CONDUCT OF MONETARY POLICY

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BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

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CONDUCT OF MONETARY POLICY

TUESDAY, JULY 14, 1981

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

The committee met at 9:35 a.m. in room 2128 of the Rayburn House Office Building; Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Gonzalez, Minish, Annunzio, Blanchard, LaFalce, Oakar, Mattox, Vento, Barnard, Schumer, W. Coyne, Stanton, Wylie, Leach, Paul, Shumway, Weber, McCollum, Carman, Wortley, Roukema, Lowery, and J. Coyne.

The CHAIRMAN. The committee will come to order.

Most of 1980, and all of 1981, interest rates have been at intolerably high double-digit levels. As a result, mutual savings banks and savings and loan associations, and some banks and credit unions, are suffering serious reductions in their ability to extend needed credit to important sectors of our Nation's economy. Their financial soundness may also be falling into jeopardy. It is this aspect of the conduct of monetary policy that will be explored in today's hearing, the first of several by the House Committee on Banking, Finance and Urban Affairs in its semiannual monetary policy hearings held pursuant to the Full Employment and Balanced Growth Act of 1978.

Almost every day now I see press reports on the plight of the thrift industry. Rumors and conflicting statements abound, and in some instances, aggravate public concern and confusion. This spring, this committee stood ready to act quickly in a full bipartisan manner to consider solutions to the thrift industry problem.

At that time, this committee was asked, in the most urgent terms, by the Federal Reserve, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and the National Credit Union Administration, to consider statutory changes to broaden their merger and acquisition authorities, and to expand the resources of the Federal deposit insurance funds. Mr. Stanton and I met on several occasions with the regulators individually, the Chairman of the Federal Reserve, and informally with newly appointed administration officials, beginning with Secretary Regan, and with our counterparts in the Senate, concerning draft legislation.

Mr. Stanton and I arranged for full briefings of committee members and staff by agency representators on the so-called regulators' bill. Given the circumstances facing depository institutions, as they were explained to me, the regulators' bill seemed to contain needed statutory changes. Unfortunately, inflammatory statements by high-ranking administration officials culminated in a Treasury Department veto. This, combined with trade association turf battles and the inability of the agencies concerned to stay together, halted further consideration of the legislation.

Now, all attention is on the "All Savers Act." However, this legislation possibly might not be enacted or it may not be a full solution, leaving us back where we began—in a situation of punishingly high interest rates, thrift institutions with serious problems, and no mechanism or solution in hand.

To assure the availability of at least one support capability, I have since last November tried to get the Federal Reserve to comply with the terms of the Monetary Control Act and offer discount window credit to thrift institutions on the same terms as those offered to banks. Recently, I again wrote to Chairman Volcker, stressing my concerns in this regard, and I expect to question him next week on this issue.

Further confusing the matter is the Federal Home Loan Bank Board's latest draft legislation. Rather than addressing the short-run problem, the bill would bring about a long-term restructuring of thrifts overnight, destroying the last vestige of a specialized mortgage finance supplier. I look forward to a full exploration of the rationale for this changed emphasis, in the weeks and months ahead.

As the heads of the Federal deposit insuring agencies, gentlemen, you have been asked to report to this committee on the present condition of the institutions under your respective jurisdictions, and provide us your best judgment as to the impact of current and projected monetary policy on the conditions of those institutions. Because interest rate levels will be a critical determinant of depository institution well-being, and since you have little control over future rates, we have asked you to evaluate future safety and soundness in the context of the three interest rate scenarios developed by the Banking Committee staff. These include: A high rate scenario, in which the 6-month Treasury bill rate is assumed to rise from its present level to 16 percent by yearend, decline to 14 percent in 1982, and continue to average 14 percent through 1983; a second scenario, which assumes the 6-month Treasury bill rate declines to 12 percent by yearend 1981, and averages 12 percent through 1982; and a euphoric scenario, in which the 6-month Treasury bill rate declines to 7.5 percent by yearend 1981, and averages 7.5 percent through 1983.

Lastly, we would appreciate hearing an explanation of your contingency plans and your recommendations as to how the problems facing depository institutions in a tight money, high interest rate environment should be dealt with by the present administration.

I will now call on Mr. Stanton, our ranking minority member.

Mr. STANTON. Thank you, Mr. Chairman.

I join you in the opening of these hearings, which will have as their primary goal the intention to place emphasis on the effect of current monetary policy on depository institutions, and their ability to deliver credit to the various sectors of the economy. I think in this regard, Mr. Chairman, it is well to keep in mind that President Reagan's programs, as announced originally on February 18, addressed as part of the four-point program this very subject. As a matter of fact, each of the four elements of the President's program should have a substantial, substantive, and positive impact on the ability of insured depository institutions to survive, and to adapt successfully to rapid changing market conditions in the years ahead.

Employment of a stable, noninflationary monetary policy offers the single best hope of restoring sufficient stability to the long-term money markets, and to permit depository institutions to offer mortgages and other long-term financing at predictable interest rates, once again. The President's effort to check the rate of growth of Federal spending will benefit the depository institutions by controlling the Federal deficit, while the consequent pressures upon the Treasury and the Federal Reserve to finance the deficits, in competition with depository institutions and private lenders, will be alleviated.

Mr. Chairman, you did allude to the conversations and the cooperation, and coordination that we had with the regulatory agencies led by the Federal Reserve Board, here several months ago, in regard to their requests for additional powers. I join you in expressing my regret that we did not succeed at that time in furthering the desires and hopes of the regulators. We were united in this effort, members of both sides of the political aisle, not only here in the House, but I think we had almost unanimous cooperation from the other body. It is regrettable that we did not separate the questions of the emergency legislation that the regulators asked for from the additional powers that the Federal Home Loan Bank Board has now requested.

But we are, and I am sure you join me, Mr. Chairman—realists, and take things as they come. So we will proceed today to take a look at what the regulators have to say in these hearings. Hopefully, out of the next few weeks of hearings, we can pursue a policy that would be best for our constituency, the country, and the world as a whole.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Stanton.

At this time, I would call upon our witnesses. We have Chairman Pratt, Chairman Connell, and Chairman Sprague.

We will hear from Chairman Sprague, first.

STATEMENT OF HON. IRVINE H. SPRAGUE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SPRAGUE. Thank you, Mr. Chairman.

I am grateful to be invited here today. As you know, I always welcome an opportunity to return to the House, which was my home for some 25 years, in various capacities.

Mr. Stanton, I am pleased to see you participating. I applaud your opening comment. I think I should recognize the fact that my hometown Congressman, Norm Shumway, is present. So we have two Stocktonians in the room today.

You specifically asked me to discuss current contingency planning efforts, and to make a statement of the adequacy of our resources.

Mr. Chairman, it has been 31 long years since the Congress has addressed our powers to handle failed or failing institutions. In these decades, the fund has increased from $1.2 billion to $11.5 billion. Banking assets have increased from $192 billion to over $2 trillion. Insured deposits have increased from $91 billion to $948 billion. Our insurance coverage has increased from $10,000 to $100,000. Thirty years ago, we had 262 banks, with assets over $100 million; today, there are 1,919. Thirty years ago, there were 18 banks with assets of $1 billion or more; today, there are 228.

In this period, banking has taken on an enormous new dimension of complexity and sophistication. Technology, transportation, telecommunications, and computers have revolutionized the banking industry. Worldwide competitive pressures and the continuing volatile economic environment insure that this change of pace will continue.

The FDIC now has seven basic options in handling failed or failing banks. We have utilized these 577 times in the Corporation's history. They are described in detail in my statement. While these procedures have served us well over the years, they are insufficient today, and we ask you to provide us with two additional tools to help us do our job in today's environment:

First, we seek authority to make capital infusion in instances where severe financial conditions exist which threaten the stability of a significant number of insured banks. Today, in order to make this capital infusion, we must find that an institution is essential to its community before providing such aid. The language is, very frankly, designed to provide us the option of providing capital assistance to the New York thrifts.

Second, we seek authority to make an out-of-State merger of a failed institution having over $2 billion in assets. Only 107 institutions in the Nation would be eligible.

These authorities parallel ability of the Federal Savings and Loan Insurance Corporation that it already has for Federal institutions. Granting these powers would enable the FDIC to better do its job of protecting the insured depositors of America. It would preserve our fund, and would result in a materially lesser impact on the Federal budget than in proceeding solely with our present authorities. It is not designed as a bailout of savings banks. Even with the new authority, some banks certainly will ultimately fail under adverse interest rate scenarios. We ask you to act now on these two modest provisions.

I notice that Mr. Pratt and Mr. Connell, who are with me here today, are also seeking some emergency provisions, along with the major restructuring of their industries. I suggest that a reasonable approach would be to take our bill as the framework, and add to it the credit union sections relating to mergers of institutions with dissimilar bonds, and the Bank Board provisions, expanding its present authority for out-of-State mergers.

This would basically be the regulator bill that we discussed with you earlier. You could then deliberate and consider all of the turf battles involved in adding much larger powers to the institutions.

I submit that if we hold up the emergency bill for this broader legislation, it would take all summer just to read it, let alone pass it. I think we do not have the option of waiting that long. You have the ultimate responsibility, and you have three basic options:

First, you can pass our legislation. If we didn't need it, it would not be used; it would self-destruct in a few years. Nobody would be harmed. You would have acted responsibly.

The second option would be for you to pass the legislation. We need it, we use it, and again, you have acted responsibly.

The third option would be for you not to pass the legislation—and we need it.

I would be pleased to respond to any questions.

The CHAIRMAN. Thank you, Mr. Sprague.

Now we will hear from Mr. Pratt of the Federal Home Loan Bank Board.

Excuse me. I noted that Mr. Sprague summarized his statement. Therefore, without objection, we will put his entire statement into the record.

[On behalf of the Federal Deposit Insurance Corporation, Mr. Sprague submitted a prepared statement entitled "State of the Banking Industry and FDIC Ability To Handle Problems" for inclusion in the record. The statement follows:]

STATEMENT BY

IRVINE H. SPRAGUE, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

It is good to be here today to give you our view of the state of the banking industry and our ability to handle problems that might arise.

I can report that our nation's banking system is fundamentally sound. Americans can continue to bank with confidence. But we need to remain vigilant. There are problems, particularly in the savings banks, as you know. We must improve our capacity to respond to any eventuality.

You specifically asked me to discuss "current contingency planning efforts and a statement as to adequacy of resources available to you to respond to all predictable contingencies."

Your request is most timely. We would be derelict in not saying that this matter is uppermost in our minds too. I refer to the need to expand our powers to deal with failed bank and failing bank situations.

We have been working under virtually the same provisions of law for 31 years.

In these three decades, our insurance fund has grown from $1.2 billion to $11.5 billion. The amount of assets in the banking system has increased from $192 billion to more than $2 trillion. The total of insured deposits has risen from $91.4 billion to $948.7 billion. The statutory amount of deposit insurance has been increased from $10,000 to $100,000.

In 1950, there were 262 banks of more than $100 million in assets. In 1981 there are 1,919. Thirty-one years ago there were just 18 banks of more than $1 billion in assets. Today there are 228.

Banking has taken on enormous new dimensions of complexity and sophistication. Technology, including vast improvements in transportation systems, telecommunications, and computers, has revolutionized the banking industry. And there is no indication that the pace of change will slow down. To the contrary, intense, worldwide competitive pressures and the continuing volatile economic environment make it more likely than ever that precipitous change will continue.

Yet, we are being asked to monitor the banking world in the jet age with nothing more than the tools that served us in banking's horse and buggy days.

We are at present in the process of managing the phase out of interest rate ceilings as mandated in the Depository Institutions Deregulation and Monetary Control Act of 1980. The Depository Institutions Deregulation Committee three weeks ago voted to take actions effective August 1 that will make long steps in that direction. An important part of our task is to oversee the transition of thrifts to a deregulated environment, the likes of which they have never experienced.

Yet, we have had no major changes in a fundamental area of FDIC jurisdiction since the enactment of the Federal Deposit Insurance Act of 1950, which included for the first time Section 13(c) power to make capital infusions to failing banks under very restricted circumstances. The only other change in this area since then occurred with passage of the International Banking Act of 1978, which extended our failed and failing bank authority to insured branches of foreign banks.

FAILED OR NEAR-FAILING BANK OPTIONS

The FDIC now has seven options for handling failed or near failing banks. First, FDIC can pay off insured depositors of a failed bank. This was done, for example, earlier this year in the failure of The Des Plaines Bank, Des Plaines, Illinois, and it was done in three bank failures in 1980 and three in 1979. In the Des Plaines case, the bank had total deposits of $42.9 million in 15,000 accounts. In a payoff, depositors are paid to the statutory limit of $100,000. Account holders with deposits exceeding the limit and other creditors receive a pro rata share of the proceeds from the liquidation of the bank's assets over a period of years.

FDIC's second option is what we call a purchase and assumption (P&A) transaction between banking organizations in the same State. Healthy existing banking organizations or new organizations bid to assume the deposit liabilities of the failed bank and to purchase certain assets and the failed bank's goodwill. Such transactions have been arranged in three cases this year and seven times each in 1980 and 1979. One notable example of this procedure occurred in 1973 when the $1.3 billion United States National Bank of San Diego, California, failed. There, FDIC as Receiver of the bank, arranged a purchase and assumption transaction in which Crocker National Bank was the successful bidder. A purchase and assumption transaction by law must be projected to be less expensive than a payoff. In practice, such transactions have also proved to be less disruptive. Depositors and other general creditors recover all their funds, and banking service continues with little or no interruption, normally at the same location.

A third option takes the form of a purchase and assumption transaction involving foreign interests. This has occurred six times, the most highly publicized in 1974 after the failure of the Franklin National Bank in New York. Franklin, at the time of its failure, had over $3.6 billion in assets and $1.4 billion in deposits. It was sold to European American Bank & Trust Company, which is owned by a consortium of European banks.

A fourth option, also a variation of the purchase and assumption procedure, is to partition the failed bank's assets and liabilities and arrange for the transfer of asset-liability packages to more than one participating bank. This occurred after the 1978 failure of the $607.6 million Banco Credito y Ahorro Ponceno of Ponce, Puerto Rico. FDIC divided the bank between two assuming banks which lessened the anti-competitive effects of the transaction.

FDIC's fifth option, under very limited circumstances, is to provide assistance in order to prevent the failure of a troubled bank. This has occurred only five times since FDIC received the power in 1950, most recently last year when FDIC, along with 27 banks, loaned the First Pennsylvania Bank $500 million to avert its failure. As a condition to receiving FDIC assistance, all directors and principal officers serve subject to FDIC approval, and FDIC must approve their compensation. FDIC also must sanction any dividends and the bank's "plans and objectives". FDIC also received warrants for the purchase of First Pennsylvania Corporation's common stock. These are some of the key conditions which we tailored for the First Pennsylvania assistance. In another such case, we would expect to develop a similar but separate set of terms and conditions as necessary to meet the situation.

A sixth option, under Section 13(e) of the FDI Act, involves assistance to facilitate the merger of a failing bank into a healthy bank prior to actual failure, but this procedure is rarely used for a variety of reasons. The most recent instance was in November, 1975, when the Corporation authorized a loan of up to $10 million to facilitate the merger of Palmer First National Bank and Trust Company of Sarasota, Florida, into a newly formed national bank subsidiary of Southeast Banking Corporation of Miami, after written confirmations were received from the Comptroller of the Currency and the Board of Governors of the Federal Reserve System that such assistance was essential to effect the proposed acquisition and to prevent the imminent failure of the Palmer Bank.

A seventh option is a Deposit Insurance National Bank (DINB). The DINB would serve solely as a vehicle for the orderly payoff of insured deposits. In 1975 the Corporation established two DINB's in connection with the closings of the Swope Parkway National Bank, Kansas City, Missouri, and The Peoples Bank of the Virgin Islands, St. Thomas, Charlotte Amalie, Virgin Islands.

PROPOSED LEGISLATION

We have proposed to the Congress and solicit your active and aggressive support for legislation to provide an eighth and ninth option: to modify the statutory Section 13(c) test to enable us to make capital infusions more easily, particularly in the New York thrifts, and to permit FDIC as the Receiver of a large failed FDIC-insured bank to arrange a Section 13(e) purchase and assumption transaction with an out-of-State institution, but only if the failed bank had $2 billion or more in assets. Only 107 banks in the Nation would be eligible -- 89 commercial and 18 savings banks in 26 States, concentrated in New York, California, Ohio, Texas, Pennsylvania and Illinois. The qualifying size is indexed so inflation will not artificially increase the universe of eligible institutions. The other 15,000 smaller banks in the nation would not be affected and have no reason whatsoever to oppose our seeking a large bank solution.

Our legislation is designed to give FDIC powers which are similar to those that the Federal Savings and Loan Insurance Corporation (FSLIC) already has. Currently, FSLIC may provide assistance to an insured S&L even if the association is not essential to its community and FSLIC may assist the merger of a failing insured S&L with an out-of-State Federal S&L. The proposed legislation gives FDIC similar capabilities. Because of the unique nature of the various financial institutions, total comparability between FSLIC and FDIC powers probably is not desirable. Our legislation, however, will provide greater comparability between the two insuring agencies.

In the case of the failure of a bank of qualifying size, FDIC could consider this new alternative for arranging a purchase and assumption transaction, together with all the other possible courses of action. The interstate option would permit the FDIC to consider a course that would produce a meaningful purchase premium for assets, avoid anticompetitive effects and continue banking service.

Under the interstate option the FDIC would be required to inform the State banking superintendent in advance whenever the FDIC determines that the interstate option might be used. This is true whether a national or State-chartered bank is involved. If the State superintendent objects to an out-of-State transaction and FDIC agrees with the superintendent's reasons, then FDIC would abandon the interstate option and attempt to arrange an in-State purchase and assumption transaction or proceed with an insurance pay off. The FDIC can go forward with the interstate option, the superintendent's objections notwithstanding. However, before any out-of-State transaction may be made, the Board of Directors of the FDIC must unanimously agree on the decision. The Board also must provide the superintendent with a written certification of its determination.

Under the interstate option, FDIC as the Receiver of a failed bank of qualifying size would solicit offers from any bank and bank holding companies in the country that the FDIC determines are qualified and capable of acquiring assets and liabilities of the failed bank. If the highest acceptable bid is from an out-of-State bank or bank holding company, the FDIC must provide the highest in-State offeror an opportunity to make a higher offer. If the in-State offeror offers more, then FDIC must accept. If the in-State offeror does not, FDIC must give the same opportunity to the highest offeror from a State adjoining the State in which the closed bank was located. If the adjacent State offeror also declines, then the FDIC may accept the high bid, regardless of the location of the bidder.

This section of the bill would provide that a winning out-of-State bidder may reopen a closed bank only as a subsidiary so that no interstate branching will result. State banking law will prevail in the operation of the subsidiary. The section would authorize operation of the subsidiary, the Douglas Amendment notwithstanding. The section also would require that before any sale may be accomplished, appropriate State and Federal approvals must be obtained. For instance, a bank holding company must have approval of the Federal Reserve to acquire assets of a closed bank as a subsidiary. The section would prohibit FDIC from making any sale that would have serious anticompetitive results. Finally, the section has a five-year sunset provision.

The other basic change in our law would enable the FDIC to provide assistance to institutions whose problems stem principally from such causes as the interest rate squeeze.

Currently, the FDIC can provide assistance to a bank only when it is in danger of failing and its continued operation is essential to provide adequate banking services in the community. The bill would modify FDIC powers to permit it also to act when it finds that severe financial conditions exist which threaten the stability of a significant number of insured banks and it is probable that any assistance to one of these threatened banks will substantially reduce the risk of loss or avert a threatened loss to the FDIC. This new test for assistance provides the FDIC with the needed flexibility to react to severe financial conditions as they arise. Unlike the current test which focuses exclusively on the essentiality of a single failing institution, the proposed new test focuses on severe financial conditions affecting the stability of a significant number of insured banks. Significance may be measured not only in terms of the total number of institutions, but also in terms of the total resources of the threatened institutions. In every instance, FDIC could provide assistance only where such action "will substantially reduce the risk of loss or avert a threatened loss to the Corporation". Essentially, this means that to qualify for assistance a bank must be among a significant number of banks whose stability is threatened by severe financial conditions, there must be a clear threat that without assistance the bank will fail, and it is probable that assistance will be "substantially" less expensive to the FDIC than other methods of handling the potential failure.

In addition to the two basic FDIC provisions, the proposed legislation makes related changes in our law to make the total process more workable. These are:

(A). A provision that would clarify that foregone earnings resulting from FDIC loans to insured institutions are insurance losses. Currently, FDIC may deduct from assessments received from insured banks any insurance losses it experiences before calculating the proportion of the assessments to rebate to the banks. For example, in a typical purchase and assumption transaction, that portion of projected losses not recovered by the purchase premium would be established as a reserve account and charged against assessment income. In other words, the FDIC would experience an insurance loss that may be deducted from assessments. A below-market-rate loan also would result in a loss to the FDIC of the difference between what FDIC could earn on the funds if left in FDIC's portfolio and what it is earning from the loan. This opportunity loss is no different from a loss arising from a P&A. The structure of the transaction should not determine whether a loss can be recognized for insurance fund purposes. The FDIC seeks to clarify that this opportunity loss also is deductible from assessments. The FDIC is totally self-funded -- that is, funded by bank assessments and interest income rather than by public monies. This amendment will facilitate that result continuing.

(B). A provision that would broaden the field of institutions which may purchase the assets and assume the liabilities of a failed bank. In addition to FDIC-insured banks, under the proposal associations or banks insured by the Federal Savings and Loan Insurance Corporation would become eligible bidders.

BUDGETARY PROBLEMS

We are fully aware of the budget problems facing our government and we believe our proposed legislation will minimize the budgetary impact of future bank failures. While we have a separate fund, every expenditure of the FDIC represents a Federal expenditure and has a budgetary impact. We believe the powers we are asking for will result in a smaller outlay and lower cost to the FDIC than if we are forced to use only the alternatives now available to us. By minimizing FDIC's costs, we will, in turn, minimize the potential budgetary impact of future failures.

NEED TO ACT NOW

We are talking today about emergency legislation to meet a specific need. The Congress will also be considering broad, comprehensive and certainly controversial legislation to greatly expand the authority of thrift institutions with commercial bank powers and to address such questions as due on sale clauses, insurance limits, usury ceilings, plus possibly export trading companies and other matters.

We urge you to keep the issues separate: act now on the limited emergency bill needed now; deliberate and act later on the more comprehensive long term legislation.

THE STATE OF THE FDIC

Both the financial and human resources of the FDIC remain strong, and we believe capable of dealing with any foreseeable eventuality, given the requisite statutory flexibility. Net income to our $11.5 billion insurance fund last year topped the billion dollar mark for the first time with a record $1.2 billion gain. This year we project net income of $1.3 billion. We also are entitled to borrow $3 billion from the Treasury if needed, although we do not anticipate it will be.

Our major resource is our corps of 3,500 skilled and dedicated employees who remain committed to fulfillment of our statutory mandate of promoting the safety and soundness of the banking system while at the same time continually seeking ways to do our job more efficiently. The Corporation is well managed. In 1979 our administrative expenditures increased just 3.4 percent, compared to 9.5 percent Government-wide. In 1980 our increase was 10.7 percent, compared to 17.3 percent throughout Government. Our 1981 outlays are well below our budget. One example of the effort of our people to improve efficiency is in the area of travel expenditures. Our staff will travel an estimated 16 million miles to carry out their bank examination duties in 1981, a reduction of 12 percent from 1980, which was itself a reduction of nine percent from 1979. We are able to achieve these savings by more careful scheduling of examinations and by more efficient car pooling, and a spirit of cooperation from our work force.

Supervisory Innovations: Some examples of supervisory innovations we have undertaken in recent years are as follows: (a) our Division of Bank Supervision and the Division of Management Systems and Financial Statistics developed a computerized system, which we call our Integrated Monitoring System, for the primary purpose of monitoring the activities of banks between examinations to help us decide where best to allocate our examiner time and resources. With this system we have been able to reduce the number of examinations conducted. (b) the development of a modified examination concept, which provides for the review of the safety and soundness essentials of a well managed bank without requiring the comprehensive detail of a full-scope examination. This program has enabled us to reduce the time required to perform most examinations. (c) in cooperation with individual States, we have significantly expanded the divided examination program so that we presently participate with 20 States in divided examination arrangements covering 3,400 banks, just over one-third of all insured State nonmember banks with resultant substantial savings. (d) last year our Division of Bank Supervision developed streamlined common application forms. These are now in joint use by the Corporation and 22 States, thereby requiring a bank to complete only one form -- a form that requires only essential information for any particular application. This effort, together with closer cooperation with the State in the processing of applications, has enabled us to render more expeditious decisions on these applications and reduced the time required by banks to complete the application.

Bank examination is the heart of our supervisory program to promote the safety and soundness of the banking system. The FDIC will continue to exercise a strong bank examination function. In 1981 we expect to conduct 5,800 safety and soundness examinations.

Recent economic circumstances have created new and serious problems for thrift institutions, including the insured mutual savings banks which we supervise. Late last year we established an ongoing project team to monitor conditions in the thrift industry and develop strategies and policies for addressing the situation. We have increased our supervision of these institutions through increased examinations and visitations, more timely and thorough reporting of financial developments by the banks to the FDIC, and more frequent meetings and discussions with the trustees of those institutions experiencing difficulties. This has placed added burdens upon our resources; however, we are able to meet the challenge largely because of our efforts to develop a total supervisory program which has the built-in flexibility to handle such situations when they arise.

EXPERIENCE OF 1980

The year 1980 was marked by substantial turbulence in the nation's economy and credit markets. Output and employment declined substantially in some vital sectors of the economy. The housing and auto industries were particularly hard hit. Inflation, as measured by indexes of consumer and producer prices, continued to soar at double-digit rates. These developments in the economy contributed to instability in the financial sector, as reflected most notably in the movement of interest rates.

The pattern of interest rate changes last year was unprecedented in recent history, both with respect to the magnitude and frequency of change. The prime rate, for example, rose from 13.25 percent to a record 20 percent, declined to less than 11 percent and ended the year at a new record level of 21.5 percent. These wide fluctuations and the unprecedented levels to which interest rates rose imposed stresses on the economy and the banking industry. The high interest rates contributed to a substantial growth in money market mutual funds during the year.

During the first half of this year, we have seen a slight reduction in the inflation rate and, during the second quarter, some evidence of a slowing in the rate of economic activity. Nevertheless, interest rates have remained at or near record levels, thereby providing an uncomfortable environment for some commercial banks and most thrift institutions.

MUTUAL SAVINGS BANKS

The mutual savings banks problem is centered in New York City but not limited to that city. Higher interest rates have significantly increased the cost of savings bank deposits. While yields on savings bank earning assets have risen, they have done so much more slowly than deposit costs. Assets are heavily concentrated in long-term, fixed-rate mortgages and bonds which turn over slowly. The problem has been exacerbated by slow deposit growth resulting from such causes as a low personal savings rate and increased competition from money market funds and market instruments. These conditions have severely limited savings banks' ability to acquire higher-yielding assets. Indeed, many savings banks are forced to use funds generated from mortgage amortization payments to finance deposit outflows and operating losses with little left over to invest in higher yielding assets available in today's market.

Last year, FDIC-insured mutual savings banks in the aggregate lost money. The loss amounted to about 0.17 percent of average assets compared with net income of about 0.45 percent of assets in 1979 and 0.59 percent in 1978. The loss was not evenly spread throughout the country. New York City savings banks, which account for about 40 percent of the deposits of FDIC-insured thrift institutions, lost about 0.62 percent of average assets last year. However, the rest of the industry had net income of about 0.17 percent. The weaker performance of many of the New York City savings banks reflects a combination of factors, the most significant being inflation and the resultant high interest rates, but also including past restrictions on permissible lending, past restrictive usury ceilings, unfavorable State and city tax treatment, relatively low mortgage activity, and a high degree of competition from large money center institutions and money market funds.

During the first half of this year, savings bank earnings have further deteriorated -- that is, losses have increased. The FDIC has been collecting monthly income and deposit data from those savings banks with deposits of $500 million or more in order to monitor their performance closely. These 79 institutions account for about 75 percent of all savings bank deposits. During the first five months of 1981, only 14 of the large savings banks had positive net income and by May only 11 had positive operating income. Overall, these 79 savings banks lost a net $400 million even after taking account of Federal tax credits and security gains from very selective asset sales. If this loss were annualized, it would amount to 0.82 percent of assets. Savings banks in New York City accounted for much of the loss. On an annualized basis, their loss for the first five months of this year was over 1.3 percent of assets and for the month of May, the annualized loss was 1.55 percent of assets. It should be noted that smaller savings institutions not included in our monthly survey generally are doing better than the larger institutions though their performance has also deteriorated this year.

Interest rate and deposit flow data for June suggest that savings bank performance that month was at least as bad as in May. Savings bank earnings during the balance of the year will be importantly affected by interest rates. If rates remain constant, or if they decline only slightly, deposit costs will continue to rise as low-cost passbook accounts and

7-1/2 and 7-3/4 percent certificates shift into higher-cost deposits or leave institutions altogether.

There still remains an extremely large pool of mutual savings bank capital available to sustain the industry for a considerable period of years, although individual institutions may well be troubled earlier if the present inflation and interest rate environment continues.

If interest rates decline quickly and markedly and remain low for a sustained period, most savings banks should be able to adjust portfolio returns to bring them into line with the market and make appropriate adjustments to attain a profitable position. Savings banks then would have the opportunity to take advantage of the broadened lending powers authorized under the Depository Institutions Deregulations and Monetary Control Act of 1980 and State laws to reduce their exposure to future interest swings. Thus far, prevailing financial market conditions and other factors have made it difficult for savings banks to take advantage of these broadened powers to any significant degree. If unfavorable conditions persist in financial markets for a prolonged period, then some savings banks are likely to need assistance if they are to continue to operate.

Since we cannot predict the future course of interest rates or other variables, we are unable to predict, as you requested, if any large savings banks face the prospect of failure or when such a prospect might begin to materialize.

CONDITION OF INSURED COMMERCIAL BANKS

Despite the conditions that prevailed in financial markets throughout last year and the sharp drop in economic activity during the second quarter of the year, most commercial banks performed quite well in 1980. In the aggregate, net income and assets grew by 10 percent.

Despite our earlier concerns and those of many financial market observers regarding the position of smaller commercial banks, most small banks -- those with deposits of less than $100 million -- performed quite well in 1980.

We should note, however, that smaller banks have experienced a sizable transfer of funds from low-cost deposits to money market certificates and other more expensive deposits. Also, many small banks hold large amounts of mortgages and other long-term assets that would prevent them from raising their return on assets sufficiently in the short run to compensate for increased money costs. Apparently, however, this was not a problem in 1980.

For 1981, in addition to the rising costs of time and savings deposits, universal NOW accounts have also put pressure on bank costs. Smaller banks, with a larger concentration in retail deposits, seem more vulnerable to the increased costs and competition associated with NOW accounts. Another factor that has become increasingly important is competition from money market funds. Growth in retail time and savings deposits at commercial banks has slowed markedly this year, although not as dramatically as at thrifts, and competition from money market funds undoubtedly played a very important role in this development. Again, small banks with a greater emphasis on retail deposits may be more affected by this development.

In assessing developments thus far in 1981, we are handicapped by the availability of data, particularly for small banks. We are just beginning to process mid-year reports which should give us a better reading on their performance thus far in 1981. We are able to make some general observations based on income reports for the first quarter of 1981, which are filed by banks with assets of $300 million and over, and from published financial statements of banks, although these tend to be more available for the larger, publicly traded institutions.

First quarter data for the larger banks suggest that they were able to maintain net interest margins despite the rising costs of deposits. Returns on assets appear to approximate those realized in 1980 and published financial reports indicated that year-to-year earnings improvement between the first quarter of 1980 and the first quarter of 1981 approximated increases in assets.

For the second quarter of 1981, we look for a mixed performance for larger commercial banks. Comparing the second quarter of 1981 to the second quarter of 1980 may well show almost as many minuses as pluses. To some degree, this appears to reflect the fact that the second quarter of 1980 was a very strong quarter for large banks. When interest rates declined rapidly in the second quarter of 1980, reduced money costs actually widened interest margins at the money center banks. That appears to be showing up now in the form of unfavorable year-to-year comparisons.

As I indicated, we do not have as precise a reading on the performance of smaller commercial banks. Weaker deposit performance and some of the other developments that I have mentioned suggest that 1981 may not be quite as good a year for small banks as 1980. However, the information we have received, including the comments from our various regional offices, indicates that most small banks continue to be performing well. They apparently have been less vulnerable to interest rate risk, at least as a group, than anticipated.

We must remain alert to any continued instability in the economy, further competition for bank and thrift funds from the unregulated sector of the financial markets, and the weakened condition of other types of financial institutions which will test the capabilities of bank managers, regulators, and legislators throughout the year.

CONCLUSION

The banking scene today is fast-changing. We at the FDIC remain firm in our commitment to the people in monitoring the safety and soundness of the banking system. We believe that the situation today warrants the revision in the tools of our trade that we have outlined. We urge your quick action.

97th Cong.
1st Sess.

July 14, 1981

TEXT OF LEGISLATION TO ACCOMPANY STATEMENT ON STATE OF BANKING INDUSTRY AND FDIC ABILITY TO HANDLE PROBLEMS

A BILL

To provide flexibility to the Federal Deposit Insurance Corporation to deal with financially distressed banks.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

ASSISTANCE TO INSURED BANKS

SEC. 1. Section 13(c) of the Federal Deposit Insurance Act (12 U.S.C. 1823(c)) is amended to read as follows:

"(c)(1) In order to reopen a closed insured bank or, when the Corporation has determined that an insured bank is in danger of closing, in order to prevent such closing, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the opinion of the Board of Directors the continued operation of the bank is essential to provide adequate banking service in the community.

"(2) Whenever severe financial conditions exist which threaten the stability of a significant number of insured banks, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, any insured bank so threatened, upon such terms and conditions as the Board of Directors may prescribe, if it is probable such action will substantially reduce the risk of loss or avert a threatened loss to the Corporation.

"(3) Any loans and deposits made pursuant to the provisions of this paragraph may be in subordination to the rights of depositors and other creditors.".

PURCHASES OF INSURED BANKS

SEC. 2. (a) Section 13(e) of the Federal Deposit Insurance Act (12 U.S.C. 1823(e)) is amended to read as follows:

"(e)(1) Whenever in the judgment of the Board of Directors such action will reduce the risk of loss or avert a threatened loss to the Corporation and will facilitate a merger or consolidation of an insured bank with another insured depository institution or will facilitate the sale of the assets of an open or closed insured bank to and assumption of its liabilities by another insured depository institution, the Corporation may, upon such terms and conditions as it may determine, make loans secured in whole or in part by assets of an open or closed insured bank, which loans may be in subordination to the rights of depositors and other creditors, or the Corporation may purchase any such assets or may guarantee any other insured depository institution against loss by reason of its assuming the liabilities and purchasing the assets of an open or closed insured bank. Any insured national bank or District bank, or the Corporation as receiver thereof, is authorized to contract for such sales or loans and to pledge any assets of the bank to secure such loans.

(2)(A) Whenever an insured bank that had total assets equal to or greater than 0.12 percent of aggregate assets in domestic (U.S.) offices of insured banks (as determined from the most recently compiled Reports of Condition filed by insured banks) is closed and the Corporation is appointed receiver, then, the Receiver may, in its discretion and upon such terms and conditions as it may determine, and with such approvals as may elsewhere be required by any State or Federal courts and supervisory agencies, sell assets of the closed bank to and arrange for the assumption of the liabilities of the closed bank by an insured depository institution located in the same State as that in which the closed bank was chartered but owned by an out-of-State bank or bank holding company. Notwithstanding subsection (d) of Section 3 of the Bank Holding Company

Act of 1956 or any other provision of law, State or Federal, the acquiring institution is authorized to be and shall be operated as a subsidiary of the out-of-State bank or bank holding company; except that an insured bank may operate the assuming institution as a subsidiary only if specifically authorized by law other than this paragraph.

(B) In determining whether to arrange a sale of assets and assumption of liabilities of a closed insured bank under the authority of this paragraph (2), the Receiver may solicit such offers as is practicable from any prospective purchasers it determines, in its sole discretion, are both qualified and capable of acquiring the assets and the liabilities of the closed bank.

(i) If, after receiving offers, the highest acceptable offer is from a subsidiary of an out-of-State bank or bank holding company, the Receiver shall permit the highest acceptable offeror of any existing in-State insured depository institutions and subsidiaries of in-State bank holding companies to submit a new offer for the assets and liabilities of the closed bank. If this institution reoffers a greater amount than the previous highest acceptable offer, then the Receiver shall sell the assets and transfer the liabilities of the closed bank to that institution.

(ii) If there is no acceptable offer received from an existing in-State depository institution or subsidiary of an in-State bank holding company, or if there is no reoffer greater than the highest acceptable offer, then the Receiver shall permit the highest acceptable offeror of the subsidiaries of the insured banks chartered in States adjoining the State in which the closed bank was chartered and bank holding companies whose banking subsidiaries' operations are principally conducted in States adjoining the State in which the closed bank was chartered (if its offer was not the highest received by the Receiver) to make a new offer for the assets and liabilities of the closed bank. If this subsidiary reoffers a greater amount than the previous highest acceptable offer then the Receiver shall sell the assets and transfer the liabilities of the closed bank to that institution.

(iii) If no offer under subparagraphs (i) or (ii) is received which exceeds the original highest acceptable offer, then the Receiver shall sell the assets and transfer the liabilities of the closed bank to the highest acceptable offeror.

(C) In making a determination to solicit offers under subparagaraph (B), the State bank supervisor of the State in which the closed insured bank was chartered shall be consulted. The State bank supervisor shall be given a reasonable opportunity, and in no instance a period of less than twenty-four hours, to object to the use of the provisions of this paragraph (2). If the State supervisor objects, the Receiver may use the authority of this paragraph (2) only by a unanimous vote of the Board of Directors. The Board of Directors shall provide to the State supervisor, as soon as practicable, a written certification of its determination.

(D) The Receiver shall not make any sale under the provisions of this paragraph (2) — (i) which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States; or (ii) whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

(E) Nothing contained in this paragraph (2) shall be construed to limit the Corporation's powers in paragraph (1) to assist a transaction under this paragraph.

(3) As used in this subsection -- (i) the term "Receiver" shall mean the Corporation when it has been appointed the receiver of a closed insured bank; (ii) the term "insured depository institution" shall mean an insured bank or an association or bank insured by the Federal Savings and Loan Insurance Corporation; (iii) the term "existing in-State insured depository institution" shall mean an insured depository institution that is chartered in the same State as the State in which the closed bank was chartered; (iv) the term "in-State bank holding company" shall mean a bank holding company whose banking subsidiaries' operations are principally conducted in the same State as the State in which the closed bank was chartered; and (v) the term "out-of-State bank or bank

holding company" shall mean an insured bank having its principal place of banking business in a State other than the State in which the closed bank was chartered or a bank holding company whose banking subsidiaries' operations are principally conducted in a State other than the State in which the closed bank was chartered."

(b) The provisions of paragraph 2 of section 13(e) of the Federal Deposit Insurance Act shall cease to be effective five years from the date of its enactment. The expiration of the effectiveness of section 13(e)(2), however, shall have no effect on the continued legality of any sale or operation authorized while it was effective.

AGREEMENTS DIMINISHING THE
RIGHTS OF THE CORPORATION

SEC. 3. Section 13 of the Federal Deposit Insurance Act is amended by adding at the end thereof the following new subsection:

"(h) No agreement which tends to diminish or defeat the right, title or interest of the Corporation in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, (3) shall have been approved by the board of directors of the bank or its loan committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank."

FDIC ASSESSMENTS

SEC. 4. The third sentence of section 7(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(d)(1)) is amended --

(a) by striking out "and" the second place it appears; and

(b) by inserting before the period at the end thereof the following: "; and (4) any lending costs for the calendar year, which shall be the difference between the rate of interest earned, if any, from each loan made by the Corporation pursuant to section 13 after January 1, 1981 and the Corporation's average investment portfolio yield for the calendar year.".

THE BANK HOLDING COMPANY ACT OF 1956

SEC. 5. Section 3(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(d)) is amended by adding after the word "application" the following:

> "(except an application filed as a result of a transaction to be accomplished under section 13(e)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1823(e)(2))".

The CHAIRMAN. Now please proceed, Mr. Pratt.

STATEMENT OF HON. RICHARD T. PRATT, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. PRATT. Thank you, Mr. Chairman, Mr. Stanton, and members of the committee.

I appreciate the opportunity to appear today on behalf of the Federal Home Loan Bank Board to testify concerning monetary policy and the present and projected conditions of the thrift industry. I will make a short opening statement, and ask that my testimony be incorporated into the record.

The CHAIRMAN. Without objection, so ordered.

Mr. PRATT. First, we at the Federal Home Loan Bank Board support the Federal Reserve and the monetary policy which it has pursued. In our opinion, the Federal Reserve has done as good a job as is possible, given the present circumstances, to assure that over the long run, we are likely to have a low and stable level of interest rates in this country, and one in which thrift institutions can survive and prosper.

The present situation in which we find ourselves, which in the last few years, has been characterized by a high level of inflation, stemming from a variety of sources, has caused substantial problems, as you are all aware, for the thrift industry. This industry, was of course structured historically on the basis of making long term, fixed-interest-rate loans to home purchasers for the purpose of housing America.

For many years, as a result of stable economic circumstances at the time, they were able to obtain short-term funds, lend them long term, and pick up a small margin by intermediating over this yield curve. However, with the intervention of substantial inflation, these institutions have found themselves with 6-, 7-, and 8-percent interest rate loans still on their books, while the cost of new money, as we know, has exceeded 14 and 15 percent; and for wholesale funds, it may exceed 20 percent.

We believe that, given the changing circumstances of the economy, this industry is structurally unsuited to survive under the present set of economic circumstances and competitive interfaces. The dictates of this Congress—to wit, that these institutions should pay open market competitive interest rates for their funds—have made the current structure, which is highly restrictive on the asset side and which precludes these institutions from competing on a fair and equal basis with other financial institutions, one which will guarantee the lack of thrift survivability and the lack of home finance money in this country.

A drop in interest rates, of course, would have a tremendous short-run impact in improving the position of all financial institutions today, especially the thrift institutions, which the Bank Board regulates. However, despite that fact, I see no clear prescription for the Federal Reserve which would automatically lead to an immediate lowering of interest rates.

It appears to us that the factors and the policy which they have been following are best suited to accomplish that objective. From a policy perspective, the current state of the thrift industry suggests to us three basic things:

First, the efforts of the administration and of the Federal Reserve to bring inflation under control must be allowed to work. The ultimate short-run solution is the lowering of interest rates and returning to a position where financial intermediation, from short to long again, makes some sense.

Second, as a means of crisis management, we believe it is vital that the Congress provide the FSLIC with certain additional tools. One of the most important of these would be to empower us to allow FSLIC-insured institutions in financial difficulty to merge with any other insured savings and loan or Federal savings bank, or be acquired by any savings and loan holding company.

This would involve an override, in extraordinary circumstances, of various State and Federal laws that are designed to inhibit the interstate spread of financial institutions. Such laws, given the diminished number of savings and loans interested in or capable of participating in FSLIC-assisted mergers, are having the effect of significantly increasing the cost of such mergers, and could lead to unnecessary liquidations.

Another step would be to streamline our conservatorship and receivership powers. The present approach of awaiting State action is proving awkward and cumbersome. The current circumstances, however, obviously put a premium on prompt resolution of problem cases. In light of present conditions, we are convinced that legislation embodying these provisions, as well as those FSLIC-related measures we described in the formal statement, would be enormously helpful in conserving FSLIC resources both in terms of money and people.

The third policy direction in which the present situation points is that of restructuring. Thrifts currently are in an essentially untenable situation, having undergone abrupt de facto deregulation of their liability side without corresponding deregulation of the asset side. As presently constituted, the industry is simply too vulnerable to volatile economic conditions, lacking the asset side empowerments to compete successfully through all phases of the economic cycle.

The Bank Board's restructuring proposals, which are outlined in detail in my formal statement, are intended to insure that thrift institutions can function over the long term as viable members of the financial community. By speaking of the long term, however, I do not wish to imply that congressional action can safely be delayed, but to indicate instead that our proposals would insure the long-term presence of thrift institutions. The factors threatening that presence are operating now and it is imperative that Congress act rapidly to counter them.

That some of the powers that we propose, by their nature and as a consequence of the debilitated state of the industry, will have a certain lag time in their effectiveness, argues particularly strongly, in our view, in favor of quick congressional consideration. If Congress does not act in the short run to address this matter, there will be no long run for a very substantial segment of the thrift industry.

We realize that the steps we are urging point toward a substantial breakdown in the legal differences between the powers granted to thrifts and banks and will generate considerable concern regarding the future of housing finance. While some thrift institutions could be expected to turn away from mortgage finance, we believe that the industry's expertise in the area, coupled with the ability to make flexible rate loans and the prospect of great housing demand over the rest of this decade, would result in the majority of thrifts continuing as housing specialists.

Unless Congress is willing to provide comprehensive and effective controls, however, the level of this specialization must be determined by each individual institution's evaluation of economic opportunities. To continue with force specialization, given the current state of affairs, simply would be to risk the relatively rapid elimination of very large numbers of thrift institutions.

Mr. Chairman, this concludes my remarks. I would be pleased to answer any questions.

[Mr. Pratt's prepared statement, on behalf of the Federal Home Loan Bank Board, follows:]

STATEMENT

OF

RICHARD T. PRATT

CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. Chairman, Members of the Committee, I appreciate the opportunity to appear today on behalf of the Federal Home Loan Bank Board to testify concerning monetary policy and the present and projected condition of the thrift industry. In addition to addressing these issues, my statement, as you requested, will deal with the contingency planning and resources of the Federal Savings and Loan Insurance Corporation and will contain, as well, proposals for statutory changes that we believe are needed to permit the Corporation to deal more effectively with periods of economic stress such as we currently are experiencing. We also will outline a number of legislative steps that the Bank Board is convinced are essential to help thrift institutions through their current troubles and remain viable thereafter through all phases of the economic cycle.

INTEREST RATES AND S&L PROFITABILITY

The financial viability of S&Ls is acutely affected by the state of financial markets because of an extreme sensitivity to cyclical and secular movements in interest rates. Fluctuations in open market interest rates that would be considered relatively modest in today's financial environment can cause substantial swings in thrift profitability. The underlying cause of this profit volatility is the asset-liability maturity imbalance of thrifts. The average maturity of assets held by thrifts--predominantly fixed-rate, long-term mortgages--greatly exceeds the average maturity of S&L liabilities--predominantly six-month Money Market Certificates (MMCs). This maturity imbalance causes thrifts' cost of funds to fluctuate more widely than their asset yields. Consequently, profitability also fluctuates widely.

Maturity imbalance was an inconsequential problem in the pre-1966 era when interest rates were extremely stable and inverted yield curves were unknown. Beginning in 1966, a more volatile financial environment emerged, but S&Ls were sheltered from that environment by the imposition of fixed interest rate ceilings on deposits. Until June of 1978, when the MMC was introduced, thrifts' cost of deposits did not fluctuate cyclically, in contrast to open market rates. Thus, thrifts did not experience the extreme profit volatility from which they currently are suffering.

The June 1978 introduction of the MMC--designed to moderate disintermediation problems caused by competition from Treasury bills and the newly emerging money market fund industry--gave thrifts more stable deposit flows, but more volatile profitability. The MMC transformed the S&L liability structure from a significant reliance on long-term fixed-rate deposits to short-term market-indexed deposits. Additionally, the removal of limits on thrift usage of large certificates of deposit ($100,000 and over) led to substantially greater reliance on those short-term CDs for funds. Thus, the maturity imbalance problem has been intensified substantially in the past few years.

The increase in thrift sensitivity to open market fluctuations has coincided with an increase in the degree of volatility of open market rates. In 1978--a year of extreme rate volatility relative to pre-1978 standards--the 91-day Treasury bill rate fluctuated in the 6 1/2 percent to 9 percent range. In 1980, however, weekly average T-bill rates varied from less than 7 percent to almost 17 percent.

