with our spending plans and programs.

Against that background, the notion that we might comfortably live with inflation—or that we could accept inflation in the interest of strong growth—was exposed as an illusion. I believe it is fair to say a clear national consensus emerged that turning back inflation had to be a top priority of economic policy—that a stable dollar is a necessary part of the foundation of a strong economy.

Monetary policy has a key role to play in restoring that stability, and our policies are directed to that end. But recent developments have confirmed again that ending an inflation, once it has become deeply seated in expectations and behavior, is not a simple and painless process. The problems can be aggravated if too much of the burden rests on one instrument of policy. And the effort to restore stability will be more difficult to the extent policies feed skepticism and uncertainty about whether the effort will be sustained—a skepticism rooted in past failures to "carry through." Monetary, fiscal, and other public policies are constantly scrutinized—in financial markets and elsewhere—to detect any signs of weakening in the sense of commitment to deal with inflation. To speed the transition to lower interest rates and healthier capital markets, to reduce the costly elements of anticipated inflation built into wage and price contracts, to permit more confident planning for the future—to, in fact, lay the base for sustained recovery—credibility in dealing with inflation has to be earned by performance and persistence.

That, essentially, is what public policy—and monetary policy in particular—has been about for some time, and there are now signs of real progress on the inflation front. That progress is reflected to greater or lesser degree in all the widely used inflation indices. Consumer prices rose 8.9 percent last year, 3½ percentage points less than the 1980 peak, and the inflation rate seemed to be trending lower still as the year ended. Finished goods producer prices have had an average increase at an annual rate of only about 4 percent for 6 months. Expectations cannot be so easily measured,

but earlier fears that inflation might rapidly accelerate have plainly dissipated.

Those gains, to be sure, have elements that may not be lasting. Some prices are depressed by recession-weakened markets, and some by the pressures of high interest rates on inventories and speculative positions; exceptionally good crops last year have held food prices down; and surpluses have emerged in oil markets, following the enormous price increases of earlier years.

But we also see evidence of potentially more lasting changes in the trend of costs as management and labor in key industries come to grips with competitively damaging productivity and wage trends. I am aware that this process has just begun, and it has been centered largely in areas where competitive pressures are most intense. But as the emerging patterns spread, we will have succeeded in establishing one of the major elements for success in the fight against inflation and for reconciling, as we must, a return to greater price stability with growth, reduced unemployment, and higher real wages. Quite obviously, policies that encourage that process of cost moderation will have a large "pay off" in future economic performance.

I am acutely aware that progress on the inflation front has been accompanied by historically high levels of interest rates and heavy strains on financial markets. Those sectors of the economy particularly dependent on borrowing—especially long-term borrowing—have been hard hit.

The pattern of economic activity last year shows the picture clearly. Over the course of 1981, the overall level of production of goods and services—real GNP—posted a slight increase. But at the same time, homebuilding dropped to the lowest level in decades. Sales of consumer durables—car sales in particular—fell markedly. And now capital investment by businesses also appears to be adversely affected, running contrary to longer term needs.

It would be simplistic to cite high interest rates as the sole cause of the difficulties in these vulnerable sectors. Part of the problem arises from other, and longer term, factors, themselves associated with the inflationary process. In housing, for example, we have had a decade of increases in prices of homes almost double the rate of inflation in the economy generally and well in excess of the rise in average family income. "Sticker shock" still seems to be the major deterrent to new car sales as the industry comes to grips with long developing competitive and regulatory problems and the enormous challenge of adapting to the higher price of gasoline.

In the best of circumstances, coping with deep-seated inflation would pose difficulties. At the same time, we have had to adjust to the huge increases in the price of energy, to meet the need for a stronger defense, and to deal with the drag on incentives and investment resulting from rising marginal tax rates. All of that implies massive economic adjustments, the threat of a growing fiscal imbalance, and a difficult transition period. The high level of unemployment generally, and particularly distressing conditions in some of our older industrial centers, are one symptom. Lasting progress toward price stability—and other needed adjustments—cannot be built on prolonged stagnation, rising unemployment, and slow growth. The relevant question is not whether current condi-

tions are satisfactory or tolerable—they obviously are not. It is whether our policies, and our policy mix, promise to achieve the needed results over time.

MONETARY POLICY IN 1981 AND THE TARGETS FOR 1982

It is against that background that I would like to review monetary policy last year and discuss our intentions for 1982.

As you know, the main responsibility for dealing with inflation has fallen on monetary policy. I would emphasize that the process of restoring stability will proceed more easily and effectively, with less strain on financial markets and on credit-sensitive sectors of the economy, to the extent the effort is complemented and supported by other policies. But, in the end, history and theory alike confirm that no effort to turn back inflation can be successful without appropriate restraint on the expansion of money and credit. I believe the record of the past few years amply reflects the needed monetary discipline.

The Humphrey-Hawkins Act specifically requires that we translate our broad objectives into quantitative monetary and credit targets. More broadly, those targets have become one means of communicating our intentions to the public in a comprehensible way. The judgments involved in setting appropriate targets are never simple, and they have been increasingly complicated by the rapid pace of innovation in financial markets. Those innovations sometimes blur the precise meaning of the various monetary and credit aggregates, complicate their measurement, or change the economic significance of a particular target. In the circumstances, elements of judgment are necessary in interpreting behavior of the aggregates, particularly when their movements diverge somewhat.

The events of 1981 surely reflect those facts, but they also seem to me to provide an unambiguous record of persistent monetary restraint. The targets we set for the year pointed toward a reduction in the growth of the monetary aggregates from the rates of expansion in 1980. In our 1981 report to the Congress, setting forth those targets, we also suggested that changing preferences of the public for different types of financial assets—influenced by regulatory developments and new “products” offered by financial institutions—might tend to push the broader aggregate M_2 to the upper part of its specified range, and that judgments about the course of the narrow aggregates— M_{1A} and M_B —would require taking account of shifts into NOW accounts, particularly during the early part of the year when they were newly introduced nationwide. These expectations were borne out, but as the year progressed the divergences among some of the aggregates became even wider than expected.

Measured by comparing fourth quarter averages in 1980 and 1981, M_{1B} growth (adjusted for the estimated shift of funds into now accounts)¹ in 1981 was 2.3 percent, a little more than 1 per-

¹ The “adjustment” allowed for shifts of funds into NOW accounts and similar instruments included in M_{1B} from sources outside of M_{1B} . The shift-adjustment was estimated on the basis of various surveys of depository institutions and individuals, as well as by statistical techniques. M_{1B} without adjustments rose by 5 percent, also below its indicated range. While the adjustment was necessarily estimated, we believe the “adjusted” data are more appropriate for assessing the trend in the money supply, particularly during the early part of the year when shifts were large.

cent below the lower end of the target range specified 1 year ago (see table 1 attached). You will recall that I reported to you in July that an outcome near the lower end of the range would be desirable.

Measured in the same way, M_2 slightly exceeded the upper end of its range after rather closely following the upper bound as the year progressed. The subsidiary target range for M_3 was exceeded by a greater margin, reflecting in considerable part some changes in the composition of commercial bank financing patterns toward domestic sources that had not been anticipated, while bank credit fell within, but toward the upper part of, its range.

In judging trends over a period of time, annual averages may be more meaningful. As table 2 illustrates, average annual M_{1B} —adjusted—growth has declined by an average of 1.1 percentage point since 1978, to a rate of 4.7 percent in 1981. On the same basis, M_2 growth was steady in 1979 and 1980, but actually rose by more than 1 percentage point in 1981. Over those years, both aggregates have been affected by institutional change. Relaxation of interest rate ceilings applicable to time deposits of depository institutions and the enormous growth of money market funds—both included in M_2 —tended to raise the trend of M_2 over the period as individuals had incentives to lodge a larger proportion of their assets in these instruments. Assets in money market mutual funds are not included in M_1 , but the enormous growth of those funds, providing virtually immediate availability of funds and checkwriting privileges, diverted some money away from checking accounts in depository institutions which are included in M_1 . Given the technical and institutional changes bearing on M_1 and its relative volatility, its movements need to be assessed in light of developments with respect to the other aggregates. Indeed, a number of analysts attach greater weight to M_2 .

Experience during 1981 also illustrates the variety of forces impinging on interest rates and credit market conditions. Over long periods of time, there should be a relationship between interest rates and inflationary expectations—that is, both lenders and borrowers might reasonably anticipate a small positive return on loanable funds in “real” terms, after allowing for inflation. When economic conditions were relatively stable in the postwar period and inflation low, that relationship with respect to long-term interest rates were fairly steady. But history is replete with deviations for a time in either direction, and high levels of income taxation distort the comparison. Before taxes, “real” interest rates—measured on the base of actual inflation—were negative during part of the seventies, but recently have been extraordinarily high. One factor, particularly in long-term markets, appears to be concern about whether public policy will, in fact, “carry through” the fight on inflation.

Even with inflation subsiding, the threat of prolonged large Federal deficits as the economy recovers points to a more imminent concern—direct Government competition for a limited supply of savings and loanable funds. The clear implication is greater pressure on interest rates than otherwise, with those interest rates serving to “crowd out” other borrowers. The most vulnerable, of course, are home buyers and other particularly dependent on

credit. But the consequences for business investment generally are adverse as well.

Monetary policy, of course, influences interest rates, but the relationship has several dimensions. As monetary restraint reduces and eliminates the risk of inflation over time, it will work powerfully toward a more favorable climate for longer term borrowing, and in the credit markets generally. In the short run, should inflation, economic growth or other factors increase the need and desire to hold money, restraint on the supply of money will ordinarily be reflected in pressures on short-term rates. However, to accept inflationary increases in the money supply in an attempt to lower interest rates would ultimately be self-defeating; even in the short run, market sensitivities might well give the opposite result.

Some of these interrelationships were evident in 1981. Short-term interest rates fluctuated over a wide range, but generally trended down from peak levels in the spring or early summer, falling particularly sharply as the recessionary forces became apparent in the fall. That was a period when pressures on commercial bank reserves positions were easing, consistent with our monetary and credit targets. However, longer term interest rates continued to rise for months after the peak in short-term rates, influenced in substantial part by growing concern about prospective budgetary deficits.

As growth in the money supply rose more rapidly late last year, and a very sharp increase developed early in January, the reserve positions of banks came under some renewed pressure as Federal Reserve open market operations constrained the supply of reserves. At the same time, there were scattered signs recessionary forces might be waning. Short-term interest rates rose from early November lows, although they remain well below levels prevailing during much of 1981. Some long-term interest rates—notably those on Government securities—returned close to earlier peaks, suggesting the impact of current and prospective Treasury financing.

This was the setting for the decision on the monetary and credit targets taken by the Federal Open Market Committee last week. The sharp increase in the money supply in January carried the level well above the fourth quarter 1981 average, the conventional base for the new target, and somewhat above the lower end of the range specified for 1981. A large increase in the money supply, accompanied by higher interest rates, is unusual during a period of declining production and economic activity. Moreover, the composition of the money supply increase in the past 3 months is heavily concentrated in a rather small component of M_1 —NOW accounts, which are held by individuals. That increase in NOW accounts has been accompanied by a reversal of earlier sharp declines in savings accounts—another highly liquid asset—and by declines in small time deposits, which provide a less liquid outlet for personal funds. Taken together, the evidence suggests some short-term—and potentially “self-reversing”—factors may be at work, inducing individuals to build up highly liquid balances at a time of economic and interest rate uncertainty.

Taking those circumstances and others into account, the Federal Open Market Committee decided to adopt the tentative targets dis-

cussed last July: For M_1 , $2\frac{1}{2}$ to $5\frac{1}{2}$ percent; for M_2 , 6 to 9 percent; for M_3 , $6\frac{1}{2}$ to $9\frac{1}{2}$ percent.

The associated range for bank credit is 6 to 9 percent.²

The M_1 target is lower than the range specified a year ago for M_{1B} ($3\frac{1}{2}$ to 6 percent shift-adjusted), but it is consistent with somewhat larger actual growth than experienced last year with the "adjusted" measure. The lower end of the range would now appear appropriate only if the pace of financial innovation again picks up—for instance, a rapid spread of arrangements for "sweeping" temporarily excess checking account balances into money market funds or other liquid assets not included in the M_1 . Given the present level of M_1 and the relatively slow growth last year, the FOMC at this time feels that an outcome in the upper half of the range would be acceptable, and that M_1 could acceptably remain somewhat above the implied "growth track" during the period immediately ahead.

In that connection, I would point out that an outcome in the upper part of the range specified for 1982 would be roughly the equivalent of a rate of growth of 4 percent from the lower end of the range targeted in 1981, as illustrated on chart II. Such a result would be entirely consistent with the objective I stated to your committee in July.

The FOMC anticipates somewhat slower growth in M_2 than a year ago, when the target was slightly exceeded. At present, an outcome in the upper half of the range appears more likely and desirable. Assets included in M_2 account for a significant part of individual savings. Should total savings increase substantially more rapidly than now anticipated in response to tax incentives or other factors—or if legal or regulatory changes, such as the wider availability of IRA accounts, result in a substantial volume of funds shifting into depository institutions from other sources—growth might logically reach (or even slightly exceed) the upper limit.

Identifiable "structural" influences of that sort on M_2 , or other aggregates, must appropriately be taken into account in formulating policy steps and judging actual developments. For example, should developments in coming months provide solid evidence that the recent exceptional growth of M_1 is indicative of some more fundamental and lasting change—such as a desire by individuals to continue to hold more liquid savings in the form of NOW accounts—the FOMC would, of course, reconsider that growth target at or before the regular midyear review.

These technicalities should not confuse a simple message: Consolidating and extending the heartening progress on inflation will require continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint. The growth ranges specified are, we believe, consistent with an economic recovery later this year, although we do not anticipate, by historical standards, a sharp "snap back." What is more important is that the re-

² While all of the monetary ranges were set, as in previous years, on a fourth-quarter to fourth-quarter basis, the range for bank credit is measured from the average level in December 1981 and January 1982 to the fourth-quarter 1982 level. This adjustment in the base for bank credit is necessitated by the opening of International Banking Facilities on December 3, 1981, which led to a shifting of certain bank assets, formerly included in the domestic bank credit data, from U.S. offices to the IBF's.

covery have a firm foundation—that it be sustained over a long period. There will be more room for real growth—and much better prospects for sustaining that growth over many years—the greater the progress on inflation.

THE COURSE AHEAD

In approaching the future, the lessons of the past bear repeating. We cannot buy or inflate our way out of recession—not without ratcheting up both inflation and unemployment over time. We cannot turn the effort to deal with inflation “on and off”—not without adversely influencing the decisions of those in the marketplace who commit funds for investment, with consequences for the recovery and productivity we want.

What we can do is set the stage for a much more favorable outlook—a future in which progress toward price stability, lower interest rates, greater productivity, slower growth in nominal wages but higher real wages, all benignly interact to support growth and reduce unemployment. That’s a process we have not seen sustained in this country for many years.

Today, we are acutely aware of disturbed capital markets, high interest rates, economic slack, and a poor productivity record. But, when the economy begins to expand, productivity should rise; tax and other measures already in place or under way should help reinforce a better trend. Productivity growth, in turn, will permit prices to rise more slowly than wages—more modest wage and salary increases in dollars will then be consistent with more growth in real earnings, encouraging further moderation in wage demands and sustaining the disinflationary process. As confidence returns to securities markets, prices of bonds and stocks should rise, and lower interest rates and more favorable capital market conditions will in turn support the continuing growth in investment and productivity. With appropriate budgetary and monetary discipline, the process could be sustained for years.

That is not an impossible vision. We saw something of it in the early 1960’s. As recently as the mid-1970’s, coming out of a deep recession, we seemed to be moving in the right direction—and then lost our way. Some of the essential elements of a brighter future—as well as some of the hazards on the way—are reflected in the longer term projections of both the administration and the Congressional Budget Office now available to you.

From the standpoint of public policy, much of the groundwork has been laid. I have spoken of the key role for monetary policy, and of our record and intentions in that regard. The tax program enacted last year can, in the right context, have favorable effects on incentives and on investment. The excessive burden of regulation is being addressed.

But, of course, for the process to get fairly started we need to resolve some large outstanding questions as well—questions that hang heavily over financial markets and prospects for interest rates, inflation, and early recovery.

I have referred on many occasions to the key importance of winding down on the cost and wage pressures that tend to keep the inflationary momentum going. The process appears to be starting,

and the faster it takes hold the better the outlook for growth and reduced unemployment. But, clearly, prospects for early and sustained expansion—an expansion that can be broadly shared by industries now severely depressed—is dependent on access to capital and credit on more favorable terms. Pumping up the money supply cannot be the answer to that problem—excessive money and the inflation it breeds are enemies of the real savings needed to finance investment.

What we can do is relieve the concerns the markets understandably have—concerns reflected so strongly in the budgetary documents before you from both the administration and your own budget office. Without action to cut spending—or, if that fails, to raise new revenues—we would face the prospect of deficits rising to unprecedented amounts, whether measured in dollars, in relation to the GNP, or as a proportion of our limited savings and the supply of loanable funds. We can debate among ourselves just what level of deficit is tolerable in coming years and what is not. We can be tempted to sit back and let a year pass as we discuss what programs should be cut or where revenues can be raised. But I think we all know that, without action, we would be on a collision course between our need for new plant, equipment and housing and our capacity to save—and it would be more difficult to reconcile the requirements for a sound dollar with our desire to grow.

It could be argued we have a little time. A large deficit in the midst of recession should be manageable; it indeed provides some support for the economy in a time of stress. There are also large potential sources of demand in the private economy. The latest economic indicators are not so weak as they were. We can see we are making some progress against inflation, perhaps as fast as could reasonably have been anticipated. In all these circumstances, a degree of patience is needed—and justified.

But delay in another matter. In my judgment, the more progress we can see in restraining costs, and the more resolute your budgetary action, the earlier we can be assured a prompt and strong recovery.

The course of action we have set in the Federal Reserve seems to me consistent with that sense of direction and urgency. But no single instrument of policy can, alone, do the job. We look forward to working with you and your colleagues in the weeks and months ahead to meet these challenges constructively.

Table 1

Monetary Growth 1981

	<u>1981 Ranges</u>	<u>1981 Actual*</u>
M1-B	6 to 8-1/2 percent	5.0 percent
M1-B (shift adjusted)	3-1/2 to 6 percent	2.3 percent
M2	6 to 9 percent	9.4 percent
M3	6-1/2 to 9-1/2 percent	11.3 percent
Bank Credit	6 to 9 percent	8.8 percent**

*Fourth quarter to fourth quarter

**December level used for calculating this 1981 growth rate incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

Table 2Growth of Money and Bank Credit
(percentage changes)

	<u>M1-B*</u>	<u>M2</u>	<u>M3</u>	<u>Bank Credit</u>
Fourth quarter to fourth quarter				
1978	8.3	8.3	11.3	13.3
1979	7.5	8.4	9.8	12.6
1980	6.6	9.1	9.9	8.0
1981	2.3	9.4	11.3	8.8**
Annual average to annual average				
1978	8.2	8.8	11.8	12.4
1979	7.7	8.5	10.3	13.5
1980	5.9	8.3	9.3	8.5
1981	4.7	9.8	11.6	9.4**

*Growth rates for 1980 and 1981 adjusted for shifts to other checkable deposit accounts since the end of the preceding year.

**December level used for calculating these 1981 growth rates incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

Table 3

Monetary Growth Targets 1982

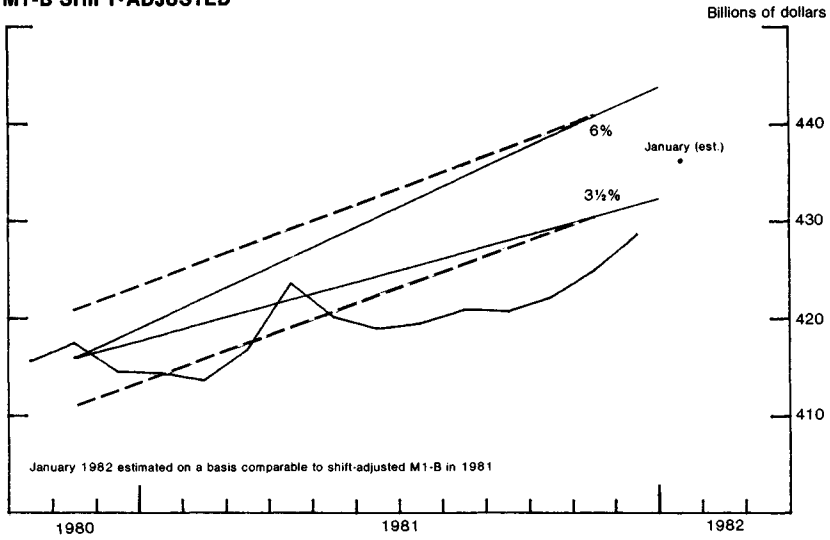
M1*	2-1/2 to 5-1/2 percent
M2	6 to 9 percent
M3	6-1/2 to 9-1/2 percent
Bank Credit	6 to 9 percent**

*The objective for growth of narrowly defined money over 1981 is set in terms of M1. Based on a variety of evidence suggesting that the bulk of the shift to NOW accounts had occurred by late 1981, the Federal Reserve is publishing only a single M1 figure in 1982 with the same coverage as the former M1-B.

**The bank credit data after December 1981 are not comparable to earlier data because of the introduction of International Banking Facilities. Thus, the targets for 1982 are in terms of growth from an average of December 1981 and January 1982 to the fourth quarter average of 1982.

Growth Ranges for 1981 and Actual

M1-B SHIFT-ADJUSTED



M2

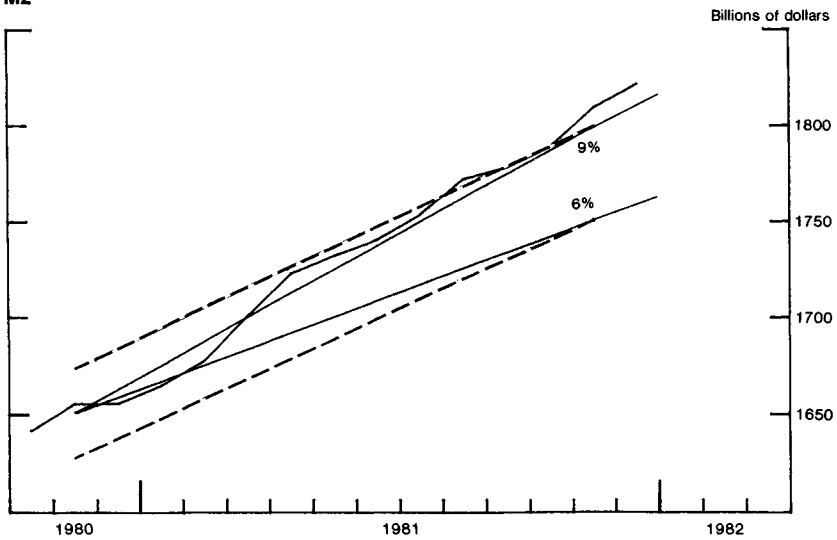
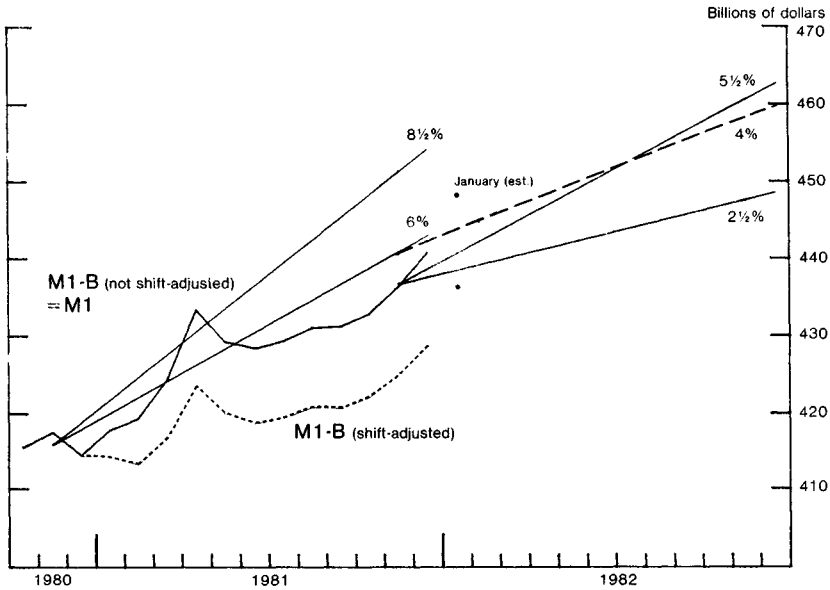


Chart 2

Growth Ranges for and Behavior of M1, 1981 and 1982

[Chairman Volcker submitted the following report of the Board of Governors of the Federal Reserve System, dated February 10, 1982, entitled "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978":]

Board of Governors of the Federal Reserve System



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

February 10, 1982

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 10, 1982

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.

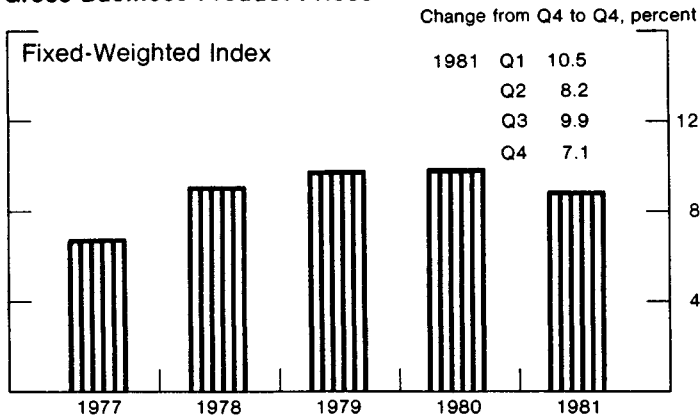
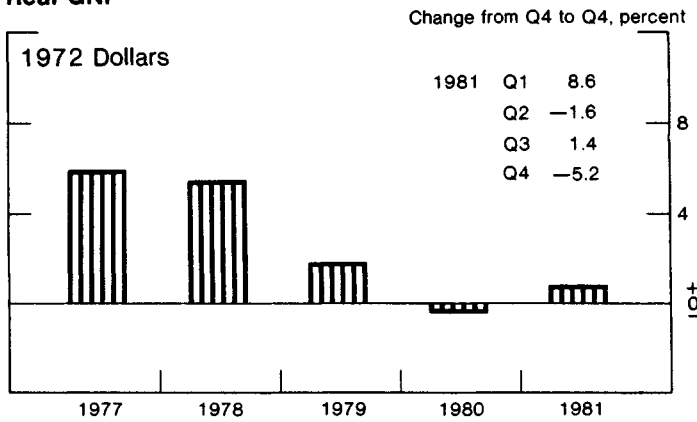
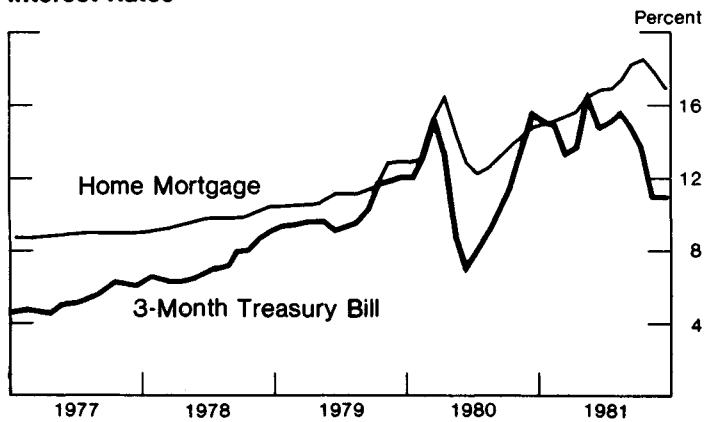
Sincerely,
Paul A. Volcker, Chairman

Section 1: Monetary Policy and the Performance of the Economy in 1981

The economy was growing rapidly as 1981 began, continuing the sharp cyclical rebound that started in mid-1980. Activity leveled out during the spring and summer, however, and it fell in the final quarter of the year. As a result, the rate of production of goods and services--real GNP--was only slightly higher at the end of 1981 than it had been a year earlier. With the weakening of output late in the year, the margin of unutilized plant capacity widened and the unemployment rate rose sharply to near postwar record levels.

While economic activity was disappointing last year, there were emerging signs of progress in reducing inflationary pressures. The rate of price inflation slowed from the extremely rapid pace of the preceding two years, and as 1981 progressed there also were indications of an easing in the rate of wage increases, particularly in some key pattern-setting industries.

Confidence in the restoration of reasonable overall price stability is needed if economic growth is to be resumed on a sustained basis. The accelerating inflation of earlier years had been eroding the foundations of the nation's economy: capital formation had slowed; productivity was sagging; the functioning of basic market mechanisms was being impaired; and inequitable and capricious transfers of wealth were harming many of the weakest among us. The task of reversing the inflationary trend of earlier years was made more difficult because a decade of escalating prices and unsuccessful anti-inflation policies had led to firmly held expectations of continued high--if not accelerating--rates of inflation. Thus, it was recognized that reducing inflation would take time and that anti-inflation policies would

Gross Business Product Prices**Real GNP****Interest Rates**

have to be applied with persistence if they were to be effective in altering expectations and slowing the rate of price increases.

While fiscal policy and decisions made in the private sector have much to do with the course of economic developments, economic theory and experience alike indicate that progress toward price stability cannot be obtained without adequate restraint on the growth of money and credit. Monetary policy was conducted in 1981 with this crucial fact in mind. The Federal Reserve set objectives for the growth of the monetary aggregates that it believed would help to damp inflation and would lead to movement over time toward trend rates of monetary expansion consistent with the growth of potential output at stable prices.

Short-term market rates of interest began 1981 at record levels, as rapid growth of economic activity in the second half of 1980 had pushed up the demand for money and credit faster than could be accommodated within the target ranges for growth of the monetary aggregates and bank reserves. Early in 1981 these demands began to subside, pressures on bank reserve positions were relieved, and money market rates declined for a time. A bulge in money demand early in the second quarter was steadily resisted by restraining the supply of reserves, and in the process short-term interest rates moved back to their earlier highs. By midsummer, short-term interest rates were declining, as demands for money and credit slackened while the Federal Reserve expanded nonborrowed reserves in an effort to maintain adequate monetary growth. Those interest rate declines accelerated in October and November as the recession took hold.

On balance, short-term interest rates--although volatile--moved down considerably over the course of 1981. In contrast, long-term rates

rose substantially over the period, despite declines in the last quarter of the year. The pressure on long-term rates appeared to reflect a combination of factors. Anticipations that continued large federal budget deficits would clash with private credit demands particularly as the economy expanded, putting strong pressures on credit markets, were a continuing strong investor concern. Despite reductions in the growth of many federal spending programs, federal borrowing in calendar year 1981 siphoned off roughly a quarter of the total funds available to domestic nonfinancial borrowers. In the background were continuing doubts and skepticism that anti-inflation programs would be carried through. Moreover, the volatility of the markets may have inhibited aggressive buying of longer-term securities.

The tensions in credit markets in 1981 had their greatest impact on business and household capital formation. Housing construction fell to its lowest level in the postwar period; only 1.1 million new housing units were started in 1981. The weakness in real estate markets last year reflected a number of influences. Of paramount importance, in the short run, was the cost of mortgage funds. The average rate on mortgages closed for new homes was 15.3 percent in the fourth quarter of 1981, up from 12.6 percent a year earlier. But it was not higher mortgage rates alone that cut into housing demand: high prices also adversely affected the ability of those seeking new homes to afford the monthly payments. Although house prices changed little in 1981, over the preceding 5 years prices of new and existing homes had risen half again as fast as the overall rate of inflation. As a result, the share of average family disposable income needed to service the monthly payment on a typical new mortgage rose from 21 percent in 1976 to nearly 40 percent last year.

Slow income growth and rising unemployment, along with the increased cost of credit, combined to damp consumer spending in 1981--particularly for more discretionary, large ticket items such as autos, furniture, and appliances. Since the mid-1970s, household real after-tax income has only been rising at a 1/2 percent annual rate, compared with a long-run trend of 2 percent. At the same time, the prices of essential items such as food, gasoline, heating fuel, utilities, and medical services--as a group--have been rising faster than the overall inflation rate, and the share of disposable income devoted to these items has been increasing. The resulting squeeze on family budgets led many households to overextend themselves during the last half of the 1970s, taking on more and more debt to finance their purchases.

With household balance sheets debt-laden and credit costs rising, a retrenchment in consumer borrowing began in 1980, and continued through 1981. As the year progressed, it appeared that household balance sheets were improving. Consumer debt burdens (the ratio of monthly debt repayment obligations to income) declined to their lowest level in more than five years. Moreover, partly in response to the higher after-tax income following the tax cut on October 1, the saving rate rose from about 5 percent in the first three quarters of 1981 to 6 percent in the fourth quarter.

In real terms, personal consumption expenditures rose 1-1/4 percent over the four quarters of 1981. The gain was concentrated in the early months of the year as real consumer spending fell, on balance, over the final three quarters of 1981. Purchases of new automobiles were hardest hit. Sales of domestically produced cars totaled 6.2 million units in 1981, the poorest performance in 20 years. The depressed conditions in the auto sector were related,

in part, to the typical cyclical volatility in the demand for motor vehicles and to credit market conditions, which affected the cost of financing new car and truck purchases. However, the current problems in the industry appear to be related mainly to longer-term trends in automotive demand. These include: the rapid increase in the price of new cars, high gasoline and other operating costs, sluggish real income growth, intense foreign competition, and government regulations that have necessitated large investments to comply with emission control standards and to improve fuel efficiency. As 1981 was ending, it appeared that the auto industry was taking aggressive actions to reduce costs and to improve the competitiveness of its products.

Business firms, like households, restrained their spending on investment goods in 1981. Demand was damped by a substantial degree of excess capacity and by the rising trend in corporate bond rates throughout much of the year, which boosted the real cost of capital. In real terms, expenditures for new plant and equipment rose only 1-1/2 percent over the four quarters of 1981. Although spending for new structures increased during the year, real equipment outlays fell for the second year in a row; the biggest declines were for electrical machinery and transportation equipment, while spending for most other capital goods remained weak.

In contrast to fixed investment outlays, sizable unintended inventory accumulation boosted business financing requirements. As the year went on, unexpectedly weak demand led to a build-up of excess stocks in several industries. The most pronounced problem was in autos, but other manufacturers and retailers also found their inventory levels uncomfortably high relative to sales. On balance, total nominal business capital spending--fixed investment and inventories--rose about 20 percent above the 1980 average.

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Early in 1981, strong economic growth helped boost corporate internal funds, greatly reducing corporate needs for external financing. But as the economy slowed, corporate profits turned sluggish and businesses were forced to rely more heavily on credit markets to satisfy their rising capital needs. The bulk of business borrowing last year was in short-term markets, as most firms felt it best to defer making long-run commitments in the current financial environment. With the accumulation of additional short-term debt, however, corporate balance sheet positions deteriorated further, and the ratio of short-term to total debt of the nonfinancial corporate sector rose to a record high.

Real purchases of goods and services at all levels of government rose only moderately during 1981 as a sharp increase in purchases by the federal government was partly offset by curtailed spending at the state and local level. The rise in federal spending on goods and services reflected another large increase in defense purchases, while federal payroll reductions helped to contain increases in nondefense outlays. At the state and local level, real purchases fell 2 percent owing to a combination of the withdrawal of federal support for many activities, the continued impact of tax limitation measures, and the effects of a sluggish economy on tax revenues.

The weighted-average value of the dollar against major foreign currencies rose by nearly one-fourth during the period from January to August. The dollar eased somewhat in the last part of 1981, but at the end of the year still remained well above its year-earlier level. The improvement in the inflation outlook in the United States was a factor in the appreciation of the dollar. Moreover, at various times during the year changes in

the differential between interest rates on dollar assets and rates of return on foreign currency assets also had a noticeable impact on exchange rates.

Real exports of goods and services increased in the first quarter of 1981, in part because of strong GNP growth in one of our major trading partners, Canada. But for the next three quarters, real exports declined in response to a slowing of economic growth abroad and the effect of the appreciation of the dollar in 1980 and 1981. The volume of imports, other than oil, rose fairly steadily throughout the year. The current account, reflecting this weakened trade performance, shifted from a surplus in the first quarter to a deficit by the fourth quarter.

Employment grew at a moderate rate during the first three quarters of 1981 and the unemployment rate edged down. Job increases were strongest in the service and trade sectors. As economic activity began to contract in the autumn, the demand for labor fell sharply and the unemployment rate climbed to 8.8 percent in December--only fractionally below its postwar high. Layoffs in the durable goods and construction industries accounted for much of the drop in employment. As a result, the unemployment rate of adult men--who tend to be more heavily employed in these industries--jumped to a postwar record of 7.9 percent in December of 1981.

Labor productivity (output per hour worked) showed considerable fluctuation during 1981, reflecting the course of economic activity. Productivity rose at a 1-1/4 percent annual rate in the first three quarters of 1981. However, as often happens at the beginning of a cyclical downturn, output fell more than employment in the fourth quarter and productivity declined, offsetting the gains earlier in the year. Averaging across short-run cyclical

movements, productivity has shown little improvement in recent years, and thus has provided virtually no offset to the impact of rapidly rising compensation on unit labor costs.

Compensation and wage increases did decelerate during 1981--with continuing progress observed throughout the year. But the slowing was moderate, reflecting the basic inertia of the wage determination process, where many union contracts last three years or more and nonunion wage agreements usually are set annually. By the second half of 1981, however, some changes in those traditional wage-setting practices were under way in several important industries: management and workers alike began to reconsider planned wage adjustments, some expiring contracts were renegotiated well in advance of termination dates, and labor agreements at a number of firms were modified in an effort to ease cost pressures and to enable them to compete more effectively. These adjustments, coupled with the progress seen in reducing inflation during 1981, suggest that the nation's anti-inflation policies have set the stage for a sustained unwinding of wage and price increases.

The trend in inflation improved noticeably during 1981, and by year-end virtually all aggregate price indexes were advancing well below double-digit rates for the first time since 1978. The consumer price index rose 8.9 percent over the course of 1981, down from the nearly 13 percent average rate in 1979 and 1980. Important factors in the slowing of inflation were exceptionally favorable agricultural supplies and declines, after the first quarter, in world oil prices. Inflation in areas other than food and energy--particularly consumer commodities and capital equipment--also began to abate, although price pressures persisted in the consumer service sector, notably for medical care. As the year progressed, surveys of consumer expectations suggested that the inflationary psychology, which had increasingly permeated many aspects of economic behavior in earlier years, appeared to be subsiding.

Section 2: The Growth of Money and Credit in 1981

The Board of Governors in its report to Congress last February indicated that the System intended to maintain restraint on the expansion of money and credit in 1981. The specific ranges chosen by the Federal Open Market Committee (FOMC) for the various monetary aggregates anticipated a deceleration in monetary growth that would encourage further improvement in price performance. Measured from the fourth quarter of 1980 to the fourth quarter of 1981, and abstracting from the effects on deposit structure of the authorization of NOW accounts nationwide, the ranges adopted were as follows: for M1-A, 3 to 5-1/2 percent; for M1-B, 3-1/2 to 6 percent; for M2, 6 to 9 percent; and for M3, 6-1/2 to 9-1/2 percent. The associated range for commercial bank credit was 6 to 9 percent.

In formulating its objectives for 1981, the FOMC knew that the growth rates of the narrow aggregates would be affected markedly by shifts into NOW accounts which for the first time became available on a nationwide basis in January. Transfers into NOW accounts, which are included in M1-B, from savings deposits and other asset holdings not included in M1 were expected to be particularly large in the early months of the year. Thus, in order to avoid confusion about the intent of policy and to facilitate comparisons with previous years, the objectives announced for M1-B abstracted from such shifts.¹ Even after accounting for such shifts, however, the FOMC anticipated that the growth rates of the various aggregates were likely to diverge more than usual, reflecting the rapid pace of institutional change in financial markets. The FOMC indicated that if M1-B growth (adjusted for shifts into new NOW accounts and other

1. The shift adjustments were estimated on the basis of survey evidence and were published regularly over the past year.

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checkable deposits) was about in the middle of its annual range, the growth of M2 was likely to be in the upper part of its range, given the popularity of the nontransactions components of M2 that pay market-related interest rates. It also was noted that the relationship of M3 and bank credit to their respective ranges would be influenced importantly by the pattern of credit flows that would emerge, and particularly by whether financial conditions would be conducive for corporations to refinance short-term borrowing in the bond and equity markets.

It soon became apparent as 1981 unfolded that the behavior of the aggregates was turning out to be even more divergent than had been anticipated. Growth rates of the shift-adjusted narrow aggregates were low in the opening months of the year, a development that was welcome following rapid growth in the latter part of 1980. A strong surge in April was offset by weakness over the remainder of the second quarter. On the whole, average growth in adjusted M1-B over the first half of 1981 was well below that which would have been expected on the basis of historical relationships among money, GNP, and interest rates. On the other hand, despite the weakness in M1-B, the broader aggregates expanded quite rapidly in early 1981. M2 growth over the first half was near the upper end of its annual range, while the expansion of M3 placed this aggregate above the upper bound of its range at midyear.

After reassessing its objectives for 1981 at midyear, the FOMC elected to leave unchanged the previously established ranges for the aggregates over the remainder of the year. However, in light of the reduced growth in M1-type balances over the first half of the year, indications that this weakness might reflect a lasting change in cash management practices of

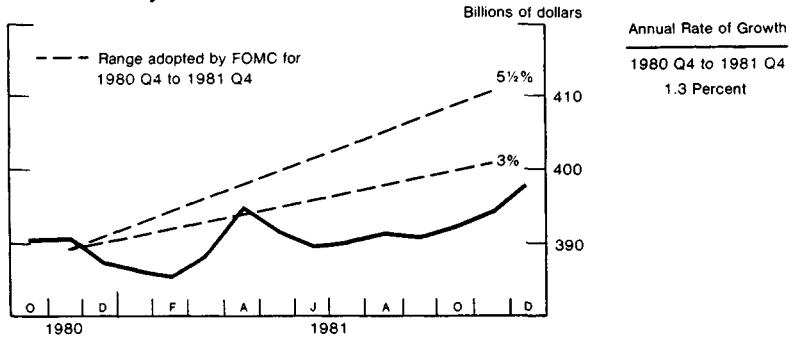
individuals and businesses related to the growth of alternative means of holding highly liquid funds, and given the relatively strong growth of the broader aggregates, the FOMC anticipated that growth of the narrow aggregates might likely and desirably end the year near the lower bounds of their annual ranges. Even so, given the sluggishness early in the year, this decision implied that growth of M1-A and M1-B would accelerate over the balance of the year. At the same time, the FOMC indicated that M2 and M3 might well end the year around the upper ends of their ranges. This expectation also reflected in part the possibility that regulatory and legislative actions as well as the popularity of money market mutual funds might intensify the public's preference to hold the type of assets encompassed in the broader aggregates.

Although growth of narrow money in the second half of the year was on average about the same as in the first half, M1-B strengthened appreciably in the final two months of the year. This acceleration appeared to reflect in part a lagged response to large short-term interest rate declines in the summer and fall and in part a shift in preferences for very liquid assets in an environment of heightened economic and financial uncertainty. Similarly, M2 growth in the second half was about in line with expansion in the first half, although growth in this measure also picked up at the end of the year. The expansion in M3, on the other hand, decelerated from the rapid pace of the first half, as sales of large CDs slowed in concert with a slackening in bank credit growth and stronger growth in core deposits.

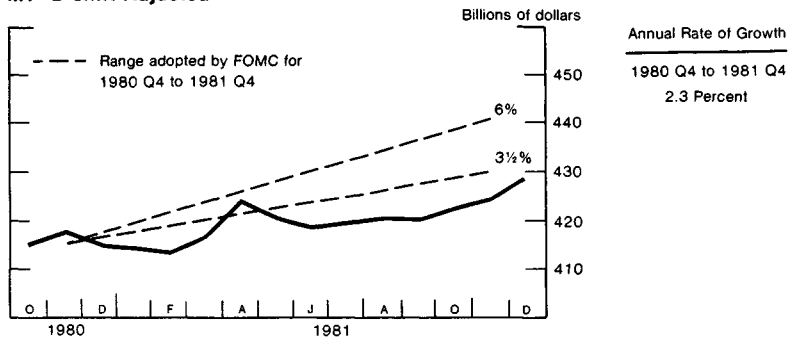
Measuring growth for the year from the fourth quarter of 1980 to the fourth quarter of 1981, M1-B growth adjusted for shifts into NOW accounts was about 2-1/4 percent--1-1/4 percentage points below the lower end of its

Growth Ranges and Actual Monetary Growth

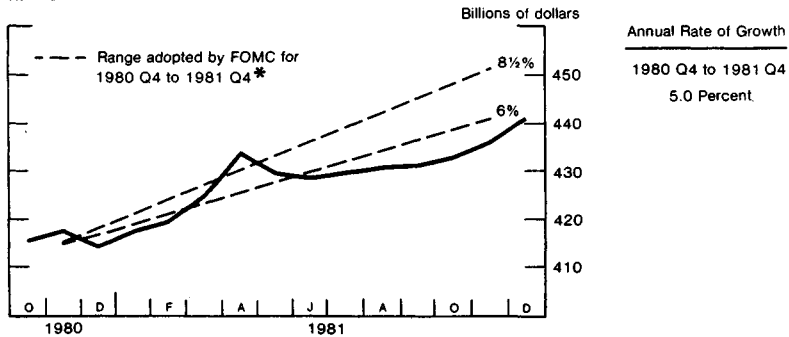
M1-A Shift Adjusted *



M1-B Shift Adjusted *



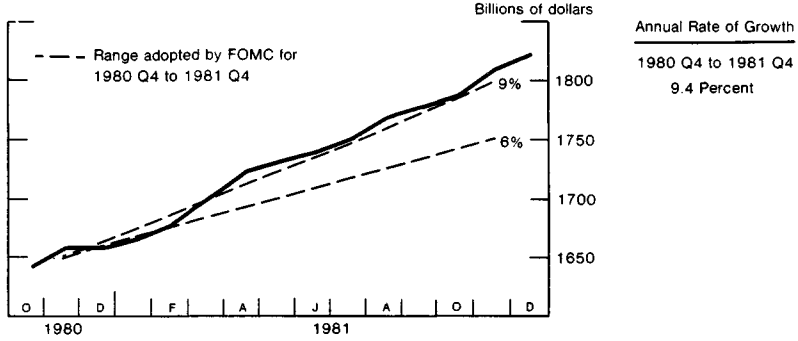
M1-B



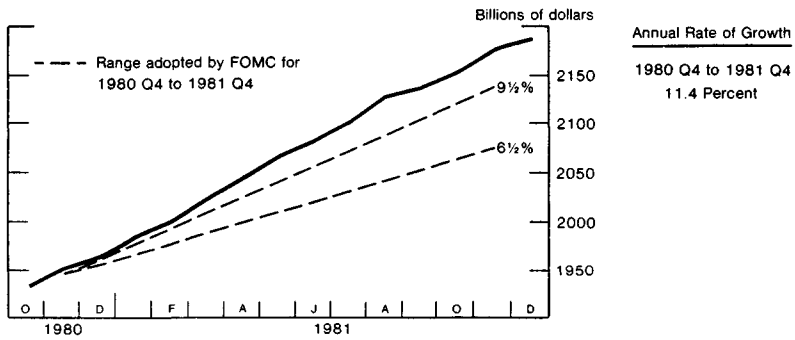
* Adjusted for impact of nationwide NOW accounts.

Growth Ranges and Actual Monetary and Bank Credit Growth

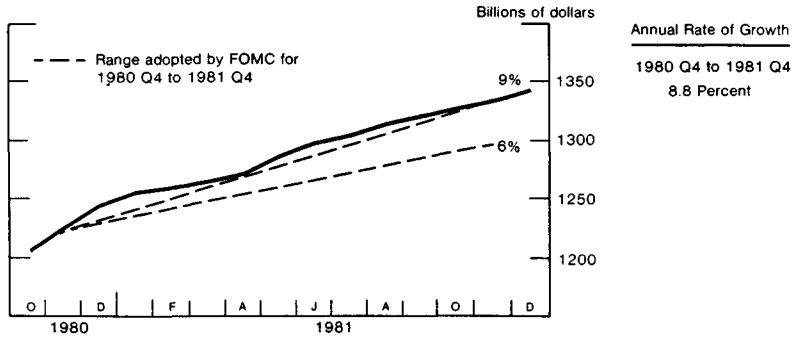
M2



M3



Bank Credit *



* Data prior to February are adjusted for discontinuity in series. December figure is adjusted for shift of assets into International Banking Facilities.

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targeted range.¹ Growth rates, of course, are affected by the particular pattern of variation that develops over the course of the year. Measuring expansion from December to December, "adjusted" M1-B growth in 1981 was at a 3-1/2 percent rate. On a yearly average basis, which reflects movements through the year as a whole relative to the level of the previous year, the increase was at a 4-3/4 percent rate. At the same time, measured from the fourth quarter of 1980 to the fourth quarter of 1981, growth of M2 was 9.4 percent, 0.4 percentage point above the upper limit of its range. Also, growth of M3 exceeded the upper end of its range by 1.9 percentage points, while bank credit growth was just inside the upper end of its annual range.

The table on page 14 puts the performance of the aggregates during 1981 into a somewhat longer-term perspective, showing two measures of annual growth. No matter which of the measures of annual growth is used, a marked deceleration in M1-B is apparent since 1978. The table also clearly illustrates that growth rates for the broader aggregates have been maintained around a higher level, and larger divergences have developed from M1-B growth. In considerable part, these differences can be explained by structural changes in financial markets.

As noted earlier, it was already obvious last February when the FOMC was meeting to set its objectives for 1981 that shifts into NOW accounts following their nationwide authorization at the beginning of 1981 would alter the behavior of the narrow aggregates. Data for early January had pointed to a very large movement of funds at the beginning of the year. However,

1. Unadjusted for shifts into NOW accounts, M1-B increased 5.0 percent from the fourth quarter of 1980 to the fourth quarter of 1981.