This increased rate volatility has occurred for a number of reasons. They include the change from fixed-rate to market-indexed deposit rate ceilings, the October 1979 revision of monetary policy procedures to emphasize monetary aggregates more than interest rates, the inflationary shocks caused by extremely large oil price increases in 1979, the imposition and removal of a credit control program in 1980, and the substantial swings in the pace of real economic activity.

Accordingly, thrifts' profitability problems are the result of the interaction of the maturity imbalance of the assets and liabilities of S&Ls and the volatility of open market interest rates. The increase in maturity imbalance and interest volatility in recent years has had the consequence of increasing thrift profit volatility. Exhibits 1 and 2 illustrate the degree of profit volatility which S&Ls have experienced recently. Exhibit 1 shows that both interest rates and thrift profitability have become more volatile over the past decade. Exhibit 2 illustrates this volatility on a monthly basis over the past year and a half.

The present dismal profitability characterizing the thrift industry is caused by the current high level of interest rates. If interest rates stay at present levels for the rest of this year, the S&L industry will record 1981 after-tax operating losses of $4 to $5 billion. This poor profitability performance is widespread; at present, over 74% of the firms in the industry are experiencing losses. We must emphasize, however, that the industry overall has a strong net worth position of almost $31 billion.

MONETARY POLICY

While if interest rates were to drop by several hundred basis points, the losses projected for S&Ls would be substantially avoided, we do not believe that such a relationship between losses and interest rates can be translated into any specific prescription for monetary policy. Although it is clear that the Federal Reserve can exert control over narrowly defined monetary aggregates, its ability to control interest rates is quite restricted. In our view, the primary determinant of interest rates is the pace of economic activity.

This is not to suggest that the Federal Reserve has no effect upon the economy. The current economic environment is the result of the interaction of a myriad of forces, including the rate of monetary expansion permitted by the Federal Reserve in past years. Our concern, however, is the level of interest rates at present and in the near future. While a decline in interest rates would provide significant benefits to the thrift industry in the short-run, the long-run result would be devastating to thrifts if such a decline in rates were engineered by a rapid rate of monetary growth which led to renewed inflationary pressures and substantially higher interest rates than at present. Thus, to the extent that the current slow rate of monetary growth and high real rates of interest are necessary to cure our inflation problems, we fully support the current monetary policy posture taken by the Federal Reserve.

Apart from the issue of the general level of tightness of monetary policy, there has been a concern raised over the Federal Reserve's revised operating procedures adopted in October 1979, whereby the Federal Reserve places greater emphasis on managing monetary aggregates and permits the federal funds rate to fluctuate over a wider band. Whereas the Federal Reserve formerly specified a 75 basis point band for federal funds, its policy directive currently specifies a 500 basis point band. The result of this revised procedure has been to allow increased interest rate volatility. As was mentioned previously, however, the rate volatility of the past couple of years has been caused by a number of other factors as well as monetary policy procedures.

To the extent that the post-October 1979 procedures have increased interest rate volatility, they have generated difficulties for thrifts with regard to operations. Standard business practices in housing finance were developed in a stable interest rate environment which are not appropriate in the current economic environment. The traditional practice of offering stand-by commitments for fixed-rate long-term loans can be risky in a volatile rate context. Mortgage sellers tend to deliver below-market loans to thrifts when rates rise, but to seek better opportunities elsewhere when market rates decline. Additionally, because of the sharp increase in interest rate volatility that occurred after October 1979, the fees charged by thrifts offer inadequate compensation for the risk exposure that those institutions have endured.

The more volatile rate environment has also created problems on the deposit side. Thrifts have been experiencing significant volumes of premature withdrawals from certificate accounts because early withdrawal penalties have been inadequate. The adequacy of early withdrawal penalties as set by the Depository Institutions Deregulation Committee is a significant concern for longer-term certificates. For example, the current early withdrawal penalty of six-months interest on a four-year certificate provides sufficient protection against early withdrawal only if open market rates rise less than about 150 basis points--a relatively modest amount in today's market.

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

At this point, I would like to make some observations with regard to the Depository Institutions Deregulation Committee. While the Bank Board fully supports the ultimate goal of the DIDC--that is, the deregulation of deposits--it should be stressed that thrift institutions are more adversely affected by deregulation than are commercial banks; indeed, one of the banking industry's most important profit centers, corporate checking, was totally excluded from the rate decontrol process, enjoying a statutory prohibition on the payment of interest.

The Bank Board's primary concern is related to the continued erosion of the rate differential. In the view of the Bank Board, removal of much of the rate differential on MMCs in May 1980 was precipitous. It has proven to be injurious to thrifts with regard to their retail savings base. We believe that it should not have been considered at such an early state in the DIDC's existence.

As a result, since May 1980 the proportion of thrift liabilities consisting of large denomination time deposits (over $100,000) and reverse repurchase agreements has increased significantly. There is a concern over the potential liquidity problems that may develop if thrifts' currently poor earnings performance impedes those institutions from rolling over these partially insured deposits. While portfolio liquidity is currently high at most thrifts, weakness in deposit flows accompanied by the public's concern about their earnings performance may strain their liquid asset holdings. We believe that reinstatement of the rate differential would enlarge the flow of MMC deposits to thrifts and help offset their dependence on CDs, repurchase agreements, and the necessity of using Federal Home Loan Bank advances to shore up liquidity.

Present evidence suggests that to sell large CDs, thrift institutions normally have to pay a 25-50 basis point premium over the commercial bank rate. In recent weeks, however, thrifts have had to pay rates 100 (on 30-day CDs) to 200 (on 90-day CDs) basis points higher than commercial banks to obtain CD funds.

Currently, there is no evidence of a widespread inability of thrifts to sell large CDs. However, there appear to have been instances of rollover problems, which may portend further difficulty in the future. This potential problem is concentrated in a relatively small number of large institutions. Exhibit 4 indicates that, as of April 1981, 301 S&Ls (representing 13.6 percent of the industry's assets) had large CD balances which exceeded 15 percent of their assets. These associations had $17.6 billion of large CDs, out of an industry total of $42 billion. We estimate that, if the MMC differential had not been removed, S&Ls would have had $48 billion in additional funds from MMCs and therefore would not have had to take on the large proportion of CDs.

FSLIC OPERATIONS

As you are aware, the adverse conditions currently besetting the industry have led to an enormous increase in the workload of the FSLIC, with problem cases rising from 79 in December 1979 to approximately 263 as of the end of May. At our FY 1982 appropriations hearings, we testified that FY 1980 was the busiest year in the FSLIC's history, with 9 cases being completed and a total cash outlay of more than $1 billion. FY 1981 already has involved approximately that amount of effort and expenditure, and clearly will see a new record set for outlays and number of cases completed. If there is no improvement in the economy, FY 1982 will be even worse. Looking at the situation from a calendar year perspective, the FSLIC in the first six months of CY 1981 has participated in 8 assisted mergers and a liquidation, versus a total of 11 problem cases resolved in CY 1980.

It should be noted that the FSLIC's insurance fund currently has a book value of over $6.5 billion and a market value of approximately $5 billion, and realizes an annual income of about $1 billion.

With respect to contingency planning, our focus basically has been to ensure, first, that the fund is utilized in a manner consistent with the projected magnitude of the problem with which we are dealing and, second, that we have adequate personnel resources to discharge our responsibilities. Concerning use of the fund, a significant amount of planning has resulted from the fact that the earnings pressures the entire industry is experiencing are reducing the ability of many insured institutions to absorb other institutions in danger of default. For this reason, the FSLIC is developing plans to provide direct financial assistance in appropriate cases so that an orderly resolution of the institution's problems can be sought and liquidation and payment of insurance can be avoided. It should be emphasized, however, that direct financial assistance by itself does not solve the problems of insured institutions in danger of default, it merely postpones them, providing time to the FSLIC to seek other resolutions of the situation. Moreover, direct FSLIC assistance will not be provided until the board of directors of the recipient association has provided the FSLIC with a merger resolution and a strict operating agreement.

In the area of staffing, the FSLIC's needs are under constant review, and we are adding personnel where appropriate. Fortunately, the FSLIC has available a large staff reservoir in the form of the supervisory staff and examiners of the Bank Board's Office of Examinations and Supervision. The FSLIC has held training sessions for selected groups of these people, who will be extremely helpful in assisting with its workload. It should be borne in mind, as a general matter, that the OES function always has been fully oriented toward protection of the FSLIC, and is designed to focus its resources on insurance risk cases as they evolve. Another possible source of "in-house" support, of course, is represented by the Federal Home Loan Bank System. Finally, we are confident that we could obtain valuable aid from the staffs of the various state thrift supervisory bodies.

We are aware that one particular area of concern has been the FSLIC's ability to cope with liquidations of institutions involving payouts of insurance. Because such occurrences historically have been infrequent, the FSLIC has not retained a full staff for the sole purpose of making payouts to insured depositors. The FSLIC still does, however, have a full time staff to administer insurance payouts. This staff has license to conscript personnel from other offices of the Bank Board, can retain many of the employees of the defaulted institution, and has authority to hire temporary help in the community where the payout is taking place.

NEED FOR ADDITIONAL TOOLS FOR FSLIC

There are a number of legislative steps that, if taken, would greatly enhance the Corporation's ability to carry out its responsibilities in a cost-effective manner. Given the enormous pressures on the insurance fund, and the direct connection we perceive between the integrity of the fund and public confidence in the financial system generally, we believe the importance of removing barriers to low-cost resolutions of problem cases cannot be over-stated.

1. Emergency Interstate Mergers and Acquisitions.

Most fundamentally, we believe that the FSLIC, when adverse financial conditions exist such as those we currently are experiencing, should be empowered to authorize any FSLIC-insured institution in danger of default to merge with any other FSLIC-insured thrift, or to be acquired by such an institution, or by any savings and loan holding company. This, of course, would involve overriding, *inter alia*, state laws barring interstate branching of financial institutions and the prohibition in the Savings and Loan Holding Company Act against S&L holding companies acquiring control of insured institutions in more than one state.

Under normal circumstances, these laws do not impinge unduly on the FSLIC's operations, for generally there is adequate home state interest in bidding for the privilege of participating in an assisted transaction. At present, however, as I have indicated, the extremely widespread nature of thrift distress has diminished substantially the pool of thrift institutions willing to consider such participation. Moreover, those thrift institutions that are interested are not evenly distributed throughout the states. The result thus far often has been to generate unnecessarily high demands for financial assistance in mergers. Furthermore, it could lead in the future to otherwise unnecessary liquidations, which would be undesirable, in that liquidations as a rule are more costly than assisted mergers, deprive the affected community of needed financial services, and shake confidence in the financial system. The problem of unnecessary liquidation is of particular concern with regard to those thrifts which are or are among the largest in their state, for such institutions, by virtue of their size, basically are foreclosed from merging in-state, and the process of liquidating them would place unusual strains on the FSLIC, as well as attracting intense and highly detrimental publicity.

By giving us this authority, Congress would vastly increase the universe of institutions potentially able to acquire a troubled thrift, thus injecting a greater degree of competitiveness into the assisted merger bidding process, and reducing the amount of FSLIC financial assistance required to induce the transaction. Concomitantly, it would avoid the development of a pattern of liquidations occasioned as a result, not of selection of the least costly of alternative approaches, but as a side-effect of state and federal laws fashioned to limit the spread of financial institutions across state borders. In our view, it would be extremely poor public policy to permit the operation of these laws to erode the strength of the FSLIC. Recognizing the strong feelings surrounding the interstate issue, however, we would have no objection to a requirement that exercise of this authority be contingent upon a reasonable effort to seek in-state partners of the same type before pursuing more unconventional arrangements, subject to the paramount need to minimize the cost of transactions to the FSLIC.

2. Emergency Federal Stock Charters.

A second and similar empowerment we seek, and one that likewise would override other provisions of law, would be the power to authorize any mutual thrift to obtain a Federal stock charter, as long as that institution is in receivership, has contracted to receive FSLIC financial assistance, or is under threat of instability because of severe financial conditions. This would greatly facilitate the salvaging of troubled institutions, for, by transforming them into a stock format, we would make them more capable of attracting private capital as well as more structurally amenable to merger with a stock association.

3. Improvement of FSLIC Conservatorship and Receivership Powers.

The third area in need of revision is that of the FSLIC's conservatorship and receivership powers. At present, the FSLIC is the sole body eligible to be conservator or receiver of a Federal association, but must await state action with respect to assuming such power over a state association. That state action is the appointment by the appropriate state authority of FSLIC or some other entity as conservator, receiver or other legal custodian.

Where the FSLIC is not the appointee, the Bank Board may appoint it as receiver, but not conservator, after the state has closed the institution or after the expiration of a 15-day period--provided circumstances exist that would justify such an appointment in the case of a Federal association, and a depositor has been unable to obtain withdrawal of his account in whole or in part. This procedure is proving very awkward and time-consuming under current circumstances, which place a high premium on our ability to deal with failing associations on a smooth and rapid basis.

The Bank Board believes that authority must be given us to appoint the FSLIC as conservator or receiver of a state-chartered insured institution regardless of any state action, provided the Bank Board determines that the institution is in an unsafe or unsound condition to transact business, has substantially dis-sipated its assets, or has assets less than its obligations. The provision we envision would not eliminate state action in this area, but would provide a supplemental vehicle for safeguarding the enormous federal financial interest at stake in cases involving troubled insured institutions. We believe this interest is of sufficient national importance to justify the relatively modest streamlining of the current law that we are suggesting.

NEED FOR ADDITIONAL TOOLS FOR THRIFTS

Beyond the issue of additional tools for the FSLIC, the Bank Board believes there is an urgent need for legislation that would help thrift institutions to weather their present problems and remain viable thereafter through all phases of the economic cycle.

1. All Savers Bill.

With respect to short term relief, I wish to voice at this point the Bank Board's help that the All Savers bill would assist in the resolution of the industry's problems.

The bill is designed essentially to provide a temporary reduction of depository institutions' cost of funds through allowing depositors to earn tax-free interest on certain deposits. We realize that the All Savers proposal is not perfectly tuned and would deprive Treasury of considerable revenue. Nevertheless, we believe it would have a significant ameliorative effect on thrift earnings during what promises to be a very difficult period for those institutions and for the FSLIC.

2. Bank Board Proposals.

The Bank Board's proposals are intended to ensure that thrift institutions can function over the long term, through the downs as well as the ups in the economic cycle, as viable members of the financial community. By speaking of the "long term" however, I do not wish to imply that action on lifting these constraints can safely be delayed, but to indicate instead that our proposals would ensure the long-term presence of thrift institutions. The factors threatening that presence are operating now, and it is imperative that Congress act rapidly to counter them. We specifically refer to the fact that thrift institutions' liability side has undergone rather abruptly a *de facto* process of deregulation, without a corresponding deregulation of their asset side. That some of the powers we will propose, by their nature and as a consequence of the debilitated state of the industry, will have a certain lag-time in their effectiveness, argues particularly strongly, in our view, in favor of quick Congressional consideration. If Congress does not act in the short run to address this matter, there will be no long run for a very substantial segment of the thrift industry.

a. Corporate Checking Power.

As a first step, we urge that the Home Owners' Loan Act be amended to allow all federal associations to offer demand deposits to any customer. This, of course, would permit thrifts to penetrate the corporate checking market that now is the unique and highly profitable preserve of the commercial banking industry. The additional transaction account authority we seek would help thrifts reduce their cost of funds and enhance their ability to attract corporate loan customers, as well as increase competition generally for accounts of this kind. Because the mechanics of handling demand deposits are no different from dealing with NOW accounts, thrifts and their customers could begin to realize the benefits of this empowerment at once. From an equity standpoint, there can be no serious complaint from the banking industry, given the practical elimination of the system of savings deposit preferences formerly biased in favor of the thrift industry. While retention of the statutory requirement that demand deposits be interest-free would be helpful to thrifts, given their current state, we would have no objection to bringing such accounts under DIDC jurisdiction for purposes of rate decontrol.

b. Broadened Real Estate Investment Powers.

Second, we believe the HOLA should be amended to provide federal associations with greatly broadened real estate investment authority. Real estate is the field thrifts are most familiar with, and liberalization in this area could be expected, consequently, to generate positive earnings results in a relatively short period of time. What we specifically suggest is that federals be allowed to invest more broadly in non-residential, as well as residential, real estate, and that they be authorized to make real estate equity investments equal to 10 percent of their assets. This would facilitate involvement in such profitable investment fields as real estate acquisition and development and commercial construction. The ability of California-chartered S&Ls to engage in land development has been instrumental in allowing many institutions so involved to remain in the black even under the present difficult environment. To provide institutions with adequate flexibility with respect to the structuring of their business transactions, we believe this authority should not be circumscribed by statutory first lien, PMI or loan-to-value limits.

c. Commercial Lending

Third, we urge that federal thrift institutions be free to make loans for purely commercial or agricultural purposes. Such authority would go hand-in-hand with development of thrift demand deposit authority, and would provide thrifts with increased portfolio flexibility. By broadening thrifts' investment options, such power would enable them to reduce their vulnerability to volatile economic conditions. While full exploitation of this empowerment would not happen quickly, thrifts nevertheless could be expected to make some helpful initial inroads with regard to the housing-related businesses that they currently serve.

d. Expanded Consumer Lending

Fourth, the Bank Board believes that federals should have power to make consumer loans without being subjected to the current

20 percent of assets restriction affecting such investments. Moreover, this power should be extended to the making of loans for inventory financing purposes, an option not currently open to federal S&Ls, and the lack of which is significantly affecting their ability to build up a reasonable volume of consumer credit business. Because of this direct relationship, the inventory financing issue should be considered separately from that of extending commercial loan authority.

e. Equipment Leasing.

Fifth, the Bank Board favors giving federals authority that would enable them to engage in the equipment leaving business, which has proven to be a major and profitable activity for many of the commercial banks with which thrifts must compete. The leasing function would offer a means to attract new customers or provide more services to existing customers. Moreover, leasing carries favorable tax implications because of the investment tax credit and the ability to depreciate the equipment.

f. Increased Service Corporation Investment.

Sixth, we support allowing federal associations to invest a greater amount in their subsidiary service corporations, which have emerged as important profit centers for many institutions. By increasing the current 3 percent of assets limitation on such investment to 5 percent, Congress would permit enhanced involvement in profitable land development activities, for example, that an institution might not wish to engage in directly.

g. Freedom to Choose Stock or Mutual Form of Organization.

Seventh, we believe that Congress should allow thrift institutions and their organizers flexibility in electing their form of organization. In our view, the Bank Board should be able to grant de novo charters to federal savings banks, not just Federal S&Ls, and all federal thrift institutions should be able to exist in the stock or the mutual form. Likewise, where state law permits, state-chartered thrifts should be free to convert directly to any form of federal thrift association they regard as most suitable to their needs.

As you are aware, the main practical consequence of such a change in current law would be to increase the number of institutions that could obtain stock charters. We believe this development would be beneficial for a number of reasons. For one thing, stock institutions under current economic circumstances are more attractive to organizers than are mutual associations. This is evidenced by the fact that, in 1980, of the 68 applications for insurance of accounts approved by the Bank Board, only 8 were from mutuals, and that, since 1977, there have been 145 new stock S&Ls chartered, as against 57 mutuals. The attractiveness of the stock form results from the enhanced competitiveness permitted by the equity base with which stock institutions begin their corporate existence; by contrast, mutual S&Ls find it quite difficult to build their equity fast enough during their early years of operation. In its current state, therefore, federal law artificially is restricting entry of new institutions, despite a need for new entrants as a means of countering the long-term constriction in the number of thrift institutions otherwise implied by the current wave of consolidation in the industry.

Of course, the ability to raise equity that makes the stock form more feasible for organizers of new institutions also makes conversion of existing mutual institutions to stock associations a beneficial option. Conversions, by infusing new capital into institutions, allow continued growth, and permit greater community service.

As a final matter, allowing expanded access to stock charters would be of benefit to the FSLIC, in that stock institutions, because of their equity cushion, have greater resistance to failure, particuarly in the vulnerable early years. Moreover, the stock form, in the event failure does occur, lends itself more readily to mergers and other non-liquidating solutions than does the mutual form. For instance, a holding company can acquire a failing stock S&L, but not a mutual institution.

h. Expanded "Leeway" Authority.

Eighth, it is necessary, in our opinion, to provide improved "leeway" authority for federal associations. Leeway power simply is the ability to make investments that otherwise would not be in accordance with statutory limits. At present, such authority for federals is restricted to 5 percent of assets, and must be used for residential or farming purposes. We believe 10 percent would be a more realistic figure, and that the nature of investments under the provision should be statutorily unrestricted -- subject, of course, to Bank Board regulatory authority. The advantage of effective leeway power is that it would give important flexibility to thrifts that they could use to take advantage of promising business opportunities not falling within normal investment limits. In addition to aiding profitability, this would be stimulative of new services.

i. Preemption of State Laws Forbidding "Due-on-Sale" Clauses.

Ninth, and finally, we suggest that a step that would be productive of considerable short-term help to thrifts, albeit on a regional basis, would be for Congress to preempt state laws banning the exercise of so-called "due-on-sale" clauses. These clauses have become standard provisions in mortgage contracts as a result of the desire of lenders to protect themselves against the effects of persistent inflation. Essentially, they allow the lender to call a mortgage loan when the borrower sells the underlying security property, thus helping to ensure that the institution's mortgage portfolio yield can support payment of competitive rates to savers.

Of course, borrowers who are selling their homes dislike due-on-sale clauses, for the ability to pass on a sub-market mortgage to a potential purchaser is a very valuable selling aid, and can allow a higher purchase price. This dislike has been translated into effective political action in a number of states, resulting in passage of laws forbidding the exercise of due-on-sale clauses.

The predictable result for institutions affected by such prohibitions has been a lengthening in the average lifespan of the low-yield loans that are currently having such an adverse impact on thrift earnings. In effect, institutions subject to these laws are having their laboriously accumulated net worth appropriated to provide unbargained-for windfalls to a small group of home sellers and purchasers. Under the circumstances, when that net worth is being drawn upon to ensure the very survival of the industry, the Bank Board believes it would be in the overall public interest for Congress to assure that the borrowers who agreed to contracts containing due-on-sale clauses honor those agreements.

CONCLUSION

To summarize my remarks, the thrift industry has been brought to a point of crisis by our nation's inability to cure our longstanding problem of excessive inflation, accompanied by high, and recently quite volatile, interest rates. This crisis is placing unprecedented strain on the FSLIC, and, from a crisis-management standpoint, we believe it is vital that the Congress provide the FSLIC the additional tools we have outlined. Under present conditions, we are convinced they would be enormously helpful in conserving FSLIC resources, both in terms of money and people; and, the signficance of these tools would increase geometrically in the event of worsening interest-rate conditions. Passage of the All Savers bill also would provide valuable short term aid to the FSLIC by reducing thrifts' cost of money and improving their liquidity.

In order to ensure that the present crisis, once bridged, does not recur, we likewise strongly urge that Congress provide authority for a protective restructuring of the thrift industry along the lines we have outlined. As presently constituted, the industry is simply too vulnerable to volatile economic conditions, lacking the asset-side empowerments that it must have to compete successfully through all phases of the economic cycle.

We realize that the steps we are urging point toward a substantial breakdown in the legal differences between the powers granted to thrifts and banks, and will generate considerable concern regarding the future of housing finance. While some thrift institutions could be expected to turn away from mortgage finance, we believe the industry's expertise in the area, coupled with the ability to make flexible rate loans and the prospect of great housing demand over the rest of this decade, would result in the majority of thrifts continuing as housing specialists. Unless Congress is willing to provide comprehensive and effective economic controls, however, the level of this specialization must be determined by each individual institution's evaluation of economic opportunities. To continue with forced specialization, given the current state of affairs, simply would be to risk the relatively rapid elimination of very large numbers of thrift institutions.

Mr. Chairman, this concludes my remarks. I will be pleased to answer any questions you may have.

NOTE: In accordance with 12 U.S.C. § 250, this statement has not been reviewed outside the Federal Home Loan Bank Board, and does not necessarily reflect the views of the President.

Exhibit 1

YEARLY AVERAGE OF 3 MONTH TREASURY BILL MARKET YIELDS AND NET INCOME TO AVERAGE ASSETS AT DEPOSITORY INSTITUTIONS

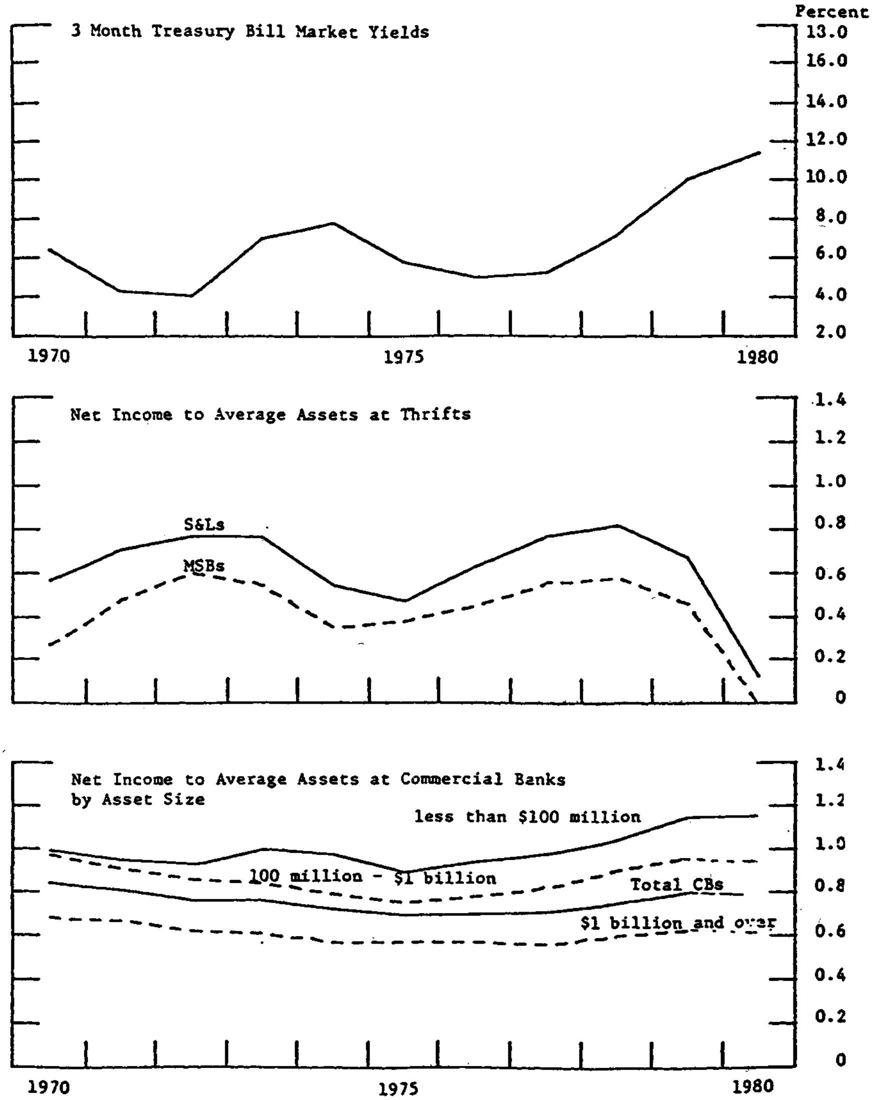

Exhibit 2

Comparison of 6-Month Treasury Bill Rate
and S&L Monthly Profitability (ROA)

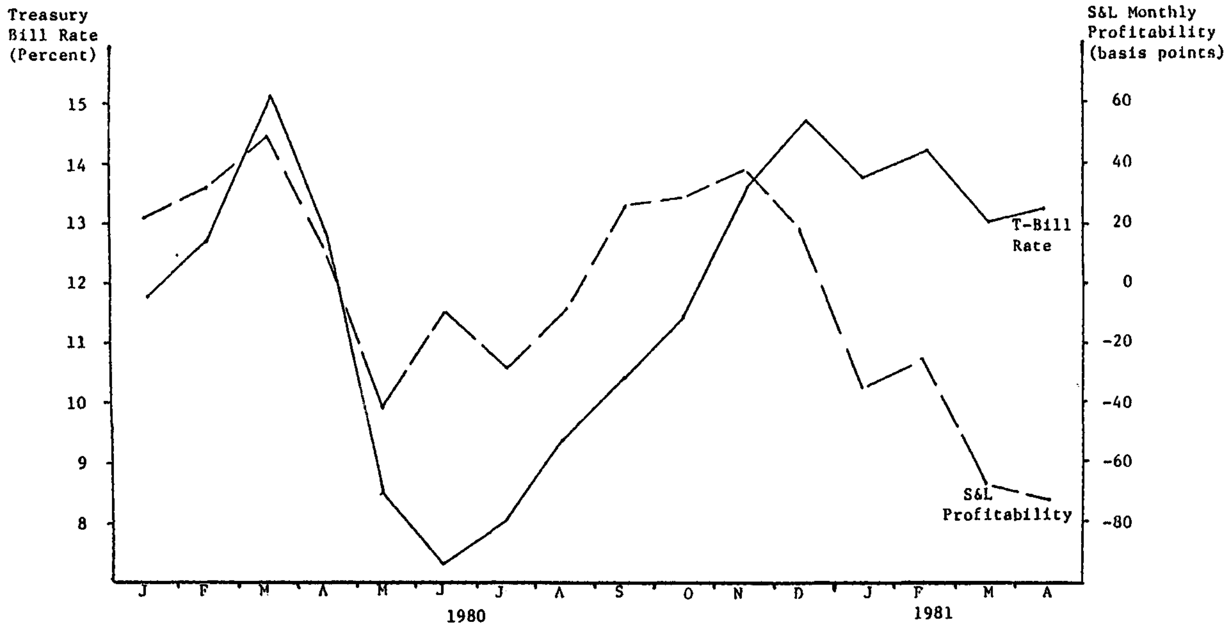

Exhibit 3

Depository Institution Shares of MMC Flows

Pre-March 1979

Total MMC Flows	S&L	MSB	CB
$119.8 bil	$ 64.6 bil	$ 19.2 bil	$ 36.0 bil
100%	53.9%	16.0%	30.1%

March, 1979 through May, 1981

Total MMC Flows	S&L	MSB	CB
$341.1 bil	$135.9 bil	$ 34.7 bil	$170.5 bil
	39.8%	10.2%	50.0%

Exhibit 4

Short-Term Borrowing and Liquidity of Associations Heavily Dependent on Large Denomination Time Deposits, April, 1981

				Ratio to Total Assets		
Large CD-to-Assets	Number of Associations	Total Assets	Large CDs[a]	Large CDs	Outside Borrowing[b]	Cash & Securities[c]
30% or more	60	$ 7.7 bil	$3.0 bil	38.7%	4.4%	10.1%
25 to 30	42	7.0	1.9	27.2	3.2	5.9
20 to 25	74	20.7	4.4	21.2	5.8	8.1
15 to 20	125	49.7	8.3	16.7	5.2	8.9
	301	85.1	17.6			

[a] Large CDs are those with a denomination of $100,000 or more.

[b] Outside borrowings are non-deposit sources of funds, not including Federal Home Loan Bank advances; about 90% of these funds are raised through reverse repurchase agreements with institutional lenders.

[c] Includes all types of marketable securities, including those not considered "eligible liquidity" by the FHLBB.

The CHAIRMAN. Thank you. Now we will hear from Chairman Connell of the National Credit Union Administration Board.

STATEMENT OF HON. LAWRENCE CONNELL, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION BOARD

Mr. CONNELL. Thank you, Mr. Chairman. I am pleased to appear before your committee and to discuss monetary policy, how it has affected the condition of credit unions currently and in the future.

I think our testimony will show that credit unions have encountered difficult situations during the past few years. Nonetheless, it is our opinion that during this period adjustments have been made both by credit unions and our agency, which have enabled us to continue to bring credit union services to the membership in the future. However, Mr. Chairman, I must point out that should interest rates persist for an extended period at excessively high levels, there are a number of larger credit unions with an excess of longer term securities that might encounter severe operating difficulties and would represent a substantial liability to the National Credit Union's share insurance fund.

In October 1979, as we all know, Mr. Chairman, the Federal Reserve adopted a new operating procedure which placed more weight on controlling the supply of bank reserves and less on limiting short-run movements in the Federal funds rate. I think that these policies necessarily have resulted in the persistently high and more volatile interest rates which the economy has experienced during the past 1½ years.

Although credit unions have had the authority to offer a wide variety of savings instruments and services, the continuous presence of inflation and high and volatile interest rates has caused a greatly reduced rate of growth during the early part of the year. Also, credit unions have experienced continuing earnings pressures like other types of thrift institutions. Additionally, the doubling of oil prices since 1978 has severely affected the U.S. automobile industry, resulting in plant closings and worker layoffs.

Older industrial plants facing competition from new and modern facilities in the Sun Belt and abroad have been forced to close. When these plants close, affiliated credit unions lose their sponsor, common bond, and often their existence, unless they merge or convert to a community-type charter.

Credit unions are also especially affected by economic policies. In terms of the 1980 experience, credit union growth was adequate but volatile during the year. On the other hand, the lending experience of credit unions was the worst since 1942 to 1944. Loans outstanding have declined by some $2.2 billion, or 7 percent.

Because of the cost of funds increasing in 1980, essentially credit unions' capital deteriorated as they were required to draw on their accumulated reserves to cover the higher cost of money and operating costs. As our statement indicates, the problems of credit unions and liquidations increased in 1980 and continued to do so in 1981, and we attribute the larger dollar figure, essentially, to larger credit unions with problems with long-term securities.

However, we should note that during this period of time the expenses of the insurance fund were able to be met by the income of the fund, and principal was not used at all. Like my colleague, Mr. Sprague, I would say that we strongly endorse and request that the committee consider the provisions of the regulators' bill that were presented earlier to Congress. In addition, as with Mr. Pratt, we have suggestions for regulatory tools such as conservatorship authority, tax exemption for the central liquidity facility which has been around for some time, and a number of additional operating powers.

Mr. Chairman, in my abbreviated statement I would like to recognize two aspects of the proposed legislation that I think are especially important. One is the expanded powers for savings and loan associations and mutual savings banks, as proposed by the Federal Home Loan Bank Board. I want to say that I fully support this effort. In Connecticut where I was bank commissioner, for example, the broader powers of State-chartered savings and loan associations and mutual savings banks have greatly contributed to their ability to weather the turbulent times of the past several years.

As far as the controversial industry acquisitions interstate provisions of the regulators' bill, a number of people have expressed concern that smaller institutions will disappear and we will be left with a limited number of giant banks operating free from geographic constraints across the country. I do not share this concern, because I believe that any such monopoly power would not occur as long as credit unions can provide a viable alternative for the consumer.

The Canadian banking system is often cited as an example of what could happen in the United States with interstate mergers and so on; a handful of banks with thousands of branches across the Nation. I do not believe this would happen in the United States anyway, because of our greater population and more extensive economic development. But even if it did occur, credit unions would fill any void that would develop, and this has actually happened in Canada where credit unions have 14.9 percent of total deposits, while in the United States they have only 4.9 percent of just consumer deposits.

Indeed, there is a similar example in the United States. The State of Rhode Island is considered a concentrated banking market. However, in that unique State, credit unions account for 18 percent of consumer savings as compared to 5 percent nationally. Moreover, 75 percent are community-type credit unions in Rhode Island as compared to only 4 percent in the remainder of the United States.

As plants close around the country, many credit unions will convert to community charter, community common bond, and indeed, the movement is underway. Thus, we look upon the structure of a successful U.S. credit union movement to more reflect what exists in Rhode Island that actually what exists in the Nation as a whole today.

In summary, Mr. Chairman, with monetary policy as the only tool to fight inflation and with the U.S. industrial plants facing closing or change in location, credit union management, like all others, will be severely challenged in the years ahead. As a regulatory agency, we are actively and aggressively reviewing and changing examination procedures and restructuring our policies to provide at the same time stronger oversight remedial actions and maximum operating flexibility, as reflected in our deregulatory efforts.

I ask that the committee act favorably toward our request for additional statutory provisions and regulatory tools to meet the demands of the future.

This is my abbreviated statement. If you would include my full statement, I would be happy to answer any questions.

The CHAIRMAN. Without objection, so ordered.

[Mr. Connell's prepared statement, on behalf of the National Credit Union Administration, follows:]

STATEMENT OF

LAWRENCE CONNELL

CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION BOARD

Mr. Chairman, members of the Committee, I am pleased to appear before you this morning during the Committee's hearings on monetary policy to present the views of the National Credit Union Administration regarding the effects of current and projected monetary policy on the condition of credit unions and their ability to adjust to a variety of economic conditions.

At the present time, the National Credit Union Administration has some 12,300 Federal credit unions which it charters, insures, and supervises. Further, we are currently providing Federal insurance coverage to about 5,000 state chartered credit unions. The total assets of these insured credit unions is $62 billion and 40 million members are being served by them. When non-federally insured credit unions are included, there are a total of 21,500 credit unions, 46 million members, and over $73.5 billion in assets.

Our testimony will show that credit unions have indeed encountered severe financial situations during the past few years and a number of actions have been necessary to assist in the overall maintenance of stability. Nevertheless, it is my opinion that during this period, adjustments have been made by both the credit unions and NCUA which should enable us to continue to bring credit union services to the membership in the future. However, Mr. Chairman, I must point out that should interest rates persist for an extended period at excessively high levels, there are a number of larger credit unions with an excess of longer term securities that might encounter severe operating difficulties and would represent a substantial liability to the National Credit Union Share Insurance Fund.

Before I detail the present condition of credit unions, let me focus on contingency planning for a moment. I believe that two of the most important components of contingency planning are education and flexibility. At NCUA, we make every effort to communicate to each credit union information which we believe is timely and useful. This is done through our examiners, our regions, in "letters to all credit unions," in news releases, and in speeches. The subjects range from the detection of the beginnings of certain unsafe practices in a few credit unions to assistance in program development.

With regard to flexibility, our effort is two-fold: first, we try to enhance the operating flexibility of the credit unions themselves to the maximum extent consistent with safety and soundness. In this context our deregulatory effort of the past year was designed to afford credit unions wide latitude in both lending and savings. Second, we seek to maximize the regulatory flexibility of the agency itself as conditions warrant. In this context we sought and received stronger enforcement powers, a Central Liquidity Facility, the restructuring of the agency, an increase in loan rates for credit unions, and are currently seeking authority for conservatorship, mergers of dissimilar common bonds, authority for the CLF to loan to the share insurance fund and a reassessment of the size of the emergency back up line for the Share Insurance Fund. I will amplify these points later in discussions of regulatory actions and of the regulators bill (emergency legislation).

Monetary Policy

Monetary policy has faced a challenging course during 1980 and 1981. Turbulent swings in economic activity and financial conditions complicated the execution of monetary policy. As the pace of economic and financial activity plunged and recovered during this period, the money stock and the level of interest rates showed large fluctuations. Despite the short-run variability, however, growth of the narrowly defined monetary aggregates for the year as a whole (after adjustment for the more rapid than expected growth of interest-bearing transaction accounts) was close to the upper limits of the Federal Reserve's annual target ranges, while the broader money measures exceeded their top limits by a small margin. Bank credit growth was well within its target range for the year.

The basic goal of monetary policy has been to reduce inflation by gradually lowering monetary growth. In pursuit of this goal, the Federal Reserve adopted a new operating procedure in October, 1979 that has placed more weight on controlling the supply of bank reserves and less on limiting short-run movements in the Federal funds rate. These policies have been partly responsible for the persistently high and more volatile interest rates which the economy has experienced during the past year. Except for a four month period during the 1980 recession, interest rates have been in the double digit range. For 12 of the last 18 months, money market rates have exceeded 12%.

The Federal Reserve reported to Congress in February, 1981 that it would continue its policy of combatting inflation by gradually reducing the growth rates of the monetary aggregates. However, they projected at that time that inflation would only ease slightly in the near term. Because of this and the large budget deficits in prospect for the year, they anticipated continued strong demands for money and credit, and relatively high interest rates for some time to come.

General inflationary pressures and the recent recession have had a special effect on credit union operations. Additionally, the doubling of oil prices since 1978 has severely affected the U.S. automobile industry resulting in plant closings and worker lay-offs. Older industrial plants, facing competition from new and modern facilities in the sunbelt and abroad, have been forced to close. When plants close, affiliated credit unions lose their sponsor, common bond, and their existence unless they merge or convert to a community type charter.

Credit Union Conditions

Mr. Chairman, the past year has been a challenging one for credit unions. Although credit unions had the authority to offer a wide variety of savings instruments and services, the continuous presence of inflation and high and volatile interest rates caused a greatly reduced rate of growth during the early part of the year. Credit unions also experienced continuing earnings pressures and erosion of capital. Lastly, I would again emphasize that credit unions are uniquely affected by plant closings and deterioration within a particular industry.

Savings and Assets

From January to April, 1980, Federal credit union savings grew at an annual rate of less than 1.3%. However, the second quarter recession which brought on a sharp drop in credit demand caused interest rates to fall rapidly. With the decline in interest rates, growth in credit union savings rebounded sharply and accelerated to annual rates as high as 50% during June and July. Although these high rates of growth were not sustained for the rest of the year, credit union savings did grow more in 1980 than in the preceding year (Table 1). This resulted in Federal credit unions growing as fast as commercial banks and faster than other institutions in the consumer savings market. Federally chartered credit union savings grew 13.9% and state credit unions grew by 10%. Consequently, credit unions maintained their share of total consumer savings at 4.9% (Table 1).

Growth in credit union assets also reflected substantial improvement over 1979's performance. Since the increase in savings and liquid assets allowed some credit unions to reduce their indebtedness, asset growth was somewhat slower than the growth in savings. Nevertheless, the 9.9% growth rate in assets was more than twice as fast as the 4.9% growth recorded in 1979.

Lending

Unlike the improvement in savings and asset growth during the year, credit union lending declined. Although Federal credit unions had an ample supply of loanable funds, loan demand remained low for the entire year. As a result, in 1980 Federal credit union loans outstanding declined by some $2.2 billion or 7.7% (Table 2). Not since the war years of 1942-1944 when national mobilization disrupted credit union fields of membership have loans outstanding at credit unions declined. The slowdown in lending activity of the last two years has caused credit union's share of consumer installment credit to decline markedly from 16.7% at year-end 1978 to 14% at year-end 1980. (Table 3). Contributing to this slowdown is the practice within the automobile industry to offer manufacturer-subsidized financing via their captive finance companies thereby permitting automobile dealers to offer their customers below market rate car loans.

Liquidity

Although many credit unions experienced considerable liquidity pressures early in the year as record high interest rates caused savings outflows, liquidity improved during 1980 as credit union savings increased rapidly after mid-year when market interest rates declined. The credit unions used the inflow of savings to reduce their borrowings and increase their short-term investments, thereby improving liquidity. Consequently, the loan to savings ratio fell to 72.7% at year-end 1980 from the year earlier level of 90.9%.

Capital

Federal credit union capital -- loss reserves and retained earnings — as a percentage of total assets has declined in recent years. From a level of 6.9% in 1975, the capital to asset ratio fell to 6.2% at year-end 1979. However, the capital ratio held steady for most of the year and dropped only slightly to 6.0% by year-end. In earlier years, the decline in capital was the understandable result of loan portfolios growing faster than earnings were retained and also a change in the law reducing the amount of required transfers to the statutory reserve account. More recent capital declines, however, are the consequence of many Federal credit unions being forced to curtail earnings retention altogether or to draw upon accumulated capital to cover higher operating and dividend expenses.

Though credit union capital has diminished somewhat over time, risk assets (or loans) as a proportion of total assets have declined at a faster rate. As a consequence, the ratio of capital to risk assets has been rising. This appears to leave credit unions momentarily in a more financially secure position.

Earnings

The historically high interest rates of 1980 substantially affected credit union earnings. In 1980, money market certificate rates rose from 11.7% in January to over 15% in March. Faced with potential large share outflows as members responded to the high yields available on money market instruments, Federal credit unions and many state credit unions were compelled to offer share certificates at rates that at times exceeded credit union loan interest rate ceilings.

P.L. 96-221 did authorize an increase in the Federal loan rate ceiling to 15% in April of 1980. However, at the very same time when credit unions were forced to offer historically unprecedented high dividend rates to retain funds, loan demand fell dramatically as a result of the recession. Therefore, Federal credit unions were limited in their ability to take advantage of the necessary relief the 15% ceiling provided. In addition, as the recession proceeded, money market interest rates declined, reducing the rate of return available to credit unions on other investments. Delinquencies also increased, further eroding earnings. By year-end 1980, interest rates once again reached the peak levels of the spring. As a result, earnings of credit unions continued to be squeezed.

To ease earnings pressures on Federal credit unions confronted with record high money market interest rates, the NCUA Board granted an across-the-board waiver of the reserve transfer requirement for the first quarter and a limited waiver for the remaining three quarters.

The total effects of 1980 were, therefore, to limit credit union management flexibility as competition forced credit unions to accomodate the persistently high interest rates. This accomodation resulted in a continuing decline in earnings and credit union capital.

Problem Credit Unions, Liquidations, and the Insurance Fund

NCUA examiners assign an overall rating to Federal credit unions after each examination. Each Federal credit union is rated excellent, good, fair, weak, or unsatisfactory — EWS codes 1, 2, 3, 4, and 5 respectively. A weak or unsatisfactory rating implies that critical problems exist in any one of a variety of areas. Federally-insured state chartered credit unions receive a similar coding based on information submitted by state supervisory agencies. This information is shown on (Table 4).

While the number of problem credit unions remained basically unchanged from year-end 1979 to year-end 1980, the total savings in problem credit unions increased from $1.4 billion to $1.6 billion. This represents a 14% increase in the total savings of this group of credit unions. As of May, 1981 total savings of problem credit unions had increased to $2.1 billion reflecting a 31% increase within five months. While some portion of this increase in total savings can be accounted for by the overall growth in all credit unions, the remainder reflects a disturbing trend toward an increase in the number of larger credit unions experiencing problems. The underlying cause for these larger credit unions to be classified as problem credit unions was investment of a large part of their assets in long term government securities. In this regard, their asset portfolios were more like savings and loan associations than traditional credit unions.

Since 1971, the first year of Federal Share insurance, 1,153 federally-insured credit unions have liquidated because of insolvency. These credit unions have been generally relatively small in size and have had little impact of the viability of the share insurance fund. However, in 1980 we witnessed a 41.4% increase in the number of insolvent federally-insured credit unions. These credit unions were 1 on average, larger than those liquidated in previous years. (Table 5). Mr. Chairman, we found that the liquidations of the larger credit unions were almost directly attributable to the cumulative impact of persistent pressures of high cost of capital, inability to generate earnings, disintermediation, and the slowdown in credit union growth. Because these credit unions were larger, they required a larger commitment of funds to expedite the payment of member insured savings and completion of the liquidation process. As a result, although there was a positive addition to the share insurance fund balance in 1980, expenses and losses absorbed a much larger percentage of income than ever before.

The ability to merge such credit unions would greatly ease NCUA's supervisory burdens while at the same time continue a very valuable service which would otherwise terminate. The main obstacle to expeditious merger action is the prohibition against combining credit unions with unlike fields of membership. While NCUA in no sense would advocate retreating from the longstanding principles of field of membership uniqueness, a relaxation of those requirements in situations involving financially distressed institutions would be an important stabilization tool. Many State laws already provide for such mergers and there is evidence that such laws have reduced the incidence of liquidation of State chartered credit unions.

Credit Unions During 1981

Unlike 1980, the interest rate situation in 1981 has seen no extended period of abatement. The rates, while fluctuating periodically, have remained consistently higher than has been heretofore experienced.

Credit unions have demonstrated a remarkable resilience and NCUA has continued to attempt to increase credit union flexibility but the persistence of the high rates can not be ignored. Although credit union savings have been retained and even a small growth noted, it has not been done without cost. While earlier in the year we had expressed some optimism concerning loan demand, there are signs of a slowdown as rates exert an ever increasing dampening effect.

Persistent high interest rates reduce the operating margins of credit unions. This reduces their ability to cover required reserve transfers, precludes the building of reserves, and as a result weakens their overall capital position. With each passing day, the rate paid for savings adjusts slightly higher maintaining the pressure on credit unions.

Extended high interest rates also severely limit credit union mortgage activity. The mortgage powers granted to Federal credit unions in 1977 have scarcely begun to be used. On the one hand, credit unions have wisely refrained from the long term low fixed rate problem of other thrifts. On the other hand, after being granted some flexibility in structuring mortgage instruments, they have encountered normal member resistance to high mortgage loan rates. More generally, high interest rates have precluded credit unions from carrying out their statutory provisions of "making available to people of small means credit for provident purposes . . . . thereby helping to stabilize the credit structure of the United States".

Statutory Changes

Returning to the matter of flexibility, Mr. Chairman, I would emphasize for the Committee the necessity for immediate action on increasing both the regulatory flexibility of NCUA and its Central Liquidity Facility and the operational flexibility of credit unions in light of anticipated persistent high interest rates.

With respect to increasing NCUA's regulatory flexibility, I am requesting that the Committee consider the provisions of the "regulators' bill" as set forth in Mr. LaFalce's bill H.R. 4050. Certainly, in view of the likelihood of continued high interest rates, the regulators should be afforded this measure. The main credit union provisions which will minimize the potential cost to the Share Insurance Fund are:

(1) Permit the Board under, certain emergency situations, to merge credit unions with dissimilar common bonds.

(2) Clarify the authority of the Board to authorize the purchase and assumption of the assets, liabilities and federally insured accounts of an insured credit union by any federally insured financial institutions.

I am also requesting an increase in NCUA supervisory authority by granting the agency conservatorship authority similar to that of the other federal financial regulators. Additionally, our operating flexibility would be increased with express authority for NCUA investment of operating funds similar to the authority to invest share insurance premiums. These and certain technical amendments are found in Enclosure (1).

To increase the flexibility of the CLF, Mr. Chairman, it is essential that an oversight in the enabling statute be corrected to ensure that the CLF is granted a tax exemption similar to those granted to the Federal Home Loan Banks and the Farm Credit Banks. Additionally, the CLF needs broader authority to invest in short-term investments strictly for cash management purposes, an incidental powers authority, and the authority to act as an Agent of the Federal Reserve System in order to funnel funds to credit unions from the discount window efficiently through established channels in the event the CLF reaches its borrowing limits and credit union liquidity needs persist. These CLF amendments are contained in Enclosure (2).

The last group of amendments, Mr. Chairman, is directed at enhancing the flexibility of the credit unions. These amendments are in the area of credit union lending powers while one addresses the matter of inactive accounts. A general description is as follows and the suggested language is contained in Enclosure (3):

(1) A grant of authority to NCUA Board to permit variances in the statutory 30 year maturity limit on first mortgage loans.

(2) The elimination of the restriction on FCU residential real estate financing which limits sales prices to 150% of the median price in the geographic area in which the property is located.

(3) Authority for FCU's to refinance first mortgage loans.

(4) The inclusion of FCU's in Sec. 501 of P.L. 96-221 in order to avoid possible usury complications when a FCU member prepays a mortgage loan in full.

(5) The extension of FCU second mortgage loan terms from 12 to 15 years.

(6) The conforming of FCU practices with those of the secondary market by permitting FCU's to require that partial prepayments on mortgage loans be made on the date monthly installments are due.

(7) The clear delineation that custodial accounts for loans sold by FCU's are insured accounts.

(8) The clarification of the authority for FCU's to sell GNMA mortgage-backed securities.

(9) The extension of "most favored lender" status to Federal credit unions.

(10) Permit a credit union board of directors to adopt a policy of terminating the membership of any member who (1) fails to vote in an annual credit union election for three consecutive years or (2) fails to either purchase shares or investments or utilize a loan account with the credit union for three consecutive years.

Credit Union Future

With respect to credit union flexibility, Mr. Chairman, I recognize that the discussion of expanded powers for various financial institutions and of expanded areas of operations often bring voices of opposition. However, I do not share this concern. I am aware of the intent of the FHLBB to further expand the powers of the savings and loan associations and I fully support this effort. In Connecticut, for example, the broader powers of the state chartered savings and loan associations and mutual savings banks have greatly contributed to their weathering these turbulent economic times.

With respect to the interstate and interindustry merger sections of H.R. 4050, some have expressed concern that the smaller institutions will disappear and we will be left with a limited number of giant banks operating free from geographic restraints. I do not share such concern because I believe that monopoly power will not occur as long as credit unions can provide a viable alternative for the consumer. The Canadian banking system is often sited as an example of what could happen in the U.S., a handful of banks with thousands of branches across the nation. While I do not believe such would happen in the U.S. because of our greater population and more extensive economic development, even if it did occur, credit unions would fill any void that would develop. This has actually happened in Canada where credit unions have 14.9 percent of all deposits while in the U.S., they only have 4.9 percent of consumer deposits.

Indeed there is already a similar example in the U.S. The state of Rhode Island is considered a concentrated banking market. However, in that unique state credit unions account for 18 percent of consumer savings as compared to the 5 percent share credit unions have on a national basis. Moreover, unlike the U.S. credit union movement in general, 77 percent of Rhode Island credit union deposits are in community type credit unions. For the rest of the U.S. only 4 percent of credit union deposits are in institutions with a community type common bond. Thus, we look upon the structure of a successful U.S. credit union movement of the future to reflect that which exists in Rhode Island.

The U.S. phenomenon of a credit union system with 86% of its deposits in credit unions with an occupational common bond is rather unique. It certainly helped credit unions to grow over the past ten years, but it may be a weakness in the years ahead because of instability caused by plant closings. In the interest of stability, viability, and growth of the credit union system in this country, I personally would actively support a change in the overall structure of the credit union system in this country. In fact we may be seeing a beginning already. During the first half of 1981 the NCUA Board has approved 19 charter amendments converting occupational or associational type

Federal credit union to community type FCU's. Of the 19 conversion amendments, 3 involved immediate plant closings and 10 more were undertaken due to such reasons as substantial employee layoffs or reductions in force and/or threatened plant closures.

In summary, Mr. Chairman, with monetary policy as the only tool to fight inflation, and with the U.S. industrial plants facing closing or change in location, credit union management like all others will be severely challenged in the years ahead. As a regulatory agency, we are actively and aggressively reviewing and changing examination procedures and restructuring our policies to provide at the same time stronger oversight, remedial actions, and maximum operating flexibility as reflected in our deregulatory effort. I ask that the Committee act favorably towards our request for additional statutory provisions to meet the demands of the future.

I will be happy to answer any questions you or the Committee members might have.

Table 1
Consumer Savings at Financial Institutions
1974-1980
[Amounts in billions]

Year	Total	Commercial banks	Savings & loan associations	Mutual savings banks	Credit unions: All cu's	Credit unions: Federal	Credit unions: State
			Amount				
1974	$691.8	$322.6	$243.0	$98.7	$27.5	$14.4	$13.1
1975	775.8	347.2	285.7	109.9	33.0	17.5	15.5
1976	885.3	387.4	335.9	122.9	39.1	21.1	18.0
1977	994.9	427.6	386.8	134.0	46.5	25.6	20.9
1978	1,098.8	471.7	431.0	142.6	53.5	29.8	23.7
1979	1,179.2	505.5	470.2	146.0	57.5	31.8	25.6
1980 1/	1,304.9	576.0	511.0	153.5	64.4	36.3	28.1
			Percentage Distribution				
1974	100.0	46.6	35.1	14.3	4.0	2.1	1.9
1975	100.0	44.7	36.8	14.2	4.3	2.3	2.0
1976	100.0	43.8	37.9	13.9	4.4	2.4	2.0
1977	100.0	43.0	38.9	13.4	4.7	2.6	2.1
1978	100.0	42.9	39.2	13.0	4.9	2.7	2.2
1979	100.0	42.8	39.9	12.4	4.9	2.7	2.2
1980 1/	100.0	44.1	39.2	11.8	4.9	2.8	2.1
			Percent change				
1974	8.9	12.1	7.0	2.5	12.2	14.3	10.1
1975	12.1	7.6	17.6	11.3	20.0	21.5	18.3
1976	14.1	11.6	17.6	11.8	18.5	20.6	16.1
1977	12.4	10.4	15.2	9.0	18.9	21.3	16.1
1978	10.4	10.3	11.4	6.4	15.1	16.4	13.4
1979	7.3	7.2	9.1	2.4	7.5	6.7	8.0
1980 1/	10.7	13.9	8.7	5.1	12.0	13.9	9.8

1/ State credit union data for 1980 are preliminary.
Source: Board of Governors of the Federal Reserve System and the National Credit Administration.

TABLE 2
Major Balance Sheet Data of U.S.
Credit Unions, by Type of Charter, 1974-80
[Amounts in millions]

Year	Total, all credit unions			Federally-chartered			State-chartered		
	Total amount	Change during period		Total amount	Change during period		Total amount	Change during period	
		Amount	%		Amount	%		Amount	%
	Total assets								
1974	$31,948	$3,573	12.6	$16,715	$2,146	14.7	$15,233	$1,427	10.3
1975	38,013	6,065	19.0	20,209	3,494	20.9	17,804	2,571	16.9
1976	45,036	7,023	18.5	24,396	4,187	20.7	20,640	2,836	15.9
1977	53,755	8,719	19.4	29,564	5,163	21.2	24,191	2,551	17.2
1978	62,348	8,593	16.0	34,760	5,196	17.6	27,588	3,397	14.0
1979	65,992	3,644	5.8	36,468	1,708	4.9	29,524	1,936	7.0
1980 1/	72,000	6,008	9.1	40,092	3,624	9.9	31,908	2,384	8.1
	Loans outstanding								
1974	24,432	2,673	12.3	12,730	1,621	14.6	11,702	1,052	9.9
1975	28,168	3,736	15.3	14,869	2,139	16.8	13,299	1,597	13.6
1976	34,310	6,142	21.8	18,311	3,442	23.1	15,999	2,700	20.3
1977	41,845	7,535	22.0	22,634	4,323	23.6	19,211	3,212	20.1
1978	50,269	8,424	20.1	27,687	5,053	22.3	22,582	3,271	17.5
1979	52,223	1,954	3.9	28,547	860	3.1	23,676	1,094	4.8
1980 1/	48,497	-3,726	-8.1	26,350	-2,197	-7.7	22,147	-1,529	-6.5
	Members' savings								
1974	27,519	3,007	12.3	14,371	1,773	14.1	13,148	1,234	10.4
1975	33,052	5,533	20.1	17,530	3,159	22.0	15,522	2,374	18.1
1976	39,098	6,046	18.3	21,130	3,600	20.5	17,968	2,446	15.8
1977	46,516	7,418	19.0	25,576	4,446	21.0	20,940	2,972	16.5
1978	53,518	7,002	15.1	29,803	4,227	16.5	23,715	2,775	13.3
1979	57,459	3,941	7.4	31,831	2,028	6.8	25,628	1,913	8.1
1980 1/	64,314	6,855	11.9	36,263	4,432	13.9	28,051	2,429	9.5

1/ State credit union data are preliminary.

SOURCE: NCUA Annual Report and Monthly Statistical Release.

Table 3
Consumer Installment Credit Outstanding
by Type of Lender, 1974-1980
(Amounts in millions)

Year	Total	Financial Institutions Total	Commercial Banks	Finance Companies	Credit Unions	Miscellaneous[1/] Lenders	Retail[2/] Outlets
				Amount			
1974	$161,990	$144,057	$80,054	$36,087	$21,895	$6,021	$17,933
1975	171,996	153,795	82,936	35,995	25,666	9,198	18,201
1976	193,525	174,265	93,728	38,918	31,169	10,450	19,260
1977	230,564	207,074	112,373	44,868	37,605	12,228	23,490
1978	273,645	247,658	136,016	54,298	44,334	13,010	25,987
1979	312,024	283,905	154,177	68,318	46,517	14,893	28,119
1980	313,435	284,025	145,765	76,756	44,041	17,463	29,410
				Percentage Distribution			
1974	100.0	88.9	49.4	22.3	13.5	3.7	11.1
1975	100.0	89.4	48.2	20.9	14.9	5.4	10.6
1976	100.0	90.0	48.4	20.1	16.1	5.4	10.0
1977	100.0	89.8	48.7	19.5	16.3	5.3	10.2
1978	100.0	91.0	49.4	19.7	16.7	5.2	9.0
1979	100.0	91.0	49.4	21.9	14.9	4.8	9.0
1980	100.0	90.6	46.5	24.5	14.0	5.6	9.4
				Percent Change			
1974	6.2	5.8	5.4	2.1	11.5	16.2	9.4
1975	6.2	6.8	3.6	-.2	17.2	52.8	1.5
1976	12.5	13.3	13.0	8.1	21.4	13.6	5.8
1977	19.1	18.8	19.9	15.3	20.6	17.0	22.0
1978	18.7	19.6	21.0	21.0	17.9	6.4	10.6
1979	14.0	14.6	13.4	25.8	4.9	14.5	8.2
1980	.5	(3/)	-5.5	12.4	-5.3	17.3	4.6

1/ In 1974, includes mutual savings banks, savings and loan associations and auto dealers. In other years, includes mutual savings banks, savings and loans and gasoline companies.

2/ In 1974, excludes 30 day charge credit held by retailers, oil and gas companies, and travel and entertainment companies. Other years exclude 30 day charge credit held by travel and entertainment companies and include auto dealers.

3/ Less than .5%.

Source: Board of Governors of the Federal Reserve.

Table 4.--Number and Total Savings of Federally-Insured Credit Unions, by Early Warning Supervisory Categories and Type of Charter, 1979-81

[Amounts in millions]

EWS category	1979 Number of credit unions	1979 Total savings	1980 Number of credit unions	1980 Total savings	May 1981 Number of credit unions	May 1981 Total savings
	Federal credit unions					
Total	12,803	$30,530	12,520	$36,348	12,327	$36,967
Code 1 & 2 1/	8,553	24,165	7,942	29,037	7,617	28,867
Code 3	3,433	5,008	3,770	5,765	3,844	6,090
Code 4	817	1,357	585	1,265	659	1,755
Code 5	(2/)	(2/)	223	281	217	255
	Federally-insured State credit unions					
Total	4,828	$14,801	4,963	$16,257	4,954	$18,016
Code 1	2,175	8,129	2,011	8,168	1,984	8,635
Code 2	1,427	3,737	1,604	4,979	1,639	5,358
Code 3	1,023	1,993	1,138	2,259	1,091	3,088
Code 4	203	943	210	851	240	936

1/ Codes 1 and 2 not broken out separately.

2/ EWS Code 5 introduced during fourth quarter of 1980. State credit unions not coded.

SOURCE: NCUA, Office of Examination and Insurance.

Table 5.--Number and Total Savings at Insolvent Federally Insured Credit Unions Fiscal Years, 1971-80*

Year	Number of Insolvent Liquidations	Total Savings (in thousands)	
		Amount	Average per CU
1971	0	0	--
1972	4	2	.5
1973	50	1,366	2.7
1974	100	2,838	28.4
1975	153	5,542	36.2
1976	128	7,527	58.8
1977	142	12,715	89.5
1978	168	14,244	84.8
1979	169	19,011	112.5
1980	239	60,000	251.0

* Fiscal years: Ended June 30th for 1971 to 1975 and September 30th for 1976-1980

NCUA Supervisory Amendments

1. NCUA Conservatorship Authority.

Sec. (a) Section 206 of the Federal Credit Union Act (12 U.S.C. 1786) is amended by redesignating subsections (h) through (o) as subsections (i) through (p), respectively, and by inserting after subsection (g) the following new subsection:

"(h)(1) The Board may, ex parte and without notice, appoint itself as conservator and immediately take possession and control of the business and assets of any insured credit union in any case in which—

"(A) the Board determines that such action is necessary to conserve the assets of any insured credit union or to protect the Fund or the interests of the members of such insured credit union;

"(B) an insured credit union, by a resolution of its board of directors, consents to such an action by the Board; or

(C) a credit union terminates its status as an insured credit union.

"(2) Not later than ten days after the date on which the Board takes possession and control of the business and assets of an insured credit union pursuant to paragraph (1), such insured credit union may apply to the United States district court for the judicial district in which the principal office of such insured credit union is located, or the United States District Court for the District of Columbia, for an order requiring the Board to show cause why it should not be enjoined from continuing such possession and control.

Enclosure (1)

"(3) Except as provided in paragraph (2), in the case of a Federal credit union, the Board may maintain possession and control of the business and assets of such credit union and may operate such credit union until such time--

"(A) as the Board shall permit such credit union to continue business, subject to such terms and conditions as may be imposed by the Board; or

"(B) as such credit union is liquidated in accordance with the provisions of section 207.

"(4) Except as provided in paragraph (2), in the case of an insured State-chartered credit union, the Board may maintain possession and control of the business and assets of such credit union and may operate such credit union until such time--

"(A) as the Board shall permit such credit union to continue business, subject to such terms and conditions as may be imposed by the Board;

"(B) as the Board shall permit the transfer of possession and control of such credit union to any commission, board, or authority which has supervisory authority over such credit union and which is authorized by State law to operate such credit union; or

"(C) as such credit union is liquidated in accordance with the provisions of section 207.

"(5) The Board may appoint such agents as it considers necessary in order to assist the Board in carrying out its duties as a conservator under this subsection.

"(6) All expenses incurred by the Board in exercising its authority under this subsection with respect to any credit union shall be paid out of the assets of such credit union.

"(7) The authority granted by this subsection is in addition to all other authority granted to the Board under this Act."

(b)(1) Section 206(b)(2) of such Act (12 U.S.C. 1786(b)(2)) is amended by striking out "subsection (i)" and inserting in lieu thereof "subsection (j)".

(2) Section 206(j)(1) of such Act (12 U.S.C. 1786(j)(1)), as so redesignated by subsection (a), is amended--

(A) in the first sentence by striking out "subsection (h)(3)" and inserting in lieu thereof "subsection (i)(3)"; and

(B) in the fourth sentence, by striking out "subsection (i)" and inserting in lieu thereof "subsection (j)".

(3) The first sentence of section 206(j)(2) of such Act (12 U.S.C. 1786(j)(2)), as so redesignated by subsection (a), is amended by striking out "subsection (h)(1)" and inserting in lieu thereof "subsection (i)(1)".

(4) The first sentence of section 206(l) of such Act (12 U.S.C. 1786(l)), as so redesignated by subsection (a), is amended by striking out "(h)" and inserting in lieu thereof "(i)".

(5) Section 206(m) of such Act (12 U.S.C. 1786(m)), as so redesignated by subsection (a), is amended--

(A) by striking out "subsection (i)" and inserting in lieu thereof "subsection (j)"; and

(B) by striking out "subsection (h): and inserting in lieu thereof "subsection (i)".

(6) The section heading for section 206 of the Federal Credit Union Act (12 U.S.C. 1786) is amended by inserting"; taking possession of business and assets" after "committee members".

2. Removal of calendar year requirement for GAO.

Sec. 102(f) of the Federal Credit Union Act (12 U.S.C. 1752a) is amended by striking the words "on a calendar year basis".

3. Elimination of requirement for partial year premium and rebates.

Sec. 202(c) of the Federal Credit Union Act (12 U.S.C. 1782) is amended by:

(1) striking all of subparagraphs (3) and (6) and

(2) renumbering subparagraphs (4) and (5) as (3) and (4) respectively.

4. Investment of NCUA operating funds.

Section 105 of the Federal Credit Union Act (12 U.S.C. 1755) is amended by adding at the end thereof the following new subsection:

"(e)(1) Upon request of the Board, the Secretary of the Treasury shall invest and reinvest such portions of the annual operating fees deposited under subsection (d) as the Board determines are not needed for current operations.

"(2) Such investments and reinvestments may be made only in--

"(A) interest-bearing securities of the United States;

"(B) securities guaranteed as to both principal and interest by the United States; or

"(C) bonds, securities, or other obligations of the United States which are lawful investments for fiduciary, trust, and public funds of the United States.

"(3) All income derived from such investments and reinvestments shall be deposited to the account of the Administration described in subsection (d).".

CLF Amendments

1. Tax Exemption.

Sec. 1. The National Credit Union Central Liquidity Facility Act (12 U.S.C. 1795 et seq.) is amended by adding the following new section (12 U.S.C. 1795j) at the end thereof:

"Sec. 311. (a) The Central Liquidity Facility, its franchise, activities, capital, reserves, surplus, and income shall be exempt from all Federal, State, and local taxation now or hereafter imposed, other than taxes on real property held by the Facility to the same extent, according to its value, as other similar property held by other persons is taxed.

"(b) The notes, bonds, debentures, and other obligations issued by the Central Liquidity Facility and the income therefrom shall be exempt from all Federal, State, and local taxation now or hereafter imposed, other than—

"(1) the Federal income tax liability of the holders thereof, and

"(2) Federal, State, and local gift, estate, inheritance, legacy, succession, and other wealth transfer taxes.

"(c) For purposes of this section--

"(1) the term 'State' includes the District of Columbia, and

"(2) taxes imposed by counties or municipalities, or by any Territory, dependency, or possession of the United States shall

Enclosure (2)

be treated as local taxes."

Sec. 2. The amendment made by Section 1 above shall take effect on October 1, 1979.

2. Investments for Cash Management Purposes.

Section 307(a) of the National Credit Union Central Liquidity Facility Act (12 U.S.C. 1795f(a)) is amended by:

(a) striking the word "and" at the end of paragraph (15);

(b) striking the period (".") at the end of paragraph (16), and inserting "; and" in lieu thereof; and

(c) adding new paragraph (17) as follows at the end thereof:

"(17) make loans not to exceed thirty (30) days in maturity to banks and other financial institutions and acquire financial assets for the purpose of effective cash management."

3. Authority tw act as an Agent of the Federal Reserve System.

Title III of the Federal Credit Union Act (12 U.S.C. 1795-1795i) is amended by adding at the end thereof the following:

"SEC. 312. AGENT OF THE FEDERAL RESERVE SYSTEM. The Facility is authorized to act upon the request of the Board of Governors of the Federal Reserve System as an agent of the Federal Reserve System in matters pertaining to credit unions under such terms and conditions as may be established by the

Federal Reserve Board."

4. Incidental Powers.

Section 307(a) of the National Credit Union Central Liquidity Facility Act (12 U.S.C. 1795f(a)) is amended by:

(a) striking the word "and" at the end of paragraph (16);

(b) striking the period (".") at the end of paragraph (17), and inserting "; and" in lieu thereof; and

(c) adding new paragraph (18) as follows at the end thereof:

"(18) to exercise such incidental powers as shall be necessary or requisite to enable it to carry out effectively the purposes for which the Facility is incorporated."

Federal Credit Union Lending Amendments

1. **First mortgage loans - maturity limit.**

Section 107(5)(A)(i) of the Federal Credit Union Act authorizes Federal Credit Unions (FCU's) to make residential mortgage loans provided the maturity does not exceed 30 years. It is requested that this be changed to permit a conventional real estate loan to be paid in 360 months, starting from the date of the first payment. This would accomodate those situations where the first payment is due more than 30 days after the date of disbursement, and would be more consistent with industry practice.

In addition, we anticipate that the 30 year maturity limit will pose problems for NCUA as we develop our alternative mortgage regulations. Our goal in developing alternative mortgage regulations is to balance the interests of Federal credit unions and the interests of their members. One alternative that we believe should be available to Federal credit unions is to extend the maturity of an ajustable rate loan, so as to keep the payments fixed instead of having increases in the interest rate automatically lead to higher payments. For example, in its VRM regulation, the Bank Board permits extension of a loan for up to a maximum of one-third of the original maturity. In the case of a 30 year mortgage loan, this amounts to an extension to 40 years. NCUA may currently lack the statutory authority to permit borrowers and FCU's to use this option.

Recommended change: Amend Section 107(5)(A)(i) by inserting the phrase "or such other limits as shall be set by the NCUA Board" between ". . . not exceeding thirty years" and "(except that . . ."). Section 107(5)(A)(i) would thus read:

". . . not exceeding thirty years or such other limits as shall be set by the NCUA Board (except that . . .)"

2. First mortgage loans - 150 per centum of the median sales price.

Section 107(5)(A)(i) permits an FCU to finance the acquisition of a dwelling only if the sales price of that dwelling is not more than 150 per centum of the median sales price of residential real property in the geographical area in which the property is located. The restriction appears to have been placed in order to prevent FCU's from financing so-called "luxury homes." House Rep. No. 23, 95th Cong., 1st Sess. 9 (1977). In practice this restriction has been found to be very burdensome.

Further, we have found that the limit does not preclude Federal credit unions from making loans they want to grant, i.e. they are not receiving applications for loans to finance luxury homes. It simply is difficult for FCU's to obtain reliable data and burdensome to comply. Such information must generally be obtained either from the Department of Commerce, the Department of Housing and Urban Development, the Federal Home Loan Bank Board, the Federal Housing Administration, the National Association of Realtors, or local realty boards.

Recommended change: Delete from Section 107(5)(A)(i) the phrase "the sales price of which is not more than 150 per centum of the median sales price of residental real property situated in the geographical area (as determined by the board of directors) in which the property is located,".

3. Refinancing of first mortgage loans.

As homeowners accumulate significant equity in their residences, they often desire to refinance their first mortgages for various purposes, such as to make home improvements or to finance their children's education. Federal credit unions may be inhibited in assisting their members in this fashion, because of the wording of their existing first mortgage lending authority. Thus, we recommend clarification of the authority of an FCU to refinance a member's first mortgage loan.

Recommended change: Delete from Section 107(5)(A)(i) the language "which is made to finance the acquisition of" and insert instead the word "on". Also, delete the word "for" the first time it appears in that section, and insert instead the words "that is or will be".

4. First mortgage loans - recomputation and refund requirement.

Currently, FCU's may be the only financial institutions in the country that are subject to interest rate ceilings when granting first mortgage loans. Section 501 of P.L. 96-221 preempted State constitutions and laws otherwise limiting the interest rates that could be set on such loans. This was done in part because of a Congressional recognition that interest rate ceilings operate to remove financial institutions from competing in the marketplace.

Not only does a fixed interest rate ceiling have this effect, but in the case of FCU's additional problems arise due to the fact that Section 107(5)(A)(vii) of the FCU Act provides that the taking, receiving, reserving, or charging interest greater than is allowed under the Act, when knowingly done, results in a forfeiture of the entire interest on the loan. Further, the borrower has the right to recover any interest paid by bringing a suit against the Federal credit union. Thus, when a first mortgage loan (with typical front end charges) is paid before maturity, it appears that the statute requires the FCU to determine the effective rate of interest it has received. (Because of the combined effect of front end charges and prepayment, the effective rate will be higher than originally projected unless some adjustment is made related to the front end charges.) If this rate exceeds the statutory maximum, then it is necessary to make an adjustment to avoid the FCU's "receiving" an excessive rate. In order to avoid the possibility of an FCU being subjected to a successful usury suit, NCUA has been constrained to require by regulation that a recomputation (and, where necessary, a refund) be made everytime a mortgage loan is prepaid in full.

Recommended change: Amend Section 501 of P.L. 96-221 to include Federal credit unions.

5. Second mortgage loans - maturity limits.

At present, FCU's may grant second mortgage loans with maturities up to 15 years if the loan is for home improvements. Other second mortgage loans are subject to a 12 year maturity limit. This distinction has led to problems in determining the proper treatment of second mortgage loans the proceeds of which are used primarily but not entirely for home improvements. The distinction has also in some instances led to problems in defining precisely what constitutes a home improvement (e.g., does the purchase of an adjacent lot qualify?). In the interest of simplicity and deregulation, we recommend that the maximum maturity for all second mortgage loans be increased to 15 years.

Recommended change: Amend Section 107(5)(A)(ii) by replacing the phrase "or for the repair, alteration or improvement of a residential dwelling which is the residence of the member" with the phrase "a second mortgage loan secured by a residential dwelling which is the residence of a credit union member."

6. Sale of real estate and home improvement loans in the secondary market - prompt crediting.

Section 107(5)(A)(viii) of the FCU Act states that "a borrower may repay his loan, prior to maturity in whole or in part on any business day without penalty." This may require that a payment be credited immediately upon receipt in order to avoid the imposition of a penalty in the amount of interest that accrues from the date the payment is received until the date the payment is credited. If in fact prompt crediting is required, then there is a conflict between the procedures dictated by the FCU Act and those used in the secondary mortgage market. Institutional investors, such as FNMA and FHLMC, typically require a seller-servicer of loans sold to them to credit payments only on the due dates called for in the loan notes. This is necessary to simplify the accounting and computing for the vast number of loans handled by those purchasers. Uniformity is also necessitated because such institutional purchasers themselves sell securities backed by the mortgages they purchase on the bond markets, where this uniformity is expected. While this problem may be resolved by interpretation of Section 107(5)(A)(viii), any interpretation of that Section will also be applicable to loans other than mortgage loans, which may be contrary to Congressional intent.

Recommended change: Amend Section 107(5)(A)(viii) by adding the following at the end:

"except that on first or second mortgage loans a Federal credit union may require that any partial prepayments (i) be made on the date monthly installments are due, and (ii) be in the amount of that part of one or more monthly installments which would be applicable to principal."

7. Sale of real estate and home improvement loans - insurability of custodial accounts.

In P.L. 95-22, Congress granted FCU's the power to sell their loans in whole or in part to third parties. This power was granted to permit FCU's to take advantage of secondary mortgage market facilities. (House Rep. 23, 95th Cong., 1st Sess. 12 (1977)). A financial institution's profit in the granting and sale of mortgage loans generally comes from loan servicing, and specifically from holding the custodial accounts.

It appears the Congress did intend for FCU's to service loans sold on the secondary mortgage market. However, this has caused a problem in interpretation, since the institutional investors typically require that the custodial accounts be insured by the Federal government, and NCUA insurance only applies to "member accounts."

Recommended change: Amend Section 101(5) by inserting the phrase "and such terms mean custodial accounts established for loans sold in whole or in part pursuant to Section 107(13) of this Act" between the phrase ". . . section 207 of this Act" and ": Provided, . . ."

8. <u>FCU authority to issue GNMA Mortgage-Backed Securities</u>.

At this time FCU's are not expressly authorized to issue mortgage-backed securities and, it is unclear whether the FCU Act provides a legal basis for such activity. An argument can be made that §107(7)(E) (invest funds) or a combination of §§107(9) (borrowing) and 107(13) (pledge of eligible obligations) provide the legal bases for such activity. Other arguments may also be available. A clear statutory expression, however, would avoid the possibility of strained interpretations of the provisions of the FCU Act. It would also place FCU's on a parity with Federal savings and loan associations, which were expressly granted this authority by P.L. 95-630.

Recommended change: Amend §107(7) by adding after "Student Loan Marketing Association," and before the semicolon:

> "or in obligations, participations, securities, or other instruments of, or issued by, or fully guaranteed as to principal and interest by any other agency of the United States and a Federal credit union may issue and sell securities which are guaranteed pursuant to Section 306(g) of the National Housing Act."

9. <u>Interest rate - "most favored lender" status</u>.

In Title V of P.L. 96-221 Congress granted "most favored lender" status to all federally chartered or federally insured financial institutions, with the exception of Federal credit unions. This placed all institutions except FCU's on a parity with national banks. This discrepancy stems from the fact that

FCU's are subject to a Federal interest rate ceiling rather than to state interest rate ceilings, whereas Title V was keyed to state laws.

Recommended changes: Amend Section 523 of P.L. 96-221 by inserting in paragraph (1) the phrase "or any provision of this Act" between the phrase "State constitution or statute" and the phrase "which is hereby preempted." The first paragraph would then read:

> "If the applicable rate prescribed in this subsection exceeds the rate an insured credit union would be permitted to charge in the absence of this subsection, such credit union may, notwithstanding any State constitution or statute or any provision of this Act which is hereby preempted . .

Also amend Section 523 of P.L. 96-221 by deleting in paragraph (2) the word "State" from the phrase "such State fixed rate." The second paragraph would then read.

> "If the rate prescribed in paragraph (1) exceeds the rate such credit union would be permitted to charge in the absence of this subsection, and such fixed rate is thereby preempted . . ."

10. Termination of Inactive Members

Section 106. Section 118 of the Federal Credit Union Act (12 U.S.C. 1764) is amended to read as follows:

"(a) Except for those circumstances set out in subsection (b) of this Section, a member may be expelled by a two-thirds vote of the members of a Federal credit union present at a special meeting called for the purpose, but only after opportunity has been given him to be heard."

"(b) The board of directors of a Federal credit union may, by majority vote of a quorum of directors, adopt a policy to expel from membership any member of a Federal credit union who (1) fails to vote in an annual credit union election for three consecutive years or (2) fails to purchase shares from, obtain a loan from, or lend to the Federal credit union for three consecutive years."

"(c) Withdrawal or expulsion of a member pursuant to either subsection (a) or (b) or this Section shall not operate to relieve him from liability to the Federal credit union."

The CHAIRMAN. Gentlemen, let us focus a little bit here. Last fall and winter I met with the two of you, Mr. Connell and Mr. Sprague, and your predecessor, Mr. Pratt, who at the time was John Dalton, as well as with the Federal Reserve Board. The reason for those meetings was that thrift industry leaders were telling me, and it was agreed by all who participated, that the savings and loans and the mutuals were in dire straits, that an emergency existed. You went to work and came up with emergency legislation, the regulators' bill. The administration vetoed it.

We have listened to your statements and you have sort of tiptoed a little bit. Now let us ask the question directly. Has anything changed since last fall and winter when everyone agreed that the situation was bleak and the action was necessary? Have the circumstances changed in any way?

I note this morning the presence of quite a few members of the committee and I think that is an indication of the concern that the committee has. I want to know, are we wrong? Is there or isn't there a problem out there as far as the mutuals, the savings and loans, and the credit unions are concerned? I will start with you, Mr. Connell.

Mr. CONNELL. Mr. Chairman, the circumstances have not gotten better since we met earlier this year. As the high interest rates persist, the equity of the institutions who are affected by the mismatch in assets continues to deteriorate.

The CHAIRMAN. Mr. Sprague?

Mr. SPRAGUE. Mr. Chairman, the need is more intense today than when we last talked to you.

The CHAIRMAN. Mr. Pratt?

Mr. PRATT. Yes, sir. There has been a tremendous change in the situation. The response which could have dealt with the situation then is simply not sufficient at this time.

The CHAIRMAN. You think the situation is worse than it was last fall?

Mr. PRATT. Substantially.

The CHAIRMAN. Now, to each of you again, the Monetary Control Act of 1980 contained a provision requiring the Federal Reserve Board to provide access to the discount window for savings and loans, mutual savings banks, and credit unions, and in so doing, to take into account the special nature of these institutions and their assets and liabilities. Do savings and loans, mutual savings banks, and credit unions indeed have actual access to the window? Let us start from this side this time.

Mr. PRATT. Mr. Chairman, about 10 days ago I wrote a letter to Chairman Volcker indicating that the Federal Home Loan Bank Board, upon consideration, had changed a previously existing policy and that we were actively requesting the Federal Reserve Board to develop programs to lend directly to savings and loan associations both for overnight adjustment credit and on a longer basis. We were further requesting that the Federal Reserve work with us in developing a line of credit to the Federal Home Loan banks. We were very well received with that letter and we have an active program going with the Federal Reserve at this time to, in fact, assure that those loans take place and that they become available in the immediate future.

The CHAIRMAN. Mr. Sprague?

Mr. SPRAGUE. To this point I am not aware of any extension of credit by the Federal Reserve to any of the savings banks which I supervise. There have been developments of the last 10 days. Chairman Volcker has called me on several occasions, and we have active discussions underway which I believe will be fruitful.

The CHAIRMAN. Would you keep the committee informed as to the results of those discussions?

Mr. SPRAGUE. Yes, sir. Chairman Volcker will be here next week.

The CHAIRMAN. I am sure that we will inquire of him, as well. Mr. Connell?

Mr. CONNELL. Mr. Chairman, there have been at least two occasions where credit unions have borrowed overnight from the Federal Reserve. We do not, at this point, see the need because the general liquidity situation is such that they have 32-percent liquidity and our central liquidity facility can meet their demands, so they have not needed to draw on the resources of the Federal Reserve System.

The CHAIRMAN. Mr. Pratt, you say that the current withdrawal penalties are not sufficient to keep depositors from withdrawing funds when interest rates vary by only 150 basis points or more. You are becoming known in town as a man who wants to further deregulate an industry to allow market forces to determine how savings and loans will operate.

Is not the withdrawal penalty an item that should be deregulated, too? Shouldn't the market determine whether a penalty will be imposed?

Mr. PRATT. Well, sir, I think this must be taken in the context of what the Congress itself said in the Deregulation Act of last year. If I remember correctly, the act clearly spoke in terms of an orderly phaseout of controls.

Let us consider what happens if we have a 4-year account that is totally deregulated as to rate, but has no withdrawal penalty. In that case, an individual, of course, really has a 1-day account, and you have gone in a single step to total deregulation of the liability side as to interest rate and other factors. It is only through the operation of something which truly keeps it a 4-year term that you can have deregulation which is phased out over time.

The CHAIRMAN. By the same token, does this not make more attractive that ogre that the savings and loans are yelling about, and the mutuals as well as the commercials, to wit: the money market fund? People may put money in a money market fund and indeed withdraw the next day.

Don't you further disable, so to speak, the thrifts in competing with these money market funds if you increase that withdrawal penalty?

Mr. PRATT. The thrifts are caught between a rock and a hard place. There are two problems which exist: an earnings problem and a liquidity problem.

Deregulation of the liability side assists in the liquidity problem in the sense that it allows these institutions to compete openly and freely for funds and therefore to retain, defend, and perhaps even increase their deposit base. At the same time, the deregulation carries with it an instantaneous increase in the cost of their funds, at a time when they are experiencing substantial losses, and which earnings levels are threatening the industry itself.

It is a very tough question to call.

The CHAIRMAN. Thank you.

Mr. Sprague, one short question: As the regulator who has the authority over the mutual savings banks, are you aware of any administration plan directly geared to their problems?

Mr. SPRAGUE. Yes. Chairman Volcker is the principal architect of this plan, and strongly supports it—the plan that I suggested to you today.

The CHAIRMAN. I am asking you not about the regulators; I am asking you about the administration: Does the administration have a plan? I do not think that Chairman Volcker, since he is independent of the executive and the Congress, can be looked on as the administration.

Mr. SPRAGUE. I was not sure how you classified him. Mr. Chairman, I believe that the Secretary of the Treasury has written to you endorsing, or at least not opposing, one of the major elements of our bill.

The CHAIRMAN. The merger section?

Mr. SPRAGUE. The interstate section. So we are halfway there. With respect to the other, no, I am not aware of an administration plan.

I can tell you that some lower level people in OMB and Treasury approached Mr. Pratt and myself with an idea of exchanging paper instead of money to in some way provide capital to institutions. I do not believe that is an administration plan that has been staffed by the Cabinet Committee or adopted by anyone. If there is any backup paper for it, I have not seen it.

We are looking at it. I told them that we would. We have not discarded it, because I am looking for more options, not less.

We are looking at such questions as what would this do to the earnings of the thrift if you just exchanged paper. We doubt that it would do anything. We are looking at how the accounting profession would look at the proposal: Would they require full faith and credit of the U.S. Government? If that were true, I guess we would have to amend our law to have an unlimited draw on the Treasury for the FDIC fund. We are looking at whether people would really believe this would help the market psychology. Would it be believable. We just don't know. But in the final analysis, we would have to have a bill, in any event, because we have that essentiality hurdle that we have very great difficulty in crossing.

Paul Nelson told me to keep my answers short, so I guess my answer to your question is, "No." [Laughter.]

The CHAIRMAN. Mr. Stanton?

Mr. STANTON. Thank you, Mr. Chairman. I would simply add, Mr. Chairman, in that regard, we do anticipate hearing from someone at the Treasury.

The CHAIRMAN. Yes. We will have someone from Treasury here next week.

Mr. STANTON. So we will ask them what their contingency plans really are.

Gentlemen, I am a little bit surprised and quite disappointed in reading over your statements last night, and the one this morning, that all of your statements come accompanied with additional legislation. It just seems to me—and I think the chairman would agree—that this is a step backward.

We came so close to a solution, at least on the regulatory powers, that we worked on for 1½ years. Now it seems unfortunate for the committee to go back and consider additional powers. There was a great advantage to a uniform approach. I believe it was interpreted by us through Chairman Volcker when he presented it that it was a united effort at that time. I do not have the time, but I wish that you would get for me a little memo of how your new legislation as far as the request for additional tools differs from what we had talked about as a regulator's bill.

Is the regulator's bill still in effect? We understand the objections from the administration for additional funds for the FSLIC, requests for additional funds which they objected strongly to. But other than that, are the tools that you all requested, still wanted?

That, of course, was a question that the chairman asked: Are these new powers appropriate? So I wish you would, for the benefit of the committee, outline either in writing, if you will, how your bills differ? How do your bills differ, in each particular case, as far as the additional tools are concerned?

Do you want to give a short answer?

Mr. SPRAGUE. Our positions are identical, Mr. Chairman. We would be delighted if you would move the clock back 90 days and pass the bill we gave you then.

Mr. STANTON. Even with the additional——

Mr. SPRAGUE. We have not even changed a comma in our sections.

Mr. CONNELL. I could certainly live with what Mr. Sprague proposes. We looked at these hearings as an opportunity to present a number of other issues as well as those that are probably not of as high priority as the regulators' bill originally was, but to describe to the committee a broad range of things that are eventually needed.

Mr. STANTON. In that regard, let me be fair. We do appreciate that. What we have to do is to try to separate what are emergency powers from additional tools, tools to carry out your prime responsibility under seminormal—certainly not emergency conditions.

We are disappointed we didn't do it a year ago. With a little leadership, we would have hoped to have done that.

Mr. Pratt?

Mr. PRATT. Mr. Stanton, let me say first that I think one important element is that a tremendous proportion of the problem exists in the savings and loan associations. Certainly in terms of the problem relative to the regulatory agencies, I think the overriding problems exist at the Bank Board. Mutual savings banks obviously have their problems, but the FDIC's membership is composed in such a manner that that is a relatively small percentage of their membership.

With respect to our bill, I think the circumstances which we saw last fall were several orders of magnitude different than what we see today, and accordingly, our bill is substantially different. In reviewing the regulators' bill, as time passed, and as economic circumstances changed, we just found that it was totally inadequate, in our opinion, to deal with the short-term problem. Our bill has a number of aspects which are vitally related to the immediate problem of making these institutions more viable, in that it makes private capital much more willing to participate in the immediate solution.

[In response to the above colloquy, the following response was furnished for inclusion in the record by Mr. Pratt:]

RESPONSE TO QUESTION FROM REPRESENTATIVE STANTON

Q. What are the differences between the provisions the Bank Board proposed in the most recent version of the "Regulators' Bill" and the FSLIC-related provisions contained in Title IV of the Bank Board's June 30, 1981, draft legislative package entitled the "Thrift Institutions Restructuring Act of 1981?"

A. The differences between the sections the Bank Board incorporated into the May 18, 1981, draft of the Regulators' Bill and our Thrift Institutions Restructuring Act of 1981 (TIRA) Title IV provisions are relatively minor, and are as follows:

1. Emergency Mergers and Acquisitions: Sections 401 and 402 of TIRA; Section 8 of Regulator's Bill

(a) Joint FSLIC-FRB approval of bank holding company acquisitions of thrifts. In section 401 of Title IV of TIRA, we have dropped language from section 8 of the Regulators' Bill designed to make emergency-context acquisitions by bank holding companies of FSLIC-insured institutions subject to prior FSLIC and Federal Reserve approval. This provision was eliminated because the Bank Board decided that it would be anomalous to put a more rigorous approval standard on takeovers of financially troubled savings and loan associations by bank holding companies than exists with respect to acquisitions of healthy associations. It should be noted that nothing in Title IV would affect existing law respecting the authority of a bank holding company to acquire a thrift institution.

(b) Sunset requirement. In addition, the Bank Board has stricken language appearing in section 8(d) of the Regulators' Bill that would have "sunset" that section five years from enactment. This action was taken in the belief that the authority contained in section 401 would represent a valuable standby tool for the FSLIC that should be available on a permanent basis.

(c) Emergency waiver of Justice Department notification requirement. A final provision appearing in Title IV that does not appear in section 8 but that relates to the same subject matter is section 402(b). The provision would provide an exception, in emergency supervisory cases, from the current requirement that the Justice Department must be given thirty days to comment on certain proposed acquisitions falling under the Savings and Loan Holding Company Act before FSLIC approval of such acquisitions can be granted. We believe the delays resulting from the requirement of awaiting Justice Department comment in failing institution cases -- the only ones to which the waiver would apply -- could have undesirable cost consequences for the FSLIC, given the premium on expeditious action existing with respect to institutions in danger of default.

2. Emergency Conversions: Section 403 of TIRA; Section 6 of Regulator's Bill

(a) Equitability requirement in conversions. In section 403 of Title IV of TIRA, the Bank Board has eliminated language specifying that conversions of mutual institutions to the stock form must be on an "equitable" basis. This requirement was regarded as ambiguous, and as adding nothing to the underlying constitutional guarantees that would require the fair treatment of mutual shareholders of a converting association.

(b) Grandfathered activities for converting savings banks. Additionally, the Bank Board has stricken language that would authorize mutual savings banks that receive federal charters under section 403 to continue to engage in certain activities permitted under state law. Because of the greatly expanded investment powers available to federally-chartered savings banks under Titles I and II of our TIRA proposal, the Bank Board determined that there was no justification for extending special grandfathering privileges to converting savings banks --- particularly since no provision is made for providing similar rights to converting savings and loan associations.

3. FSLIC Conservatorship and Receivership Powers: Section 405 of TIRA; Section 7(b) of Regulator's Bill.

Title IV of TIRA, in section 405(c), (d), (e), (f), and (g), would provide the FSLIC with conservatorship/receivership powers over State-chartered insured institutions approximately equal to those which it now has with respect to Federal associations. This proposed new authority was not included in the Regulators' Bill. Under these new provisions, while the FSLIC still could accept an appointment as receiver or conservator from a State authority, and operate according to its regulation, the Bank Board would be able to appoint the FSLIC as sole conservator or receiver of a State-charted insured institution, superseding and preempting any state appointment, upon a determination that the institution was in an unsafe or unsound condition to transact business, had substantially dissipated its assets, or had assets less than its obligations. Current law provides that such pre-emptive power exists only where an institution actually has been closed or a State receiver has been appointed for at least 15 days, where grounds exist identical to those required to appoint a receiver or conservator for a Federal association, and an account-holder has been unable to obtain a full withdrawal of his account.

Section 405(b) of TIRA would clarify the fact that when the FSLIC acts in its capacity as a receiver of a Federal association, it pays the credit obligations of that institution only in its capacity as receiver. The present statutory language raises the possibility that the FSLIC's insurance fund might be held liable for all the debts of a defaulted Federal association.

Additionally, the amendment would allow the FSLIC, as receiver of a defaulted institution, to make such disposition of the defaulted institution as it determines to be in the best interests of the association, its savers and the Corporation itself. Currently, an anomalous situation exists whereby the ability of the FSLIC to make "such other disposition" of a defaulted S&L as is in the best interests of its insured members applies only to state-chartered insured institutions, and not to Federal associations. Section 405(b) is identical to section 7(b) of the Regulators' Bill.

4. Borrowing Authority of FSLIC: Sections 407 and 408 of TIRA; Section 10 of Regulators' Bill

(a) Line of credit with the Treasury. Unlike the Regulators' Bill, which in section 10(b)(1) provides for an increase to $3 billion from $750 million in the Bank Board's line of credit to the Treasury, the TIRA would leave the existing credit line undisturbed. This omission stems from the fact that the Administration has made it clear that an increase in our line of credit would not be favorably regarded at this time.

(b) Federal Home Loan Bank lending authority. While TIRA and the Regulators' Bill contain identical authorization for the FSLIC to borrow from the FHLBanks, no power is given the FHLBanks in the Regulators' Bill to make loans to the FSLIC. This defect is remedied in section 408 of TIRA.

Mr. STANTON. One last question. I noticed, in reading your statement, that you assured the committee of your support for the all savers bill.

The question among some of the members is if it is such a good solution to a particular problem, why wouldn't it be fair to offer the so-called all savers bill?

Mr. PRATT. As I understand it, the original all savers bill does incorporate all depository institutions within it.

Mr. STANTON. You have no objections?

Mr. PRATT. An old professor of mine once told me that something beats nothing all to hell. The all savers bill is something. Our estimates are that it would provide a substantial amount of benefit, it would relieve the earnings problems to a substantial extent, and would make our lives, as far as being able administratively and financially to cope with the situation, substantially easier. It would certainly help.

Mr. STANTON. You are in favor of the Senate version rather than the House version?