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Growth of Money and Bank Credit
(percentage changes)

	M1-B ¹	M-2	M-3	Bank Credit ²
Fourth quarter to fourth quarter				
1978	8.3	8.3	11.3	13.3
1979	7.5	8.4	9.8	12.6
1980	6.6	9.1	9.9	8.0
1981	2.3	9.4	11.4	8.8
Annual average to annual average				
1978	8.2	8.8	11.8	12.4
1979	7.7	8.5	10.3	13.5
1980	5.9	8.3	9.3	8.5
1981	4.7	9.7	11.5	9.4

1. Growth rates for 1980 and 1981 adjusted for shifts to other checkable deposit accounts since the end of the preceding year.

2. December level used for calculating these 1981 growth rates incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

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the pattern and magnitude of subsequent movements could not be predicted with any certainty. As events unfolded, the shifts into NOW accounts were more concentrated in the early part of 1981 than was anticipated by the working assumptions of the Board's staff. Through June, the adjustments made to the aggregates to correct for such shifts had the effect of raising M1-A by \$28 billion and lowering M1-B by \$9-1/2 billion. Over the second half of 1981, further adjustments for shifts into NOW accounts raised M1-A by only another \$6 billion and lowered M1-B by about \$2-1/2 billion more. While these adjustments are imprecise and based on evidence from a variety of sources, data on the number of NOW accounts coupled with other available information confirm that the shifting of funds from demand deposits to new interest-bearing checking accounts tapered off considerably by the fall. A surge in NOW account balances near the end of the year and early in 1982 appeared to reflect primarily the precautionary savings behavior noted above rather than shifting of funds into new accounts.

As was indicated above, the growth of the narrow aggregates adjusted for shifts into NOW accounts was low in 1981 compared with the other aggregates and also relative to past relationships with income and interest rates. Continued high interest rates provided a substantial incentive for businesses to intensify efforts to pare narrow money balances and to make increasingly widespread use of sophisticated cash management techniques. At the same time, explosive growth of money market mutual funds (MMMFs), many of which offer check-writing or other third party payment services comparable to conventional checking accounts, appeared to induce some households to minimize checking account balances. Also, the broader availability of NOW accounts

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may have stimulated households to reconsider in a more general way their habits of cash management.

Likewise, the strong growth of M2 over the past few years reflected changing financial practices. Money market funds and instruments offered by depository institutions that pay market-related interest rates have been accounting for an increasing proportion of M2, as such assets have become much more competitive with open market instruments. Indeed, the attractiveness of small time deposits was enhanced last year by the liberalization of the interest rate ceilings on small savers certificates and to a limited extent by the introduction of all savers certificates. Even so, three-fourths of the increase in the nontransactions components of M2 was accounted for by MMMFs which grew 140 percent last year.

The distortions in the aggregates resulting from the expansion in MMMFs are difficult to quantify. Surveys of household behavior and data on account turnover suggest that most shareholders of money funds have made little or no use of their accounts for transactions purposes. Thus, the direct substitution effect of MMMFs on the growth of M1 has appeared small, perhaps on the order of 1 percentage point on the rate of growth for the year. However, indirect effects may have been larger as the potential availability of such a highly liquid asset may facilitate holding less funds in demand and NOW accounts.

The direct effect of MMMFs on M2 appears more substantial in dollar terms. Presumably, the great bulk of the \$20 billion inflow in 1981 to MMMFs catering only to institutional investors was funds that otherwise would have been invested in assets not included in M2. In addition, it seems likely

-1/-

that a small portion of the \$90 billion growth in other types of MMMFs also reflected diversions from assets not in M2.

In light of the sizable distortions created by the growth of institution-only MMMFs, M2 has been revised to exclude such funds but they will continue to be a component of M3. In addition, M2 has been revised to include retail RPs. Retail RPs, which previously had been a component only of M3, were promoted on a substantial scale in 1981, likely attracting funds mainly from household small time deposits and MMMF holdings and thus resulting in a downward bias on M2 growth. The net effect on M2 growth of reclassifying institution-only MMMFs and retail RPs, along with other minor revisions, was small.

M3 increased more rapidly than M2 last year largely because of the substantial expansion in large CDs, particularly over the first half of the year. With growth of core deposits weak on balance over the year, depository institutions increased their managed liabilities to support expansion in loans and investments.

Bank credit growth accelerated somewhat in 1981 but stayed just within the upper end of its annual target range. The pick-up in bank credit growth was concentrated in business loans. Growth in this category was bolstered by the high level of corporate bond rates through most of the year, which tended to focus business credit demands on short-term borrowing such as bank loans and commercial paper. Although merger activity contributed significantly to the growth of loan commitments over the year, actual takedowns for this purpose influenced loan growth only slightly. Real estate loans at banks in 1981 grew at about the same moderate pace as in the prior year, while

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consumer lending strengthened a little from 1980. Security holdings at banks grew somewhat more slowly than loans in 1981.

The bank credit data in December were affected by the shifting of assets to accounts in the newly authorized International Banking Facilities (IBFs). It is estimated that about \$22 billion of loans to foreign customers were shifted from U.S. offices to IBFs in December. The data presented in this report are adjusted for this shift. Without this adjustment, the increase in bank credit from the fourth quarter of 1980 to the fourth quarter of 1981 was 8-1/4 percent, one-half percentage point less than shown by the adjusted data.

Broader measures of credit flows reflected the slowing pace of production and income in 1981 and the effects of high interest rates. Households and businesses continued to increase their borrowing over the first three quarters, but their use of credit contracted in the fourth quarter in response to the weakening of the economy. In view of the high level of long-term interest rates during most of 1981, virtually all of the increase in funds raised was in short-term debt instruments. Overall, net funds raised by nonfinancial sectors rose 7 percent in 1981 and continued to fall relative to GNP for the third consecutive year.

Section 3: The Federal Reserve's Objectives for the Growth of Money and Credit

The Federal Reserve remains committed to restraint on the growth of money and credit in order to exert continuing downward pressure on the rate of inflation. Such a policy is essential if the groundwork is to be laid for sustained economic expansion.

There was a distinct slowing of inflation during 1981, and the prospects for further progress are good. Failure to persist in the effort to maintain the improvement would have long-lasting and damaging consequences. Once again, underlying expectations would deteriorate, with potentially adverse effects on financial markets, particularly long-term rates. The result would be to embed inflation even more deeply into the nation's economic system--with the attendant debilitating consequences for the performance of the economy. A failure to continue on the current path would mean that the next effort would be associated with still greater hardship.

Progress toward price stability can be achieved most effectively and with the least amount of economic disruption by the concerted application of monetary, fiscal, regulatory and other economic policies. But it is quite clear that inflation cannot persist over an extended period unless financed by excessive growth of money. Thus, a policy of restraint on the growth of the monetary aggregates is a key element in an anti-inflation strategy.

Targets for the monetary aggregates have been set with the aim of slowing the expansion of money over time to rates consistent with the needs of an economy growing in line with its productive potential at reasonably stable prices. The speed with which the trend of monetary growth can be lowered without unduly disturbing effects on short-run economic performance depends, in part, on the credibility of anti-inflation policies and their

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effects on price expectations as well as on other forces influencing interest rates and credit market demands, including importantly the fiscal position of the federal government. More technically, financial innovation or other factors affecting the demand for specific forms of money need to be monitored.

In its deliberations concerning the target ranges for 1982, the Committee recognized that the recent rapid increase in M1 placed the measure in January well above the average level during the fourth quarter of 1981, the conventional base for the new target. Experience has shown that, from time to time, M1 growth can fluctuate rather sharply over short periods, and these movements may be at least partially reversed fairly quickly. The available analysis suggested that the recent increase reflected in part some temporary factors of that kind, rather than signalling a basic change in the amount of money needed to finance nominal GNP growth.

In the light of all these considerations, the FOMC reaffirmed the following ranges of monetary expansion--tentatively set out in mid-1981--for the year ending in the fourth quarter of 1982: for M1, 2-1/2 to 5-1/2 percent; for M2, 6 to 9 percent, and for M3, 6-1/2 to 9-1/2 percent.¹ The FOMC also adopted a corresponding range of 6 to 9 percent for commercial bank credit. These ranges are the same as those agreed to in July and reaffirm the

1. The objective for growth of narrowly defined money over 1982 is set in terms of M1 only. Last February, when the FOMC set its targets for narrow money, it was recognized that regulatory changes allowing for the establishment of nationwide NOW accounts would distort the observed behavior of M1-A and M1-B. Accordingly, the targets were set on a basis that abstracted from the shifting of funds into interest-bearing checkable deposits. Based on a variety of evidence suggesting that the bulk of the shift to NOW accounts had occurred by late 1981, the Federal Reserve reaffirmed in December its previously announced intention that starting in January 1982 shift adjustments would no longer be published and only a single M1 figure would be released with the same coverage as M1-B.

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Federal Reserve's commitment to reduce inflationary forces. As has been typical in the past, these changes are measured from actual fourth quarter levels from the previous year.¹

During 1981, M1-B (shift-adjusted) rose relatively slowly in relation to nominal GNP.² On the assumption that the relationship between growth of M1 and the rise of nominal GNP is likely to be more normal in 1982, and given the relatively low base for the M1-B range, the Committee contemplated that growth in M1 this year may well be in the upper part of its range. At the same time, the FOMC elected to retain the 2-1/2 percent lower bound for M1 growth tentatively set last July in recognition of the possibility that financial innovations--especially techniques for economizing on the use of checking account balances included in M1--could accelerate, with restraining effects on M1 growth.

The actual and potential effects on M1 of ongoing changes in financial technology and the greater availability of a wide variety of money-like instruments and near-monies strongly suggest the need for also giving careful attention to developments with respect to broader money measures in the implementation of monetary policy. The range for M2 growth is the same as in 1981 when actual growth slightly exceeded the upper bound of the range. The Committee contemplated that M2 growth in 1982 would be somewhat below the 1981

1. Because of the introduction of International Banking Facilities, the bank credit data after December 1981 are not comparable to earlier data. Thus, the targets for 1982 are in terms of growth from an average of December 1981 and January 1982 to the average level in the fourth quarter of 1982.

2. M1-B velocity, before shift adjustment, rose at a rate closer to historical experience. However, the shift of funds from savings accounts or other sources of funds not included in measures of the narrow money supply temporarily depressed that velocity figure, particularly early in the year.

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pace, although probably in the upper part of the range. However, should personal saving, responding to recent changes in tax law or other influences, grow substantially more rapidly in relation to income than now anticipated, or should depository institutions attract an exceptionally large inflow to IRA accounts from sources outside measured M2, growth of M2 might appropriately reach--or even slightly exceed--the upper end of the range. The ability of depository institutions to compete for the public's savings will, of course, also be affected in part by deregulatory decisions that may be made by the Depository Institutions Deregulation Committee.

The 1982 ranges for M3 and bank credit were left unchanged from those for 1981. These aggregates again will be influenced importantly by the degree to which credit demands tend to be focused on short-term borrowing and are funded at home or abroad.

Section 4: The Outlook for the Economy in 1982

Economic activity still appears to be contracting; industrial production and employment certainly declined further in January, with the extent of the fall worsened by exceptionally bad winter storms. Demand in the key sectors that had led the decline--housing and consumer spending--showed some signs of leveling off as the year began, and the recent cuts in production likely have helped to relieve some of the remaining inventory imbalances. Recent weather-related disruptions may affect the incoming data for a time, but it would appear that the economy is in the process of bottoming out, and a perceptible recovery in business activity seems likely before midyear.

One element supporting final demands in the economy is the federal government. Part of the recent expansion in the deficit reflects the cushioning effects of reduced taxes and increased government expenditures that result from declining income growth and rising unemployment. In addition, however, the build-up in defense spending is a continuing source of stimulus. The second phase of the tax reductions that occurs in July will provide another expansionary impetus to the economy. At the same time, the deficit--particularly if expected to continue at exceptionally high levels in later years--adversely influences current financial market conditions.

The Federal Reserve's objectives for money growth in 1982 are consistent with recovery in economic activity. The expansion is likely to be concentrated initially in consumer spending. Given the substantial margin of excess capacity, outlays for business fixed investment may remain weak, particularly if long-term interest rates continue to fluctuate near their current high levels. A continuation of high levels of long-term rates also

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would inhibit the recovery in residential housing, although demographic factors will continue to buttress demands in that sector.

The effort to deal with inflation is at a critical juncture. The upward trend in inflation clearly has been halted and the process of reversal is underway. There are signs that price setting, wage bargaining, and personal spending decisions are beginning to be made that over time will serve to moderate, rather than intensify, inflationary pressures. Nonetheless, the behavior of financial markets and other evidence strongly suggests that there continues to be considerable skepticism that progress in reducing inflation will be maintained. Lasting improvement in financial markets--particularly for longer-term instruments--is dependent on confidence that progress against inflation will continue; looming federal deficits have served to shake that confidence. Prospects for lower interest rates and for sustaining recovery over a long period--indeed for the timing of recovery--are thus tied to prospects for a more stable price level.

How we emerge from the current recession will be crucial to further curtailing inflation. The recovery phases that have followed recent recessions have sometimes been associated with an acceleration of inflation. However, if monetary and fiscal policies are appropriately disciplined, this pattern need not recur; and recovery from the current recession will be consistent with further progress towards achieving sustainable growth, price stability, and lower levels of interest rates.

Given the current circumstances and in light of the monetary aggregate objectives for the coming year, the individual members of the FOMC have formulated projections for economic performance in 1982 that generally fall

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within the ranges indicated in the table below. The members of the FOMC expect inflation to continue to moderate in 1982. At the same time, real activity is expected to accelerate with most of the growth coming in the second half of the year. With inflation continuing to be substantial and the prospect of the federal budget deficit remaining large even as the recovery gathers momentum, demands for credit should intensify as the year progresses. In these circumstances, the recovery is likely to be somewhat restrained, with the result that unemployment probably still will be substantial at year-end.

Economic Projections for 1982

	<u>Actual 1981</u>	<u>Projected 1982</u>	
		<u>FOMC members</u>	<u>Administration</u>
Changes, fourth quarter to fourth quarter, percent			
Nominal GNP	9.3	8 to 10-1/2	10.4
Real GNP	0.7	1/2 to 3	3.0
GNP deflator	8.6	6-1/2 to 7-3/4	7.2
Average level in the fourth quarter, percent			
Unemployment Rate	8.3	8-1/4 to 9-1/2	8.4

The FOMC member's projections generally encompass those that underlie the Administration's recent budget proposals. The consensus view of the FOMC anticipates an improvement in inflation during 1982 comparable with the Administration's as well as a similar outlook for the labor market. The Administration's projection for real growth falls at the high end of the FOMC consensus. If, in the event, prices and wages should respond more rapidly to anti-inflation policies than historical experience would suggest or should more favorable productivity trends develop, then the recovery could be faster without adverse pressures developing on prices, wages, and interest rates.

Chairman VOLCKER. You addressed a couple of questions to me, Mr. Chairman. Let me just briefly respond.

You note, I think, that the actual unemployment in 1981 was above the range in the forecast we gave you. It looks to me like it was only above the range by rounding a number—8.3 instead of $8\frac{1}{4}$ percent and that reflected a pretty close estimate.

I don't think the projections we give this year at all mean we should expect unemployment to be around 10 percent in 1982. The projections are lower than that, and that's what we anticipate.

You raised a question about where the Federal Reserve stands with respect to the administration's program, which has several elements, as you know, in terms of monetary policy. In terms of general direction and substance, as we have both said, my understanding is that we see things in a parallel way. The Federal Reserve, I think, in general sees benefits accruing from action on the regulatory side of things; we can help productivity and reduce costs by progress on regulation, a point the administration has emphasized.

I do believe the tax policy can be important, as I emphasize in my statement, in terms of productivity, and growth and incentives over time. The issue which we have emphasized all along is reconciling that tax action, which can be constructive, with a budgetary outcome that does not, by working in the other direction, make the job not only of conducting monetary policy but of bringing down interest rates and setting the stage for recovery much more difficult.

I think the issue is the deficit spending—the combination of revenues and spending. You have before you a budgetary document submitted by the President which proposes some very major measures, as you know, to bring that deficit down to a level that will be more tolerable than permitting a deficit in the neighborhood of \$150 billion as projected for next year to materialize. The administration has proposed some very large steps in that direction.

The CHAIRMAN. How about the administration's projections on the 3-month T-bill rates, to wit: 11.7 in 1982; 10.5 in 1983; and 9.3 percent in 1984? Do you agree with those projections?

Chairman VOLCKER. I don't agree or disagree. I don't have great faith in my ability to project precise levels of interest rates in the short run or in the long run. I think their projections do reflect, historically, relative to the inflation rate—just to use that as a benchmark—and, in general, a relatively high level of interest rates.

The feasibility of having that declining trend or doing better, I think, rests in very substantial part on the deficit question that we have referred to.

The CHAIRMAN. Therefore, a lot of iffiness as far as those projections.

Chairman VOLCKER. There's bound to be a lot of "iffiness" in any interest rate projection. But I think the kinds of measures that need to be taken to maximize the chances for low interest rates are quite clear.

The CHAIRMAN. Chairman Volcker, in the state of the Union address, the one point that the President pointed to with pride was the rate of inflation as measured by the CPI. Inflation declined

more than 3 percentage points in 1981 to 8.9 percent. That reduction, however, was only partly due to the economic program that was adopted.

It seems to be commonly agreed that energy and food prices, over which none of us had any real control, rose less than expected, due to the oil glut and to record harvests. Home sale prices, depressed by high interest rates, did the rest.

Now my question to you is this: now that that's secured, I don't think we can look forward to more of that. And in order to bring inflation down even further in 1982, how many American citizens are going to have to look forward to sacrificing in the form of unemployment?

Chairman VOLCKER. I allude to this point, of course, in my statement. You are quite right; I don't think we can pick out oil prices or even food prices and say they're entirely removed from general economic policy, but there are special factors at work. I think more generally it is quite true that the degree of progress on prices at the moment reflects, in part, the fact that the economy is in recession.

You can't succeed in dealing with inflation over time by having an economy in recession. You want an economy in growth. What is important, therefore—and what I would emphasize—is that we build on this effort to deal with inflation, on the clear signs of progress we see, and convert that into a platform for building a lower rate of cost increase into the economy—the kind of thing that can last.

We begin to see that going on. But that comes more slowly than the immediate effects you get from the special influences that you mentioned or from high interest rates or weak markets in so many areas. But I think we are beginning to see the process at work, with a lower rate of inflation, from whatever cause, in the short run beginning to be built into the wage and cost structure.

I think we see business and labor together turning their attention, quite properly, not only to restraint on the wage side, but to measures that will improve productivity over time, which is very basic to continuing to wind down the inflation rate while the economy expands.

The CHAIRMAN. My question, Chairman Volcker, was—and it's the question, I think, in the minds of most American people today—it seems to be more important to the American people now than the rate of inflation—and that is unemployment. How many unemployed must be looked forward to during 1982 to keep bringing down inflation?

Chairman VOLCKER. We gave you some projections for 1982.

The CHAIRMAN. You gave us some projections; yes.

Chairman VOLCKER. We have an economy which, while it is not perfectly clear, is probably still declining. I am sure the February figures will reflect that, because of the weather, if nothing else. We have an unemployment rate which was 8.9 percent in December. It moved, probably flukishly, lower in January. We are going to have a high level of unemployment this year, reflected in our own projections and the projections of others. But we think the prospects are good for some economic recovery beginning before midyear.

The CHAIRMAN. Mr. Stanton.

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

Mr. Chairman, I would assume that the administration will find a lot to applaud in your statement. There are a few things I presume they won't.

It seems to me that the targets that the Secretary of the Treasury was hoping for, especially in M_1 , were about the same as what you announced. The differences seem to be in the fluctuation of the money supply, and this, of course, is something that has been going on since October 1979.

The first question to you: Should we look forward to the same money supply fluctuations this year as we have seen in the last 6 months, or is there any chance or hope for improvement in that and, if so, why?

Chairman VOLCKER. I think we will see fluctuations. I think that is the nature of the beast. Let me say I think this is a matter that, to my mind, for good and sufficient reason, has not been much emphasized in the past—this kind of emphasis on monthly or even quarterly fluctuations.

The studies that we have done of the matter and, I think, the studies of which I am aware that most other people have done on the matter suggest that the fluctuations are not significant to economic activity or the general course of interest rates or, certainly, inflation. You wouldn't know it from listening to some of this discussion, but we happen to have, in M_1 , about the most stable money supply in the world.

I have looked at a lot of other industrialized countries and about the only one that I find that compares in terms of stability is Italy. The trend in Italy happens to be a little different. It goes up about 20 percent a year, but it's relatively steady around that trend.

Let me give you some figures for some other countries. You could look at monthly numbers or I could give you quarterly numbers. Canada had a month last year when the money supply went down at an annual rate of 40 percent. They had a month in which it went up at an annual rate of 87 percent. We have these self-inflicted wounds from looking at everything in terms of annual rates, so I'll give you the figures for other countries in terms of annual rates.

Germany had a month where money went down at an annual rate of 32 percent and one where it went up at an annual rate of 17 percent. Japan, often pointed to as having remarkably good monetary policy recently, had a month where the figure went down by 44 percent at an annual rate, and a month where it went up at an annual rate of 93¾ percent—and I want to get that ¾ percent in there.

Switzerland's figures varied between minus 42 and plus 14. We had a month where M_1 went up at an annual rate of 19½ percent, meaning it went up about 1½ percent that month; we had 1 month where it went down by an annual rate of 10 percent, meaning it went down by less than 1 percent in that month. So I don't want you to think of this as a phenomenon of the United States. In the international league, we have a relatively stable money supply, and I must confess I find my foreign central banking colleagues—they may all be wrong—constantly expressing some degree of con-

cern and dismay as to why we worry so much about the short-term fluctuation.

You have a checking account and it doesn't remain absolutely steady from month to month, I presume. I am not sure you would want us to compel you to keep it absolutely steady from month to month.

We are, in effect, dealing with a checking account for a large portion of the world. We have a money supply of about \$400 billion. There are about a half trillion dollars a day of transactions around the world and I think it's a question of whether the world's checking account is going to come out precisely stable from month to month any more than your checking account is going to come out precisely stable from month to month, or even whether it would be desirable to enforce that rigidity on the system.

The other side of the coin would be that if you tried to keep it stable, interest rates would fluctuate much more greatly than they do in the short run, and I'm not sure that that is the result that anybody would really like to see.

What is important is that we maintain a trend toward restrained growth and lower growth, and I am satisfied our record shows that. M_1 has come down an average of about 1 percent a year for the last 3 years, looking at the average growth from year to year.

The CHAIRMAN. Mr. Gonzalez?

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

Chairman Volcker, I think it impelling on my part to report to you that the fears, I am sure, that have obsessed you should be allayed with respect to my impeachment resolution. I had a letter from Chairman Rodino in which he indicates that he can't proceed on that for the immediate future. He says they have got so much business—and I hope I don't let the cat out of the bag—but maybe they are working on impeachment on the President—but they can't entertain it at this time. However, I intend to proceed in absentia on the House floor.

My question is: If President Reagan is right and if you are so right, why is the stock market in such a state of hysteria? Why are the bond markets collapsed? Why is investment down? Where is all the confidence and growth that was supposed to come out of "Volckernomics"?

The results so far have been re-Volckering. You know, this is what the business constituencies ask, and how do you answer that? If your course of action over these 3 years and everything is so dead right, why this condition?

Chairman VOLCKER. Let me note that the Federal Reserve is responsible for monetary policy, not anything else. But let me also emphasize that I think the basic answer to your question is that we are in an extremely difficult period of time. We have some extremely difficult economic problems that have accumulated over a long period of time.

I don't think you can point to any statements of mine that suggested that this would be anything but a difficult period in terms of turning some of those trends around. We are seeing that, unfortunately, in spades. I think we can also see some developments moving in a potentially constructive way.

I think we are taking steps and have taken steps to lay the base for a much brighter future, as I tried to outline in my statement.

Mr. GONZALEZ. But, Mr. Chairman, by every accepted definition the administration is following a loose fiscal policy and you are pursuing a tight or restrictive monetary program. In other words, the President is pushing on the gas pedal and you're standing on the brakes. Why do we have this contradiction, this conflict?

Do you think the President's program is irresponsible or is it the other way around?

Chairman VOLCKER. I think the way you meet that problem, Mr. Gonzalez, is by attacking those potential budgetary deficits that sit out there. I think you quite accurately point to an actual and potential problem. The President has outlined a program. If you ask me, I would be even more delighted if you succeed in taking budgetary actions that reduce the deficit even further than he has suggested, but he has certainly put a large menu on the table and you can pick and choose, I suppose, the way to do it. But I think it is important to move to get that deficit down so the potential contradiction, if you will, that you referred to is alleviated.

Mr. GONZALEZ. Mr. Chairman, for instance, yesterday in emergency the House passed overwhelmingly a \$1.8 billion appropriation as an emergency measure because of unemployment and because of the action just taken last December, in obedience to your recommendations, the President's recommendations.

The President came in and said we had to have \$1.5 billion more in foreign aid, when he ran all over the country assaulting the Carter administration, the Democrats, and the likes of me as spenders because we had been supporting that program. Now, how in the world with this contradiction can we reconcile this?

Chairman VOLCKER. Let me make one point regarding timing. What I am talking about in terms of the threat of deficits, the kind of threat that you referred to, is primarily a problem for 1983 and 1984 and the years beyond. It is the potential collision between the investment needs for and during a period of recovery and the continuing, rising budgetary deficits that is the problem.

While I am not suggesting at all, obviously, opening up the spending taps now, your concentration in terms of dealing with the budgetary problem seems to me properly focused on 1983 and 1984. That's where the large, exceptionally large, deficits loom. The deficit this year, if it were not for the recession, would be very substantially smaller.

What concerns me and concerns a great many people is the fact that those deficits would increase during a period of recovery when you have the potential problem in the financial markets. The problem that we are struggling with now is that that potential problem for 1983-84 is reflected back in the market today and, indeed, is a major obstacle to getting the recovery started in the first place.

Mr. GONZALEZ. Thank you very much.

The CHAIRMAN. Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman.

Chairman Volcker, I want to congratulate you for an excellent statement and for the work you and the Federal Reserve Board have done in contributing to the progress this country is making in lowering the rate of interest and lowering inflation. I think you are

on target on what you are doing, and that you have also been the target of a considerable amount of criticism which you don't deserve for high interest rates and unemployment.

As you know, I have spent several years suggesting that the number one problem in this country is inflation and I am still committed to the process of reducing further the size of the federal deficits to manageable proportions, as being necessary to bring down inflation and interest rates. I agree with you on that, Mr. Chairman.

At some future time, most economists expect that the business conditions will improve. They are suggesting that by midyear business conditions will improve. Do you agree with that assessment?

Chairman VOLCKER. I would generally agree with that assessment. I don't think anybody's forecasting record is all that brilliant in recent years. But I would agree with the assessment that that is the probability.

I think there are clearly risks in the situation and I would simply come back to the point that, since so many of those risks are bound up in what happens in financial markets, the greatest contribution the Congress can make to minimizing those risks and, indeed, to enhancing the prospects for early recovery—and without doubt enhancing the prospects for sustaining the recovery—is to deal with this budgetary problem.

Mr. WYLIE. OK. If business conditions improve, this would presumably lead to increased demand for money, an increased demand on money markets by firms and individuals. Have you made projections in that regard? How do you visualize Fed money policy if that point arrives?

Chairman VOLCKER. I don't know how far ahead we have projections. The staff is constantly examining different possible outlooks in that respect.

Let me say that the early stages of recovery do not necessarily bring heavy credit demands. It depends on how profits evolve and a number of other things. But certainly, over time, recovery would bring greater credit demands, greater need for investment.

We have the homebuilding industry depressed, and that is a very clear area of need. The homebuilding industry and the home buying public chews up enormous amounts of credit when it is in a strong position. It's not doing that now because it is so depressed, but we don't want it so depressed. And it is quite clear that that industry alone would lead to very large additional demands for credit.

That is simply another way of saying let's get the Federal demand for credit out of the way so there's room for that private demand.

Mr. WYLIE. So you are taking that into account?

Chairman VOLCKER. We are indeed.

Mr. WYLIE. You mentioned earlier the fluctuations in checking accounts as making it difficult for you to determine what the money supply might be. On page 14 of the Federal Reserve's monetary policy report which just came out this week, there is a table giving the growth rates of monetary aggregates during the last 4 years.

Roughly speaking, M_{1B} has been increasing at a decreasing rate, while M_2 has been increasing at an increasing rate. Now money market mutual funds are in M_2 .

Chairman VOLCKER. Correct.

Mr. WYLIE. Many of our constituents are writing checks against their deposits in their M_{1B} accounts and buying money market mutual funds, which puts them into M_2 right away.

Chairman VOLCKER. That's right.

Mr. WYLIE. Now many of these money market mutual funds in turn permit checks to be drawn for payments to third parties, which makes them a lot like M_{1B} . I am one of those who suggested that perhaps you ought to have the authority to place a reserve requirement on those accounts. Would that help you in the conduct of monetary policy?

Chairman VOLCKER. Yes; I think it would be of some assistance. We made some proposals before this committee 9 months ago or so suggesting that we don't have to put reserve requirements against the whole of money market funds, but at least against that portion that is used, in effect, as a substitute for checking accounts and would be like the kind of accounts in M_1 .

I might note that I think you get a better idea of the trend from the bottom part of the table, you refer to which has annual averages and reflects the steady downward progression in M_1 . It shows not a steady upward progression in M_2 but a fairly stable picture—actually a slightly declining picture, until last year, when it did go up.

I think those divergent trends are illustrative of exactly the point you are making. Money market funds are included in M_2 , and that is one factor that, for structural reasons, has tended to keep M_2 up, particularly last year, when the growth was so explosive; some of that money comes from funds outside of M_2 .

To the extent there is a shift from areas outside of M_2 into M_2 , we should allow for that. Some of it comes out of M_1 , and we should allow for that, too, and we try to in our operations.

It may be of interest to the committee that we have examined this, obviously, as closely as we can. The proportion of money market funds accounts that is used actively as checking balances is still small, but the funds have been growing rapidly, of course; we have various estimates that the impact on M_1 may have been between roughly 1 and 3 percent—in that area—last year.

Mr. WYLIE. Some of my colleagues are saying that you should increase the rate of increase in the M_{1B} by urging you to expand reserves through open market purchases of Government securities. Would you care to comment on that and then my time has expired.

Chairman VOLCKER. I don't believe we should. Our policy is gaged at maintaining a growth in M_1 that we feel appropriate to this job of bringing down the inflation rate over time, and we believe the target this year would also allow for the kind of recovery that's been projected during this time period.

Mr. WYLIE. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Minish?

Mr. MINISH. Thank you, Mr. Chairman.

I am pleased to welcome my former constituent, and I want to say, Chairman Volcker, you are the best drawing card that this

committee has had in the 20 years that I have been on it. They are standing out in the hall, and I suppose if you could charge admission it would help you decrease the deficit, but of course we can't do that.

You know, I want to make a couple of comments. I don't know where people shop when they say that food prices are going down, but let me assure you in the area that the chairman himself lived in, all you have to do is walk into a supermarket—and I do that with my wife, on occasion—and I am besieged by at least 10 or 15 people asking me, "What's this about food prices going down?" They're not going down. I think you can ask anyone out there, but at least in New Jersey they're not going down.

On the question of—

Chairman VOLCKER. They are a little more stable than they were anyway, Mr. Minish; that's what the figures show.

Mr. MINISH. Well, I don't know what your level of "stable" is.

Chairman VOLCKER. We still have inflation.

Mr. MINISH. Fine. OK, inflation is cut down, and on page 5 in your statement you talked about the impact that homes—houses—have on inflation. Homes have not really come down in price, as I see it, and still there is an increase in inflation, which means, to me, if I interpret it properly, that homes now take a bigger portion of the inflation rate than they did prior to inflation coming down.

Chairman VOLCKER. Home prices are very difficult to measure. The measurements that we have are subject to a lot of reservation. Generally, they show some leveling off in home prices, but some continuing increase. Those figures do not take account of the fact that so many homes now are sold under special financing arrangements that, in effect, decrease the price of the home.

If one allows for that, it may be that prices are declining. But, in general, the data suggest that they are much more stable than they were. I think you are right that the data don't show absolute declines, not over any period of time, anyway.

Mr. MINISH. What do you foresee for the future of the young people that would like to own a piece of America by owning their own home?

Chairman VOLCKER. That's more difficult now than it was before. You know that. It's more difficult for two reasons, I would emphasize. Not only are interest rates extraordinarily high now, but, as I noted in the statement, the price of a home relative to everything else is higher. That is a situation which one would expect to be corrected, at least in part. You are not going to correct, probably, for the fact that land becomes increasingly scarce, and that's a factor in prices. But prices are part of the whole inflationary process, and as we are successful we would foresee the lower interest rates.

There is a great deal of activity in the homebuilding industry, a great deal of thinking and planning in the homebuilding industry—I think I can testify from some firsthand exposure recently—toward building smaller houses, building houses more efficiently, which moves in the direction of addressing the very problem you mention.

The typical home got quite a lot bigger over the last decade. I think builders are finding ways of returning to a somewhat smaller

size house, to a different kind of planning, a different kind of land use, and all the rest, reflecting adaptations to this problem.

Mr. MINISH. Of course, I know you are fully aware of the problems with the thrift industry, particularly up in the Northeast, where many of them are having liquidity problems. Has the Federal Reserve given consideration to this plight, because this really is the industry that provided the mortgage money for the average family.

Chairman VOLCKER. We give consideration to that problem constantly. It is an extremely difficult problem. The only really satisfactory solution is to get lower interest rates. That is the only thing that will bring them back to real health—that and the passage of time—is the only kind of basic solution. But we have addressed ourselves to this problem repeatedly.

As you know, we presented some legislation to deal with it in a very short-term context, which this committee passed and the House as a whole has passed. It seems to me unfortunate it has not passed the entire Congress. It is not a complete answer to the problem by any means. It is a means of coping with some of the immediate stresses more efficiently.

There is discussion of broadening the powers of the thrifts, but that is more a long-term matter than a short-term matter. There is a very great problem in that industry. It has affected our ability to deregulate deposit rates, for instance. We have moved more slowly on that issue than otherwise would be desirable because of the need to avoid further pressures on that industry in an already very difficult situation.

Mr. MINISH. Well, notwithstanding the need for the legislation, is there anything that the Fed is doing or can do to alleviate some of these problems?

Chairman VOLCKER. We are prepared to and do lend to them when they have longer term liquidity problems or when they have short-term liquidity problems. But the basic problem that they are coping with is not a liquidity problem. Most of those institutions have ample liquidity. In fact, their liquidity tends to be higher now than it has been historically. The problem is an earnings problem and the Federal Reserve does not have the tools to deal with an earnings problem.

Mr. MINISH. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Hansen.

Mr. HANSEN. Thank you, Mr. Chairman.

As the ranking minority member for the Domestic Monetary Policy Subcommittee, I am pleased to join in welcoming you, Chairman Volcker, this morning, and I have been most interested in your presentation on behalf of the Federal Reserve Board.

Mr. Volcker, the conclusion of your statement is very strong. There is really nothing very new that can be said or asked at this time which I and others of this committee have not voiced over the past several years at similar hearings. However, in view of our current economic crisis, I want to preface two key questions with a rehearsal of several concerns, some of which have been addressed in your statement. And, as you are well aware, this is important because the Federal Reserve, the White House and the Congress are under increasingly heavy fire by nervous citizens demanding action

and answers, not more economic jitterbugging and buckpassing, as they do often term it.

Now, Mr. Volcker, first, I think it is time for the President, the Congress and the Fed to clearly stake out their areas of responsibility and take action. It is important that you reassert, as you have done recently, that the Federal Reserve System cannot adequately compensate, with manipulation of money policy, for problems created by several decades of irresponsible fiscal policy.

Frankly, it is difficult for me to see how monetary policy can succeed in its goals unless the current Congress will continue to make significant cuts in spending and reduction in Government waste, as you have suggested this morning, and your meaningful input is sorely needed on this issue.

Second, it is time for the Fed to get its act together and put an end to the wild ride we have been on, getting on the money supply and interest rate rollercoaster. It would be well if you could assure us that you are aggressively working on a more accurate system of operations which will allow you to function within your monetary supply target range and avoid the wide variances we have discussed in the past.

Much of the hesitancy and distrust in the markets is obviously a result of some concern as to whether the Fed can assess the day-to-day money markets accurately enough to respond in a way which will accomplish the monetary policies you are trying to implement. And I didn't find too comforting your analysis of the individual checking account compared to the worldwide checking account, so to speak, because I would hope that there would be more stability in an overall situation than on an individual basis.

Third, it is time to do what must be done for the relief of the hard-pressed economy without further delay. And this may be less direct, but I am getting a tremendous amount of mail from my constituents, and particularly small businesses who have been willing to sacrifice if it would help in the long run. But they are getting into a time frame which now they consider to be "the long run," and a great many are being pushed to the brink of bankruptcy as a result of the continuing high interest rates.

This persistence of high interest has now spanned two administrations and they are blaming you and your organization more than anyone else for this dilemma. Because so much depends on the Fed, I am trying hard to defend you and the monetary policy you are attempting to implement, but time is running out, and these people need help immediately.

These are not the marginal businesses which failed 2 years ago when interest rates first doubled and then tripled. These are the long-time family businesses which have prospered over the years and are now scraping the bottom of the barrel as they have dipped into their accumulated earnings, reserves, and resources to survive. There will not be many locally owned businesses left in my district or anywhere in the Nation, I believe, if we don't see some meaningful signs of a turnaround soon.

I suspect that a little more confidence in the Fed's programs and the accuracy of their methods and procedures would go a long way toward providing the kind of assurances to set a lasting downward trend in the interest rates, giving my constituents and the money

markets sufficient encouragement to make some long-range plans and commitments.

Now in this regard, Mr. Chairman, on page 24 of your report you state the effort to deal with inflation is at a critical juncture. And after noting some encouraging signs in the fight against inflation you continue, and I quote: "Nonetheless, the behavior of financial markets and other evidence strongly suggests that there continues to be considerable skepticism that progress in reducing inflation can be maintained."

Now I must ask to what extent do the actions of the Federal Reserve overshooting the targets for M_{1B} growth in 1980, undershooting these same targets in 1981, allowing the money supply of M_1 to grow at roughly 17 percent for the last 3 months—how does this contribute to market skepticism?

Chairman VOLCKER. It's all a matter of judgment, I suppose, Mr. Hansen. I do not believe that is the major element in market skepticism.

Mr. HANSEN. Well, if credibility in dealing with inflation has to be earned by performance and persistence, as you note on page 3 of your statement, what else should or could the Federal Reserve be doing to improve its own credibility in the market?

Chairman VOLCKER. I think if you look at the table Mr. Wylie referred to, you will see a trend, in M_1 growth particularly, that shows a steady diminution which is what we have said we would do. I think the record is pretty clear in that respect.

While you could find, I am sure, differing strands of opinion in the market, I think there is general recognition of that in the marketplace. We would love the money supply to be perfectly stable from month to month, and I think your point is quite correct; you would expect the total to be more stable than any individual component thereof.

But these fluctuations are relatively small; we blow them all up and speak of them in terms of annual rates, but they are relatively small fluctuations. You are going to have some fluctuations from month to month. I pointed out that they are characteristic all over the world, and if you followed a technique to attempt to keep that absolutely rigid—which is beyond our or anybody's capacity—I think the tradeoff would be more instability in interest rates which would probably be more upsetting to people than short-term fluctuations in the money supply.

When you build a building you permit it to bend a little bit in the wind—and there are a lot of winds out there in the money market—in the interest of the overall strength and the durability of the whole. I think you can look at the money supply a little bit that way.

When we have an abnormal fluctuation in demand—and there are all of the characteristics of that in the recent few months, where the increase is so heavily concentrated on one limited component of the money supply—you have to ask yourself whether that is a temporary or a more lasting change.

If it is indeed temporary, then to force an adjustment very harshly to that change in the short run would produce a lot of money market instability to no end.

Mr. HANSEN. As a followup to that question—

The CHAIRMAN. I'm sorry, but the gentleman's time has expired.

Mr. HANSEN. Could I just get a yes or no answer?

The CHAIRMAN. Your time has expired. If you would like you can stick around for another round.

Mr. Mitchell.

Mr. MITCHELL. It is good to see you always.

Chairman VOLCKER. It is good to see you, Mr. Mitchell.

Mr. MITCHELL. Your testimony is pursuant to the Full Employment and Balanced Growth Act of 1978. I just want you to recall the many conversations about black unemployment that I have had with you since you have been in your position. We have always talked about full employment and the fight against inflation. We have simply abandoned the attempt to do anything about black unemployment. Now that white America is increasingly unemployed, we see that this is becoming the No. 1 problem in the Nation, unemployment not inflation. I think we will cure the unemployment problem. I honestly do. We cannot have people unemployed forever.

But I would just like to go on record by stating that when the white rate of unemployment is cured, there will be no cure for the black rate. You have simply abandoned my people. I guess I just have to live with that. That is the way America works, I suppose.

Now, I have some specific questions I would like to put to you. You did an incredible thing in December and January; \$1.5 billion in new money came out, an increase of 16 or 17 percent. I said it is incredible, and I am not judging that negatively. I am not putting a negative or positive connotation on it. You explained why you increased M_1 , which, by the way, is a very imprecise measure. We should not even be fooling with M_1 anymore because it is so imprecise.

It has been the general policy of the Fed once you shoot out a lot of money like that in a period of time, 2 months, 3 months later you go back and make adjustments. Most frequently, those adjustments have resulted in increases in interest rates.

Now, you have to make the adjustments in this period in which you put out that much money, you have to make an adjustment later on to stay within the parameters, the ranges that you suggest.

In short, then, what do you see are the precise implications for this sudden influx of money, the sudden increase in M_1 ? Three months from now, 4 months from now, will you be tightening it up again?

Chairman VOLCKER. As I indicated, Mr. Mitchell, this recent increase has been heavily concentrated in one component of the money supply.

Mr. MITCHELL. Yes.

Chairman VOLCKER. I am searching for the numbers here, but, as I recall, money supply may be up \$15 billion in the last 3 or 4 months—

Mr. MITCHELL. Yes.

Chairman VOLCKER [continuing]. Of which about \$9 billion is in NOW accounts. This has some of the characteristics of a development peculiar to the circumstances that exist. You are quite right in terms of the techniques we follow; we do not provide the reserves through our open market operations to support that kind of

increase, so you see a tightening in the money markets when you get that kind of an increase. But it also has some characteristics—although this will bear close watching—of a kind of development that may be self-reversing, if you will, over a period of time. So I would not want to jump to too strong conclusions on the basis of the development, particularly in January; it is largely a January phenomenon.

Mr. MITCHELL. All right. The point I am trying to make is, though, and you are not going to answer the question because obviously you cannot, but will the adjustment exacerbate the present economic problems that we are now having when you make the adjustment?

Chairman VOLCKER. Nobody is very happy about seeing the money supply—more importantly in this case, interest rates—rising at a time of recession.

Mr. MITCHELL. OK. I have one or two other questions, and I am going to try to move quickly. I said M_1 is a very imprecise measure. Frankly, I would like to look at some other base, really.

Chairman VOLCKER. I would say it is better over a longer period of time than when you look at it in a very short time period.

Mr. MITCHELL. Short time period. Yes. But now, the Federal Reserve publishes data on total reserves, the amount of total reserves, but not on the amount of reserves held against M_1 . Is that correct? You publish your data on the total reserves.

Chairman VOLCKER. Right.

Mr. MITCHELL. But do you publish data on the amount of reserves held against M_1 ?

Chairman VOLCKER. No. You can make a computation of that. It is a little bit technical because to the extent you have excess reserves, you do not know where to allocate them. But you can make a calculation of the reserve requirement against M_1 -type deposits.

Mr. MITCHELL. But it would seem to me that it would be awfully important to publish that data. You see, there are different reserve requirements against different types of financial assets—

Chairman VOLCKER. Right.

Mr. MITCHELL [continuing]. As you know. When the public shifts from a checking deposit, let us say, to a savings deposit or other types of financial assets, this obviously causes a significant change in the money supply. And it seems to me that it would be—

Chairman VOLCKER. We try to compensate for that.

Mr. MITCHELL [continuing]. But it seems to me that it would be prudent for you to publish your data on reserves held against M_1 .

Chairman VOLCKER. Offhand I cannot think of any reason why that cannot be done. We do make those kinds of computations internally, yes.

Mr. MITCHELL. Then I would make a very strong recommendation that, if possible, we start publishing that data so that too is available to those who want to analyze the fluctuations in the economic system.

Do I have time for another question?

The CHAIRMAN. The gentleman's time is expired.

Mr. MITCHELL. My time has expired? Well, I had not even gotten my rapier—well, OK, my time has expired.

The CHAIRMAN. Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Mr. Volcker, I would like to follow up a little bit more on the discussion on the rapid growth of the money supply in January. It is my understanding that it did grow, M_1 grew slightly faster, at a rate of 19 percent.

When do you actually realize this? Do you realize this on January 1 or January 31, or do you realize it personally in the middle of February? I am just trying to get a handle on how you know what is going on.

Chairman VOLCKER. We collect the money supply figures weekly, as you know. We publish them about as soon as we have a clear fix on them, and those figures are subject to revision the following week. We get some fragmentary data before we publish the numbers, but we do not have complete data until we publish them.

Mr. PAUL. Which is?

Chairman VOLCKER. We publish them on a Friday for the week ending not the previous Wednesday, but the previous Wednesday to that. Today is Wednesday; we will publish the figure for the money supply for the week that is now ending a week from Friday.

Mr. PAUL. So there is no deliberate decision made by the Fed to have a money supply growth of 19 percent?

Chairman VOLCKER. Of course not, no.

Mr. PAUL. And you only knew this after the fact?

Chairman VOLCKER. Virtually all of this came in the first week of January, which we learned about a week later.

Mr. PAUL. So you only can make decisions after you have the information?

Chairman VOLCKER. That is correct.

Mr. PAUL. In other words, you cannot control the money supply?

Chairman VOLCKER. We cannot control the money supply on a week-to-week basis, no.

Mr. PAUL. OK. I wanted to refer to the figures on table 1, where I see that M_3 exceeded your projected growth by approximately 2 percent. I know we do not deal with M_3 very often, but I would just like to pose a question to you that maybe this is somewhat deceptive, maybe there is a lot more money growth going on here than anybody realizes, assuming that 2 percent, you might say that 2 percent is not all that bad, but 2 percent of over \$2 trillion—

Chairman VOLCKER. Yes.

Mr. PAUL [continuing]. Seems to be a lot of dollars. And if these are in 30-day CD's—

Chairman VOLCKER. Right.

Mr. PAUL [continuing]. We could very easily say this is liquid capital—

Chairman VOLCKER. Right.

Mr. PAUL [continuing]. And we are having a fantastic amount of monetary growth.

Chairman VOLCKER. Exactly. That is why we look at all these figures. If I did not have an explanation for that overshoot, some of your conclusions might follow. In fact, I think that figure last year was somewhat distorted by two developments, one of which was the technical way that figure is calculated; it includes domestic liabilities of banks and excludes certain foreign liabilities of banks, and we had a mix of growth this year in banking liabilities that was

skewed toward the domestic issuance of CD's with a reduction in their borrowings from their branches abroad. The way we compute the figure, it gave what we think is an upward bias to the number that does not have much economic significance. But if you look at the broader aggregates generally— M_2 , M_3 , even L , which includes all liquid assets—it does not reflect, you are quite correct, the sharp diminution of monetary growth that you might conclude if you only looked at M_{1B} adjusted. That higher rate of growth in those other aggregates was one reason we were willing to permit M_1 to run a little low.

Mr. PAUL. Then you would concede that if you took theoretically the 2 percent excessive growth in M_3 and this happened to end up in M_1 , we would have had a fantastic amount of monetary growth.

Chairman VOLCKER. That is right, because M_1 is a small number.

Mr. PAUL. Right.

Chairman VOLCKER. But as I said, I think that is partly an artificial result, a statistical artificiality.

Mr. PAUL. A lot of our discussion so far has been on interest rates, and there is justified reason for this, because when we go and talk to the people, everything they see and hear about is in terms of interest—

Chairman VOLCKER. That is right.

Mr. PAUL. Because they cannot buy a house because of high interest rates.

On page 10 you recognize the fact that if you have an inflationary growth in the money supply with the attempt to lower interest rates, this might even have a reversed effect and not necessarily lower the interest rates.

Just for a moment, if we decided that your job was only to maintain interest rates at 10 percent and you had no other responsibilities as far as looking at what it would do to inflation and to the economy, do you have the tools to literally create an interest rate of 10 percent? Can you mechanically do that?

Chairman VOLCKER. No, I do not believe we could, Mr. Paul, certainly not for any length of time, and certainly not for all interest rates, because if the results of that policy were to create great inflationary forces, you could not hold that 10 percent interest rate for very long against all the forces in the marketplace.

Mr. PAUL. If you wanted to alter interest rates, what are your tools? Is it the discount rate as well as the money supply, or mainly the money supply?

Chairman VOLCKER. The discount rate can have some short-term influence and will in many particular instances. A decision on the discount rate will have some immediate effect on the money markets, but, over time, it is basically how much money you are creating.

Mr. PAUL. What is the most significant factor in the high interest rates then? Is it the marketplace, the Congress, or the Federal Reserve?

Chairman VOLCKER. It is a blend of all those things, and in different directions. Treasury financing is a major element in the market uncertainty, I think, at the present time. We have a lot of pressure, as is evident, on the money markets through a relatively restrictive monetary policy relative to what the market would like

to borrow and the amount of money it would like to hold. That has a short-run influence, tending to keep short-term rates in particular firm.

But when one looks at that in a longer term perspective, against the inflationary consequences and outlook, as you yourself described better than I can describe, it has the opposite kind of effect, so you are looking partly at what immediate short-term influences are and judging that against what the influences are over a longer period of time.

Mr. PAUL. Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. Mr. Fauntroy.

Mr. FAUNTROY. Thank you, Mr. Chairman.

Mr. Volcker, as you know, the administration is projecting a nominal GNP growth of 9 to 11 percent over the next 5 years. And over that period the Federal Reserve will presumably lower its monetary targets by about a half of a percentage point each year. My calculations show that velocity would have to grow at a rate of at least 5 to 7 percent if GNP is to grow at the rate that the administration projects. And money supply is increasing at or below the rate that you have targeted. Does that conform with your understanding? And are such rates of velocity possible?

Chairman VOLCKER. If you make those arithmetic assumptions, yes, you get a very high rate of velocity.

Mr. FAUNTROY. All right. Inasmuch as velocity has increased only an average of 3 percent over the last 20 years, does that not historically anomalous high velocity rate suggest a basic flaw in the administration's program and its economic projections?

I mean, if velocity does not increase that radically and the growth of the money supply continues to slow, as slow as the administration wants it, does that not mean that economic growth would be certainly below the levels projected by the administration and that the deficits and the interest rate would be accordingly higher?

Chairman VOLCKER. We have had a substantial reduction in M_1 already, as we have already discussed. We have not presented specific targets for coming years. We have expressed the general philosophy, of course, that we have to move that down to noninflationary levels. I think you judge progress in that respect with what is going on with inflation in the economy.

The administration has projected, for the next few years, reductions in the inflation rate, which, of course, are consistent with our intentions. And the lower that inflation rate is, the more room you have in the terms you are using for real growth. But we have not made any precise targets for years beyond the current year as yet, which were to be assessed in the light of what seemed necessary and desirable at that time against the general philosophy that, yes; we are looking for continued reductions in the inflation rate and for the monetary policy that would be congruent with that.

Mr. FAUNTROY. But you do see a velocity of between 5 and 7 percent over the next couple of years?

Chairman VOLCKER. I would not make a judgment on just what velocity is going to be over that period. You know, in the end, whether that kind of velocity figure is a reasonable expectation or not depends upon technology. If we have a lot of reduced use of

what we have in M_1 because of the kinds of things you see on the horizon now; for example, where every time you have a slight surplus balance in your checking account the money is shifted out automatically—then you need much less monetary growth than under other circumstances.

If, conversely, we make a lot of progress on inflation, interest rates are down—as we would hope would be the case—and people want to hold more money, that represents a kind of equilibrium situation; we are making progress on inflation, we are making satisfactory progress, we want to allow enough room for growth. We take that into account in our targets.

You are getting out in a time horizon where I think a lot of particular judgments would have to be made at the time, but we are certainly making those against the background of a monetary policy which is aimed at facilitating that steady decrease in the rate of inflation that is projected.

Mr. FAUNTROY. If you were an investor, would you be prepared to be making investments on the basis of the economic growth projections that the administration has suggested?

Chairman VOLCKER. The market has to make its own judgments, but these interest rates are extraordinarily high, as has been emphasized, certainly against our objectives with respect to inflation and what seem to me perfectly reasonable projections of inflation.

From that standpoint, these interest rates look very high and one might say attractive. But that is me talking. The market has to make that judgment, and the kind of judgment it makes is going to have a lot to do with the degree of confidence that it feels that the inflation rate will come down. The greater the confidence, the better the prospects for interest rates coming down.

That is not the only factor impinging on interest rates—we have got this deficit problem, for instance—but it is a factor, and it is a factor bearing upon the importance of our sticking with the policy, seeing it through. It is a factor that bears on the importance of the administration and the Congress carrying through on the fiscal front. The more confidence there is in that prospect, the better the outlook for interest rates.

Mr. FAUNTROY. Finally, Mr. Volcker, I am disappointed that you are not more alarmed than you appear to be about the size of this deficit and the implications for it if we do not do some serious belt tightening on those areas of the budget, other than the 3 percent which I referenced at the outset of the hearing today.

Chairman VOLCKER. I had not expressed my deepest concern about the course that the budget is on, on the assumption of no action. I am making a no-action assumption now. Those deficits seem to me directly inimical to the kind of progress we want to see both in the economy and with respect to interest rates. And, of course, those two factors are very much intertwined.

I think the challenge is enormous. It is urgent for the Congress. The President has presented his budget. He has proposed some very substantial cuts. He has proposed some revenue-raising measures. As I indicated, I would like to see more progress than that, but you have a major challenge to achieve what he has indicated is necessary I would be delighted for you to go beyond that. I think that would be much safer and more desirable.

What deficit is really appropriate during this period depends upon the savings rate, how optimistic one can be about that, and on a number of other factors. But there should be no doubt that leaving the situation as it stands, without any action, runs directly counter to the desires that I am sure you have and we all have for dealing with inflation, with promoting economic recovery and sustaining that recovery.

Mr. FAUNTROY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Bethune.

Mr. BETHUNE. Thank you, Mr. Chairman.

Mr. Volcker, on page 17 of your prepared statement you say with respect to the deficit:

Without action to cut spending or, if that fails, to raise revenues, we would face the prospects of deficits rising in unprecedented amounts.

Chairman VOLCKER. Which is basically the point I wished to make just now.

Mr. BETHUNE. Then I have a two-part question. One, can I take it from this language that it would be the preference economically, in your judgment, to cut spending rather than to raise revenues?

Chairman VOLCKER. In broad economic terms, I think that is correct, in looking at the performance of the economy generally. If that cannot be done, if there are social, defense, or other reasons that make that impossible, then I think you have got to go to the revenue side.

Mr. BETHUNE. Thank you. And the second part of my question concerns the reference to deficits rising to unprecedented amounts. Would that be the case if we do not make the policy changes that the President has recommended?

Chairman VOLCKER. Precisely; yes.

Mr. BETHUNE. If, in fact, we make the policy changes that the President has recommended and come in with a deficit of \$91 billion, then that deficit, as a matter of fact, would be less, would it not, by any measure than the deficit that we had in the year 1976?

Chairman VOLCKER. Not by any measure. But it would—

Mr. BETHUNE. By most measures?

Chairman VOLCKER. Be less by relative to GNP.

Mr. BETHUNE. All right.

Chairman VOLCKER. But then I think that was a very large deficit that year.

Mr. BETHUNE. Yes; it was.

Chairman VOLCKER. And you have got to look beyond 1983, I think, to the implications of your action. The year 1983, hopefully, will be a year of recovery, but you want to expand beyond 1983. I think you must get this budget on a course where 1983 is a transition year to still lower deficits.

Mr. BETHUNE. I agree with you, and I am not making a case for large deficits.

Chairman VOLCKER. No; I understand.

Mr. BETHUNE. I am just trying to add a measure of perspective to the discussion.

Chairman VOLCKER. That is right. I was talking about the deficit before action; the President has proposed a very sizable package of actions which take effect in 1983 and 1984. You will have to make

the judgment about whether that is the right package, but I would say go at least that far and, if you can go further, it can be nothing but helpful. I would feel much more comfortable if the deficit were reduced more than that.

Mr. BETHUNE. Now let me ask you another question. Regarding the question of interest rates and the discussion we have had here about the nature of the forces of supply and demand and how they operate on interest rates up to this point has focused principally on the demand side of the equation. We have talked about the deficit and how it crowds out and takes credit out of the pool.

Of course, I am a sponsor and one of the prime movers in trying to fashion a credit budget to keep other demand out of the credit pool. But I do not want to talk about that now.

I would like to shift over and talk a little bit about something we have not talked about, and that is the supply of credit that might be available out there.

Chairman VOLCKER. That is right.

Mr. BETHUNE. There has been no discussion of that this morning. In your prepared statement there is a reference to the fact that we might see an increase in the savings rate as a result of the tax incentives.

But might we not also see an increase in the available credit in the country as people's inflationary expectations subside and they move their money from antiquities, lead bathtubs, rings, and so forth, and move it into the credit pool? And how would that play out in terms of interest rates?

Chairman VOLCKER. I would think it could be profoundly important. You could get effects on the savings rate in a favorable direction. I hope and expect that we will, as the inflation rate comes down. I do not think you can measure that by movement out of antiquities or something else. Somebody has to buy those, and I do not think that movement has much effect; if you can sell them, somebody else is buying them. I do not think that is going to have that much effect on the overall savings rate as a percentage of income.

But I accept your general point that, as confidence is restored in the currency, you have a more favorable climate for savings. Indeed, these high interest rates, for all their difficulties, also provide an incentive for more savings, in addition to the tax measures.

I think there is a good possibility for a higher savings rate. But I would not want to bet a whole economic program on an enormous, extraordinary increase in the savings rate. If it happens, that is fine. But in historical perspective, these things change less dramatically, more slowly, usually. I hope it will go, and I expect it to go in a favorable direction. But it is a matter of proportion, and to the degree the rate goes up, it helps.

Mr. BETHUNE. I would like to compliment you on the excellent statement you made at the outset as to the cause of the recession that we are in now, when you traced back to some of the fundamental problems that have plagued our economy for a long, long time.

And I would just follow that with one last question. And that is, When do you think this recession started?

Chairman VOLCKER. Started?

Mr. BETHUNE. Yes.

Chairman VOLCKER. In the narrow sense, I think the official arbiter said in July. You can always debate with the official arbiter, the National Bureau of Economic Research. There is always doubt about the precise month. I think it became clear in the September figures, let us say. We actually had growth in the overall economy, according to the gross national product figures in the third quarter. But July is as good a date as any.

Mr. BETHUNE. That is a couple of months or 1 month before the Economic Recovery Act was signed.

Chairman VOLCKER. That is correct.

Mr. BETHUNE. The tax cuts did not even begin until October 1.

Chairman VOLCKER. That is right.

Mr. BETHUNE. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

As you know, Mr. Chairman, the President has sort of thrown down the gauntlet now. He has said that if we do not like his program that we ought to come up with something better and we ought to put up or shut up, so to speak. I think that is a fair challenge, and certainly we ought to do that.

It does seem to me, though, that it is only fair that we understand our economic history and most particularly our recent economic history.

It seems to me clear, from my perspective, that the reduction in inflation over the last couple of years can be attributed primarily to Federal Reserve action; and, in addition to this—depending on how that rate of inflation is measured—the stabilizing of oil prices. As you indicated, imports have been somewhat cheaper because of a strong dollar. Finally we have had several good crop years, which have held down food prices. I do not think it would be fair in any sense to give the President or his program any credit whatsoever for this reduction in inflation. They have had no part in it.

Now, what about the recession? The picture there is somewhat less clear. It does seem to me that interest rates are the prime culprit.

Among a number of factors, I think the very sharp reduction in the rate of growth in money between April of last year and the fall of the year must have had something to do with it. Historically, you can chart sharp reductions in the rate of growth of money with recessions. There is a very rapid and clear impact.

Then if you ask questions about why they persist, why do we continue to have high interest rates when the rate of inflation is clearly coming down by any measure, the answer seems to be that it is because we are pursuing policies that are not balanced.

Now we get to the President's program. The investment community is making decisions about the future. There is this ongoing poll that takes place every day in financial markets, in the stock market, in the bond market. And what investors are saying there is that they do not have confidence in this program.

Why do they not have confidence? With all the good intent—and I certainly do not question the intent of anyone—it is because it is not balanced. It does not add up. The administration has projected a deficit of about \$100 billion or \$90 billion for this year. That is

not a realistic projection of the deficit. It is clear now that the deficit will be much higher than that for this year.

My first question would be on that subject, and I would like to state two or three questions, if I may, because I know my time will expire in a hurry.

The first one would be: Do you generally agree with this analysis of why inflation has come down? And do you generally agree that the financial markets are making a decision based on their projection of the future? And do you think that this budget estimate is a correct or a faulty one? And let me just throw in a couple of other quick ones, if I may.

In the first less than 3 months of this year, Mr. Chairman, already M_1 somehow has grown about 43 percent of what would be allowed to hit the high mark of the M_1 target for the whole year. If you were to hit the midpoint—that is, 4 percent—for the year, M_1 growth has been about 60 percent in less than the first 3 months of the year than would be allowed in the whole year.

I think that presents a severe problem for you, and I would like to know how you are going to deal with it.

And I would like, if I may, to ask just one other quick question, and that is to follow up on this question about velocity. If the President is correct that the nominal GNP is going to be 10.4 percent and you are going to hit the midrange of your target growth of 4 percent, that would mean that velocity will have to be 6.4 percent, about double what it has ever been in our history over any same period of time. I just wonder if you think that is realistic.

And that is the least of my questions. I wish you would touch on the others first.

And I thank you, Mr. Chairman.

Chairman VOLCKER. I think maybe I will leave the first question, which had some loaded connotations to it, alone.

Mr. NEAL. How could you say that? [Laughter.]

Chairman VOLCKER. Of course, the financial markets are in the business of judging the future constantly, and their confidence and concern about the direction of policy, the mix of policy, underlying economic circumstances and all the rest, enter into those judgments.

They have been in a highly uncertain state, which just emphasizes to me the importance of consistency in policy, in terms of monetary policy and other instruments of policy, particularly the importance of fiscal policy coming into conjunction with what is reasonably financeable in the periods ahead.

I am less worried about the current deficit, so heavily affected by the recession, which could pass above the \$100 billion level instead of just below it, as the administration projected. That is a small difference that may be affected by the imprecision of economic forecast. I do not think that is the heart of the problem. The heart of the problem is out there in the future when the economy recovers.

You refer to the recent increase in the money supply. I do not know whether it is a problem or not. You can make those kinds of arithmetic computations that you make. They would look quite different if we had a decline in money supply, which would not upset us at all, in February or March; then all that arithmetic looks quite different.

You refer to the velocity computations. I think velocity figures are much steadier on an annual basis than they are in any particular quarter. We have had a rather exceptional decline in velocity, apparently, for two quarters in a row, including the present quarter. If you look at the administration projection or most other projections of economic activity for the year and make a reasonable projection of the average level of the money supply this year entirely consistent with our targets—taking account of what we know so far—you will find a velocity that is not extraordinary for this year.

Mr. NEAL. But then the economy could not grow at that rate, could it?

Chairman VOLCKER. No; if you look at it on a fourth-quarter to fourth-quarter basis, we had a decline in velocity in the fourth quarter of last year. We are having a decline in velocity right now of large proportions. If the economy grew in line with a recovery forecast for the rest of the year, you would have to get a big increase in velocity for a couple of quarters, but that is not unprecedented coming against the background of very slow velocity for a couple of quarters.

Looking at this year, there is no necessary inconsistency there.

The CHAIRMAN. Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

I cannot resist the temptation to add that the previous questioner said that he wanted to put you in that position with some reluctance. That is about like a chicken jumping on a June bug. I think he enjoyed it.

And this may come as somewhat of a surprise from somebody sitting on this side of the table, Mr. Chairman, but I am going to continue to pursue that line of questioning.

I think communication is the soul of a free society. And as long as you and I are privileged to represent the public interest, we ought to try to communicate with the people that we represent. And I know, talking to you, Mr. Chairman, is always an enlightening experience. It is a lot like sitting through an economics course in college that I did once long ago.

I know that you must deal in the dispassionate rhetoric of the financial community, but the report, this report and your statement this morning, was excellent, but it deals in what I call abstract. It is not a red-herring on a security issue.

In one classic understatement that I have underlined here, it says, "Volatility of the markets may have inhibited aggressive buying of longer term securities." That is code for the fact that the long-term bond market is dead in the water. Nobody will buy anything that deep discount bonds will not be purchased by the rational American because they have no confidence in the reduction of inflation in the future.

I listened with some interest to your comments about prices and the levels of bank deposits being stable. Now, a stable is a place where you keep a horse. And the only deposits they make is the inevitable byproduct of anatomical existence. And I think we have dealt with some of that here this morning. [Laughter]

Mr. PARRIS. I submit to you that the average American believes that GNP is a pill that teenagers experiment with, or maybe the

initials of a former President, and that M_{1B} is a gun that we used in World War II, and velocity is something that you and I studied in high school physics.

What do you do when a homebuilder sits in your office and says he is in bankruptcy and there is no housing market, which is the biggest industry in my district, when three-fourths of the people in construction are out of work, when you cannot sell a house without engaging in some kind of bizarre financing, when the banks will not even talk to a small businessman about an extension of credit?

What do you say in the real world? And I submit to you, Mr. Chairman, that the suggestion that it will get better over time or that their individual needs are relative to the demands is insensitive, politically naive, and perhaps asinine.

Now, the question, Mr. Chairman, is how much pain can the American industry, the American economy, and the American citizen stand? Is there no need to let up on the documented human needs in the real world?

Chairman VOLCKER. You live in what State?

Mr. PARRIS. Northern Virginia. You can hit it with a rock from here.

Chairman VOLCKER. Pardon me?

Mr. PARRIS. You can hit my area of concern right across the river with a rock from this building. And it is not a deep industrial area, Mr. Chairman.

Chairman VOLCKER. No.

Mr. PARRIS. It is a suburban community not untypical, I think, of most of the United States. I am sorry, I did not mean to interrupt you.

Chairman VOLCKER. I was simply going to say that the kind of contact you have with the real world is very similar to the kind of contact I have with the real world. I am asked the same question, and I wish I knew a quick and easy answer. I do not, and I feel very frustrated in responding to that question because I do not have a quick and easy answer.

I do have the same answer I have given before, and I know how abstract it sounds sometimes, but it is not abstract at all. The homebuilding industry, more than any industry, has a stake in the functioning of the capital markets of this country. And that is what we are talking about in a very direct sense when we talk about the competition that the Government provides in that capital market. It is going to impinge upon somebody else, and the somebody else that it impinges upon first and most heavily is the homebuilder. I think there is considerable understanding of that in the homebuilding industry.

Mr. PARRIS. Well, Mr. Chairman, just to go back to what Dr. Paul dealt with just a moment ago, you say in your statement that a bulge in the money demand early in the second quarter was steadily resisted by restraining the supply of reserves.

And in your statement you said a very sharp increase in the money supply developed in January, and a statement that you did not include in your summary at least was, "as the Federal Reserve open market operations constrained the supply of reserves."

Chairman VOLCKER. Correct.

Mr. PARRIS. And I think this is consistent with my previous comments, Mr. Chairman. Is there not some place, does there not come a time when the Federal Reserve Board in its academic review of all these multiple charts and graphs and stuff like spaghetti thrown against that wall, does there not come a time when that has to be related to what is happening out there in the real world? And can there not be some middle course where you let up just a little bit once in a while?

Chairman VOLCKER. Those are judgments that we make all the time. I think, as my statement and previous discussion have emphasized, we have to stick with and intend to stick with the basic course of the policy. How one responds to the short-term changes has elements of judgment in it.

Basically, we are going to resist bulges in the money supply in either direction. That is what we have done in this recent period. Sometimes, you have a certain amount of discretion about how strongly you resist. I comment in the statement that the January increase was not deeply disturbing to us because we think it does have temporary elements and will ease down on its own.

We continue to evaluate the situation, and if we see something more structural or permanent going on, we would reevaluate the targets; that is always the case.

Mr. PARRIS. Thank you, Mr. Chairman. My time is expired.

The CHAIRMAN. Mr. Patterson.

Mr. PATTERSON. Thank you, Mr. Chairman.

Chairman Volcker, you are undoubtedly one of the five most powerful men in the world. I think the fact that the full Banking Committee has sat here for 2 hours, that this has been a packed room, that we have people standing outside, and that there are nine television cameras over there, not to mention how many radios hanging on every single word you utter, shows that you are one of the five most powerful men in the world.

As Chairman of the Federal Reserve, you have half the responsibility for our Nation's economic policy and, at least in terms of monetary policy; the Congress and the President have responsibility for fiscal policy.

What the American people really want to know is when is the recovery going to occur? When are high interest rates going to come down? When is unemployment going to come down? And when are we going to see inflation stay down?

You said, as I recall, earlier in your statement that recovery would come by midyear. Do you mean this year?

Chairman VOLCKER. Yes.

Mr. PATTERSON. By mid-1982. Now, in your role as Chairman of the Fed, it seems to me you have kind of two hats you wear. One is the hat that takes all the tools that the Federal Reserve has and all the knowledge and all the data, puts it in into some form that the American people and the banking community can understand so that we can judge accordingly how to manage our business and so forth. The other hat is part of a public confidence role where you say everything is going to get better and be OK.

I guess my question is, when you say recovery will come by mid-year, which of those two hats are you wearing? Are you telling us this in your public confidence role so that we will believe it and

then maybe try to actualize it? Or do you really have the hard data that supports that kind of forecast?

Chairman VOLCKER. I have not stated outlooks that I do not believe, or given rosey statements for the sake of giving rosey statements. I think what I said this morning was that our analysis suggests a probability that recovery will come before the middle of the year; it could be several months before the middle of the year.

I also stated that I think there are some risks, as there always are in any economic forecast. I think that is a correct way to look at this situation; what kind of actions should we take, should you take, should everyone take, to minimize the risks and maximize the potential.

As you quite correctly point out, we are responsible for the monetary side, and we have described our intentions. We have indicated that, for instance, all things considered at the moment, and given that we had this bulge at the beginning of the year, an outcome in the upper part of the range would be acceptable as influenced by these kinds of considerations.

But I would just come back to the point that, as we view the situation, a major element in assuring the recovery—and I think it is much more important than any precise date—is that we get policies in place that assure the recovery will be sustained, whether it begins in March or June, and that it will not soon be forgotten.

The real objective is to continue in 1983 and 1984 and 1985 to get out of this syndrome of ups and downs and unsatisfactory growth and productivity and to sustain that policy over a period of time.

There needs to be a contribution from the fiscal side. We have exactly the opposite situation from what traditional thinking may have been 20 years ago, that the bigger the budget stimulus the more growth.

We are getting those deficits out of the way, moderating them, getting them on a pattern of reduction consistent with recovery; that is a key to the recovery itself.

Mr. PATTERSON. Do you really think that the Reagan administration's budget deficit of close to \$100 billion is going to encourage recovery?

Chairman VOLCKER. I am not sure that is the real question. The question is, as the deficit—

Mr. PATTERSON. Both this year and the out-years down the line.

Chairman VOLCKER. The President has given you his plans. He has also told you that without the kind of action that he is proposing—and the Congressional Budget Office has told you that without any kind of action—you are facing a deficit on the order of \$150 billion, rising in subsequent years.

Whatever debate we can have about precisely what level of deficit is appropriate, we ought to agree that that kind of outlook, without any action, is not conducive to any kind of recovery that could be sustained; it is not conducive to calm financial markets; it is not conducive to lower interest rates. That is the point I want emphasized.

The next question is, "Well, is the President's program big enough?" That could be a matter for debate. I will tell you, if we can put together a bigger program and get it enacted, I think that would be a safer course for the economy.

I have stated on a number of occasions in recent months that I saw the deficit problem as one that required roughly \$100 billion worth of action by 1984. The President has proposed not quite \$100 billion; he has proposed around \$82 billion.

I am very aware that \$82 billion or \$100 billion requires a lot of action that has not been taken yet, and that is the point I want emphasized.

Mr. PATTERSON. My time is expired. I do not understand how you can say that the policies of a President, which in 4 years will be responsible for the addition of one-third of the entire Federal deficits accumulated in our country's history, how you can say that such policies will lead us on the road to recovery.

Chairman VOLCKER. You can pull that deficit down faster.

Mr. PATTERSON. No, not whether we can pull it down. I am talking about the President's proposal. In 4 years he is going to have the four highest budget deficits in the history of the United States of America. And that is his budget. And you are saying, OK, Congress, go further.

Chairman VOLCKER. I would urge you to go just as far as you can.

Mr. PATTERSON. Where do you want us to go? To defense?

Chairman VOLCKER. That is a judgment, I think—

Mr. PATTERSON. You have one of these long terms. You are appointed by the President.

Chairman VOLCKER. That is not a decision I was appointed to make.

Mr. PATTERSON. I will trade you jobs.

Chairman VOLCKER. I might take you up on it. [Laughter]

The CHAIRMAN. Mr. Weber.

Mr. WEBER. Mr. Chairman, along those same lines, we are talking about the deficit and the possibility of crowding out borrowers and putting upward pressure on interest rates, what is the percentage of lendable funds that is now being borrowed by the Government? I hear different figures.

Chairman VOLCKER. I can answer you in a somewhat different way; I can tell you the percentage of the net savings of the economy that is being absorbed by the Government, which in 1981 will be about 61 percent.

Mr. WEBER. About 61 percent?

Chairman VOLCKER. Of the net private savings.

Mr. WEBER. What does net private savings mean?

Chairman VOLCKER. It is the total savings of the economy less the private consumption allowances. If you assume that we want to invest privately the amount of capital that we are depreciating, we need about \$155 to \$160 billion worth of savings. This is last year's number. The Government in its deficit and in the off-budget programs absorbed about \$95 billion of that, 61 percent.

Mr. WEBER. Is that up from previous years?

Chairman VOLCKER. It is up from 1980, slightly. I have figures for the last decade in front of me; the savings absorbed by the Government ran an average of something below 20 percent in the early 1970's; in the later 1970's it ran about 45 percent or higher. Performance deteriorated all during that period, and the figure is 57 percent in 1980 and 60 percent in 1981.

I think that tells you something about the underlying deteriorating trend in the budget before now.

Mr. WEBER. What is the projection for 1982?

Chairman VOLCKER. This year, of course, we are going to have a big deficit, and that figure is going to be large. I would guess that it is going to be larger than last year. But these figures tend to be large in a recession year because other investment activity goes down.

The real question is what that is going to be in 1983 and 1984. If nothing were done to this budget, those figures would remain in that area or perhaps go higher unless we had an enormous increase in the savings rate. As I said, I think we can expect some increase in the savings rate, but I do not think we can bet on an enormous increase in the savings rate.

Mr. WEBER. I have one other question. We had introduced House Joint Resolution 365, which has been sponsored by the chairman of our committee and Mr. Reuss and various others. One of the proposals in House Journal Resolution 365 was to leave the M_1 target 1982 at the 1981 level.

As I understand it, your 1982 target for M_1 is 2.5 to 5.5 percent, whereas the target for 1981 was something in the range of 3.5 to 6 percent if you are looking at the M_{1B} adjusted, or 6.5 to 8 percent if you are looking at just M_{1B} .

What would be the implications of leaving the target at the higher level, which would be the 1981 range, rather than the target you have adopted for 1982 for M_1 ?

Chairman VOLCKER. Of course, the higher and lower targets would overlap over a good part of their range, so that would not necessarily imply coming out any differently. But I think the implication would be that you would be a shade more relaxed on providing money. Whether that is a good idea or a bad idea depends first of all on what you think the appropriate substantive policy is for continuing to work down the supply of money.

Conceivably, there could be more structural changes that you would want to adjust to, which would not have economic significance; you could be adjusting to a change in the marketplace that affected the amount of money that people wanted to hold in the particular form that we arbitrarily define as M_1 . I noted that if we were convinced that such structural changes were going on that gave rise to a larger need for money, then we would look again at the target, but we are not convinced of that at this time.

Mr. BETHUNE. Would the gentleman yield for a point of clarification?

Mr. WEBER. Yes.

Mr. BETHUNE. When the Chairman states that the Government is taking a certain percentage of the savings in the country, is the Chairman including along with the raw deficit the other Government credit assistance programs, the Government-sponsored entities?

Chairman VOLCKER. No. I was including the \$20 billion or so of direct Treasury financing for credit programs off-budget; I was not including all the sponsored agencies.

Mr. BETHUNE. But there are many more of those?

Chairman VOLCKER. There are many of those. I do not want to be misunderstood. I was quoting this against the net savings.

If you calculate it against gross savings, the capital consumption allowances are very big. You get a figure more like the percentage of total credit in the economy, and then you find in the early 1970's the Federal share of savings was running at comfortably less than 10 percent. In the second half of the 1970's it was running around 20 percent, and it has been around 20 percent for the last 2 years and would remain very high this year.

Again, the issue is how big is that figure when you look out ahead. Again, unless there were a big change in the savings rate, if something were not done about the deficit, that would get to be a very high figure historically.

Mr. WEBER. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. D'Amours.

Mr. D'AMOURS. Thank you very much, Mr. Chairman.

Chairman Volcker, thank you very much for coming before us today. I always enjoy your testimony.

You have been described today in very heady terms, "one of the five most powerful people in the whole world," the chairman of an independent agency. I am not sure I agree, by the way, that you are one of the five most important people in the world. I do not know who the other four are. You probably consider that a slight, I do not know.

Chairman VOLCKER. I did not align myself with that statement.

Mr. D'AMOURS. I am aware that you did not.

But it does tend, your independence and your undoubted importance, does tend to underline, I think, the need, as Howard Baker said 3 or so weeks ago, for you to have some kind of a summit meeting with probably the most important person in the world today, and that is the President.

Have you ever had such a personal meeting with him to discuss the trade-offs involved in his policy and the things you might be able or willing to do if he were to implement any given policy?

Chairman VOLCKER. I meet with him from time to time. I certainly do not think of it in the nature of a summit meeting, but rather as a continuing form of communication and dialog.

Mr. D'AMOURS. Do you one on one with him discuss the trade-offs on the various policies he is implementing?

Chairman VOLCKER. One on one, we have not.

Mr. D'AMOURS. You have not met with him personally?

Chairman VOLCKER. I meet with him personally, but not with only two people in the room.

Mr. D'AMOURS. You do not discuss it just between you and he?

Chairman VOLCKER. No.

Mr. D'AMOURS. Earlier, when Mr. Mitchell from Maryland pointed out that your policies are on a direct collision course with the President's policy, you nodded your assent to that statement when he made it, that he was stepping on the gas and you were stepping on the brakes. And you nodded your assent when Mr. Mitchell made that statement. I assume you agree that your policies are divergent and going in opposite directions. Do you disagree?

Chairman VOLCKER. I do not remember the exact context of that statement. What I agree with is that it is very important to have

the deficit reduced. The so-called baseline deficit is not helpful in——

Mr. D'AMOURS. I only have 5 minutes. Do you think your policy is consonant and consistent with the administration's policy?

Chairman VOLCKER. I think our policy is very consistent with what the administration in general wants to do. The uncompleted job is the deficit that is sitting out there.

Mr. D'AMOURS. Which is the administration's deficit. Is that consistent with your policy?

Chairman VOLCKER. The administration is trying to reduce the deficit, as I understand it.

Mr. D'AMOURS. But it also created the deficit, did it not?

Chairman VOLCKER. I do not think I would put it in those terms, no. I think what is important is——

Mr. D'AMOURS. Somebody did.

Chairman VOLCKER. Obviously. The Congress and the President enacted a big tax reduction last year; you also cut some spending. The net result, looking to the out-years, is that there was a lot more tax reduction than there was spending cutting.

Mr. D'AMOURS. I happen to believe, and I hope you do not disagree too strenuously with the fact, that your policy of tightening up credit in the money supply is not consistent with some of the tax cuts that were passed last August and with the overall deficit that the administration has implemented.

And by the way, I do not disagree with the position you have taken. I think that we have got to get at the underlying inflation rate.

But I think there is a judgment involved here that it is better over the near term to have a recession, perhaps even a deep recession, than it is to have pernicious, long-term continuing inflation.

That seems to be how the judgment was made. If that judgment were not made, you would be relaxing your policy, and interest rates would be coming down and inflation would be on the increase.

But how long do you think it is reasonable to persist in that judgment and in that policy? What happens if there is no recovery in July? What happens if there is no recovery by next December? Do you still persist in your policy at that point?

Chairman VOLCKER. Nobody deliberately sets out, and certainly we did not deliberately set out, to create a recession. I do not think we did.

Mr. D'AMOURS. I did not mean to imply in any way that you did.

Chairman VOLCKER. All right, let us leave that aside.

You are certainly correct in your general judgment that our policy echoes the administration policy, and I think there is a general consensus in the country that we have to deal with this longer term problem. There are always risks when you try to change the great momentum of inflation—the great momentum that had adverse effects in other ways, and we are seeing some of those risks and some of those transitional costs incurred in the interest of putting the economy on a sustained growth path, which is always the objective.

If you tell me of a situation where the economy continues to decline or not grow for an indefinite period, and if in that situation

the inflation rate was declining and the judgment was this was a continuing proposition, we would be forced to come back and, among other things, question whether the monetary growth targets were right or whether they were not too restrictive in that situation. I do not think that is the kind of situation we are going to face.

I think you would also look around to see what other policies need adjustment in those circumstances. Nobody is going to be content and not look at the dial if the economy over a long period of time were not showing performance.

Mr. D'AMOURS. If the economy does not improve, let us say, by late summer or early fall or into next winter, would you agree that that would be a time to reassess your policy, to loosen up?

Chairman VOLCKER. You certainly reassess, but you reassess that and other policies to see what the source of the difficulty is. I cannot answer that question now. I would not expect that we are going to find inadequacy of money in a general way. After all, we are projecting increases in the money supply. We are aiming for increases in the money supply.

Mr. D'AMOURS. One thing I would like to clarify as to your policy of tight money. You indicated in your statement on page 5 that one of the reasons for the rise in the costs of homes or one of the reasons for the drastic decline in the home market is the inflation in the cost of the home.

I want to tell you something, every homebuilder in my district that I have spoken to and every automobile dealer says they can sell their product at current prices if they could arrange the reasonable financing.

Chairman VOLCKER. I think if the financing were cheap enough, that is right, but this is an interesting kind of problem. The rising prices of homes undoubtedly stimulated home purchases for a while. Everybody said, "Let us buy a house or buy a second house or buy a bigger house because it is going to have a higher price next year." As part of the fundamental change in the inflationary trend, that prospect is no longer so clear, and it should not be so clear in a noninflationary world.

People are changing their minds about whether buying a house is a great deal as a speculative investment or as a home; so the industry feels that adjustment very sharply.

You described some scenarios that I do not think are going to happen, and I certainly do not think they would be caused by a basic lack of money. We are increasing money. But I am very hopeful that we are in the midst of a fundamental change in the inflation environment and the inflation tendency that has gripped this country for 15 years and gotten progressively worse over that period. As it was prolonged, it got more difficult to deal with and tended to feed upon itself.

There is a lot of evidence that we are beginning to make a fundamental change in that trend, and if we are successful in doing that, then I think we will have laid the foundation for the converse in the 1980's of what we saw in the 1970's; that is, that productivity growth can be sustained over this decade at good rates instead of dwindling away as it did in the 1970's.

Mr. D'AMOURS. My time has expired. I wish you good luck, Mr. Chairman.

Chairman VOLCKER. Thank you.

The CHAIRMAN. Mr. Wortley.

Mr. WORTLEY. Thank you, Mr. Chairman.

Chairman Volcker, the Budget Office in a recent report said there is a significant risk of an unprecedented clash between monetary and fiscal policy that could produce either a flat no-growth economy or a go-stop economy, and a spike in the interest rates, driving the economy into recession once again. Are you going to let that happen?

Chairman VOLCKER. As I read that report—and I did not have a chance to read it completely—my sense was they drew that implication, although I would not describe it in just the same way. But you had better not let that happen and deal with the budgetary problem.

Mr. WORTLEY. Do you and Secretary Regan meet regularly?

Chairman VOLCKER. Yes.

Mr. WORTLEY. The quality of your cigars notwithstanding, is there a large difference of opinion between pursuit of his fiscal policy and your monetary policies?

Chairman VOLCKER. I do not have a sense of any disagreement about the basic thrust of monetary policy. We have, apparently, some difference of opinion on the significance of short-term fluctuations. On fiscal policy, my private conversations parallel my public conversations.

Mr. WORTLEY. He does not smoke cigars, does he?

Chairman VOLCKER. No. He gave me some cigars the other day.

Mr. WORTLEY. We all seem to agree on the need to reduce the deficit when I look at the soaring defense budget. Does it concern you that in the outyears, in order to achieve the levels of defense spending that have been projected, that it is going to throw our balance of payments considerably out of whack; namely, the American industrial defense base is not broad enough to meet the needs of the defense budget and a considerable amount of money is going to have to be spent overseas? Is this a concern to you?

Chairman VOLCKER. I have not looked into that very carefully, Mr. Wortley. I confess that sometimes you run into that kind of a problem in an economy that is very tight and in which industrial capacity is taxed; if you have a big increase in defense spending, you may impinge on other activities that could go into exports. I am not familiar, frankly, with the proportion of the defense spending that could go overseas in terms of the future trend.

Mr. WORTLEY. Is it a balance-of-payments problem?

Chairman VOLCKER. The balance of payments has been in pretty good shape recently relative to other countries, taking into account that all industrialized countries—or most of them—have to pay a much bigger oil bill. In recent years our balance of payments has been relatively good.

I think the strength in the exchange rate of the dollar recently is likely to bring some pressure on our current account as recovery proceeds. But it has been in relatively good shape, so some change within limits there would not be terribly disturbing.

You can always go too far, and our external competitive position is something that has to be continually watched, but I am not concerned about the outlook in the next year or two.

Mr. WORTLEY. Thank you, Chairman Volcker.

The CHAIRMAN. Ms. Oakar.

Ms. OAKAR. Thank you, Mr. Chairman.

And I thank you, Chairman Volcker, for coming.

It is interesting to me to see the kind of mutual admiration society that you and the administration have. I noticed Sunday, watching Secretary Regan, that he endorsed your tight-money policy, and today on page 16 you comment on the positive effects of the tax bill.

Would you not agree that the tax bill and high unemployment also add to the deficit? I am from Ohio, and our State has the second highest unemployment in the country, 12.5 percent. And a lot of our people think that is directly attributable to the tight fiscal policies, the high interest rates, and the impact of the budget. Now, with another budgetary proposal that guts out unemployment programs and so forth, they are very concerned.

My question to you and, in effect, to the President, because I think you really both basically agree with the approach: How long can my State wait, how long can these unemployed workers wait? They do not have money to save. I mean savings are out of the question for them. They think this is the end of the middle class. And what is happening to them—and these are not just the autoworkers and the steelworkers, these are career employees who are 45 years old, who were making \$35,000 or so a year, who are now out of a job and have no future, no optimistic reports in their favor.

And so we are seeing in our State—and I am sure this is happening across the country—we are seeing our small farms go under, we are seeing our small businesses go under, we are seeing traditional jobs eroded. We are seeing an increase in divorce, we are seeing an increase in mental illness. We are seeing an increase in crime. We are seeing an increase in suicides.

How long are the American people supposed to wait because some economists think that when you bring down the inflation rate by a percentage or two, you have to sacrifice 3 million more jobs. How long are the people supposed to wait? You told us a number of times that an upturn would be on the horizon. How long can they wait?

Chairman VOLCKER. If I knew an easy answer to the question of dealing with that problem, a solution that I did not think created worse problems, I would not keep that light under a bushel.

Ms. OAKAR. But you endorsed a tax bill—you kind of contradicted yourself earlier—but you endorsed it on page 16.

Chairman VOLCKER. I indicated some of the potential benefits of that tax bill on productivity and all the rest. I think I—

Ms. OAKAR. But it added to the deficit, did it not?

Chairman VOLCKER. I spent a year before this committee and other committees indicating my concerns about the imbalance in the budget that could result. I think we are left with that imbalance in the budget. It seems to me the implication of that tax bill is that it gave up much more in revenues than it saved on the

spending side. The job is clearly incomplete, because we are left with this deficit situation. And you are right, the unemployed add to the deficit.

Ms. OAKAR. By about \$25 billion, is it not, for every percentage point?

Chairman VOLCKER. When I look at that deficit, I mentally discount the part that is due to the rise in the unemployment rate and the recession.

Ms. OAKAR. Why would you do that when you are mandated by the Humphrey-Hawkins Act to consider it? How ironic it is that you would make a statement like that. I mean I have to lay it on the line, I do not think you are concerned. Here you are mandated by the Humphrey-Hawkins Act, which has as its major goal full employment for this country, and you come to this committee and say you mentally discount unemployment.

Chairman VOLCKER. No; I did not say that.

Ms. OAKAR. I do not see a thrust toward eliminating that problem.

Chairman VOLCKER. Wait a minute; we are not communicating. I do not mentally discount the unemployment. In assessing the budget, I mentally take account of the impact on the budget of the unemployment so that I do not overestimate the underlying deficit.

What concerns me is not the \$25 billion that you lose in revenues or additional spending because the unemployment rate is up. What concerns me is that the deficit would go up when the unemployment rate declines.

Ms. OAKAR. Wait a minute. Just so I understand what you just said. You just said that what concerns you is not that there is a \$25 billion deficit or an impact on the deficit when there is 1-percent increase in unemployment?

Chairman VOLCKER. I would rather not have it, but the problem is the unemployment.

Ms. OAKAR. What really concerns you? Finish that sentence.

Chairman VOLCKER. The problem that concerns me is the unemployment.

Ms. OAKAR. Yes. And that adds to the deficit.

Chairman VOLCKER. That does add to the deficit. But the \$100 billion deficit, to me, has an ingredient of reaction to the unemployment. The unemployment is bad, and among its other consequences, it increases the deficit. But I would not be up urging you for action on the deficit or on the budget if that deficit were going to disappear as the economy recovered and the unemployment rate went down.

The problem is the deficit is going to get bigger without any action even when the economy recovers and the unemployment rate goes down.

Ms. OAKAR. Let me tell you, people employed are a lot more important than whether or not the deficit goes up or down, when they are committing suicide. They will not have to worry about any deficit in the way you define it.

Chairman VOLCKER. I agree with that. But how are we going to help the person employed or the person unemployed? What I am suggesting to you is that that budgetary outlook is a hazard for those very people who are unemployed. They have more at stake

than anyone else, in a sense. The unemployed carpenter has more at stake in reducing that deficit during a period of recovery than any other person in the economy because he is going to be most directly affected by the competition of the Treasury in the markets. I do not have to limit it to a carpenter.

Ms. OAKAR. Well, let me say my time is expired. But I do not think you or the administration fully developed a policy of diminishing the high unemployment rate that we have in this country, which you acknowledge adds to the deficit. That does not seem to be of paramount concern for you or the President, witness his speech in which he hardly even mentioned it.

Chairman VOLCKER. If we have any difference, and I am not sure that we do, it is my concern to create conditions that minimize the chances of being back in this situation again or prolonging this situation. We may have some differences as to how to do that, but there cannot be, I think, any fundamental difference about the fact that that is the key problem and challenge, to get together a set of policies that will get the economy on the right course.

Ms. OAKAR. In the meantime, they will be dying off and so on. Right? Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Lowery.

Mr. LOWERY. Thank you, Mr. Chairman.

Chairman Volcker, you stated that you thought the recession probably began about July, a month before the President's program for economic recovery took effect, and certainly before the tax cuts took effect. Would you say that the recession we are currently in would be more severe without those programs having been enacted, particularly the tax cut aspect?

Chairman VOLCKER. I am not sure I have any strong feeling on that one way or the other. You have some support from the tax reduction that was made in the fall. On the other hand, concerns about the deficit have been a big factor in the financial markets, which, of course, affects business activity.

I think that program has to be judged by its long-range implications and how it comes out over time. And I agree it has not been in place very long; only a small portion of it has been in effect.

Mr. LOWERY. Would you concur with the soundness of the idea of stimulation to the economy, to increase productivity?

Chairman VOLCKER. The 5-percent tax reduction, by providing some stimulation in the fall; yes.

Mr. LOWERY. You suggest that you are looking to the second or third quarter of this year for an improved economy. On what information do you base your suggestion?

Chairman VOLCKER. On analysis of a variety of recent trends. We have had a sharp decline in production. We have some evidence of inventory liquidation at the moment. These are the kinds of forces that usually presage a cyclical recovery. We do have a second stage of that tax program coming in July which provides some assurance that disposable incomes will increase at that time.

I think there is quite a lot of repressed demand in the economy, if I can put it that way. Interest rates are at extraordinarily high levels. I would hope and expect that they would come down at some point; I do not know the precise timing, but that would also provide some support.

You have some normal cyclical developments, the depressing effects of which may be waning and will be taken over by expansive effects and you have some policy measures that will help.

Mr. LOWERY. Do you feel the July tax cuts will have a very positive influence?

Chairman VOLCKER. I think they provide quite a lot of insurance that that could happen.

Mr. LOWERY. What do you think about the advisability of accelerating the tax cuts from July to January or April to stimulate the economy?

Chairman VOLCKER. I have seen a couple of different versions of that proposal. Do you accelerate it with the same revenue loss, which means a lower percentage cut, or do you bring the whole thing forward and make the immediate deficit a little larger? I do not feel enthusiastic about either idea.

The thing is in place. It is not very far off. It would be hard, I think, mechanically, to accelerate it very far now in terms of changing the withholding pattern, which is what presumably would count.

Mr. LOWERY. Mr. Chairman, it strikes me that the President's program is sound, but it will take some time to work. The concern that I have is with the Federal Government and the money markets; specifically, I have heard percentages anywhere from 42 percent to 78 percent of available credit goes to finance Federal deficits. I do not know what figure you would use.

Chairman VOLCKER. I gave some figures earlier, which represent one particular way of looking at that, matching savings against the Government deficit. It takes either 60-plus percent, if you take the net, and it takes half of that or less if you take the gross. You can look also at it against the total volume of funds in the credit market.

I think whatever particular measure you take, the problem is the Government takes a high and rising proportion—if nothing is done about the deficit.

Mr. LOWERY. Is that the stumbling block, the private sector having sufficient credit available to finance the recovery?

Chairman VOLCKER. In the kind of conditions we have now, where we obviously have congested credit markets, that is a problem.

Mr. LOWERY. Have you an estimate as to how many dollars would be required to finance economic recovery, this pent-up frustration of enterprise to reinvest?

Chairman VOLCKER. I do not have any figures at hand. Sometimes we make estimates, with a given increase in economic activity, of the implications for different kinds of financing. I do not have any with me now.

Mr. LOWERY. If you could provide me with those figures, I would be very appreciative.

[The information follows:]

Chairman Volcker subsequently submitted the following information for the record.

Table 1 shows an estimate by Federal Reserve staff of total credit obtained by nonfinancial sectors of the economy that might, in terms of historical patterns, be consistent with the Administration's GNP forecast for FY 1982-84. As may be seen, absent the enactment of the Administration's deficit reduction program, the Treasury will be absorbing a very large share of aggregate credit flows (and these figures on federal borrowing do not include guarantees or sponsored agency takings).

These data employ Administration estimates of the deficit. The CBO has estimated significantly higher deficits, before or after assuming enactment of the President's budget.

Note also the appropriate historical comparisons for fiscal 1984 should be with earlier prosperous business years, not with recession years when Federal financing is normally an exceptionally large share of credit markets.

Table 1

FEDERAL BORROWING AND CREDIT MARKETS

<u>Fiscal years</u>	<u>Total funds raised by nonfinancial sectors¹</u>	<u>Federal borrowing from the public</u>	<u>Federal borrowing as a % of funds raised</u>
	(\$ bil)	(\$ bil)	(%)
1972	152	19	12.8
1973	198	19	9.8
1974	187	3	1.6
1975	174	51	29.2
1976	242	83	34.3
1977	310	54	17.2
1978	379	59	15.6
1979	413	34	8.1
1980	342	70	20.6
1981	405	79	19.6
1982 ^e	420	115 (118) ²	27.4 (28.1) ²
1983 ^e	494	108 (164)	21.9 (33.2)
1984 ^e	548	97 (181)	17.7 (33.0)

1 Nonfinancial sectors, excluding equities.

2 Numbers in parentheses assume the Administration's deficit reduction program is not enacted.

Source: Special Analysis F, Budget of the United States Government, 1983 except for 1982, 1983, and 1984, which are staff projections based on Administration's economic and budget projections.

Mr. LOWERY. The Treasury Department offsets the deficits by saying that we will see sufficient savings growth to cover the \$100 billion deficit to meet the private sector needs. What would your comment be on that?

Chairman VOLCKER. I have two comments. First of all, they use a \$100 billion or \$90 billion or \$80 billion deficit out in the future. We are not there; we are \$80 billion away from there or more in 1984 as things stand, so when you say that deficit can be financed, if that statement is right, you are talking about an \$80 billion problem just to get you there.

I would also feel that you might still have a problem; I would not want to count on that big an increase in savings.

Mr. LOWERY. What are you using by way of numbers to project?

Chairman VOLCKER. I do not have a precise number. I do not know what their precise numbers are. But given the numbers I have had, it seems to me the implication would be a very sharp increase in the savings rate. As I said, I think we will get some increase in the savings rate, but I would not want to count on an increase as sharp as that projection.

Mr. LOWERY. Mr. Chairman, if you could provide me with the best available numbers you have, I would be most appreciative.

[The information follows:]

Chairman Volcker subsequently submitted the following information for the record.

Table 2 gives some hypothetical saving projections, based on patterns observed in earlier years. While the range of possible outcomes is substantial, the figures indicate that the federal deficit will be absorbing a comparatively large share of total private saving in the economy unless major steps are taken to cut spending or increase revenues. It is interesting to note that the deficit-to-saving ratio looks especially high in comparison to earlier experience in relatively prosperous times, which is the appropriate comparison for projections based on an assumption of a high level of business activity.

Note that these data are Administration deficit program and GNP estimates; other estimates (e.g., by the CBO) suggest higher deficits and consequently greater strain on our savings capacity.