Mr. PRATT. I have heard a great number of versions. I would really prefer not to——

Mr. STANTON. That is fair enough.

The CHAIRMAN. Mr. Gonzalez?

Mr. GONZALEZ. Thank you, Mr. Chairman. I wish to thank the three members of the panel. At the very outset, I want to compliment Mr. Sprague and Mr. Connell, with whom I have had a chance to correspond over the years and to say that they have done a very good job, especially Mr. Sprague. And Mr. Pratt being brandnew, I have not had much of an experience with him.

You have had for the first time since the Depression a bailout by the Board. I think it was in Chicago, that a savings and loan went completely under. There was no time, or, I guess, opportunity for merger, and through the years—and I don't want anybody to interpret this as being partisan, because beginning with the regime of President Johnson, who was not only a neighbor, but a great man and a great President, I had correspondence and personal visits that in fact upset him, because the handwriting has been on the wall.

In fact, some of you may not have been officials at the time the Hunt Commission was organized and reported. What you are asking for is really in driblets what the Hunt Commission had been envisioning on a more comprehensive scale. It ended up, like many other commissions, a lot of noise for awhile. Nothing was done.

But today, for instance, Mr. Pratt, we have the administration coming in on the one hand, absolutely with a program of blight, for example, with respect to housing. Absolutely nothing. The only thing the—it admits that there is a crisis. We have a housing crisis. But it says, "We are appointing a commission to study the housing situation and see what we can do about it," and in the meantime, savings and loans either remain or are due for extinction as the traditional source of home construction funds, mortgages, and the like.

So in effect, what we are being asked to do here, in the guise of emergency—because in your statement you say that we must have expeditious action, quick action, if we are going to save from—something, you don't spell it out—but something awesome.

No matter what we do under the circumstances, we are apt to do what we end up doing when we are pressured, and that is ending up with inadequate legislation or faulty legislation, and still failing to address ourselves to the basic question. The basic question, as envisioned by the Hunt Commission, was that we had reached a stage where the divisions of the traditional financial markets and institutions of our country, savings and loans, banks, commercial banks, mutuals and savings, and the other institutions, credit unions, had faded and that there was a need to approach—and in fact, they recommended a unitary regulation and the like.

The Congress did not respond, and it has not. It has not risen to the occasion, but neither has the executive branch. In the meanwhile, we see a failure on the part of such vast enterprises as the Federal Reserve to maintain the banking system as it was intended by the Congress for it to function; that is, with a prime public interest feature. Instead, the tremendous overwhelming financial resources of the nations are being used by the behemoths. Look at the current struggle between these troglodytes, and what are they using? They are using banking resources.

The H. L. Hunt—Chairman Volcker, I believe, is quite eligible for impeachment just in the role that he demonstrated in the H. L. Hunt escapade in which there were available huge banking resources for what public purpose and necessity? That is what a bank is chartered for. Everybody has forgotten that. I believe that unless we address ourselves to that first, interest rates, everyone here and everybody in leadership since 1969 treats interest rates as if it is an act of God. Nobody can do anything about it, nobody should, is what Secretary Kennedy told us in June of 1969.

I believe it is useless for us. We are not going to stop the inevitable. The inevitable is a collapse, as I see it, and I hate to think of it and I hope I am dead wrong; but I do not see how these recommendations you have here can stem the tide.

Director Stockman used a phrase that he was urging the President to utilize and invoke the equivalent of Franklin Roosevelt's moratorium, the first 100 years' emergency in 1932, and I am old enough to remember. He said it was economic Dunkirk. I think what we have here is an economic Waterloo, not a Dunkirk. I wish it could be a Dunkirk, and I do not know what the regulatory agencies, as they are presently set up, can gain to control this situation in time, short term or long term, through this legislation that is being requested at this point to stem this tide.

Unless we really invoke an emergency and the executive branch is really willing to come in and invoke an emergency and really consider these forces as controllable by the sovereign government, I do not see how this will do any good, gentlemen.

I appreciate what you are trying to do, and I feel that actually there is no alternative. What else? But it is just like trying to plug a leak in the dike that is already bursting. But I want to thank you anyway, gentlemen. [Laughter.]

The CHAIRMAN. I am impressed by my colleague's gratitude. Mr. Paul?

Mr. PAUL. Thank you, Mr. Chairman. I want to direct my first question to the entire panel.

Last year we passed the Monetary Control Act and brought the FDIC and the FSLIC more liabilities. We added approximately 10,000 institutions that qualified to borrow money at the discount window. I would like to get an idea how many of the new institutions have made use of this discount window in the past year and what the trend is for nonmember use.

Mr. PRATT. I would be happy to start. At the time, it was the position of the Federal Home Loan Bank Board that, given its system of regional banks, member institutions should first essentially exhaust the credit available to them through that system of banks. As a result of that I think that there was no Federal Reserve bank lending. There may have been one institution that received a loan from the Fed somewhat by accident. I would have to investigate, just to see if money actually changed hands in that particular circumstance.

However, we feel the times have substantially changed. Access to the Federal Reserve is important on a regular basis in order to provide the benefits of Fed lending, and it is important on an emergency basis because the Fed is the ultimate source of liquidity. We have, therefore, in the last week directly and forcefully changed our position and petitioned the Fed to begin making these loans, and I suspect that they will respond fovorably. The initial reaction has been positive and I should think, should I return in 90 days, that I would report that a number of institutions would have borrowed by that time.

Mr. PAUL. Are you saying that none of the institutions that were brought in in the last year have made use of the discount window?

Mr. PRATT. The institutions, for the most part, which are regulated by the Federal Home Loan Bank Board would not have made use of the window. Some of our mutual savings bank members who previously may have had some access may have continued to do so; but in any case, it would have been virtually nonexistent.

Mr. PAUL. How about our credit unions?

Mr. CONNELL. The credit unions have not had to use the discount window. First of all, they have had very ample liquidity the past year. There have been two occasions where credit unions have used overnight money, as I understand from the discount window. But overall, they have had an excess of liquidity in the past year.

Furthermore, we have a central liquidity facility which some 50 percent of the credit unions belong to in the country, and that has provided liquidity to them as needed. But overall, they have not had to use it. They have been using the Federal Reserve facilities acting as passthrough agents and have benefited from that portion of the bill over the past year.

Mr. SPRAGUE. Most of the institutions that were added by your law are the smaller commercial banks in the country that we supervise. The use has been minimal. As Mr. Connell points out, the funds are for liquidity and we have set up a mechanism with the Federal Reserve and decentralized it within the regions to expedite it. But should an institution make an application, we can provide a telephonic response within a few hours on whether or not the institution essentially qualifies.

The use has been very, very small. I would have to provide the numbers for you in the record.

Mr. PAUL. I have made inquiries along this line and have seen reports that showed several hundreds of institutions that had not qualified before the Monetary Control Act; that have actually made use of the discount window. Your information and my information contradict each other.

Mr. SPRAGUE. Mr. Paul, with 9,000 institutions, if the 200 figure were true, that is minimal in relationship.

Mr. PAUL. There were several hundreds.

Mr. SPRAGUE. I will provide the answer for the record.

[In response to the request of Congressman Paul, the following information was submitted for the record by Mr. Sprague:]

In reference to your inquiry concerning credit extended to insured state nonmember banks at the Federal Reserve discount window, during the 46-week period from September 3, 1980 through July 16, 1981, 336 such banks borrowed a total of 1,833 times. The number includes 332 commercial banks and four mutual savings banks. Commercial banks account for all but a few of the borrowing transactions. Weekly transactions by insured state nonmember banks during the 46-week period ranged from one to 108, the high figure being recorded the week ending July 1. The trend in borrowing at the discount window, by insured state nonmember banks, has been upward since September 3, 1980.

Mr. PAUL. Mr. Sprague, I want you to comment a little bit further on the need for capital infusion. First, I would like to challenge you a little bit on the word capital. I have the notion that true capital comes only from savings, and when Government creates credit and provides it for certain banks, it is not accurately defined as capital. In present day terminology I understand we use the word as such, but economically it does not act that way. What kind of dollars are you talking about? What is this going to mean in the budget? What kind of additional funds do you need here?

Mr. SPRAGUE. One of the reasons we support the bill is that we are terribly concerned about the budget problems of the Government as a whole, and some 15 years or so ago the law was changed to incorporate our budget in the general Federal budget, even though we are completely an independent agency. I cannot tell you the rationale, but I guess it is probably because we had a large surplus and it helped the budget look better.

If we proceed under our present authorities and if we have to pay out a large institution or if we have to dispose of it under any of those seven options that I have included in my statement, it will have extraordinary budget impact. It will mean that for those who are supporting military spending, less for that. For those who are concerned about social spending, possibly more cuts there. For those who are concerned about balancing the budget, additional problems.

That is one of the major reasons we want this legislation. The present facilities we have are very, very costly. Loaning money to an institution in relatively small amounts would, we think, prevent some failures at minimal cost.

Mr. PAUL. Do you have an estimate on the dollar amounts? What would you use if you had had this power in the past year?

Mr. SPRAGUE. We would not have used it in the past year, Mr. Paul. When we first started drafting this legislation in the winter of 1979, under the leadership of the Treasury Department—Under

Secretary Carswell was the principal architect—we had a session every Monday night over at the Treasury, just the principals and an attorney, to draft the bill, and we had projections which I guess were indefinite, but enough to make us feel that there would be a problem in Dick Pratt's industry in 1981 and that there would be problems in the savings banks in 1982. The legislation was designed to help us both in a timely manner. So, if we had all of the powers I asked for now, I doubt that we would use them this year. I feel certain we would next year.

Mr. PAUL. I still don't know how many dollars you need, but my time has expired.

The CHAIRMAN. Mr. Minish?

Mr. MINISH. Thank you, Mr. Chairman.

Mr. Connell, on page 11 you propose permitting the Board, under certain emergency situations, to merge credit unions with dissimilar common bonds. What does "dissimilar common bonds" mean?

Mr. CONNELL. The common bond is the limitation of the membership of a credit union. You can only do business with a credit union if you are within that group. It could be an occupational group, it could be an associational group such as a union, or it could be people living within a clearly defined community, neighborhood, or rural district. The common bond is like the McFadden Act problem. If we have a steel company credit union closing and we don't have any steel company credit unions nearby to merge it, we cannot merge it with a hospital credit union or a teacher's credit union. We have to liquidate the institution.

In fact, this happened in Chicago this past year, where a credit union of about $8 million that had been around since 1934 and was very well run, the members woke up one morning and found out that their plant was closed and we had no choice but to liquidate the credit union. It is to prevent that type of liquidation that we are dealing with this. It would be similar to interindustry, or interstate mergers for banks.

Mr. MINISH. When you are aiding the thrifts through the discount window—how would the Fed keep the money supply under control?

They have about $90 to $100 billion to work with.

Mr. PRATT. I am sorry. I missed the first part of the question, sir.

Mr. MINISH. If the Fed were to aid the thrifts with discount window loans, how would they keep the money supply under control?

I don't know that you are concerned whether the Fed controls the money supply or not, but I thought I would ask you.

Mr. PRATT. I have great confidence in their ability to handle that. I suppose the way they would do so would be to offset thrift access with open market operations in another sector of the economy. This, of course, is an allocation of resources.

Mr. MINISH. Your concern is, of course, that the thrifts get it? You are not concerned about what happens with the banks, are you?

Mr. PRATT. The banks are capable of defending their own interests.

Mr. MINISH. I agree with you.

That's all, Mr. Chairman.

The CHAIRMAN. Mr. Leach?

Mr. LEACH. Thank you, Mr. Chairman.

I would like to address a question to Mr. Pratt. I must begin it with a brief preface. As you know, we are in a financial Armageddon between the financially regulated institutions and the financially deregulated. It is obvious that the only fair competitive answer is either equal regulation or equal deregulation. In this sense, along with several others, I have proposed an equal regulation approach that implies putting reserve requirements on money market mutual funds.

But I think most of us, and I as well, would prefer an equal deregulation approach. It strikes me that a package that involves, as you have suggested, more powers to the Federal Home Loan Bank Board, more powers to individual savings and loans, coupled with a tax-exempt savings certificate, coupled, as well with an accelerated phaseout of regulation Q, so that regulated institutions can compete more equitably for deposits in given areas, is probably a better approach than the equal regulation approach.

Speaking personally, I think it is a better approach. Speaking politically, I think it is the most savings and loans can get, and probably the best they can get.

The question I would pose to you is: Is that enough to keep your industry afloat?

Do you think that that will be sufficient, to allow the savings and loan industry to survive in a very competitive way, in the near future?

Mr. PRATT. Well, looking into the future is always difficult. It depends entirely on what the economy holds for us over the coming months and years. It is also a matter of degree.

Clearly, there are thrift institutions that will be competitive, and especially so if given the powers we are suggesting, regardless of what the economy may do. There is another group of thrift institutions which are well run, and which have served their communities, but which are quite vulnerable to economic circumstances.

Based on what we can see now, the program that you have outlined, which would preclude some immediate financial amelioration through tax-exempt savings or some other approach, shows a willingness to face the problem, and a particular willingness to face the fact that you cannot deregulate deposit interest rates without providing deregulation of the ability to use the money. We think the combination of those actions and the other things we have asked for would see the industry through.

But if we are going to have a tough time. The next few months are going to be months of great pressure. However, the immediate financial effects of congressional action would be to encourage capital to flow to the institutions, and the statement of confidence by Congress that these institutions will be made competitive and given the fair ability to compete with others, would inspire public confidence in their ability to compete and survive.

Mr. LEACH. Thank you.

I would only like to comment that the whole idea of a tax-exempt savings certificate, in terms of congressional viability, is really only 1 month old. I think it is the most imaginative approach that this Congress can take at this time, and it is frankly a preferable approach to putting reserve requirements on money market mutual funds. If we go in that direction, it should be clear from a congressional point of view that it will be considered a tradeoff against the placement of reserve requirements on money market funds and that this approach will have to be abandoned at this time.

Thank you.

The CHAIRMAN. Mr. Annunzio?

Mr. ANNUNZIO. Thank you, Mr. Chairman.

I want to make a few comments. I really have no questions to ask. I want to express my appreciation for the heads of the various departments; the regulators that are here this morning. They have my complete sympathies, as they know. In the last conference on deregulation, I did not sign the report; I did not vote for the legislation. There was nothing in that legislation that would protect the thrift institutions and the mutual savings banks.

To me, to have a Board composed of the Federal Reserve and the various regulators, and then to expect the Federal Home Loan Bank Board to come out on top—Mr. Pratt, you only got one vote, and that is all you will ever have. You have been doing a good job.

I voted for the term of the Chairman of the Federal Reserve in this committee and in the House, to run coterminous with the President. President Reagan has my complete sympathies for inheriting Mr. Volcker. Had our bill passed in the Senate, as it should have passed—but we just don't do anything right around here, when it comes to the vast masses of the American people. We kid ourselves into believing that the Fed is an independent agency. Now, if you believe that hogwash——

You know, independence—independent people who do not belong to something—an organization—have destroyed every institution that they have ever touched. I have almost seen my own party destroyed by independents, because they do not know if they are Democrats or if they are Independents, or some other title, you know, that they place on themselves. So independency is a luxury we cannot afford in America.

We are a great country because we developed a great two-party system. You know, we like to criticize the European parliaments as compared to our own representative government here in America. Well, we have seen our representative government become a coalition government, just like any European government. We have seen that demonstrated twice on the floor of the House.

I want to say to the regulators that you had a bill, known as the regulators' bill. That bill was vetoed by the administration. So what is going on is really not your fault, but it is a long history of not passing legislation as far as the Fed. The last deregulation bill was a farce.

Now we are told that one of the reasons that your legislation, the regulators' bill, was vetoed is that Mr. Stockman and the Secretary of the Treasury, Mr. Regan, did not want any draws on the Treasury which would upset the phony numbers in the Gramm-Latta II reconciliation bill. I am not an economist, so I am not going to argue about the $35 billion in cuts, because anything can happen.

I know that when the President comes to the Congress in October, for $1 trillion debt ceiling bill, I know the Republicans might run. But I have been here 17 years, and I never voted against the debt ceiling; and if it is $1.5 trillion, I am going to vote for it. We made the bills, and they are going to have to be paid. So the President will have the honor of being the first President to ask for a $1 trillion debt ceiling bill.

I would also like to point out that I want to wish Mr. Stockman a lot of good luck. I do not agree with his economics. I think that the deficit in the end, when we get through with this $1.3 trillion bill that we have been discussing, in the Department of Defense they are going to have a deficit of at least $60 billion, $70 billion, to $80 billion.

But this situation is a lot more serious than we try to imagine. I want to know, in my own city of Chicago, that the thrift institutions, like everywhere else, the mutuals, are in very serious trouble. When the blow comes, these people who are trying, you know, to protect a theory—I think it is some professor of economics' curve, the Laffer curve—they want it to come out at the expense of the American people.

You are going to see—and I hope I am wrong—Dave Stockman's $35 billion so-called cuts go down the drain, if you have 200 or 300 or 400 of these institutions close, Mr. Pratt and Mr. Sprague. You know the small banks are in trouble, and everybody is going to save everybody else by opening up, crossing State lines, and create bigger and bigger banks.

Well, we had a Great Depression. It was known as the Hoover Depression. When these institutions start folding up, I do not think that this legislation is going to do it. We have not prepared ourselves to do it. I agree with Mr. Gonzalez, you are going to have David Herbert Hoover Stockman of 1981. This is what is going to happen.

I yield back the balance of my time. [Laughter.]

The CHAIRMAN. Certainly the members of the panel want to comment. [Laughter.]

Mr. Shumway?

Mr. SHUMWAY. Thank you, Mr. Chairman.

Mr. Sprague, if I might address my first question to you. You have asked us to consider a couple of provisions which would extend the ability of your agency to come to the rescue of thrifts. Dr. Paul asked some questions about the dollar impact of those provisions, and I don't think that you were able to fully answer his questions.

My question deals with a related matter. I get in my mail, from time to time, a string of letters commenting on the ability or lack of ability, as it really is, of the FDIC to really provide the kind of insurance that America's depositors and savings institutions are led to believe is there. Now, whether that is in fact true or not—I am just wondering if, in the event there were a massive failure of these financial institutions in America, and the FDIC were called upon to bail out all of the individual depositors; and assuming further that it would have a difficult time in doing so; how can we now realistically talk about expanding those programs, expanding the potential dollar liability of the FDIC by these two provisions which you have described to the committee here this morning?

It seems to me that if indeed you are going to be hardpressed to back up, in terms of insurance, the deposits that you are now obligated to protect, aren't you putting your neck even more into the noose by going into new and more expensive programs that would call upon your Agency to come forward with even more dollars?

Mr. SPRAGUE. Mr. Shumway, I think I can answer both of you at once, with this response:

Our fund now is approximately $11.5 billion. It is fully adequate, as far as we can tell, for any eventuality. It has grown rapidly. Under the normal course of events, the fund would be $25 billion by 1985.

Now, you talk about expanding our authorities. Very rough numbers—please do not hold me to them; they are ballpark. You have a $2 billion institution that we must pay off. We write a check on day 1 for $2 billion. You have that same $2 billion institution, but we work out a merger, assuming a 30-percent depreciation in the portfolio. We put up perhaps $600 million on day 1. You have a $2 billion institution that we can keep alive by providing $200 million of capital.

We are not asking for more authority to spend more money. We are asking for authority to save money and hold down the deficit. The numbers are dramatic.

Mr. SHUMWAY. Right now, the fund stands at $11 billion—$11.5 billion—and you expect it to expand to $25 billion by 1985?

Mr. SPRAGUE. Well, if we get this bill, yes.

Mr. SHUMWAY. Mr. Pratt, if I might address this question to you. You have outlined to us some of the proposals that we have had before, but which we know would be—they would have as their effect the overriding of certain State prerogatives. Many of us in Congress have really gone to bat in terms of trying to preserve what is left in America of home rule, and honoring the role of States.

It seems to me, at this particular point in time, States are just as aware and just as concerned, and just as anxious to search for solutions for the problems of savings and loans, and banks, and thrift institutions, and the problems of disintermediation, as is this committee, as well as the entire Congress.

I am not satisfied, as one member here, that there has been a sufficient case made that we should be overriding those State prerogatives; that we somehow have a better solution at hand.

Now certainly, if you are suggesting that we confine our efforts to interstate matters—things that States themselves, by their own actions, cannot attend to—certainly I would understand that. But if we are going to invade the prerogatives of States, and say that "Washington wants it this way," in an effort to save the thrift institutions—I would just like to know: Do you believe that a sufficient case has been made to proceed in that direction?

Mr. PRATT. Let me give a couple of quick examples. One, where we have experience already, is the override of State usury laws affecting first mortgage loans. In my opinion, that was socially very beneficial and was strongly supportive of the public interest.

A second issue concerns the "due-on-sale" clause. A portion of our legislation would provide for Federal preemption of State laws forbidding excercise of the due-on-sale clause. The due-on-sale clause, of course, states that at the time the borrower sells the security property, which in the case of a mortgage loan is his home, the lender may call that loan.

Our preemption proposal would not disturb his secure tenure and fixed payment while he is in the house, but does not necessarily allow him to capitalize on the value of a low-yielding loan for resale and add that to the profits from his house—unless his contract permits such a result.

The Federal Home Loan Bank Board believes that it is very much in the public interest, in that it makes more mortgage credit available and lowers the cost of mortgage credit if "due-on-sale" clauses are allowed to operate. Please remember that these clauses are part of private contracts between borrower and lender.

As you know, a number of States has struck down these clauses, saying that they cannot be enforced. What this does, of course, is transfer wealth from future borrowers to past borrowers. It creates substantial windfall gains. But why is it a Federal problem?

Well, one example of why it is is that the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association have said that they will require the exercise of due-on-sale clauses in all States in which it is legal.

What this, of course, has provoked is a substantial number of States passing legislation to make the clauses illegal. It was a beggar-thy-neighbor policy in two regards: One, across State lines; and two, the people who have received loans essentially taxing those not receiving them, as well as those who provide capital to thrift institutions.

We think in that regard, a major piece of the problems which thrift institutions face is because of the persistence of inflation, which they could not possibly have anticipated. It is a very tough question, but I think there are instances where Federal preemption serves the public interest even though it is is distasteful in some respects. There it is advantageous in that it will save the use of Federal money directly, and in any event it is essentially equitable.

Mr. SHUMWAY. Thank you, gentlemen.

My time has expired.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Blanchard.

Mr. BLANCHARD. Thank you, Mr. Chairman.

I want to commend you on holding these hearings. As you know, a good number of the members of the Banking Committee have been deeply concerned for some time about potential widespread failures of financial institutions and what that might do to the public competence.

In our system of money and credit, I have talked to a number of financial analysts who are not in charge of regulating institutions and do not perhaps run them. All of them concur; as one of them said, the situation with regard to savings and loans at least, and mutuals, is a ticking time bomb, that if left unaddressed will be a matter of grave concern for our economic system.

Now, I am having a hard time understanding what all of you are really saying, other than it seems like you are kind of poking at the margin here of something that is far more serious that you would really rather discuss publicly.

As I understand it, Federal spending will continue to go up, despite the eloquent speeches of the President and Members of Congress. There is very little else therefore being done to fight inflation. There is no incomes policy.

Essentially, everyone I have talked to—and that means conservatives and the liberals, economists and businessmen, but bankers and the like, concur that inflation is being fought almost exclusively with monetary policy. We are borrowing a tax cut to sprinkle around which does not due much to ease the pressure and interest rates either. It would appear we are going to have continued high interest rates, albeit hopefully slightly lower than they are at this point.

So, with what I see, no relief in sight, all of us, including you and members of the administration, have a responsibility to prevent the condition you describe from getting any worse.

Now, I am concerned because the psychology, as discussed earlier, created when an institution is permitted to fail or perhaps allowed to be liquidated can be very serious. In my home State, there are several institutions in which there is a run going on on them, because certificates that people hold in excess of $100,000 are not insured. I think the panic can increase if they see the FSLIC allowing liquidations to occur, rather than some other method of rescue.

I do not think it would take too many failures in too many States for the average person to lose faith in the integrity of our financial institutions and cause a problem far greater than the one exists now.

Now, having said all that, I am curious as to whether you concur in my analysis? Also, given your range of powers, how many institutions under your jurisdiction are in serious trouble?

Mr. Pratt?

Mr. PRATT. Well, your analysis was wide ranging. In looking at the situation of the thrifts and the savings and loan associations under our jurisdiction, clearly there exists a substantial earnings pinch. This has a number of implications to it, particularly for a number of institutions which very likely are not viable unless economic conditions change rather substantially.

We do see a tremendous ability on the part of management to solve its own problems and to take effective steps to get through this very difficult time. We are seeing a tremendous number of voluntary mergers, and generally a tremendous creativity on the part of management in dealing with their own problems. We should not underestimate their ability to do so.

Beyond that, we have a wide variety of powers with which to deal with those institutions which ultimately become the concern of the FSLIC. The caseload of the FSLIC, however, is very, very large as compared with any other historical period——

I believe the last number that we reported in this regard was something over 200 institutions, 263 I believe, which we feel have special problems. How this situation will evolve is tremendously dependent on what happens in the economy. It depends on whether the all savers bill is passed, for that would represent money to the bottom line. It depends on the level of interest rates, and on how rapidly they change. At this time, we think we have the ability to deal with it.

Mr. BLANCHARD. What are your current resources with your insurance fund, including any expected income that you have or additional assessments or Treasury borrowing authority that you could use to deal with this problem if the situation seriously worsens?

Mr. PRATT. The FSLIC has about $6 billion, and it has an income of about $1 billion a year.

Mr. BLANCHARD. There are reserves from Treasury you could use?

Mr. PRATT. We have a line with the Treasury of $750 million.

Mr. BLANCHARD. I am curious. As I understand it, you were hoping to see the FSLIC have its borrowing authority increased, even thought those reserves may seem quite ample; is that correct?

Mr. PRATT. Yes; we did. In the original regulators' bill there was a provision asking that the line of credit be increased from $750 million to $3 billion. This would be consistent with the growth which has occurred in the responsibilities of the FSLIC.

Mr. BLANCHARD. Isn't it also true you were concerned that available reserves were not sufficiently out. Given the nature of this problem, that the possible savings and loan failures might, in terms of numbers, exceed what was available to you?

Mr. PRATT. At this time, we think that we do have the resources to deal with the failures which will occur.

Again, one cannot forecast the economy—at least I cannot—and the absolute level of interest rates, the level of public confidence and other factors. But our best analysis at this time indicates that, in fact, we can deal with the problems as they arise.

We also think enactment of the legislation we are proposing would aid tremendously in dealing with the problems that might exist, and would cause a number of them to be taken care of on a rapid basis.

Mr. BLANCHARD. One concluding question here: Your recent legislation on savings and loan powers did not contain any such insurance fund strengthening provisions. Is that essentially because the White House and Treasury asked that you not include them? Or was there a change in your judgment?

Mr. PRATT. There are really two things: First, we were not led to believe that such a suggestion would be well received. Second, we believe that the bill, as we have now structured it, which is substantially different than that which existed previously, will greatly increase the likelihood of bringing private capital into an industry which to them would then appear to have reasonable prospects of profit and liability and that the private markets, which we basically rely on, would become a much larger portion of the solution.

Mr. BLANCHARD. I hope you are able to deal with this before it is too late.

Thank you.

The CHAIRMAN. Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

I have a number of questions. I will try to be as rapid as possible so we can squeeze them all in.

First of all, the all savers bill, Chairman Pratt supports it very strongly.

Mr. Connell and Mr. Sprague, what are your feelings on that act?

Mr. CONNELL. Mr. Weber, first of all, the all savers bill appears to be a very expensive approach to the issue. It is a rather crude tool to deal with the particular problems.

I think the thing that concerns us mostly is that provisions that limit it to institutions that have a high proportion of their assets in housing, savings and loan associations essentionally, if that were passed in that form, we think it would be very disruptive.

Mr. WEBER. Assuming we had an all savers bill that did not have that type of credit allocation, which is, I believe, what the Senate bill provides?

Mr. CONNELL. Yes; then it would be beneficial to credit unions, as it would encourage greater savings to flow from other types of nondepository instruments.

Mr. WEBER. Thank you.

Mr. Sprague?

Mr. SPRAGUE. I believe the Treasury projections are that this would be an enormously costly legislation, $4 billion, $6 billion—I don't know what the cost would be—and that the benefits would essentially go to those in the upper income brackets.

I think the breakoff figure is 34 percent, marginal income tax bracket. Further, there is some dispute about how much new savings it would bring in and whether the effect would be just to provide benefits to those who are already saving. I discount that. I think that it inevitably would bring in some additional savings. I also think that probably the big commercial banks will scoop up most of the gravy. On balance, I would oppose the bill.

Mr. WEBER. Thank you very much.

Now, a point of information—I am a little bit confused by the testimony of Mr. Pratt and the testimony of Mr. Sprague.

On page 10 of your testimony, Chairman Pratt, you are complaining that State laws now prohibit the interstate merger of failing saving and loan institutions. There is a prohibition in the Saving and Loan Holding Company Act against the saving and loan holding companies acquiring control of insured institutions in more than one State.

On page 6 of Mr. Sprague's testimony, there is the statement that the FSLIC may assist the merger of a failing insured savings and loan with an out-of-State savings and loan.

Can the two of you clear up my misunderstanding?

Mr. PRATT. The savings and loan business, as is true with commercial banks, is chartered under dual chartering systems, with some State charters and some Federal charters.

With federally chartered institutions, we have relatively complete control. And we can allow them to merge across State lines.

If institutions are State chartered, then it would depend upon the laws of the State. And as a matter of fact, of course, there are savings and loan associations, quite a number of them, that operate on an interstate basis in the United States at this time under State law.

The Holding Company Act is a specific issue that is of importance to us. I do not think there is a conflict. I think it is just working through the labyrinth of various regulations and laws.

Mr. WEBER. Your statement on page 10, what is the change in legislation that you are seeking to expand the interstate acquisition?

Mr. PRATT. There are two or three items that deal with this. One would be the authorization of holding companies to hold institutions in more than one State.

The second type of problem that we are seeking to deal with is represented by the situation that exists, for instance, in the State of New York at this time, where we have problems converting a mutual to a stock association. Such a conversion facilitates our dealing with the problem, enabling us to sell someone who might have cash for such an investment.

So, the legislation gives us power to allow various forms of organization which will best meet the needs for injections of private capital by allowing merger on a basis which will solve the problem.

Mr. WEBER. Are you seeking a law that permits State-chartered savings and loans to merge across State boundaries?

Mr. PRATT. We would be seeking increased authority for supervisory cases only in this regard.

Mr. WEBER. I don't understand what that means.

Mr. PRATT. It would only apply to institutions which are essentially failing institutions.

Mr. WEBER. Mr. Sprague while we are proceeding on the interstate question, on page 8 of your testimony you state under your interstate change of law, a winning out-of-State bidder may reopen a State bank only as a subsidiary, so that no interstate branching will result.

You will have to explain to me the difference between interstate branching and operating as an interstate subsidiary.

Mr. SPRAGUE. Yes; very briefly to respond to your first question, our request is somewhat similar, but somewhat different from Mr. Pratt's authority. We have a very limited entree under our proposed bill. Only the 107 largest institutions would be eligible for across-State mergers. None of them would be eligible until they had been closed, dead and gone. It has nothing to do with viable interstate branching. Very, very limited provision that we are seeking.

The difference, as proposed in our bill, is to preserve the prerogatives of State law. The way our bill is designed, the winning bidder would have to operate as a subsidiary and be totally controlled by the laws of whatever State he goes into. As contrasted by having them just extend their branch network of their existing institution. It is a major States rights provision.

The CHAIRMAN. Mr. Mattox?

Mr. MATTOX. Thank you, Mr. Chairman. Let me start off by stating my preexisting prejudice, and that is against the crossing of State lines by institutions. We have had it in Texas. We had a situation where there was a grandfather provision where, I think, Imperial Savings & Loan of California already had some interest in Gibraltar Savings, which bought four of them in Texas, and they merged across State lines through a grandfather provision.

But in your testimony, you cite on page 6 the provisions that the FSLIC right now may approve a merger of a troubled savings and loan with an out-of-State savings and loan institution, at the very bottom of the page, page 6.

Mr. SPRAGUE. Yes.

Mr. MATTOX. It is my understanding that even though they have got that power, that they have never used that power, or the power has not been actually given by legislation, but there is nothing to prohibit the FSLIC from granting that—or taking that action; is that your understanding of the situation?

Mr. SPRAGUE. Mr. Pratt would have to respond. That is my understanding. But they came right to the verge in the last month of using the power.

Mr. PRATT. I would believe we have certainly approved a number of institutions' operating on an interstate basis. Savings and loan associations have historically in certain parts of the United States had extensive interstate operations. States of Washington, Oregon, Utah, Montana, Hawaii, and many others already operate on a regular daily basis with healthy institutions across State lines. I would have to research what approvals we have—may have made, of mergers.

I believe that we did approve an interstate merger, and perhaps more than one.

Mr. MATTOX. Of a troubled institution?

Mr. PRATT. Yes, sir.

Mr. MATTOX. The question I am really trying to get to, if this piece of legislation that basically you have divided into three parts and brought back to us is so important, is it important because you think that there is going to be an immediate need to approve an assortment of these across-State-line types of mergers with savings and loans? Mr. Pratt, I would ask you.

Mr. PRATT. I think at this time we do not have pending any such backlog of cases. Again, what the future will bring, I do not know at this time.

It is important to note that we do have some geographical problems. There are some instances where, because of the economic conditions within a certain State or the status of its State laws for a period of time—let us say with respect to usury—that we have concentrations of problems. We do not have a such a good mixture of, let us say, strong and weak institutions, which make solving the problem within a State or within a small area more difficult than under other circumstances.

Mr. MATTOX. What you are telling the committee is that at the present time, there is no critical need for mergers across State lines of troubled with healthy institutions, at the present time.

Mr. PRATT. At this moment, I don't know of any cases. I am not saying that that could not arise in 1 week, or 2 weeks, or 5 weeks. Various things trigger a need for us to act, and there are tremendous numbers of institutions which are working out their own problems. We may not see their suggested solutions until they are asking approval for it.

Mr. MATTOX. I have not had a chance to study your legislation carefully, but it is my impression that what you are asking for is to allow the Home Loan Bank Board, FSLIC, basically, to approve, perhaps, the merger of a bank with a savings and loan or a bank holding company to purchase savings and loan inside of the State, or to allow the purchase by a bank holding company of a savings and loan across State lines.

Would you comment on whether that is a correct interpretation of what——

Mr. PRATT. This would obviously be very helpful to us. We recognize it is an important public policy question, however, and our FSLIC-related provisions would make no changes in existing law in this regard.

As a general matter, we intend to seek the guidance of Congress even in some areas where we believe we have legal authority to act, but that involve matters of substantial public policy. We would like to hear the Congress voice on such issues. We will implement whatever that voice would be.

The CHAIRMAN. Under the Bank Holding Company Act, the Federal Reserve right now has the power to authorize bank holding company acquisitions of savings and loans, doesn't it?

Mr. PRATT. That is my understanding.

Mr. MATTOX. They have not done so. I guess they have ruled the opposite: They have ruled that they will not approve that kind of action.

Mr. PRATT. I think that they are reexamining that. They have that issue out for comment. I believe they turned down such an acquisition recently, without prejudice. But those would be questions, obviously, that would be better asked of the Fed.

Mr. MATTOX. Let me move into another area. I know that there are several savings and loans that have approached you about the possibility of making major loans to the institutions, and in effect, taking back the security for those loans, the low-yielding mortgages that they hold in their portfolios, with the agreement that possibly at a later time they may come back in and reacquire those mortgages over a 5- to 7-year period, in effect to allow them to phase themselves out of some of the problems.

Now, with the legislation that you are talking about, would it permit you to have additional capital to bring about those solutions?

Mr. PRATT. No, sir.

Mr. MATTOX. You are not providing any kind of additional means for that?

Mr. PRATT. It improves our ability to perform such operations, but it does not include any funding within it.

Mr. MATTOX. I don't mean direct funding; I mean such as allowing——

Mr. PRATT. It does expand the flexibility with which we can operate. It does increase the flexibility we have to provide various solutions, including those which would involve the injection of capital for a period of time.

Mr. MATTOX. It does not allow a direct draw on the Treasury for additional money.

Mr. PRATT. That's correct.

Mr. STANTON. Would the gentleman yield? I am curious about that.

Would you need additional legislative authority to do what the gentleman from Texas is talking about, buying old loans?

Mr. PRATT. I don't know that we have examined the exact question of buying old loans. We have staff working on developing capital instruments which we feel we could legally purchase under present law. There are, again, some Federal and State law questions that sometimes make these cumbersome, and those questions are dealt with in our legislation.

Mr. MATTOX. If I could ask one more question, would you tell me the extent of the moneys you would need to deal with the existing troubled savings and loans to implement a plan that would allow you to in effect go in and purchase the low-yielding instruments with the agreement that the savings and loans would come back and buy those instruments back over a 5- to 7-year period, with not only paying the principal, but also the subsidy interest? Do you have that kind of a figure?

Mr. PRATT. I can't give you that figure. I would be more than happy to supply that to you in written form. I think we could come up with some pretty good estimates for you.

Mr. MATTOX. You understand the question I am asking?

Mr. PRATT. Yes, sir; and we can clarify it.

Mr. MATTOX. I would appreciate it.

[In response to the request of Congressman Mattox, the following additional information was submitted for inclusion in the record by Mr. Pratt:]

MATERIAL REQUESTED BY REPRESENTATIVE MATTOX

Federal Cost of Five-Year Warehousing Program

Table 1 shows estimates of the outstanding principal balances of below current market coupon mortgages held by savings and loan associations as of December 31, 1980. As can be seen from this table, the bulk of the below current coupon mortgages are in the 9 to 10 percent range. Accordingly, the estimates provided of the federal cost for a five-year warehousing program are based on purchase of mortgages bearing coupons below 10 percent.

The table below shows the estimated cost to the federal government if it were to purchase at par all mortgages carrying interest rates below 10% for a five-year period, subsequently selling the mortgages back to the original selling institution, also a par. Shown below are both the initial outlay (a portion of which would be recouped when associations repurchased the mortgages) and the cost, termed the warehousing cost, to the government of carrying these mortgages for the five-year period. The warehousing cost is the difference between what the government would earn on the mortgages and what it would have to pay to finance the purchase. This cost is based on current costs of intermediate-term government debt. 1/

Initial Outlay $305.2 billion
Warehousing Cost $94.9 billion

A few caveats are in order. First, the cost estimates are based on an assumption of no mortgage prepayments. A prepayment would lessen the cost since the government could retire the financing debt when the mortgage prepaid. Second, the costs are understated since no attempt was made to estimate the increase in Treasury's borrowing costs caused by the increased demand placed on the credit markets as a result of the additional borrowing. Third, no estimates of transactions costs are included. Fourth, no estimate of a lower cost resulting from additional tax revenues as associations invest the proceeds from the sale of mortgages to the government in higher-yielding assets is included.

1/ Yield on 5-year Treasury Security. As of week ending July 24, 1981, the yield was 15.24 percent.

Table 1
Residential Mortgage Holdings by
Coupon Rate at Savings and
Loan Associations

	Less than 6.00%	6.00–6.99%	7.00–7.99%	8.00–8.99%	9.00–9.99%	10.00–10.99%	11.00–11.99%	12% and over	TOTAL
Percent outstanding mortgages, 9/80 1/	1.26	3.37	9.52	22.89	29.67	14.30	9.32	9.65	99.98
Residential mortgages, 12/80 (million $)	5,765	15,420	43,560	104,735	135,757	65,431	42,644	44,154	457,466
Assumptions:									
Coupon	5.50%	6.5%	7.50%	8.50%	9.50%	10.50%	11.50%	12.50%	9.55
Original maturity 2/ (years)	22	24	24	25	26	27	27	27	
Average age (years)	17	13	8	5	2	1	1	1	
Remaining Life (years)	5	11	16	20	24	26	26	26	

1/ Based on a survey taken by the U.S. Savings League in September, 1980.
2/ Based on when these coupon rates were prevalent.

The CHAIRMAN. Mr. McCollum?

Mr. McCOLLUM. I would like to clarify something, Mr. Pratt. Is my understanding correct that you would favor the purchase or merger between bank holding companies, commercial banks, and savings and loan institutions?

Mr. PRATT. I don't know if it is a question of what I would favor. It is a question of our having a problem and what are the possible solutions. That is clearly a solution which exists and which might provide substantial infusions of capital into ailing thrifts and which would not require the use of public funds.

Obviously, there is a public policy question which has been stated as to the appropriateness of the financial structure of the United States, and obviously that is the question you have to deal with. It would help us. It would allow us to deal more effectively with our problems.

Mr. McCOLLUM. Would the use of that merger action within the intrastate idea avoid the necessity of interstate merging?

Mr. PRATT. I think the two of them go together in many respects. Each of them provides a portion of the solution. Obviously, the most total solution is provided by a combination. Institution eager to go interstate will find this opportunity the most attractive. They are going to be willing to put up the most capital. They are going to be willing to go the furthest in solving the problems which we may be facing. Therefore, the broader geographical net you can cast, the better that solution will be.

Mr. McCOLLUM. Mr. Sprague, your testimony on pages 10 and 11 indicates some similar thinking with regard to the merger potentialities between commercial banking establishments and savings and loans.

Do you agree with what Mr. Pratt has said with respect to this? Or do you think that your position is different in some respect on that issue?

Mr. SPRAGUE. I am in complete agreement. What we need is more options.

Mr. McCOLLUM. Mr. Pratt, from an equity standpoint, there is probably no serious question that—and this is what you said—the banking industry ought to allow savings and loans to have demand deposits. But you have indicated in your testimony that you do not think there is any serious question.

I presume that means there is no serious question in your mind. But is there a serious question in the banking industry's mind? Do you know what their thinking is about that?

Mr. PRATT. I would not see them rushing to support this legislation. They clearly should represent their own self interest. I am not sure that seeing competitive equity in this regard is necessarily something which they see as of substantial benefit.

Mr. McCOLLUM. Am I correct that the basic proposals you have in the long term section of your statement would just simply break down most of the barriers between commercial banking and savings and loan institutions?

Mr. PRATT. Yes, sir. It is my belief, that given the mandate of Congress that institutions must bid for funds in an open, free, and competitive market, that the only structure which makes any sense and which will allow survival and competition and serving the public interest, is to allow institutions to sell funds in a competitive market. To the extent we have major legislative constraints, that clearly does not exist.

Mr. McCollum. In light of the long-term goal, and even though I am aware of the short-term problems that savings and loans have right now, do you think that returning the differential at this time would be really that beneficial to savings and loans in terms of their drawing of capital away from other markets that seem to be broadening and more available? Would it not in fact damage the long-term prospect?

Mr. Pratt. I may be a little bit like the person who loved humanity but hated people. I do not wish to talk out of both sides of my mouth here, but as I did mention earlier: There is a short-run problem; an immediate earnings problem; as well as a structural problem.

This earnings problem has been caused by the configuration of these institutions over time, and the losses have already occurred. It is a question of how to ameliorate these losses. How do we deal with them? Imposition of the differential is clearly a short-term move away from competitive equality, in one sense, and in another sense, to the extent that these institutions do not have the other powers, it may be an establishment of better equality, which then should be removed as the powers are given.

Mr. McCollum. What I am getting at is with money market funds, with the availability of such different types of borrowing and investment opportunities today for the consumer, would the return of the differential be significant at all in the short term for the savings and loans in the current financial environment?

Mr. Pratt. If we look at the 6-month money market certificates prior to removal of the differential, savings and loans held about $2 for each $1 that commercial banks held. At the present time, that is almost totally reversed.

Further, if we look at the ability of these institutions to capture household savings, where we would think savings and loans would be strongest—this is really their area, dealing with households—in the last 3 years their market share of these households savings flows has decreased tremendously.

Money market mutual funds have increased in size, but very interestingly, commercial banks have essentially held their own. So what you have had is, in my opinion, a very dramatic shift from savings and loan associations to commercial banks as a result of the removal of that differential.

Now, given that savings and loans do not have competitive asset powers, it seems to me that was not an orderly phasein of deregulation.

Mr. McCollum. I yield back the balance of my time. Thank you.

The Chairman. Mr. Vento?

Mr. Vento. Thank you, Mr. Chairman.

Gentlemen, I appreciate your being here today. You know I paid special attention to the comments, especially with regard to the Tax Code, for financial institutions to acquire help through that particular means.

Is it your judgment, Mr. Sprague, that that is the only game in town? Is it the most efficient one, or do you think more efficient changes to help financial institutions would be through a regulatory method or through Congress dealing with special programs?

Mr. SPRAGUE. As I said, Treasury apparently is searching diligently for an alternative to what is not too attractive a solution. I do not know if they will come up with one or not.

Over the long term, I think proposals like Mr. Pratt has made about improving the ability of the institutions to do their job should be looked at.

Over the short term, like now, I think we have to have some legislation to let us handle things that may well happen before the impact of all of these other changes comes about.

Mr. VENTO. You do not believe that trying to provide the regulatory relief or trying to provide some remedy for problems that exist through a tax code is very efficient?

Mr. SPRAGUE. We don't know. It may postpone some of the problems a few months or years. I don't look to it as any ultimate solution.

Mr. VENTO. That seems to be the only thing that is moving around here and frankly the only place where we can offer help. I am not enamored with that as a solution. As long as we are going to pass the tax bill, some of us say we should try to make it noninflationary, provide savings incentives in it. Maybe it will help, and maybe it won't with regard to specific problems, but we do not find it efficient. It helps both the healthy and the unhealthy. It does not target the money generally, and when you do try to target it, such as the housing targeting in supposedly the All Savers Act, you get the response that is the evidenced at the witness table this morning.

Let me address one other problem that is apparent to me. One of the things so far in the discussion that we have talked about is the viability of financial institutions and the proposed modifications to keep them solvent within current and future economic circumstances.

My question is, What about the purpose for which they are created? Are you extending credit, providing capital growth with regard to special functions, or have these activities been markedly affected by the movement to different arenas—money market certificates, bonds, and so forth? Will the modifications that you have proposed address the totality of maintaining the roles that you actually have. That really is the question.

It seems to me this morning we are talking about a holding action until the economic storm blows over. The question is whether the assets will ever come home. I am interested in that particular question.

Are we going to be able to do the job, or are we just talking about saving some institutions that have a bad portfolio of paper versus doing the job in terms of what you are supposed to do?

I do not know what types of studies or what type of testimony you can give to that particular question.

Mr. SPRAGUE. Our mandate from the Congress clearly is to protect the insured depositors of America. It does not say anything about saving banks or savings and loans or building housing or doing any of those other things. We have a very narrow perspective from our corporation—insurance corporation, and that is to handle our business in such a way that no insured depositor will ever lose a nickel. I can assure you, it just cannot happen—any scenario that the chairman may draw—no insured depositor is going to lose anything.

Now others have different charters, but that is our charter—to protect the insured depositors.

Mr. VENTO. But what about the institutions that engage the use of that insurance? Are they going to end up healthy as a consequence of this? Will they be able, under the existing circumstances or future circumstance—to engage in the commercial activities successfully?

In other words, will we see a return, for instance, with these changes themselves that will not cause a change in terms of the level of activity right now that we see centered around savings and loans or commercial banks or credit unions?

In other words, they are designed to protect the insurance fund, to protect the depositors, more than they are to really deal with what might be characterized as a type of disintermediation.

Mr. SPRAGUE. We do not attempt to address the structural problem. The structural problems—Mr. Gonzalez talked about the Hunt Commission report of a dozen years ago. There have been a number of other reports along the way. Mr. Pratt has a proposal today. There is room for an extraordinary amount of turf fighting over this problem.

All I am trying to suggest today is, can't we please not solve everything at once? Let us just zero in and take care of today what we need today.

Mr. VENTO. But shouldn't we be concerned about some sort of a formal analysis of such problems in terms of where the institutions are going? At least we ought to know for the integrity of the insurance fund, shouldn't we?

Mr. SPRAGUE. Certainly.

Mr. VENTO. And you are saying that we cannot address that. I think Mr. Gonzalez, in terms of talking about the Hunt report, probably identified a legitimate benchmark—myself.

Maybe, Mr. Pratt, you have been talking about the health of the savings and loans. Maybe you would like to try to address that question yourself.