Table 2
DEFICITS, GNP AND SAVING

Fiscal Years	Budget Deficit (\$ billions) ¹	Deficit as % of GNP	Deficit as % of gross non-federal saving ²	Deficit as % of net non-federal saving ²
*1965	-1.6	0.2	1.5	3.0
1966	-3.8	0.5	3.2	6.1
1967	-8.7	1.1	6.7	12.9
1968	-25.2	3.0	17.7	34.5
1969	3.2	0.4	2.3	5.0
*1970	-2.8	0.3	1.9	4.2
1971	-23.0	2.2	13.5	29.3
1972	-23.4	2.1	11.9	24.9
*1973	-14.8	1.2	6.6	13.1
*1974	-4.7 (-6.1)	0.3 (0.4)	2.0 (2.6)	4.2 (5.5)
1975	-45.2 (-53.2)	3.1 (3.6)	18.2 (21.5)	45.8 (53.9)
1986	-66.4 (-73.7)	4.0 (4.5)	22.8 (25.2)	53.2 (59.0)
1977	-44.9 (-53.6)	2.4 (2.9)	13.0 (15.6)	29.1 (34.7)
*1978	-48.8 (-59.1)	2.3 (2.8)	12.3 (15.0)	27.0 (32.6)
*1979	-27.7 (-40.1)	1.2 (1.7)	6.6 (9.5)	15.9 (23.0)
1980	-59.6 (-73.8)	2.3 (2.9)	13.3 (16.5)	35.2 (43.6)
1981	-57.9 (-78.9)	2.0 (2.8)	11.7 (15.9)	31.5 (42.9)
Potential Deficits with No Saving Plan (Administration's "Baseline") ³				
1983	-147 (n.a.)	4.3 (n.a.)	21.2 (n.a.)	n.a.
1984	-167 (n.a.)	4.4 (n.a.)	20.7 (n.a.)	n.a.
Administration's Proposed Deficits				
1983	-92 (-107)	2.7 (3.1)	13.2 (15.4)	n.a.
1984	-83 (-97)	2.2 (2.6)	10.3 (12.0)	n.a.
	Deficit adjusted to 6% unemployment	High Employment Deficit as % of potential GNP	High Employment Deficit as % of gross nonfederal saving ⁴	High Employment Deficit as % of net nonfederal saving
Potential Deficits with No Savings Plan (Administration's "Baseline") ³				
1983	90	2.5	13.7	37.0
1984	128	3.2	18.0	48.6
Proposed Deficits				
1983	35	1.0	5.3	14.4
1984	44	1.1	6.2	16.7

1. Unified budget deficits; data in parentheses include "off-budget" programs financed by U.S. government.

2. NIPA gross saving excluding NIPA Federal surplus (or deficit) plus net foreign investment (sign reversed); net nonfederal saving equals gross less capital consumption allowance with adjustment.

3. CBO estimates of baseline deficit are somewhat higher.

4. Saving as percent of potential GNP equals ratio in average of high employment years in the 1970s.

*Reasonably prosperous years; unemployment rates of 4.9%, 4.0%, 5.2%, 5.0%, 6.3%, and 5.8%, respectively.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

President Reagan, with the Fed's cooperation, has really been a wonder. In just 1 year his policies which Congress, the administration and the Fed have followed with a passion have taken an economy on its knees and knocked it on its back.

You have been a good soldier, Mr. Volcker, on the Federal Reserve Board. You have carried out well the Reagan-Regan—Sprinkle supply-side scenario, in spite of the fact that everyone gets a little paranoid with regard to whose side you are on. In fact, there is a question in my mind really as to just how independent the Federal Reserve Board is at all today. I really begin to wonder.

The Fed appears to be a cog in the free-market wheeler-dealer Reagan economics. The Fed has abandoned its role of leadership, which fits well with the Reagan withdrawal of the National Government from the real economic world.

Indeed, one could easily deduce from your statements that the Federal Reserve Board has nothing to do with nor responsibility for the economic consequences of these policies. Let me remind you that the recession deficits to which you seem to give your tacit blessing this morning are not being targeted to the distressed. I want to make that very clear. These deficits you say we ought to tolerate are not going to the people that are unemployed in this country to fill the role of the economic shock absorbers as they have in the past.

In fact, they are going to the special interest hemorrhage of tax dollars that was passed and an explosive Pentagon spending program, which I noticed again that you find necessary to refer to in a positive sense in your statement.

Lord save us if this is conservative economics. Your endorsement of Reaganomics today amazes me, especially when you keep your foot on the brake while the Republican administration pours on the gas. Figuratively, these policies are tearing this country and our economy apart with really the worst economic circumstances since the Great Depression.

There are a number of questions that I would like to ask. But the first one is, are you willing to let monetary policy function on the same basis that we passed this tax bill, all of these activities passed into the future without any idea of what the hell is going on out there in the future? In other words, we have got tax cuts going into effect, we have got indexing, we have got these lease provisions. Do you think that monetary policy ought to be run on the same basis, on this free-market system so that everyone knows what to expect in the future?

Chairman VOLCKER. Let me say, first of all, that we are only responsible for monetary policy, and I think you implied—or I inferred from your statement—that you were giving me responsibility for elements of the administration's program that I have absolutely nothing to do with.

Mr. VENTO. Are you under any restraint? I am not familiar with any restraint with regards to your voicing your opinions on the fiscal side of the equation for deficits. I notice that the only word that you could give us this morning on the deficit was pretty much the same thing that the President has said. That is, if you want to

do something to improve it, why don't you do it? That is fine, but anything you can do will be helpful.

Chairman VOLCKER. That is right. I am very concerned about that deficit, but I do not think it is my function to tell the Congress or the administration what the defense program should be or what the mix of expenditures should be.

Mr. VENTO. Well, you do not have to tell us, but you can suggest that this deficit is unacceptable, that a deficit of something less, that a tax bill that automates—how about the question on the automated nature of monetary policy right along the same economic lines as the tax policy that was passed?

Chairman VOLCKER. Let me comment on monetary policy. I have tried to make my view perfectly clear, that the smaller that deficit is the happier I am. It is much too big as it stands, and if you can go beyond the President's program, I wish you well. I urge you to go beyond the President's program.

Mr. VENTO. Well, I was going to ask you a question about that program.

Chairman VOLCKER. You made some references to independence. I am not aware that the basic thrust of our monetary policy is any different now than it was since I took office.

Mr. VENTO. I agree with that, and I agree that it took effect in the October 1979 fiasco that you initiated. I want to ask you a question about that. Has the Federal Reserve given up any significant part of its responsibility when only dealing with—and I might add, imperfectly, as I think you have noted in some of your comments—the monetary aggregates and discount rates and not directly targeting toward interest rates.

Do you not think that you have given up anything? You have got the greatest resource in terms of information. I heard you spewing out these facts on capital, which I have some questions on also. But have you not really given up a great deal? I mean this fits in with the free-market philosophy that actually arrived 2 years before Reagan and the manifestation of that outrage.

Chairman VOLCKER. I do not know whether that goes to any philosophy of free markets, but I think we do have a different method of targeting now, and we have given up something in that process. That is right; we gave up something in order to get something else.

Mr. VENTO. Well, the something else that you have given up I do not think is acceptable to small businesses and the recovery that you talk about. I think you are going to wash out all the small businesses that are credit dependent. And that carpenter, I will worry about him. The carpenter is not going to have any money because the tax bill that was passed is going to take and strip all of that money out of housing.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Coyne.

Mr. JAMES COYNE. Thank you, Mr. Chairman.

I would like to welcome you back, Mr. Volcker. I guess you are a little relieved, after listening to this for over 3 hours, that no one has blamed you for the bad weather in January. They seem to have done a good job of blaming you for just about everything else.

In fact, I was surprised to hear one of the Members on the other side suggest that they should be switching jobs or the two of you could swap.

Of course, what we have been hearing for much of the last 2 hours is people trying to get you to do their job. Congress has a job to do. It has had a job to do for 40 years that I think it has ignored and shirked.

Mr. PATTERSON. Will the gentleman yield to me?

Mr. JAMES COYNE. Certainly.

Mr. PATTERSON. I think you referred to my comment. If the gentleman would yield, the reason I was going to switch jobs was more to get a longer term, but also I think I could recommend better Fed policies. And perhaps Chairman Volcker, he keeps telling us Congress has to do the balancing of the budget, not the President nor he in their lockstep agreement.

Mr. JAMES COYNE. I was referring to your colleague from Ohio when I was making the reference.

Mr. PATTERSON. Oh, I am sorry, I thought you were referring to me.

Mr. JAMES COYNE. It was your colleague from Ohio that was—

Chairman VOLCKER. Just in case there is any doubt, I think the budgetary policy is a joint project of the administration and the Congress.

Mr. JAMES COYNE. Well, that is the point I am trying to make. If I could reclaim my time, Mr. Chairman.

The point I am trying to make is that our Constitution gives to Congress and gives to the administration the responsibility for drafting the budget. We have heard over the last couple of weeks this great debate about this so-called budget. The cold, cruel reality is that we really do not have a budget. We have almost lost the ability to create a budget. Many Members of Congress over 40 years have become pleased and comfortable and relaxed with the capability of getting reelected by promoting more spending and then financing that spending by getting you to print more dollars.

I think you essentially tossed down the gauntlet 2 years ago when you said that we were not going to keep printing more dollars, we were not going to keep financing a profligate Congress that was refusing to balance its own budget. You said you were going to turn back to Congress its own responsibility to decide how much of our country's GNP it was going to be spending on Government services.

Of course, this Congress is rebelling. It is being forced like a small child to do what it is supposed to do, and now they come to you and ask you to tell them where to spend the money. My colleagues are saying, you tell me how much to spend on defense. I just find it a dereliction of our duty here in Congress to face some tough decisions.

Granted we have an election coming up in November. Granted that it is easier to face an election by telling people, "You will not be unemployed," but then do some fancy footwork with deficit spending and make sure that that person is unemployed this year and that he will still be unemployed 2 or 3 years from now.

But decades and decades of fancy footwork and printing more money has got to come to a stop. I am very pleased that you have

had the courage to come before this group and accept the tongue lashing that a lot of people are so eager to give you but at the same time are turning that tongue lashing back.

Now my question is, Do you have the resolve, and does the Federal Reserve have the resolve, not to reflate in the face of all this pressure? On that chart you can see that a few months before the last congressional election there seemed to be a small period of reflation, where some people allege that the Federal Reserve was not sticking to its guns, and that in order to buckle under to Presidential power at that time, it was persuaded to reflate and, of course, lower its effort to control monetary growth.

Are you going to be continuous in this policy throughout the year and be adamant in not reflatting the economy despite what our colleagues in Congress say and despite what pressure may come even from the administration itself?

Chairman VOLCKER. Yes, sir, the whole thrust of our policy is not to have inflationary increases in the money supply. I might recall that during that period when we had 5 months or so of too rapid growth in the money supply, we did move to restrain it. One can argue whether we moved too fast, too slowly, or whatever. All I know is we got a certain amount of criticism from the administration at the time.

Mr. JAMES COYNE. Well, I hope we can maintain this independence.

The other question I have is a more technical one dealing with your interest in stimulating savings. It seems to me that there is a qualitative priority here as well as a quantitative one. We are talking, as you were in your testimony, about the increase in short-term savings, or what you call highly liquid deposits, which a lot of people are putting into NOW accounts or money market funds.

How are we going to really build up our housing and our durable goods sector without shifting the focus to long-term savings? Do you only feel that you have a responsibility to urge us toward savings in general, or cannot the Fed do something through administrative procedures to create greater incentives differentially for long-term savings versus short-term savings?

Chairman VOLCKER. I do not think there is much that we can do about the savings rate in general or the direction of savings—I'm speaking of the Federal Reserve now, not of fiscal or other measures—except to do what is most fundamental of all, restoring confidence in the currency. The key problem in the financial markets, in the long-term financial markets, is that that confidence has been eroded over a long period of time.

Mr. JAMES COYNE. But it seems to me that your answer to my prior question is exactly the type of thing that is going to restore confidence in that currency.

Chairman VOLCKER. That is right.

Mr. JAMES COYNE. We have confidence that you and your successors and the other members of the Board are going to continue that fight. The problem may, in part, take care of itself. People will have more confidence in the dollar and begin to save long term.

Chairman VOLCKER. That is an underlying rationale of our policy.

Mr. JAMES COYNE. Well, I hope it is successful, and I hope that you will continue on this effort.

We, of course, are seeing many elements of our economic marketplace and the financial institutions raising questions about your resolve. I think in the last year and a half, if there is anything that the marketplace has determined, it is that you are consistent and sticking to your guns. The uncertainty that causes distrust is not uncertainty with the Fed, it is uncertainty with Congress. I think right now there is the highest level of uncertainty as to whether Congress will stick. I just wish that we as a body had the type of commitment to our program that you do.

Thank you very much.

Chairman VOLCKER. Thank you.

The CHAIRMAN. Mr. Patman.

Mr. PATMAN. Mr. Volcker, when the budget and tax bills were passed in 1981, Congress was told that we would have a balanced budget by 1984. Did you know last year that those representations were false?

Chairman VOLCKER. You put it in a prejudicial way, obviously. I did not make any—and you did not say I made any—such misrepresentations.

Mr. PATMAN. Of course.

Chairman VOLCKER. I repeatedly stressed to the Congress my skepticism on the budgetary outlook.

Mr. PATMAN. When did you know they were really false, at what point during the year?

Chairman VOLCKER. Well, I do not know when one knows an outlook is really “false.” You are looking out over a long period of time. It was apparent at the time; I think I said out loud, repeatedly, that to have a balanced budget or come close to a balanced budget, and if you were going to have that tax bill, you were going to have to cut spending a lot more than you cut it last year.

I repeated that and repeated that and repeated that. I urged, you may recall, to do the expenditure cutting before the tax bill so that you made sure that you did it.

Mr. PATMAN. Now, are the representations false that are now being made by the administration with respect to its budget for the fiscal year 1983 and its projections for 1984 and 1985?

Chairman VOLCKER. You have more experts predicting the budget, both in the Congressional Budget Office and in the OMB, than I have. We look at the budget in a shorter term time perspective.

When you look at the 1983 trends reflected in roughly a \$100 billion deficit for 1983, without any action, I do not find that an unreasonable estimate. Our analysis would show the same thing. When you go beyond that without any action, the deficits will get bigger.

Beyond that, you are asking both about economic forecasts in the near term and what the administration and the Congress will do to cut the deficit. Anyone can have a judgment on those.

Mr. PATMAN. Will you support the representations that are made this year by the administration on its budget projections for next year, for fiscal year 1983?

Chairman VOLCKER. I think one can quibble with the details. In general magnitude, what those projections show, as I understand it, is a large and widening deficit as the economy recovers, and I agree in general contour that is the prospect we face.

Mr. PATMAN. In other words, your statement last year, except for some reservations and some concerns expressed about the tax bill?

Chairman VOLCKER. I had a similar concern last year.

Mr. PATMAN. You do not have the same concerns this year then?

Chairman VOLCKER. I had a similar concern last year that the deficit was going to get larger and not smaller, and I expressed it.

Mr. PATMAN. Last year did you warn the administration that its fiscal policies would result in higher interest rates?

Chairman VOLCKER. I urged the administration to lower the deficit, yes, and I expressed my concern about high interest rates. I expressed it publicly.

Mr. PATMAN. Did you tell the administration that it would have higher interest rates in this country caused by its policies?

Chairman VOLCKER. I expressed that publicly, repeatedly, Mr. Patman.

Mr. PATMAN. You said higher interest rates were coming if the administration's program was adopted?

Chairman VOLCKER. I may not have put it in those words.

Mr. PATMAN. But that is what you felt?

Chairman VOLCKER. I felt that if you were going to have bigger deficits, you would have a problem, and that was the course we were on. In 1981, we were talking about deficits in 1983 and 1984. Nobody knew what the administration or the Congress was going to do between 1981 and 1983 and 1984. I recall using quite explicitly in testimony before the Budget Committee last summer that \$100 billion figure; I said that on the course we were on you had to do \$100 billion more to get the deficit, not to zero, but in shape.

Mr. PATMAN. And did you tell the administration that we were headed toward a recession if we adopted their policies?

Chairman VOLCKER. You put that in a prejudicial way: "Did I tell the administration we were headed for a recession if we adopted their policy?" I told the administration that I thought there were great uncertainties in the business outlook and that things might not move as fast as they hoped, all through last year.

Mr. PATMAN. Did you tell them at any point that the recession was coming because of their policies?

Chairman VOLCKER. I told them you cannot exclude that possibility; I never have.

Mr. PATMAN. Cannot exclude it?

Chairman VOLCKER. Last year, again, I said it publicly. There seems to be some implication I tell them something different than what I say publicly.

Mr. PATMAN. And did you say publicly that we were headed for a recession?

Chairman VOLCKER. I did not know we were headed for a recession for a certainty. I thought there was some risk.

Mr. PATMAN. Does the administration fully support your actions?

Chairman VOLCKER. The only thing I can conclude from what they have said is that they support the general thrust of our intent

and policy to bring down the growth of money. They obviously have some concern about how we go about it.

The CHAIRMAN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

Chairman Volcker, just to relieve you of the fact that your ordeal today is nothing new, I would like to read you an excerpt from one of our great works of literature that was written about 80 years ago.

It said, "The crying need of the Nation is not for better morals, cheaper bread, temperance, liberty, culture, redemption of fallen sisters and erring brothers, nor the grace, love, and fellowship of the Trinity, but simply for enough money."

And that was from Major Barbara. I am sure after today you feel more like St. Joan than Major Barbara.

I would like to ask you a few questions. As you know, I have a great deal of respect for your integrity and this difficult tightrope upon which you must walk.

But let me ask you this. Right now, if nothing else were to change in terms of your monetary projections, you stick to those, Congress does everything that the administration now has proposed with one exception, the deferral of the 10-percent personal income tax in 1983, would that be a better or worse move for our economy?

Chairman VOLCKER. You give me an awkward choice; there are obviously other alternatives.

Mr. SCHUMER. Well, this may well be the choice that we will face.

Chairman VOLCKER. I am not sure, because obviously as nearly as I can see, they would be dead set against that.

If you ask me whether we would be better off taking further action that takes effect, say, late in fiscal 1983 and 1984 to reduce the deficit, yes, I think we would be better off. Whether that particular form of action is desirable and necessary is another question.

If you ask me whether another \$30 billion or \$40 billion off that prospective deficit, everything else equal, would be a good thing, yes, I believe that would be a good thing.

Mr. SCHUMER. You believe it would. No matter where it came from?

Chairman VOLCKER. That is right.

Mr. SCHUMER. Increased taxes?

Chairman VOLCKER. In general.

Mr. SCHUMER. I will grant you that.

Next question. I am very perplexed that the chairman of our committee, our distinguished chairman, had asked you earlier about the 10- to 11-percent T-bill note rate that the administration had projected. I do not understand that.

I consider the \$91 billion deficit in the 1983 budget as something that I call a new language in America, called Stockmanese. I think \$91 billion in Stockmanese is about \$140 billion in English.

And the reason for that is this, and I just would like your comment on it, I do not think you can project the following three things at the same time economically unless you really stretch your economics: a 5.2 percent growth in the GNP; a T-bill rate at

10 to 11 percent; and a \$91 billion deficit. They just seem to me inherently contradictory.

Would you care to comment on that?

Chairman VOLCKER. I thought you were going to put the money supply in that equation, too.

Mr. SCHUMER. That gives you an out.

Chairman VOLCKER. That is right. You say "inherently contradictory." I do not know what you are referring to. I am searching for their estimates.

Mr. SCHUMER. Those are their estimates.

Chairman VOLCKER. For what year?

Mr. SCHUMER. 1983.

Chairman VOLCKER. 1983. The stronger the recovery is in 1983 all other things equal, the greater the pressure on interest rates.

Mr. SCHUMER. That is just my point.

Chairman VOLCKER. I realize that is your point. And the higher the deficit is, the more strain there is going to be. But I do not think I want to say, without a lot more analysis, anyway, that that is an impossible combination of circumstances. My instinct would be that it is not, but there are a lot of risks in the other direction.

Mr. SCHUMER. I mean you would put it if in other words the T-bill—let us keep the other two figures the same, 5.2 percent, \$91 billion deficit—you would say it is far more likely that the T-bill rate would be 12 or 13 or 14 percent than it would be 11 percent or 10.5, I believe is what they say.

Chairman VOLCKER. I have just been handed the administration forecasts. It has 11.7, close to 12 percent.

Mr. SCHUMER. Is that not 1982?

Chairman VOLCKER. Oh, that is 1982, I am sorry, yes.

Mr. SCHUMER. 1983, I believe it is 10.5

Chairman VOLCKER. 10.5.

Mr. SCHUMER. I gave them the benefit of half a percent.

Chairman VOLCKER. You are correct.

Mr. SCHUMER. Would you say it is more likely, given the other two figures, that the T-bill rate will be 12 or 13 percent than 11?

Chairman VOLCKER. I am not going to make that fine judgment. The T-bill rate has moved outside ranges that I thought were likely in a shorter period of time than that. People would attribute more prescience to my judgment than it would deserve in that respect.

I think what you can say—

Mr. SCHUMER. Well, I will tell you what, I attribute a lot more prescience to your judgment than to Mr. Stockman's.

Chairman VOLCKER. I have not looked at this closely enough. I think you can say without equivocation the lower the deficit is, the better the chances are for getting the rate down. The less pressure there is on monetary policy for the restraining ingredient, the less of a problem there will be in terms of interest rates.

I do not think it is out of sight at all. It is not in our normal projection for a recovery period, but if I had to set a range of likelihood, I do not think I would want to count on growth being that high next year. I think you could have good growth, however.

Mr. SCHUMER. My time is up. It just strikes me that when Mr. Stockman in his article in Atlantic Monthly said, well, we sit down and just basically dream up figures, that he has done a very good

job of dreaming up figures and the projections upon which the 1983 budget are based are really sort of dreamt up.

Chairman VOLCKER. Collectively, we have put a lot of strain on monetary policy in recent years; the cutting edge of restraint has been monetary policy. That means higher interest rates than you otherwise would have in the short run. But dealing with the inflation will obviously improve things over a period of time. The longer that inflation situation lasts, the longer you have the threat of higher rather than lower interest rates.

The CHAIRMAN. Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

Mr. Chairman, I would like to pursue the question of the administration's attitude toward your policies. And I think this is a case where politics and policy have really intersected.

Of course, I find when I talk with people there is a great deal of uncertainty as to what in fact the administration's view toward you is, and that fact affects the real climate, whether or not they are pressuring you to change. When the President said he was neutral on whether or not you would resign, that is not simply political rhetoric. Those have impacts on people.

I understand your position. From what you said today—let me see if I understand it correctly—as far as you can determine, the administration is quite supportive of the general thrust of your goals. There may be a little concern, they may think it is possible to be more technically competent in some ways, but that is not easy to do from outside—but as far as you are concerned, they are completely supportive of the thrust of your policies since they took office?

Chairman VOLCKER. Yes, I believe they said that.

Mr. FRANK. Has there been any communication to you from the President, from the Secretary of the Treasury, the head of OMB, the Council of Economic Advisers, that said that you in fact were too restrictive and that you were interfering with their recovery plans? Did they make any specific suggestions to you that you ought to ease up and relax more and accommodate them more?

Chairman VOLCKER. I do not think that comment has ever been made in a general sense, if I may put it that way, about our policy over time. You have probably read some complaints in the newspaper—I did on occasion—that in terms of the money supply at times we were too tight and other times we were too easy.

Mr. FRANK. Are those accompanied or preceded or succeeded by comments to you, or is that just newspaper talk?

Chairman VOLCKER. It is not just—

Mr. FRANK. I do not mean by saying just newspaper talk—

Chairman VOLCKER. I mean it is not just newspaper talk in the sense of some reporter making it up, I presume.

Mr. FRANK. No. But they are saying it for public consumption. My suggestion is this: Things are not working out as well for this administration as we had all hoped things would economically, and I think we are seeing a tendency toward scapegoating, and I think from time to time you have become one of the scapegoats. And what I am suggesting is that we see occasionally when things go bad, when real investment is not projected to be what it was sup-

posed to be, somebody takes a whack at you. And I am wondering whether that is——

Chairman VOLCKER. I do not recall any time, just to answer your question directly, that they have come to me and said you are being too tight or you are being too easy.

Mr. FRANK. All right. That confirms my sense. I must say I have to—maybe we ought to get you before Foreign Affairs or Armed Services, because you have been a great exemplar, I think, of the policy of unilateral disarmament, because they have been taking shots at you all year when they think they need to take the heat off themselves, and you have been quite gracious to them, I think, frankly, more than I would have been in your place.

But I did think it is important, the suggestion that we get—and it is more than a suggestion; it comes from within the administration, it comes from Members of Congress who are supportive, from people in the Wall Street Journal and elsewhere—the suggestion that the administration is in disagreement and that your monetary policy has in fact thwarted the hope for recovery has no basis as far as you are concerned in your communications with the administration?

Chairman VOLCKER. We get comments after the fact that the money supply has gone up for months. Then comment is why did it go up for a month? If it went down for a month, the comment is why did it go down for a month? I wish it did not happen, but those things are inevitable.

I do not think, to pin down one point which maybe lies behind some of your questions, that we are going to solve our economic problems by contemporaneous reserve accounting or floating the discount rate, for instance. Those are matters of technicality.

Mr. FRANK. So you are saying the technical concerns you have are not really relevant to the thrust of the problems?

Chairman VOLCKER. I do not think they are relevant to the thrust.

Mr. FRANK. But what is your reaction as we see from time to time, as I am sure you have seen, these newspaper comments on the part of the administration that tend to blame the Federal Reserve Board for the fact that the economy is not performing better?

Chairman VOLCKER. The Federal Reserve has been around for quite a long time, and I think Congress in its wisdom provided it a great deal of independence and insulation, perhaps recognizing that comments of this sort from an administration or from a Congress occasionally arise.

Mr. FRANK. So that you would say that these are part of the political process but do not reflect in any way any fundamental policy divergence between you and the administration?

Chairman VOLCKER. I am sure that some people in the administration feel very strongly about using some techniques. But in terms of the fundamental thrust of policy——

Mr. FRANK. All right, let me just ask a quick one, if I could. There is some debate within the administration about deficits. Congressman Kemp has had a religious conversion. He says he no longer worships deficits. Do you think that the administration as a whole has a proper concern, given your perspective, for the impact,

the negative impact economically of deficits, or are they underplaying it?

Chairman VOLCKER. I wish they had more concern; I think it has been underplayed, from my perspective.

Mr. FRANK. By the administration?

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Reuss.

Mr. REUSS. Welcome, Chairman Volcker. I want to express my continued affection and admiration for you and ask a couple of questions.

Chairman VOLCKER. Thank you. What is coming now? [Laughter]

Mr. REUSS. Last week the Open Market Committee, in the face of recordbreaking unemployment and record high interest rates, voted to lower for 1982 the M_1 target from the 3.5 to 6 percent, which the country enjoyed, or did not enjoy, last year to a considerably lower 2.5 to 5 percent.

Was that vote unanimous?

Chairman VOLCKER. No.

Mr. REUSS. Would you elaborate?

Chairman VOLCKER. We voted on all the targets together, so I would not want to single out any one.

Mr. REUSS. Would you give me the vote of the various 12 members of the Committee on that composite question?

Chairman VOLCKER. 11 to 1.

Mr. REUSS. And who was the one?

Chairman VOLCKER. Mrs. Teeters was the dissenter.

Mr. REUSS. The Treasury has testified within the last week before both the Joint Economic Committee and this committee that they would like to see a monetary growth rate in M_1 for 1982 of between 4.5 and 5.5 percent. That is more than double the monetary growth rate for that aggregate for 1981; is it not?

Chairman VOLCKER. It is not quite the same aggregate, but comparing it with the adjusted figure; yes. Comparing it with the unadjusted figure, it is lower, or the same.

Mr. REUSS. Well, but the figures you—

Chairman VOLCKER. I think the more appropriate comparison is with the adjusted figure; but it is not quite the same aggregate.

Mr. REUSS. Your gloss is noted.

In the President's economic recovery program of last February 18, it was set forth, was it not, that the Federal Reserve for the next 5 years was to successively reduce the growth of the monetary aggregates? That is on page 18.

Chairman VOLCKER. In general terms, yes, there was some general expression of that kind. You put it in terms of direction; we make our own decisions on that.

Mr. REUSS. Yes. Are you not getting somewhat mixed signals from the administration? Did they not, last February 18 and all along, more recently, say they wanted the money supply growth figures lowered each year? And are they not now telling you—not directing you, because you are independent, but telling you—that they want the monetary growth figures doubled—

Chairman VOLCKER. I do not much like the word "telling."

Mr. REUSS [continuing]. Over last year?

Chairman VOLCKER. Yes. I think you have to look at these things in some perspective, Mr. Reuss. As I indicated in my statement, we would think it probable that we will have higher growth in M_1 on a fourth-quarter to fourth-quarter basis, which depends on whether each of those particular quarters come out higher this year than last year.

We expect to have M_2 lower this year than last year. M_2 went up a little last year. We think that structural influences bore upon both of those aggregates last year and pushed them further apart and kind of pushed M_1 down and the M_2 up a little bit from our original intentions.

I think if you look at the results over a period of time, the downward course has been apparent in the past and I think it will continue to be apparent in the future, even if M_1 is higher this year than it was last year.

Mr. REUSS. Well, is not M_1 the most commonly used aggregate? When Secretary Regan, for instance, talks about money, is he not talking about M_1 ?

Chairman VOLCKER. I do not know what he is talking about. He may often be talking about M_1 . When I talk about money, I have got more than M_1 in mind. I think it is fair to say that what is most commonly used is probably M_1 , but a lot of people think that M_2 is more relevant. I would say let us look at both of them and let us look at other information that we have, because that is necessary in interpreting what happens to any single one of them.

I think it would be a great mistake to put all our money in one basket and let whatever forces impinge upon that one number, which may give you an odd reading, dictate policy. That seems to me inappropriate. During a situation particularly of the kind we have now, we know you can go out and talk to people in the market about how their cash management practices changed because of the introduction of technology. We had better look at more than the number that is most sharply affected by that technology. M_2 has performed quite reliably in recent years—we have not got a very long growth pattern—relative to nominal GNP, for instance.

Mr. REUSS. Then is it your testimony that you do not feel you have been getting misleading signals from the administration, from an administration which consistently regards M_1 as the most important aggregate and from an administration which has consistently urged the lowering of the monetary aggregates in 1982 over 1981 and in 1983 over 1982, and so on, world without end?

You do not feel you are getting an inconsistent signal when they come up here and testify, as they did——

Chairman VOLCKER. You may——

Mr. REUSS. If I can just finish—as they did twice last week that they want you to produce a 4.5 to 5.5 percent, which is more than double the M_1 increase of last year? Do you not feel put upon at all?

Chairman VOLCKER. I guess, you know, in the context of being put upon and getting signals and all the rest, I start from a different position, Mr. Reuss. We make up our mind on these things, and I do not hang around trying to read the entrails of some statement that the administration may make, because it is our responsibility to make up our minds about these things, and we do so.

Mr. REUSS. You do, however, read the President's economic recovery program.

Chairman VOLCKER. Surely. But I mean that I don't go back and compare what they said before to see whether it is consistent or inconsistent with what we said now. Forget about what the administration says for the moment.

I say in my statement that we would think it likely this year that M_1 —just looking at that single aggregate on a fourth-quarter to fourth-quarter basis—will increase more than it did last year. It only increased by 2.3 percent last year. As I suggested, looking at what we know now, we would find an increase in the upper part of the range acceptable. That would be a bigger increase measured in that manner than we had last year for that particular aggregate.

I do not find that at all inconsistent with the basic thrust of our policy. I suppose you would expect me to say that, but I do not. And I suppose they would not find their comments inconsistent with the basic thrust, because I think we are in agreement on the basic thrust.

Mr. REUSS. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Stanton.

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

I simply want to pass on to you, Chairman Volcker, thanks on behalf of the entire committee. We always look forward to your testimony.

A couple of observations that I would make. Probably today was no different than what has taken place every 6 months in that the majority of the questions are often politically motivated.

And it does remind me of being home in Ohio last week and talking to an unemployed friend of mine, when he said, you know, I did not vote for that Reagan and I am not going to vote for him again. But, he said, if you ever get a chance to tell him something, he said, you tell him I am hoping and praying that you will go along with his program to the extent that if he succeeds, I am going to succeed and if he does not succeed I am sure there is no hope for me. And that is the underlying political position that we are in at the present time.

Let me just ask you something else in observing your testimony today. I sensed a sense of optimism to a degree that has not been present before. And I was looking for a reason for this, and it seemed to me that you did say something significant when you said that you did sense a fundamental shift in inflation. And we obviously know it is down, but it could be very, very significant. And this would be, to me, a very far-reaching thing as far as long-term bond markets are concerned.

Do you think that perhaps you see something there that is a very different shift?

Chairman VOLCKER. If you were to interpret my comments as optimistic, I think you have put your finger on the source of it. Getting the inflation rate down simply because we are in a recession is no achievement of any lasting import in and of itself. The question is whether we can see forces in the economy that promise to offer the prospect that inflation can continue to come down as the economy expands, and I do think we are beginning to see that.

I do not want to overplay it. We are going to have to see it in new contract settlements, for instance, in labor. We are going to have to see it in the nature of those settlements and of work practices and of potential productivity improving. It is much harder to measure what emphasis management itself is putting on production, as opposed to more peripheral activities to the health of the economy.

But I do think you can begin to see that going on, and I think clear evidence relatively recent, frankly. It is only just beginning to show up in the figures to any extent. I do not want at all to suggest that we are on a clear downward slide on the rollercoaster of inflation. But I do think if we stick with this—and that has monetary policy implications, implications for the deficit and for fiscal policy—if we stick with it, we may be able to look back and say this was the turning point on this insidious inflation, on the low productivity, on the ratcheting up of the unemployment rate that went on with it. That is what we are dedicated to.

Mr. STANTON. School is still out? Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Congressman Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman Volcker, you detected a note of politics in my last question, and let me try to rephrase a couple of those questions in a neutral vein, if I could, because to me, anyway, they are important questions because I am trying to understand how our economy works.

But it seems to me that we can attribute the reduction in inflation that we have been seeing clearly over the last couple of years primarily to policies of limiting money growth begun a couple of years ago.

Chairman VOLCKER. I think that is largely fair. We have had some breaks in the oil situation that helped it along.

Mr. NEAL. Well, I was going to add that we can attribute then, especially by another measure, we can attribute much of the rest and probably the balance of that progress to some luck in oil prices and some luck in food prices and some reduction in import prices because of the strength of the dollar.

You could explain probably all of it or 90 percent of it in those terms. And would you generally agree with that?

Chairman VOLCKER. I think I would generally agree. Let me point out that a lot of people talk about oil prices being something different from our policy or even from food prices. There are elements, maybe large elements that are extraneous, but, on the other hand, what the dollar is doing internationally as well as domestically, and the level of interest rates, both affect oil prices as well as other product prices.

Mr. NEAL. Well, I think that is true, but I guess what I am getting at is it seems to me that these changes in the rate of inflation are largely due to policies that were begun, in the case of Fed policy, back in the fall of 1979, maybe some would say in the fall of 1978. And there was a noticeable change in direction and with oil, you can attribute some of the stabilization of the price of oil to those policies, you might attribute some of it to decontrol.

Chairman VOLCKER. That is right.

Mr. NEAL. Well, decontrol took place several years ago. I just do not want it to be a part of the permanent record that somehow these prospective cuts in aid to the disabled and the blind and the hungry and so on, that somehow that becomes a permanent part of the record that that is what has turned the corner. I do not think that argument can be sustained.

I think the President is fair in saying that he is not responsible for the situation in 1981. In other words, he cannot take credit for the rate of inflation in 1981, and he probably should not be blamed for a large part of the recession.

Now, I think you have answered that question clearly. You agree with me on that point. You would not put in the political terms, I understand that. But I am trying to look at objective facts and get away from the politics at this time.

The recession, it seems to me, clearly has been caused by the same policies, like it or not. I am not trying to place any blame; I am just saying that there has been a change in expectations, and a whole range of other considerations has resulted in part of that.

It does seem to me, though, the reasons for the continuing recession and the continuing high interest rates are something else. I would like to ask you a question about this, if I may. It seems to me that the continuing high interest rate, historically high real interest rates, are the result of uncertainty, lack of confidence, fear of the future. They are not related directly to what one would think they would be related to; that is, the rate of inflation. Is that not essentially true? Is that not what is going on? Or am I missing the sense of this?

Chairman VOLCKER. I think there is a large element of that. I would want to supplement your answer. I think you focused particularly on long-term rates, and they are certainly influenced by the factors you mentioned. They are influenced by their own instability in recent years, which is a bad thing in and of itself, in my opinion.

Long-term rates, particularly in this situation, are not insulated from short-term rates. I think we have to face the fact that if the main brunt of the restraining effort and the anti-inflation effort falls so heavily on monetary policy, you are likely to get higher short-term rates than you otherwise would have. That is a factor in this situation.

Mr. NEAL. My time has expired. May I just ask two yes-or-no type questions?

The CHAIRMAN. Surely. In fact, why don't you just take the chair.

Chairman VOLCKER. They do not have to be yes-or-no questions. [Laughter]

Mr. NEAL. Mr. Chairman, I do appreciate that. I will not try to carry on too long. We do have a vote, and that sort of saves the day.

So it seems to me then, if I understand your answer, that you are agreeing again that at least some of the reasons these historically high, especially long-term rates, is this uncertainty, this element of fear.

Chairman VOLCKER. Yes, I agree with that.

Mr. NEAL. It does seem to me that much of that is triggered by, as you said in your testimony, the view that there will be large and increasing deficits, increasing in size for a number of years to come.

Chairman VOLCKER. Yes.

Mr. NEAL. And I guess this question, which I would like answered yes or no, if I could get it, would be: Would it not be more important to the long-term health of our economy for us to give a higher priority to reducing those deficits, if this is what it took, than to continuing the tax cuts? Is it not a more important question, or is it reducing the deficit more important than reducing taxes?

Chairman VOLCKER. If you put it as generally as reducing taxes, I think I would agree with you. But I do not want to give a yes-or-no answer. It is the same question I think Mr. Schumer asked about a particular tax cut; that is not the only alternative.

Mr. NEAL. I am not asking that.

Chairman VOLCKER. I would say, if you cannot do it on the spending side, for whatever political, social, defense, security, or whatever reason, then I think you have got to look on the revenue side.

Mr. NEAL. One last question, if I may. And that is, when I asked you the question about velocity, I was trying to get at the potential for growth in the economy. And I was not asking a question about month-to-month changes and so on. The question I was asking is, Could velocity ever, over a sustained period, year over year, be high enough to bring about that kind of growth in the economy if you were to hit your targets for M_1 ?

Chairman VOLCKER. If you were on M_1 alone——

Mr. NEAL. Yes, sir.

Chairman VOLCKER [continuing]. You would be very unlikely to get that kind of sustained growth and velocity unless there is some technological change going on. If the money market funds take over the world and we do not include them in M_1 , that is a different story, but there can be other kinds of technological changes.

Mr. NEAL. Again, I guess that leads me to the conclusion that it is very unlikely that we are going to hit that kind of economic growth if you hit your targets; and if we do not get that kind of economic growth, it seems unlikely that the other projections for the deficits, for savings, for all of these other things are unrealistic.

Chairman VOLCKER. We expect the money supply to be declining, but our targets basically are directed toward sustaining the progress on inflation.

Mr. NEAL. And I agree with that, certainly.

Chairman VOLCKER. Yes, I am sure we have no disagreement. Let me state it positively, as I suggested in my statement: I think if we do this right, which is not just a question of monetary policy, we can look forward to a long period of economic expansion consistent with a declining inflation rate.

Whatever money supply targets we come up with in subsequent years, I would say, would be consistent with that declining inflation rate.

Mr. NEAL. Mr. Chairman, we have had the second bell on a recorded vote.

Mr. PATMAN. I am just being paired, Mr. Chairman.

Mr. NEAL. Pardon me?

Mr. PATMAN. I am just being paired on that vote, so I am going to miss that one.

Mr. NEAL. All right. Well, would you take the chair so that I might answer the vote?

Mr. PATMAN. Surely.

Mr. NEAL. Mr. Chairman, thank you very much.

Chairman VOLCKER. You are welcome.

Mr. NEAL. You have certainly helped me in understanding our economy and giving us some guidance by answering these questions.

Chairman VOLCKER. This is not a new statement, but the more progress we make on inflation, the more room you have for growth within those targets.

Mr. NEAL. Well, Mr. Patman is on his way. Let me ask you this. Why is it necessary to keep the discount rate at 12 percent when we have the Federal funds rate at 15 or so?

Chairman VOLCKER. That is a great mystery to many people, and I understand why it is.

Mr. NEAL. Does it not encourage banks to come to the discount window to borrow?

Chairman VOLCKER. We put banks on kind of a leash when they come to the discount window. The trouble is, if you raise the discount rate, market rates will go up. That may be good or bad, but that is the consequence of—

Mr. NEAL. Short run.

Chairman VOLCKER [continuing]. Short-term rates. And raising the discount rate in today's market could easily affect long-term rates.

Mr. PATMAN. Mr. Volcker, I have just a few more questions. With respect to the economy of the United States, how close is our country to a national calamity? [Laughter.]

Chairman VOLCKER. I do not think we are on the verge of any national calamity, Mr. Patman. I think we would eventually get to a calamity if we had let the earlier trends in inflation continue unchecked.

Mr. PATMAN. You do not see any likelihood of a sharp increase in the bankruptcies of banks, for example, or the insolvency of those banks?

Chairman VOLCKER. Of banks? No.

Mr. PATMAN. Savings and loans?

Chairman VOLCKER. We are having a sharp increase of problems in the savings and loan industry.

Mr. PATMAN. Do you anticipate that will increase or remain the same at projected level of increase?

Chairman VOLCKER. It will be a continuing source of difficulty at these levels of interest rates.

Mr. PATMAN. How soon do you anticipate that interest rates will decline?

Chairman VOLCKER. I would like them to decline as soon as possible, but I just do not engage in the game of trying to give a precise forecast on that.

Mr. PATMAN. Have you noted the high increase in personal bankruptcies?

Chairman VOLCKER. For several years. That is partly related to the new bankruptcy law, and you cannot distinguish the two. But certainly, they are running high, historically.

Mr. PATMAN. And you have noticed a sharp increase in business bankruptcies?

Chairman VOLCKER. Yes.

Mr. PATMAN. Those do not indicate to you that we are heading toward some real crisis in the economy?

Chairman VOLCKER. No. They indicate a lot of problems out there.

Mr. PATMAN. But nothing of great concern?

Chairman VOLCKER. They are of great concern.

Mr. PATMAN. Do you feel like lower interest rates would be of assistance to those problems, in solving them?

Chairman VOLCKER. Those particular problems? Yes.

Mr. PATMAN. And to what extent would you equate the deficit and the projected deficits as to their contribution to higher interest rates?

Chairman VOLCKER. I think it is an important factor.

Mr. PATMAN. Fifty percent or seventy-five percent?

Chairman VOLCKER. Fifty percent of what?

Mr. PATMAN. Fifty percent of the probability or what?

Chairman VOLCKER. Of the probability of what?

Mr. PATMAN. If you took all of the factors into consideration on what caused high interest rates, would you give high deficits a very large portion of that contribution?

Chairman VOLCKER. I simply cannot give you a quantitative estimate of that sort.

Mr. PATMAN. How much of our present unemployment has been caused by high interest rates?

Chairman VOLCKER. That is an unanswerable question, Mr. Patman. What is the alternative that you present? If you present an alternative of interest rates half as high and everything else the same and inflation continuing to come down and everything else very nice, you would say a very high percentage.

But that is not the alternative we are faced with.

Mr. PATMAN. Irrespective of the alternatives, just considering the present situation, how much of the present rate of unemployment is caused by——

Chairman VOLCKER. I do not think the question is answerable.

Mr. PATMAN. Well, just give me the best you can on it.

Chairman VOLCKER. It carries the implication that I have got to compare it with something. What am I comparing it with?

Mr. PATMAN. Well, do high interest rates cause high unemployment?

Chairman VOLCKER. High interest rates cause difficulties for business and, of course, difficulties for home buying; they cause difficulties for other industries, and in that sense, they contribute to unemployment. But that is not the whole story. The question is how to get those interest rates down.

Mr. PATMAN. Well, I know, but without respect or regard to what you get into on that, I just want to know the effect of the higher

interest rates. And you do think that they do cause unemployment, do you not?

Chairman VOLCKER. The fact is that we came into the grip of a great inflation that had to be dealt with. We are in a recession now, but unemployment did not begin 6 months ago; we have had an adverse trend of unemployment for 10 years.

Mr. PATMAN. But the question, Mr. Volcker, is not what caused the high interest rates. The question is do high interest rates cause unemployment?

Chairman VOLCKER. The question phrased that way is unanswerable.

Mr. PATMAN. Well, in other words, you do not think you can say whether high interest rates do cause unemployment or do not cause unemployment?

Chairman VOLCKER. You have to ask me what lies behind high interest rates, whether you have an alternative, what the situation would otherwise be and what unemployment would be in other instances. I cannot give you the answer to all those questions. If I could get interest rates down and everything magically improved, I would do it.

Mr. PATMAN. It seems like that would certainly be a part of your statement on page 16 when you say, "I referred on many occasions to the key importance of winding down the cost-and-wage pressures that tend to keep the inflationary momentum going."

From the standpoint of the inflationary momentum and judging what cost means, is not, of course, a high interest rate a cost?

Chairman VOLCKER. Yes.

Mr. PATMAN. And so you would want to wind them down, too?

Chairman VOLCKER. Yes.

Mr. PATMAN. And so high interest rates do contribute along with wages to inflationary pressures?

Chairman VOLCKER. Not on balance, but they are a cost element. On balance, they do not contribute to inflation, in my opinion.

Mr. PATMAN. Well, on balance. But taken by themselves they—

Chairman VOLCKER. They have other effects. Taken by themselves, I do not think—

Mr. PATMAN. Taken by themselves, they do cause and do contribute to inflation, do they not?

Chairman VOLCKER. They do contribute to the costs.

Mr. PATMAN. And costs contribute to inflation?

Chairman VOLCKER. They are one factor contributing to inflation. But interest rates have other effects as well that are offsetting.

Mr. PATMAN. You mean they have beneficial effects as well as detrimental?

Chairman VOLCKER. They do that—

Mr. PATMAN. Is that what you are saying?

Chairman VOLCKER. They do on inflation, yes.

Mr. PATMAN. They do what?

Chairman VOLCKER. They do on inflation.

Mr. PATMAN. They have a beneficial effect. Well, do you not recognize then that interest rates contribute to inflation?

Chairman VOLCKER. No.

Mr. PATMAN. You do not? You deny that?

Chairman VOLCKER. I deny that in a balanced view, yes. I think they are an element in costs.

Mr. PATMAN. Well, Mr. Volcker, several people who have asked questions today have related to and have stated that the housing industry is going broke, the automobile industry is going broke, businesses throughout this country are suffering because of high interest rates.

I think that is true, and I think that damages the very structure and strength of this country. And I just want to tell you that there will not be any demand for blood after all the patients have died.

Chairman VOLCKER. In general terms, I agree with the statement that high interest rates create a lot of problems in the economy. But the relevant question is how we get them down.

Mr. PATMAN. I do want to encourage you to work with the administration in coordination closely with them and those members and see if you all can get a coordinated policy going that you can agree on that will not cause inflation and not cause this high unemployment.

Chairman VOLCKER. That is the objective. We have no disagreement about that.

Mr. PATMAN. Well, do you then tell us that you have worked in close harmony in the last year and a half or the last year?

Chairman VOLCKER. We worked with them and we have been in harmony on the objectives of monetary policy.

Mr. PATMAN. Evans and Novak in one of their columns said that you are a Democrat. You do not claim to be a Democrat, do you?

Chairman VOLCKER. I was registered as a Democrat the last time I was registered with a party affiliation. I do not think it is appropriate to register with a party affiliation in my present job.

Mr. PATMAN. Right. Well, had you ever been registered as a Republican?

Chairman VOLCKER. No.

Mr. PATMAN. Did you vote for President Carter last time? [Laughter.]

Chairman VOLCKER. I think there are limits to how far I will go in this direction, Mr. Patman.

Mr. PATMAN. In your past experience as a holder of political office, the highest job you held, prior to the one to which you were appointed by President Carter, was one to which you were appointed by President Nixon, was it not?

Chairman VOLCKER. Yes.

Mr. PATMAN. Unemployment is, as we have all talked about, at a very high level—

Chairman VOLCKER. I had been appointed to public office, if it helps any, in the Kennedy administration, the Johnson administration, the Nixon administration, and the Carter administration.

Mr. PATMAN. I am sorry, I did not mean to interrupt your statement there. What was it?

Chairman VOLCKER. I was just repeating all the administrations in which I have been appointed to public office.

Mr. PATMAN. We have all talked about unemployment, and I have, and people here today have, and about its being at a very

high level. If that high level continues to rise, is there a level at which you would decide to change from a high interest rate policy?

Chairman VOLCKER. I do not describe our policy as a high interest rate policy. I do not describe it as an interest rate policy. We do restrain growth in money and credit.

Mr. PATMAN. If you have a high interest rate in existence in the country, does that tend to depress the level of money and credit—

Chairman VOLCKER. Yes.

Mr. PATMAN [continuing]. The money and credit supply?

Chairman VOLCKER. All other things equal, yes.

Mr. PATMAN. Sir?

Chairman VOLCKER. All other things equal, it would tend to depress the growth in money and credit. It would not depress the supply of savings. It would tend to dampen the growth in money, all other things equal.

Mr. PATMAN. And in fact, when we are talking about the money supply, we are really talking about money and credit supply, are we not?

Chairman VOLCKER. There is a large overlap in the concepts, yes. But we are not talking about savings, and that is the key distinction. The Federal Reserve can facilitate the creation of money. We cannot create savings. Real investment has to come out of real savings, not out of money.

Mr. PATMAN. I hate to take too much of your time, Mr. Volcker. Other members have gone to the floor, and if you care to make a closing statement, please do so.

Chairman VOLCKER. I do not. I think we have pretty well exhausted the subject this morning, Mr. Patman. [Laughter.]

Mr. PATMAN. If there are no further questions, the committee stands recessed, subject to the call of the Chair.

Thank you, sir.

[Thereupon, at 2:02 p.m., the committee was adjourned, subject to the call of the Chair.]

CONDUCT OF MONETARY POLICY

TUESDAY, MARCH 30, 1982.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building; Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Reuss, Gonzalez, LaFalce, Evans of Indiana, Vento, Barnard, Schumer, Patman, William J. Coyne, Stanton, Wylie, Evans of Delaware, Shumway, Parris, Weber, Carman, and Roukema.

The CHAIRMAN. The committee will come to order.

This morning we will resume this committee's hearings under the Full Employment and Balanced Growth Act. Last month we heard from Chairman Paul Volcker of the Federal Reserve Board.

Today's first witness is our distinguished majority leader, James Wright, better known as Jim, of Texas, who has been an outspoken critic of the current tight money high interest policy.

Jim Wright has dramatized in a highly articulate manner the pain and suffering that this prolonged period of high interest rates had inflicted on the small businessman, the worker, the farmer, the prospective home buyer. He represents a Democratic leadership that has deep concern about what high interest rates are doing to the basic economic fabric of this Nation.

So, we welcome you this morning, Mr. Majority Leader, and we will ask you to proceed as you will. If you have a prepared text, we will introduce it in the record, and you may proceed as you will.

STATEMENT OF HON. JIM WRIGHT, A REPRESENTATIVE IN THE CONGRESS FROM THE STATE OF TEXAS AND MAJORITY LEADER OF THE HOUSE OF REPRESENTATIVES

Mr. WRIGHT. Thank you very much.

What you are doing today is probably the single most significant thing being done in the Capitol today. There is not another item in the economic agenda more important than finding a way to reduce these devastating interest rates.

There is not a single more hurtful thing in the economy than the high and sustained level of interest rates, which have stifled the growth of new enterprise, which have prevented the stimulative tax policies of the administration from performing their intended work, which have thrown many people out of work, which have made it almost impossible for a young couple to buy a home, which has caused devastation in the homebuilding and automobile and

thrift industries, and which threaten, if not halted and reversed, to plunge us into the depths of a recession such as we have not experienced in this country since the days of the Great Depression.

I don't think that there is any question but that the policy deliberately pursued by the Federal Reserve Board, resulting in higher interest rates than this country ever has suffered, is responsible for the increase in unemployment.

There can be no question that it is responsible directly for the sharp decline in automobile sales and manufacturing in the United States and for the home building industry.

These two industries, home building and automobiles, together with the spinoff effects that they have in the secondary employment factors, or people who are engaged in lumbering, appliance manufacturing, manufacturing of rubber and tires and other accouterments related to automobiles, probably account for one job in every four in the United States.

So, when home building and automobile sales decline at the rate that they have declined, then it is very difficult to begin or to sustain any kind of a revival in the economy.

We know, of course, what has happened with regard to homes. A young couple 5 or 6 years ago seeking to purchase a \$50,000 home, which was not then and surely is not now a mansion, and amortized that over a period of some 30 years would have had to pay approximately \$433 a month in their monthly payments. Many, if not most young couples, could afford that sum.

Today, however, if they could purchase that house for \$50,000, which probably they could not—let us say whatever house they could purchase for \$50,000, a lesser dwelling—amortized over the same 30-year period would cost them not \$433 a month but considerably more than \$800 a month. Their monthly payments would just about have doubled.

For those monthly payments they get less than they would have gotten. For the first several years, that \$800 plus a month buys them no equity. It is spent for the dubious privilege of borrowing the money only. Now they can't afford it. Most young couples simply can't afford that.

An average priced new home, to be amortized over 30 years, probably costs very close to \$1,000 a month. The National Association of Homebuilders estimates that only 3 percent of America's newly emerging family units, only 3 percent, can qualify to buy a new home in the markets of the United States today.

What is happening, of course, is that these devastatingly high interest rates are in the process of killing a very important part of the American dream.

We set out as a nation to differ from other countries in two or three important respects, but the most important one I think was that instead of creating an aristocracy, a landed gentry, composed of a few people who were born to it and to which others were forever denied, we deliberately decided that we were going to create the possibility of continued upward mobility. We were not going to have any ceilings on aspirations of what people could do. We were going to make it easy for more people to get a piece of the action.

So, in that regard we were not like some of our European ancestors, nor indeed were we like the French Revolution or the revolu-

tion which sought to destroy the aristocracy and installed in its place a dictatorship of the proletariat, reducing everything to the lowest common denominator.

That wasn't our goal, either. Our goal was to expand the aristocracy, to expand the landed gentry, to make everybody a potential capitalist, to have a nobility to which all could aspire and most, indeed, could attain.

That was the American dream, that a family, an average family, not just a wealthy family, but an average family, and indeed a family of modest circumstances, would be permitted to own its own home. That dream is going out the window very rapidly because of high interest rates.

So far as automobiles are concerned, everybody is familiar with the term 'sticker shock'. Anybody who has gone to an automobile dealer with a dream of buying a new car has experienced sticker shock.

The appalling thing is that now amortizing those automobiles over a 5-year period, not really knowing whether the car is going to be worn out at the end of 5 years or not, a young couple or a young person attempting to buy a car, or a middle-aged person, a person of medium means thinking about buying a new car can confront the reality that in order to pay for that car he or she is going to have to pay as much monthly as just a few years ago he or she would have had to pay for a home.

Now, I suggest that that is just absolutely ridiculous. As a consequence of all this, of the interest rates which have driven people out of the home building market and out of the automobile purchasing market, and which have shriveled the net worth of many, many farms and many, many thrift institutions, which are probably now causing more farm foreclosures than we have seen since the Great Depression, let's see if we can quantify it.

During the first 10 weeks of this year, from January 1 up to about the end of the first week in March, approximately 5,000 businesses have failed. They have closed their doors in the United States. The average is 486 a week, 486 business failures a week.

Most of these are small- and medium-sized businesses, but since the beginning of this year 99 industrial plants have closed. That many we know about by having read the newspapers.

I am going to have a chart, a map of the United States that I am going to show on the House floor either later today or at some future time in which I am going to show where plants have closed in the United States, just since the beginning of this year. We know of 99 that have closed, and we know, as a result of that, of some 150,000 layoffs that have occurred.

All in all, some 500,000 workers, some 500,000 Americans have been added to the Nation's unemployment rolls since the beginning of this year because all of the different layoffs, of all of the different restrictions, all of the different plant closings, all of the different small businesses that have gone out of business, about a half million people thrown out of work.

I think more than any other single cause that has contributed to that, we have to look to the high interest rates, which have continued at an unwarranted, unconscionable and inexplicable level.

If high interest rates continue, one can only expect those numbers to grow. I know it is going to be said by some that these high interest rates have begun to curb inflation, but I don't really believe that is the case.

I do know that inflation has begun to fall at an appreciable rate, and I think we all need to be grateful for that. But we cannot look to the inflation factor alone. We must remember that we didn't have any inflation problems at all during the Great Depression, and yet people were suffering. People were out of work. The economy was staggering before collapse.

It seems to me instead that the decline in the inflation rate today is a desperate last gasp of an economy that is reeling from these continued blows of high unemployment rates.

The gross national product, adjusted for inflation, has dropped this year to a negative 4.5 percent. GNP is not rising. The economy is not growing, as the President suggested when he advocated 1 year ago this month, in March of 1981, the kind of tax bill which he thought was going to create the flow of the stimulative juices of the free enterprise economy and stimulate more investments in those kinds of enterprises that would create jobs.

Unfortunately, it just didn't work. The President said in March of last year, these were his words, "Immediately upon passage of this tax reduction we will see a sudden upturn, a sudden upturn in the economy."

Those are the words of Mr. Reagan, and I am sure he believed it. The tragedy is that what we saw was precisely the reverse. We saw sudden and continued downturns beginning in August, the very month that we finally passed the tax cut.

Well, what happened? Let's say that the tax cut was intended as a stimulus to business investment. I am sure it was. I am sure that those who engineered it had a logical rationale in their minds and good intentions. They wanted to create investments in the American economy that would create more jobs.

The trouble is at the same time, because it portended such astronomically high deficits, nobody believed that it was going to improve the economy, nobody felt that it was going to be justifiable to take this money that was showered upon those at the top of the economic pyramid and invest it in new job-creating enterprises.

People didn't invest that money, unfortunately, in anything that was speculative, in anything that would be inclined to improve the job base of this country. What did they do? Well, they put it in money markets or they put it in certificates of deposit and enriched themselves and enhanced their own economic position.

Or some people, some companies may have used it to finance more mergers. Those mergers in turn, rather than creating more employment created higher unemployment. So, that has been the result.

It was as though we had gone out in the forest at night, shivering from the cold, trying to create a little fire by which we could warm ourselves. Laboriously we went out and gathered a few sticks and a few twigs and a few leaves and we husbanded them very carefully.

These leaves and twigs and sticks were the elements of the tax cut, which was supposed to stimulate an economic recovery. Then

we took our match and carefully lighted the fire and blew on it carefully until it was just about to ignite. Then there came a great rainfall and put it out. The rainfall was the high interest rate.

You have had two policies of the Government fighting one another. You have had the so-called supply side theory of releasing this money into the private economy to create more investments, and on the other hand you have had this kind of an exercise that old Charles Atlas used to teach you. Use one muscle to build the other muscle. The trouble is the muscle that has been weak is not the supply side muscle, it is the monetarist muscle.

The monetarists, fighting the supply siders in the same economy and in the same administration, have just absolutely won the day. Paul Volcker, elected by no one, approachable by no one, removable by no one, apparently, not amenable to discussing things with anybody, has singlehandedly and through his influence put at naught what the President of the United States and people in Congress—who I think at the time were ill-advised in voting that tax cut, but nevertheless well-intentioned—intended to do.

Let me show you just a couple of charts because I would like very much, if I could, to dispel some myths about the idea of interest rates being anti-inflationary. I think they are the most absolutely inflationary things that we could imagine.

I wish this chart went back to the forties because it shows a consistent pattern, since World War II. The pattern that it demonstrates is that inflation follows rather than precedes high interest rates. Let me say it again another way. High interest rates are like pouring gasoline on a fire. They don't curb inflation, they feed inflation.

Here, from 1970 until 1981, an 11-year period, we have a line that represents the prime interest rate and a blue line that represents inflation, as represented by the implicit price deflator.

In every instance, when the prime rate began to come down it was only a little while until the inflation rate began to come down. A rise in the prime rate preceded, in 1973, a rise in the rate of inflation.

The prime rate peaked in 1974. Inflation peaked about a year later, 1975. Here at one point the prime rate was even below the rate of inflation, while it was catching up. But then, here in 1979, the prime rate again began to rise, and we see this rise in the inflation rate.

Now, we have seen a leveling off in the inflation rate. These last few months show that. It may have had something to do with a leveling off in the prime rate, although it has not been appreciable.

The second thing I want to show to you, however—and I do wish that I had a chart which represented a longer span of years because it would be even more dramatic—is that over the years, historically, certainly in the economies that have existed in the United States since 1946, the end of World War II, the prime rate, the rate that lenders reserved for their best customers, has hovered just ahead of but only something like two or three percentage points at the most above the rate of inflation, somewhere between 2 percentage points and 3 percentage points difference.

Historically this is true. This would go back for 30 years or 20 years prior to 1970. Historically the prime rate has shown only 2 or

3 percentage points above the inflation rate. That has been a premium that everybody has agreed money was worth.

Well, look what is happening now. You can extend this line for another third of a year and it would tell the same story, spread the gap along prolonged spread of interest rates hovering about 10 percentage points above the rate of inflation.

Nothing could be more dampening on the economy. Nothing could cause this so-called economic recovery to be stillborn in a more effective way.

Now the second thing I want to show you is that not only do high interest rates not help with inflation, but they cause inflation by adding an extra cost at just about every layer of the marketplace. They cause depression. They cause unemployment. They precede unemployment.

The prime interest rate has been a precursor of the unemployment rate. In this same 10-year period you can see that as the prime rate went up, beginning in 1972, the unemployment rate started going up behind it. The prime rate peaked in 1974 and the unemployment rate peaked shortly thereafter, 1975. Then it came down.

Now, the prime rate kept going up until unemployment in desperation began going up. In 1980-81 it went up some more and now 1982 it is up a little bit more yet, to about 9.5 percent.

Well, what does that tell us? It tells us, I think—and I believe that an extension backward of this map to 1945 or 1946 would tell us even more emphatically that whenever you have high interest rates, you are going to have more unemployment.

Now, let me ask you to examine one other statistic with me. Someone may say—and I am sure Mr. Volcker truly believes that it is justifiable for him to control the interest rate and keep it high by means of controlling the money supply and keeping it tight and restrictive—that that is going to help the inflation rate. I think he is sincere about that. But let me show you a little chart here.

This is a chart that may look more exaggerated than it really ought to, but it traces the money supply as a percentage of the gross national product.

In 1970, M_1 , the money supply was 22 percent, right at 22 percent of the gross national product. In 1971 it was 21 percent of the gross national product, the money supply. In 1973 it was 20 percent. In 1975 it was between 18 and 19 percent, it was 18 point something percent. Now, today, in 1981, it is 15 percent, down from 22 percent of the gross national product to 15 percent of the gross national product.

This chart simply suggests to me that the Federal Reserve Board has been unduly restrictive in its zeal to suppress the money supply. In suppressing the money supply, it has not materially brought down the rate of inflation, except as a byproduct of having created higher than necessary interest rates, higher than warranted, and therefore creating higher unemployment than this Nation can stand.

Now, Mr. Chairman, that concludes my initial testimony. I appreciate the privilege that you have given me to come and say these things. It just seems to me that there is not a single thing that this Congress could do that would be more effective in turning

around the recession than by doing something effective to bring down interest rates and keep them at a livable level for a predictable period of time.

The CHAIRMAN. Thank you, Mr. Majority Leader.

At this time I would call on the chairman of the Joint Economic Committee, who would like to discourse with you, Henry Reuss.

Mr. REUSS. I will be very brief.

You have made an excellent analysis, Mr. Wright. Would you agree with me that when the administration and the Federal Reserve are pursuing policies which lead to disastrously high interest rates, such as you have described, that it is not only the right but the duty under the Constitution of Congress to tell the administration and the Federal Reserve that they must change those policies?

Mr. WRIGHT. I most emphatically do, Mr. Chairman. I don't think we can abdicate that responsibility. Too long have we hidden behind the notion that we don't have anything to say about the Federal Reserve, that is their business, let them take care of it as best as they can and we will blame everything on them.

I don't think we can afford to do that any longer. I think we have responsibilities to the public. We are elected by the public, after all. The Federal Reserve isn't. We are answerable to the public, after all. The Federal Reserve isn't. I think we have that responsibility.

Mr. REUSS. Thank you. You said it all, as far as I am concerned.

The CHAIRMAN. Mr. Stanton?

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

Mr. Majority Leader, we welcome you once again before our committee. I asked the chairman a minute ago if you ever served on our committee. You do have a great interest in this subject, and I was just curious. He said that he doesn't think you ever did.

Mr. WRIGHT. I never had that privilege, Mr. Stanton.

Mr. STANTON. The thing I liked about your remarks, really, was that they were fundamentally nonpolitical. They address the problem primarily of the responsibilities on the Federal Reserve Board, the culprit of high interest rates.

I always thought Congress could come in somewhere for a little bit of the blame in the economy and the country. We do some things differently today than we would have a year or 2 years ago.

The question that comes to my mind is I don't remember you having a positive suggestion of what we should do at this point in time. You were very articulate in pointing out the problems of our country and outlining the extent of these problems, but I don't remember any positive, constructive suggestions.

Mr. WRIGHT. Would you like for me to try to come forward with some suggestions?

Mr. STANTON. In due time. You don't have to do it here today. I think it is time that we would appreciate seriously suggestions from all sides of the aisle, especially the leadership, about what we could do.

Mr. WRIGHT. I think Congress does share a substantial part of the blame because we have failed to fulfill our responsibilities in curbing the Federal Reserve, and we have created conditions that give excuse to the Federal Reserve and rationale to those who believe in high interest rates to maintain them at a high level.

We have done that by setting in motion those factors which have made absolutely inevitable the highest deficits in history.

Mr. Volcker, in his theorizing, relates interest rates to deficits. I talked with him in 1980, after a group of us had sat down together and laboriously, painfully, come to \$21 billion in reductions in expenditures.

We talked to Mr. Volcker at the time and said if we put this in effect after an around-the-clock session for about 10 days, presided over by the then majority leader of the Senate, Mr. Byrd, and myself, and participated in by all committee chairmen, we said Mr. Volcker, if we put these into effect, will you then move with a more accommodating monetary policy so that interest rates may come down by 3 or 4 percentage points? He said yes, that is basically what we have in mind. This is what it is going to take. Well, we did, and he did not.

I think we were trying to fulfill our responsibility at that time. So what do we do now? What is causing the high interest rates?

Let's take the prevailing theory that they are caused by the prospective deficits. The deficit for fiscal year 1983 probably will not be \$91.5 billion, as originally advertised. Only last week before the Budget Committee the Secretary of the Treasury, Mr. Regan, said it would be quite substantially more than that because of this sharp decline in the economy.

Probably now it is acknowledged in the administration that it will be \$120 billion, if we do everything just exactly as the President has asked us to do for fiscal year 1983, \$120 billion. That compares rather roughly with the figures suggested by the Congressional Budget Office, which I think come out to like \$126 billion.

All right, let's say that is a culprit, that big deficit and the probable deficit of \$140 billion in 1984 and \$150 billion in 1985. Therefore, let us examine what is causing the deficits.

Why so suddenly do we have these bigger than ever deficits looming ahead of us, in spite of having reduced domestic expenditures by about \$40 billion last year? What is different that makes these deficits loom so large?

Well, the first thing that comes to mind, of course, is that monumental tax cut, the biggest tax cut in history; \$96 billion of the 1983 fiscal deficit is going to result directly from the tax cut that we voted last year.

We bled the Treasury of some \$96 billion. Some of that may have been good, you know. I think there were some good ideas in the tax cut, the idea of trying to encourage people to invest in those specific things that would improve our productivity and make American products more competitive. That was good.

There were some other things that were good. I don't want to blame it as a whole, but it was excessive. I think all of the economists—conservative, liberal, and moderate alike—tell us that the tax cut last year was grossly excessive, adding some \$96 billion to the deficit in 1983.

If you abolish the tax cut, you could nearly abolish that deficit in one fell swoop. But of course that is not likely to be done.

Let's look at it frankly. You say this is our responsibility—

Mr. STANTON. Excuse me for interrupting, but that is the kind of answer that I expected and I wanted. This is a good dialog, but the

difficulty of the Congress is that we got into a bidding war on the taxes. The difference between the Democratic proposal and the Republican bill that passed was very small at the time all of the bidding on the tax bill took place.

So, fairly and realistically the leadership on both sides and the Members, including ourselves, are to blame that we did not get together with a tax bill. I am certainly not blaming the Democratic Party for that.

Mr. WRIGHT. I am not blaming the Republican Party per se.

Mr. STANTON. We should learn from that, though, that we had no alternative. Both of them went too far.

Mr. WRIGHT. I think that is true. I would agree with you. The bidding war was very unproductive, counterproductive, and what we did as a Congress, I think, set in motion inexorable forces that make that budget deficit loom so large.

As a matter of fact, I did go see the President one day, at his invitation, the Speaker, Chairman Rostenkowski, and I. We went to visit with him and Senator Byrd and some of the Republican leaders of the House and of the Senate at his invitation, ostensibly, to see if there were some way in which we could find some compromise on the tax cut.

I took a piece of paper with me which represented a suggestion that I had, conceptual. It would have had instead of a 5-10-10 a 5-5-5 individual tax cut, and it would have tilted it a little bit more to the average income people instead of just, you know, the wealthier people.

I would have allowed certain things such as targeted tax breaks for investments designed specifically to improve our industrial plant machinery and a few of the other things that were included in the President's bill, but the total tax loss, instead of being \$280 billion over the next 3 years, would have been just about half of that figure in the 3-year term. Instead of being \$96 billion next year it would have been in the nature of \$45 billion next year.

That was scoffed at. The President took it and looked at it and didn't say anything, but Mr. Regan and some of the others just said that is no good, and I got the impression that our purpose in being down there was not to see if there were some mutual place that we could agree but rather to persuade us to compromise on what the President's people had already decided.

That was the impression I got. In any event, it was unavailable, it was not a successful endeavor. I think if someone—perhaps not I, but someone else—had been able to prevail upon the powers that be, both Democratic leaders in the House and the President, to settle for a less ambitious, less costly tax cut last year, we would be in an awful lot better position today and interest rates would be lower.

Mr. STANTON. I appreciate your remarks, Jim. We could keep on like this, but everybody would get mad at us.

Mr. WRIGHT. Those that aren't getting mad at me are getting mad at you and vice versa.

The CHAIRMAN. That was a very good repartee. I would like to mention to the members that we have the distinguished majority leader with us, and in the wings we have waiting—and he has been here about 15 minutes—the Secretary of the Treasury.

So I would ask the members to take note of that as we go through the question and answer period with our majority leader. Mr. Gonzalez?

Mr. GONZALEZ. Thank you, Mr. Chairman. Thank you, Mr. Leader.

I recall vividly the last visit you had under similar circumstances. I think it was last year or maybe it was the year before. I need not belabor this except that though our distinguished ranking minority leader brought up the fact that one of the things he admired was your nonpartisanship. But that is the issue.

He also said that there was very little difference between the Republicans and the Democrats in these great crises such as the tax bill, which to me represents the most retrogressive, the biggest giveaway of the Treasury since Andrew Mellon. If that is not partisan, I don't know what is. There were some of us that are Democrats that did everything we could and were belabored for being partisan and being obstructionists.

I admired very much the presentation. Some of us have been like coyotes out in the brush, braying to the moon, nobody listening except those unfortunate people that have insomnia.

Mr. Leader, I think the distinguished ranking minority leader here on this committee did make a point; that is, where do we go? What are our marching orders? This is what the people are waiting for, and they are there. They know the difference.

It is true interest rates is the big demon, but here we have been told it is inflation. Now that inflation is down nobody in my district that I have talked to, including my wife, would tell you that inflation has gone down. That grocery bill is bigger than ever and gets less than ever.

So, the people aren't being fooled. I mean, we can kid ourselves up here and we can have this camaraderie about being nonpartisan and all of that, but we have to fight this. The big criticism is that you all are like rapiers, really fine rapiers, but what we need is a sledge hammer.

I don't know. You know, it is like my predecessor from this district, Maury Maverick, Sr. when he was assailed—and I was a student, but I remember it like it was today—because he was accused by the then conservatives as being against the Constitution.

The Supreme Court was retooling most of the action that Congress was taking on an emergency basis. Old Maury said sure, I am for the Constitution. I have gone to war on behalf of the Constitution. I have suffered wounds because of that war. Of course I am for the Constitution.

But I am for the Constitution and groceries, too, and this is the issue right now. Where do we go? What is our marching order? I know that I just came across this here that this is what I think we need and want, Democrats with guts. This is what we have desperately needed since last year.

What can we give as a marching order? I have been advocating impeachment and everything I could come up with that I think the Congress—the gentleman said a while ago, I almost thought I was going to get an endorsement when you said there is nothing you can do about Volcker. Of course you can. You made a pretty good beginning case of impeachment this morning.

I realize the reality of the situation, but what is our marching order? The people want to know. What are we doing about it? We know what the problem is. What do we do about it?

Mr. WRIGHT. Maury Maverick wrote a book which both of us read at the University of Texas, "In Blood and Ink." Do you remember that book? I think some of the things I am ready to suggest to you might be the sort of thing that old Maury would have appreciated.

In the first place, Mr. Volcker, the reason I said there isn't much we can do about it is because I think he is appointed by the President and I would presume removable by the President.

When Lyndon Johnson was Vice President he told me something I suppose all Presidents knew. He told me that Mr. Kennedy had a policy in which whenever he appointed anybody to any administrative office he received from that person that day of his appointment an undated but signed letter of resignation. He put all of these in a drawer. Then upon his determination—his, the President's—he could pull one out, date it, call in the press and say I am so sorry to announce that today I have received a letter of resignation from this great American, which I accept with such reluctance.

I told that to Jimmy Carter after he had been President about 3 years and he never knew it. I feel bad I had not suggested it before. I tried to get the word to President Reagan about that idea. I don't know whether it registered. He is the guy that can remove Volcker. He is the one who can remove Volcker.

Harry Truman, when he was President of the United States in 1951, I guess it was, the Federal Reserve Board increased the prime rate from 5.5 to 6 percent. Whereupon Harry Truman, President of the United States, called in members of the Federal Reserve Board and said gentlemen, this won't do. The people cannot afford interest rates that high. You have to go back and disgorge. Whereupon they did because Harry Truman was President of the United States.

Andrew Jackson had a great battle with the Bank of the United States to determine who was running the country. It emerged that Andrew Jackson was President of the United States.

Now it seems to me when you get in a situation like that we here sitting in the Congress, 435 of us in the House and 100 over in the Senate, wise though they be, cannot fine-tune the interest rates. You know, we cannot decide on a day-to-day basis, vote on what the prime rate is going to be. Somebody has to do it. That somebody has to be appointed by the President.

I think he has to be answerable to the President. I think the President has to have the responsibility to move him if he isn't.

Second, what do we do about these deficits? What I am getting ready to say doesn't represent the Democrats, just me. I will tell you doggone well quick what I think I would do.

I know that we are not going to be able to reduce that deficit by any appreciable amount unless we come to grips with what is causing the deficit, and that is the monstrous, monumental tax cut, the biggest in history, \$250 billion taken out of the Treasury in the next 3 years.

I surely would do away with the so-called safe harbor leasing provision, which is encouraging the biggest companies in the country to buy and sell and barter and trade among one another in tax avoidance schemes.

I think that is the first thing I would do away with.

I think it would be prudent if we were to look at that third year, 10-percent marginal rate cut. You know, it isn't a 10-percent cut in taxes. That is where people were deceived, bless their hearts. They heard that and they thought oh, good, I am going to have myself a 10-percent cut in the taxes I pay.

Well, that isn't true, of course. The average citizen, if he pays at a 20-percent rate, got last year 5 percent—not 5 percent of his taxes, but 5 percent of the 20 percent, which is 1 percent, not enough to let him buy a car, not enough to let him buy anything that would stimulate the economy. The average citizen got practically nothing.

As a result of that tax cut voted last year, the relative percent of the tax burden in the income tax code, as borne by corporations and by individuals, shifted dramatically.

Last year, 1981, corporations paid 28 percent of the income taxes and individuals paid the remainder. That was down substantially from 40 percent that corporations paid in 1960.

You know what they are paying this year? 14 percent. 14 percent is one-half the amount—one-half the percent of the taxes paid would be paid by corporations this year and that slack, of course, is taken up by individuals who now are paying 86 percent of the income tax.

Mr. GONZALEZ. Are they headed for zero?

Mr. WRIGHT. Of course they are headed for zero, if this thing continues as it is set to continue. You know, any corporation that pays taxes, I think the executive officer of the corporation is probably going to be in trouble with his board of directors for malfeasance.

Now, we have got to change that around if we are going to do anything meaningful about balancing the budget. We can fiddle around all we want to with all of these little old things.

You know one-third of the budget is entitlements. Now, I don't want to cut the pay for the social security recipients for the retiree. The guy who has given his life to serve the U.S. military, I don't want to reduce his pay. That is about one-third of it.

Another one-third of it is military. As much as I am a defender of and believe in a strong military establishment, I think one of the things we can do is to hold back the rate of increase to the 7-percent real term increase that the President himself advocated last year as a steady annualized proposition.

He said if we raise our military expenditures in real terms after inflation by 7 percent a year, year after year, we will establish in the minds of the world we mean business.

Last year we voted about a 9, 9.5-percent increase for this year. This year he is asking for about a 13-percent increase. If you cut some of that back, we can save some money.

I say those things and you ask what can we do. I think those are a couple of things we can do to reduce the deficit. I have an idea about how we can make it less profitable for people to charge high interest, but it is so unorthodox, Henry, that I don't know whether

even you would like it. If so, you would be about the only one, you and I.

The CHAIRMAN. The time of the gentleman is expired.

Mr. STANTON. Mr. Chairman, I have never seen the majority leader more eloquent than he is now or has been this morning. I would call upon him for a little cooperation.

We do have a problem on the committee. We do have an opportunity to see the majority leader quite often and good colloquys take place.

We do have this morning the Secretary of the Treasury, who has come up. I promised him when he set it up at 10 or so that he would be free at 12:30 for a very important meeting. I wonder if somehow we couldn't get some kind of cooperation to get the majority leader back.

Mr. WRIGHT. I would be delighted to step aside and yield my place to Secretary Regan, if that is the wish of the committee, because I know his time is valuable and I don't really have any desire to usurp the time of the committee.

I would be glad to yield.

Mr. STANTON. We on this side would appreciate that deeply.

The CHAIRMAN. One moment, please. Let me ask the members on this side if any of them have any burning questions that they would like to propound to the majority leader at this point in time, with the understanding that certainly you would be happy to return in the near future?

Mr. WRIGHT. I appreciate that. Sure.

The CHAIRMAN. Mr. Leader, we thank you for your presentation and cooperation, and I personally want to apologize to you and the members for this conflict.

Mr. WRIGHT. It is not necessary at all. I am just honored to step aside for such a distinguished American as Don Regan.

The CHAIRMAN. At this time we will ask the Secretary of the Treasury, Donald Regan, to appear from the wings.

Good morning, Mr. Secretary. Welcome.

I would like to state for the record that indeed many members on this side did have many questions of the majority leader. They understand the time restraints and they relinquish and cooperate with the chairman and Mr. Stanton, allowing the Secretary of the Treasury to appear at this time.

Our second witness this morning is the administration's chief economic spokesman, Secretary of the Treasury Donald Regan. We have been very anxious to have you before us before we completed our hearings and reported to the House on monetary policy. It is essential that this committee should know how well the announced policies of this administration mesh with the Federal Reserve's monetary policy.

With all due respect to both you and Chairman Volcker, the public, specifically the financial markets, have been bombarded with conflicting signals about just how the Federal Reserve and the administration horses are hitched to the Nation's economic wagon. Over the past few weeks and months the romance has been off and on. Perhaps only Liz Taylor and Richard Burton have had more instant reconciliations.

The Wall Street Journal for January 21 carries a big headline: "Treasury Chief Steps Up Criticism of Fed, Urges Better Control Over Money Supply."

On January 28, the Washington Post: "Regan Blames Fed For Interest Rates—Urges Easier Money Policy."

On January 30, the New York Times devotes 20 inches of type under a headline: "Reagan vs. Fed: The Fallout."

On February 1, the same New York Times comes back with a new story with the headline: "Reagan Officials Praise Federal Reserve Moves."

On February 3, the Wall Street Journal carries this reassuring headline: "Treasury Chief Reiterates That The Economy Will Have 'Roaring' Recovery."

Ten days later the Washington Post splashes this headline across its pages: "Volcker Points Again At Deficit, Economy Will Not Come 'Roaring' Back, He Says."

And the Wall Street Journal: "Volcker Warns Of Collision In Fiscal Policies. Deficits Pit Reagan Growth Plan Against Bid To Curb Inflation, Fed Chief Says."

A few days later, on February 19, the front pages carried a new message. The New York Times: "President Backs Federal Reserve and Tight Money."

And the Washington Post: "President Offers to Cooperate with Federal Reserve."

Five days later, the Washington Post: "Volcker Blasts Huge Deficit."

In his last press conference on February 19 President Reagan stated: "I have confidence in the announced policies of the Federal Reserve Board."

Mr. Secretary, may we judge from that statement and other related comments at that same press conference that the administration and the Federal Reserve are on the same wave length, that the Federal Reserve's targets are your targets?

I think it is very important not only to this committee but to the financial markets to know the present state of this ping pong match. I must admit, Mr. Secretary, that I can well understand why you and Mr. Volcker are so anxious to find someone else to blame. The economy is a sorry mess and neither one of you really wants to take credit.

Reaganomics has now been in place 434 days. More than 10 million Americans, who want jobs, are without work. Millions more, discouraged by futile searches for jobs, are idle.

I might state the unemployment rate in Rhode Island, where Succotash Point is located, as of Saturday is 10.3 percent. Thousands of American families, unable to afford 17 and 18 percent mortgages, have seen the dream of home ownership fade.

Scores of small businesses, crushed by high interest rates and a slumping economy, have padlocked their doors and others face certain bankruptcy in the coming months. Nearly one-third of the Nation's manufacturing capacity stands idle, producing neither jobs nor goods.

This is the bleak picture as we emerge from the second winter of the administration's grand experiment with supply side economics. Through the months the administration's line remains the same:

"Wait, wait, wait, the miracle is coming somewhere, sometime and somehow." I am not sure it is getting through to the inner circles of the administration, but the country is responding with a loud "Enough, enough, enough."

With all due respect to you, Secretary Regan, and the other economic architects of this administration, it is time perhaps to admit failure. This has been a losing season. It is time for a new game plan, as George Steinbrenner would say.

Supply side economics has come up with one product in abundance—uncertainty: uncertainty for the financial markets, uncertainty for workers trying to find jobs, uncertainty for small businessmen struggling to survive, uncertainty for nearly everyone in this country.

Mr. Secretary, the March 22 edition of *Business Week* quotes you: "* * * interest rates are performing an act of levitation that we cannot explain believably." Yes, Mr. Secretary, we are all having great difficulty "explaining believably" any part of the administration's program.

Mr. Secretary, we will put your entire statement in the record and we will allow you to proceed. We want to thank you for your patience with having a witness prior to you who was very eloquent and stimulating.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman, and members of the committee. It is a pleasure to be with you today to discuss the economic outlook and the budget.

The economy continues in the grip of the second recession in 2 years. This latest downturn began in July of 1981, hard on the heels of the sharp recession of 1980, from which the economy has never really recovered. Together they form one long period of near zero growth.

The causes of the problem are clear: years of excessive money growth, rising inflation, rising interest rates, rising tax rates and rising Federal spending as a share of GNP.

With the help of the Congress we hope to bring the Federal spending and deficits under control. With the help of the Federal Reserve we hope to bring inflation and interest rates down. These steps will lead to an early end of the current downturn.

In spite of the continued slide in the first quarter of 1982, there are some hopeful signs. Excessive inventories are being drawn down at a rapid rate. This is typical of the last stages of a recession. Retail sales are rising, housing starts are up slightly, durable good orders have leveled off and, very important to the financial well-being of all Americans, whether of working age or retirees, inflation continues to fall.

More importantly, we have in place a sound, long run tax system. It will not only help bring an early end to the current recession, but it will promote rapid growth of income, savings, investment, and employment for years to come.

That tax system, with a healthy economy, will generate as much revenue as Government should reasonably be allowed to spend.

However, the short run revenue picture has been heavily affected by two factors: the recession and the drop in inflation.

Nominal GNP is estimated to be 4 percent lower than the one forecast last March; the 1982 unemployment rate, over 1½ percentage points higher. These changes in the economic assumptions have added roughly \$60 billion to the deficit projections for fiscal year 1983 compared to our estimate for last year. Higher interest rates and a higher level of national debt by fiscal year 1983 have added \$30 million more.

We therefore have to face some tough decisions about how to finance the deficits until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive creating tax cuts already in place. The result would have been lower real growth for many years into the future, a self-defeating major change in a permanent tax program to handle a temporary problem.

Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program and renew our efforts at controlling spending.

Deficits must be reduced. They rob the private sector of financial and real resources needed for growth and divert those resources to government use. So do taxes.

The root of the problem is the Federal spending, which appropriates those real resources and then must find the means to pay for them in one way or another. The budget deficit can and must be narrowed, primarily from the spending side.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits by borrowing rather than by taxes. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth and would choke our future expansion.

The budget deficits can be handled in a nondisruptive fashion. The first three charts in my prepared testimony help to put the deficit in a perspective. As can be seen, the projected deficits, though some of them are of record dollar levels, are not unusual following a recession when measured as a percent of gross national product.

There has been considerable concern that our projected deficits will drive up interest rates. However, we believe there will be ample private sector savings to finance these deficits and permit strong increases in capital formation.

There will be no need for inflationary money creation by the Federal Reserve, which would indeed drive up interest rates. Compared to 1981, private savings will be more than \$60 billion higher in 1982, more than \$170 billion higher in 1983 and more than \$260 billion higher in 1984.

Lack of growth has been responsible for much of the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1-percent increase in unemployment, the budget deficit widens by more than \$25 billion. In fact, if we had grown fast enough over the past 4 years to get unemployment down below 6 percent, the current deficit would be roughly \$75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. I would like to point out very firmly that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business savings by as much or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. There are behavior changes and economic repercussions from tax and spending shifts which affect savings, investment, labor supply, income and revenue.

The facts should be kept clearly in mind as we look at the deficits in this budget.

TAXATION SPENDING IN THE BUDGET

The Tax Code we have in place plus the tax proposals contained in the administration's budget regarding obsolete provisions and improved tax compliance measures will generate as much revenue in the long term as the Government should be allowed to spend.

We project long-term receipts between 19 and 19.5 percent of gross national product between 1983 and 1985, under our proposals. These percentages would rise slowly thereafter with real economic growth and scheduled payroll tax increases.

This compares with 18.7 percent from 1964 through 1974; 19 percent from 1975 through 1979. Receipts were 20.1 percent and 21 percent of gross national product in 1980 and 1981, and they will be approximately 20.3 percent in 1982. Receipts, therefore, will be in line with or even higher than historical levels.

On the other hand, spending on- and off-budget is already too high and threatens to go higher. It was 23 percent and 23.7 percent of GNP in 1980-81 and will exceed 24 percent of gross national product in 1982. This compares to 19.8 percent from 1964 through 1974 and 22.1 percent from 1975 through 1979.

We have recommended a decline to just over 21 percent of gross national product by 1985 and further declines thereafter.

There is a general perception that spending and taxes have been slashed. In fact, all we have done so far is to reduce the rate of growth in spending, and we have just begun to see a modest tax reduction.

The personal tax rate reductions of the ERTA are not substantially larger between 1981 and 1984 than the continuing bracket creep and the payroll tax increase of 1981-82. In fact, there was a net personal tax increase of roughly \$15 billion in 1981.

In 1982 taxpayers will just about barely break even. Not until 1983 and 1984 will there be real cuts for most families, totaling \$12 to \$15 billion each year. Taxes will rise again in 1985 due to a scheduled payroll tax increase.

On the other hand, even under our proposed spending restraint, spending will remain well above long-term averages for several years to come. If major budget changes are to be made, they should be made in spending levels, not taxes.

THE IMPORTANCE OF A STABLE TAX POLICY

It is unlikely in the extreme that tax increases could succeed in balancing the budget. First, they would weaken the economy and would be partially offset by slower growth. Second, they would encourage higher spending. In spite of the fact that the tax receipts of the Federal Government rose nearly \$250 billion from fiscal year 1977 through fiscal year 1981, the Government ran deficits of nearly \$200 billion.

BUSINESS TAXES

Stability in tax policy is essential for private sector planning and economic recovery. Millions of firms planning billions of dollars of investment decisions now must be in a situation of great uncertainty with respect to leasing, ACRS and other provisions.

The decisions of the Congress regarding ACRS and related provisions have the power to unleash a flood of investment or to choke off tens of billions of dollars of spending on modernization and expansion of plant and equipment. Until the political decisions are made, the economic decisions and the economic recovery are on hold.

TAXES ON SAVING

Consider the impact on personal saving of a decision to suspend the third year of tax cuts and indexing. Over the life of a 10-year bond purchased in 1983, the higher and rising tax rates would reduce the rate of return on that bond from between 1 and 2 percent to about zero after taxes and after inflation. This would discourage savings by \$25 to \$50 billion per year, with obvious adverse consequences for interest rates, investment and real growth.

TAXES ON LABOR AND SMALL BUSINESS

There are those who would preserve the business portions of the ERTA and cancel most of the remaining individual tax rate reductions. Such a move would be extremely counterproductive to business, as well as to individuals.

In my years at Merrill Lynch I came to appreciate the importance of the individual and his or her role as a saver, an investor, an entrepreneur. I am surprised that others in commerce or industry do not appreciate the importance of the individual in the roles of employee and customer.

Those who think a business is only in terms of large corporations, forget the millions of partnerships, proprietorships and subchapter S corporations run by entrepreneurs whose profits are taxed at the individual level, at individual tax rates.

As for employees and consumers, consider the effects of suspending the third year of the tax cut and indexing on the cost of labor and the standard of living of the American family.

It may come as a surprise to some, but labor is a far larger factor of production than capital. Labor is between two-thirds and three-quarters of the total cost of inputs in most years for most products and industries.

Labor inputs outweigh capital inputs 2 or 3 to 1. It is time to remember that taxes on labor and the resulting higher labor costs are extremely damaging to American business.

Tax rates on labor at the Federal, State and local level have risen until it now costs a firm more than \$1.70 to compensate a worker for a \$1 increase in the cost of living. Without indexing, it would cost \$2.50 or more in the 1990's.

Any wage increase, whether merely COLAs or a real wage hike, would send taxes rising and tend to push labor costs up faster than the prices the firm receives for its products. The likely consequence of such a tax situation would be falling profits, falling employment and falling after-tax wages.

Labor would absorb substantial portions of the rising tax burden, amounting to several hundred dollars in higher taxes by 1986. This is only the direct cost.

The weaker economy, reduced savings, investment and growth, lower productivity and reduced competitive position of American labor in the world economy would lower the market wage itself, reducing the family's real earnings by hundreds of dollars more.

American workers and savers are the primary customers of American business. There is no way such an impact on the real income of its customers would be good for business.

THE IMPORTANCE OF A STABLE MONETARY POLICY

The President's original economic program included the recommendation that money growth be gradually reduced to a noninflationary pace. During the past year the Federal Reserve made significant progress toward that goal, although somewhat faster at first and more erratically than we had anticipated.

Recognizing the short-run costs and the long-run benefits of controlling inflation, the administration remains committed to its goal of slow and steady growth in the money supply over the long run.

Given that goal, we supported money growth in the middle of the Federal Reserve's M-1 target range in 1981, and we support money growth in the upper third of the Federal Reserve's tentative M-1 target range for 1982.

Currently M-1 is about \$4 billion above the upper bound of the 1982 target range due to an unexpected bulge in money growth in January. This was partially wound down in February.

We are confident the Fed can and will meet its targets for the year while allowing relatively modest but steady expansion of M-1 from here on.

There are those who are urging the Federal Reserve to abandon its goal of a steady and moderate growth in the money supply. They believe faster money growth would depress interest rates. History does not support that view, as the attached charts show very plainly.

For many years it has been apparent that inflation is the main factor determining the level of interest rates. Excessively rapid money growth in the past has brought about the current high levels of interest rates.

The evidence is very clear, faster growth of the monetary base produces faster growth of M-1 and is associated with rising interest

rates. Slower growth of the monetary base in M-1 leads to falling interest rates. Volatility in the growth of the money supply also adds to interest rates by adding to uncertainty and risk.

The administration strongly supports the Federal Reserve's announced goal of a steady and moderate growth of the money supply, not because we seek to drive interest rates up, but because it is the only way to bring inflation and interest rates down on a permanent basis.

Mr. Chairman, I would be pleased to answer any questions you might have.

[The prepared statement of Secretary Regan follows:]

TESTIMONY OF THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE BANKING COMMITTEE

Mr. Chairman and Members of the Committee,

It is a pleasure to be with you today to discuss the economic outlook and the Budget. I hope this occasion will be part of an on-going dialogue between the Committee and the Administration over the need to restore a stable fiscal climate to promote long-term noninflationary growth in the American economy.

As you know, the economy continues in the grip of the second recession in two years. This latest downturn began in July 1981, hard on the heels of the sharp recession of 1980, from which the economy had never really recovered. Together they form one long period of near zero growth. The causes of the problem are clear: years of excessive money growth, rising inflation, rising interest rates, rising tax rates, and rising Federal spending as a share of GNP.

With the help of this Committee, we hope to continue the fight to bring Federal spending and deficits under control. With the help of the Federal Reserve, we hope to bring inflation and interest rates down. These steps will lead to an early end to the current downturn.

In spite of the continued slide in the first quarter of 1982, there are some hopeful signs. Excess inventories are being drawn down at a rapid rate. This is typical of the last stages of a recession. Retail sales are rising. Housing starts are up slightly. Durable goods orders have leveled off. And, very important for the financial well-being of all Americans, whether of working age or retirees, inflation continues to fall.

More importantly, we have in place a sound long-run tax system for the 1980's. It will not only help bring an early end to the current recession, but will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend.

However, the short-run revenue picture has been heavily affected by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have significantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

Nonetheless, nominal GNP is estimated to be 4 percent lower than was forecast last March, and the 1982 unemployment rate over one and one-half percentage points higher. These changes in economic assumptions have added roughly \$60 billion to the deficit projections for FY-1983 compared to our estimate last year. Higher interest rates and a higher level of national debt by FY-1983 have added \$30 billion more.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the \$666.1 billion in revenues and the \$757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

Borrowing diverts a portion of private savings away from capital formation to enable the government to gain command over a portion of current output. Taxing also enables the government to have at its disposal a portion of current output. Taxation reduces private saving and it too cuts back the resources available for capital formation.

However, there is a difference. In recent years, tax increases have generally taken the form of allowing inflation to push taxpayers into higher brackets, or allowing inflation to erode the value of depreciation allowances. The former reduces the value of incremental present or future wages and interest income; the latter reduces the rate of return on plant and equipment. The effect is to reduce the supply of labor, savings, plant and equipment, cutting down on future output. Thus, taxation often produces disincentives which adversely affect future output, as well as directing a portion of current output to the government.

Federal borrowing creates debt that must be serviced, and this implies the future payment of taxes, but it need not require an increase in marginal tax rates, as long as economic growth produces an enlarged tax base. Thus, borrowing should have less adverse impact on future output than taxation.

Therefore, in deciding how to cover the transitional deficits associated with the current recession, we feel it is better to borrow, while leaving the tax incentives in place for long-run growth, rather than to undo the structural tax reforms of the ERTA, and choke off future expansion.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. The first three charts help to put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession.

There has been considerable concern that our projected deficits will drive up interest rates. However, we believe there will be ample private sector saving to finance these

deficits and strong increases in capital formation. There will be no need for inflationary money creation by the Federal Reserve, which would indeed drive up interest rates.

The deficits will be manageable because of the growth of private sector saving. Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal Government in 1983 and 1984 and thereafter.

The annual additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed \$40 billion each year. This will be supplemented by the additional personal savings and additional business retained earnings induced by the tax cuts. Compared to 1981, private saving will be more than \$60 billion higher in 1982, more than \$170 billion higher in 1983, and more than \$260 billion higher in 1984. Private saving was \$480 billion in 1981. It is projected to rise to more than \$740 billion in 1984.

Unfortunately, not all of this saving is available for growth and financing deficits. Some is needed to replace worn-out equipment. Net saving, which is gross saving less depreciation, is being diverted to finance government spending at an alarming rate, although not so severely as in the recession of 1974-1975 (see appendix). Fortunately, net saving will rise with gross saving. Nonetheless, every effort should be made to restrain Federal spending to promote future investment and growth.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than \$25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly \$75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

Taxation, Spending and the Budget

The tax code we have in place, plus the tax proposals contained in the Administration's budget regarding obsolete provisions and improved tax compliance measures, will generate as much revenue over the long term as the government should reasonably be allowed to spend. We project long-term receipts of between 19 and 19-1/2 percent of GNP between 1983 and 1985 under our proposals. These percentages would rise slowly thereafter with real economic growth and scheduled payroll tax increases. This compares with 18.7 percent from 1964 through 1974 and 19.0 percent from 1975 through 1979. Receipts were 20.1 and 21.0 percent of GNP in 1980 and 1981, respectively, and will be approximately 20.3 percent in 1982. Receipts, therefore, will be in line with, or even higher than historical levels.

On the other hand, spending, on- and off-budget, is already too high and threatening to go higher. It was 23.0 and 23.7 percent of GNP in 1980 and 1981, respectively, and will exceed 24 percent of GNP in 1982. This compares to 19.8 percent from 1964 through 1974 and 22.1 from 1975 through 1979. We have recommended a decline to just over 21 percent of GNP by 1985, and further declines thereafter.

There is a general perception that spending and taxes have been slashed. In fact, all we have done so far is to reduce the rate of growth of spending, and we have just begun to see a modest tax reduction.

The personal tax rate reductions in the ERTA are not substantially larger between 1981 and 1984 than the continuing bracket creep and the payroll tax increases of 1981 and 1982. In fact, there was a net personal tax increase of roughly \$15 billion in 1981. In 1982, taxpayers will barely break even. Not until 1983 and 1984 will there be real tax cuts for most families, totalling \$12 to \$15 billion each year. Taxes will rise again in 1985 due to a scheduled payroll tax increase.

On the other hand, even under our proposed spending restraint, spending will remain well above long-term averages for several years to come. If major budget changes are to be made, they should be in spending levels, not taxes.

Importance of a Stable Tax Policy

It is unlikely in the extreme that tax increases could succeed in balancing the budget. First, they would weaken the economy, and be partially offset by slower growth. Second, they would encourage higher government spending. In spite of the fact that the tax receipts of the Federal Government rose nearly \$250 billion from FY-1977 to FY-1981, the government ran deficits of nearly \$200 billion.

Consequently, the Administration hopes to balance the budget by restraining spending and encouraging growth through a stable incentive-creating tax program.

Business Taxes

Stability in tax policy is essential for private sector planning and economic recovery. Consider the impact of sudden changes in the tax law on the cost of plant and equipment and the related investment decisions.

Millions of firms planning billions of dollars of investment decisions must be in a situation of great uncertainty with respect to leasing, ACRS and other provisions. There is no way for a firm to determine whether an investment is practical or not until the tax picture is clarified. The decisions of the Congress regarding ACRS and related provisions have the power to unleash a flood of investment or to choke off tens of billions of dollars of spending on modernization and expansion of plant and equipment. Until the political decisions are made, the economic decisions, and the economic recovery, are on hold. The right decisions will start the economy climbing. The wrong ones will set it tumbling.