Mr. PRATT. Yes, sir; I think you have hit it directly. That is really the issue of the efficient functioning of these financial markets.

We believe that our legislation and our proposals go directly to the ability of thrift institutions to serve the marketplace and to provide financial services. We are suggesting that a major part of the steps which we have been talking about today are designed, in fact, to improve the competitiveness with which the consumer is served and to allow him a broader range of choice as to where he gets his financial services, and to make sure that institutions which have ability and expertise in various types of financing, including residential real estate finance, are there to provide funds to the consumer.

Mr. VENTO. You are asking for a redefinition of your functions. In a sense, you point out that 20 percent, in terms of commercial credit, was not adequate. You are asking for that.

The fact is, does that mean a desertion of the former functions that thrifts and savings and loans have performed?

Mr. PRATT. No, sir; I don't think it does. I think we will see some institutions move in different directions. I think it is very much a question of giving housing a good-sized slice of a growing and viable pie or giving housing, maybe, a bigger piece of a pie that is disappearing; 100 percent of nothing is substantially less than 70 percent of something large.

Mr. VENTO. Very good. I appreciate your response. Thank you very much.

The CHAIRMAN. Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman, and distinguished gentlemen of the panel.

I think you put your finger on one of the problems that we have as far as the committee is concerned, Mr. Sprague, when you said a little while ago that there is a considerable amount of turf fighting.

Do you endorse Mr. Pratt's approach that he has submitted to us here this morning?

Mr. SPRAGUE. I am not even going to have time to address his proposal. I am going to spend my full time trying to get the emergency bill. When we have that, I will sit down and really work with Mr. Pratt on his.

Mr. WYLIE. You have not analyzed his proposal?

Mr. SPRAGUE. No, it is too long.

Mr. WYLIE. Now you have one. Do you endorse Mr. Sprague's proposal, Mr. Pratt?

Mr. PRATT. I have no problem whatsoever with the FDIC getting the legislation they need to deal with their problems. I invite the FDIC to help us get the legislation we need to deal with our problems.

Mr. WYLIE. Did you hear the comment, Mr. Connell? You see the thrust?

Mr. CONNELL. Certainly, Mr. Wylie. I agree with Mr. Sprague in terms of the regulators' bill, that it should be passed, and we are in full support of that.

I am also in support of what Mr. Pratt proposes in terms of broadening the operating powers of savings and loan associations. We have a system that was designed in the thirties to meet a Depression-era market situation. We are in an entirely different situation today.

It is just not possible evidently for thrift institutions to operate as long-term lenders, as they have in the past. The missing ingredient which will take a longer time, I think, to analyze and evolve is how one develops an incentive system for housing finance, as we have developed since 1934. That will take a great deal more thought.

But it is a missing ingredient, and the structure that we have developed, that was developed in the thirties, does not suit the eighties, and so I think we have to reanalyze that entire structure of the Federal Home Loan Bank System, the entire regulatory structure.

Mr. WYLIE. I agree with you, and I think that that is very perceptive. For that reason, I cosponsored the All Savers Act. I think it is important to get money flowing into the savings and loans and commercial banks.

You have suggested, Mr. Sprague, that you do not like the All Savers Act because it would benefit higher income people a little more. In attempting to analyze this situation, before the first of the year, I introduced a bill which would exclude up to $10,000 in interest—in taxes on income from savings—interest on savings accounts. The United States is the only country in the world that penalizes savings. That is my opinion.

I think something like that, as I say, which would exclude up to $10,000 from taxes on savings deposits might very well encourage business and give a nice boost to the depressed housing industry at the same time.

What would you think of that approach? I know that is not necessarily in your field, but you do have some expertise. I am not getting very far with my bill, and I have not asked anybody on this panel about it yet. I am taking the opportunity I have now.

Mr. SPRAGUE. You just stole my answer. You said that was not my field. It really is not; I am not an expert in that area.

People in Treasury tell me that it could result in a lot of shifting of savings, but not necessarily new savings, and people who already are saving will just get this benefit. I don't know.

As long as it is so extraordinarily expensive and those kinds of questions are not answered, I think you ought to go slow. Now you are going to have Treasury people in front of you a week from today, and I would suggest——

Mr. WYLIE. I have already put the question to Secretary Regan. He thinks it would be too much of a tax loss. I do not know how you sort it out as to whether there would be more of a tax loss on this kind of a bill or a 10-10-10 in all savers or whatever.

Mr. SPRAGUE. I don't know.

Mr. WYLIE. The savings and loans allege, and I think the commercial banks too, that in many cases money market mutual funds are taking money from all over the country and investing that money into a few large financial institutions in some of the large banking communities, as you know.

Is there a national problem developing there? I have put this question to some people in the money market mutual fund industry, and they suggest that an attempt now is being made within the money market mutual funds to reinvest the money which they take from the community back into that community. Have you seen any movement in that regard?

Mr. SPRAGUE. No. We identified the problem that you suggested earlier of funneling the money from the little communities of America essentially into the large, central city banks.

I am not aware of any solution to the problem. I will certainly check with my regional directors. I will be meeting with them next month.

Mr. WYLIE. Do you have any expertise on that?

Mr. PRATT. No, sir. I don't have any figures on it. I would think that money market mutual funds operating efficiently, as they do, with very small margins for the most part are certainly going to look for generally wholesale outlets for their funds which require little or no management. Therefore I would certainly not expect them to be involved in directly serving credit needs of small communities. Perhaps by limited investment in savings and loans and commercial banks of those communities they might, in fact, achieve some of that.

Mr. CONNELL. I have seen reports in the paper about attempts to recycle the money through smaller banks. But I think overall, it is more cosmetic than substantive at this point.

Mr. WYLIE. I want to get into some of the substance of the bill, but I know my time is about to expire—it has, he says.

I will finish my question, and then I would like to submit some questions for the record if I may, Mr. Chairman.

The CHAIRMAN. Without objection.

Mr. WYLIE. What impact would the extension of demand deposit powers to Federal associations have on the Federal Reserve's implementation of monetary policy and control of the money supply?

On page 15 of your bill, Mr. Pratt, you say:

As a first step, we urge that the Home Loaner's Act be amended to allow all Federal associations to offer demand deposits to any customers.

Mr. PRATT. Yes, sir. First, I guess it does seem extremely surprising to me, given the great support for deregulation which I have found among certain elements of the banking community and elsewhere, that they would have any objection to letting others have the same accounts that they have.

Second, I see no difficulty whatsoever with regard to the monetary role of the Federal Reserve. As a result of the legislation last year, thrift institutions, for monetary purposes, were brought under Federal Reserve control. They could continue to exercise their reserve controls over these institutions—and in my opinion, without difficulty. You might want to ask the Fed.

Mr. WYLIE. Thank you.

The CHAIRMAN. Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Pratt, there are 10 new deregulatory elements that you included in your bill. Are these new powers essential to the long-term survival of the thrifts?

Mr. PRATT. Yes, sir. In my opinion, and given the mandate of Congress for competition in the purchase of funds, they are essential.

Mr. BARNARD. Are these powers as broad, or are they broader, than those granted to national banks?

Mr. PRATT. I have not studied the national banking laws. I would think, for the most part, that they would be similar. There are a couple of areas where, in fact, they might be broader; and that would perhaps be in the direct investment in real estate, which a number of State-chartered institutions presently have, and which many of them in fact are using to solve their problems at this time.

The States of California and Florida have direct real estate investment powers.

I am also not entirely familiar with national banks' authority to have what we call service corporations, which allow the development of ancillary activities. So, it would, for the most part, bring effective equality, we think. I am sure there are some differences.

Mr. BARNARD. If you study it carefully, you will have broader powers than the national banking system.

Are not these new powers that you are asking for, Mr. Pratt, all addressing the asset side of the ledger?

Mr. PRATT. Not all of them. One important power—and I don't understand why thrifts don't already have it—is the ability to take checking accounts from all customers. It does seem amazing to me that we tell a major financial institution that it will not be allowed to service a certain set of customers.

Mr. BARNARD. But primarily, they are affecting the asset side of the ledger?

Mr. PRATT. Yes, sir. The Congress has dealt effectively—and some people think too effectively—with the liability side, through the deregulation act of last year, which mandates the broadening and deregulation of powers on the liability side.

Mr. BARNARD. If they have, then why has the liability side for savings and loans, mutual savings banks, thrifts, credit unions, and banks been so eroded?

Don't you think that the impact of certain funds—namely money market mutual funds, to the tune of $135 billion—is somewhat of a problem?

Mr. PRATT. Yes, sir.

Mr. BARNARD. How is that addressed in your bill?

Mr. PRATT. It is addressed by giving thrifts the ability to earn sufficient returns on assets so that total deregulation on the liability side could take place and, so that rates, comptitive with those offered by nonregulated or nondepository institutions could be offered.

Mr. BARNARD. Aren't you dodging the issue, if you do not have the liabilities to service the assets?

You cannot make leasing loans, consumer loans, consumer loans if you don't have the funds to do that.

Mr. PRATT. Of course, the two sides of the balance sheet are connected. You must have sufficient earnings in order to go out and compete with those funds. If your point is, would we support deregulation of the liability side in order to compete with money market mutual funds, we would support it totally, if the Congress sees fit to give our institutions the right to earn from their assets.

Mr. BARNARD. It looks to me like we are dealing with a very, very narrow spectrum, in trying to correct the problem. The problem is a much broader picture, as I see it, than has been brought out this morning.

I think we are somewhat myopic if we believe that we can change a few asset laws and a few other liability structures, and we will solve the problem. The problem is money market mutual funds, and the need for small savers to earn market rate interest.

Do you have the power to permit savings and loans to commingle funds?

Mr. PRATT. For what purpose? For a money market mutual fund?

Mr. BARNARD. Right.

Mr. PRATT. I would like to doublecheck this with my general counsel. But, subject to check, I believe we have the authority to authorize service corporations to run money market mutual funds.

Mr. BARNARD. Why hasn't the Federal Home Loan Bank Board done this?

Mr. PRATT. It is a very complex issue, in my opinion. As you know, the spreads on the money market mutual funds tend to be very thin—I think in the neighborhood of 50 basis points, something of that nature. For small and regionalized savings institutions to offer such funds, one of the big problems is that they would be primarily competing with their own deposits.

Assume you have First Federal money market funds: If it pulls money out of its own institution, which funds then must be arbitraged into U.S. Government securities and other things; and the savings and loan consequently has to go to the Federal Home Loan Bank and borrow money at 21 percent, then would have substantially harmed themselves.

It is an intricate question. It is one that is presently under consideration, and we have not come to a final conclusion as to whether it would be helpful to the institutions and to the public. But we are studying it.

Mr. BARNARD. With all that we see in the news today—the expansion of American Express and the insurance industry into the investment business, and even into the banking business—when we see so many of the other securities dealers getting into the banking business in so many regards, do you see that there is a need to address the Glass-Steagall Act?

Mr. PRATT. Yes; we need to look at the total set of financial services and the conditions under which they are being offered in this country. We really need a very basic public policy examination of the direction in which we are heading, and whether we wish to continue going that way.

Mr. BARNARD. Mr. Sprague, can you answer that same question?

Mr. SPRAGUE. I believe that you are probably going to do that—reexamine everything. The world is moving so fast. Reexamination would be useful, and I hope you address it promptly, after you pass our bill.

Mr. BARNARD. Mr. Connell?

Mr. CONNELL. I would be for a quick repeal. The act is unnecessary. The securities laws that have developed from 1933 on address the issues that really were the core problems that caused the Glass-Steagall Act to be enacted.

Mr. BARNARD. Every one of you gentleman express urgency, that something be done.

Do you feel that we need to do something as far as Glass-Steagall, as soon as possible?

Mr. PRATT. Are you addressing me?

Mr. BARNARD. Yes.

Mr. PRATT. I don't have the expertise to know with what degree of urgency Glass-Steagall should be examined.

Mr. BARNARD. You would agree that the money market mutual funds' erosion of thrift deposits is one of the biggest problems we have got?

Mr. PRATT. It certainly is. I would certainly agree with you to that extent.

Mr. BARNARD. Mr. Sprague?

Mr. SPRAGUE. It should be addressed in the context of the total package. If you are going to reexamine the missions and roles of all of the institutions, Glass-Steagall comes into that category.

Mr. BARNARD. While we are talking with broad subjects, let us talk about the McFadden-Douglas restrictions.

Mr. Sprague, how do you feel about any changes in those particular laws, in light of what is going on today, with the competition among financial and nonfinancial institutions, and all that it is doing to depository institutions?

Do you feel that this question, likewise, should be addressed?

Mr. SPRAGUE. We think it should be addressed, but we have no preconceptions of the resolution. As you are aware, we are forced by necessity to request a minor change in Douglas right now.

Mr. BARNARD. You would agree that banks particularly, as well as savings and loans, are being discriminated against today, because of the prohibitions of McFadden-Douglas, as far as nonfinancial institutions?

Merrill Lynch, American Express, Bache—you name it, they already have interstate operations, but banks are limited to operations in one State.

Mr. SPRAGUE. There is no question about that.

Mr. BARNARD. Thank you, sir.

The CHAIRMAN. The Chair would like the indulgence of the members. Something has just come to his attention. I would like to ask one question of Mr. Pratt.

Mr. CARMAN. Fine.

The CHAIRMAN. Mr. Pratt, I am reading from the July 13, 1981, Washington Financial Reports, and I want to make sure that it is accurate. I am sure you do, as well:

> Pratt also briefed the panel on the current state of the S. & L. industry, which he acknowledged is experiencing a substantial period of difficulty. As of the end of April, he said the bottom 10 percent of the industry, 395 associations, had a net worth of assets ratio of 1.68 percent, with an industry average of 5 percent, and a negative return on assets of about 350 basis points. About 80 percent of all savings and loans are now experiencing operating losses, he said. Without any intervening factors, Pratt said an average of one S. & L. per day would hit zero net worth. Overall, he said about one-third of the industry, worth about $200 billion in assets, is not viable under today's conditions.
>
> Under a downslide estimate, but not a wildly radical, pessimistic estimate, Pratt said the failure of those institutions could produce losses of about 30 percent, or $60 billion. Those losses would be possibly offset by $10 billion in book net worth of the associations, and $5 billion in Federal Savings and Loan Insurance Corporation funds, leaving a $45 billion gap.

And then you go on to speak about mergers, to close the gap.

The full text of this article will apear in the record at this point.

[The material referred to by Chairman St Germain is from Washington Financial Reports and follows:]

(From Washington Financial Reports, July 13, 1981)

"SWEEPING LEGISLATIVE CHANGES"
URGED BY FHLBB CHIEF TO AID S&Ls

Chairman Richard T. Pratt of the Federal Home Loan Bank Board June 9 said he will soon propose "sweeping legislative changes" to help the financially ailing thrift institutions.

Pratt, in a briefing for members of the President's Commission on Housing, said the bank board's proposals will "virtually amount to rewriting the 1933 Home Owners' Loan Act to allow institutions statutorily to choose the line of business they will be in. The board believes that the de facto direction in the deregulation of the purchase of funds must have logical sequence in the sale of funds."

The board's approach as a regulatory agency, he said, "is to do everything within our power to give management the right to solve its own problems, invest funds in a competitive market and let the market work."

Pratt said a bill to carry out the board's proposal for the "sweeping changes" has been sent to the White and the Treasury Department for review. The FHLBB chief said he hopes to discuss the proposed measure when he testifies July 14 at the opening of hearings by the House Banking Committee on the impact of the government's policy on the S&Ls and other financial institutions (Report No. 130, A-1).

The legislation also would allow S&Ls to have demand-deposit accounts, or checking acounts, for businesses, and Pratt acknowledged that if the bill is enacted, an S&L "would really be able to be a commercial bank if it chose to be one."

The chairman argued, however, that the deregulation of deposit rates, which has raised the cost of funds, means thrift institutions must have expanded asset powers in order to remain viable. Any attempt to force institutions to remain specialized housing lenders while they have to pay market rates for funds could lead to the disappearance of the thrift industry, Pratt warned. He added, however, that he expects thrifts to continue to specialize in residential and household finance because of their expertise in those areas.

Pratt also contended that housing will be better off with a healthy, growing thrift industry, even if the percentage of thrifts' funds going into housing declines.

To improve S&L earnings and investment flexibility, Pratt said the bank board intends to propose regulations July 22 authorizing full balloon-payment loans. He said he expects final regulations to be in place by September 1.

In a balloon-payment loan, the amortization schedule is based on a loan which extends beyond the actual loan term, leaving a large unpaid balance when the loan matures. This balance must then be paid off or refinanced at current interest rates. This plan is widely used in home mortgages in Canada.

Pratt also briefed the committee on the current state of the S&L industry, which he acknowledged is experiencing a "substantial period of difficulty."

As of the end of April, Pratt said, the bottom 10 percent of the industry (395 associations) had a net worth to assets ratio of 1.68 percent -- the industry average was about 5 percent -- and a negative return on assets of about 350 basis points per year. About 80 percent of all savings and loans are now experiencing operating losses, he said.

Without any intervening factors, Pratt said, an average of one S&L per day would hit zero net worth. Overall, he said, about one-third of the industry, with about $200 billion in assets, isn't viable under today's conditions.

Under a "downside estimate," but not a "wildly, radically pessimistic estimate," Pratt said the failure of those institutions could produce losses of about 30 percent, or $60 billion. Those losses would be partially offset by $10 billion in book net worth of the associations and $5 billion in Federal Savings and Loan Insurance Corporation funds, leaving a $45 billion gap.

Mergers: One way to close the gap, or avoid the losses, Pratt said, is through mergers but he said those are getting harder to arrange under current law.

The bank board's draft legislation would alleviate the problem, Pratt said, by allowing the board to arrange interindustry and interstate supervisory mergers and acquisitions. In other words, an ailing S&L in one state could be merged with an S&L in another state or with a commercial bank.

In addition, Pratt said, the bill would allow supervisory conversions of associations from mutual to stock form, which should make it easier for them to raise new capital. The bill also would provide increased flexibility in chartering, including new federal charters for mutual savings banks and conversions between S&Ls' and savings banks' charters. Eventually, Pratt said, this could lead to the amalgamation of the S&L and savings bank industries.

Pratt said the bank board will also seek a federal preemption of state laws restricting the enforcement of mortgage due-on-sale clauses. As much as 10 percent of S&L losses may be attributable to state legislation and court decisions preventing associations from calling a loan or raising the interest rate when a property is transferred, Pratt said.

On the liability side, Pratt said high interest rates and competition from other institutions, such as money market funds, have driven S&Ls out of the retail savings market, forcing them to rely for funds on "jumbo" certificates of deposits, Wall Street, and Federal Home Loan Bank advances.

Pratt expects a "record increase" in FHLB advances during the second half of 1981, which could be a "testing of the bank system's ability to expand." As of the end of May, S&Ls had $50.9 billion in advances outstanding, up about $4 billion from the end of 1980.

Asked about the possibility of subsidized advances to reduce the S&Ls' cost of borrowing, Pratt said he would support such a plan only if the money to cover the subsidy comes from the Treasury, rather than from the Federal Home Loan Banks.

The CHAIRMAN. Is that an accurate report of a statement by you?

Mr. PRATT. A portion of those numbers come off some very preliminary monthly indications that we receive. And therefore, they have some margin of error in them. But the report would be generally reflective of what was discussed, as far as the second half of the statement goes. This was a briefing to a professional group, a housing commission—the finance subset of it. And the second half of it represents essentially a hypothetical circumstance, but one that perhaps could be envisioned.

The CHAIRMAN. Is that an accurate report?

Mr. PRATT. Yes. An accurate report of my discussion.

The CHAIRMAN. Thank you, Mr. Pratt.

I thank the members.

Mr. Carman?

Mr. CARMAN. Thank you, Mr. Chairman.

I would like to express my thanks as well, for the presentations that each one of you gentlemen have made. I would like to follow up immediately on what the chairman has raised.

I understood you to say, Mr. Sprague, that under no circumstances would depositors lose any funds in this country, whether through the FDIC or the FSLIC. I suspect that is true.

I am very, very concerned—as I think many members of this Banking Committee are concerned—with what has been discussed, which Chairman St Germain just alluded to. I feel that we are presaging an economic hurricane. The winds have been blowing, and I think that by October, they are going to be extremely strong; and by January or February of next year, it is going to be a very, very difficult problem.

I do not see, Mr. Pratt, specifically how you are suggesting that we are going to meet the short-term liquidity problems that are going to have to be met by the industry, specifically the thrift industry, if we are to insure that we are not going to have wholesale problems which will affect not only the thrift industry, but the entire financial community, as well.

Perhaps you perceive the all savers legislation as being that answer? I do not know, but I am concerned about it and I wonder if you might tell us how that is going to be solved or what you are projecting.

Mr. PRATT. In looking at the liquidity, there are several levels of defense. The first of these is really the liquidity of the individual associations, which is relatively high at this point in time; substantially higher than the regulatory level which we have required, and which I think represents a defensive——

Mr. CARMAN. Let me interject this. We have, in general terms, about $800 billion worth of assets in the thrift industry nationwide. They have between $31 and $35 billion overall in reserves.

What the gentleman from Rhode Island just spoke to a few moments ago was the hypothetical situation where we could be down as much as $45 billion. The hypothetical situation obviously has to contemplate that we are going to have interest rates as high as they are now. These institutions are holding on to portfolios that are like cement blocks around their necks in a race.

I just don't see how in the world, from what has been proposed thus far, how we are not going to be into "negative reserves." I have heard people talk about infusions of capital, but—my specific questions to you are: First, do you believe that the Federal Home Loan Bank Board, at the present time, has sufficient authority to meet the short-term liquidity problems we may face in the very immediate future? Second, do you need additional materials in addition to what you have asked for here?

It looks like it is a very difficult problem to avoid. I think we have a problem, now. The question is: How do you meet it?

Mr. PRATT. We believe we have the ability to meet liquidity needs, and the legislation of last year giving the Federal Reserve the ability to lend to thrift institutions, is particularly promising. There are administrative and mechanical factors which are involved, and we believe we can deal with them. If times change, you will be assured that we will be back with proposals that we think are necessary under those circumstances.

Mr. CARMAN. My specific concern, then, following that up, would be the time we have to act. A dialog has been going on between the regulatory agencies and members of this committee for some time. The industry as a whole is wondering how long people can hold their breath, so to speak, in an economic sense. Last year was certainly a bad year. This year is bad. You certainly have testified that 1982 could be worse. No one seems to know what 1983 can bring. Notwithstanding all of the prognostications that the economic situation will change—inflation will go away, interest rates will drop, and so forth. There do not appear to be any solutions being proposed to deal with the immediate problem. How quickly do you anticipate you will be coming before us? Shouldn't you be coming before us now to ask for the kinds of relief you believe are needed or necessary? Or don't you think you need relief?

Mr. PRATT. I think there are two options you have, when you talk about this multiyear period. One is an option of being ready to provide public funds on a continuing basis. The second is to be willing to face the issues which associations and institutions have, and make them viable in an unpredictable economy. We have addressed that issue very strongly. As the economy changes in the short run, it is clear that financial needs could occur. At this time, we think we can meet what we see, but if we cannot, we will be back.

Mr. CARMAN. In your testimony, Mr. Pratt, you discuss the need to give broader powers to the savings and loan associations, and indeed the entire thrift industry.

Mr. Connell, you allude to the fact that you think there is a need to give broader authority to the institutions. Indeed including allowing stock to be issued by various mutuals which would take away the public ownership that we now have, generally speaking, with Federal savings and loan associations.

It would appear to me that at the present time that housing is not being considered a major priority. Do you anticipate that we will continue to make housing a major priority if we are moving toward an integrated banking system?

Mr. PRATT. I think the question of the level of priority to be assigned to housing has never really been addressed by the Congress. If "priority" means expenditure of Federal funds to subsidize housing, then that is clearly something that ought to be addressed very explicitly.

I think that if one means having a housing priority which in some sense attempts to tax a certain category of financial institutions, the thrifts, it is clear they simply do not have the funds to pay the tax, and that strategy will fail. If this Congress wishes to have housing subsidies or to set housing priorities, it should go about it directly, and these institutions will clearly be there to provide the finance.

Mr. CARMAN. Thank you very much.

Mr. LAFALCE. Mr. Patman.

Mr. PATMAN. Thank you, Mr. Chairman. My questions are primarily to Mr. Pratt and Mr. Sprague, but maybe also to Mr. Connell later on.

It has been said that $1 in money market mutual funds is worth $2 in the bank. Does that apply also to savings and loans, with the current interest rates, Mr. Pratt?

Mr. PRATT. The numbers I have seen recently for money market mutual funds would indicate the yields are in the range of 17 percent at the current time, whereas a money market certificate, depending when it was purchased, would be in the range of 14½ percent. There are, of course, other advantages to the depository institutions, but the high rates of the money market mutual funds have obviously been quite persuasive to a number of people.

Mr. PATMAN. With those figures, it is actually worth $3 in the bank or $3 in the savings and loan.

Mr. PRATT. No; on $100 in a money market mutual fund, you would earn $17 a year, roughly speaking, whereas from a money market certificate, $14.50. It is more like $1.25 something like that.

Mr. PATMAN. What about passbook savings accounts?

Mr. PRATT. Passbooks pay slightly over 5 percent. There would be about 3-to-1 in terms of return.

Mr. PATMAN. As to the protection now provided to your depositors and those in banks, what is the ratio of the amount we have—Mr. Sprague, you mentioned $11½ billion—to the total deposits that are insured by that amount?

Mr. SPRAGUE. The ratio of our fund to deposits, approximately 1.15. It has been in that range for a number of years.

You recall that in the last legislation that this committee addressed the possible problem of the ratio dropping, and changed the assessment refund from 66⅔ to 60 percent, and also provided a bottom and top. It is roughly 1.15.

Mr. PATMAN. Percentagewise 1.15; right? Is that what you say?

Mr. SPRAGUE. Right.

Mr. PATMAN. What about the ratio of the protection to the net worth of the institutions you have deposits in which you are providing protection?

Mr. SPRAGUE. I don't have that figure. I will have to get it for the record.

Mr. PATMAN. What about you, Mr. Pratt? Do you have that?

Mr. PRATT. The insurance fund relative to deposits would be slightly over 1 percent. These figures are subject to check. It is about $6 billion against something in the neighborhood of $500 billion. In terms of the insurance resources relative to the net worth of institutions, it would be about one-fifth. The net worth of institutions is approximately $30 billion. The insurance funds are approximately $6 billion.

Mr. PATMAN. Do you give the percentage of the protection fund to the deposits?

Mr. PRATT. Approximately 1½ percent. We will be happy to provide you the exact figure.

[In response to the request of Congressman Patman, the following additional information was submitted for inclusion in the record by Mr. Pratt:]

RESPONSE RECEIVED FROM MR. PRATT

As of June 30, 1981, the ratio of the book value of the FSLIC's insurance fund to: (a) total insured deposits was 1.4 percent; and (b) total industry net worth was 21.7 percent.

Mr. PATMAN. If interest rates stay at the present level, Mr. Pratt, how long will it be until savings and loans, all of the savings and loans in the United States, are in serious trouble?

Mr. PRATT. Well, we don't think that all of the savings and loans in the United States would be in serious trouble, even at this level of interest rates. There are certain institutions which can continue to be profitable at this level. They would go through a period of decreased earnings, perhaps zero earnings for a period of time, but would come out viable at the conclusion.

Mr. PATMAN. Even if the present rates at their present levels stay that way for an indefinite period of time?

Mr. PRATT. Yes, sir. At some point in time, of course, circumstances begin to turn around for an institution that has the ability to survive. While the transition is very slow, at some point, the assets begin to be replaced with the higher yielding assets which return the institution to viability.

That is not to say that a very substantial portion of the business does not have substantial problems, and that a continuation of rates at this level would present a very difficult circumstance.

Mr. PATMAN. The higher levels of interest rates or yields that you are looking forward to, those are represented by higher rates of interest that the prospective homeowner pays. Is that true in loans, by and large?

Mr. PRATT. Yes. The present rate on mortgages is substantially above the level of the portfolios, of course, and may even be forced somewhat higher than might have occurred otherwise, because of the earnings problem and structural problem which these institutions have.

Mr. LAFALCE. The time of the gentleman has expired.

Mr. Wortley?

Mr. WORTLEY. Thank you, Mr. Chairman. I direct my question to each of the three of you. You can give me just a brief answer.

The first question, Do you have a gravity schedule of troubled institutions? If so, do you categorize them by those that are in trouble by virtue of market forces or those that just have plain poor management?

Mr. CONNELL. Mr. Wortley, we do have a schedule of credit unions that are troubled, and we do not categorize them according to market forces and management, necessarily. They are the problem cases that we have to deal with. The method we take to deal with the problem differs when it is market forces versus management.

Mr. SPRAGUE. My answer is essentially the same as Mr. Connell. The basic list is not differentiated. But those kinds of questions clearly are considered when we decide what to do.

Mr. WORTLEY. May I follow up and ask you, about how many institutions do you have on your list at this time?

Mr. SPRAGUE. I dislike getting to the question of a problem list, because as I say, we don't work with lists, we work with banks. The lists are so outdated. They are useful for our annual report that we will print a year from now, for example.

What we really work on are problem institutions. For example, Mr. Thompson, head of my division of bank supervision, meets with me every Friday and we go over in some detail problems that might arise over the next 60 or 90 days.

I guess we have a list floating around someplace that says there are about 200 institutions on it.

Mr. WORTLEY. Thank you.

Mr. Pratt?

Mr. PRATT. My answer would be similar. Again, we maintain a list of institutions that bear watching, and the list is not categorized as to the source of the problem.

Mr. WORTLEY. What do you do with the funds that you receive from the respective financial institutions in terms of premiums? Do you invest those funds? If you do, who determines how they are invested? What sort of return do you get? Do the funds go into the U.S. Treasury, or do they remain in your so-called trust accounts?

I know that is several questions in one. But, starting with Mr. Connell, would each of you respond?

Mr. CONNELL. We invest them in U.S. Government securities, mostly short term. I cannot give you the return right now, but I would be happy to give you the most current return. It changes because so much of it is in short-term securities. About $100 million in short term, about $70 million in longer term.

Mr. WORTLEY. Does that income accrue to your own trust account, or does it go to the Treasury?

Mr. CONNELL. That accrues to the trust fund, and is used for liquidation expenses only. It does not accrue to the general revenues of the Treasury.

Mr. WORTLEY. It is not included in the general revenue.

Mr. CONNELL. No, it stays in the insurance fund.

Mr. WORTLEY. How much does that amount to in the course of a year?

Mr. CONNELL. We have a small fund, probably in the area of $25 million this year.

Mr. WORTLEY. Mr. Sprague?

Mr. SPRAGUE. All of our money is in U.S. Treasuries. We try to keep $200 or $300 million on 1-day money for an emergency. The rest on the short range, I will have to give you the exact figure of what we are earning now. Last year it was about half of our $1.3 million increase in the fund, something like $600 million, and it all goes in the fund. That is one of the reasons that I feel so good about our ability to take care of the depositors——

Mr. WORTLEY. You don't invest in money market funds?

Mr. SPRAGUE. No, sir. The United States of America.

Mr. PRATT. Our investments are in Treasury securities. We earn more than $600 million per year, which is entirely available for the FSLIC.

Mr. WORTLEY. Who determines how it is invested?

Mr. PRATT. It all goes into U.S. Treasury securities, and it would be, I suppose, a matter of negotiation between ourselves and the Treasury as to the maturities that might be chosen.

Mr. WORTLEY. Does the amount of income returned on those investments—would that almost pay for the operations of your agency?

Mr. PRATT. Historically, it has been far in excess of our needs, and has allowed substantial growth of the insurance fund.

Mr. WORTLEY. Thank you, Mr. Chairman. I yield back the balance of my time.

The CHAIRMAN. Mr. LaFalce?

Mr. LAFALCE. Thank you, Mr. Chairman. I am having lunch shortly with a professor of economics from Stanford University, and he is reputed to have said with respect to the problems of the thrift industry they are having some earnings problems. So what? All companies have earnings problems. Why should we come in and bail them out?

How would you answer that professor of economics? Some people would compare the "So what?" statement to the statement of Mr. Ford, President Ford, saying to New York City, "Drop dead."

But how would you answer it?

Mr. SPRAGUE. I would get another luncheon partner, for starts. [Laughter.]

Mr. LAFALCE. Are you suggesting we get a new Secretary of the Treasury, Mr. Sprague?

Mr. SPRAGUE. You are extending my remark beyond the limits of prudence.

The CHAIRMAN. Don't have lunch with him.

Mr. SPRAGUE. I am not a member of the "so what" school. It may well be that we should at some point in time just have one kind of a financial institution, amalgamate them all along the lines the Hunt Commission that Mr. Gonzalez talked about and what Mr. Pratt and Mr. Connell are talking about today.

But in the interim, thrifts, in my judgment, have provided an extraordinary service to the country. I would like to give them one more chance.

Mr. LAFALCE. Let me go on. I want to make the point——

Mr. SPRAGUE. You did.

Mr. LAFALCE. I can't quite understand how the administration could so strongly oppose the regulators' bill—at least that portion of it which would permit the infusion of capital into the thrifts. Apparently they have plead nolo contendere regarding the merger provisions, or they have taken a position of neutrality in any event. They can oppose a loan to be paid back and yet apparently be neutral, or at least acquiesce in silence, with the all savers bill, which will call for a direct—an indirect expenditure of Federal dollars, not on a loan basis, but in grant form of perhaps $4 billion.

Now, I want to understand a little bit better the position of the three regulators.

Now, Mr. Connell, as I read your statements—and tell me if I am right or wrong—you think it is a bad concept, the all savers bill, you think it is inefficient, you think it is expensive; you think if it passes, favoring those institutions which have a certain percentage of their moneys in housing, it could be extremely destructive to the credit unions.

But despite all of this, you hold your nose if the credit unions would be included within its embrace and it would not favor institutions that go along with housing. Is that basically correct?

Mr. CONNELL. I essentially stated that I thought that the proposal was expensive—a rather crude instrument—and if it was geared just toward housing, would be disruptive.

In my responsibility for the stability of the credit union system, I have to address that issue in terms of tax incentive programs, I personally favor the IRA approach toward savings incentives and expanding that area, because it is more directly targeted.

Mr. LAFALCE. What if we were to make the approach—at least prospectively—a credit approach, as opposed to a deduction? Wouldn't that even make it more attractive, especially to your clientele?

Mr. CONNELL. The credit—of course, a tax credit is always more appealing to a taxpayer than a tax deduction.

Mr. LAFALCE. We would have to change the dollar amounts. We would not permit the same credit that you get for the deduction.

Mr. CONNELL. What I particularly liked about the IRA-type of savings approach—and that would include modification for withdrawals for home purchase and that type of thing—it encourages regular savings.

Mr. LAFALCE. And long-term savings.

Mr. CONNELL. Yes. It gets the American public back into the concept of savings.

Mr. LAFALCE. It would also counteract the problem we are having with social security.

Mr. Sprague, you not only hold your nose at the all savers bill, but you actually say no to it; correct? You said you opposed it.

Mr. SPRAGUE. Yes, that is true.

Mr. LAFALCE. Good enough.

Thank you. Just wanted to clarify.

Mr. SPRAGUE. All right.

Mr. LAFALCE. I cosponsored the all savers bill with the thought in mind that if the administration realized that we want to do something about the problems of the institutions, they surely would not go along with the all savers bill, but they would perhaps go along with something like the regulators' bill.

Now I find we are going to have the exact opposite situation. They are not going to retract on the regulators' bill, but they are going to permit the all savers bill to go into effect.

I have now gotten reservations about what we have wrought. I just cannot believe the administration is going to go ahead with this. I am all for tax incentives for savings, but not all tax incentives are made alike. This one certainly is not made alike.

Now, Mr. Pratt, as I read your statement, you certainly do support it, I understand. But it was a brief, very small—one paragraph, about one or two sentences.

Let me just ask you this question: Which would you prefer, the regulators' bill or the all savers bill?

Mr. PRATT. The all savers bill would be much more helpful, of course, than the regulators' bill. I am not referring to the totality of our legislative proposal, however.

Mr. LAFALCE. You already have the problems—you already have the powers that Mr. Sprague does not have.

Mr. PRATT. Pretty much; yes, sir.

Mr. LAFALCE. If you were Chairman of the FDIC, which do you think you would favor?

Mr. PRATT. I would go to lunch with the professor from Stanford. I would like to have the financial position that the Chairman of the FDIC has. I do not know how I would respond under those circumstances.

Mr. LAFALCE. If the all savers bill is passed, are the savings and loans going to invest those newly found moneys in housing? Or might those savings and loans, because the all savers bill is just a 1-year bill, might they turn to some alternative forms of investment other than the housing market, that which could maximize their gain within a 1-year period?

Mr. PRATT. I think it would be most helpful if they would use those funds to reduce the cost of operations, and they reduce the probability of other public funds having to be applied to the problem. That is, of course, what we would encourage. It would seem to be of questionable prudence to divert those funds to long-term loans at fixed rates, given the short-term nature of the bill.

Mr. LAFALCE. You are saying that we cannot expect a particular bonanza for the housing market through the passage of the all savers legislation?

Mr. PRATT. The bonanza comes through maintaining the health and viability of the principal mortgage lenders.

Mr. LAFALCE. What about the complaints of the municipalities—my time is up?

The CHAIRMAN. Mr. Coyne.

Mr. J. COYNE. Thank you, Mr. Chairman.

I am concerned that Congress or many of our regulators are really ignoring the very fundamental change in our financial institutions that is occurring in this decade and perhaps in the last decade, and analogous to going from the horse-and-buggy era to the automobile. I am afraid that many people are calling for us to subsize or support the buggy maker and make sure that he is restricted from going into the automobile business, for example, when, in fact, the marketplace and the consumer are making changes and forcing changes upon the industry.

Of course, the most fundamental element of this is the shift from savings institutions to money market funds for many of our savers.

I would like to first address the question to Mr. Sprague.

When Commissioner Shad was before us, he affirmed that those people investing in money market funds are not savers, but rather investors. Of course, he said that the FDIC should look after savers and the SEC should look after investors.

Do you agree that depositors using the money market funds are somehow different? Are they investors, and not savers, as are your depositors, the people you oversee? Should there be a difference between the two, and should we have two different regulatory agencies overseeing these two different types of institutions?

Mr. SPRAGUE. Clearly, money is flowing from banks and savings and loans into the money market funds. It is the same money.

Mr. J. COYNE. You would declare that the money market fund participants are savers just as in your institutions?

Mr. SPRAGUE. To a large extent, I would think so.

Mr. J. COYNE. That brings a question of why we should have two different agencies reviewing or regulating two different elements of the savings institution marketplace?

Mr. SPRAGUE. You are suggesting that the FDIC, rather than the SEC, would regulate mutual funds; is that the thrust?

Mr. J. COYNE. Perhaps the first step might be to bring the Fed, as has been mentioned earlier, some of the oversight for the monetary funds, of money market funds.

Mr. SPRAGUE. The long-term answer is get to a free market and have less regulation, rather than more.

Mr. J. COYNE. But you said earlier your responsibility was to look after the interest of the American saver.

Mr. SPRAGUE. The insured depositor.

Mr. J. COYNE. If those depositors, for some short-term gain, or whatever, decide to remove all of their assets from your insured institutions and move them into uninsured institutions at the rate of $3 billion a week, you don't consider that a problem?

Mr. SPRAGUE. Once they leave, they are not our responsibility. They also are not insured.

Mr. J. COYNE. You feel they are not the Government's responsibility? If the Government has a responsibility for them when they are part of your institution, do we abdicate a responsibility when they mover over under the SEC?

Mr. SPRAGUE. Of course not. The Government——

Mr. J. COYNE. It seems that we are turning our back on the American saver to a substantial measure.

I would like to turn over, if I may, to Mr. Pratt, very briefly.

The savings bank, savings and loans, it seems to me, engage in very, widely varying businesses. One, of course, is the origination of savings, the development of savings.

Another one, of course, is loan origination, especially for the homebuilding industry.

The third might be considered cash management services for local people who want to maintain checks or business accounts.

Can you say that the savings institutions are dealing with each of these different businesses equally? Or are we perhaps seeing a phenomenon in which the savings origination portion of the business is shifting to the money market fund. Perhaps the savings and loans will become more proportionately a loan-origination type of business, perhaps a cash management business, to the extent that they want to provide that service to their communities. What was principally the savings, retail, and wholesale element of their business, may shift to the money market funds, because apparently the money market funds have been able to provide their service more competitively?

Mr. PRATT. No, I don't see that happening. In fact, I think that that would be managerially unfortunate. It seems to me the great expertise the savings and loans have and the great thing going for them is that they are well located relative to the homeowner. They are identifiable. They are part of the community. They have a history of dealing with people. They need to stay strongly in the acquisition of savings; this is one of their fortes.

What they need, of course, is the financial strength to be able to compete. That is what they don't have at this time. That is what has caused the tremendous shift to money market mutual funds.

I would expect that under an equilibrium situation they would be heavily engaged in the solicitation of retail savings and should be encouraged in that direction.

Mr. J. COYNE. Do you have any data to suggest that the marketing of this service is holding its own?

My a priori data would suggest that in the 20- to 35-year age bracket people virtually are not using savings and loan for savings depositories anymore.

Mr. PRATT. I think the savings and loans have been almost totally forced out of the retail savings market at this time. That is a very bad development.

Mr. J. COYNE. People have used the "forced" terminology a lot. I am curious as to whether it really is a situation of forced, or whether it is, in fact, marketplace taking advantage of the 20th century, and perhaps even some of the 21st century technology, involving increased productivity, if you will, in developing institutions for accumulating savings, and pulling that, and then refunneling it back into the society?

I was not here the past 10 years and did not get an opportunity to listen to representatives of the savings and loans with regard to their quest for protection in regulation. But many who were here tell me that they were not forced into this, that rather the choice between borrowing short and lending long was a choice that they made on their own and that they, in fact, fought for that right, to borrow short at protected rates and lend long.

Now we have a marketplace where, obviously, that strategy has not been wise. In fact, they were not forced at all to choose a market path or a marketing strategy that has led to this very, very serious problem.

Mr. PRATT. What is forced and what is not is probably a difficult thing to develop. I think there is certainly a very strong element of correctness in what you say. The interpretation I would place upon it, of course, is that those institutions perceive at that time that it was the intention of Congress to maintain a sheltered housing finance sector.

Mr. J. COYNE. Now you are talking about the other business, loan originentation in terms of providing loans for housing.

Mr. PRATT. It was sheltered on both sides. To the extent that you had regulation Q, it was sheltered regarding the acquisition of funds. To the extent that this caused funds to be provided at lower rates, it was sheltered on the other side. The market or the Congress, or both, then changed dramatically and said, "We are not going to hold down rates paid to savers. They should have the right to earn a competitive rate." It was that abrupt transition from a sheltered housing finance sector to an unsheltered one which has generated the present conditions.

Mr. J. COYNE. Thank you.

Ms. OAKAR. Let me ask Mr. Connell a few questions first of all. It was in this room, I think, that former Chairman Patman, my good colleague's father, said that next to the church, credit unions were the most important institutions. I am wondering about the Bankruptcy Act that we passed a couple of years ago. How has that impacted on your members?

Mr. CONNELL. We are in the process of completing a study on that very subject and our preliminary indications are that of course first of all, very obviously, bankruptcies have gone up and losses to bankruptcies have increased since the act was passed.

Ms. OAKAR. I think there were 350,000 filings in 1980.

Mr. CONNELL. They have been up considerably. About 53 percent of that I think we can attribute to the changes in the act, and the remainder, quite frankly, is attributable, to a certain extent, to more liberal lending practices. The act has had an adverse effect, but not nearly all of the losses are due to the Bankruptcy Act itself.

Ms. OAKAR. Let me ask, since so many Federal employees turn to the credit union because of convenience, let me ask if you have done any analysis on the impact of the reduction of Federal employees. As you know, the Reagan Administration proposes to reduce Federal employees by 100,000. There are $4.2 billion of reductions in Federal employees' compensation and benefits. Is that going to have an impact on the credit union movement, particularly those Federal credit unions that serve Federal employees?

Mr. CONNELL. Yes; credit unions are going through a structural change. I alluded to it in my statement specifically with respect to the automobile industry, but the same phenomena exists with public employees. Of the $40 billion in Federal credit union assets, about $16 billion represents savings of Government employees. Now, that would include State, county, and municipal as well as Federal and educational employees.

We expect that, as propositions 13 and 2½ and the programs to reduce Government employees at the State and Federal level occur, they will affect the credit unions and for that reason we see them evolving into community-type credit unions and community banks over a longer period of time.

Ms. OAKAR. Let me ask Mr. Pratt one quick question. From what I recall, we have saved about 50 percent less since 1975, compared to what we save today. If you look at our competitors in West Germany and Japan, they save, I believe, about 14 percent to more than 20 percent of their salaries. How do you account for their thrust in savings versus our rapid decline beyond, citing money market mutual funds and unfair competition, and so forth. They have inflationary problems also.

Mr. PRATT. I simply have not studied that. I have seen the numbers but I have made no definitive study of the incentives that might be provided for savings in those nations. There are so very many variables: The effect of cultural patterns, the relative strength of inflation, and so on.

Ms. OAKAR. Don't you think that would be a good subject to study, if they are on the upswing and we are on the decline? They might be doing some things right that we are not. Our industries are now taking a look at what they are doing perhaps more competitively than we are, in terms of the various industrial outputs that we have. It seems to me, and I don't mean to be openly so critical, but it seems to me that there ought to be more kinds of avenues that you would have researched that would—as my colleague Congressman Barnard indicated—make some recommendations that were a little more creative than some of the things that we have before us.

Mr. PRATT. One must keep in mind the scope of responsibility which we have as regulators. Moreover, when one looks at the Japanese experience, for instance, it is my understanding that their economic system is substantially different from ours. The integration of monetary and fiscal policy is particularly different. I have had experience in working as a consultant in Korea, which used the Japanese economic system as a model. Those are things that I have taken substantial note of and I could go into some explanations.

Ms. OAKAR. You don't think the economy, because of the various differences, really merits any kind of study, then?

Mr. PRATT. I think such a study would be more properly performed at the congressional level, as a basis for broad action on the economy. In my fairly extensive work in foreign countries, I have not seen institutional or regulatory factors that would be an explanation of the things you are talking about.

Ms. OAKAR. Could I just cite one other thing, and that is that some of us were somewhat disappointed that there is a possibility that the Ways and Means Committee may eliminate the $200 to $400 tax-free interest area, and that the tradeoff is the $1,000 savings certificate business. I am wondering how you feel about the tradeoff?

Mr. PRATT. If you are asking me as a regulator, I feel it would be a very helpful tradeoff. If we are going to expend some public funds, which is what tax manipulations actually do, we should at least be oriented toward some solution of the problem.

Ms. OAKAR. Wouldn't it hurt the small saver? Aren't we discouraging people who are of moderate- to middle-income means, then, from getting a little break by saving?

Mr. PRATT. As I understand, there are alternatives such as tax credits which are being discussed. It seems to me that a bill could do both, if Congress wishes.

Ms. OAKAR. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Barnard, for a brief question.

Mr. BARNARD. Mr. Pratt, during our previous questioning we discussed briefly the similarity that would develop with these additional powers between thrifts and national banks. If we found that such a similarity did exist, we would be achieving parity between institutions as far as services are concerned. Why shouldn't a question about repealing the Home Loan Bank Act and have a unified financial structure where all institutions can operate under the same law and have the ability to specialize in home mortgages if they choose to get the tax advantage, be seriously examined at the same time?

Mr. PRATT. We feel it would be an approach which would not be fruitful for us to pursue at this time. But in the longer run, It would seem a worthy area for congressional scrutiny.

Mr. BARNARD. One further short question. Your draft legislation includes a provision raising the deposit insurance levels on IRA and Keogh accounts to $500,000, providing insurance at that level for new types of retirement accounts. Given the concerns over the current coverage of the insurance funds, the number of problem institutions and the questions that many have over the usefulness of insurance or attracting deposits, how can you justify this increase and this expansion in potential liabilities for the fund?

Mr. PRATT. First, concerning attractiveness, we find at this time that some individuals may well have retirement plans which on an individual basis exceed the insurance amount. We think that it does not serve the public interest for people to have to worry about this and consider splitting their fund between two or three institutions.

In terms of increasing the exposure of the insurance fund, we feel that the ability to attract and hold these funds would more than offset any particular increased exposure that might occur.