Taxes on Saving

Consider the impact on personal saving of a decision to suspend the third year of the tax cut and indexing. Under current law, over the life of a 10-year bond purchased in 1983, a taxpayer who will be in the 33 percent bracket following the third year of the tax cut would pay roughly one-third of his interest to the government. But without the third year and indexing, that tax rate would start at 39 percent and rise within a decade to 44 percent and 49 percent, as the taxpayer's income rises through the tax brackets with inflation. The average of these tax rates would probably be nearly 44 percent

At a 10 percent nominal interest rate and 5 percent or 6 percent inflation, this rise in the tax rate would be enough to cut a 2 percent real after-tax interest rate in half, or a 1 percent real after-tax interest rate to zero. Historically, such swings in the real after-tax interest rate have shifted the personal savings rate by one or even two percentage points. This would be enough to remove \$25 to \$50 billion dollars per year from the credit markets over the next decade, with obvious adverse consequences for interest rates, investment, and real growth.

Furthermore, the potential saver would know as soon as these provisions were repealed what the impact would be on the rate of return to saving. He would react at once, before the bond were purchased, not 5 or 10 years later after having committed money in good faith.

Taxes on Labor and Small Business

There are those who would preserve the business portions of the ERTA, and cancel most of the remaining individual tax rate reductions. Such a move would be extremely counter-productive to business as well as to individuals. I am frankly amazed at the lack of thought behind such proposals.

In my years at Merrill Lynch, I came to appreciate the importance of the individual in his or her role as saver, investor and entrepreneur. I am surprised that others in commerce or industry do not appreciate the importance of the individual in the roles of employee and customer.

Those who think of business only in terms of large corporations forget the millions of partnerships, proprietorships and sub-chapter S corporations whose profits are taxed at the individual level at individual tax rates. The decisions of these owner-investors and entrepreneurs are heavily influenced by the personal rate reductions and estate and gift tax reforms recently enacted.

As for employees and consumers, consider the effect of suspending the third year of the tax cut and indexing on the cost of labor and the standard of living of the American family.

Total net output of goods and services in the economy results from the combination of labor and capital. The value added by these two factors of production is reflected in the wages, salaries, rents, royalties, interest and dividends they receive. Value added equals total national income and total net output.

It may come as a surprise to some, but labor is far and away the larger of the two factors. Value added by labor is

between two-thirds and three-quarters of the total in most years for most products and industries. Labor inputs outweigh capital inputs two or three to one. It is time to remember that taxes on labor and the resulting higher labor costs are extremely damaging to American business.

Over the last 15 years, inflation, bracket creep and payroll tax hikes have sharply increased the pre-tax cost to the firm of giving a worker a one dollar after-tax wage increase.

A median income worker now faces 40 percent to 44 percent tax rates on added income. This is the sum of social security and Federal marginal income tax rates, plus state and local taxes at the margin. It is up sharply from the late 1960's, when the marginal rates would have been roughly 26 percent to 30 percent.

Consequently, it now costs a firm more than \$1.70 to compensate a worker for a \$1.00 increase in the cost of living. This is up from \$1.40 in the late 1960's. Without indexing, it will rise to \$2.00 by the late 1980's, and to \$2.50 or higher in the 1990's. Any wage increase, whether merely COLA's or a real wage hike, would send taxes rising and tend to push labor costs up faster than the prices the firm receives for its products. Profits, employment, or real wages would tend to fall continually over time in the absence of extraordinary productivity increases. The competitive position of U.S. labor in the world economy would suffer.

The likely consequence of such a tax situation will be a falling after-tax wage. Labor will absorb a substantial portion of the tax burden. The cost of eliminating the third year of the tax cut and indexing to a wage earner making \$20,000 in 1982 and receiving a cost-of-living increase thereafter would be substantial: \$80 in 1983, \$203 in 1984, \$289 in 1985, and \$369 in 1986. This is only the direct cost. The weaker economy, reduced saving, investment and growth, lower productivity and reduced demand for American labor would lower the market wage itself, reducing the family's real earnings by two or three times the direct cost of the higher taxes. American workers and savers are the primary customers of American business. There is no way such an impact on the real income of its customers would be good for business.

Regulatory Reform

My emphasis on the importance of the structural reforms of our tax system is consistent with this Administration's general regulatory reform program, the goals of which are also to promote savings and investment and to reduce the costs of government regulation for all sectors of the economy. The Administration's efforts are nowhere

more clear than with regard to the financial system, where in past years an outdated regulatory system has caused the redistribution of funds out of depository institutions to institutions offering new financial products and services. Thus, to assist our troubled thrift industry, the Administration has supported legislation to remove or lessen restrictions which prohibit thrift institutions from exercising broader lending powers and would permit, through separate subsidiaries, banks to compete in certain securities activities. Further, as a member of the Depository Institutions Deregulation Committee, I have been involved in the process of removing interest rate limitations on depository institutions so that they can compete equally to obtain funds with which to support their vital lending functions.

In addressing the earnings losses of thrift institutions, a variety of programs have been proposed which would involve costly temporary infusions which would increase the Federal budget deficit. We believe that Federal regulators now have the necessary powers to assist troubled institutions and that subsidy programs are not necessary. We have focussed on structural changes to give the industry the ability to be healthy in changing economic circumstances.

Importance of a Stable Monetary Policy

The President's original economic program included the recommendation that money growth be gradually reduced to a non-inflationary pace. During the past year, the Federal Reserve made significant progress toward that goal.

Fourth quarter to fourth quarter, M1B grew by 5 percent in 1981. December to December, the rate was 6.4 percent due to rapid money growth at year's end. Compared to the inflationary rates of monetary expansion in the past -- 7.3 percent in 1980 and an annual average of 8.0 percent in the preceding three years -- this is a substantial deceleration in money growth. The Federal Reserve's tentative target ranges for 1982, 2-1/2 to 5-1/2 percent for M1, represent continued progress toward noninflationary money growth and the Administration fully supports that general policy.

The Administration's original recommendation was that the rate of money growth gradually be cut in half by 1984 from the average 7.8 percent rate of the prior four years; this is the assumption that we built into our economic projections. The deceleration that has actually occurred was initially much more rapid -- almost three-fourths of the planned reduction in the first year -- until end-of-year increases in money growth rates raised the level of M1B above the lower end of last year's target range.

This more rapid deceleration of money growth has economic consequences -- some good, some bad. It is leading to a faster reduction in inflation, but it also means reductions in real output, employment, and real income. Lower inflation and lower real output mean lower GNP and lower Federal tax revenues. Lower inflation also means lower Federal outlays on indexed programs, but only with a considerable time lag. In the interim, the deficit widens. It is amply clear from history, both here and abroad, that deficits, if not monetized, do not produce inflation. Indeed, the lower rate of inflation is a partial cause of the current deficit.

Recognizing the short-run costs and the long-run benefits of controlling inflation, the Administration remains committed to its goal of slow and steady money growth over the long run. Given that goal, we supported money growth in the middle of the Federal Reserve's M1B target range in 1981, and we support money growth in the upper third of the Federal Reserve's tentative M1 target range for 1982.

There are those who are urging the Federal Reserve to abandon its goal of a steady and moderate growth rate of the money supply. They believe that faster money growth would depress interest rates. History does not support that view, as the attached charts show.

For many years, it has been apparent that inflation is the main factor determining the level of interest rates. Excessively rapid money growth in the past has brought about the current high levels of interest rates. As inflation has risen or fallen in the past, interest rates have moved in step.

In the last year or two, however, interest rates have risen relative to the inflation rate. This may be due, in part, to the unusual volatility of money growth rates since 1980.

In the last two months of 1980, M1 fell at an annual rate of 1.4 percent per year, after a sharp rise in the previous five months. All of the growth in M1 in 1981 occurred in the first four months of the year, when it grew at a 14.2 percent annual rate, and the last two months of the year, when M1 growth was at a 11.6 percent rate. In the interim, M1 was fairly flat. In the six months from April to October, the net change was a decrease of 0.2 percent, annual rate.

Early 1982 saw a very rapid increase in the money supply through January, followed by a levelling off in February. Currently, the level of M1 is \$4 billion above the target range for 1982. The rapid growth of money from November

through January was accompanied by rising interest rates, reversing the dramatic decline in interest rates that had been under way since September.

The evidence of the past two years is very clear:

- Volatile money growth undermines the credibility of long-run monetary controls, adds to uncertainty and risk, and thereby helps keep interest rates high as lenders seek to protect their principal.
- Faster growth of the monetary base produces faster growth of M1 and is associated with rising interest rates. Slower growth of the monetary base leads to slower money growth and falling interest rates.

The Administration strongly supports the Federal Reserve's announced goal of a steady and moderate rate of growth of the money supply, not because we seek to drive interest rates up, but because it is the only way to bring inflation and interest rates down on a permanent basis.

It is easy to illustrate why the financial markets watch the money supply so closely, and why variability of inflation and interest rates creates turmoil and uncertainty in the bond markets. Old securities must fall in price to remain competitive with new issues as interest rates rise. Conversely, bond prices rise when interest rates fall. Consider the history of the Treasury's 6-3/4 percent 20-year bond issued on October 1, 1973, priced at \$99.50 per \$100 of face value to yield 6.79 percent. Its value over time has fluctuated substantially with market interest rates:

	<u>Price</u>	<u>Yield to Maturity</u>
9/30/74	84.63	8.41
9/30/75	85.69	8.32
9/30/76	92.19	7.59
9/30/77	95.44	7.25
9/30/78	86.06	8.44
9/30/79	80.19	9.38
9/30/80	69.69	11.37
9/30/81	55.75	14.96
latest	62.50	13.38

As interest rates and bond prices have become increasingly unstable in recent years, the risk involved in buying bonds has increased. This has resulted in greater reluctance to buy bonds on the part of those who cannot afford a risky portfolio, and the emergence of a risk or volatility premium which has driven interest rates higher than normal relative to inflation in recent years. This is why stability in the rate of money growth and interest rates is critical to the success of our program.

APPENDIX

Full Employment Deficit

One way to illustrate the impact of the back-to-back recessions of 1980 and 1981-1982 on the budget deficit is to examine the high employment budget deficit. This concept has been used in the past to measure the "stimulus" of budget policy, on the theory that deficits increase total spending and pump up "demand". We reject the notion that deficits per se are inherently stimulative. They must be financed by borrowing in the absence of inflationary monetary creation. Nonetheless, the one useful insight the high employment budget does provide is a measure of the fundamental relationship between the current policy level of spending and the current tax code's capacity to generate revenue with the distorting effects of the recession removed.

The high employment budget estimates the budget aggregates that would result if the economy were continuously operating at a high level of employment under the tax and spending proposals contained in the FY-1983 Budget documents. The unemployment rate at high employment is traditionally estimated for this purpose to be about 5.0 percent. (However, many observers feel the real economy has a long-term basic unemployment rate somewhat higher.) Potential real GNP is assumed to grow 3.2 percent annually. (We believe this potential growth rate can be increased by proper policies, but have conformed to convention to provide estimates consistent with those of earlier years.)

The CEA has estimated the high employment deficit through FY-1985 on a unified budget basis. (The high employment deficit can be computed on a national income accounts (NIA) basis or on a unified budget basis. The major differences are the inclusion of offsetting receipts from oil and mineral leases and asset sales and the netting out of Federal retirement receipts and outlays in the unified budget.) The figures are available through FY-1985:

	<u>FY 81</u>	<u>FY 82</u>	<u>FY 83</u>	<u>FY 84</u>	<u>FY 85</u>
Receipts	636	691	723	768	830
Outlays	<u>644</u>	<u>702</u>	<u>739</u>	<u>793</u>	<u>860</u>
Deficit (-)	-8	-11	-16	-25	-30

It is clear from the tables that the major portion of the projected deficits of nearly \$100 billion in FY-1982 and FY-1983 is due to the fact that the economy is operating at less than

full employment. The phased tax reductions result in small year-to-year increments in the high employment deficit, and,

even in "demand" terms, cannot be regarded as large or excessively stimulative. The bulk of the deficit increase, from \$11 to \$25 billion, is completed by FY-1984. By FY-1985, high employment receipts grow 8.1 percent over FY-1984, nearly matching the growth of outlays at 8.4 percent.

Savings Flows and How They Fit into the Scenario

The following outlines some of the concepts underlying the gross and net private savings figures commonly cited and provides background on the savings numbers consistent with the economic scenario underlying the budget. By whatever savings measure one prefers, projected deficits as a share of savings are less than in the 1974-1975 recession and the subsequent recovery, and are declining.

Concepts

- o In the National Income and Product Accounts (NIPA), gross private saving is the sum of:
 - Personal saving -- the difference between after-tax personal income of the household sector and outlays of that sector for consumer goods and services, interest payments, etc.
 - Corporate saving, consisting of depreciation allowances plus undistributed after-tax profits. (This is equivalent to the cash flow available to corporations, both to maintain and add to productive assets. Inventory profits are excluded.)
 - Depreciation allowances of the noncorporate sector including unincorporated business enterprises plus imputed depreciation on owner-occupied homes. The latter, roughly \$40 billion or about one-twelfth of gross private saving, is the only item in the saving figures which does not represent true cash flow.

Gross private saving forms by far the larger part of total gross saving. In addition to private saving, the total includes the surplus of state and local governments (largely the surplus of the pension funds for their employees, as surpluses on operating account have been fairly narrow) and the surplus or deficit of the Federal Government. The latter is on a NIPA basis. In the next couple of years, the NIPA deficit will be wider than the more widely cited unified budget deficit (the difference arising from sales of mineral rights and other transactions that are not reflected in the NIPA but affect the unified budget).

Table 1 attached presents historical data on gross savings flows as percentages of GNP.

Net private saving in the accounts is comprised of personal saving and the undistributed profits of corporate business. (Profit-type income of unincorporated businesses gets into personal saving.) Depreciation allowances are not included in net saving. (The net saving figures are close to, but do not quite represent available cash for net investment, as undistributed profits and returns to unincorporated enterprises are after allowances have been made for full replacement of inventories and fixed capital used in the production process. They exclude inventory profits, and depreciation is on a so-called economic rather than book-basis, i.e., replacement rather than historical cost.) Savings or dissavings of government can be added to net private saving to get total net saving.

Net saving figures are commonly compared with net national product (NNP, or GNP less depreciation allowances). Thus, depreciation is excluded from both numerator and denominator. Table 2 attached presents net savings flows as percentages of NNP.

Domestic savings flows, either gross or net, may be augmented by inflows from abroad, which are likely to be attracted by the new tax climate.

In an accounting sense, total gross saving (including any dissaving by the Federal Government) must match total gross investment -- the net additions to the stock of plant, equipment, inventories, and residential structures plus an amount sufficient to replace existing assets that have worn out or become obsolete. In any year, investment to replace existing assets far exceeds net additions to the stock of productive assets. Similarly, total net saving must equal net investment.

Gross Savings Flows in the Scenario

Savings flows consistent with the economic scenario underlying the 1983 Budget were worked up by the CEA. They were, of course, forced to fit within the constraint of the total uses of savings -- overall investment response to the rate of return changes in the ERTA plus Federal, state and local deficits and foreign flows. The breakdown between corporate and personal savings within the totals can be affected by dividend payout assumptions, capital intensity assumptions across corporate and non-corporate businesses, etc. In keeping within the totals, personal savings rates appear to have come out a bit low by historical standards.

The estimates yield substantial private savings flows, although they do not appear to be out of line with the sum of normal year-to-year growth, the business share of ERTA and historical responses by individuals to tax reductions.

- o Historically, gross private saving has averaged about 16-1/2 percent of GNP. The peak ratio in the postwar period was 18.2 percent in the recession year of 1975. The next highest ratio was 17.5 percent in 1967. (See left-hand column of table 1 attached.)

Gross Private Saving as a Percent of GNP

<u>Budget scenario</u>	
1956-65	16.3
1966-75	16.6
1976-80	16.7
1981	16.4
1982	17.2 projected
1983	18.5 "
1984	19.1 "

The impact of ERTA on gross private saving can roughly be estimated by calculating saving on the assumption that the historic 16-1/2 percent share of GNP had been maintained and comparing those numbers with the higher saving flows projected in the new scenario. The implication of these calculations is that gross private saving in the new scenario in 1985 is \$101 billion more than if old saving patterns prevail.

<u>Gross Private Saving</u>						
<u>Calendar Year</u>	<u>Level in Budget</u>	<u>Yearly Increase</u>	<u>Level at 16.5% of GNP</u>	<u>Difference from Budget</u>	<u>Tax Cut ERTA</u>	<u>Added Savings as % of ERTA</u>
	(1)	(2)	(3)	(4) = (1)-(3)	(5)	(6)=(4)/(5)
	----- billions of dollars -----					
1981 actual	480	--	--	--	--	--
1982 projected	542	62	521	21	58	36
1983 "	651	109	581	70	115	61
1984 "	742	91	641	101	151	67

In terms of total saving flows, including government surplus, note that increased government deficits (dissaving) resulting from a tax cut have no effect on total saving if those tax cuts flow directly into increased private saving, as the funds from ACRS, which are recorded as retained earnings, might be expected to do. Of course, private saving may increase by more or less than any tax cut, depending on responses of households and businesses to changes in after-tax real rates of return on prospective investments. In the mid-1960's, personal savings increases, partly as a result of above average income growth, exceeded 70 percent of the marginal tax rate reductions for three years, rising to exceed the tax reductions in the fourth year and thereafter. The personal savings rates in the scenario assume a savings increase averaging roughly 45 percent of the personal tax cuts from 1982 to 1984.

Composition of Gross Private Saving in the Budget Scenario

o The rise in business saving reflects:

1. A recovery of the profit share (before allowance for ACRS) and retention of a large portion of those increased profits, rather than their distribution in dividends.
2. ACRS and other tax changes which reduce profits taxes by about \$10 billion in CY-1982, \$19 billion in CY-1983, and \$27 billion in CY-1984.
3. The depreciation thrown off by a rising stock of capital.

The path of the personal saving rate is as follows:

<u>Personal Saving Rate (%)</u>	
<u>Budget scenario</u>	
1980	5.6
1981	5.3
1982	6.7 projected
1983	7.0 "
1984	6.1 "

The dip in 1984 was conditioned by overall constraints imposed on the forecast, and appears to be an understatement. Personal saving available to households is related to prospective real after-tax rates of return; these should be vastly improved from returns available during the 1970's, and higher in 1984 than in 1983. Personal savings rates averaged 7.6 percent from 1965 to 1975.

Net Private Savings in the Scenario

Net saving figures indicate resources available to increase the stock of productive capital after allowance has been made for its maintenance.

- o As indicated by the figures in the left-hand columns of table 2, ratios of total and net private saving to net national product (NNP) were severely eroded in the late 1970's. In 1981, net private saving was 6.1 percent of NNP compared with 8-3/4 percent during the late 1960's. The scenario shows that late 1960's ratio being restored, though not surpassed.

	Net private saving as percent of NNP	Federal deficit as percent of net private savings plus S&L surplus
1956-65	8.1	- 2.8
1966-75	8.6	-14.5
1974	7.6	-10.9
1975	8.9	-53.8
1976	7.7	-39.0
1977	7.3	-30.0
1978	6.9	-17.9
1979	6.7	- 8.6
1980	6.2	-35.0
1981	6.1	-31.8
1982 projected	7.0	-45.0
1983 "	8.7	-32.0
1984 "	8.8	-28.0

The right-hand column of table 2 and the tabulation on the prior page show the ratio of the NIPA Federal deficit to the total net private savings plus surpluses (if any) of state and local governments. That ratio hit a peak of 54 percent in 1975. As indicated on the prior page, that ratio in the scenario for 1982 never approaches the 1975 figure, and ratios for 1983 and 1984 stay below respective figures for 1976 and 1977.

	Gross private saving as percent of GNP		Net private saving as percent Of NNP	
	Administration	DRI	Administration	DRI
1981 actual	16.4	16.3	6.1	6.0
1982	17.2	16.7	7.0	5.8
1983	18.5	17.7	8.7	7.0
1984	19.1	18.4	8.8	7.6

GROSS SAVING AND INVESTMENT

LEVELS

	1979	1980	1981	1982	1983	1984
Gross Private Saving	400.0	434.1	478.7	542.0	650.7	741.8
Personal	86.2	101.4	106.6	150.8	171.7	163.4
Business	313.9	332.7	372.1	391.3	479.0	578.4

PERCENTS OF GNP

	1979	1980	1981	1982	1983	1984
Gross Private Saving	16.6	16.5	16.4	17.2	18.5	19.1
Personal	3.6	3.9	3.6	4.8	4.9	4.2
Business	13.0	12.7	12.7	12.4	13.6	14.9

GROSS SAVINGS

PERCENT OF GNP

	GROSS PRIVATE SAVING	PERSONAL	CORPORATE	RETAINED EARNINGS	CORPORATE CAP. CONS. ALLOWANCE	NONCORP. CAP. CONS. ALLOWANCE	TOTAL GOVT.	FEDERAL	STATE & LOCAL	NET FOREIGN INVESTMENT	GROSS PVT. DOMESTIC INVESTMENT	PERSONAL SAVING RATE
1907	11.719	8.297	6.062	2.021	4.041	3.400	6.170	5.793	0.436	3.484	14.767	3.100
1908	15.443	4.242	0.100	3.848	4.252	3.538	3.255	3.205	0.051	0.930	15.056	5.900
1909	15.080	2.896	0.370	3.767	4.643	3.832	-1.302	-1.021	-0.281	0.339	14.847	4.000
1910	14.891	4.160	0.488	2.520	4.668	3.734	2.794	3.214	-0.421	-0.645	16.116	5.800
1911	15.371	4.956	4.792	2.293	4.499	3.714	1.834	1.968	-0.134	0.266	14.779	7.100
1912	15.746	4.444	6.967	2.356	4.611	3.800	-1.087	-1.073	-0.014	0.180	14.075	7.300
1913	15.467	5.044	6.630	1.973	4.657	3.789	-1.840	-1.929	0.039	-0.348	14.423	7.300
1914	15.829	4.624	7.244	2.285	4.958	3.956	-1.448	-1.645	-0.303	0.062	14.790	6.600
1915	16.040	4.111	0.139	3.283	4.056	3.840	0.786	1.104	-0.318	0.111	15.604	6.000
1916	16.772	5.059	7.777	2.524	5.248	3.936	1.231	1.439	-0.207	0.695	15.728	7.300
1917	16.738	5.020	7.776	2.324	5.453	3.942	0.208	0.514	-0.306	1.083	15.284	7.200
1918	16.739	5.241	7.433	1.827	5.606	4.066	-2.808	-0.523	0.199	0.199	14.101	7.400
1919	16.364	4.332	0.214	2.827	5.387	3.823	-0.324	-0.233	-0.091	-0.236	14.853	6.200
1920	15.394	3.884	7.766	2.381	5.385	3.744	0.611	0.594	0.012	0.557	14.394	5.600
1921	15.818	4.386	7.719	2.375	5.344	3.713	-0.811	-0.741	-0.070	0.728	13.813	6.300
1922	16.010	4.122	0.339	3.221	5.118	3.598	-0.670	-0.752	0.082	0.600	14.010	6.000
1923	15.566	3.669	0.443	3.419	5.024	3.454	0.120	0.093	0.077	0.740	14.234	5.400
1924	16.670	4.635	0.669	3.742	4.927	3.366	-0.356	-0.513	0.156	1.070	14.385	6.700
1925	17.316	4.871	9.171	4.336	4.835	3.275	0.076	0.077	-0.001	0.786	15.001	7.100
1926	17.014	4.756	9.052	4.234	4.819	3.206	-0.170	-0.237	0.066	0.401	14.758	7.000
1927	17.497	5.542	8.705	3.720	4.985	3.250	-1.701	-1.648	-0.132	0.323	14.069	8.100
1928	16.254	4.802	8.214	3.200	5.014	3.238	-0.603	-0.693	0.010	0.069	14.360	7.100
1929	15.216	4.300	7.591	2.443	5.149	3.325	1.053	0.893	0.159	0.042	14.773	6.400
1930	15.978	5.614	8.438	1.488	5.450	3.421	-1.065	-1.253	0.188	0.323	14.202	8.000
1931	16.734	5.628	7.142	2.115	5.527	3.424	-1.805	-2.044	0.234	-0.067	14.733	8.100
1932	15.458	4.436	0.076	2.576	5.500	3.473	-0.281	-1.118	1.138	-0.424	15.583	6.500
1933	17.166	5.453	7.788	2.435	5.353	3.428	0.540	-0.422	1.012	0.440	15.431	8.600
1934	16.353	5.435	6.744	0.436	5.813	3.664	-0.330	-0.804	0.474	0.201	14.456	8.500
1935	18.247	6.086	0.300	1.878	6.422	3.861	-4.114	-4.472	0.353	1.174	13.744	8.600
1936	17.136	4.802	0.542	2.148	6.395	3.743	-2.125	-3.000	0.464	0.248	14.321	6.400
1937	16.808	3.863	9.104	2.725	6.380	3.841	-0.956	-2.418	1.463	-0.723	15.709	5.600
1938	16.483	3.541	9.009	2.685	6.324	3.933	-0.010	-1.355	1.344	-0.639	16.381	5.200
1939	16.525	3.570	8.885	2.447	6.437	4.070	0.444	-0.614	1.108	-0.070	16.501	5.200
1940	16.483	3.857	8.366	1.687	6.679	4.257	-1.222	-2.330	1.108	0.225	15.777	5.000
1941	16.344	3.648	8.459	1.644	6.765	4.233	-0.854	-2.108	1.249	0.079	14.797	5.300
.....
FIVE YEAR AVERAGES												
1931-1935	15.701	4.728	7.154	2.438	4.716	3.820	-0.461	-0.315	-0.146	0.054	14.738	6.868
1936-1940	16.404	4.707	7.793	2.378	5.416	3.903	-0.216	0.007	-0.223	0.452	14.073	6.748
1941-1945	16.276	4.337	8.468	3.414	5.049	3.471	-0.328	-0.377	0.049	0.705	14.289	6.308
1946-1950	16.342	5.004	8.100	3.017	5.683	3.289	-0.529	-0.587	0.058	0.232	14.433	7.320
1951-1955	16.891	5.608	7.711	1.980	5.723	3.572	-1.189	-1.832	0.643	0.274	14.441	8.068
1956-1960	16.687	3.927	8.781	2.330	6.443	3.979	-0.764	-1.461	1.197	-0.102	15.538	5.700

Table 1

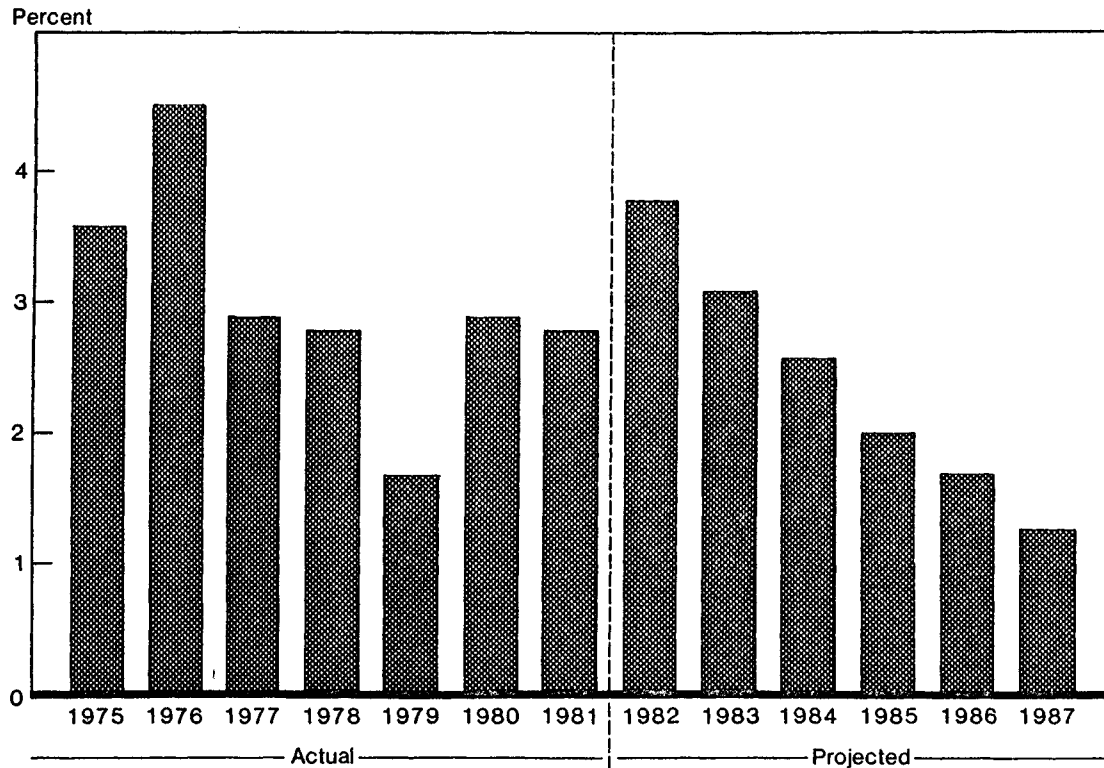
Table 2

2/9/82

NET SAVINGS

	PERCENT OF NET NATIONAL PRODUCT						PERCENT OF
	TOTAL	PRIVATE	PERSONAL	CORPORATE	STATE & LOCAL	FEDERAL	PRIVATE PLUS BAL. SAVINGS FEDERAL
1947	11.29	4.61	2.43	2.18	0.47	6.20	122.11
1948	12.36	4.83	4.65	4.17	0.06	3.48	39.12
1949	5.86	7.28	3.16	4.11	-0.31	-1.12	-16.00
1950	10.32	7.28	4.53	2.75	-0.46	3.50	91.35
1951	9.79	7.79	5.29	2.50	-0.15	2.14	28.05
1952	6.84	6.03	5.45	2.57	-0.01	-1.17	-44.63
1953	5.60	7.67	5.51	2.15	0.04	-2.11	-87.32
1954	5.45	7.59	5.08	2.51	-0.33	-1.81	-84.88
1955	8.96	8.10	4.50	3.60	-0.35	1.21	25.61
1956	9.71	8.36	5.57	2.79	-0.23	1.58	79.49
1957	8.33	8.10	5.54	2.56	-0.34	0.57	7.30
1958	4.72	7.82	5.80	2.02	-0.58	-2.53	-34.90
1959	7.53	7.89	4.77	3.11	-0.10	-0.26	-3.30
1960	7.57	6.89	4.27	2.62	0.01	0.66	9.55
1961	6.54	7.43	4.82	2.61	-0.08	-0.81	-11.07
1962	7.31	6.04	4.51	3.53	0.09	-0.82	-10.12
1963	7.88	7.74	4.01	3.74	0.08	0.05	0.60
1964	8.75	9.13	5.05	4.08	0.17	-0.36	-6.01
1965	10.10	10.02	5.30	4.72	0.00	0.08	0.83
1966	9.59	9.77	5.17	4.60	0.07	-0.26	-2.61
1967	8.15	10.09	6.04	4.05	-0.14	-1.80	-18.06
1968	7.96	8.72	5.23	3.49	0.01	-0.75	-8.64
1969	8.52	7.37	4.70	2.67	0.17	0.98	12.94
1970	6.63	7.80	6.17	1.63	0.21	-1.37	-17.17
1971	6.52	8.50	6.18	2.32	0.26	-2.24	-25.60
1972	7.40	7.70	4.87	2.83	1.25	-1.54	-17.40
1973	9.84	9.20	6.53	2.67	1.11	-0.46	-4.48
1974	7.23	7.59	6.56	1.03	0.52	-0.89	-10.94
1975	4.29	8.88	6.78	2.09	0.39	-4.98	-53.77
1976	5.37	7.74	5.35	2.39	1.07	-3.44	-34.04
1977	6.27	7.34	4.30	3.03	1.63	-2.69	-30.04
1978	6.93	6.94	3.95	2.99	1.50	-1.51	-17.89
1979	7.28	6.72	3.99	2.73	1.21	-0.69	-8.62
1980	4.85	6.23	4.33	1.89	1.24	-2.62	-35.03
1981	5.04	6.00	4.10	1.90	1.40	-2.37	-31.98
*****	*****	*****	*****	*****	*****	*****	*****
FIVE YEAR AVERAGES							
1951-1955	7.33	7.83	5.17	2.67	-0.16	-0.35	-4.64
1956-1960	7.57	7.81	5.19	2.62	-0.25	0.01	-0.37
1961-1965	8.11	8.47	4.74	3.73	0.05	-0.81	-5.15
1966-1970	8.17	8.75	5.46	3.29	0.06	-0.64	-6.71
1971-1975	7.05	8.37	6.18	2.19	0.71	-2.03	-22.84
1976-1980	6.14	6.99	4.38	2.61	1.34	-2.19	-26.13

Budget Deficits in Relation to GNP*



* On and off budget as percent of fiscal year GNP.

Budget Deficits in Relation to GNP

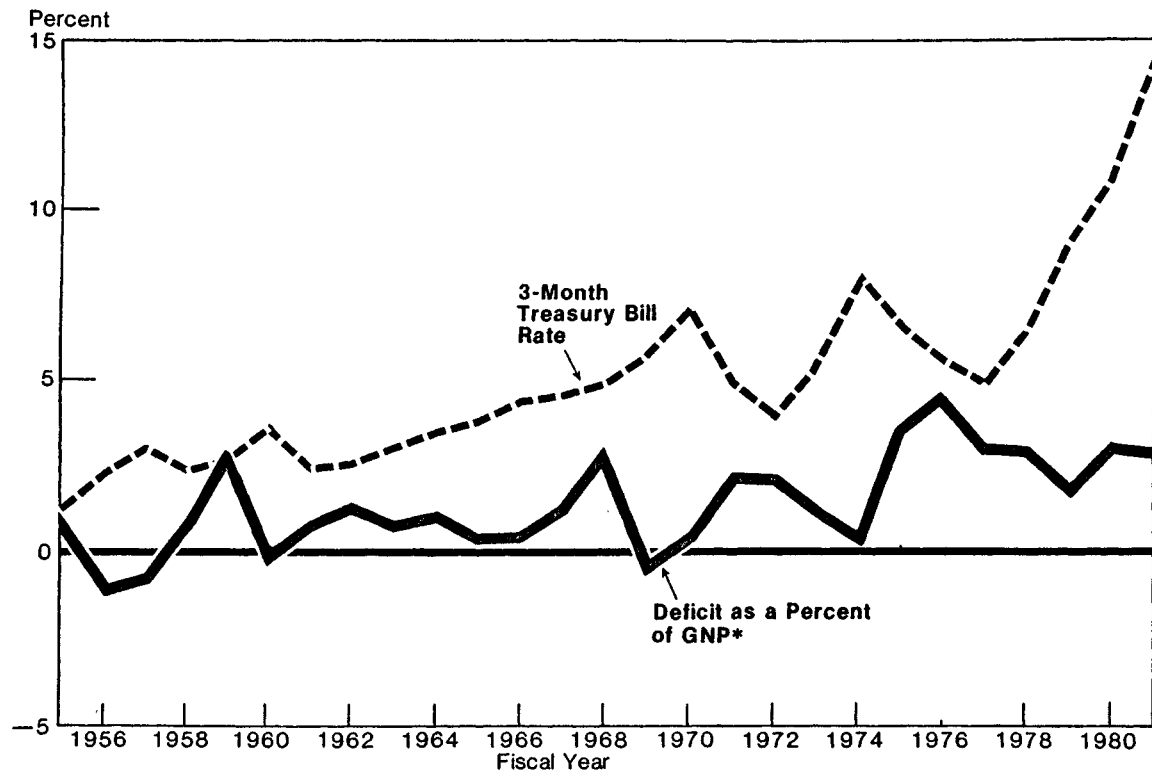
<u>Fiscal Year</u>	<u>Deficits</u> (Bil. of dols.)	<u>Percent of GNP</u>
1975	-53.2	-3.6
1976	-73.7	-4.5
1977	-53.6	-2.9
1978	-59.2	-2.8
1979	-40.2	-1.7
1980	-73.8	-2.9
1981 actual	-78.9	-2.8
<hr/>		
1982 projected	-118.3	-3.8
1983	-107.2	-3.1
1984	-97.2	-2.6
1985	-82.8	-2.0
1986	-77.0	-1.7
1987	-62.5	-1.3

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Note: Figures include off-budget entities.

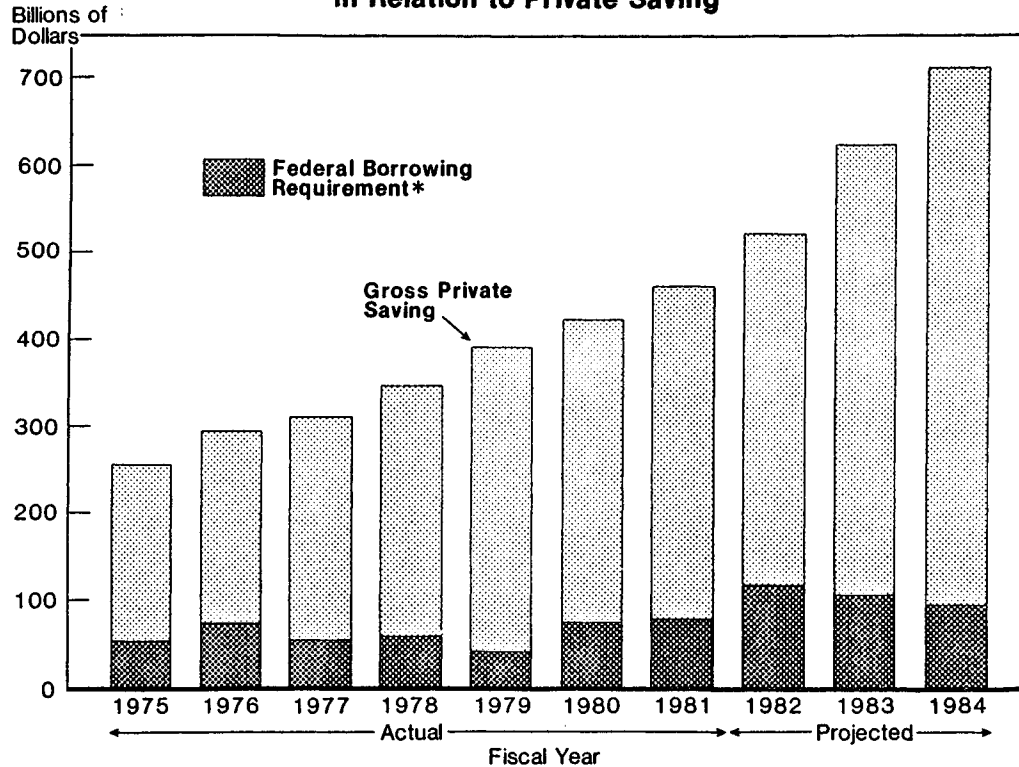
3/23/82

Interest Rates and the Relative Size of the Deficit



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.

Projected Borrowing Requirement in Relation to Private Saving



* Total budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

March 24, 1982

Projected Borrowing Requirement in Relation to Private Saving

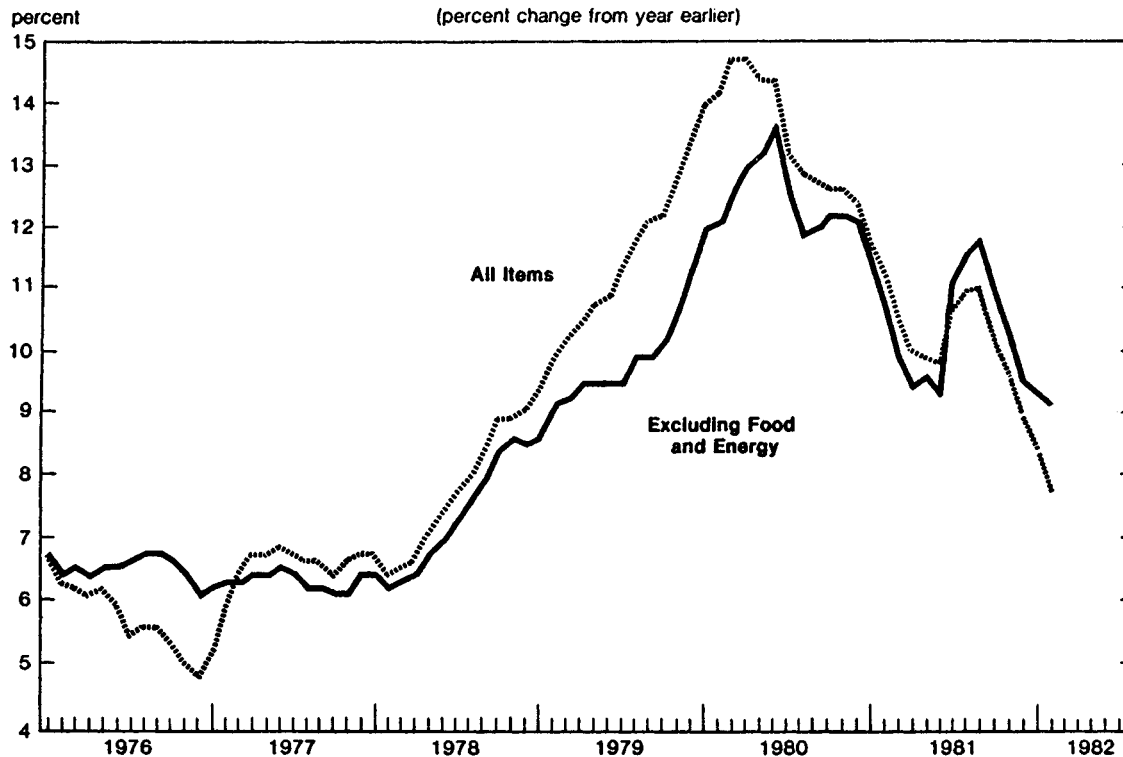
<u>Fiscal year</u>	<u>Gross private saving</u> (---billions of dollars---)	<u>Federal deficit including off-budget</u> (---billions of dollars---)	<u>Deficit as share of saving</u> (percent)
1975	253.4	-53.2	-21.0
1976	295.6	-73.7	-24.9
1977	309.8	-53.6	-17.3
1978	347.4	-59.2	-17.0
1979	392.2	-40.2	-10.2
1980	423.0	-73.8	-17.4
1981 actual	462.3	-78.9	-17.1
<hr/>			
1982 projected	523	-118.3	-22.6
1983	624	-107.2	-17.2
1984	712	-97.2	-13.7

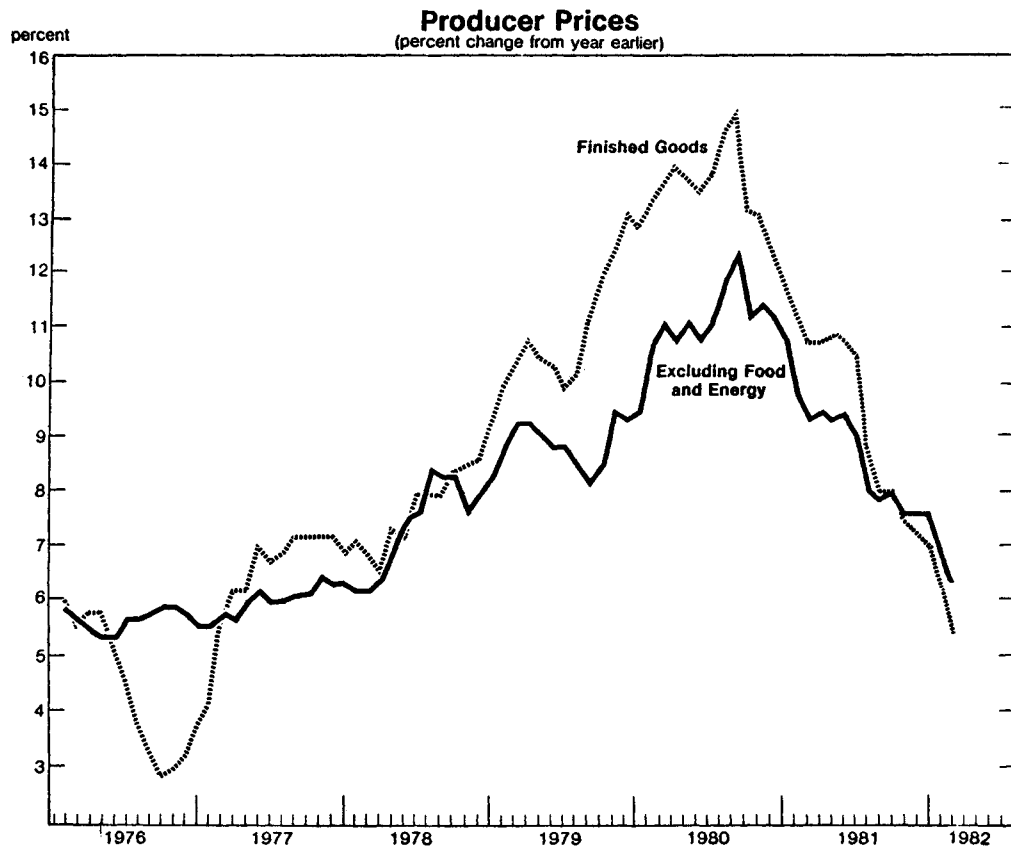
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3/23/82

Consumer Prices

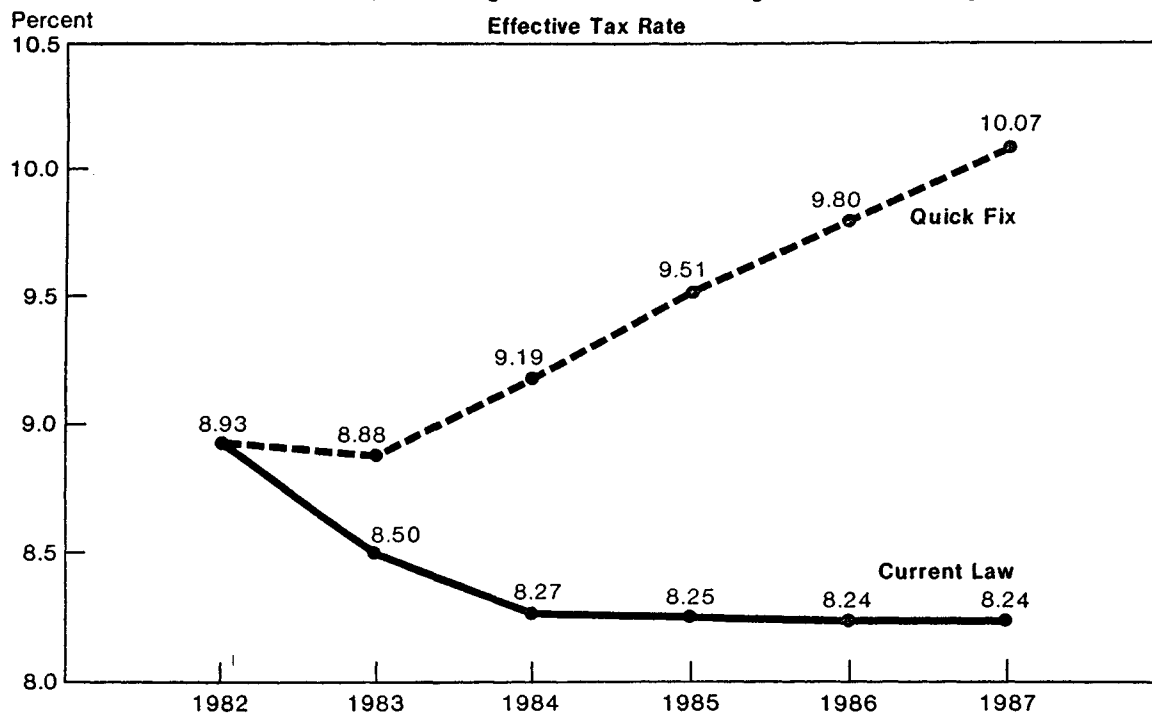
(percent change from year earlier)



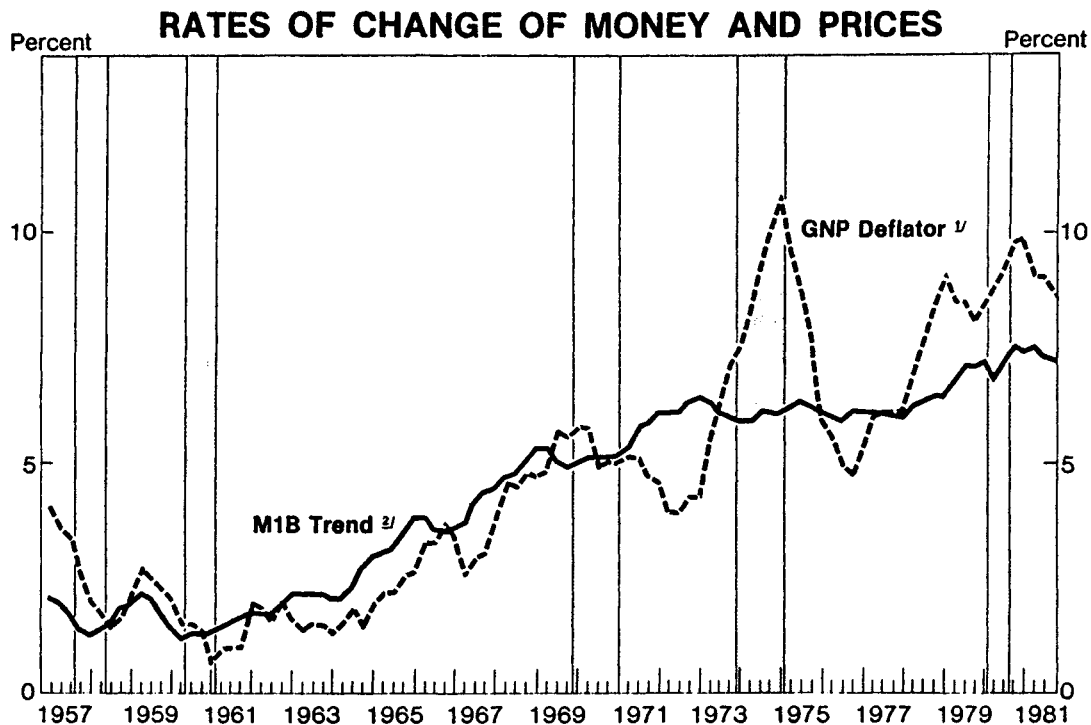


Current Law Tax Reduction vs. Quick Fix Alternative

Worker with \$20,000 in Wage Income in 1982 Rising with Cost of Living



Quick Fix alternative leaves the July 1, 1982 tax rate reduction in place, but cancels the July 1, 1983 tax rate reduction and indexing.