Mr. BARNARD. You would apply this increase across the board?

Mr. PRATT. Yes, sir.

Mr. BARNARD. For all financial institutions?

Mr. PRATT. Absolutely.

The CHAIRMAN. The Chair, without objection, would state that all members will have the opportunity to submit written questions for the record.

The Chair would at this time announce that Chairman Volcker will appear before this committee on July 21, and on July 22 the Deputy Secretary of the Treasury, Mr. McNamar and very probably Mr. Mehle. In addition, the Under Secretary for Monetary Policy, Beryl Sprinkel, will appear to discuss the matters of monetary policy, as well as the matters we have been discussing this morning. As a result of your fantastic presentations this morning, you have given us a great number of questions and topics to discuss with both Chairman Volcker and the representatives of the Department of the Treasury.

The Chair would also like to express his deep appreciation to the panel and congratulate them. As you see, you have attracted quite a number of members of the full committee, which is most unusual. You should be very pleased with the concern and interest that the members of the committee have for the problems that you gentlemen are encountering.

The committee will be in recess, subject to the call of the Chair.

[Whereupon, at 12:47 p.m., the hearing was adjourned, subject to the call of the Chair.]

[The following written questions were submitted by committee members to Mr. Pratt, and a response to the questions may be found commencing with page 493:]

Questions Submitted by Congressman Wylie

Question 1. In communities which have a single bank and a competing Federal S. & L. association, could the sharing of demand deposit balances threaten the profitability of the bank?

Question 2. If we followed your suggestion, could it be said that Congress would be simply recreating the national banking system at significant cost and without provisions requiring home financing?

Question 3. Will the restrictions on overdrafts and insider activities contained in FIRA and applicable to banks be applied to S. & L.'s under these provisions?

Question 4. Will restrictions placed on national banks in their lending and investment activities apply to S. & L.'s (e.g., single borrower limits)?

Question 5. If service corporations are to be truly that, shouldn't they be limited to doing what S. & L.'s can do for themselves, as with bank service corporations?

Question 6. Does section 212 mean that investments in state-chartered, non-Federally insured institutions would count toward liquidity requirements?

Questions Submitted by Congressman Lowery

Question 1. Under section 210 of your proposed legislation, you suggest that federal institutions be allowed to invest up to 10 percent of their assets directly in real estate. Do you feel enactment would hinder traditional residential mortgage lending activities?

Question 2. If, in the near future, the distinctions between different depository institutions become blurred to the point of non-recognition, what proposals would you make to change the regulatory structure into a system more in touch with the state of modern financial intermediation?

Question 3. You suggested that removal of the rate differential on money market certificates in May 1980 was premature. Could you describe these circumstances under which the elimination of the differential would be appropriate?

Question 4. On page 10, you state "we believe that the FSLIC, when adverse financial conditions exist such as those we currently are experiencing, should be empowered to authorize any FSLIC-insured institution in danger of default to merge with any other FSLIC-insured thrift, or to be acquired by such an institution, or by any savings and loan holding company."

On page 11, you state "by giving us this authority, Congress would vastly increase the universe of institutions potentially able to acquire a troubled thrift, . . . it would avoid the development of a pattern of liquidations occasioned as a result, not of selection of the least costly of alternative approaches. . . ."

In view of the trend toward the homogenization of depository institutions, why should merger prospects be limited to FSLIC-insured institutions?

CONDUCT OF MONETARY POLICY

TUESDAY, JULY 21, 1981

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, Annunzio, Fauntroy, Neal, Blanchard, Hubbard, D'Amours, Lundine, Vento, Barnard, Frank, Patman, W. Coyne, Stanton, Wylie, McKinney, Hansen, Leach, Paul, Parris, Weber, McCollum, Wortley, Roukema, Lowery, and Bereuter.

The CHAIRMAN. The committee will come to order.

This morning the committee resumes its semiannual hearings on monetary policy. Too often these hearings become bogged down in esoteric discussions of the "M's" with no attempt to determine that the real world impact of money supply targets might be. The focus has been on aggregate numbers and the total economy rather than looking at the experience of small business, individuals, and regions of the country to see what these numbers really mean.

Last week we began a series of hearings designed to provide that analysis. The committee heard from the three depository institution insuring agencies. All three agencies provided the committee with data which reveals the severe impact that monetary policy and high interest rates have on the financial industry. The number of institutions on the problem list is rising quickly.

Those institutions which have limited asset flexibility are especially hard hit. Savings and loans, mutual savings banks, and credit unions find it increasingly difficult to continue operating as interest rates push up their cost of funds. Liquidity is decreasing at thrifts. Earnings have been devastated by the negative marings on income and expenses. Net worth ratios continue to decline and the number of institutions with unsatisfactory net worth levels grows monthly.

When these institutions face the problems they do, then other segments of the economy suffer as well. Credit availability is reduced since the depository institutions either do not have lendable funds or they shift to investment strategies emphasizing shortrun profits and arbitrage.

Credit for mortgages, automobiles, and other consumer purchases fall in aggregate terms. People cannot find, let alone pay, for loans to finance transportation and housing. Mortgage loan commitments by thrifts have steadily fallen to $5 billion from $10 billion per month over the last half of 1980 and 1981. Housing starts are at their lowest annualized level since the recession in 1974. Automobile sales continue to sag because people cannot afford to pay the high costs of the cars and the financing charges as well.

The high levels of interest rates coupled with extreme violatility in rates and the continuance of an inverted yield curve play havoc with the credit markets. The bond market is virtually closed as a result of inflation and the interest rate structure. The ratio of current liabilities to current assets of nonfinancial corporations continues to decline as firms load up on short-term liabilities because they do not want to lock in high-cost, long-term financing.

The Congress is continuing to wrestle with fiscal policy which is impacted by monetary policy. The conference on the reconciliation bill is hopefully nearing an end. The result will be a major slowdown and reduction in governmental programs which provide assistance to those people in our economy who cannot afford current high interest rates, cannot find decent sanitary housing, and often cannot find a decent meal. Programs within the jurisdiction of this committee take particularly stiff cuts.

This process is part of the administration's purported four-point plan to improve the economy. It wants to cut Government expenditures, cut taxes, control the money supply, and simpify the regulatory process. The recommended budget cuts, I believe, fall with a heavy hand on the lest fortunate in our society. The administration's tax recommendations benefit the wealth and, given the magnitude of the proposed reductions, raise questions about the level of the Government's deficit and the ability of the monetary system to cope with the increased flow of funds without further increases in interest rates.

Monetary policy, with its emphasis on the monetary base and its devil may care attitude about interest rates also impacts the most on the least fortunate and the small firms which cannot afford such costs but have to rely on credit. The papers are filled with daily stories about huge credit lines going to companies engaged in bidding wars and takeovers. DuPont, Conoco, Marathon Oil, Texaco, Mobil, Pennzoil—these companies have no problems securing all the credit that they need for any purpose. The charts supplied by the Federal Reserve in its mandated report clearly point out this discrepancy. Household and State and local government borrowing continue to fall rapidly, yet nonfinancial corporations continue to borrow and to borrow large amounts.

This committee needs to know why the impact of monetary policy falls so unevenly on the population. Why is it that takeover loans totaling almost $35 billion yesterday, $40 billion today, can be made on short notice, yet those who need loans for automobile purchases, for home mortgages, cannot find money? Or, if people can find money, the interest rate risk is transferred to the borrower through instruments like the adjustable mortgage instrument?

Is our Government becoming a Government run by and for big business? Are corporations taking over the government and the economy at the same time? The corporate mergers mentioned earlier are raising the issue of economic concentration once again. And these mergers are being fueled by credit—credit that, if available to small businesses at all, is at prohibitively high rates that foreclose inventory financing and recapitalization, and, what is more tragic, has a devastating effect on unemployment.

Are our credit markets becoming the province of the rich and the powerful? Will the average man or woman be able to find credit and other financial services at any price? I do not know the answers to many of these questions, but I intend to elicit the response of the Chairman of the Federal Reserve on many of these issues.

Mr. Volcker, I want to personally welcome you. Prior to my recognizing you, I know that Mr. Stanton would like to make an opening statement, and I understand Mr. Fauntroy would also.

I will recognize Mr. Stanton.

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

Mr. Volcker, we welcome you back once again to what is this committee's sixth hearing on the conduct of monetary policy pursuant to the Full Employment Balanced Growth Act of 1978, better known as the Humphrey-Hawkins Act.

I think you would agree with me that economic history teaches us that probably the No. 1 opponent to reaching the fundamental goals of the Humphrey-Hawkins Act is inflation or perhaps more importantly, the psychology of inflation. In this regard, I would hope that your report today, together with recent and future actions of the Congress and the Reagan administration, will help to reduce the inflationary pressures in the months and immediate years ahead.

Yet, just as our inflationary problems were not created overnight, I am aware that there are no easy short-term solutions. In fact, there are very real and sometimes very painful costs associated with any program to reduce inflation and promote economic stability.

The scenario that our chairman most painfully had to remind us of at this time is obvious to all of us.

In going back to basics, I think, Mr. Chairman, though, there is an element of encouragement, however, slight, in the immediate future. The pace of inflation seems to be slowing considerably in the first half of this year. It has receded from double-digit figures for the first time in 2 years. The Consumer Price Index as noted on page 29 of your report is decelerating from a 12½-percent pace in 1980 to an annual rate of about 8½ percent through May of this year.

So, Mr. Chairman, it is with pleasure that I join our Chairman and members of our committee in looking forward to your testimony. Thank you very much, Mr. Chairman.

The CHAIRMAN. The Chair recognizes Mr. Fauntroy.

Mr. FAUNTROY. Thank you, Mr. Chairman.

Mr. Volcker, it is a privilege for me, likewise, to welcome you. Once again, we meet to take testimony on the conduct of monetary policy pursuant to the requirements set forth in the Humphrey-Hawkins Full Employment and Balanced Growth Act. Once again we find little with which we can take any comfort at all. While inflation as measured by the CPI, has moderated in recent months, the decline in areas such as energy and food, which are likely to rise in the future, the basic rate of inflation, based on the rate of wage increases that represent two-thirds of all business costs, remain at or close to 10 percent.

Meanwhile, the interest rates remain at near-record levels. These high interest rates have kept unemployment at rates well in excess of 7 percent. This unemployment rate, which is unconscionably high, represents one of the longest sustained periods of high employment. Needless to say, for those who are black, the unemployment rate is more nearly double the national rate.

Much as I wish to see inflation brought under control, I cannot support a program that relies solely on monetary policy to do so. The costs of such a program in terms of economic stagnation and high unemployment are far too severe. Monetary policy itself is too imprecise to serve as the only weapon against inflation. There are grave difficulties in discerning which elements of the money supply should be focused upon, in translating long-term objectives into intermediate targets given problems of float, seasonal shifts in currency demands, and changes in velocity.

Controlling the money supply as part of an anti-inflation program is clearly important. It is equally clear that increasing the money supply simply to reduce interest rates is self-defeating. However, the Federal Reserve must pursue a pragmatic monetary policy that recognizes the crudity and imprecision of its powers to control the growth of money aggregates.

For similar reasons, the Federal Reserve must be cautious in its actions to prevent interest rates from being unnecessarily high or tightening credit so much that a severe depression and terribly high unemployment results.

However, inflation, like cancer, is a complex disease. Treating it only with monetary policy would be like treating cancer only with surgery, or worse, only with laetrile. The treatment may, or may not work, but the patient may die. Yet, I am afraid that the administration, its protests notwithstanding, is doing exactly this. Its fiscal policies and deregulatory efforts seem to have less to do with prudent Government policy or inflation than with a purely philosophical dislike for the Federal Government and what the public sector has contributed to the well being of the poor and middle class instead of the rich and powerful.

Nothing is done to help bring down the rate of pay increases that are propelling inflation along, nothing is done to reduce the economic concentration that keeps prices high when demand drops, and nothing is done to prevent the diversion of scarce credit into speculative and unproductive activities like mergers and acquisitions of large companies. Without a prudent fiscal policy, and without a credit policy, the administration seems to leave the control of inflation to the Federal Reserve, at the cost of recession and continuing high unemployment.

While an effective anti-inflation program must include monetary policies which counsel restraint, it must not be the only program. We simply cannot have an economic policy which prods the Fed to tighten the money supply more and more until a recession or depression finally brings prices, wages, and the whole economy to a screeching halt.

Our policies, whether from the Fed or other places, must be measured. The burdens they impose must be shared by all and not merely by the poor, the elderly, and those who have modest credit needs that support housing, automobiles, education and health care.

Mr. Chairman, under your guidance, these hearings mark the turning point which will show the American people the foolishness of this administration's policies and the consequences of relying upon one institution to do the work that a whole Government must be committed to doing. In creating this opportunity today and tomorrow, you have again done yeoman's work for this country, and I commend you for this.

Thank you.

Mr. HANSEN. Mr. Chairman, as ranking member of the subcommittee, may I respond also, as Mr. Fauntroy?

The CHAIRMAN. The gentleman is recognized. I think we are going to put a 5 minute limit on these, however.

Mr. HANSEN. I have never been known to speak over 5 minutes, Mr. Chairman.

Mr. Chairman, I, too, want to welcome the Chairman of the Federal Reserve here.

I appreciate very much your being here, Mr. Volcker. These are serious times. That is the reason I have asked to speak out, because I feel that somehow the voice of the small guy, the small businessman and middle America is just not being heard, Mr. Chairman.

I would just like to read an excerpt of a letter, to give you an idea of what we are getting here in Congress:

> I wish to express my concern regarding the high price interest rate and detrimental effect it is having on Idaho based small business. As you may know, First Idaho Corporation is a Boise-based public financial services company. We are currently paying 22½ percent interest on $3.4 million. Since January 1, 1981, First Idaho Corporation's losses have been in excess of $275,000.
>
> During the past 24 months, we have cut our staff more than 20 percent. We have sold assets, taken other steps to survive the conditions created and encouraged by the Federal Reserve.

I received another letter. They talk, of course—before I go on—about a number of their clients who also have been having similar problems, and many of them have gone into bankruptcy as a direct result of the high cost of money. Then they talk about the senior vice president of a mortgage company who says, "The capital formation cannot occur with short-term rates at 20½ percent plus. That means the Reagan economics is doomed to failure. Paul Volcker must be forced to look at the other side of his restrictive monetary policies."

Mr. Chairman, my concern is that over the past 2 or 3 years—and this is something that perhaps there is good explanation for—but we have had an erratic monetary supply management policy which has seen us not going on some kind of a direct line toward realizing our targets, but we have been on a roller coaster, up and down and all over the deck.

Twenty percent. Then during the political campaign, for whatever reason, coming down from 20-percent to businessmen being in the IFA needle of the storm, seemed to take some kind of heart. They reinvest, get themselves committed again on huge flooring situations or whatever. Then all at once they are hit with an extended 20 percent roller coaster again. This is the kind of thing we are finding. We are forcing these people out of business.

Now, I sent a couple of years ago, Mr. Chairman, a couple of staff members from the Banking Committee and my staff to New York to the Fed there to try and see what was going on, if there was some kind of preoccupation with foreign lending or something else that maybe was not allowing the Fed to get the real feeling of what is going on within America down at the small business level. I found that there was a preoccupation all day long with this type of thing.

Finally, at the end of the day they admitted they were getting complaints from upstate New York and other areas. The point I am trying to make is I am just not sure the Federal Reserve has been getting the message, even way into the time when some of these small businesses were having their problems, Mr. Chairman, and I mean we are dead in the water, we had statements issued from the Feds, yourself and others stating I think the message is finally getting to the countryside.

I would like to ask when the message is going to get to Washington, because the thing that is happening here is that we find Government overspending for years has created a problem which we are trying to deal with now in the Federal Reserve, and some credit to you—has been trying to help us alleviate the problem by this. But in doing so, it seems we are always penalizing the private sector and making them sacrifice.

I hear some of the large corporations say they are making unprecedented profits and doing very well. But this is not true out in the countryside. I am afraid if we continue the money policies we have now, trying to preoccupy ourselves, as the gentleman from the District of Columbia said, with inflation alone and with the interest rates, we are getting to the point where there is not going to be anything left to save in the countryside and we are going to have a European-type economic situation where you have a few people own it all and the rest working for them, Mr. Chairman.

It seems to me when you look at the credit situation as envisioned by the takeover of Conoco by certain large corporations, you see the differences in the way interest rates are treated between the large corporations and others.

I would like to leave this little bit of counsel. I think what is happening is we are destroying the small businessman, we are destroying middle America and the American dream, the ability to own a car and home. We are feeding inflation more than we are actually defeating it, because anytime you have the Federal Government paying 20 percent or 18 percent or whatever for the money it is borrowing, you actually are heaping it on the Federal debt and creating larger deficits than we had before.

And, Mr. Chairman, I think it is time we got away from catering to the big banks, big corporations, big income people, and catering to a type of capitalism in this country it was never designed to have, and see if we can't have something for middle-America. I encourage you to take a look at this in the testimony and the answers you are giving today.

The CHAIRMAN. The Chair will instruct staff to find a seat on this side of the dais for the gentleman from Idaho, after hearing that statement. [Laughter.] Mr. Volcker, I think your time has come. [Laughter.]

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

Mr. VOLCKER. Perhaps the most constructive thing I can do at this point, Mr. Chairman, is read the statement I have prepared which deals with some of these questions.

I am pleased to be here this morning to review the conduct of monetary policy and to report on the Federal Reserve's objectives for the growth of money and credit for this year as well as tentative targets for 1982. You have already received our formal report, but I would like to briefly summarize some points and amplify others.

I do not need to belabor the point that the current economic situation is far from satisfactory. That has already been done fairly satisfactorily here. We do see some encouraging signs that we are beginning to make progress against inflation. I realize the evidence in the recent price data is not, by itself, conclusive. However, I strongly believe that we now have the clear opportunity and responsibility to achieve and sustain further progress on the price front. That progess, in turn, will be an essential ingredient in laying the base for a much healthier economy in the years ahead.

The process inevitably requires time and patience. It would obviously be much more pleasant for me to appear before you today were both unemployment and interest rates lower. High interest rates undeniably place a heavy burden on housing, the auto industry, small business, and other sectors especially dependent on credit. The thrift industry, in particular, has come under heavy stress as its costs of funds exceed returns on fixed rate assets acquired when interest rates were much lower.

The high level of U.S. interest rates also has repercussions internationally, complicating already difficult economic policy decisions of some of our major economic partners. The surprisingly strong growth in national output last winter has given way to a much more sluggish picture. With continuing sizable increases in the labor force, unemployment has not declined from higher levels reached last year. The trend of both productivity and savings remains low.

Amidst these difficulties, we must not lose sight of the fundamental point that so many of the accumulated distortions and pressures in the economy can be traced to our high and stubborn inflation. Moreover, turning back the inflationary tide, as we can see, is not a simple, painless process, free from risks and strains of its own. All that I would claim is that the risks of not carrying through on the effort to restore price stability would be much greater. Dealing with inflation is essential to our future well being as a nation, and the Federal Reserve means to do its part.

As I noted, we have begun to see some tentative signs of a realization of price pressures. To be sure, much of the recent improvement in various price indicators is accounted for by some reversal of "special" factors that drive the inflation rate higher in 1979 and part of 1980. Instead of the huge increases of the last 2 years, energy prices have stabilized and some oil prices have even declined in the fact of the recent production surpluses.

Retail food prices have risen at rates less than 1 percent this year, partly reflecting improved crop conditions, in contrast to the 10¼ percent pace in 1980.

Commodity prices generally have been weak, as speculative forces have subsided under pressure of the high cost of finance and more restrained price expectations. Despite sharply rising mortgage costs, the recorded overall cost of homeownership has been rising less rapidly.

Some of these developments could prove temporary. Special factors and short term improvements in the prices most sensitive to credit restraint alone cannot be counted upon to sustain progress indefinitely. The deeply entrenched underlying rate of inflation is sustained by the interaction of labor costs, productivity, and prices.

So far, there are only small and inconclusive signs of a moderation in wage pressures. Understandably, wages respond to higher prices. But in the economy as a whole, labor accounts for the bulk of all costs, and those rising costs in turn maintain the momentum of the inflationary process.

Low productivity gains, high taxes, and unnecessary regulatory burdens aggravate the situation. Moreoever, to the extent firms and their workers are shielded form the competitive consequences of poor productivity and aggressive price and wage policies, those attitudes are encouraged.

These considerations help point to the wide range of policies necessary to support a sustained and effective effort against inflation. Fortunately, recognition of the need is widespread, and progress is being made in a number of directions. But there can be no escaping the fact that monetary policy has a particularly crucial role to play and, in current circumstances, has a particualrly heavy burden.

An effective program to restore price stability requries reducing growth in money and credit over time to rates consistent with the growth of output and employment at stable prices. That is the basic premise of our policies, and I believe consistent with the philosophy of the Humphrey-Hawkins Act mandating our report to you today on our monetary growth ranges. The periodic decisions we in the Federal Reserve reach about those monetary targets, and the implementation of policy, are entirely within the broad policy context; essentially, they are matters of how much, how fast, not basic direction.

In approaching its midyear review of the monetary and credit targets within this framework, the Federal Open Market Committee was faced with rather sharply divergent trends in the several aggregates during the first half of the year.

These trends were significantly influenced by the rapidity of market responses to regulatory or structural changes, including the exceptionally rapid growth of NOW accounts nationwide and of money market mutual funds.

The basic measures of transaction balances—"narrow money" or M_1—have risen relatively slowly, after adjusting for the effects of the one time shifts of funds into interest bearing NOW accounts; those accounts were available for the first time nationwide, and have been aggressively marketed by banks and thrift institutions. To a degree that cannot be precisely measured, individuals and businesses, spurred by high interest rates, appear to have intensified cash management practices designed to minimize the use of traditional transactional balances, tending to speed up the velocity relationship between M_1 and GNP during early 1981.

For example, to some limited degree, needs for M_1 transaction accounts may have been reduced by the growing popularity of money market funds—not included in the definition of M_1 —which can be used as a substitute for demand deposits or NOW accounts.

At the same time, as shown on table 1, the broader aggregates, M_2 and M_3, which do include money market funds and some other close money substitutes, have been rising at or above the upper end of the target ranges. You may recall I suggested to the committee in presenting the targets for 1981, that these broader aggregates might well be expected to rise toward the upper part of their ranges. This expectation is reinforced by the further liberalization of interest ceilings of depository institutions by the Depository Institutions Deregulation Committee, a continued growth of money market funds, and potentially the availability of tax exempt so-called "All Savers Certificates" at depository institutions, all of which could continue to result in some diversion of funds from market outlets into M_2 and M_3.

In the light of this situation, the committee considered the possibility of making small adjustments in the 1981 ranges to account for the impact of institutional change. However, it seems probably that the strongest impact of the introduction of NOW accounts and of adjustments of cash management practices to high interest rates may be behind us. Therefore, the committee did not feel that changes in the growth ranges for 1981 were justified. And I might say these growth ranges are set forth in table 2.

However, given developments during the first half of year and the need to avoid excessive growth in coming months, the committee agreed that growth in M_{1-B} near the lower end of its range for the year as a whole—that range is 3½ to 6 percent, after adjusting for NOW account shifts—would be acceptable and desirable, particularly should relatively strong growth in the other aggregates continue.

As indicated at the start of the year, the committee does feel it acceptable that growth in M_2 and M_3 be toward the upper part of their ranges—6 to 9 percent and 6½ to 9½ percent respectively. Growth of bank credit, while often fluctuating considerably from month to month, is expected to remain within its specified range of 6 to 9 percent.

In its tentative consideration of the targets for 1982, the committee decided to plan for targeting and publishing a single M_1 figure, equivalent in coverage to the present M_{1-B}. Assuming that further structural shifts into NOW accounts from nontransaction accounts are by that time minimal, shift adjusted targets and data should not be necessary. The tentative range for M_1 in 1982 was set at 2½ to 5½ percent, the midpoint of 4 percent is three-quarters of 1 percent below the midpoint of the closely comparable current range for M_{1-B} shift adjusted.

The tentative ranges for the broader aggregates in 1982 were left unchanged at 6 to 9 percent and 6½ to 9½ percent for M_2 and M_3, respectively. However, we would anticipate actual growth closer to the midpoint in 1982, consistent with the desired reduction over time.

Setting precise targets has inevitably involved us in consideration of the effects of technological and regulatory change on monetary measures. Those technical considerations should not obscure the basic thrust of our intentions—that is, to lower progressively effective money and credit growth to amounts consistent with price stability. We believe the targets for both 1981 and 1982, and our operations, are fully consistent with that objective.

I have often emphasized that money supply data—like many other financial and economic data—have some inherent instability in the short run. The trend over time is what counts, both as a measure of monetary policy and in terms of economic effect. For some months in the latter part of 1980, as you will recall, the rise in M_1 was relatively rapid. Against that background, the sluggish growth during most of the first half of 1981 was welcomed as a desirable offset by the committee, conforming the trend toward a lower rate of growth over time.

At the same time, we have been conscious of the relative strength of M_2 and M_3. Those measures include money market funds, short-term repurchase agreements, and certain U.S.-held Eurodollars, that to a greater or lesser degree can serve as substitutes for M_1 balances. With those components growing relatively rapidly, our experience this year, to my mind, reinforces the need to take account of all available information in assessing the significance of short term movements in the monetary aggregates and judging our policy posture.

More fundamentally, what recent experience also confirms is that demands for money and credit growing out of an expanding and inflating economy, pressing against a restrained supply, will be reflected in strong pressures on interest rates and credit markets—pressures that in turn restrain the growth in business activity. Some important sectors of the economy are relatively impervious for one reason or another to direct financial restraint—energy, high technology, many services, and defense. Those sectors have been strong sustaining forces in the economy generally, and particularly in some geographic areas.

The brunt of the restraint falls on other credit dependent sectors, and as the dollar has sharply appreciated, increasingly on exporters faced with a less favorable competitive position. Should interest rates decline in response to weakness in the economy, many of those sectors would likely, and rather promptly rebound.

In a longer time frame, the outlook for interest rates will depend importantly on confidence that inflation will be controlled, and on actual progress toward greater price stability, as well as such factors as the Federal deficit. Differences of opinion about these matters help to account for the relatively wide range of forecasts now characteristic for the period ahead, including those set forth by members of the Federal Open Market Committee, which are attached to this statement.

I cannot fully resolve all these uncertainties in the outlook for you this morning. What does seem clear to me is that progress on inflation is a prerequisite for lasting improvement in financial markets, and for sustained, balanced growth. I can also emphasize the policies that seem to me necessary to speed the transition to more equable financial markets and to a more prosperous, productive, economy generally.

First, as I have already indicated, curbing inflation will require persistent restraint on the growth of money and credit. An attempt to escape from high interest rates and strains on financial markets and institutions by abandoning that restraint would be self-defeating. By encouraging expectations of more inflation, that approach would soon stimulate even more borrowing, further reduce incentives to save, and ultimately result in still higher interest rates and more economic difficulty.

You and I know that, after a decade and more of disappointment, there is persisting skepticism and doubt about the ability of the Nation to persevere in an anti-inflation program. I believe that skepticism is unwarranted, but we must make that claim good by our actions. Indeed, sustained monetary restraint, by encouraging greater confidence in the price outlook, will in time help bring interest rates lower.

Pressures on financial markets can also be relieved by actions from other directions, entirely consistent with the anti-inflation effort and the longer run needs of the economy. Specifically, today, Government deficits and credit programs absorb today a large fraction of our available limited savings.

You are well aware that the administration and the Congress are hard at work on both sides of that equation. It requires a difficult balancing of priorities. Some forms of tax reduction are justified by the need to improve incentives and to reduce costs. But if we are to be convincing in our efforts to reduce the deficit at the same time, Congress will need to maintain and even intensify the courageous effort to reduce the upward trend in spending.

Monetary restraint does imply that the growth in the current value of our output—the nominal GNP—will also be restrained. To the extent that restraint falls on prices, the more room there will be for the growth in real output we want. I have already suggested that the recent improvement in the price performance has some elements that we cannot count on continuing. But along with the present slack in many labor and product markets, the more encouraging price data certainly does help create a more favorable setting for changing the fundamentals of price policy and wage behavior in ways that can be sustained.

A bulge in labor compensation early this year, and related continuing large increases in unit labor costs, have reflected in substantial part a catchup in wages after last year's large rise in the consumer price index, as well as sizable increases in the minimum wage and social security taxes. These sources of pressure should be much diminished or absent in the period ahead. Intensified by the appreciation of the dollar internationally, there are also strong competitive incentives domestically and internationally, on important industries to control costs.

In these circumstances, there is a compelling logic, from an overall economic view, in looking toward a sense of greater caution and restraint in both wage and pricing behavior. What is at issue is the extent to which that need will seem equally compelling, viewed from the specific shop floor or the individual executive suite. Those decisions are, of course, made continuously in the nonunion sector of the economy, but a crucially important round of union wage bargaining begins next January, potentially setting a pattern for several years ahead.

That is one reason why we need to be clear and convincing in specifying our monetary and fiscal policy intentions, and their implications for the economic and inflation environment. Without room for financing both high levels of inflation and strong growth, inflationary behavior by individual firms can jeopardize markets, jobs and profits.

The lesson already seems apparent in some key industries. Government can and should help directly by removing unnecessary regulatory burdens, and by reviewing laws and practies that actually inhibit competitive pricing and add to costs. I believe it can also help indirectly by making clear that industries suffering from problems of their own making are not entitled to new governmental protection.

What this all adds up to is that we are at a critical point in the fight on inflation.

We do see the first stirrings of progress in the most recent data.

With enormous effort, the administration and the Congress are moving together to attain control on spending. We all know much remains to be done for future years, but the unparalleled effort bodes well for the future. With a full measure of success, the most urgently needed tax reduction can be responsibly reconciled with reduced deficits.

We in the Federal Reserve are committed to reducing growth in money and credit. There is, I believe, a genuine urge to let the competitive marketplace work, and to review Government practices that unnecessarily add to costs or limit competition.

These policies can and will be effective. But if they are to work, they must be sustained with conviction. Then, the apparent reluctance of many to bet on reduced inflation—in financial markets, in wage bargaining, in pricing, and in other economic decisions—will change. As they do, the unwinding of the inflationary process should be much easier.

In a real sense, the hardest part of the job faces us now and in the months immediately ahead. We must demonstrate our ability to carry through on our good intentions, not just in monetary policy, but in the fiscal and other areas as well.

I have talked at some length this morning about the technical aspects of monetary policy and our numerical targets for the various monetary aggregates. I have reemphasized why the Federal Reserve must be and is determined to avoid excessive growth in money and credit. I have stressed the key role other policies, including budgetary restraint, must play if we are to make real progress toward price stability and relieve pressures on financial markets.

That may all seem abstract and even singleminded, given the pressing problems of the real world.

For far too long, we have not had acceptable economic performance. The average worker has found his or her real income growing slowly, if at all. The overall unemployment rate, high as it is, does not reflect the intensity of the problem for some groups and areas, and the burden too often falls on those least able to bear it. Interest rates are at extraordinary levels.

We in the Federal Reserve are acutely aware of these problems. We do not restrain money and credit for its own sake, or simply because inflation is an evil in itself.

Financial discipline is a means to an end. It is an essential part—if only a part—of strengthening our economy so that productivity and living standards can rise and worthwhile jobs can be found, not just for a few months, but for the longer period ahead.

Thank you, Mr. Chairman.

[Mr. Volcker's prepared statement follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 21, 1981

I am pleased to be here this morning to review the conduct of monetary policy and to report on the Federal Reserve's objectives for the growth of money and credit for this year as well as tentative targets for 1982. You have already received our formal report, but I would like to briefly summarize some points and amplify others.

I do not need to belabor the point that the current economic situation is far from satisfactory. But we see some encouraging signs that we are beginning to make progress against inflation. I realize the evidence in the recent price data is not, by itself, conclusive. However, I strongly believe that we now have the clear opportunity and responsibility to achieve and sustain further progress on the price front. That progress, in turn, will be an essential ingredient in laying the base for a much healthier economy in the years ahead.

The process inevitably requires time and patience. It would obviously be much more pleasant for me to appear before you today were both unemployment and interest rates lower. High interest rates undeniably place a heavy burden on housing, the auto industry, small business, and other sectors especially dependent upon credit. The thrift industry, in particular, has come under heavy stress as its costs of funds exceed returns on fixed rate assets acquired when interest rates were much lower. The high level of U.S. interest rates also has repercussions internationally, complicating already difficult economic policy decisions of some of our major economic partners. The surprisingly strong growth in national output last winter has given way to a much more sluggish picture. With continuing sizable increases in the labor force, unemployment has not declined from higher levels reached last year. The trend of both productivity and savings remains low.

Amidst these difficulties, we must not lose sight of the fundamental point that so many of the accumulated distortions and pressures in the economy can be traced to our high and stubborn inflation. Moreover, turning back the inflationary tide, as we can see, is not a simple, painless process, free from risks and strains of its own. All that I would claim is that the risks of not carrying through on the effort to restore price stability would be much greater. Dealing with inflation is essential to our future well-being as a nation, and the Federal Reserve means to do its part.

As I noted, we have begun to see some tentative signs of a relaxation of price pressures. To be sure, much of the recent improvement in various price indicators is accounted for by some reversal of "special" factors that drove the inflation rate higher in 1979 and part of 1980. Instead of the huge increases of the last two years, energy prices have stabilized and some oil prices have even declined in the face of the recent production surpluses. Retail food prices have risen at rates of less than 1 percent this year, partly reflecting improved crop conditions, in contrast to the 10¼ percent pace in 1980. Commodity prices generally have been weak, as speculative forces have subsided under the pressure of the high cost of finance and more restrained price expectations. Despite sharply rising mortgage costs, the recorded overall cost of homeownership has been rising less rapidly.

Some of these developments could prove temporary. Special factors and short-term improvements in the prices most sensitive to credit restraint alone cannot be counted upon to sustain progress indefinitely. The deeply entrenched underlying rate of inflation is sustained by the interaction of labor costs, productivity, and prices. So far, there are only small and inconclusive signs of a moderation in wage pressures. Understandably, wages respond to higher prices. But in the economy as a whole, labor accounts for the bulk of all costs, and those rising costs in turn maintain the momentum of the inflationary process. Low productivity gains, high taxes, and unnecessary regulatory burdens aggravate the situation. Moreover, to the extent firms and their workers are shielded from the competitive consequences of poor productivity and aggressive price and wage policies, those attitudes are encouraged.

These considerations help point to the wide range of policies necessary to support a sustained and effective effort against inflation. Fortunately, recognition of the need is widespread, and progress is being made in a number of directions. But there can be no escaping the fact that monetary policy has a particularly crucial role to play and, in current circumstances, has a particularly heavy burden.

An effective program to restore price stability requires reducing growth in money and credit over time to rates consistent with the growth of output and employment at stable prices. That is the basic premise of our policies, and I believe consistent with the philosophy of the Humphrey-Hawkins Act mandating our report to you today on our monetary growth ranges. The periodic decisions we in the Federal Reserve reach about those monetary "targets," and the implementation of policy, are entirely within that broad policy context; essentially, they are matters of how much, how fast, not basic direction.

In approaching its mid-year review of the monetary and credit targets within this framework, the Federal Open Market Committee was faced with rather sharply divergent trends in the several aggregates during the first half of the year.

These trends were significantly influenced by the rapidity of market responses to regulatory or structural changes, including the exceptionally rapid growth of NOW accounts nationwide and of money market mutual funds.

The basic measures of transaction balances -- "narrow money" or M1 -- have risen relatively slowly after adjusting for the effects of the one-time shifts of funds into interest-bearing NOW accounts; those accounts were available for the first time nationwide, and have been aggressively marketed by banks and thrift institutions.* To a degree that cannot be precisely measured, individuals and businesses, spurred by high interest rates, appear to have intensified cash management practices designed to minimize the use of traditional transaction balances, tending to speed up the "velocity" relationship between M1 and GNP during early 1981. For example, to some limited degree, needs for "M1" transaction accounts may have been reduced by the growing popularity of money market funds -- not included in the definition of M1 -- which can be used as a substitute for demand deposits or NOW accounts.

At the same time, as shown on Table I, the broader aggregates, M2 and M3 (which do include money market funds and some other close money substitutes) have been rising at or above the upper end of the target ranges. You may recall I suggested to the Committee in presenting the targets for 1981, that these broader aggregates might well be expected to rise toward the upper part of their ranges. This expectation is reinforced by the further liberalization of interest ceilings of depository institutions by the Depository Institutions Deregulation Committee, a continued growth of money market funds, and potentially the availability of tax-exempt so-called "All Savers Certificates" at depository institutions, all of which could continue to result in some diversion of funds from market outlets into M2 and M3.

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*These shifts sharply depressed recorded (i.e., before "shift adjustment") M1A early in the year because the bulk of the NOW accounts reflected transfers from demand deposits which are included in M1A. Recorded M1B, which includes NOW accounts, was "artificially" increased to the extent funds were shifted into NOW accounts from savings accounts or other assets not counted as transaction accounts, but continue in part to serve the economic function of savings. The Federal Reserve publishes estimates monthly of "shift-adjusted" data based on a variety of sources. As the transfers diminish, as appears to be happening, the "adjusted" and "unadjusted" data will more closely coincide.

In the light of this situation, the Committee considered the possibility of making small adjustments in the 1981 ranges to account for the impact of institutional change. However, it seems probable that the strongest impact of the introduction of NOW accounts and of adjustments of cash management practices to high interest rates may be behind us. Therefore, the Committee did not feel that changes in the growth ranges for 1981 were justified. (All targets for 1981 and 1982 are shown in Table II.)

However, given developments during the first half of the year and the need to avoid excessive growth in coming months, the Committee agreed that growth in M1B near the lower end of its range for the year as a whole (3½-6 percent, after adjusting for NOW account shifts) would be acceptable and desirable, particularly should relatively strong growth in the other aggregates continue. As indicated at the start of the year, the Committee does feel it acceptable that growth in M2 and M3 be toward the upper part of their ranges (6-9 percent and 6½-9½ percent, respectively). Growth of bank credit, while often fluctuating considerably from month to month, is expected to remain within its specified range of 6-9 percent.

In its tentative consideration of the targets for 1982, the Committee decided to plan for targeting and publishing a single M1 figure, equivalent in coverage to the present M1B. Assuming that further "structural" shifts into NOW accounts from non-transaction accounts are by that time minimal, "shift adjusted" targets and data should not be necessary. The tentative range for

Ml in 1982 was set at 2½-5½ percent, the midpoint of 4 percent is three-quarters percent below the midpoint of the closely comparable current range for MlB "shift adjusted."*

The tentative ranges for the broader aggregates in 1982 were left unchanged at 6-9 percent and 6½-9½ percent for M2 and M3, respectively. However, we would anticipate actual growth closer to the midpoint in 1982, consistent with the desired reduction over time.

Setting precise targets has inevitably involved us in consideration of the effects of technological and regulatory change on monetary measures. Those technical considerations should not obscure the basic thrust of our intentions -- that is, to lower progressively effective money and credit growth to amounts consistent with price stability. We believe the targets for both 1981 and 1982, and our operations, are fully consistent with that objective.

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*The tentative range for Ml in 1982 is substantially below the range of 6-8½ percent specified for recorded MlB growth for 1981. Recorded MlB data for 1981 have been strongly affected, particularly during the early months of the year, by the "one-time" shifts into NOW accounts of savings and other funds not included in the Ml series. These shifts are diminishing, and the new tentative target for 1982 assumes they will be essentially completed by the end of this year. The slightly wider range specified allows for the possibility of some residual shifting. That assumption will, of course, be reviewed at year end.

I have often emphasized that money supply data -- like many other financial and economic data -- have some inherent instability in the short run. The trend over time is what counts, both as a measure of monetary policy and in terms of economic effect. For some months in the latter part of 1980, as you will recall, the rise in M1 was relatively rapid. Against that background, the sluggish growth during most of the first half of 1981 was welcomed as a desirable offset by the FOMC, confirming the trend toward a lower rate of growth over time. At the same time, we have been conscious of the relative strength of M2 and M3. Those measures include money market funds, short-term repurchase agreements, and certain U.S.-held Eurodollars, that to a greater or lesser degree can serve as substitutes for M1 balances. With those components growing relatively rapidly, our experience this year, to my mind, reinforces the need to take account of all available information in assessing the significance of short-term movements in the monetary aggregates and judging our policy posture.

More fundamentally, what recent experience also confirms is that demands for money and credit growing out of an expanding and inflating economy, pressing against a restrained supply, will be reflected in strong pressures on interest rates and credit markets -- pressures that in turn restrain the growth in business activity. Some important sectors of the economy are relatively impervious for one reason or another to direct financial restraint --

energy, high technology, many services, and defense. Those sectors have been strong sustaining forces in the economy generally, and particularly in some geographic areas. The brunt of the restraint falls on other credit-dependent sectors, and, as the dollar has sharply appreciated, increasingly on exporters faced with a less favorable competitive position. Should interest rates decline in response to weakness in the economy, many of those sectors would likely, and rather promptly, rebound.

In a longer time frame, the outlook for interest rates will depend importantly on confidence that inflation will be controlled, and on actual progress toward greater price stability, as well as such factors as the Federal deficit. Differences of opinion about these matters help to account for the relatively wide range of forecasts now characteristic for the period ahead, including those set forth by members of the FOMC. (Table III sets forth the range of those projections.)

I cannot fully resolve all those uncertainties in the outlook for you this morning. What does seem clear to me is that progress on inflation is a prerequisite for lasting improvement in financial markets, and for sustained, balanced growth. I can also emphasize the policies that seem to me necessary to speed the transition to more equable financial markets and to a more prosperous, productive economy generally.

First, as I have already indicated, curbing inflation will require persistent restraint on the growth of money and credit. An attempt to escape from high interest rates and strains on financial markets and institutions by abandoning that restraint would be self-defeating. By encouraging expectations of more inflation, that approach would soon stimulate even more borrowing, further reduce incentives to save, and ultimately result in still higher interest rates and more economic difficulty. You and I know that, after a decade and more of disappointment, there is persisting skepticism and doubt about the ability of the nation to persevere in an anti-inflation program. I believe that skepticism is unwarranted, but we must make that claim good by our actions. Indeed, sustained monetary restraint, by encouraging greater confidence in the price outlook, will in time help bring interest rates lower.

Pressures on financial markets can also be relieved by actions from other directions, entirely consistent with the anti-inflation effort and the longer-run needs of the economy. Specifically, government deficits and credit programs absorb a large fraction of our available limited savings. You are well aware that the Administration and the Congress are hard at work on both sides of that question. It requires a difficult balancing of priorities. Some forms of tax reduction are justified by the need to improve incentives and to reduce costs. But if we are to be convincing in our efforts to reduce the deficit at the same time, Congress will need to maintain and even intensify the courageous effort to reduce the upward trend in spending.

Monetary restraint implies that the growth in the current value of our output -- the nominal GNP -- will also be restrained. To the extent that restraint falls on prices, the more room there will be for the growth in real output we want. I have already suggested that the recent improvement in the price performance has some elements that we cannot count on continuing. But, along with the present slack in many labor and product markets, the more encouraging price data certainly helps create a more favorable setting for changing the fundamentals of pricing policy and wage behavior in ways that can be sustained.

A bulge in labor compensation early this year, and continuing large increases in unit labor costs, have reflected in substantial part a "catch up" in wages after last year's large rise in the consumer price index, as well as sizable increases in the minimum wage and social security taxes. These sources of pressure should be much diminished or absent in the period ahead. Intensified by the appreciation of the dollar, there are also strong competitive incentives domestically and internationally, on important industries to control costs.

In these circumstances, there is a compelling logic, from an overall economic view, in looking toward a sense of greater caution and restraint in both wage and pricing behavior. What is at issue is the extent to which that need will seem equally compelling, viewed from the specific shop floor or the individual executive suite. These decisions are, of course, made continuously in the non-union sector of the economy, but a crucially important round of union wage bargaining begins next January, potentially setting a pattern for several years ahead.

That is one reason why we need to be clear and convincing in specifying our monetary and fiscal policy intentions, and their implications for the economic and inflation environment. Without room for financing both high levels of inflation and strong growth, inflationary behavior by individual firms can jeopardize markets, jobs, and profits.

The lesson already seems apparent in some key industries. Government can and should help directly by removing unnecessary regulatory burdens, and by reviewing laws and practices that actually inhibit competitive pricing and add to costs. I believe it can also help indirectly by making clear that industries suffering from problems of their own making are not entitled to new governmental protection.

What this all adds up to is that we are at a critical point in the fight on inflation.

We see the first stirrings of progress in the recent data.

With enormous effort, the Administration and the Congress are moving together to attain control of spending. We all know much remains to be done for future years, but the unparalleled effort bodes well for the future. With a full measure of success, the most urgently needed tax reduction can be responsibly reconciled with reduced deficits.

We in the Federal Reserve are committed to reducing growth in money and credit.

There is, I believe, a genuine urge to let the competitive marketplace work, and to review government practices that unnecessarily add to costs or limit competition.

These policies can and will be effective. But if they are to work, they must be sustained with conviction. Then, the apparent reluctance of many to bet on reduced inflation -- in financial markets, in wage bargaining, in pricing, and in other economic decisions -- will change. As they do, the unwinding of the inflationary process should be much easier.

In a real sense, the hardest part of the job faces us now and in the months immediately ahead. We must demonstrate our ability to carry through on our good intentions -- not just in monetary policy, but in the fiscal and other areas as well.

I have talked at some length this morning about the technical aspects of monetary policy and our numerical targets for the various monetary aggregates. I have reemphasized why the Federal Reserve must be and is determined to avoid excessive growth in money and credit. I have stressed the key role other policies, including budgetary restraint, must play if we are to make real progress toward price stability and relieve pressures on financial markets.

That may all seem abstract and even singleminded, given the pressing problems of the real world.

For far too long, we have not had acceptable economic performance. The average worker has found his or her real income growing slowly if at all. The overall unemployment rate, high as it is, does not reflect the intensity of the problem for some groups and areas, and the burden too often falls on those least able to bear it. Interest rates are at extraordinary levels.

We in the Federal Reserve are acutely aware of these problems. We do not restrain money and credit for its own sake, or simply because inflation is an evil in itself.

Financial discipline is a means to an end. It is an essential part -- if only a part -- of strengthening our economy so that productivity and living standards can rise and worthwhile jobs can be found, not just for a few months, but for the longer period ahead.

Table 1

GROWTH RANGES AND ACTUAL GROWTH IN MONEY AND CREDIT
(All data percent at annual rates)

	Growth Ranges	Actual	
	1980_{Q4} - 1981_{Q4}	1980_{Q4} - 1981_{Q2}	1980_{Q4} - Latest Data
M1-B*	3-1/2 to 6	2.2	2.6 (July 8)
M2	6 to 9	9.5	8.7 (June)
M3	6-1/2 to 9-1/2	11.5	11.1 (June)
Bank Credit	6 to 9	8.9	8.7 (June)

*Adjusted for shifts into NOW accounts. The range for recorded M1B associated with the "shift-adjusted" M1B range at the start of the year was 6 to 8-1/2 percent. Actual growth in that measure from 1980_{Q4} to 1981_{Q2} was 6.8 percent at an annual rate. With NOW account growth larger than anticipated at the beginning of the year, the divergence between the recorded and shift-adjusted data should be slightly greater than anticipated at the start of the year.

Table 2

GROWTH RANGES AND ACTUAL GROWTH OF MONETARY AND CREDIT AGGREGATES
(Percent changes, fourth quarter to fourth quarter)

	M1-A	M1-B	M2	M3	Bank Credit
Growth Range for 1980	3-1/2 to 6	4 to 6-1/2	6 to 9	6-1/2 to 9-1/2	6 to 9
Actual 1980	6-1/4[1]	6-3/4[1]	9.6	10.2	8.0
Growth Range for 1981	3 to 5-1/2[2]	3-1/2 to 6[2]	6 to 9	6-1/2 to 9-1/2	6 to 9
Growth Range for 1982	n.a.	2-1/2 to 5-1/2[3]	6 to 9	6-1/2 to 9-1/2	6 to 9

1. Adjusted for unanticipated transfers into ATS and other similar accounts from other assets.
2. Adjusted for shifts into NOW accounts.
3. Assumes negligible impact of shifting into NOW accounts.