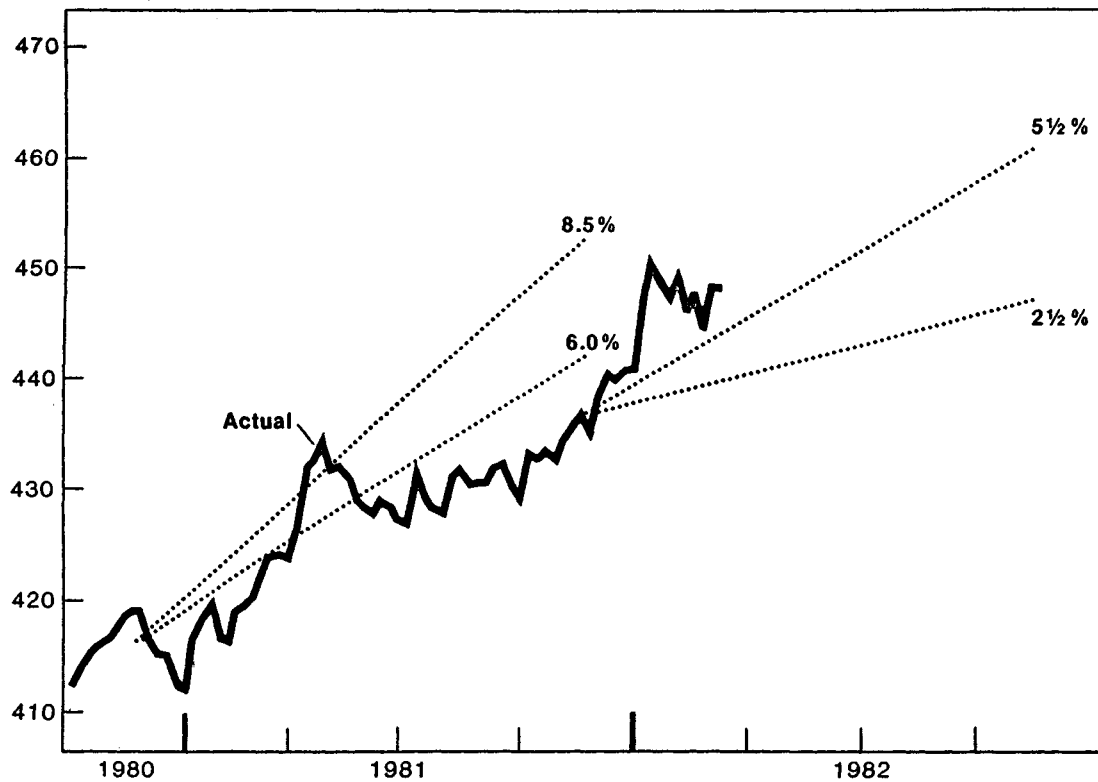
1/ Four-quarter rate of change;

2/ Twenty-quarter rate of change; data prior to 1st quarter 1964 are M1.

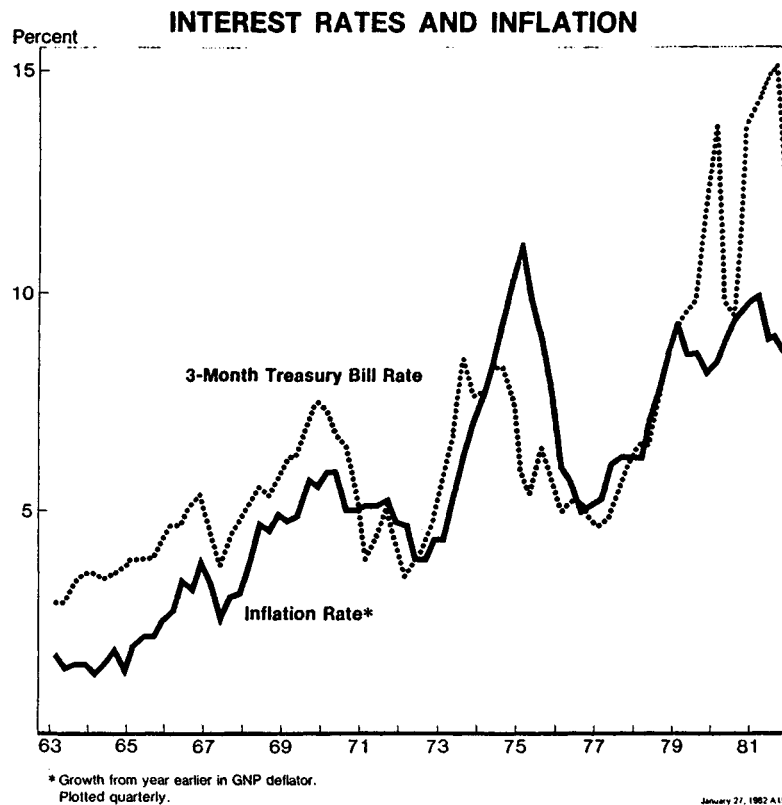
Latest data plotted: 4th quarter

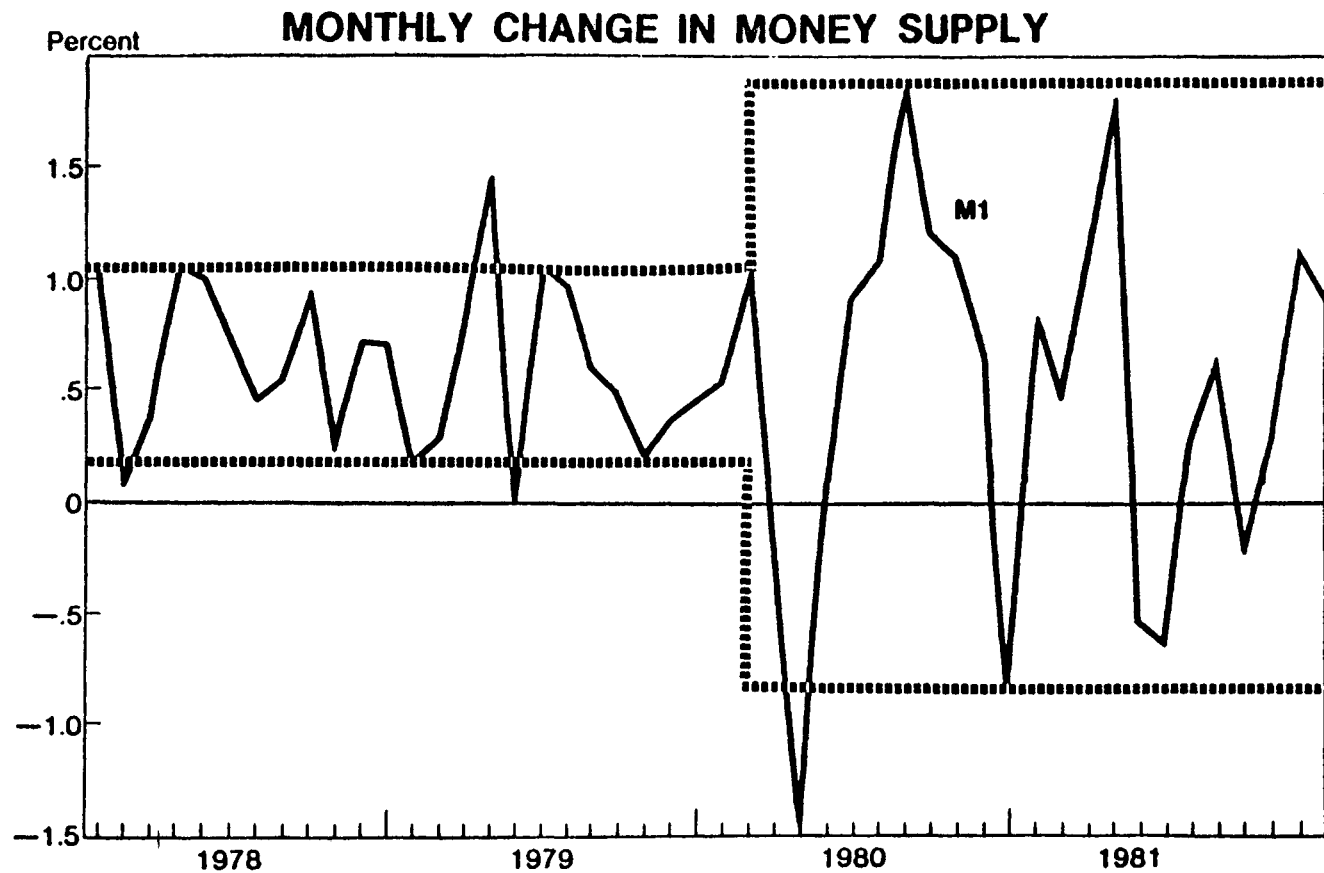
January 27, 1982-A164

M₁ VERSUS TARGET RANGE*

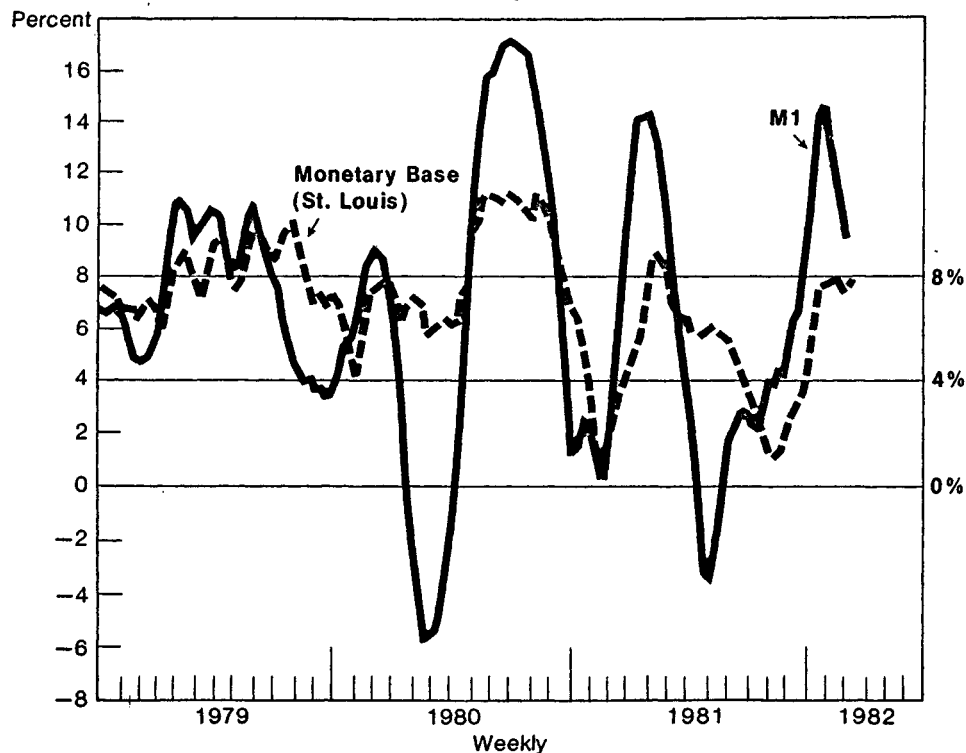


*Weekly Averages-Seasonally Adjusted

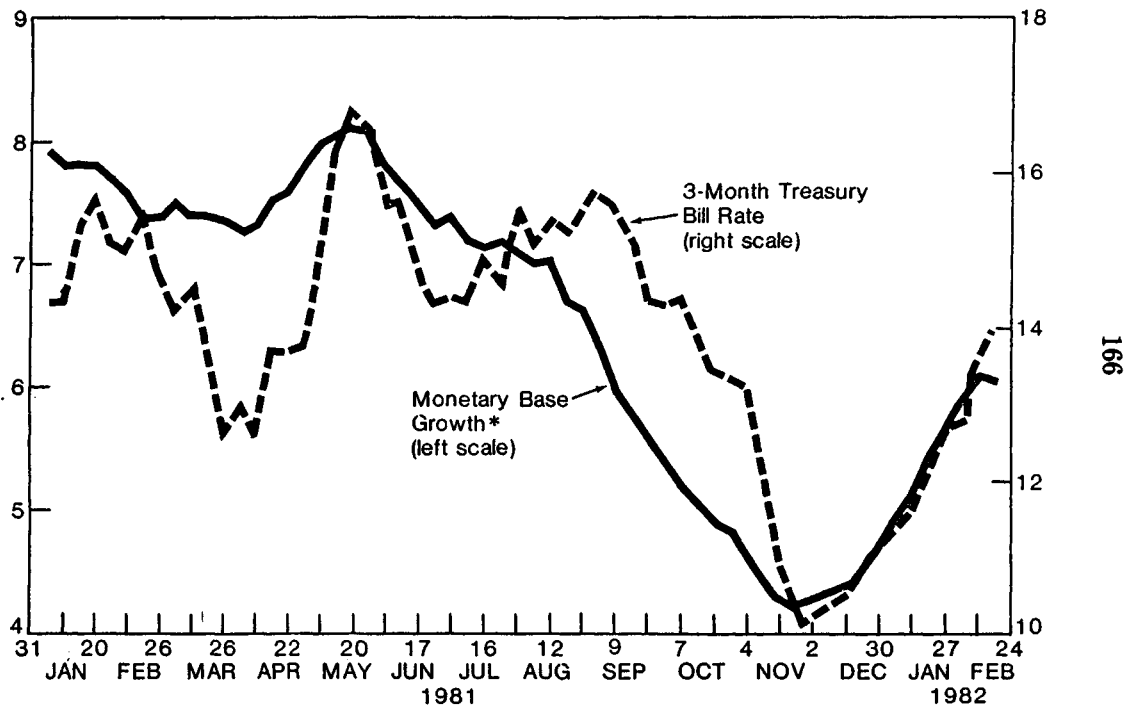




Quarterly Rates of Growth of Monetary Base and the Money Supply (M1)*



Monetary Base Growth vs. 3-Month T-Bill

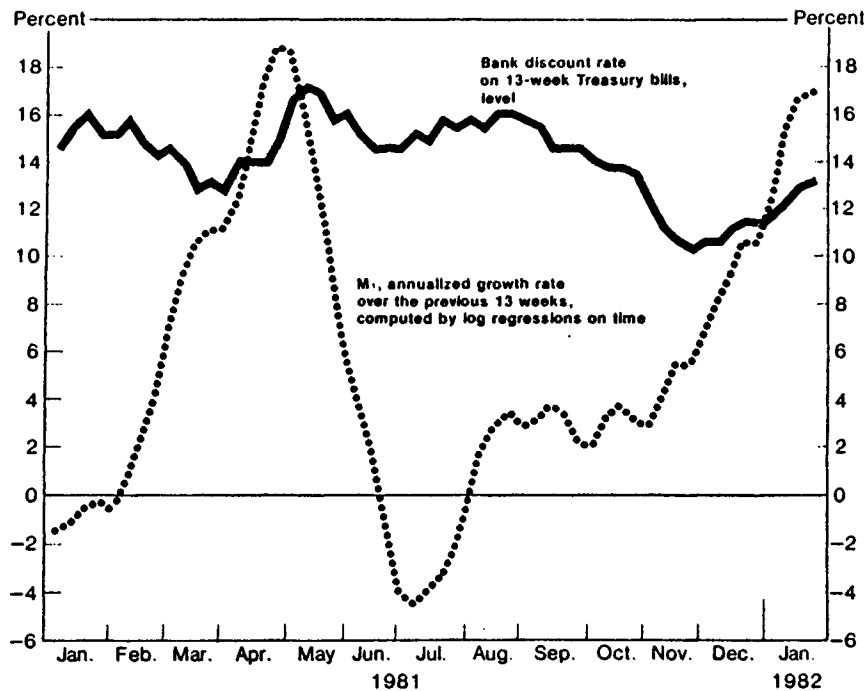


*52 Week Growth on 4-Week Moving Averages

NOTE: Monetary Base data do not reflect recent revisions in the series by the St. Louis Federal Reserve.

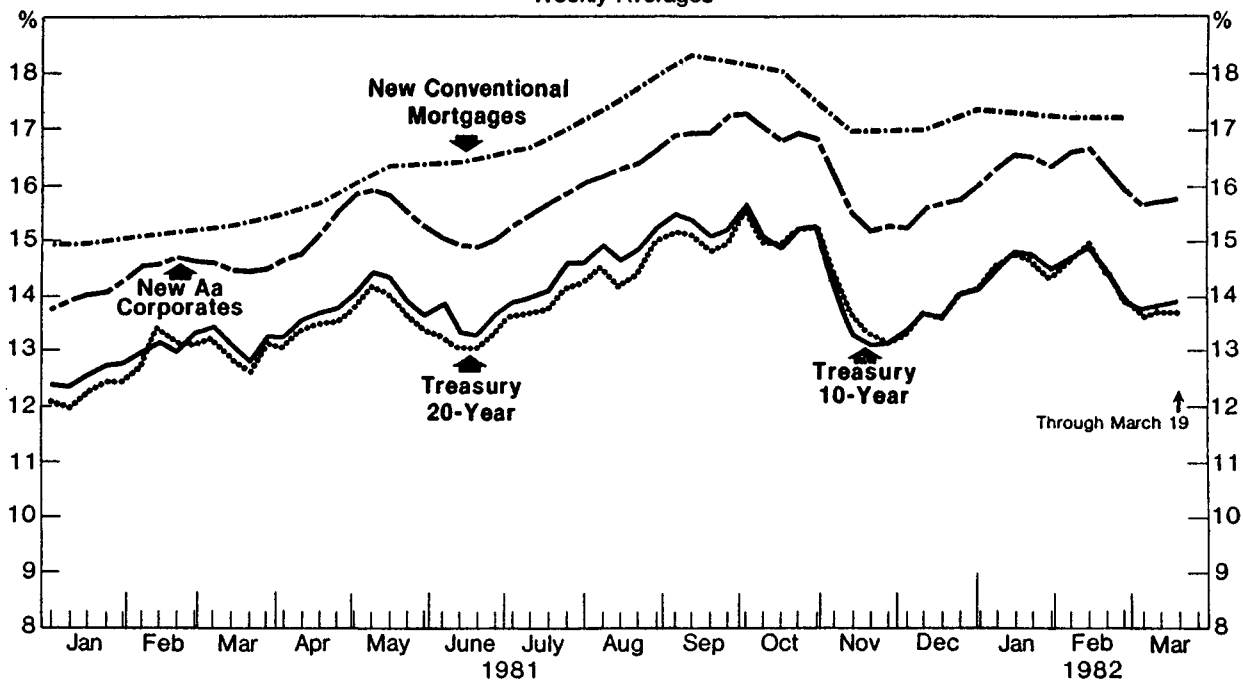
March 24, 1982

THE THREE-MONTH TREASURY BILL RATE AND GROWTH OF M₁



INTERMEDIATE AND LONG MARKET RATES

Weekly Averages



Note: Mortgage data plotted monthly

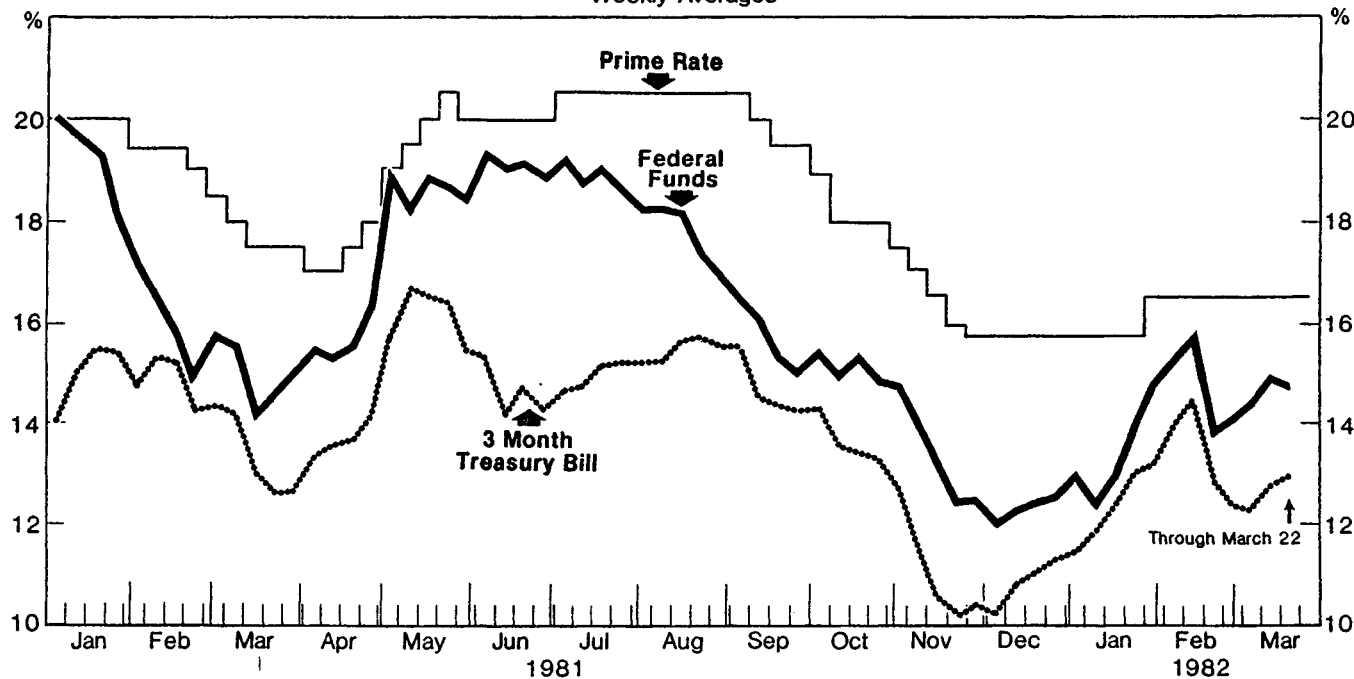
Office of the Secretary of the Treasury
Office of Government Financing

March 24, 1982

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SHORT TERM INTEREST RATES

Weekly Averages



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Office of the Secretary of the Treasury
Office of Government Financing

March 24, 1982

The CHAIRMAN. It was reported in the New York Times on March 26 that you had won a fight within the administration to avoid including revised economic forecasts in the administration's April 10 letter to Congress containing the administration's reestimates of future deficits.

Was that an accurate report, incidentally?

Secretary REGAN. I don't think there was any fight. There was a discussion within the administration as to what should be in the letter that, as you know, by law has to go to the Congress.

The CHAIRMAN. Let's say it was a discussion and debate. Let us say there was a dissension and——

Secretary REGAN. There were differences of opinion.

The CHAIRMAN. Oh, all right. You prevailed.

Secretary REGAN. Let us say that we are not going to submit those. I don't think we have to go through that exercise again until July.

The CHAIRMAN. All right. Now we know that Mr. Weidenbaum feels that unemployment will rise no more than 9 percent. Mr. Kudlow says that recovery will not be as strong as the administration has predicted. Now, we are told that. Did you meet with the President earlier this morning to discuss the economy again?

Secretary REGAN. No; I did that last Friday.

The CHAIRMAN. OK. At that time did you give him an economic forecast in terms of real GNP interest rates, unemployment, and inflation for those items discussed?

Secretary REGAN. No; I did not because we already have in place our forecasts. I brought him up to date on what was happening in the economy.

The CHAIRMAN. Would you share with this committee your forecast as far as GNP is concerned between now and what will be? What is your economic forecast for real GNP between now and September of this year? Can you share that with us?

Secretary REGAN. The Commerce Department flash indicates that their preliminary figure is minus 4.5 in real growth for the first quarter of calendar 1982. We believe that the second quarter will be a plus quarter but not very strong, perhaps between zero and 1 in that area. We are expecting a recovery somewhere oh, 4.5 to 5, in through there, for the third quarter of 1982.

The CHAIRMAN. With respect to interest rates between now and September of this year, would you give us your own forecast as to what we might look forward to? That is a very, very important point.

Secretary REGAN. I understand that. I spent 35 years on Wall Street ducking that question.

The CHAIRMAN. You are now Secretary of the Treasury.

Secretary REGAN. I understand that. Even the Secretary of the Treasury is not very precise when trying to project interest rates. I would say, Mr. Chairman, that I think that interest rates will probably start down, if any movement is seen on getting the deficits down.

I think that is one of the reasons they are high now. I think that if there is an indication that the administration and the Congress can work together, to get these deficits down, you will start to see interest rates start down.

The CHAIRMAN. The President submitted a budget and the President has made a point that he and you reiterated this morning the fact that you don't think we should touch in any way, shape, manner, or fashion the tax program that was enacted last year. The President stated that he would not agree to any decrease in military spending.

Given those facts and given the deficit projections by the administration, as well as by the Congressional Budget Office, I would ask you for your projection on interest rates, having those thoughts in mind.

Secretary REGAN. Well, let's put it this way. I can't give a simple answer to that. First of all, regarding our tax program, we didn't say that in no way, shape, or fashion could it be changed. As a matter of fact, we have sent up to this Congress recommendations for tax increases in the neighborhood of about \$13 to \$15 billion.

In addition, the President reiterated again yesterday something he has been saying for the last several months, that if the Congress can show him a comprehensive program that would improve the outlook for the budget, he would be more than willing to look at it.

He is saying that the need to do something about these deficits goes beyond parties. So, I would suggest that if there were such a program that certainly it would be given the most careful consideration at the highest levels.

The CHAIRMAN. But the point is——

Secretary REGAN. The point is——

The CHAIRMAN. Wait a second. The point is that to date there has been a lot of discussion back and forth but no movement. As far as the general public is concerned and the investing public, all we know of is the submission by the President to the Congress of a budget.

Now, given that, I ask you what your projection is. Certainly you subscribe to the budget that was sent here by the President. Under those circumstances, what are your projections between now and September of this year, if there is no change in that budget?

Secretary REGAN. If we could come up with a deficit of \$90 billion, as was approximately called for by the President, if that is what the Congress votes and does that, I think that interest rates will come down sharply.

I think the markets are anticipating deficits higher than \$90 billion.

The CHAIRMAN. Even the administration agrees at this point that that deficit will be higher.

Secretary REGAN. Mr. Stockman sent up a letter saying that it would be about \$4 to \$6 billion higher due primarily to the CCC program, which is running \$4 billion higher for various types of commodities that are going into storage, and also because of the higher rates of interest that are staying consistently high.

The CHAIRMAN. All right. Now unemployment is now above 9 percent; in Rhode Island, above 10 percent. What can we look forward to between now and September of this year on unemployment, given the budget that we are faced with, the only budget we are aware of at this point in time?

Secretary REGAN. I would say we are forecasting unemployment to top out right around this range, in the 9-percent area, let's say

somewhere in that range, give or take two- or three-tenths of 1 percentage point one way or another that would top out in that area.

The CHAIRMAN. You feel at this point it has peaked?

Secretary REGAN. Not peaked, but in the process of it. As I say, it is very hard to be precise here on tenths of 1 percent. Since it is a lagging indicator unemployment will not come down as rapidly as interest rates will, and as other things, such as the leading indicators, will perk up. I would suggest that unemployment as a result will probably stay above 8 percent between now and September.

The CHAIRMAN. So you are stating, if I can make sure I get this clear, that if indeed the President's budget were to be adopted as presented that interest rates between now and September would drop sharply?

Secretary REGAN. Yes.

The CHAIRMAN. Thank you.

Mr. Stanton?

Mr. STANTON. Thank you, Mr. Chairman.

Mr. Secretary, I extend to you a warm welcome for your first appearance before this subcommittee and congratulate you on your statement.

May I make the observation that I am delighted you didn't get into some bidding war on interest rates. Your predecessor in the last campaign changed his mind seven times on interest rates. I am delighted that you didn't get into that subject.

The observation of the relationship between the administration and the Federal Reserve Board I thought best might be put to rest here.

During the last couple of weeks when the new member of that Board, Mr. Preston Martin, appeared before the Senate, it seems to me that in his confirmation he stated that he basically approves of the present policies of the Federal Reserve Board.

I am sure that the President wouldn't have appointed him to that Board if he wanted someone with different views. Wouldn't you agree with that?

Secretary REGAN. Yes; as you noticed, Mr. Stanton, I said in my prepared remarks that we generally agree with their policies, the 2.5- to 5-percent range for 1982, with a recommendation that they stay toward the upper part of that range during most of the year.

Mr. STANTON. I want to keep this moving, Mr. Secretary. In this morning's paper it alluded to the housing task force that the President had asked for and reported to him. It is my understanding that there is quite a similar task force taking place on the thrift industries problems.

Am I right in that? Do you have a deadline to report to the President with recommendations or is that a wrong assumption?

Secretary REGAN. What has happened here is that the Cabinet Council on Economic Affairs, which I chair, has had the responsibility for monitoring the thrifts ever since we took office because right at that point the thrifts were in perilous condition and they remained that way.

So, we are constantly monitoring it. There is no particular task force that has a certain date they are supposed to come in.

There is a working group of assistant secretaries, under secretaries and the like, who monitor the thrift industry on a week-to-week

basis and report to the Cabinet-level Council on Economic Affairs once a month.

The CHAIRMAN. Is this a large group that works on this problem?

Secretary REGAN. I would say there are seven or eight members to it. There are representatives of the Treasury, OMB, Labor, Commerce—I am trying to think. I know that the White House has a member on it. There are several other departments that have members on it.

Mr. STANTON. Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. Welcome, Mr. Secretary.

You have testified that both the administration and the Fed agree on the super-tight 2.5 to 5.5-percent monetary course, a course which, as you know, I think is wrong. In fact, we are now approaching the end of the first quarter of 1982, and the Federal Reserve in fact has created new money at double the ceiling rates.

The ceiling is 5 percent. They have created it at 11 percent. That means that for the remaining 9 months of this year the administration and the Federal Reserve will be enforcing an even crueler diminution of the money supply.

Do you really think that you are on the right course?

Secretary REGAN. From where the Fed is now, slightly above their target—

Mr. REUSS. Double their ceiling?

Secretary REGAN. The last 15 weeks it is down to 8.5 percent. So they are starting to take that January bulge out of the money supply. If they go to a 4-percent rate for the next 3 or 4 months and then continue at a 5-percent rate, they will come right out in the high side of their target, which is exactly where we would like to see them.

Mr. REUSS. Well, I believe you are heading for continued disasters by your refusal to adopt a reasonable rate of monetary growth.

I come now to my second point. Admittedly the money growth of the Fed has over the short term, during 1981, been volatile. It has bumped up and down. You have a chart here showing that up until October 1979 it wasn't at all volatile. After October 1979 it got very volatile.

Now, all during last year there was testimony by the administration, by the Treasury, by Mr. Stockman, by Mr. Weidenbaum, by Under Secretary Sprinkel and many others, including yourself. Not one of them made the slightest complaint during 1981 about volatility. Indeed, the general administration testimony was: Don't worry about volatility on a month-to-month basis, you have to look at it on an annual basis.

Now, in 1982 you, Mr. Secretary, have taken the position that the Federal Reserve is way off base, somehow, for its volatility. You say on page 11 of your testimony "Volatile money growth undermines the credibility of long run monetary controls."

My question: Why didn't you tell us that during 1981?

Secretary REGAN. I will try to find you the citations for this. I am sure that I did talk about it. I thought the chairman in some of the headlines that he had clipped from the Times and other things would go back a little further.

I criticized the Fed, if you will recall, at the end of August 1981 and was promptly taken to the woodshed by most people, including most economists.

Mr. REUSS. What did you criticize them for?

Secretary REGAN. Too tight a money growth.

Mr. REUSS. But that has nothing to do with volatility? You were right, briefly.

Secretary REGAN. At the same time I was so critical of their volatility that I likened it in a speech to a golfer. This story became so famous that Paul Volcker's daughter actually drew a picture of this and I have it signed by him.

I am not sure, Mr. Reuss, that you are a golfer, but as one who loves the game, you start off, and this is your fairway and here is your tee and you shank one off the tee into the woods. Then you come out of the woods and cross over here into the rough on this side of the fairway. Then you land up near the green in a sandtrap. Then you sink one from out of the trap and you have a four and a par four. You say I have got my par.

That is exactly what the Fed did last year. They came out slightly under their target, in their range, though, but they did it by the worst volatility I have ever seen. They were up to 12 or 13 percent the first part of the year. They were almost zero growth from April through October. Then they pumped it up again in November and December. So the volatility was there.

[Secretary Regan subsequently submitted the following additional comment for inclusion in the record:]

ADDITIONAL COMMENT RECEIVED FROM SECRETARY REGAN

My concern about the volatile growth of the money supply followed explosive growth last spring, and a falling money supply in early summer. There was virtually no growth for the 6 months ending in October, 1981. I raised these concerns first in private discussions with the Fed, and more publicly beginning last August. In the November to January period, money grew very rapidly, at rates approaching 16 percent per year. My Joint Economic Committee testimony on January 27 contains a more detailed statement of the volatility program.

Mr. REUSS. If I take up golf again, a pastime I admit I have been forced by the pressure of duties to quit doing——

Secretary REGAN. I also have, in the current job.

Mr. REUSS. And if you are my coach, I will want you to tell me when I am slicing and hooking, not wait until the season is over and then claim that that is what was wrong with my 36 point handicap.

Anyway, please either furnish me or the committee with some evidence that you were sounding the alarm on this volatility during 1981 when it was occurring. Unless you do that, let's not hear anymore of it because it really is a copout.

The trouble with the administration is that it endorses the Federal Reserve's too tight monetary policy. The trouble is not that there is volatility. Volatility is what comes from the October 1979 reform, which everyone—you, I, everybody on this committee—approved of.

So, let's not dump on volatility. The real evil is the too tight, too extreme corset in which you and the Federal Reserve are placing

this country. That is what is causing the bankruptcies, that is what is causing the unemployment, the deficits.

Secretary REGAN. I have to disagree slightly there, Mr. Reuss. If you ask the Wall Street traders, the international money traders and the like, treasurers of corporations and the like, ask them what worries them about the money supply, they will use such words as uncertainty, volatility, and the like.

This does have quite an effect on interest rates inasmuch as there is an uncertainty premium. They don't know what is going to happen. Were the conditions a lot smoother, as the Fed is trying to do, and if they were to achieve that goal, there would be a lot less of this uncertainty.

As a result, I think you would have some of that real rate volatility premium out of interest rates.

Mr. REUSS. I have asked the traders—I have even talked to people at Merrill Lynch—and what they tell me is the big trouble with uncertainty is that you and the Fed pose unrealistically low targets. Then the Fed goes over the target and of course it drives them bonkers.

But that is another day. My time is up.

The CHAIRMAN. Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman.

Just before you appeared, Mr. Secretary, the majority leader was just ahead of you. I did not get a chance to question him, but I wanted to say to him that he is a very articulate spokesman for his position.

He suggested that the culprit for high interest rates is the tax cut program, and you have a difference of opinion on that. He also suggested that Mr. Volcker is adding to the problem with his tight monetary policy. He even went so far as to suggest that maybe Mr. Volcker ought to resign unless he adopts more accommodating monetary policy.

I wanted to tell him I respectfully disagree with him, as I do with the distinguished chairman of the Joint Economic Committee.

I note on page 11 of your statement, which you presented ahead of time, that faster growth of the monetary base produces faster growth of M-1 and is associated with rising interest rates. Slower growth of the monetary base leads to slower money growth and falling interest rates.

I noticed an article in the Washington Post this morning that says, "Yields on short-term Treasury securities went up yesterday after declining for 3 of the previous 5 weeks. The rise followed a \$500 million increase in the money supply last Friday." So interest rates went up with this increase.

I also wanted to ask him this question: M-1 growth during the past 12 months has been over 6 percent. During the past 3 months it has been over 9 percent. Just how fast should he think money growth should be?

Do you think that would have been an appropriate question, given the scenario that developed with his statement?

Secretary REGAN. I think you are entirely right on asking that question, Mr. Wylie, because we used the adjectives tight, easy, loose, and so forth in a very imprecise fashion.

The Fed literally has not been too tight with its money over the past 3 months. As a matter of fact, if anything they have been too loose with money. Yet, they are condemned for that.

I would like to go back to your first point that you made and to respectfully disagree with the majority leader that tax cuts lead to deficits. If that is the case, then you are saying that the working man, the average American Joe out there in the street is causing the deficit.

Now, I fail to understand how the average working man in the country is causing this deficit. I think that deficit is caused by us, the Congress and administration, spending too much money.

As much as anything else, that is it. Certainly not by cutting a guy's taxes are you causing an increase in deficit unless we—that is the Federal Government—own all of the money in the world and everybody works for us.

I have to disagree with that statement.

Mr. WYLIE. I disagreed with it, too, and wanted to say so. I happen to think the real culprit for high interest rates is the huge budget deficit right now and the anticipation that it is going to be even larger.

I think that as a member of Congress we have a responsibility to try to help the administration, try to help the President bring that deficit down. In that connection I have suggested that maybe there ought to be a reduction in defense spending, which I have said to you before when you appeared before the Joint Economic Committee, and perhaps even an excise tax on tobacco and alcohol.

I have now added maybe a tax on luxuries like that which we had during World War II. Would you care to comment on that?

Secretary REGAN. Well, I would put it this way: Again, if you put on too much in the way of excise taxes, again that is going to cut down on consumption. Cutting down on consumption as we start to come out of a recession might be self-defeating at this particular time.

I think there are other ways to raise whatever revenues are advisable in ways that wouldn't be as counterproductive as perhaps direct excise taxes might be.

Mr. WYLIE. You mentioned one in your testimony. You spelled out the beneficial effect of improved growth rates on the economy of revenues and lower deficits, as you put it. Then you suggested that you favored borrowing to finance the deficit rather than rescinding or deferring the tax cut.

Isn't borrowing to finance the public deficit part of the problem we have vis-a-vis high interest rates now?

Secretary REGAN. Yes. Obviously if we are going to have a deficit and we take that as a given, we in the Treasury have to get that revenue somehow or another. If we get it by taxes, going as they are now about 20 percent of GNP, we think that the tax rates, will become so high that it will discourage increases in work effort saving, and investment. They will say what is the use? Government will take it away from us.

That has happened time and time again in other countries. It leads to tax cheating. It leads to all kinds of endeavors to get out from under the burden of taxes.

On the other hand, if we borrow, certainly we will be competing with American industry for whatever pool of savings there are. But we think that with the incentives of the tax cut the annual rise in savings will exceed the size of the deficit; in other words, savings will grow faster than the deficit, so that there will be an increasing amount of money available for business; not as much as if we had a smaller deficit, but nevertheless sufficient, we think, to handle it.

Mr. WYLIE. I have one more question. I was called out a little while ago by Mr. John O'Neill, president of the National Association of Industrial and Office Parks. He says current market conditions are terrible and nothing new in the foreseeable future will allow anything to come into the pipeline.

He suggests something which the home builders said to me. He said, "Lowering of the Federal discount rate to recognize realities of the marketplace might help bring interest rates down."

Now, I don't happen to think that would be the answer to it, but I would like to have your comment.

Secretary REGAN. I don't think that is particularly what is needed at this point. The discount rate will come down automatically as other rates of interest start to come down.

Again, I think the whole key—I am sincere in this, not just posturing—I think the whole key here is the size of the deficit. I think that is the main worry that the money markets have at this point and is holding up the fall of interest rates, which traditionally should be falling since we have got inflation down this much.

Mr. WYLIE. Thank you very much.

The CHAIRMAN. Mr. Gonzalez?

Mr. GONZALEZ. Thank you.

Sir, when I got the notice of this meeting a week or so ago I had thought of preparing some questions, mostly questions having to do with the Chinese fortune cookie predictions that you and other administration spokesmen have been giving out on the economy and so forth.

But then I read your statement, and I wanted to thank you for having submitted it in time to examine it before the meeting. Right off the bat, on the first page, you say, "More importantly, we have in place a sound, long run tax system for the 1980s."

Now, any man or woman that would come before us with that kind of a statement is beyond remedy. There is no use asking questions. It just can't be that you are that obtuse.

So, the only thing I can ask occurred to me as I was listening to you, and you pointed out that as having been identified, as you have been, with this great market operation, and on page 7 you have the statement, "I am surprised that others in commerce or industry do not appreciate the importance of the individual in the roles of employee and customer."

I don't know if you can, but can you tell us specifically who you are speaking of? Don't you come from the middle of that general section of the economy known as "employers in commerce or industry"? What do you refer to there? I am surprised that others in commerce or industry do not appreciate the importance of the individual?

Secretary REGAN. I will be glad to. You say I am beyond redemption. If you mean that cutting taxes makes one ready for the gates of hell, I think that is a hell of a statement to make.

Mr. GONZALEZ. Oh, no, sir.

Secretary REGAN. I do think that what we have crafted—

Mr. GONZALEZ. That is not what you said. That is not what I quoted. You are talking about a sound, long run tax system for the 1980's.

Secretary REGAN. That is what I believe it is.

Mr. GONZALEZ. And I am saying that anybody that has taken place and proudly admits to a \$750 million giveaway in a 5-year period to the biggest vested interest of this country—and you are talking about the individual little taxpayer that is getting nothing in the way of tax cuts, at least not even meaningfully for the first 3 years—has to be either obtuse or just a member of the modern day cult, because we have a cult known as Reaganomics.

Secretary REGAN. I am proud to be a member of that cult.

Mr. GONZALEZ. That is what I am saying. But don't distort the criticism. Don't say that that means that immense task reduction because that is not what we are talking about. I am talking about a statement, a categorical statement that in the light of what actually happened has presented the country.

You can say that that is my interpretation, but this seems to be the conclusion of many, many preeminent experts that are not in politics that it now represents one of the most regressive tax systems of any country, not just the United States; very regressive to the point of unfairness. After all, the hallmark of a good tax is fairness.

That is what I was referring to. So you know it doesn't surprise me, in anticipating answers to questions, but for you to now follow through and obviously distort the thrust of my questioning of that statement I think adds insult to injury.

Secretary REGAN. I think the tax cut we made was fair. It was across the board. An equal percentage for everybody. What could have been fairer than that? We coupled that with a very fast depreciation schedule in order to modernize business, to make it more productive, to try to get more jobs available for people. I think that was well done.

What I was referring to in my remarks about industry and commerce, and people of that nature, is that there have been statements by business leaders, particularly those in the Business Round Table, urging that the third year tax cut be done away with but the business tax cut preserved.

That is what I don't understand, how business can say take the tax cut away from an individual but preserve our tax cut for us, realizing, or not realizing, that the laborer and the worker who would be taxed higher as a result of this is their customer and their consumer. If they don't want that person to have the money, they want us to have it here in the Federal Government to spend. I just don't follow that line of reasoning in commerce and industry.

Mr. GONZALEZ. But sir, even the President, if I recollect correctly what he said not too long ago, was admitting that there was need for some revision, some correction I think is the way he put it, of

some of the tax features that were included in what you say is a perfect tax measure.

Am I not correct in saying that?

Secretary REGAN. No. What we are saying is that we are not correcting any of what we did last year. There are other sections of the code that were previously enacted, or interpretations of the code that have been thought up since the laws were passed by the Congress.

I will give you an example of what I mean, Mr. Gonzalez. In the paper this morning you may have noticed that the Equitable Life Insurance Co. paid no taxes whatsoever last year, in spite of the fact that the year before they had paid millions and the year before that hundreds of millions in taxes, all because of an interpretation of the code called a modification for insurance companies in which they changed their method of accounting and set up separate corporations to co-insure.

Now, that is an interpretation of the code that was never approved by this Congress. That is an interpretation that was never approved by the IRS. It is something we are asking the Congress, therefore, to change so that these people will pay at least a minimum tax, like you and I do.

It is that type of thing, that we have suggested to Ways and Means for additional revenues for fiscal year 1983.

Mr. GONZALEZ. I recall the President was addressing himself specifically to the tax bill that was passed last year. I think with reference to the purchase of these tax credits——

Secretary REGAN. On leasing. It may well be that leasing will have to be modified in view of experience. We don't know. We have a further study coming out. We have issued our initial ones.

There have been proposals from some that we abandon leasings. The airline companies tell us if we abandon leasing, they can't come up with any new equipment. The steel companies tell us the same thing, as do some of the other types of industries.

Automobile companies in particular say don't do away with that, don't modify it. So we are looking at it from both sides at this particular time.

The CHAIRMAN. Mr. Evans?

Mr. EVANS. Thank you, Mr. Chairman.

Mr. Secretary, I must admit that I have to make my pars these days in the manner you described, out of a sandtrap. My handicap has gone from two to eight and is still climbing in the short number of years I have been here.

I was not here for the distinguished majority leader's testimony, but I understand that he described the tax cuts that we enacted last year as monstrous in nature.

I would just like to point out for the record that the 5 percent tax cut that went into effect October 1 meant we had a 1¼ percent reduction for 1981. Since this is the last day or close to the last day of March, we have had an additional 1¼ percent, which amounts to a current total of 2½ percent. That is not even enough to offset the increases in the social security taxes that went into effect in January. It seems to me that we have not given that tax cut and that tax incentive and that stimulus time to work.

Mr. Secretary, would you care to comment a little further on what a deferral or rescission of the personal income tax cuts might mean to the financial community and to others?

It seems to me that we need some stability in this economy, and that is one thing that the President is bringing to it. His program is fundamentally sound, but that doesn't mean we can't make some tactical modifications to perhaps make it even more sound and preserve its credibility.

In my opinion, to defer that tax cut now would be spectacularly ill-timed in view of the recession that we are in. Could I have your comments, sir?

Secretary REGAN. Yes, first of all, as you know, Mr. Evans, on July 1 of this year all taxpayers get another 10 percent cut. Since we are in a recession and by that time will be just emerging from the recession, even a Keynesian would say that has to be well positioned at this particular moment in order to stimulate the economy.

Mr. EVANS. If you will yield, sir, there have been some who have suggested that we defer that tax cut, even the tax cut for 1982. I just think that would be going in the wrong direction.

Secretary REGAN. That would be absolutely the wrong direction because we do need stimulus to the economy. We do need not only more spending, but we need more savings and we would get neither if the Federal Government hangs on to that money.

The second tax cut comes July 1, 1983. There again, hopefully, we will be in a more prosperous time. But if you consider why should that one go—

Mr. EVANS. I think we will reach more prosperous times if we are steadfast in the direction we are going, Mr. Secretary.

Secretary REGAN. I agree. Mr. Evans. In 1981 there was a 1¼-percent tax cuts for individuals, as you said. This year we will get a total of 14 percent between the 10 percent of the second half of the year and the remainder of the 5-percent cut.

Put those together and it just about keeps an individual even with inflation, plus the social security tax increase. So that the first tax cut an individual literally gets is in 1983. It won't be until then that we will give anyone a tax cut.

Why you should take the only tax cut that a person would get in 3 or 4 years away from them is more than I would know. I think that the taxpayers deserve that break.

Mr. EVANS. I agree with you. I think they do deserve that break.

Mr. Secretary, we are having, in the midst of this recession, an unusually difficult time for some industries; the automobile industry, the real estate industry, the homebuilding industry.

I have heard a number of proposals to help specifically the home buyers, the homebuilders, the realtors. They have historically led us out of a recession. I think they can lead us out of this one.

Most of the programs that I have heard would aggravate an already bloated Federal deficit rather substantially. If we could come up with something realistic that did not aggravate that budget deficit, you would not oppose it as a matter of principle?

I am thinking of a gentleman from Texas, Mr. Gonzalez, who talked about tax breaks for the biggest vested interest in this country. One of the tax breaks that we are providing for Mobil and

Texaco and some consortiums of Japanese and Germans comes through the Synfuels Corporation and in the form of a subsidy.

It seems to me that we might consider taking some of what has already been authorized and appropriated there and provide a little of that for home buyers and realtors and homebuilders. I think that would make some sense if we didn't increase the budget deficit.

Secretary REGAN. Well, in general I would agree with the statement that whatever is done by the Congress should not increase the deficits. They are too high now, and they should be cut severely.

As far as what we are doing for homebuilding, the President announced a program yesterday. One of the things that I would like to elaborate on a little bit, because I am not sure people focused on it yesterday, is ever since the start of ERISA and pension funds it has been practically made impossible for these large pension funds to invest in mortgages.

They have about \$500 billion that are now invested. It is primarily in bonds and some in stocks. Only \$7 billion of that is in mortgages out of the \$500 billion. Those funds will soon grow to \$1 trillion and in the out years to \$2-\$3-\$4 trillion in size. If this condition were to persist, again there would be nothing in it for the building industry.

In the Labor Department and in other areas of this administration we are working quickly to change those provisions of ERISA to allow these funds to invest let's say up to 25 percent of their funds in mortgage. That would be a pool of \$250 billion of capital available.

Now, we all know the thrifts are in dire straits. We are not sure how soon their recovery will take place and how soon they will be back into the mortgage market with billions of dollars. In the meantime ERISA will more than make up that slack. That is what we are trying to do.

Mr. EVANS. I applaud the initiatives taken by the President yesterday and announced at the National Association of Realtors. I think perhaps we could go a little bit further in providing some assistance to some industries that are in failing health these days without exacerbating the already bloated deficit we have.

I thank you, Mr. Secretary, very much.

The CHAIRMAN. Mr. LaFalce?

Mr. LAFALCE. Mr. Secretary, let us assume, for the sake of argument at least, that the high real interest rate, the difference between the inflationary rate and the interest rate being charged, is caused by the expectation, the probability of excessively high deficits in future years. I think most people would hold to that explanation of the long-term high real interest rates, not the short term.

How do you explain the short-term high real interest rates? The expectation of future excessive deficits should not be the explanation for that.

Secretary REGAN. Mr. LaFalce, I think it is a combination of uncertainties; uncertainty as far as what is actually going to happen to the deficit this year and whether or not there will be crowding out in the near term, as far as the Treasury borrowings versus private borrowings.

I think the second item has to be this volatility in money supply growth rates for the simple reason that money supply growth is an imprecise thing in the marketplace, they do not know what is going to happen to it, whether it is going to be excessive or it is going to be too tight, where they are going.

Institutions have lost money on this. I think as a result you have this unusual premium.

Mr. LAFALCE. Let's assume we both agree that we have to cut the deficit for fiscal year 1983 and in future years. Let's try not to be partisan at all, either you or I. Last night, though, I saw Senator Dole on TV, his Republican credentials are impeccable, he was criticizing the President for being too rigid and not compromising.

This morning I read the Wall Street Journal and I saw that Senator Laxalt said in the Wall Street Journal, and his relationship with the President cannot be questioned, that the President is being too rigid. Both seem to be saying that we have to do something about defense cuts, and about the tax bill that was passed last year if we are going to reduce the deficit.

Since the increase in the defense budget and the reduction in revenues account for such a large portion of the 1983 deficit and the expectation of future excessive deficits, if those two items are removed from the bargaining table, it does not seem to me that one can realistically say one wants to compromise. That seems to me to be what Senator Laxalt and Dole were saying just yesterday?

Secretary REGAN. Maybe in answer to you I could come up with an analogy in a different sport. If we went to play ball and I have thrown the ball to you and you fail to throw it back to me and just complain about the way I threw it or the size and dimensions of the ball or something of that nature, we do not get to play ball. You have to throw it back to me so I could throw it to you unless you expect me to get a second ball more to your liking and throw it back to you.

Mr. LAFALCE. It seems to me the only way we will achieve compromise is if we gather together in the same room, at the same time, at least the following individuals: The President of the United States, the Senate majority leader, the Speaker of the House, and if they walk out of that same room, out of the same door, at the same time, saying the same thing.

The political realities are such that if we are going to make meaningful cuts, if we are going to assuage the fears of the financial markets, we are going to have to do that. And it seems to me that the President is going to have to show some leadership in bringing these individuals into that same room at least.

I do not think that has been done.

Let me take issue with you, if I might, in one area, and I want to focus in on the tax bill now. You have described the tax bill as across-the-board tax cut and ask what could be fairer? You have also said that we need it this coming summer in order to stimulate the economy.

One of the difficulties I think with this administration has not been so much the legislation that has been proposed, but the rhetoric that has been used by some members or supporters of it in the promises that they have used. I think too many promises were

made and associated with the program that was enacted. I think the rhetoric of a supply-side economics has been a gross distortion.

Herb Stein, Chairman of the Council on Economic Advisers under both Nixon and Ford, called the primary across-the-board tax cut bill that was advocated a form of punk supply-sidism, not true supply-sidism.

He said it would stimulate demand rather than supply. If it is to be effective, in helping us out of the recovery this summer, and I certainly think we do need a tax cut effective this summer, it will be primarily because it stimulates aggregate demand as opposed to stimulating supply. All tax cuts will stimulate both. It is a question of what the primary effect will be.

Insofar as the fairness of the cut, that is where I take issue with it. Not whether we should have had a cut, but the equity of it, the distribution of it. You say what could be fairer than across-the-board. That is so simplistic.

What happened to the personal exemption? We did not touch the personal exemption? We are going to do it, we think, in 1986 or 1985, when indexation goes into effect, modestly, but what will inflation have done to it by that time.

Of course the theory of the personal exemption is that you should not tax that portion of a person's income necessary for his daily sustenance. We did not touch that. That hurt the little guy a heck of a lot more than it hurts the big guy. So it was not fair to the little guy. What did we do for the standard deduction or zero bracket amount? We did not touch that and inflation has eroded that.

Of course, 72 percent of American taxpayers do not itemize. They really need an increase in the zero bracket amount. So I can suggest a number of things that would have been fairer than the across-the-board tax cut.

Also, when you speak of the across-the-board tax cut, you speak of it as if it is so fair because it is the same percentage cut in one's taxes for all. But, more than 50 percent of Americans pay more than 50 percent of their Federal taxes through the social security tax, not the income tax.

The across-the-board tax cuts that only impact the income tax rather than the social security tax, will cut 10 percent of far less than 50 percent of the total Federal tax burden for most Americans compared with 10 percent of perhaps 96 percent of the tax burden for the individual who is making \$100,000 or more.

So on all of those scores, I find the rhetoric and the substance of the tax cut bill that was promoted by the administration and passed by the Congress inequitable and ineffective. I am sure you care to comment.

The CHAIRMAN. If I may interrupt for a moment. The bells are for a vote to approve the journal of previous day's record, and the Chair is not going to participate in that vote. I shall stay. If Members want to go to vote and return, we will keep the hearing running. Sorry to interrupt.

Secretary REGAN. Well, Mr. LaFalce, I would say this, that one of the things that you have overlooked is that the personal exemptions and the standard deductions have been raised several times since 1969.

Mr. LAFALCE. Not since 1978.

Secretary REGAN. The tax brackets have not been changed since 1965.

Mr. LAFALCE. Kemp-Roth did not change the tax brackets at all, it changed the rates.

Secretary REGAN. The rates themselves have not also been changed since 1965. So I think that what you are saying here is that in spite of inflation, which I think has been primarily due to the Federal Government—the Federal Government is the cause of inflation—because inflation has kicked the average wage earner into higher brackets, we should continue to tax that away.

As I pointed out in my testimony, we raised taxes \$250 billion in a 4-year period from 1977 to 1981. Then we went ahead and spent an additional \$200 billion which ended up as deficit. I think that if you were to keep that system up, you obviously are just going to discourage anybody from working. You are going to make an effort poured into tax shelters and that sort of thing much more worthwhile instead of more productive investments.

I think you have to think through how do we finance these deficits that we are creating. As a result of that, I think that you have to come to the conclusion that the only way to do that, literally, is through greater savings rather than monetizing the debt and causing inflation.

Unless you are prepared to do something to create savings, that is to leave more money in the hands of individuals, you will not get that great a savings. So our tax program was designed along that route, to increase savings.

The business side of it obviously was designed to get a more productive United States. Our plants, equipment, so forth are gradually becoming outmoded, and depreciation allowances could not keep up with inflation. The net result of that is that we are now trying, through the 10-5-3 method to get depreciation allowances closer to the rates of inflation.

We think perhaps we will be able to achieve that.

Mr. LAFALCE. Personal exemption, by the way, was \$1,000 in the 1930's. Then for World War II it was cut in order to raise money. So right now it is still where it was at in the 1930's, Mr. Secretary.

The CHAIRMAN. Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman. It is always a pleasure to welcome one of my most distinguished constituents from Virginia. I would like to talk for just a minute, Mr. Secretary, if I might about inflation, which I know you would agree is the cruelest tax of all. I think, very frankly, I do not mean this in any sense as a personal criticism, I think we have done, we the Administration and those of us who have the privilege of serving in elected office, we have done a not very credible job of explaining the situation of what has happened to inflation to the American people.

I regret that. Again I reiterate, I do not mean that as any criticism. Other than what we have all heard as the old example, old perhaps now, that if you take the average three bedroom, two bath house in your neighborhood, with a quarter acre lot, if inflation stayed at the highest level it was in the worst quarter of last year, by the time that \$110,000 house or something is available for purchase by today's babies 35 years from now, it will cost \$6 million.

Now we have heard at some length observations of the majority leader this morning. I think yet what we are getting is a first peek at a disinflated economy. And the latest figures we have had is something around 3.5 percent. I think very honestly we are winning that war.

But at the same time, we have experienced a literal revolution in the investment climate in this nation. Overnight, basically, we have gone from a leveraged borrowing economy to a cash and carry economy. It is simply cheaper to have equity than it is to engage in borrowing it at the excessively high costs that include, in my view, a premium, still based on inflationary expectations.

My real question to you this morning is: Could you tell us how do we reduce the premium of inflationary expectation or volatility? What do we have to do as members of Congress? What do you have to do as a leading spokesman of the administration to impact on the local banker, on the financial community of this Nation, to reduce the costs of money to the traditional historical 2 or 3 percent above the inflation rate so that we can get this interest rate situation in hand and give an opportunity for ventilation to the real estate business, to realtors themselves, to homebuilders, to the people who are literally hanging on the edge of financial disaster by their fingernails?

What would you suggest that this committee might do to have the greatest possible impact on that at the earliest time frame?

Secretary REGAN. I think, Mr. Parris, that what we have to do—again I come back to what I said to the Chairman and said earlier in my prepared remarks. At this moment, the fear of high deficits is what has money rates staying up there. Now you can go through history and find very little tangible evidence of correlation between deficits and high rates of interest. There have been periods in history where deficits have gone down, interest rates have gone up. There have been other times when the deficits have gone up and interest rates have come down.

But right now, in people's minds are deficit forecasts in triple digits, 120, 150 million of dollars each year and raising over the next 2 to 3 to 4 years, and they think that will cause severe inflation later, that is later in 1982 or 1983 and 1984, in the United States.

Until such time as we can convince them that we are going to do something about that deficit, those rates are going to stay up there. If they are convinced that we are going to work seriously to get those rates down, primarily by cutting Federal spending, then you will start to see some break in those rates.

As these rates break, they will feed upon themselves and the fear will lessen. They will start coming down, I think as the economy revives, I think frankly as far as real estate is concerned, when rates are somewhere in the neighborhood of 12 to 13 percent, I think you will start to see a revival of the real estate market.

I think at that point, again, seeing that there will be more savings and the like, as our program takes effect, later in 1982 and in 1983, the fear of crowding out will diminish. Again, that real rate of interest premium will start to shrink. So we will be getting back to what the normal premium should be.

Mr. PARRIS. The majority leader—and I am paraphrasing his comments now—led us to believe that high interest rates cause inflation. He showed the chart with the usual gap at the ends of it. On page 10 of your statement, Mr. Secretary, you basically say, and I think the majority leader said this, that those of us who would abandon this steady moderate growth of monetary reserves and monetary supply, that they believe that faster money growth would depress interest rates. And you say that history does not support that view and you have an attached chart and so forth.

It seems to me in basic interpretation of both of those statements, that you and he take the same information and reach directly the opposite conclusions. Would you comment on that?

Secretary REGAN. Yes. Obviously we think we are right and we think that from this chart that we have in there on interest rates and inflation, you can definitely see that the inflation leads the interest rates. As far as the recent case has been that interest rates have stayed up, even though inflation is coming down. This is a very unusual phenomenon that has been apparent only in the last couple of years.

Over history, the deficits have little bearing on interest rates. If you want to track this, look at the growth in the monetary base. You will see that chart following the money supply. That is what is causing your rates to change. I think there is where you will see it.

Mr. PARRIS. I can only make the observation, I certainly share your point of view, Mr. Secretary, although I admit to being slightly prejudiced in that regard.

Thank you. My time has expired.

The CHAIRMAN. Thank you, Mr. Parris. You know, a straight remark here. It seems to me when the President presented the budget, that large deficit, he said not to worry because it is such a low percentage of GNP. Maybe I am wrong, but that is my memory.

I think I am correct in that.

Secretary REGAN. Who said it, sir?

The CHAIRMAN. The President?

Secretary REGAN. I do not think he said not to worry. I think he said we should all be concerned about it. However, it is less as a percent of gross national product than in the 1974, 1975 recession.

No, he has been saying time and time again that deficits do matter and we must get deficits down.

The CHAIRMAN. So that the people who have that psychological blockout there, it is because of the high deficits, is that correct?

Secretary REGAN. They have to be convinced that we are going to get the deficits down. They are not believing our \$91 billion or now \$96 billion. What we are saying is that it is going to be even higher than that, because the Congress would not enact all of the spending cuts that we have proposed and so on and so on and so forth.

The net result will be that there is a deficit out there somewhere between \$120 and \$150 million; that is what has him worried.

The CHAIRMAN. I apologize, Mr. Vento. I just could not resist.

Mr. VENTO. Well, Mr. Chairman, Mr. Secretary, I appreciate you coming over this morning so we can understand a little bit of this economics. It is sort of like a dog-chasing-his-tail-around-a-tree discussion I am afraid.

We will all be arguing about how we got here but last summer there were some actions taken and it is my view and I expect not yours, that they compounded whatever was in the mill. They compounded it. The problem is where are we going from here.

Unfortunately, I think that we have this big deficit which CBO says is something like \$120 billion if we adopt the President's policies. We are well aware of the proposed tax changes or increases you proposed. We are not aware of the ones that you have not proposed. We feel some probably should be proposed in order to steer this thing on a little steadier course.

One of the concerns I have is with your statement on page 2, "Deficits are not good." I guess we all agree with that. While no one likes taxes, we think maybe there ought to be more discipline. That is why I voted last summer for a tax bill offered by Mr. Udall that was more modest than that offered by the administration.

I think we would have been better off if it had passed. You talk about robbing the private sector of resources to do something. This has been in effect for over a year now, in the form of the accelerated cost recovery portions and many other provisions of the tax law. But I mean the fact is that all of the government spending in terms of these programs was stimulative in some respects.

In other words, not all money that is spent by the National Government is sort of dumped in the ocean, is it? It does have and can have a positive effect if it is utilized efficiently and properly, can it not?

Secretary REGAN. But only about one-third as efficient as in the private sector.

Mr. VENTO. I think it is important to look at that. But in looking at some of the tax proposals, like now we are looking at enterprise zones and a variety of other things, it reminds me of someone trying to put a piece of plate glass in with a sledge hammer, in terms of the cumbersomeness of some of the provisions.

We look at various stimulative things. You look at what the costs of those are in terms of the successful programs we have, I become very upset. The leasing provision. Your estimates have been exceeded in that, whatever the merits are—and I do not see much merit in it—you obviously see more based on last week's news reports with regard to that issue.

It seems like the costs of doing some of these items is far greater. We agonized in this committee about providing loan guarantees for Chrysler Corp., loan guarantees, Mr. Secretary. Yet there are billions of dollars that have gone off through tax changes with virtually no input, no public policy statement, 59 different changes in taxes as had been itemized by one of my colleagues, and I suspect that is correct.

I think we should really strive to eliminate those portions—we never look at tax expenditures once cuts are made. And it has been one of the fastest growing areas in terms of loss. For you to suggest that that has nothing to do with the deficit, I think, does not further responsibility and discipline in this particular area.

We look to the administration to evoke some discipline. God knows Congress has not had that under other administrations, I do not think we have had it under this administration. I would hope you would reel back in some of that ability, and try to guide these

things and craft them a little more clean. I think you have a chance here to make some improvements without necessarily extinguishing the flame that you proposed initially in your measures last summer.

Secretary REGAN. Let me comment on several of those things. First of all, enterprise zones, you will admit I think that there is a problem with the inner cities, particularly the inner cities of the East and the Central States. And this is an attempt to help them out.

The budgetary effects, the tax effects of what we are proposing there are less than a half a billion dollars. But a lot of this, we think, will be very stimulative to getting people to go into the enterprise zones, to establish factories there, other types of endeavors in order to raise employment there, particularly among blacks and other minorities, in these inner cities where the unemployment rate is running very high.

So I do not think that enterprise zones are going to be a, a budget buster, and I think they will be a darn good thing for the inner cities.

As far as leasing, that did not exceed our projections. We projected there would probably be about \$18 billion of leasing in the 1981 period. Our preliminary estimate is \$19.3 billion. I think we are pretty much on the mark as far as anticipating what the effect would be.

That is not the budget effect, that is the total amount of leasing. The budget effect is about \$1,500,000,000, which is what we suspected it would be in 1981.

As far as tax expenditures are concerned, I have to disagree with that word. We do not own people's money. And when we allow them to keep their money through some type of interpretation of the tax law, that is not an expenditure by the Federal Government. It is allowing people to keep their own money. So I do take exception to that.

But in the category of loophole closings and other changes in the tax code, we have proposed 13 billion dollars' worth of those. And we think that is quite a lot. We also agreed to work at least with the Senate Finance Committee—as yet Ways and Means has not gotten to it—on the underground economy, to collect our moneys that are probably due to us.

There are estimates that run as high as \$95 billion that are due to us in the underground economy which we never collect. So we are going to try to go after that. Again I come back to deficits and tax cuts. What I was referring to there, when I was talking, was the individual tax cut, particularly that third year, and I said that I did not think that that was monstrous, as the majority leader characterized it.

I do not think that it is something that we should abandon, because it is going to create a higher deficit. If that is so, then you are saying the man on the street is responsible for the deficit and he better darn well pay up and get his share of the deficit down.

Mr. VENTO. The majority leader was talking about the total tax package of 59 different cuts, not focusing on this individual one.

Secretary REGAN. The majority of those tax cuts were in the individual sector.

Mr. VENTO. Some were, some were not. One of the things he pointed out was the decrease for instance in corporate taxes from an average 28 percent, from a high of about 40 at the beginning of the 1960's, down to 14 percent. This decrease is probably partly due to the recession, but largely due to the tax changes that have been enacted. Plus, of course, there have been estimates that—and I think the President's proposal for a minimum tax suggests—that the corporate tax is effectively zero.

If you are so concerned about the individual, and feel inclined to create these tax expenditures, which you are reluctant to call them, perhaps you ought to be as concerned about loading the entire tax burden on them. Indeed, some Senators are even proposing that social security taxes now, which have been exclusively used for social security benefits, ought to make up for the deficits that we have this year due to whatever reason.

I would submit to you that those may be some thoughts that should be circulated within the administration in terms of their concern about the individual, because I am going to tell you that those are concerns that are being aptly expressed by the people that I represent.

Secretary REGAN. I do not think people are talking about anything except the taxes that are being imposed upon them by the Federal Government. I think that what they are saying is to cut the spending so we do not have to be taxed as much. I think that is exactly what is on their mind.

If you look at most polls, they are saying cut spending, do not tax us as much. We are in sympathy with that. That is exactly what we are saying. As far as the business cut is concerned, from the point of view of our 10-5-3 and the like, that was exactly paralleled by the democrats last year in Ways and Means.

Mr. VENTO. Too bad I did not have an opportunity to vote against that bill in there. But I think that if you could have offered some discipline at that point, which other administrations have done with regard to tax policy on the Hill, we would not have had something like that occur.

Secretary REGAN. Discipline, sir, in raising \$250 billion in 4 years from 1977 to 1982 and then overspending by \$200 million. I do not consider that discipline.

Mr. VENTO. The popular and easy thing to do is cut taxes. Congress has never had any trouble doing that in the past. With your help they did just a wonderful job in terms of decimating the revenue system of this country and our ability to support the things that are necessary, whether it is highways, defense, or whatever.

You have done a great job in taking the economy, which was on its knees, and knocking it on its back. I sincerely hope that we can work at this particular point to rectify what has happened. But I do not see that attitude emanating from the administration.

Secretary REGAN. I would have to object, sir, to your characterization of a tax cut that did not go into effect until August as having caused this recession that started in July.

The two simply do not go together. Second, I also have to say to you that since we are going to collect this year, 20.3 percent of gross national product in taxes, which except for 1981, is the high-

est share in over a decade, as a percent of gross national product, that we have not knocked the tax system all to pieces.

I think that we are collecting too much right now.

Mr. VENTO. Next year you may be able to collect it all because none of the businesses in my area, small, large, or individuals are making any money because of the recession or depression.

Secretary REGAN. That has been brought on by high rates of interest.

Mr. VENTO. Like I said, Mr. Chairman, a dog chasing his tail around a tree.

The CHAIRMAN. Dr. Paul.

Mr. PAUL. Thank you, Mr. Chairman. Welcome, Mr. Secretary.

I would like to follow up on the discussion on taxes, because I think my view is slightly different from what we have heard so far today. I would like to suggest that there could be an argument for a real tax cut. I would like to get your comments on this proposal. This year, it is estimated that our revenues could go up between \$20 and \$25 billion. So as you have said, we have not had any real tax cut.

I believe that we have only nullified a proposed \$96 billion increase in taxes, and evidently those who decry the fact that this nullification of a proposed tax increase has occurred would like to raise taxes by \$96 billion in the midst of a recession.

I think that would be a total disaster. It is amazing to me to hear the people who have traditionally advocated tax cuts in periods of recession now saying we should have tax increases. I would like to suggest that we ought to really cut taxes for a change.

We had a severe depression in the 1930's. Some claim it ended with the war. I do not accept that. I think taking 12 million men, putting them in uniform, lowering the standard of living further, and then killing 1 out of 20 does not end a depression. The depression ended after the war. After the war we cut spending by 75 percent over a 3-year period, we cut taxes in real terms by 37 percent.

Revenues went down by 37 percent between 1946 and 1949, and the depression finally ended. I am suggesting that what we really need to do is cut taxes. But, of course, it would be very nice if we would also cut the spending. I am afraid that the problem is not that politicians like to cut taxes. That is not a problem; that is a great event.

The problem is when are they going to get the guts to cut the spending? Would you go along with a program to really cut taxes? I realize you are struggling to keep Congress from raising taxes, but I would be delighted to see a real tax cut.

Secretary REGAN. That is why last year we supported indexing, when it was suggested so that we would have a break on tax increases in the future. And hopefully, this would bring about the balanced budget. I personally, although the administration has not taken a position, favor a constitutional amendment if necessary in order to get a balanced budget from this Congress and from this administration or any administration in the future.

I think such a move is going to be necessary inasmuch as it does not seem that we can accomplish balancing the budget in any other fashion.

Mr. PAUL. I have an additional question on a different subject that has to do with the leading economic indicators. They are coming out today and I want to refer to them.

Question 1, in particular, concerns the money supply figures. When we read the money supply figures, whether we use the factor of L or M_2 in relationship to CPI, if the supply is going up, this is interpreted by the Government as a positive sign. Yet the marketplace reads it differently.

If we have a sudden increase in the money supply, the market certainly discounts this as a very negative factor. In the last several months we have had a \$5 billion increase in M_2 and the CPI has been going up slowly, which according to the conventional interpretation of the indicators, is a very positive thing.

I do not think the market sees it as a positive thing. And besides, if you have M_2 and CPI increasing in a uniform way, this is read as a neutral factor. If the money supply is going up at the same rate as prices, this is completely neutral.

I would question whether or not maybe we should reassess the interpretation of the money supply factors as leading economic indicators?

Secretary REGAN. I would agree with you. The money supply does have an enormous effect on the leading indicators in a perverse way. I do not think that it absolutely characterizes what should be a leading indicator of further economic growth. I think that we probably have here a case of mistaken identity. I think that it is something that literally economists should think through in view of current circumstances as to what those leading indicators and lagging indicators are doing.

It is very peculiar, you know, what has happened in today's indicators. The leading indicators are down, and the lagging indicators up, and that would indicate that we are in prosperous times and sometime in the future we might be going to have a recession which obviously is incorrect.

So I think you have to discount entirely these leading indicators.

Mr. PAUL. Who is in charge of determining which indicators are to be used and what their interpretations are?

Secretary REGAN. They emanate out of the Commerce Department. The National Bureau of Economic Research works with the Commerce Department in establishing the indicators.

Mr. PAUL. Thank you, Mr. Secretary. My time has expired.

The CHAIRMAN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman. I appreciate your sitting here and waiting for us, the more junior members of the committee.

This junior member is puzzled, to say the least, by some of the economic figures that your administration is standing by. It seems to me that these figures are almost hallucinogenic. I wondered who was doing what when you came up with these figures. How can it be that in the 1983 budget the administration projects 5 percent GNP growth, a budget deficit of \$96 billion, and still maintain that Treasury bills will be sold at 10.5 percent.

Can you name one person outside of the administration who thinks those predictions are consistent in any kind of economic

framework? Can you find one person who thinks Treasury bills are going to be sold at 10.5 percent?

That is why Wall Street is worried. I have talked to Wall Street people, too. They do not believe your predictions. No one else does either, whether they be from the right, the left, or the middle. We are not being fooled. I would like an answer on your 10.5 percent Treasury bill rate prediction. Do you really believe in your heart of hearts that fiscal 1983 Treasury bills are going to be sold at 10.5?

Secretary REGAN. We sold T bills last year at about 10 percent, in spite of the fact that starting out the year we had an inflation rate of 12.5 percent. We had a prime interest rate of 21.5 percent.

Mr. SCHUMER. What are you selling them at now?

Secretary REGAN. About 14.25.

Mr. SCHUMER. And you think——

Secretary REGAN. Two weeks ago they were 13. The T bill rate can move very fast.

Mr. SCHUMER. Do you really believe it is going to be sold at 10.5 percent? When you look at the mirror while you are shaving do you say that we will have T bills sold at 10.5 percent by September?

Secretary REGAN. If you guarantee that Congress goes along with the deficit in the 1980's and produces these tax decreases and budget cuts that we have asked for and gives us a budget, which so far the Congress has not done, but gives us a budget——

Mr. SCHUMER. The President's budget you are talking about.

Secretary REGAN. Anything closely approximating that range of deficit. If you will do that, T bills will sell at 10.5 percent.

Mr. SCHUMER. We are being very conundrumic. First we are hallucinogenic, now we are conundrumic.

Secretary REGAN. You asked how we came up with these figures. I am explaining how. We assumed Congress would do this. If you are telling me Congress will not do it, we will have to go back and change our estimates.

Mr. SCHUMER. If Congress does enact the Reagan budget, and God forbid that from happening in the way that it has been proposed, there will not be a budget deficit of \$96.5 billion according to every single person I have spoken to who does not wear the mantle of the administration.

Whether they be conservative, moderate, liberal, Communist, Fascist, nobody on Earth thinks that if this budget is enacted, we will have a deficit of \$96 billion. So when you say to me if we enact this budget we will, you are standing alone. You are at the Alamo.

Secretary REGAN. I do not talk to Communists and Fascists. But others that I talk to indicate that they do not believe the Congress will give us our budget.

Mr. SCHUMER. That is not the issue. The issue is——

Secretary REGAN. That is the issue because ours was focused on the fact that we sent up our budget. Based upon that we said T bills would sell at 10.5 percent.

Mr. SCHUMER. I have asked people if the deficit will be \$96.5 billion if Congress enacts the Reagan budget just as proposed and if they believe T bills will be sold at 10.5 percent. The answer is a deafening no. Can you cite for me a well-known economist of any repute who believes that? Outside of the administration?

Secretary REGAN. Alan Greenspan has said if the deficits are as low as \$110 billion, that interest rates will be down sharply and he is projecting——

Mr. SCHUMER. I know he said that.

Secretary REGAN. He is projecting at least 3 percentage points down.

Mr. SCHUMER. I beg your indulgence——

Secretary REGAN. You asked for a well-known person who would say this.

Mr. SCHUMER. He said that if the deficit was \$110 billion, interest rates would go down. What I am asking is, Who has said that if the administration budget is enacted, the deficit will be that low? I have not found anybody.

Secretary REGAN. Alan Greenspan for one. Wait a minute, sir, he talked to me. After all he does report to me in his capacity as one of the heads of the Economic Advisers, and he said——

Mr. SCHUMER. That moots my point. I asked for someone outside of the administration. But OK. I have one other question and that is just a viewpoint I would like you to respond to.

Secretary REGAN. For the record, I would like to find such a name and put it in the record.

[Secretary Regan subsequently submitted the following additional information for inclusion in the record:]

RESPONSE RECEIVED FROM SECRETARY REGAN

According to the New York Times, the fiscal year 1983 deficit in the President's budget was estimated to be \$95 billion by Irwin Kellner of Manufacturers Hanover Trust, and \$90 to \$100 billion by John Wilson of Bank of America.

Mr. SCHUMER. I would very much appreciate that. The one other question I have deals with the issue of fairness. Let us assume that we all think the budget should be cut, and accept as an axiom that taxes should not be increased more than the \$13 billion you have proposed. If we accept these conditions then all of the cuts have to come on the spending side. I want to ask you your judgment. Do you think in the name of fairness, the American people do not and my constituents do not, that we should cut student loans and mass transit and medicare in the amount we have cut and leave syn-fuels, water projects, agricultural subsidies, virtually uncut as was proposed in this budget?

Secretary REGAN. Well I——

Mr. SCHUMER. My point is this: My constituents who benefit from the first set of programs, not from the second, are willing to take a share of their cuts. But right now, unlike last year, there is a feeling that those cuts are slanted and unfair and geared at keeping a political constituency together rather than administering the economic medicine that we need.

I would like your comment.

Secretary REGAN. First of all, let's take a look at student loans. I had occasion last week to make a speech at a major college and in preparation for that speech I looked into it. As I understand in fiscal year 1983 the budget provides more than \$2 million in total tuition support. That is \$1.5 billion less than in 1982, but three times the level available in 1977. This means that there are 7 mil-

lion loans, scholarships, or grants available for college students in the United States.

There is a college population of 11 million. That means that more than one out of every two of all of the students in the United States has the opportunity for assistance under our proposal. In addition to that, of course, there are State grants, State aid, of various types, plus private.

So that the cuts that everyone is fearing here, and are yelling about, are not of that dimension. We have not gutted the program when more than one out of two of the students has the opportunity for Federal aid. I have checked this out with several universities as to what percentage of their students are now getting Federal aid. Some run roughly around two-thirds. Some are about 50 percent.

Mr. SCHUMER. The figure, for instance, under the administration proposal is \$30,000. I do not know if that squares with the two-thirds but you will agree with me that it is hard for a family making \$31,000 to send a student to a private university without any student aid?

Secretary REGAN. There are numerable private types of help available through private institutions for such students who are not getting Federal aid and who need more aid. Now, as far as the fairness is concerned, I am not a real authority on agriculture or water resources.

So I would have to say that for the record, I will go back and get you an answer. Right now, I could not comment in that area.

Mr. SCHUMER. I am sorry, Mr. Chairman——

The CHAIRMAN. You are overtime.

Mr. SCHUMER. I will continue the dialog in writing, if you will.

Secretary REGAN. I think I would enjoy that.

Mr. SCHUMER. I do not know if I would.

[In regard to the above colloquy with Congressman Schumer, the following additional information was received from Secretary Regan for inclusion in the record:]

RESPONSE RECEIVED FROM SECRETARY REGAN

I agree with the President's statement in his Budget Message, that the Administration's deficit reduction plan addresses each area of the budget where actions to reduce the deficit are possible and desirable. The new proposals will have no adverse impact on our economic recovery program, are fair and equitable, and will contribute significantly to the reduction of future deficits.

The CHAIRMAN. Mr. Weber.

Mr. WEBER. I am going to pass this time.

The CHAIRMAN. Thank you, Mr. Weber.

Mr. Patman.

Mr. PATMAN. Mr. Secretary, does the administration accept any of the blame for the deficits that have occurred?

Secretary REGAN. Well, I would say yes. Because inflation came down and to a certain extent we are responsible for inflation coming down but there were other factors.

So to the extent that over \$60 billion of the deficit is now caused by the reduction of inflation, sure we are responsible for it.

Mr. PATMAN. That is the only part that you accept?

Secretary REGAN. Yes, because everything else we have been trying to cut back on.

Mr. PARRIS. How much of last year's tax cuts are currently being financed by borrowed money?

Secretary REGAN. I have no idea, sir. How much of last year's tax cut is being financed by borrowed money? I know that the deficit is being financed entirely by borrowed money. But I am not sure that I could give you that percentage.

Mr. PATMAN. Would you say the deficit was caused in part by the tax cuts last year?

Secretary REGAN. No. And I will tell you why. There was only a 1¼-percent tax cut last year, for individuals who make up roughly 60 percent or more of tax collections and that barely kept—in fact did not keep pace with inflation, so we actually took more from the average taxpayer last year than otherwise.

Mr. PATMAN. Are you telling the committee that a tight money policy results in lower interest rates?

Secretary REGAN. Yes. That is correct.

Mr. PATMAN. When you were with Merrill Lynch, did you pay close attention to interest rates then?

Secretary REGAN. Certainly.

Mr. PATMAN. When you heard the Fed was going to embark on a tight money policy, did you conclude that you were going to have lower interest rates?

Secretary REGAN. That usually followed. Except in the 1960's, it did not follow in the 1960's. It changed during the 1970's and in the 1980's.

Mr. PATMAN. Did the average Joe on the street get the tax break last year?

Secretary REGAN. I beg your pardon?

Mr. PATMAN. Did the average Joe on the street get the tax cut last year?

Secretary REGAN. He got 1¼ percent, yes.

Mr. PATMAN. Of the total tax expenditure or tax cut, the lower estimates that we anticipate in revenues, what percentage was given to the average Joe on the street?

Secretary REGAN. I have no idea. We would have to figure that out for the record. I will come back to you on that.

Mr. PATMAN. Actually, it certainly was not the fellow that gets less than \$20,000 worth of income?

Secretary REGAN. He did not get too much of a tax cut, no.

Mr. PATMAN. \$30,000?

Secretary REGAN. Once you get into that \$30,000 to \$50,000, you are starting to get into where the majority of American's earnings are and where the majority of taxes are collected, so your proportion goes up rather sharply in that area.

[In regard to the above colloquy Secretary Regan submitted the following additional information for inclusion in the record:]

RESPONSE RECEIVED FROM SECRETARY REGAN

For 1981 taxpayers with annual income of \$20,000 or less received about 16 percent of the tax tax (as they had about 16 percent of the tax liability) and those with annual income of \$30,000 or less received about 36 percent of the cut (they had about 36 percent of the liability). Median income for a family of four is about \$25,000 per year.

Mr. PATMAN. You talked about the uncertainties in the market and how they influence interest rates staying up. How does a person react feeling an uncertainty of how interest rates will go and how policies are going to go and withholding his funds from the market and thereby causing inflation to rise or rather interest rates to rise?

Secretary REGAN. From that point of view, what happens here is that the average lender of money, whether it be an insurance company or bank or what have you, decides that there is no way that they can make money just by loaning it out with 2 or 3 percent over the inflationary rate. They are going to have to demand more if they are uncertain as to what is going to happen to the supply of money over the near term and indeed, what is going to happen to inflation over the long term.

Mr. PATMAN. From whom does the insurance company and so forth demand this higher rate?

Secretary REGAN. From all borrowers, business, individuals, and the like. Although individuals borrowing on their life insurance policies, as you know by contract, can get it at a lower rate of interest.

Mr. PATMAN. Are you telling us then that the interest rate really is largely administered by people who decide what it is going to be?

Secretary REGAN. It is a decision of thousands, indeed millions of people. But all are looking at more or less the same statistics.

Mr. PATMAN. What percentage and how few of them? What percentage of the rate, what percentage of the borrowing is influenced by a small number? It is a difficult question but let's go into how it impacts on the Treasury bill rate.

How does a person feeling uncertainty react about the rate of inflation?

Secretary REGAN. We put our bills out for auction and the dealers, both dealer banks and nondealer banks bid on them. We do not know what goes into their forecasts except that they look at current rates of interest and put in some type of thought as to what is going to happen over the near term if these are 91-day bills, as to what they think will happen to the rate of interest over that period of time and bid accordingly.

Mr. PATMAN. My time is expired; thank you, Mr. Secretary.

The CHAIRMAN. Mr. William Coyne.

Mr. W. COYNE. Last year when the economic recovery program was proposed to Congress, we were told that enactment of the tax cuts for the business community throughout the country would be a stimulus to reinvestments and would create jobs and an upswing would begin to happen.

Many people do not believe that has begun to happen. As late as yesterday, David Roderick, chairman of the board of United States Steel, said he just did not believe that the business community had responded as predicted.

Would you care to comment on whether or not the business community has been responding as it should and as this administration wanted it to?

Secretary REGAN. The response has not been as great as we would have liked it. I think actually, in point of fact, what happened here is that business has been overtaken by the recession,

and the recession has gone deeper than most forecasters thought it would.

The net result is that we have idle capacity, capacity utilizations down in the low seventies 70, 72 percent, in that range. That is hardly the type of thing that leads a businessman to think of building a new plant, particularly when he takes a look at the rates of interest that would be charged him, long-term rates, for AAA bonds now are in the 15.5-, 16-percent area.

You can hardly make the figures come out correctly to where you show a good profit on 16 percent money. So I think that the combination of high rates of interest, and the recession, have postponed most of these plans. I do not think they have killed them, I think they just postponed them.

Mr. W. COYNE. On another subject that was raised earlier, it was indicated that this administration would like to take some credit for the reduction in the inflation rate. But they are reluctant to take responsibility for the high interest rates and the high unemployment rates, saying those were caused by prior administrations and prior Congresses.

I just wonder at what point during the tenure of this administration we can get an answer that would say well, we indeed are responsible for the status of the economy?

Secretary REGAN. In answer to a similar question about 3 months ago in testimony I made a statement I will stick with today, I said 1 year after our tax bill and our budget cuts went into effect, that we should be held responsible. But particularly the tax portion should have at least 1 year. That would mean August of the coming year.

Mr. W. COYNE. But has not the business section of the tax cuts, has it not had more than a year to take effect? I mean, it was retroactive, wasn't it?

Secretary REGAN. That was retroactive to February as I recall, and has been now in effect just about a year.

Mr. W. COYNE. So we will have to wait beyond a year, I guess?

Secretary REGAN. On the business portion as I previously discussed with you, I think that portion will come around as soon as we get the interest rates down and as we emerge, as I think we will in the second quarter, from the current recession.

Mr. W. COYNE. Thank you very much.

The CHAIRMAN. Mr. Secretary, one last question, if I may. In our original discussion we discussed, I asked you a question as to your prediction or projection on interest rates between now and September of this year, if the President's budget were to be adopted. Since that is the only budget we have before us at this time.

Your answer was that you felt that there would be a sharp drop in interest rates.

Secretary REGAN. That is correct, sir.

The CHAIRMAN. Now, for the benefit of the committee and others, would you for us define what you look upon as a sharp drop in interest rates?

Secretary REGAN. You will recall I prefaced that adverb by a statement, Mr. Chairman, that for 35 years I have been ducking the precision of that question. Again I will have to duck.

The CHAIRMAN. Mr. Secretary, please do not. Please do not. I mean you parred that hole even though you shanked and went into the rough.

Secretary REGAN. That was the Federal Reserve that shanked. I never did.

The CHAIRMAN. I thought you were talking about yourself. Because you know, in the past you have told me about your acuity and your silence on the links which probably would not be as good when you finish your term as Secretary of Treasury, but I am sure you will get it back again.

Please do not, this is a very serious important question.

Secretary REGAN. You recall that I said to Mr. Schumer in our dialog that I believe that if our program is enacted, that there will be a 10.5-percent T bill rate later this year. And I will stick on that.

The CHAIRMAN. See, prime rate now——

Secretary REGAN. Is right now 14.25 for T rates.

The CHAIRMAN. Prime rate, let's go to——

Secretary REGAN. That would indicate the short-term rate is coming down about 3 to 4 percentage points.

The CHAIRMAN. Three to four points on short-term rates. You have answered my question. We thank you. And we appreciate your appearance, your patience, and your waiting. I am sorry about that, I apologize for that.

Thank you for a very stimulating session.

Secretary REGAN. Remember the conditions on the short-term rate. That we must have the budget deficit down in the nineties.

The CHAIRMAN. Well, I prefaced the question with our accepting the President's budget. And the President's budget has a built-in deficit which originally was \$91 billion.

Secretary REGAN. Let's make sure we are talking about the right fiscal year, in fiscal 1982 our projection is \$102 billion. Our projection for 1983 is \$96 billion. On that premise.

The CHAIRMAN. All right. Again thank you.

Secretary REGAN. Thank you, Mr. Chairman.,

[Whereupon, at 1 p.m., the subcommittee was adjourned.]

[The following statement of Vere Vollmers of the Minnesota Farmers Union, St. Paul, Minn., was submitted for inclusion in the record:]

STATEMENT
OF
VERE VOLLMERS
VICE PRESIDENT
MINNESOTA FARMERS UNION

My name is Vere Vollmers. My wife, Ellen, and I farm 800 acres near Wheaton in west central Minnesota. We have three children, two of which are in school.

I would like to address my comments today to my farming operation, to my rural community, and to the state of agricultural economy.

Traverse County, my home county, has the highest percentage of tillable land of any county in Minnesota. Ninety-three percent of the land is tillable. Average farmland is available for sale today at between \$1000 to \$1500 per acre. Rental farmland can be leased at approximately \$65 per acre.

The town of Wheaton is a farming town of 2000 persons. We don't have manufacturing plants or assembly lines. Our rural main street businesses literally live and die according to the health of the farming economy. But, right now that economy is nearly dead.

Last year declining purchasing power by farmers forced a car dealership to close its doors. Rumors are that Traverse County is also about to lose an implement dealer. Those are pretty dramatic changes for a county with a population of only 6000 persons.

. The reason I mention my county and the town of Wheaton is simple: the fact is that the business and the personal tax breaks advanced by the Administration and approved by Congress last year will have almost no impact on our local economy. Unless the farm economy improves through higher farm prices our rural community will continue to suffer.

Tax breaks are only good if you make enough money to qualify for them.

In many ways my farming operation is different from my neighbors. I am taking over my father's farm but I am doing it on more favorable terms than most farmers in my county.

Even so, last year my gross income for 800 acres was \$150 per acre. My personal debt load at a bank or other lending institution is small in comparison to most farming operations. Consequently, my yearly interest payments are also lower.

But let's suppose for a minute that some day soon I'll have to buy out my brother's and sister's share of my father's farm. And let's suppose that I am able to buy the land at an average of \$1000 per acre and I am able to finance it at 17 percent interest at a local bank.

In this example, my interest payment on this additional land would be \$170 per acre per year. To re-emphasize, \$150 per acre was my gross income for 800 acres in 1981.

I used this example to illustrate a point. You won't find a farmer today who doesn't favor lower interest rates. But the farmers of America are growing tired of hearing the Administration rejoice every time interest rates decline by a fraction of one percent. The reality is that even if the prime interest rate declines to 14 percent, I can't afford to buy more land and pay the interest payment with the cash receipts from that land.

There have been many auction sales in Traverse County in the last decade. It used to be the older farmers--the retiring farmers--who sold out. Once upon a time, the young farmers would go to these sales and literally get started in farming with auction sale machinery.

The auction sales in Traverse County had a new look this past year. The older farmers are still selling out but so are the young ones. The young farm families in my community are giving up, selling out, and moving off the land.

It is my belief that most of the current sales are the result of two primary reasons:

1. These farmers expect no improvement in grain prices and farm income during the next few years.
- . These farmers foresee no help coming from this Administration to correct the crisis.

In 1981, I heard much rhetoric about the "safety net for farmers" that would be part of the Administration's Farm Bill. Let me remind you that net farm income last year was \$18.9 billion.

The Administration argued during debate on the farm bill that their "safety net" would protect the declining farm income we had.

This year, however, net farm income is projected to be much lower than last year---perhaps below \$15 billion.

It is my conclusion that the Administration's safety net for last year is not the same safety net being used this year. If the safety net really exists, then this Administration and Congress need to do something quickly because \$4 billion in farm income is about to slip through the net.

The U.S.D.A. has acted on one front to encourage farmers to cut back on production in the hopes that farm prices will improve. At best, the reduced acreage program is dismally poor and those within the U.S.D.A. know it. Even Sec. of Agriculture John Block has announced he will not participate in the program...but he expects that other farmers will.

For the record, I intend to sign up for the program but I will decide later on whether to participate. As I see it, the reduced acreage program will cost the government pennies in comparison to the income dollars sacrificed by farmers.

What we need in American agriculture today is a farm program with realistic loan levels for the major commodities. I am not talking about a nickle increase or a dime increase in loan levels. We need levels at least close to the cost of production.

Loan support levels are exactly what the term means. They are commodity loans to farmers - loans repaid with interest.

I do not come to this hearing today asking for a handout. The citizen of Traverse County are not asking for a handout either. In our county less than 1 percent of the farm families are on food stamps though many families qualify. Of the more than 6000 residents in our county, records show that only an average of 2 families per month receive general welfare.

So, as you can see, the spirit of helping others--the spirit of volunteerism--is alive in my community. The spirit of volunteerism is alive in my family through the eyes of my two adopted daughters.

But not all the volunteers in the world can help the farm families in my community who have their back to the wall. The fact is American agriculture needs help now. The foreclosures and bankruptcies continue. Young and old farmers are being driven off the land and the auction sales continue.

Our farm economy is not moving ahead with our current economic policy. In fact, the agricultural economy has slipped greatly since January 1981.

What has Reaganonomics meant to me?

- ' It has meant higher school lunch prices for my children and less variety for those meals at school.

- . The 1981 tax breaks have had no apparent impact on our county economy. General Electric, as I have seen, greatly benefitted from the tax breaks because they made huge profits. The tax break of was little value to my family.
- . Reaganomics provided American farmers with a Farm Bill that has the greatest spread between loan levels and the cost of production in the history of federal farm programs.

If that is what Reaganomics is---and nothing more---then I got nothing from it.

THANK YOU.



INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW

DOUGLAS A. FRASER, PRESIDENT

RAY MAJERUS, SECRETARY-TREASURER

VICE-PRESIDENTS

OWEN BIEBER

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April 5, 1982

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The Honorable Fernand J. St. Germain, Chairman
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This is to convey to you and your committee the UAW's deep distress at the relentless tight-credit course pursued by the Federal Reserve Board with the support of the Administration. I request that this letter be inserted in the record of your hearings of March 30, which regrettably I was unable to attend.

Though tight money and accompanying sky-high interest rates drove the entire economy into recession starting in mid-1981, industries like auto which are so sensitive to credit market conditions have borne the brunt of the monetarists' assault. While the economy as a whole has been in recession for nine months auto has been deep in a depression for 36 months due to the combined effects of skyrocketing imports, an uncertain energy outlook, and Volcker's relentless monetary grip.

In his letter of last July, UAW President Douglas A. Fraser gave you an account of the crisis in the auto industry, and explained how that crisis has been severely aggravated by the Federal Reserve Board's policies. Since then, the crisis has gotten even worse: relative to the same period in 1981, 1982 domestic car and truck sales through March 31 were down 10%. Compared with early 1979, the industry's last healthy period, early 1982 sales of domestically produced cars and trucks were down 33%. Production in the first quarter of 1982 barely exceeded 1 million cars, down 35% from 1981's already depressed first quarter to the lowest level in 30 years. Capacity utilization in the motor vehicle industry plunged to 43.6% in January and 47% in February, the lowest figure on record for any industry since official publication of the statistical series began.

In the car assembly companies alone, over 250,000 workers are on indefinite layoff. According to the Bureau of Labor Statistics, production worker employment in the industry has declined by 40 percent since July 1979. Including the loss of supplier and other auto-related manufacturing jobs, the decline in employment has exceeded 1 million.

The four domestic auto companies sustained a combined loss of \$4.2 billion in 1980, and lost another \$1.3 billion in 1981. Many supplier companies have found themselves in an even worse predicament: business failures among transportation equipment companies rose from 38 in 1978 to 55 in 1979, 92 in 1980, and over 100 in 1981.

Dealers have closed their doors at an unprecedented rate. Between January 1979 and September 1981, 2,864 dealerships went out of business, 12% of the total.

Not only auto, but other basic metalworking industries employing large numbers of UAW members, have been hit by the Fed's iron fist. Sales of construction equipment, which UAW members also build, have been pummelled by the slump in construction: unit shipments were down 38 percent in the third quarter of 1981 from the first quarter of 1979. Employment dropped apace: more than 21,000 workers — fully 18 percent of the total workforce — have lost their jobs.

Tight credit has also hit the demand for farm equipment. Unit shipments fell 40 percent from the first quarter of 1979 to the third quarter of 1981, putting 20,000 workers (18 percent of the workforce) on the street. Compared with the same period in 1979, sales of medium and heavy trucks in the first two months of 1982 were down almost 50 percent. The manufacture of commercial aircraft — another industry where thousands of our members work — has also been hit, due to the plight of major airlines caught in the squeeze between recession and tight money.

Beyond the direct impact of tight money, to the extent that high interest rates contributed to an unwarranted surge in the value of the dollar in the recent past, there has been a further depressing effect on domestic industries as imports have been stimulated and U.S. exports have become less competitive in world markets.

Weak sales, excess capacity and the forbiddingly high cost of credit threaten to permanently damage auto and other basic industries. As their investment plans are postponed or permanently scaled back, their future competitiveness is at stake — and so are the hundreds of thousands of jobs they provide.

While the viability of key industries is threatened, the entire economy is immersed in what will doubtless become the worst recession since the Great Depression. The unemployment rate now matches the May 1975 high with no end to its rise in sight; business failures appear to have reached a 50-year peak; and the housing industry has sunk to its lowest point since World War II. Productive investment has plummeted across the board: as 30 percent of manufacturing capacity lies idle, business is cutting back capital spending below last year's already depressed level.

In spite of two back-to-back quarters of 4.5 to 5 percent estimated annualized drop in real GNP, interest rates remain at incredibly high levels, both in absolute and relative terms. Short-term rates have dropped only 1.8 percentage points from their recent peak in the third quarter 1981, while the drop at a comparable stage in the three previous recessions averaged 2.7 percentage points — from a substantially lower base. With the recent decline in inflation, "real" interest rates are widely believed to be at the highest level in the nation's history, reflecting the continued stringency of credit market conditions.

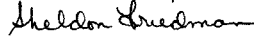
With Administration support, the Fed maintains that it will continue to keep a tight rein on credit until the record federal deficits projected for the next few years have been reduced. This is Hoover economics at its worst; among the policies urgently needed to combat today's severe and deepening recession are adequate fiscal stimulus and adequate credit supply growth. Though we are deeply disturbed by important aspects of the Administration's fiscal proposals — including the gutting of vital social programs, the wasteful and dangerous military build-up, inequitable tax policies, and the disastrous erosion of needed federal revenues in future years — one thing we do not quarrel with is the need for fiscal stimulus now and into 1983 to help pull the

nation out of recession. If monetary stringency continues, however, fiscal stimulus alone will not do the trick.

Responsibility for high interest rates and the pain and damage they are inflicting rest squarely with the unconscionably tight credit policies that Chairman Volcker is still adamantly pursuing — with the full support of the Administration.

While other policies are also badly needed, the economy will not get back on a path of healthy and sustained growth until the monetary grip is relaxed, and the Federal Reserve Board once again permits normal credit expansion. Only under those circumstances will hundreds of thousands of UAW and other workers be back on their jobs.

Sincerely,



Sheldon Friedman
Research Director

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