Table 3

FOMC MEMBERS' ECONOMIC FORECASTS

	Actual 1980	Projected 1981	Projected 1982
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.4	10 to 11-1/2	9-1/2 to 12-1/4
Real GNP	-.3	1 to 3-1/2	1 to 4
Implicit GNP deflator	9.8	7-1/2 to 9	6-1/2 to 8-1/2
Average level in fourth quarter			
Unemployment rate (percent)	7.5	7-1/2 to 8-1/4	7 to 8-1/2

The CHAIRMAN. Thank you.

Mr. Chairman, you recall I recently sent you a letter expressing my dismay and my concern over the lines of credit that have been obtained by various corporations to engage in the monopoly game going on to purchase Conoco. At that time, we were looking at $35 billion worth in lines of credit. Since then, you testified before the JEC and stated that, well, this is not too much concern, because only one bidder will be successful.

However, subsequent to your testimony, we find that Gulf Oil has obtained a $5 billion line of credit, and they ain't telling who their target is. Rumor has it that their target is City Service.

Then lo and behold, Pennzoil has a $3 billion line of credit. And they stated they really don't know who they want to take over, but they figure they want to get into the act. They want to play the game.

Now, as a matter of fact, Mr. Chairman, I think that the subsequent events, following your testimony before the JEC should give rise to further real concern. No. 1, these funds aren't being put into any productive capacity. During the period of time that these lines of credit exist this denies credit to other people. We are talking here about $35 billion last week, and now $40 billion tied up. Money supply growth last Friday was $9 billion, and yesterday the market dropped 18 points and the bottom fell out of the bond market.

My guess is, subsequent to your testimony before the JEC, when we look at what is happening in this game of monopoly and mergers, and the urge to merge, don't you feel, don't you think that this is becoming a serious situation? And doesn't this have a dramatic effect on the interest rates that the small businessman and the potential home purchaser and the automobile purchaser are forced to pay?

Mr. VOLCKER. I believe I expressed some concern about the matter last week, Mr. Chairman. One has to wonder what accounts for this great flurry of takeover bids or financing in preparation for such bids. This month, all of a sudden, so many billions of dollars are potententially involved, even though so much of these commitments potentially are duplicative. Why does this all go on now when these didn't look like such good deals 1 month ago or 2 months ago or 3 months ago? This raises some concerns as to ordinary banking practices: How much financing goes on how quickly without, perhaps in all cases, knowing what purpose the money is used for?

This activity does raise that kind of question. I think it is true that a lot of these lines of credit may not be drawn on because they may have the same company as target. I think it is also generally true that in this kind of a situation the money does not leave the market. If it is drawn upon, someone is buying a company from somebody else who then has the money to put back in the market. There is always the question of what is a justified and a productive merger.

The CHAIRMAN. Isn't some of this money coming in from Europe? That is my understanding. Doesn't that affect your attempts for monetary control?

Mr. VOLCKER. Some of it can come from abroad potentially. These international flows of funds are large, in any event. This is a particular avenue through which funds flow across national borders, but that is going on all the time anyway. These dollar markets are very well connected, and these are to the best of my knowledge, dollar loans, impacting on dollar markets, worldwide. I don't think that you can make a distinction between the international and domestic impact, but it is certain that some of the money is coming from foreign banks, rather than from domestic banks.

The CHAIRMAN. You stated that there is a question in your mind as to why this is happening. Does it not occur to you that it might be as a result of the policy of benign neglect that has been announced by the Department of Justice with respect to antitrust cases from here on in? And don't you think that these tremendous takeovers do impact on your attempt to control the money supply and to have an effective monetary policy? Although you are an independent agency, don't you think you should consult with the administration on this new attitude they are taking and the effect it is having?

Mr. VOLCKER. I would not want to suggest that the impact on monetary policy or the credit markets at this point has been of such a degree that we could even isolate it. There are a lot of commitments, as you pointed out. I know of only one large one that has actually been drawn upon, with the money employed. That money has been placed back in the market; it is not typical to draw down a bank loan and put the money back in the market, so the net impact on the credit markets is more limited than the usual case.

But there are questions that arise out of this general degree of flurry. It raises the old questions that have been with us a long time, about the treatment of equity investment. Our treatment of savings and investment has not been kind in the Tax Code, generally, but I think it is particularly adverse so far as equity investment is concerned.

As a result, you get relatively depressed equity prices which may help create conditions that make some of these takeovers attractive. There are a lot of issues that arise when you look at the situation.

The CHAIRMAN. Mr. Volcker, I look at a chart—I think it is out of the New York Times—under the urge to merge. It says from January to June 1981, $35.7 billion has already been expended on major corporate mergers, $35.7 billion.

Mr. VOLCKER. I don't know where those figures are from. We have tried to identify, in the recent banking figure, how much bank loans have been going up due to large takeover situations; we have not been able to identify very much. There is some increase, but not a very large figure so far. My impression is that these announcements in the press recently of large amounts are for commitments and not actual drawdowns.

The CHAIRMAN. These are actual drawdowns. I would like to include my recent letter to you, and several articles, because my time has expired.

[The referred-to letter from Chairman St Germain and newspaper articles follow:]

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SEVENTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

July 15, 1981

Honorable Paul Volcker, Chairman
Board of Governors
Federal Reserve System
Washington, D. C. 20515

Dear Mr. Chairman:

As you know, the pages of the newspapers have been filled in recent weeks with reports of multi-billion dollar financings involving the takeovers of large corporations. One publication referred to the activity as "mob psychology" that promises to generate more billion dollar credits.

Among the activity have been lines of bank credit approaching $15 billion and centered on maneuvers involving oil and gas mergers, including the highly publicized efforts to acquire Conoco. Texaco is reported to have received bank credits totalling at least $5.5 billion; Mobil $5 billion; Shell Oil Company $3 billion. A number of other multi-billion dollar credits apparently are being processed in this takeover mania.

Such activity would require close scrutiny at any time, but at a time of highly restrictive monetary policy it is particularly questionable. Many areas of the U. S. economy, particularly housing and many sectors of the small business community, are at near collapse because of a severe shortage of credit -- a shortage clearly not shared by the huge oil companies who desire funds for an international game of monopoly.

It is interesting, and a somewhat sad commentary on our priorities, to note that the credit extended by commercial banks to just two oil companies -- Mobil and Texaco -- for merger activity almost equals the $11 billion in budget reductions this Committee is required to make in assistance to housing programs for low and moderate income families in FY 1982.

This Administration and the Federal Reserve insisted on pursuing a tight money, high interest policy and have asked, in effect, that everyone in the economy "bite the bullet" in fighting inflation. Public support for such a policy requires, at a minimum, a perception that everyone is sharing in the hardship. Anything less destroys public confidence. These huge multi-billion dollar extensions of credit for non-productive international oil and gas takeovers are bitter pills for small business people who face bankruptcy because of a lack of credit on reasonable terms.

The Federal Reserve and this Administration cannot escape responsibility for the imbalance that is so clearly apparent in the credit markets. While I am sure there are lengthy dissertations available about the limits of the Federal Reserve's authority, I do know that it is possible for you and the other members of the Federal Reserve Board to make it clear to the nation's money center banks that this is a very inappropriate moment for huge chunks of the nation's available credit to be used for corporate takeovers and other non-productive purposes. The Federal Reserve has many implied powers and no banker will ignore a clear signal from the nation's central bank. If the Federal Reserve wants to put an end to the "mob psychology" of corporate takeovers fueled by unlimited bank credit, it clearly has the power and influence to do so.

Sincerely,

Fernand J. St Germain
Chairman

(New York Times, July 19, 1981)

Clarifying Some Mixed Signals on Antitrust Law

By ROBERT PEAR

WASHINGTON — When officials from the antitrust division of the Justice Department met with staff attorneys last week, they had to correct some misunderstandings about the Reagan Administration's antitrust policy.

Abbott B. Lipsky Jr., a deputy assistant attorney general, said the lawyers were getting "woefully incorrect signals" if they thought that William F. Baxter, the Assistant Attorney General for antitrust, was "soft on enforcement." With corporate mergers sweeping the business world — the bidding for Conoco in recent weeks is the most dramatic example — Mr. Baxter and Mr. Lipsky emphasized that the Administration was not flashing a green light to all such takeover bids.

The signals were, however, easy to misread. Mr. Baxter and Attorney General William French Smith have been promising a policy more sensitive to concerns long expressed by business. Last month, Mr. Smith vowed to root out "misguided and mistaken concepts" that discourage competition in the name of promoting it. "Bigness in business does not necessarily mean badness," he said; "efficient firms should not be hobbled under the guise of antitrust enforcement."

Two other Reagan appointees sounded similar themes last week. John S. R. Shad, the chairman of the Securities and Exchange Commission, said that corporate mergers were often healthy for the economy, because they facilitated capital formation. And Treasury Secretary Donald T. Regan said he was not particularly concerned about mergers involving big oil companies or financial institutions. "Let's face it," he said, "our economy is growing, our nation is growing and the world is growing. So why shouldn't companies grow?" Last week, the Mobil Corporation, the nation's second largest oil company, joined Du Pont and the Seagram Company in the bidding war to acquire Conoco, the nation's ninth largest oil company.

Federal officials have substantial latitude in enforcing antitrust laws. The language of the major statutes is broad, even vague. Moreover, antitrust policy usually depends heavily on economic analysis and often expresses a social or political philosophy on the ownership and control of the nation's productive assets. Many people, such as Mr. Baxter, see economic efficiency as a primary purpose of the antitrust laws. Others take a populist view, contending that the laws were designed to protect small businesses from the predatory practices of giant competitors.

Principle and Practice

Avoiding novel interpretations of the law, the Reagan Administration is taking antitrust enforcement back to basics, focusing on corporate activity to which liberals and conservatives both object. What this means, in practice, is continued vigorous prosecution of "horizontal" price-fixing and other restraints of trade by companies that would ordinarily be competitors — but much less opposition to "vertical" restraints, that is, arrangements between one company and another in its production, supply or marketing chain. Horizontal restraints, the classic type of cartel behavior, artificially restrict output and raise prices to consumers. There is less agreement about the consequences of vertical arrangements.

This month, the Justice Department dropped a civil suit against Mack Trucks Inc., which was accused of conspiring with independent distributors to fix the prices of parts. The arrangement failed to meet Mr. Baxter's test for illegal vertical restraints: It did not facilitate collusion and did not have any "horizontal effects," he said.

Some critics, such as Lawrence Anthony Sullivan of the University of California at Berkeley, say the Administration approach apparently represents a decision not to enforce a well-established area of the law. Mr. Sullivan said that Administration officials "are trying to turn antitrust law into applied Chicago School economic theory and, in so doing, have drastically oversimplified many problems." However, Donald F. Turner, chief of the antitrust division under President Johnson, said that "Mr. Baxter is a very tough fellow and he's not there to sell antitrust down the river."

The perception of a more favorable climate in Washington is widely believed to be a factor in the current "merger mania." The future course of the Federal Trade Commission, an independent regulatory agency that shares responsibility for enforcing the antitrust laws, is harder to predict.

President Reagan has nominated James C. Miller 3d, executive director of the Presidential Task Force on Regulatory Relief, to be chairman of the five-member board. David A. Clanton, the acting chairman, said recently that the agency, while not shying away from big cases, would try to define its legal theories more clearly. Last month, staff lawyers recommended that the commission drop its eight-year-old antitrust case against the country's eight biggest oil companies.

The outcome of the Justice Department's biggest case, to break up the American Telephone and Telegraph Company, may be the ultimate test of the Administration's antitrust policy. Mr. Baxter has immersed himself in the case and vowed to "litigate it to the eyeballs."

Defense Secretary Caspar W. Weinberger and Commerce Secretary Malcolm Baldridge would be happy to see it dropped. The Pentagon regards the existing telephone network as an asset to national security. The Commerce Department wants to end uncertainties in the communications industry and strengthen its ability to meet foreign competition. Mr. Baldridge is among those who say that Congress, rather than the courts, is the proper forum in which to decide the future structure of the industry.

The Senate Commerce Committee last week approved landmark legislation to deregulate and restructure the telecommunications industry. The Justice Department is opposed to any measure that would change the status of A. T. & T. before the antitrust case is resolved, but Mr. Baldridge has endorsed the "general thrust" of the bill.

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The urge to merge

	Number of corporate mergers and acquisitions completed or pending	Dollar volume of major acquisitions (in billions)	Number of mergers and acquisitions where purchase price was $100 million or larger
1975	2,297	$11.8	14
1976	2,276	$20.0	39
1977	2,224	$21.9	41
1978	2,106	$34.2	80
1979	2,128	$43.5	83
1980	1,889	$44.3	94
1981*	1,184	$35.7	55

*Jan. to June

Source: W.T. Grimm & Co.

(New York Times, June 3, 1981)

Credit Needs Cited For Oil Industry

LONDON, June 2 (Reuters) — The petroleum industry will require more than $700 billion from world credit markets in the 1980's to meet oil demand, according to a Chase Manhattan study released here today.

This would possibly force some economic dislocations and continued upward pressure on interest rates, Patrick Keenan, a bank vice president for energy economics, said in the study prepared for a Financial Times energy meeting.

The study said oil would remain the dominant energy source, and predicted that crude prices would rise at about 3 percent above inflation to reach $102 a barrel by 1990.

Oil industry capital investments would grow 17 percent, reaching a cumulative total of $3.2 trillion by 1990, the study said.

Expected strong net income growth would allow the industry to finance 73 percent of capital requirements from internal cash flow, with the balance generated by borrowing, the Chase study said.

(Wall Street Journal, July 7, 1981)

Merger Mania

High Borrowing Costs Fail to Stem Interest In Takeover Activity

Cash-Laden Oil Firms Are Both Buyers and Targets; Bolder Corporate Tactics

Not Just Shedding a Turkey

By TIM METZ and BILL PAUL
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK—As every professional on Wall Street knows, or used to know, sky-high interest rates sharply restrict corporate-merger activity.

When interest rates began to spiral in early 1980, savvy investment bankers and takeover lawyers predicted an end to the acquisition binge that began in the mid-1970s. One law firm that specializes in mergers, Skadden, Arps, Slate, Meagher & Flom, even accelerated its diversification to lessen its reliance on takeover activity.

But as this week's merger news indicates, the professionals were wrong. Despite the high costs of money, with the prime lending rate around 20%, the merger mania is becoming even more manic. Du Pont Co.'s agreement to acquire Conoco Inc. in a record $6.9 billion transaction came on the same day that Societe Nationale Elf Aquitaine of France increased its offer for Texasgulf Inc. to $2.74 billion.

W. T. Grimm & Co. of Chicago, a merger broker that keeps track of acquisition announcements, says second quarter activity kept pace with the first quarter, when corporate purchases set a record of $17.5 billion, up from $7.2 billion a year before. Tomislava Simic, Grimm's research director, says, "There's every possibility that the full-year 1980 record total of $44.3 billion will be surpassed by the end of the third quarter."

Many mergers in the current wave are undertaken by oil companies that have large cash reserves from recent record profits. Some other oil companies, such as Conoco, are takeover targets because chemical companies and other large oil consumers want to avoid another shortage like the one they endured in the 1973 oil embargo.

Borrowed-Money Mergers

But many of today's mergers rely on high-priced borrowed money. Du Pont, for instance, said it will borrow $3 billion from a group of banks, although the terms weren't disclosed. The reasons for many of these mergers are less clear.

Merger specialists, however, have some theories about why the merger activity remains so brisk with interest rates so high:

—Long-term corporate strategies have become bolder as expectations of continued high inflation rates have become entrenched.

—Corporations and merger experts have become more familiar with, and more amenable to, takeover tactics, even if the acquisitions are hostile.

—Companies paying high rates now to finance their acquisitions hope to refinance the loans if rates fall as expected.

—Foreign buyers are getting in on the act because of the relative stability of the U.S. economy.

—Prices of some oil and natural-resource takeover targets are bargains now compared with a year ago.

—The antitrust climate is more favorable under the Reagan administration (see story in column one).

—And, according to one expert at least, the big acquisition has become a way for chief executives nearing retirement to leave their mark on the corporation.

Oil Companies' Activity

Whatever the reasons, the beat goes on. Wall Street insiders say that a number of eager buyers, led by cash-rich foreign companies and U.S. oil giants, are close to announcing other big takeover plans.

Texaco Inc., which ended the first quarter with $3.6 billion of cash, is widely rumored to have just arranged a $5 billion line of credit for an acquisition. Since its merger with Conoco was rebuffed last week, rumors about Texaco's possible target now center on Cities Service Co., but neither company will discuss the matter.

No one on Wall Street is sure that Standard Oil Co. of California has given up its designs on Amax Inc., the big mining concern, despite its recent withdrawal of a $4 billion bid that Amax shunned.

And Seagram Co. of Canada, with more than $3 billion of cash and cash-equivalent assets on hand, seems certain to make a major acquisition soon, following its presumed loss to Du Pont in the high-stakes bidding for Conoco.

The Reagan Role

The prominent role of big oil companies in the merger wave largely reflects the more favorable investment climate under the Reagan administration. Moreover, many oil companies, laden with cash from record profit levels, are rethinking their long-term corporate strategies with an eye toward more diversification.

Oil-company profits have surged since the hefty oil-price increases instituted by the Organization of Petroleum Exporting Countries and President Reagan's decontrol of U.S. petroleum prices.

Until recently, the oil firms didn't have many investment opportunities because almost everything they looked at raised antitrust questions. But last month, Federal Trade Commission prosecutors advised the commission to drop its seven-year-old antitrust case against the nation's eight largest oil companies, a suit that some lawmakers had hoped would lead to the breaking up of the oil giants.

That move, plus other indications by the Reagan administration of a more relaxed antitrust stand, has prompted oil companies to become acquisition-minded again. In fact, Wall Street oil analysts say Conoco and Texaco wouldn't have discussed a possible merger last week unless they felt there wouldn't be an antitrust problem.

The improved investment climate in the U.S. contrasts sharply with the Canadian climate. The Canadian government is seeking greater control over U.S. companies' operations there. U.S. oil executives are increasingly trying to shield themselves from all foreign interference, especially in the Mideast.

Their approach generally is to strengthen oil and natural-gas holdings in the U.S. This has led to an unprecedented amount of domestic drilling and also to an unprecedented courting of companies with promising landholdings for oil and gas exploration. Companies considered to be such takeover targets include Texas International Co., Pogo Producing Co., and Louisiana Land & Exploration Co. Spokesman for all three denied their companies are involved in any merger talks.

Oil companies also want to diversify, to become "natural resource" companies with mineral holdings as well. This had led to the acquisition of a number of mining firms by oil companies, and continued speculation about several others.

"I'll be surprised if there are any independent mining companies left by the end of the year," says Donald W. Mitchell, a Boston-based management consultant, only half-kiddingly.

Cash-Rich Companies

Among the oil companies that have billions of dollars in the till, plus the ability to raise billions more in credit markets, are Exxon Corp., Mobil Corp. and Standard Oil Co. of California. Texaco Inc. also has cash, and many oil analysts are betting Texaco will buy somebody before long. "They (Texaco) look like they're in the mood," says Arthur Smith, an oil analyst at First Boston Corp.

Bache Halsey Stuart Shields Inc., a unit of Prudential Insurance Co. of America, yesterday began circulating to its brokerage customers a list of oil-company stocks that it said may benefit from future takeover bids. Included on the list: Marathon Corp., Cities Service Co., Kerr-McGee Corp., Pennzoil Co., Union Oil Co. of California and Sun Co.

Another aspect to the merger wave is what analysts refer to as "backward integration." That's when a company such as Du Pont, which relies heavily on petroleum as a feedstock, acquires its own source of oil, in this case Conoco. Elizabeth Sospenso, an oil analyst at Thomson McKinnon Securities Inc., thinks pharmaceutical and textile companies may also try for backward integration, though she believes some other big chemical firms—Celanese and Allied Corp., for example—are in a better cash position to make an acquisition. Allied's stock price spurted up $5 yesterday afternoon, but the company said it didn't know why.

Foreign interest in U.S. investments is also evident in the acquisition boom. Worries about the newly elected Socialist government in France and about unrest in Poland and the Mideast have spurred European companies to step up their acquisitions in the U.S., where conditions are relatively stable, investment bankers say.

Figuring the Cost

The high cost of borrowing to finance mergers has certainly had an effect, although it hasn't seemed to slow the stampede.

"Managements a few years ago estimated the long-term cost of money at anywhere between 8% and 10%," says Eric Gleacher, the head of the mergers and acquisitions department at Lehman Brothers Kuhn Loeb Inc., which is having a record year in the merger-advisory business. "Now they're routinely calculating it at around 15%." Yet, rather than pull back, "they are raising their requirements for the growth rate of potential acquisition targets," Mr. Gleacher says.

Executives also look for a decline in long-term interest rates. "You can't justify borrowing at 20% to do a deal when your long-term money-cost estimate is 15% unless you think that the acquisition borrowings can be refinanced later at a lower cost," says Barry Friedberg, the mergers and acquisitions director of Warburg, Paribas, Becker Inc.

(Wall Street Journal, July 14, 1981)

Merger Boom Finds Bank Loans Plentiful, Sparking Fear on Credit Markets' Health

By DANIEL HERTZBERG and TIM METZ
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK—Wall Street's latest merger boom has found banks willing to open their credit spigots wide, and some fear the credit markets could be flooded.

Some economists and nonbankers say heavy borrowing could conflict with President Reagan's economic program by keeping interest rates high and diverting funds from investment in new productive facilities. They also say the high rates could cause trouble for other borrowers.

There "could be a crowding out" of less-creditworthy companies if acquisition-minded concerns exercise their credit lines and later refinance at lower rates in the bond market, said Thomas S. Johnson, executive vice president at Chemical Bank.

Undaunted by high borrowing costs, players in the merger game already have lined up more than $20 billion in bank lines of credit. Du Pont Co. and Seagram Co., battling for control of Conoco Inc., each has a $3 billion credit agreement with U.S. and international banks.

Conoco has lined up its own $3 billion bank line, which would allow it to buy its own stock to keep away from unfriendly suitors. It also could use the funds to make an acquisition that might make it less attractive to its suitors.

Mobil Corp., indicating it's ready to join in the Conoco bidding, said yesterday that it was arranging for bank credit through a syndicate led by Citibank. The amount wasn't disclosed.

Texaco Inc. last week arranged a $5.5 billion credit line, which it reportedly hopes to use to buy Conoco or another major concern, possibly Cities Service Co.

Among the other companies making loan arrangements, Societe Nationale Elf Aquitaine has a $1.9 billion credit to help finance its acquisition of Texasgulf Inc. Canada Development Corp. has a $1.75 billion line to finance its planned purchase of Texasgulf's Canadian assets in conjunction with the Elf

MAJOR CREDIT LINES

COMPANY	CREDIT ARRANGED	BANKS
Conoco	$3 billion	Syndicate led by Bank of America, Chase Manhattan Bank and Morgan Guaranty Trust Co.
Seagram	$3 billion	31 North American and European banks led by Citibank, Manufacturers Hanover Trust and Bank of Montreal
Elf Aquitaine	$1.9 billion	20 U.S. and Canadian banks
Texaco	$5.5 billion	Syndicate led by Chase Manhattan Bank
Du Pont	$3 billion	Syndicate led by Chase
Pennzoil	$2.5 billion	Syndicate led by Citibank
Canadian Development	$1.75 billion	Syndicate led by Bank of Montreal, Bank of Nova Scotia and Royal Bank of Canada

Aquitaine transaction. Pennzoil Co. said it arranged to borrow $2.5 billion so it could take advantage of any sudden acquisition opportunities.

"There are certainly large companies around that can line up amounts in excess of a billion dollars in a day's time," Mr. Johnson said.

Some analysts say the surge in takeover lending comes at a difficult time for the credit markets, which have faced near-record interest rates recently. Business demand for short-term credit has been heavy, with borrowings from banks and the commercial paper market growing at a steamy 30% annual rate in the past eight weeks.

Large takeover loans "add to the upward pressure," warns Lacy Hunt, chief economist at Fidelity Bank, Philadelphia.

The loans also could complicate the Federal Reserve Board's task of controlling the money supply, experts say. In making a loan, a bank simply credits a borrower's account, adding that amount to the money supply unless it is offset in some fashion.

Many of the loan commitments are being booked in overseas bank branches, including the $3 billion credit line Seagram arranged last year and Texaco's $5.5 billion line. Lenders have increasingly sought Eurodollar loan arrangements because the rates are currently lower than U.S. prime, or base, rates. Bankers like the arrangement, too, because such loans in some cases don't have to be backed with reserves, as domestic loans must be.

Some business officials say the takeover lending commitments also are exacerbating the U.S. housing industry's trouble arranging loans.

William C. Smith, a Pittsburgh real estate developer and home builder who has been following U.S. funds flows closely during the past two years, complained that "our economy is shipping out its savings dollars for use by the likes of Seagram and Texaco in takeover loans."

Money transfers, he contended, are siphoning dollars from U.S. thrift institutions to Eurodollar deposits, which in turn are being lent to both foreign governments seeking to finance their budget deficits and to big multinational corporations on an acquisition binge.

Last year, in imposing short-lived credit controls, the Fed warned against loans for such "unproductive" purposes as takeovers where a clear growth in earnings power wasn't likely. However, proponents of mergers point to economies of scale and potential productivity growth through agglomeration.

"It isn't unproductive investing," said Alan Greenspan, a former chairman of the President's Council of Economic Advisers. "It's basically a restructuring of the ownership of existing assets. And, as such, it neither contributes nor detracts from funds for real investment."

Because some suitors are seeking the same corporate bride, many of the credit lines may never be used, and bankers say the size of the lines is deceptive anyway.

"The accumulation of the bidders makes the number look astronomical," said William Griggs, senior vice president at J. Henry Schroder Bank & Trust Co. But he insisted that in the vast sea of U.S. and international credit markets the latest takeover loan commitments represent just "a ripple, not a tidal wave."

(New York Times, July 14, 1981)

Chase and Citibank Help Raise Billions In Takeover Stakes

By ROBERT A. BENNETT

When it comes to raising really big money, the nation's largest corporations have been coming home to their traditional bankers, Chase Manhattan and Citibank.

Over the last few weeks, these two banks have arranged to raise almost $19 billion for a handful of companies seeking to acquire other large companies or trying to stave off such acquisitions.

Only a month ago, a $1 billion line of credit was considered to be extraordinary. But since early this month, credits of $5.5 billion have been arranged for Texaco, $5 billion for Mobil, $3 billion each for Conoco and Du Pont, and $2.5 billion for Pennzoil. And it was learned yesterday that the Cities Service Corporation, a takeover target, has begun to arrange a credit of about $1 billion.

With the exception of the Conoco deal and the Cities Service loan, still in the early stages, Chase and Citibank have received the mandates for pulling the giant credits together, although most of the financing is expected to come from foreign banks.

'A Worldwide Effort

And even in the Conoco transaction, Chase is one of three co-managers, together with the Bank of America and the Morgan Guaranty Trust Company. As of yesterday, according to banking sources, it appeared that Morgan would be chosen to lead the Cities Service syndicate, but it was not yet certain.

"Credit, especially in large amounts, calls for a worldwide effort," said the treasurer of a leading oil company, who asked not to be identified. "We need a bank that is entirely capable on a global basis," he added. "It has to have the kind of staff that can handle the huge amount of paper work, and it has to be a bank that has done this kind of thing before."

When the Houston-based Pennzoil Company decided to raise $2.5 billion, it turned to Citibank, one of a handful of banks with which it has had a close relationship. "The managing bank has a sizable oil, gas and mineral department," said J. Hugh Liedtke, Pennzoil chairman, in a phone interview yesterday. "Citibank is known to be outstanding in that area."

Within the oil business, Chase Manhattan has at least as strong a reputation. Thus, Chase was named to lead the Texaco credit, even though Morgan traditionally has been Texaco's lead bank. Some banking sources report that officials at Morgan were incensed that they had received only a $50 million chunk of the $5.5 billion Texaco deal. Morgan declined to comment yesterday, saying that its policy forbids it to discuss individual clients.

Bank of America is the largest bank in the United States. Citibank is second, with Chase third, Manufacturers Hanover fourth and Morgan fifth.

Fed Regulations a Factor

Although the lead banks and the companies involved are American, it is estimated that foreign banks will supply most of the money. This is because Federal Reserve regulations, which apply to all major American banks, prohibit them from lending more than 10 percent of their capital and surplus to any individual borrower. Thus, at present, the most that the 50 largest American banks, combined, can lend to any one customer is $3.9 billion, far less than the amounts being sought by Texaco or Mobil.

Most foreign banks do not have lending limit restrictions, nor many other rules that bog down American banks. In the recent loans, for example, it generally took only a few hours for the foreign banks to respond to a request to join the syndicate, while it usually took at least a day for an American bank.

Bankers say that these loans, in

Largest Managers of Syndicated Loans
Based on syndicated bank credits in the first half of 1981

	NUMBER OF LOANS	TOTAL AMOUNT OF LOANS
CHASE MANHATTAN	70	$15.1 billion
CITIBANK	68	$13.3 billion
BARCLAYS BANK	37	$11.2 billion
BANQUE NATIONAL [illegible] PARIS	30	$11.1 billion
MANUFACTURERS [illegible] OVER	56	$11.1 billion
BANK of AMERICA	52	$10.8 billion
BANK of TOKYO	59	$10.8 billion
J.P. MORGAN & COMPANY	39	$10.7 billion
ARAB BANKING CORPORATION, London	34	$ 9.5 billion
BANK of MONTREAL	27	$ 8.3 billion

Source: Ageli — International Bondletter and Eurocurrency Financing Review, London

themselves, are not lucrative for the banks. They contend that participating banks do so either to protect their current business with the borrower or to develop new business.

On its eight-year, $5.5 billion loan, Texaco would have a number of options concerning the rate on the loan. It could pay the prime rate, now 20½ percent, or three-eighths of a percentage point above the cost to banks of borrowing in foreign markets. After the fifth year, this would rise to one-quarter of a percentage point over prime, or one-half a percentage point over the overseas rate.

In addition, the borrowers must pay certain fees. A "management fee" is paid to the managers for putting the deal together. In an ordinary syndication, this is often one-half of a percentage point of the amount borrowed. On a $5.5 billion loan, that could amount to a whopping $27.5 million, but bankers indicated that the actual fee would be far less.

Banks also charge a "commitment fee" on any unused portion of the credit. In the Du Pont loan, this would be one-quarter of a percentage point for the first six months, and three-eighths of a percentage point after that.

In giant loans that are organized rapidly, there also are so-called drop-dead fees that the borrower must pay if it decides not to go ahead with the loan. It is not known how big the drop-dead fee might be.

(New York Times, July 14, 1981)

S.E.C.'s Chief Gives Blessing to Mergers

By JEFF GERTH

Special to The New York Times

WASHINGTON, July 13 — John S.R. Shad, the chairman of the Securities and Exchange Commission, today gave his blessing to the recent wave of corporate mergers and takeovers, echoing the general theme of the Reagan Administration that "bigness in business does not necessarily mean badness."

Mr. Shad's remarks at his first news conference emphasized the role of the S.E.C. in "facilitating capital formation" and contrasted in some respects with the philosophy of his predecessor, Harold M. Williams.

Mr. Williams, while encouraging capital formation, also raised questions during his tenure about whether corporate takeovers diverted credit and capital from more productive and innovative uses.

While Mr. Shad did not comment specifically on recent mergers or takeover offers, such as the contest to acquire Conoco Inc., he did express a "belief" that there is "a net economic gain" in large mergers.

In other remarks, Mr. Shad seemed to be charting for the S.E.C. a course of deregulation with a minimal involvement by the commission in corporate affairs, a continuation, for the most part, of many of the policies of Mr. Williams.

While the S.E.C. has limited jurisdiction over mergers, it does review the adequacy of disclosure statements filed with the commission in connection with acquisitions and Mr. Shad promised to simplify that process by "reducing excessive registration, reporting and other regulatory burdens."

Specialized in Acquisitions

Before his appointment as S.E.C. chairman, Mr. Shad, as vice chairman of E.F. Hutton & Company, specialized in mergers and acquisitions.

Speaking about corporate governance, another issue that Mr. Shad had experience with in the private sector, where he was a director of several public corporations, the S.E.C. chairman questioned the effectiveness of outside directors in reforming corporate behavior.

Mr. Williams had frequently urged corporations to add independent directors, and the enforcement division had sought such relief in many of its cases, but Mr. Shad disclosed today that the commission, under his tenure, was increasingly questioning changes in corporate boards as a sanction in enforcement actions.

He also echoed the priorities of his new enforcement chief, John M. Fedders, by calling for emphasis on the narrower issues of policing the marketplace for fraud, manipulation, abuse of insider information and organized criminal activities.

Meetings With Commodity Aides

Mr. Shad also said that there had been private meetings between top S.E.C. officials and their counterparts at the Commodity Futures Trading Commission in hopes of "quietly" settling jurisdictional disputes.

He called reports of poor morale in the enforcement division since the departure of Stanley Sporkin "exaggerated" and said attitudes would improve when Mr. Fedders takes over next week.

Mr. Shad said the S.E.C. would announce within the next month further simplification of disclosure and registration requirements by the division of corporate finance.

He added that, while the S.E.C. was moving toward more self-regulation by the securities industry, the commission did need to "improve oversight" in the investment company adviser area and fill in gaps in intermarket surveillance.

The CHAIRMAN. Large corporations are able to obtain all the money they wish for prospective bidding wars, yet small businessmen have difficulty getting credit. Has the Federal Reserve studied the differences in impact of current monetary policy on large corporations and small businesses? And if the study has not been undertaken, would you give serious consideration to it?

Mr. VOLCKER. We have attempted to look at that from time to time in the past. It is a difficult area to pin down statistically. We are certainly aware of the problems and complaints of the small businessman as alluded to here this morning. We hear about them every day. Certainly different businesses are impacted differently. I would be glad to supply for the record what information we do have on this, but I will tell you, we don't have right up to date——

The CHAIRMAN. Would you give consideration to attempting another study?

Mr. VOLCKER. We do that more or less continuously. I think we have something underway at the moment. Let me update you on that.

The CHAIRMAN. Thank you.

[Mr. Volcker subsequently submitted the following information for inclusion in the record of the hearing:]

(Response received from Mr. Volcker)

A three-part study is now underway, under the direction of an Interagency Task Force on Small-Business Finance, in response to the following provision of an act (Public Law 96-302) approved July 2, 1980:

> "In consultation with the Administrator of the Small Business Administration and the Bureau of the Census, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency and the Federal Deposit Insurance Corporation shall conduct such studies of the credit needs of small business as may be appropriate to determine the extent to which such needs are being met by commercial banks and shall report the results of such studies to the Congress by January 1, 1982, together with their views and recommendations as to the feasibility and cost of conducting periodic sample surveys, by region and nationwide, of the number and dollar amount of commercial and industrial loans extended by commercial banks to small business. Reports shall, when transmitted to the Congress, be referred to the Senate Select Committee on Small Business and the Committee on Small Business of the House of Representatives."

The first part of the study comprises a group of background papers which are now in final draft. These papers cover a broad range of subjects related to small-business financing, including sources and characteristics of small-business credit, the impact of various laws and regulations, the effect of changes in banking structure, and the relation between firm size and bank lending terms.

The second phase of the study, subject to approval by the Office of Management and Budget, will consist of personal interviews in early fall 1981 with lending officers at a national sample of commercial banks. The proposed survey questionnaire is designed to provide a profile of commercial bank practices and experience with respect to their lending to small business. It asks for information about availability of small-business credit at the bank and in its market area, and about the nonprice characteristics of the bank's small-business loans. It also includes detailed questions about the way the bank prices its loans to small business and how this varies with changes in interest rates generally and how it compares with pricing of loans to large business.

The third part of the study will be the recommendations requested by the Congress with respect to future collection of data on bank loans to small business. They will take into consideration the data needs revealed by the background studies and the information obtained in the survey of commercial banks. In drafting these recommendations, the interagency task force will be examining a variety of options with respect to their feasibility, cost and usefulness.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Thank you.

Mr. Chairman, it has now been about 21, 22 months since October 1979, when you shifted your focus from interest rates to controlling bank reserves. And because of this change of policy, I would be the first to point out that there is a decrease in the rate of inflation. Since you have been given so much criticism today and in the press in general, you should be given credit for that.

But I think there is a consensus that as a result of these operational changes, we see more fluctuation in interest rates than at any other single time. You could say that interest rates have changed maybe in a year or in 1 week, 2 weeks, more than you have in several years. We have had a recent experience of that type of fluctuation in the last week alone.

What you also have seen is a lessening of the historical relationships of interest rates to the rate of inflation. I was taught there is a historical relationship: Sometimes interest rates lag behind the rate of inflation as they did a year ago, or vice versa. Now, of course, you see the interest rates considerably higher, 4, 5, 6 points higher than the rate of inflation.

Also, on that point, one has to be concerned at the actions of last Friday reflected in the marketplace yesterday, when interest rates rose in response to last week's bulge in M_{1-B}. You seem to have made your point all right in regard to the need for controlling bank reserves in that people now take weekly changes in the money supply as gospel. There is more reaction—I will put it that way—more reaction to that weekly number than if we pass an historic reconciliation bill a week from Friday.

It just seems that the market is more concerned in responding to your weekly money supply figures than they are to what the Congress does in terms of budgetary and fiscal policy. My question is: Do you see any change in the weeks or months ahead in this scenario of the volatility of interest rates—will they continue to be as volatile?

Second, what do you think it will take to bring the rate of interest down? This seems to be disputed among many people.

Everybody agrees that certainly interest rates are historically high. What is it going to take to bring interest rates down?

Third, what scenario would you put together where you see interest rates actually coming down?

Mr. VOLCKER. Let me respond to the volatility point first, Mr. Stanton.

I think it is fair to suggest—and in fact it was anticipated—that the operating techniques we now use would create more volatility in the short-term markets. We have certainly had more volatility in the long-term markets as well during this period. But what you cannot distinguish is the volatility that is there as a technical matter—which, while I think is there, I wouldn't want to overemphasize—from the volatility that may be inherent in a period when we are trying—and I think with some early signs of success—to change the very deeply seated inflationary trend that has built up over at least 15 years. You could argue it has existed over 30 or 40 years.

This is a period of unusual uncertainty. What is the price outlook? What does that mean for interest rates over a period of time? I don't think people are totally convinced yet, as I suggested in my statement, that the inflation rate is going to come down. They may be beginning to think that maybe it will; there is a little more hope than before, as I read the situation.

The situation is very volatile in terms of expectations or confidence. That may be inherent after a long period of inflation where everybody became convinced it was just going to go on and on forever. This situation could turn into a period of shaking that conviction, into a period, I hope, of convinction that inflation will decline.

We don't have a firm base of expectations as we had for many years—certainly up until the 1970's and to a degree, through a good part of the 1970's. Until those expectations settle down, until there is more conviction that indeed, inflation will come down, I think the market will be prone to react to very short-term impacts, like last week's money supply figures, which obviously had no significance in terms of the basic inflationary outlook. But the market is looking for something to trade on for the next week, or at least the next 3 days, until it begins worrying about the next week's money figure.

The volatility is a reflection of the underlying uncertainty which is there, but which our policies and hopefully your policies are designed to deal with over time.

What does it take to bring the interest rates down? What it is going to take is basically two things. More confidence that the inflation rate will, in fact, come down; and, more important than that, the evidence that it is coming down. Expectations can have an important influence on interest rates.

I have been looking a little bit at this real interest hypothesis, which I don't want to deny. I think expectations are important in interest rates. Certainly during the postwar period there has been a certain stability in the so-called real interest rate. Part of the problem with that analysis is that it really depends upon what inflationary expectations are, and they are very hard to measure. But if you look back in history, very sizable fluctuations in real interest rates extending over months or even years are not at all unusual.

There is no magic that says that if the inflation rate is 8 or 10 percent this year, and then interest rates will be 12 or 14 percent. If you look at the long sweep of history, they have been all over the lot. I think there should be a tendency toward lower rates, but just how long that tendency takes to develop is what is at issue. We are restraining the supply of money; velocity is going up. That will happen when we have a high rate of inflation and economic growth, and that is normally associated with high interest rates.

The way to get around this obviously, ultimately—the only way to get around it that is at all satisfactory—is to get the rate of inflation reduced. Then we will have enough money to finance real growth at lower interest rates. But I can't wave my hand and have that come about. You can increase the money supply, which presumably will increase the inflation rate and not help at all. Otherwise, you can undertake those policies—monetary, fiscal and others—that are going to reduce the inflation rate, and that is what is going to bring interest rates down.

The only final point is also an obvious one. The bigger the Government deficit, the less money there is for financing small businesses, homebuilders, home buyers, and everyone else in the private economy. So the deficit is an important factor.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman. Welcome, Mr. Volcker, to this Humphrey-Hawkins session in which you have the Federal Reserve's 7 Governors, and its 12 reserve bank presidents, tell us what you think is wrong with the American economy, and we of the Banking Committee are under statutory obligation to declare what we think is wrong.

I note with interest in the issue of this week of U.S. News and World Report, July 27 issue, a statement on page 12:

> The biggest economic puzzle in Washington: Top Reagan economic advisers, as well as officials of the Federal Reserve Board, which manage the money supply, can't figure out why interest rates stay so high while the economy is so sluggish.

Well, I think I can figure it out. It is because the policies of the Federal Reserve System and the Reagan administration are wrongheaded and in violation of the Humphrey-Hawkins Act.

Specifically, there is no reason in my judgment for lowering what were already very tight and austere 1980 targets this year. Yet the Federal Reserve, with full administration support did so, against the recommendation of the Democrats of the Joint Economic Committee. We warned against exorbitantly high interest rates. The warning was disregarded. And now we have what we have.

Second, the administration is now embarked upon a budgetary scenario by which massive and abrupt increases in military spending, and massive and abrupt decreases in tax revenues are going to produce deficits in 1981, 1982, 1983, and far as human eye can see.

I think the Federal Reserve, the 19 officials that I am talking about, have a duty to speak out against that kind of fiscal policy, in which borrowing by the Federal Treasury results in short-stopping savings which would otherwise enhance inflation-fighting investment.

Yet, so far as I know, there hasn't been 1 ounce of criticism or even analysis of the administration's deficit-prone program.

Those who are given independence and don't use it, may not deserve it. I am disappointed that this deficit policy, which is so obvious to the markets and to the friends and allies of the United States the world over, somehow escapes the attention of the Federal Reserve.

The third point in which I think the Fed and the administration are in violation of the Humphrey-Hawkins Act concerns the second half of the element of monetary policy.

The first half is control over the supply of money. I am for that—no criticism of that general principle.

But you also have to look at the demand for money and credit. And the Federal Reserve and the administration haven't been doing it.

The Federal Reserve facilitated the enormous commodity silver speculations of Bunker Hunt. And it continues to sit still for those in similar commodity speculations.

The Federal Reserve has not, so far as I can see, taken any particular interest in the problem that Chairman St Germain raised, the enormous amount of the Nation's credit which is now going to unproductive takeovers and mergers.

Finally, the Federal Reserve remains oblivious of the fact that a large part of America's credit is hijacked and skimmed off by very questionable foreign lending, both in the transmittal of American bank balances to the Eurodollar market, and more recently, in the direct invasion of American regional banks by the big New York banks who skim off their lending power and plunk it down overseas in Eurodollar and Asian dollar markets.

I suggest the Federal Reserve has a duty to look at the demand for money and do something about it, as well as the supply of money. In connection with the merger matter that Mr. St Germain talked about, I know that you tend to pass aside the effect on the diversion of credit by these mergers by saying that these huge sums, $35 billion, was mentioned, of bank funds available for takeovers are just commitments, and that since many of them represent commitments for the takeover of the same company, they won't all be honored. Doesn't that really miss the point? If these commitments are made, in a sum many times what the actual takeover would cost, doesn't that mean that the hard-pressed homebuilder or businessman who wants to put productive investment on line, or the construction borrower or the farmer or the small businessman, doesn't that mean that they can't get the credit?

I wish you'd respond to that. I think the standby is just as bad as an actual loan. Indeed, it is worse, because it immobilizes five times as much.

Mr. VOLCKER. Let me respond as best I can. I must say, at the start, that I don't recognize some of your strictures in terms of what the Federal Reserve has or has not been doing. You do not appear to have any basic disagreement with the idea that we need to have restraint on money and credit.

Mr. REUSS. Right, though I have said that I think you could have let it go at last year's restraint, which brought two points of 20-percent interest rates.

Mr. VOLCKER. We do want to move, and I don't think it would be helpful not to move, in the direction of reduced growth of money, because I don't think doing otherwise would be helpful in terms of conditions in the financial markets or of interest rates over time, as I suggested. I certainly think that we have expressed caution on the fiscal policy side repeatedly.

That doesn't say there isn't a case to be made for tax reduction in particular. But if I have had any theme in my comments to the Congress, it is about the importance of expenditure restraint in order to make tax reduction responsible, and also that the limited amount of funds available for tax reduction should be made as efficient as possible in terms of the legitimate objectives of reduction.

Mr. REUSS. Yes; but it isn't.

Mr. VOLCKER. I think I have spoken out on that repeatedly. So far as the demand for money and credit is concerned, I assure you, we realize that there is a demand as well as a supply, and that constantly preoccupies us.

I think it is a reversal of truth to say our policies have facilitated speculation. I suspect that the movement of prices and conditions in more speculative-prone areas of the economy would prove just the reverse, that our policies have pretty well helped deflate those areas. In the area of foreign lending—and I will get to takeovers in a minute—there is a very big two-way flow of money. I do not have the impression that on balance, American money is flowing out; quite the contrary.

Chairman St Germain referred to the amount of foreign money that may be involved in these takeover situations. But there are many other channels through which foreign money is coming here. And, of course, that has given rise to a certain amount of discomfort and complaint from our trading partners.

On the takeover point itself, I have expressed concern, last week to you and here this morning, about some aspects of this. One of the aspects that would concern me, as I said last week and say again today is, if a very large volume of these commitments are being made rather rapidly, are the banks prudent, and I hope they are. Also those tie up a certain amount of commitment and lending capacity, and can have implications for banks' own internal operations which we have to be concerned about here and abroad as part of our normal supervisory responsibility.

I do not deny that, to some degree, lending of this sort can affect the distribution of credit in the economy. That does not contradict the general point that, to the extent the money isn't drawn down or is drawn down and goes back into the market, the overall balance of credit demand and supply may not be appreciably changed.

But there are still influences on the direction in which that flow is going.

Mr. REUSS. My time is up. I did want to express my concern. I think I have.

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Thank you, much. Mr. Volcker, my question is somewhat repetitive. I recognize that.

Mr. Reuss and you both touched on it, but I want to take a little different approach, which suits my purpose a little better. It has been my impression over the years that the size of the Federal deficit, in and of itself, constitute problems for the conduct of monetary policy.

That is, the greater the deficit, the greater the problem for the Federal Reserve. And more recently, the emphasis of concern seems to have shifted from the size of the deficit to the growth rate of Federal expenditures.

Congress is now deciding whether to have a tax cut extending over 3 years, with the 1 year possibly contingent on the favorable performance of selected economic indicators.

Some are saying that the size of the Federal deficit should be one such indicator. My question is, in your opinion, to what extent does the size of the Federal deficit limit the Federal Reserve in its conduct of a noninflationary monetary policy?

Mr. VOLCKER. I think it all depends upon the economic circumstances, Mr. Wylie. I would accept, as a very broad generalization, your comment that, all things equal, the deficit complicates things, or at least makes it more difficult for competing borrowers in the market.

The practical effect of that depends, I think, entirely upon the context in which that deficit takes place. Just to put it in extreme form, in the day of the depression, or in days of very large recessions, when private credit demands are not strong, Government deficits can be readily financed without the kind of impact upon interest rates that are disturbing.

That is not the situation we are talking about; we are talking about the impact of deficits when credit markets are already extremely tight and we are in an inflationary recession.

What deficits do then is put more pressure on the market, lead to the kind of concerns that have been so eloquently expressed by the committee so far this morning, and in that sense, create a very real problem.

Mr. WYLIE. Money market funds are having a great impact on the financial markets right now. What are the implications of these funds on the conduct of monetary policy?

Mr. VOLCKER. In a technical sense, we have to make some judgments—as I unfortunately had to touch upon in my statement although it is a rather technical matter—as to whether the growth of these funds, and particularly the extent to which they are used as transactions balances or substitutes for transactions balances, impinges upon the supply and demand of what we arbitrarily define as M_1. I say arbitrarily, it is the best definition we can make. But you are dealing here with a matter of more or less. We have put money market funds slightly outside that definition, but you have to consider the implications for the funds that are inside the definition. It is a difficult judgment to make.

We think the impact so far has been relatively small, but it is in the direction of reducing the growth and demand for defined M_1.

That kind of judgment has to be made. In that sense, money market funds complicate our life, and the issue would become much more important if money market funds were to develop actively in the direction of being used as transactions balances. There are some funds with extended check-writing privileges, and perhaps even more speedily, these funds are moving into the credit card area and the like, where they, basically, can be used as a substitute for transactions balances.

Somewhat in the opposite direction, to the extent people are investing in money market funds, which we include in M_2 and M_3, instead of investing in Treasury bills or other securities in the open market, those numbers are artifically inflated. A little bit of that has been going on, too.

Mr. WYLIE. I think we need to know where these funds are coming from, and if they are, in fact, causing disintermediation among financial depository institutions. Last week, I might state in that connection, Chairman Pratt had some rather pessimistic views about the future of S. & L.'s and mentioned that as a possible source of difficulty for the S. & L.'s.

I might say I asked for Chairman Sprague's position on Chairman Pratt's proposal. You are familiar with his proposal.

You have been before us with a proposal of your own. And he said,

> That I am not even going to have time to address his proposal at the present time. We have our own proposal before you, and we would like to go off in that direction first before we get into something else.

Have you been able to sort the two out, or have an opinion on it?

Mr. VOLCKER. My view on that is quite clear. We developed a regulators bill. By "we," I mean the regulators. The Federal Reserve's role was primarily a coordinating role.

Provisions of that bill were strongly supported by the FDIC and the Federal Home Loan Bank Board.

It is a bill which, in my opinion, gives regulators tools that they need during this very difficult period of strain and tension for dealing with the situation. I would urge the Congress to go ahead and provide the regulators with those tools that seem to me to be necessary and desirable.

The kinds of issues that Mr. Pratt raises further, and I am not familiar with all the details, go to a basic restructuring of the thrift industry. I am sure there are legitimate issues there. Those issues do not, in my judgment, to any really significant extent, bear upon the viability of those institutions in the time horizon of the next year or more. There may be some particular provisions that do, but by and large, the major restructuring is not going to bear on the earnings and viability of those institutions in that kind of time frame.

These seem to be matters that can and should be looked at by the Congress. But they don't have the same urgency as the provision of the tools that, in my judgment, the regulators really need and could usefully use at this point.

Mr. WYLIE. My time's expired, but I do think Congress has a very difficult obligation which concerns me greatly. I thank you for any help you can give us on it.

Thank you.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being with us. Whatever I say subsequently, I hope you don't interpret personally. [Laughter.]

Mr. VOLCKER. I may find that difficult, but I——

Mr. GONZALEZ. When I use the word "you," it should be understood that I mean you and the Board or the majority of the Board. Of course, I certainly have long been one of those raising elements, or maybe all of the congressional litany you have heard.

There is no question that you, that is, the policies, have nationalized, have legalized usury beyond any kind of conscionable limit.

You have sacrificed on these bloody alters the lifeblood of the small businessman. I am not talking about the United States Chamber of Commerce.

The last time they appeared before the Small Business Committee I belong to, they admitted that over 80 percent of their executive board represented not small business, by any definition. And the Fed is the same way.

Of the 14,000 or so banking institutions that the Fed says it is responsible to and is actually supposed to be the one controlling—

Mr. VOLCKER. If I can just——

Mr. GONZALEZ. I haven't seen any record other than a strict subservience to the interest of less than David Rockefeller, Chase Manhattan, First City, and the like, absolutely prostrated, first and foremost their interest.

Let the devil take the hind post. They are going to be taken care of. It doesn't surprise me after the role of the Fed in permitting the banking institutions of this country to repeat the grave errors before the pressure of 1929, the wholesale entry into the most speculative yet controlled market, the gold, silver, how much banking resources were lost just in the last few gyrations in the gold markets, God only knows.

Certainly the Congress gets no accountability. Your predecessor, in private, voiced concern when, on the urgings of the then administration and Secretary of the Treasury and majority of the Congress, voided the 1932 law without providing safeguards in that respect, and your predecessor voiced private concerns about the fact that perhaps the banking institution would be substantially involved in speculative ventures of that kind.

The fact that the rather despicable role of the Fed in the case of H. L. Hunt's ventures into the speculation and others, and continues, taking of vital banking resources, and everybody forgetting why banks are chartered to begin with.

Banking institutions are the most privileged institutions, in fact, more privileged and the only privileged class in this Nation. In some respects, insubordinating the inherent constitutional powers of the Congress.

So that all that litany, you know, is repetitive. A couple of generations of Americans are being cheated out of such things as homeownership. Interest rates that by all accounts are not only unprecedented. Even at the height of the Civil War, you had no such thing.

Yet you, that is, the Fed, the Board, told us that it is you who are in control, you are the central bank. You are independent and you boast of it.

We have craven Congresses and craven and controlled presses, and therefore the people's interest is totally forgotten.

Now, I know the philosophy, and I don't want to dispute that. You have expressed it. The last question I had, you stated the ordinary folk can wait, and they should wait until this other big demon, inflation, has subsided and we can address ourselves to their needs.

Also, you were quoted as saying at the outset of the policy changes, Mr. Stanton referred to a couple of years ago, that, of course, what it meant and what was inherent in meaning was that the standard of living of some Americans would have to be sacrificed, or depressed.

Well, the question is, what Americans? Certainly not the most affluent sector of our country. So that I have come to the conclusion, and all this litany is fine and all these protestations and incantations and everything else, but I think we have reached the point where it is proper to prepare a bill of impeachment for you and the majority of the Board because of the callous disregard for the basic overall interest of the greatest number of this country.

And you know, it is fine to say, well, look, you are permitting these mastodons, dinosaurs, to—predatory dinosaurs to struggle over these corporate ventures by sucking up again billions and billions and billions of banking resources which the banks were chartered to serve a public need, necessity and convenience.

Everybody forgets that, it seems to me. So that I have three questions. I ask unanimous consent that I be permitted to extend and revise my remarks and submit three specific questions in writing to Mr. Volcker for the record, if he could address himself to them.

The CHAIRMAN. Is he allowed to bring his counsel to the table for his defense?

Mr. GONZALEZ. Well, I have started the preparation of the bill of impeachment. So we have to wait for that.

The CHAIRMAN. Without objection.

Mr. VOLCKER. I am permitted a brief period of time, I hope, to respond, Mr. Chairman. [Laughter.]

I won't respond in any great length——

Mr. ANNUNZIO. That is before you are impeached.

Mr. VOLCKER. I am afraid Mr. Gonzalez' remarks reflect a quite different conception than mine of how the Federal Reserve is run and what its purposes are and how it is controlled.

I would only, perhaps, invite him to hear some testimony by the banking community in the United States and see whether they think they are in charge of the Federal Reserve and how much time we spend in trying to protect what they conceive of as their own interest.

We have quite a few interesting discussions with bankers on that point. I just want to deny completely any implication that our policies in any way, are motivated by or influenced by the interest of the banking system in a narrow sense, certainly not by the interests of the big banks in a more particular sense.

I would hope our policies are, over time, in everyone's interest in the broadest sense. They are not parochially designed.

Let me just pick up the point on the standard of living. There was some discussion about my remarks on this some time ago. My point was a very simple one; if productivity in the economy is declining, there is no room or ability to increase people's standard of living. We had to realize that, that was what was going on. In fact, that was an outgrowth in large part of the inflationary problem and the related distortions that had appeared.

Our object is quite the opposite, to create conditions in which we can have growth, we can have employment, and we can have a rising standard of living. You are not going to be able to do that if the economy is operating with poor productivity and poor performance in many respects.

I think you have entirely misconstrued the object of the policy and the sense of those statements I have made from time to time when asked about the implications of low and declining productivity in the economy.

I think we have to face up to those implications. If we want a more stable financial market and a prosperous economy and lower interest rates we have to do something about inflation.

I think, even if I am going to be impeached, you are still going to be left with the question of how to go about accomplishing that very task effectively, and the hard dilemmas and the hard problems are going to remain, whether I am sitting here or somebody else is going to sit here.

The longer those problems go on, the more difficulty you are going to have and the Nation is going to have in the years ahead.

Mr. GONZALEZ. Will the chairman yield at that point?

I think it is perfected in—it is the culprit blaming the victim, as page 3 where you state,

> But in the economy as a whole labor accounts for the bulk of all costs and those rising costs in turn maintain the momentum of inflationary pressures.

In other words, what we are getting at here is certainly, yes, I know there is cause and effect, inflation and pressures and the like. But you are blaming the victim.

Mr. VOLCKER. I am blaming the situation.

Mr. GONZALEZ. You are coming back to the same old nostrum that labor is to blame for whatever.

Mr. VOLCKER. I did not suggest that. I suggested it is going to be in everybody's interest, including labor's interest, to get this economy working better, and that labor's standard of living is going to increase as we deal with inflation.

The CHAIRMAN. Mr. McKinney.

Mr. MCKINNEY. Thank you, Mr. Chairman.

Chairman Volcker, to paraphrase an old expression I guess, if it walks like a duck and swims like a duck and quacks like a duck, it must be a duck.

Now we have more and more money market funds that look like a bank, act like a bank, have transactional accounts like a bank even to the point of turning themselves into payroll accounts.

Do you feel as Chairman of the Fed that we better start looking at money market funds that wish to engage in all of the activities that a bank engages in and start calling them banks and start requiring that they have some reserves?

How do you feel about that?

Mr. VOLCKER. I wouldn't call them banks, but I did present some testimony 3 or 4 weeks ago before Mr. Fauntroy's subcommittee where I made what I think are some intelligent proposals in this respect. [Laughter.]

Given some of the characteristics that you refer to, it would be useful to set a framework for the operations of these funds for the years ahead. And the particular proposals that we made were really twofold:

First, considerations of both monetary policy and equity among institutions suggest that money market funds should have the same reserve requirement as depository institutions, to the extent they are running a transactions business. At this point I think that is a relatively minor part of their business and it wouldn't have a very large impact on their operations. But it would establish a framework along the lines that you are suggesting.

Second, we also suggested that not only for money market funds, but for other institutions, we should be careful about drawing a line, as best we can, between transactions balances and essentially liquid savings types of funds. We should, in general, try to distinguish between a transactions balance payable on demand—payable to third parties, payable by check or credit card or whatever—and liquid savings balances, which money market funds are today to a predominant extent.

As a corollary of that approach, I would not burden money market funds with a lot of banking regulations that I think are either peculiar to "banks" in the true sense of the word, or in some cases, are regulations on the banking system that we ought to be relaxing.

Let's not go in the direction of putting every regulation on money market funds, but let's look at what is really necessary for banks and consider what regulations are appropriate for banks, but not for money market funds.

Money market funds do not make loans to individual customers. The whole panoply of safety and soundness regulations we apply to banks doesn't seem to me appropriate to money market funds.

But, in the case of reserve requirements on transactions balances, where there are both equity and monetary policy considerations, I think the logic that you express is hard to refute.

Mr. MCKINNEY. One of the things that fascinates me about the money market funds is that what I consider to be large banks in Connecticut are certainly not money center banks, but their attitude towards the money market funds and what they are dong to them is rather interesting.

If you say to someone from Manhattan, or Chase, or one of our big money center banks that you think we ought to do something about money market funds they go into a long litany of how wonderful they are because, of course, they are hand-in-glove as far as sharing the profit is concerned. But your—I don't like to name local banks, but if you take a good size State bank as Connecticut National Bank or Hartford National, they have a real concern.

Is there any possible way that the Fed can go so that all the advantages of this accumulated money doesn't just go to money center banks, which is where, quite frankly, I feel that these purported set-asides for a Conoco takeover are coming from?

Mr. VOLCKER. Some of the money market fund people have been working on arrangements of various sorts where their outlets might be expanded beyond a few of the major banks in the country, so that CD's from smaller banks might be more available to them on terms and conditions that they would find competitive.

There are difficulties in that process, but a good deal of work is going on, and I think that that is constructive in the light of the concerns that you expressed. The impact of the funds is differential—there is no question about it—on different types of banks, and we would encourage in spirit that kind of effort because it does smooth out the impact; it is not dramatic but moves in that direction.

Mr. MCKINNEY. One last question. Not as Chairman of the Fed but as a Government official, do you feel that the Government should move in on mergers of the size suggested by du Pont and Conoco, this tremendous transfer of money for no productive purpose?

Mr. VOLCKER. I don't think I could comment helpfully on that, Mr. McKinney. It is in an area that is obviously outside my particular authority. Your questions are legitimate, but I haven't got any basis for a judgment as to whether the particular kinds of mergers or takeovers that are under discussion now are healthy or unhealthy in terms of industrial structure, or more narrowly, on antitrust grounds.

This is just simply not an area in which I can express a judgment, other than that those are relevant considerations.

Mr. MCKINNEY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Mr. Volcker, I have been here almost every time you have appeared before this committee. Virtually without exception, your testimony and that of your predecessors, to be fair has been along the same lines. I want to congratulate your department that runs the mimeograph machines. They seem to turn the pages over. But you never learn anything when you get through.

Mr. VOLCKER. It is a study in consistent monetary policy.

Mr. ANNUNZIO. That is right. It goes something like this: "Our policies of tight credit have not achieved the result that we would like, but we do see some signs of improvement in the economy."

You always see improvement, but no one else seems to see any improvement. Ask a homebuilder. Come to my district, any district, walk out on the streets.

I mention these groups because every time I read the paper somebody from the Fed is addressing the Chamber of Commerce or some big bankers organization. But I don't read where you are addressing a labor group or a senior citizens group or a much smaller group, an unemployed group.

Mr. VOLCKER. I would be glad to send you some of our press notices in that respect, Mr. Annunzio.

Mr. ANNUNZIO. I would be glad to look at them. Ask a homebuilder. Ask an automobile dealer if he sees an improvement. Ask a young couple trying to buy a home if they see improvement. Walk out on the street. Stop 100 people. Ask them if they see improvement.

I don't think you will find anyone who shares your view of there being improvement. Is it possible that your policies are dead wrong? I want to get serious about that. And you just will not admit it, none of you fellows.

In my 17 years on this committee I have never heard anyone from the Fed admit they have made a mistake. And I think that is what is hurting this country. Your course of action is wrong. It must be wrong.

When the dollar was weak abroad and all the central bankers complained about the dollar being weak, what happened? We helped them, we used francs, we used marks, we bought up American dollars, we stablilized the dollar so that the dollar is now strong, and it is helping the people from this country who travel abroad. They can get more for their dollar abroad.

The multinationals now can get more for their dollar abroad. But the Americans who live here get less for their dollars.

I would like to know what kind of a policy it is that shows improvement when we help people abroad and not help people at home. I would like to know how you can say your policies are working, when no one else—and I am not trying to be critical. [Laughter.]

There isn't anybody at all who says you are right.

Mr. VOLCKER. Is there a question there, Mr. Annunzio?

Mr. ANNUNZIO. The question is, you said your policies are working. Your statement is replete with how they are working. On page 3, as Mr. Gonzalez brought out, here is a $35 billion line of credit, that is not inflationary.

You give the workingman 10 cents an hour in a contract and that is inflationary. Now I want to know the difference between $35 billion given to these large corporations and 10 cents given to an American worker that creates inflation in your mind. Now explain that to me, why $35 billion doesn't create inflation and 10 cents does create inflation.

Mr. VOLCKER. I have not given $35 billion to American corporations.

Mr. ANNUNZIO. Line of credit.

Mr. VOLCKER. I have not made it easier for them to raise $35 billion.

Mr. ANNUNZIO. Have you come out against it? Does your policy say to these bankers, you are wrong for establishing this line of credit because it is going to create inflation? I haven't read one word. But I have read a lot of words every time there are labor negotiations going on, if there is a 10-cent raise.

Mr. VOLCKER. I expressed concern about this matter this morning. I expressed concern about it last week. I don't have any easy answers to the problem.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

Mr. Volcker, as someone who doen't look for your impeachment, it seems that some of the problems you have may be created here on the Hill.

I wonder if you can advise us on a particular issue we are going to be voting on in the next week or 2 weeks that hasn't been subject to much by way of hearings, but which touches very much on your particular profession. That involves the issue of a tax-exempt savings certificate. One of the subissues all of us are going to have to deal with is whether or not to make this tax-exempt certificate which we think is likely to pass directed in any sense.

Should institutions that take in this money allocate their resources in a particular direction such as housing, agriculture, small business, whatever?

Would you have any comments on how the tax-exempt certificate should be structured?

Mr. VOLCKER. Let me say first of all, that I think I understand the problems of the thrift industry very well. We have proposed legislation and have concerns about that problem.

I have not thought that the tax-exempt certificate is an effective or efficient way to solve that problem. There will be limited help for the thrift industry, as I see it, per dollar of revenue loss, and I don't think it really does anything for the overall savings rate.

Having expressed all those doubts and problems with the bill as a whole, my impression is that this is some kind of backdoor way to inject more money into those institutions—rather inefficiently, as I suggested.

I think you probably will run into more problems by distorting flows among institutions and in the credit markets and by trying to trace this money to particular outlets, which is a very difficult job. That is an additional complication and negative aspect of the bill in terms of its impact on financial markets.

Mr. LEACH. Let me just ask one more question then. Chairman Pratt announced last week that he is working with you on the notion of establishing more effective ways for the savings and loans to approach the discount window. Have those negotiations been successfully completed, and can you clarify what is taking place?

Mr. VOLCKER. Let me clarify the situation. The Federal Reserve posture all along has been—and the law, of course, requires—that if these institutions have liquidity problems they can come to us and, provided they are going concerns but facing liquidity needs potentially over a considerable period of time, we are ready to lend to them.

That has been the policy from the start. What is different now is that the Home Loan Bank Board took the view that had enough money to lend to them, and since funds were available elsewhere there was no need for Federal Home Loan Bank members to come to the Federal Reserve.

The Bank Board has changed its view in that respect. I would anticipate a good many of these institutions coming to the Federal Reserve. We have not quite completed but are pretty close to finalizing our policies in this regard. Home loan banks would adopt policies—and we would adopt the mirror image of those policies—covering which institutions might come to the Federal Reserve, to what extent, and which portions we would respectively continue to handle of the liquidity needs that exist.

Mr. LEACH. Thank you very much.

The CHAIRMAN. Mr. Fauntroy.

Mr. FAUNTROY. Thank you, Mr. Chairman.

Mr. Volcker, my first question has to do with a followup to a question raised by the distinguished chairman of the Joint Economic Committee, Mr. Reuss. In preparation for assuming the role of chairman for the Domestic Monetary Policy Subcommittee, I quite frankly became convinced of the wisdom that you have been giving us for several years; namely that in order to really regulate inflation you need, not only to regulate monetary policy, but cooperation from the Congress and the President in fiscal restraint that balances the budget and that reduces deficit spending. Therefore, as a function of my role as chairman of the Congressional Black Caucus I was able to convince my colleagues in fashioning a constructive alternative to the Reagan administration's proposals to come in with a proposal that was balanced indeed, gave $7 billion in surplus. A budget that eliminated altogether deficit spending in an effort to cooperate.

What puzzles me, as puzzles the Chair of our Joint Economic Committee, is that as an independent agency, while you have praised the action thus far by the Congress and the President, in spending, you have not exercised the authority of the independence that you have in judging administration and congressional actions that are pending that will substantially increase the deficit over the long run.

Why we can't have that independent voice raised as a caution to a policy that is going to substantially increase military spending and at the same time reduce the revenues available to the country.

Mr. VOLCKER. Our role is monetary policy, as you point out. Other factors impinge upon any given monetary policy, and on financial markets. We have, I think, in all our statements, made this relationship clear: If one were working in a vacuum, and the only concern were the condition of financial markets, then the smaller the deficit, the better off we would be.

I don't think we can produce a balance budget next year, but certainly, from the point of view of the Federal Reserve in the conduct of monetary policy, that would desirable and helpful.

At the same time, it is obvious there are other priorities, other purposes, served by Government. Take defense spending. It is a profound political decision as to how many resources we want to allocate to defense spending and what is required for the defense of the country.

The sole concern of the world is not the condition of financial markets as important as that is, and it is not for us to decide how high defense spending can be. We can point out that the higher the deficit is, other things equal, the harder the job of the financial markets and, in some sense, the harder our job is in restraining money and credit consistent with low-interest rates. I would repeat that this morning; that is, I think, our proper and appropriate role.

Mr. FAUNTROY. Well, you correctly point out the administration is planning a large and rapid increase in defense spending. You pointed out, moreover, that one of the problems has been the fact that while the cost of living is moderating, falling below 10 percent as an annual rate, wages and compensation costs have not fallen commensurately.

Yet, you know, this enormous increase in military spending for warships and tanks and planes and for higher military salaries is certainly going to increase the demand for skilled engineers and workers and managers and drive up the very wages that you have expressed concern about.

I just wonder why from your independent posture you can't caution us, as we have been cautioned about Federal spending, about maybe meeting those needs in the nature of defense and security with increased taxes, rather than increased deficits.

Mr. VOLCKER. There are legitimate, necessary reasons for reducing taxes. Again, we come to a matter of balancing priorities. How fast does the Nation want to move in that direction, recognizing that in the short run—not necessarily, in the long run but in the short run—it has consequences for deficits and for financial markets?

I have repeatedly urged, and would urge again this morning, that in assessing those priorities, the Congress and administration be careful in targeting and arranging a program that has maximum favorable impact per dollar of revenue loss.

There is great debate, obviously, about the precise way in which each tax proposal may fit into the general scheme of things. I expressed the opinion a minute ago that not all the proposals seem to me to be very efficient. Again, there are reasons for moving ahead with tax reduction, but we can't do everything we want to do at the same time.

And, to the extent the tax reduction moves ahead of or moves out of phase with expenditure reduction, you are creating more troublesome problems in financial markets than would otherwise exist. That is the kind of choice we have.

The CHAIRMAN. Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Mr. Volcker, on page 10 you say,

> You and I know that after a decade and more of disappointment there is a persisting skepticism and doubt about the ability of the Nation to persevere in the anti-inflation program.

Then you further add you believe this skepticism is unwarranted. There certainly are a lot of people in the country who still believe that we are not persevering. There are some who even believe it is impossible to do so under today's rules as far as the rules we are operating under in managing our money.

Since 1971, since the closing of the gold window, we have had literally a managed irredeemable paper currency. Under those conditions we have done poorly.

History suggests that we are not likely to do very well, when you take into consideration that we have only tried that two other times, one when we had a continental dollar. That currency was destined to destroy itself. Then we had a greenback era in the Civil War period. Following this we had to mend our ways to get back a sound backing of the currency.

Now we have lived 10 years in the era of the modern greenback currency.

There are some in the country who would not advocate impeaching the Chairman of the Federal Reserve Board but they might suggest that the paper-dollar standard should be impeached.

Since 1971, the dollar has literally lost more than 50 percent of its value. It has been depreciated to that extent by the increasing of its supply. Stocks have lost their value in real terms. Bonds have been destroyed. Savings and loans are in trouble.

The pension funds—once the exact condition they are in is revealed to us, we will realize they are not much better off than the bond market. And yet, we did have people in the early part of the 1970's, when gold was still $35 an ounce, saying this is exactly what would happen.

They would say, "You know, that type of skepticism is unwarranted." Yet, during that 10 years we saw the dollar value in terms of gold go from $35 up to $800 and now back to $400. Still, a vote of no confidence in the dollar.

Now, those same people who were rather accurate in their predictions, are saying that the same thing will continue. And that in a few years, 5 years, 6 years, 8 years, we will be going from a base of $400 now and we will further depreciate our currency to the point where it will be $2,000 and $3,000 and maybe $4,000 to the ounce of gold. Not that the price of gold will change but only the devaluation of the dollar will continue. Gold always stays the same; it is the "golden constant."

Now we see many individuals, many economists coming out of the woodwork, so to speak, reputable members of the academic community advocating some sort of a connection between paper and gold. There have been legitimate polls done in this country and we find gold-backed currency is a very popular idea.

About 60 to 70 percent of the people advocate a sound dollar backed by something of real value. Strangely enough, a large number of American citizens still believe the dollar has a backing to it.

Now my question is this: Do you foresee any time or any conditions under which you would ever consider supporting the use of gold in the monetary system?

Mr. VOLCKER. Let me say that we are, I think, dedicated to avoiding the kind of scenario that you have outlined. I am much more optimistic and hopeful than you are, although I don't suggest we have an easy job whatever technique we use. I think the restiveness that has been expressed by some members of the committee suggests it is not an easy job to turn around the inflationary situation you have described that has built up over the past 10 years.

The element of truth in and the sympathy that I would have with your approach is that you are looking for a way to further assure the kind of broad discipline that I think is necessary in economic policy.

I would question whether the price of gold has been all that stable. It has been quite unstable, in real terms as well as in nominal terms, in recent years. I think it has shown a certain amount of instability throughout history. But I appreciate the point that this is one theoretical way, at least, of trying to impose discipline. Of course, discipline requires adhering to the standard you set.

One of the fundamental questions you have to deal with in that respect is whether it is really meaningful and convincing in the present day and age to try to set a fixed dollar price for gold, given all that has happened. Would it really last, because if it doesn't last, you haven't accomplished your purpose. If it does last, and if all policy is directed toward maintaining that price, you have a different set of problems.

I would think that the course we have set ourselves on monetary discipline embodies the most important fundamental principle in your suggestion and offers more promise to do the job.

I am not as pessimistic as you are.

Mr. PAUL. Thank you.

Some would claim gold is unstable; others would say that, of course, it is the instability of the dollar, the anticipation of what is happening to the dollar rather than the gold itself being the problem.

Mr. VOLCKER. There is some element of truth in that.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Mr. Volcker, I have come to think that the tax-cutting fever that's claimed us on both sides of the aisle is going to result, it seems to me, inevitably in very high interest rates next year.

Let me tell you why I say that, and then ask you to comment on it. Here's what we have done.

We have started with a current services level of spending of $711 billion. From that, we exempted from cuts $264 billion in that basic social safety net, about $200 billion for defense spending, about $100 billion for interest on the national debt, leaving about $147 billion for everything else that the Federal Government does, education, science, trade, and everything else.

From that $147 billion figure, we cut $37 billion, or about 25 percent. Now, this time next year, it seems to me, we will be looking at a deficit of about $40 billion that the Reagan administration says we will have.

There is good evidence that we have underestimated defense spending considerably, so I imagine instead of the $40 billion, it will at least be another $10 or $20 billion on top of that.

If we pass the tax cut bill—and I am talking about the multiyear personal tax cuts, not the business and the targeted personal tax cuts—if we pass the whole package now, then we will build into the system an additional $75 billion in personal tax cuts for 1983. That indicates to me that we will be facing this time next year a budget deficit of somewhere between $60 and $100 billion.

And we are going to have to make some very difficult choices. Now the choices will be as follows, it seems to me. Either we will go into that basic social safety net, social security retirement program, disability program, and there is some indication that the Reagan administration wants to do that. But I think that the Congress will reject that approach.

Or we will go into defense spending, and I think neither the Congress nor the President will want to do that. We can't go into the $100 billion of interest on the national debt. So we will be looking at now $110 billion.

In other words, already cut 25 percent, for everything else the Federal Government does, we will look at that to cut, or we will have to raise taxes. Or we will have to let the budget deficit ride. And if we let the budget deficit ride, and you don't monetize it, then it seems to me we are going to face very, very high interest rates which will then choke off what recovery there has been in home building and autos and so on.

That is the most likely scenario that I see, and I just wonder if you would comment on the accuracy of that. And if you agree, then what do you suggest?

Mr. VOLCKER. I can't comment on the accuracy of your figures. I haven't got any insight into whether defense spending or some of these other expenditures that you suggest will go up more rapidly.

I would note that the administration and the Congress, in developing the spending program, have recognized that, in line with reducing the deficit and eventually returning to a balanced budget, there were going to have to be some very sizable further spending cuts. That consequence is there, and you have reiterated it this morning.

Mr. NEAL. Wait a minute, you mean further spending cuts beyond those that we have already made?

Mr. VOLCKER. Beyond those we have already made.

Mr. NEAL. Well, where will they come from?

Mr. VOLCKER. It is not our job in the Federal Reserve——

Mr. NEAL. The purpose of those spending cuts would be to reduce the deficit, isn't that correct?

Mr. VOLCKER. Those spending cuts are assumed in the administration's program. They haven't been identified yet. But when you move into 1983 and beyond, the administration program has a line that is for future spending cuts of large size, necessary and consistent with its own estimates of defense spending and these other factors.

I fully agree with the implications of your comment: There is a lot more spending cutting that will have to be done, consistent with both the tax program and other elements in the outlook—not to mention the contingencies of misestimates.

Mr. NEAL. So what you are saying is that if we don't say that, this time next year, cut deeper into——

Mr. VOLCKER. Into something—maybe defense, but into something.

Mr. NEAL. Somewhere, then you would agree we would have these very high interest rates?

Mr. VOLCKER. We will have high deficits and that will be a factor on interest rates. How high interest rates will be, I think, depend on two other factors, apart from the deficit: How much progress have we made on inflation, and what is the current strength of the economy? It is obviously unsatisfactory to have low interest rates because the economy is weak; a weak economy is not a basic answer to the dilemma, although it is important in determining just what the level of interest rates will be at any point in time. But it is not a real answer over time from the standpoint of economic policy.

Mr. NEAL. It is certainly conceivable, though, that we would have a situation—if we don't make deep further cuts in spending—that's very similar to the situation we have now, which, by any measure, inflation is under 10 percent, yet the prime rate is 20 percent.

Mr. VOLCKER. I can't rule that out. But if we make better progress on inflation, I would be more hopeful than that analysis suggests.

If you told me the budget's going to be in much worse shape, then I would assume you'd have another problem.

Mr. NEAL. What are you assuming?

Mr. VOLCKER. I am not assuming big overruns in the defense area. I would assume—but I just have to reiterate it is an assumption—that there will be sizable further expenditure cuts. And I am also assuming that as the tax program completes its way through the Congress, there isn't going to be a lot added to it. I know there is a lot of discussion about that.

Mr. NEAL. I wasn't talking about adding anything.

Mr. VOLCKER. Right, I am thinking about additions beyond, say, what the administration proposed in May or whenever the compromise proposals came forward.

Mr. NEAL. What you are saying then is that if we don't make further deep spending cuts, it would not be unreasonable to anticipate very high interest rates this time next year?

Mr. VOLCKER. Interest rates will depend upon how well the economy is doing. If the economy is moving ahead strongly under those conditions, making only limited progress on inflation, I think that kind of an implication is there.

The CHAIRMAN. Mr. Shumway?

Mr. SHUMWAY. Thank you, Mr. Chairman.

Mr. Volcker, you have essentially given us assurances that the policies we have embarked upon are the right ones; that they will eventually lead us into a better economic situation in America and we need to stay with them.

It seems to me that if this, indeed, is the case, the question is just how much of the cure America's economy can stand. I am sure you can tell from those of us on this committee who are exposed to public reaction to these policies and other economic problems in America that there are some very difficult times ranging there.

I think perhaps your position, as distinguished from ours, is somewhat shielded from those harsh realities which we, as politicians, necessarily have to confront.

Certainly, in our case, we are not given the privilege of relying solely on numbers or statistics. We really have to respond to people. It is very obvious in America today that people are hurting.

I don't say this in particular criticism of your policy, but just in reference to many of the questions that have been voiced on this panel today and to the economic situation as a whole.

I think, however, that it is very easy for you to say that interest rates are somehow tied to inflation, and so long as inflation continues out of hand, we will not have a real answer to high interest rates, and that the base causes for inflation are either psychological on the one hand, or relate to continued deficit spending by the Government on the other hand.

In some respects, it seems to me that this approach and that answer is simply an attempt to solve the problem by shoving it into a closet and then closing the closet door.

There are some nagging questions that bother me. One is the fact that Congress has indeed taken some action, albeit not finished at the present time, but Congress has reduced considerably the budget authority for the coming year and has given great indication to the American public that it wants to get out of the pattern of deficit spending.

Why is it that there still is a gap between the public performance and response to what Congress has done, and why haven't we been able to narrow that gap and perhaps curb some of this psychology of inflation?

I am concerned about what we might yet do and what remains undone.

Mr. VOLCKER. I would suspect you are narrowing the gap, Mr. Shumway.

Mr. SHUMWAY. We haven't yet succeeded in doing that.

Mr. VOLCKER. You haven't succeeded in convincing everybody that the inflation is going to go away promptly and speedily, I think simply because of a background of years where the opposite has been happening. The American people have been fooled, in a sense, by seeing a higher inflation rate than they really anticipated, certainly a higher inflation rate than either economists or successive administrations told them was likely, for the last 15 years.

They have seen efforts to cut back before that have not been carried through. I happen to think the effort that you are making in the Congress this year is, as I said in my statement, without parallel to any I have seen in Washington during the years that I have been in and out. I think it is both courageous and constructive. But it hasn't had instantaneous results. The problem is also very great.

Mr. SHUMWAY. How long do you think it will take before the efforts of Congress to date are successful in closing that gap?

Mr. VOLCKER. It will take a shorter period of time to the extent that both we in the Federal Reserve, and you in the Congress, and those in the administration, carry through with real conviction. I think this is the answer the people are looking for in markets and elsewhere right now. They see, in many respects, that things are not very happy in the economy; of course, we had a big growth most of the past year, but it is quite sluggish at the moment. And some areas of the economy, as have been amply reflected in this discussion this morning, are under extremely heavy pressure. So many people are saying, "Now we have got the first whiff of gunsmoke and they will back off."

Is it going to be a repetition of the same old policies we have had pretty much throughout the postwar period? As soon as we fear some short-term consequences, will we back off from the policies? I think we have learned that will have more adverse consequences in the long run.

You raised the question in the way which I am sure many people see it: can we stand the cure? I would like to turn that around.

Can we stand not to cure this problem that's gotten a grip on us, progressively, in the past 10 or 15 years? If we back off now and say, "Well, we are not up to dealing with inflation," then the outlook would obviously be poor.

I don't think that is going to happen. I don't think we can permit that to happen because we have had too much experience behind us with just that kind of approach, landing us just where we are now. I think that is precisely the issue that is before us.

Mr. SHUMWAY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Blanchard.

Mr. BLANCHARD. Thank you, Mr. Chairman.

Mr. Volcker, I would just like to repeat a warning or a caution that I made to you a year ago here, and also privately, which is, I think, very clearly you are going to become a scapegoat for kind of a schizophrenic economic policy, both from Democrats and Republicans.

I note that privately recently Murray Weidenbaum, at a conference board symposium, indicated that the Fed wasn't doing enough in the area of monetary restraint. Yet publicly in Canada and Ottawa, the President has seemed to disassociate himself from the independent policies of the Federal Reserve Board.

I know, hearing my colleagues, Chairmen Gonzalez and Annunzio talk, that they do, in fact, reflect the feelings of many Americans in small- and medium-size businesses in terms of their concern for the tight money policies of the Fed.

So I simply want to repeat that because I know that you believe that something more is required in fighting inflation than simply monetary restraint.

My concern is that when you add up all the various policies we are pursuing, we do indeed place excessive reliance on monetary policy to fight inflation.

Now, before this committee, David Stockman said that any deficit as a result of a tax cut or high defense spending would not be inflationary, or at least necessarily inflationary, unless the Fed chose to monetize that debt.

Steve Neal was pursuing, I think, a line of questioning which many people are concerned about, which is you don't have any choice but to monetize that deficit as I understand it, or you are going to be putting enormous upward pressure on interest rates.

So my question would be, are you planning to monetize this year's deficit, and don't you think it is foolish to talk about the fact that you shouldn't monetize the deficit?

Mr. VOLCKER. I am not always quite sure what "monetizing the deficit" means. It doesn't make any difference whether we monetize private or public debt in some sense, but we happen to operate in Government securities.

Let me just phrase your question a little differently. The purpose of this hearing is for us to tell you what our monetary targets are. That tells you in broad dimension what we intend to do in terms of increasing reserves and increasing the money supply. What I have told you this morning is that we intend, over time, to bring down money creation. That is not consistent with increasing the money supply simply to facilitate Treasury financing; we don't intend to do that. If that policy is, in the opinion of members of the committee, wrongheaded, or we should be going faster or slower, I would expect to hear that. But we have attempted to quantify our objectives as best we can in line with the Humphrey-Hawkins Act, and we think they are appropriate, and we intend, over a period of time, to keep reducing the trend rate of growth in money and credit.

I continue to feel that is appropriate.

Mr. BLANCHARD. I want to pursue this. You state on page 8 that more fundamentally what recent experience also confirms is that demands for money and credit growing out of an expanding and inflating economy pressing against the restrained supply will be reflected in strong pressures on interest rates and credit markets, and so on.

Now, if the Federal Government borrows this tax cut on the private credit markets, which as I understand is what will happen, will any kind of credit demand which we presently have, wouldn't that put upward pressure on interest rates?

Mr. VOLCKER. I think we see that situation to a considerable extent now. We have had a reasonably strong economy. It is sluggish right now, but we have had good growth in the economy in the past year or so. We have had high deficits; we have had restraint on money and credit creation; and as a result of all these things we have had high interest rates.

Mr. BLANCHARD. How are we going to get the various sectors of the economy which are especially credit-sensitive out of the swamp? As you know, it is expected tomorrow that Chrysler Corp. will announce a modest profit which, in view of the circumstances, is rather miraculous.

How in the name of economic sanity will Chrysler and the dozens of other businesses, not just autos, survive with continued high interest rates?

Mr. VOLCKER. The answer in the end—and I must keep coming back to it because I know of no other answer—is that you can't have things working together properly without the inflation rate coming down. That is the answer. We can't finance inflation if we are going to have room for the vigorous real growth that we all want.

Chrysler is a kind of laboratory example of both some of the problems and some of the solutions, if I could suggest that. The automobile industry has done poorly in the second quarter and continuing into early July. Chrysler took a lot of measures, as you well know, to reduce the scope of their operations, to reduce their costs. They have done somewhat better than the other automobile companies. I think all those companies are suffering first and foremost from a very rapid increase in car prices in the past 4 or 5 years that startles people when they go in to buy a new car if they haven't bought a new car for 4 or 5 years. They say, "I don't want to pay that much for a car."

That has certain lessons for us all. There is an industry where a certain amount of self-help is in the interest of the companies and the workers and the jobs.

The CHAIRMAN. Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

Mr. Chairman, I think your statement this morning was excellent. It is generally encouraging. Particularly on page 9 where you talk about the outlook for interest rates. I, like my colleagues, believe there is a rapidly approaching liquidity crisis for small business in the United States.

But I would like to address for just a moment the psychology of the inflationary expectations as it impacts on financial markets, and remind you that some in the financial community were considerably optimistic after the adoption of Gramm-Latta, and some of the actions that have been taken in the Congress on budgetary restraint, your monetary policy.

Instead of a beneficial reaction from all of that, the stock market went down, interest rates went up. We got exactly the opposite result that many of us had hoped.

And certainly the experts, Dr. Sprinkel, Dr. Ture, testified before the task force on economic policy that interest rates and inflation will abate after the market is convinced that the Federal Reserve is serious about controlling the money supply.

Your statement on page 10 apparently is very consistent with that. I would like to ask you the question that I believe is on the minds of most Americans, certainly as reflected by my mail, and the conversations that you hear around the Halls, around this place. It may be slightly redundant, but let me try it on you.

Your statement before the Joint Economic Committee was that it would not be prudent to expect interest rates to drop quickly. Given a couple of assumptions, Mr. Chairman, assuming that the Congress continues to go on its recent course, assuming that—in terms of budgetary restraint.

Assuming that your monetary restraints or policies are consistent and successful, could you give us some idea of a timetable on the expectations of amelioration of interest rates? Will it be closer to 6 months or 2 years?

Mr. VOLCKER. I hesitate to respond to that question in any way that might be interpreted as a forecast. Let me just say, again, that I don't know what you mean by "the economy as it is at the moment."

Are you implying a level economy, a growing economy, a declining economy? I raise that question because I think, in the very short run, that tends to be the dominant influence on credit demands and interest rates, and even to some degree, on expectations.

The outlook is a bit uncertain, but the kind of assumptions you made are all in the direction, over time, of lower interest rates.

Just when that will come about depends upon two factors: First, how business is performing in the short run, before the inflation rate actually comes down and comes down convincingly, so there is a lot more room for real activity in financing demands; and second, on the degree and speed with which expectations change.

I think those expectations may well be in the process of changing but I don't think they have dramatically changed as yet. When that might happen, I suspect, will depend upon further evidence—of actual price performance—bearing out the more favorable signs we have seen recently, and also on a feeling, as I just said, that the administration, the Congress, and the Federal Reserve are going to stick to policies that promise that result in the long run.

By "long run," I don't mean forever, I mean into next year. Perhaps that is the most important of all. If that sense of confidence that these policies are going to be maintained is shaken, you will simply delay the improvement in financial markets we would like to see.

Mr. PARRIS. Mr. Chairman, I submit to you, though, that how business performs in the short run is a self-fulfilling prophecy in terms of how they perceive the posture of the Congress on fiscal restraint and your posture on monetary supplies and the like. Doesn't it all somewhere come together?

Mr. VOLCKER. They interact back and forth with each other, which is what makes it so difficult to make estimates for any short period.

Mr. PARRIS. But it is real tough to tell a guy who runs a hardware store in Springfield that, as soon as the economy gets to performing adequately, then interest rates will come down on his inventory.

Mr. VOLCKER. That's right. That is the box you are in. That is the box we have been in the past year. That is the box you will remain in until you put in the other ingredient, namely, an inflation rate that is coming down. That is the only way I see of getting out of that box.

Mr. PARRIS. How do guys like me say to guys like him, look, just hold out another *x* period until such time as everybody gets economically healthy here and it will be all right?

And he says, "Is that 3 months, 6 months, 2 years, 10 years? What is that?"

Mr. VOLCKER. It is not 10 years.

Mr. PARRIS. Let's hope not.

Mr. VOLCKER. I hope it comes, obviously, I would love to see it come tomorrow. But I don't think it is particularly useful to try to specify a precise timetable.

Mr. PARRIS. I understand.

Mr. VOLCKER. When this thing gets revolutionized. You have to stick at it until that happens. And it will happen.

Mr. PARRIS. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Hubbard.

Mr. HUBBARD. Thank you, Mr. Chairman.

Mr. Volcker, thank you for being with us. Why are interest rates at 20 percent nowadays when inflation is only at 10 percent?

Mr. VOLCKER. I think several factors enter into that. First, let me just note as a preliminary, we have never had an inflation rate like this, entrenched as it is, with expectations as they are, and with monetary policy pushing in the other direction and a tax structure pushing people into very high brackets.

You say interest rates are 20 percent, but they are not 20 percent for a lot of people. That was driven home to me again the other day by a middle-level employee at the Federal Reserve who told me she had gone out and bought some land. I said, "How'd you finance it?" She took a mortgage. I was a little surprised that she was willing to pay 16 percent or more for the mortgage. I said, "Why?" She said, "I want one of those tax breaks." So it was not 16 percent in her mind, and I think to a lot of people, it is not 16 percent.

In fact, it is not 16 percent if you are a taxpayer. We have never had this kind of interest rate before with this kind of tax structure, which impinges upon the real after-tax rates of interest. Let me just say that as background.

Second, I don't think that 20-percent rate should be surprising, during a period of high inflationary momentum, when expectations have been in the direction of expecting more inflation, when so much burden is put on monetary policy in the sense of restricting money and credit, and when you have a low ratio, historically, of money to activity and a low ratio of expansion of credit and money to the expansion of the nominal GNP that is reflected in high interest rates. That is the ratcheting device.

Mr. HUBBARD. Mr. Chairman, do you expect that the Reagan economic program, if enacted by the 97th Congress, will produce more inflation?

Mr. VOLCKER. No; I think the inflation rate is headed down. I think the question that we are struggling with here this morning to a considerable degree is how long will it take?

From my perspective, the shorter the better. That depends upon a lot of other policies.

Mr. HUBBARD. You said earlier that you believe sincerely that major budgets and spending cuts by the 97th Congress are, indeed, courageous and constructive. Do you believe that the tax cuts proposed by President Reagan, and he's the one who first mentioned major tax cuts, 3-year tax cuts, are these suggestions courageous and constructive?

Mr. VOLCKER. I think there are constructive reasons to have tax reduction. I think that is one factor all bound up in this problem of our economic performance and even the inflation. The point's been made over and over again: I think what you have to do is balance the tax side against the expenditure side.

Mr. HUBBARD. How can the tax cuts, which will produce more deficits, be constructive?

Mr. VOLCKER. Because they do have implications for incentives and for costs and all the rest. The degree to which they are constructive depends upon the total budgetary picture. That is where the spending side comes in; these have to be put together in a pattern.

Mr. HUBBARD. Are you saying that even the third year tax cuts proposed by the Reagan administration will be constructive to the overall economy and to the deficits?

Mr. VOLCKER. I don't know precisely what the economic situation will be in the third year, which is the issue in that consideration. There are advantages in having the program spelled out. If spending or economic activity went in a direction that was not assumed, you would have a different kind of a problem. The question is how much conviction you have as a Congressman that indeed the spending cuts, in particular, will be as planned, that you recognize the implications, and that you feel confident that the program can be attained.

Mr. HUBBARD. If we don't know what the third year economy will be and we are fearful of it, is it wise to have this huge third year tax cut adopted as a part of the Reagan economic package?

Mr. VOLCKER. I would put the emphasis more on the spending side, although these other questions are not irrelevant. Again, you have a balancing act; there are reasons to do that cut. It is the Congress in the end that is going to decide whether and where the spending side of the budget matches the tax cut. If you feel that is an impossible approach, I think you would have legitimate doubts about the tax cut. If you think it can be done—and many do—and it is a reasonable objective, then maybe you are less doubtful.

Mr. HUBBARD. I yield back the balance of my time, Mr. Chairman.

The CHAIRMAN. Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

Mr. Volcker, I believe if I can just paraphrase your testimony, you are telling us that inflation is our No. 1 priority in fighting inflation because inflation inhibits economic growth and the creation of jobs. I certainly agree with you.

I believe, implicitly, in your testimony you are telling us that we have more than just monetary policy as a tool to fight inflation. We also have fiscal policy, income policy, and productive policy. Of course, you have expressed your view on monetary policy. I support that view.

You have expressed your views on what Congress fiscal policy should be. You have implicitly, I think, addressed an income policy by pleading for letting the world competition determine wages and prices. I take it that you would be opposed to wage and price controls. Am I right?

Mr. VOLCKER. Yes; I noted the importance of that dimension, but suggested there are ways of approaching it entirely consistent with the competitive market rather than through controls, with regards to which I think our history has not been encouraging.

Mr. WEBER. I agree with you. You have also mentioned the need to increase productivity in American industry. I take it regulatory relief and tax incentives would be the methodology there?

Mr. VOLCKER. Yes, sir.

Mr. WEBER. For my own clarification, can you explain the interrelation between the incentives for savings for which, at one point in your testimony, you pointed out a need, which I assume would go into M_2 and M_3, and the Fed's attempts to restrain growth of M_2 and M_3. I am a little bit perplexed by what seems to be a paradox there.

Mr. VOLCKER. Some savings do and some don't go into M_2 and M_3. If the net result of the increased incentive to save is more productivity, and that in turn helps to relieve the price pressures, I think that would be consistent with the kind of targets we have for M_2 and M_3. These targets tend to be related over a period of time, when savings are high or when savings are low, to the growth in the normal GNP. If the normal GNP is reduced, hopefully by reducing the rate of inflation—which is, of course, the object of the whole exercise over time—then I think we can manage the increased flow of savings within the framework of that target.

Mr. WEBER. We have got maybe four monetary aggregates here, $M_{1\text{-}A}$ and $M_{1\text{-}B}$, and M_2 and M_3. M_1 is below the target range you have set. M_2 and M_3 are over your target ranges.

Mr. VOLCKER. M_2 is just about there.

Mr. WEBER. The higher range?

Mr. VOLCKER. Right.

Mr. WEBER. Which of these aggregates is most important to your monetary policy?

Mr. VOLCKER. I think over time we have tended to look at the first instance at the M_1 which has the special characteristic of being transactions balances. I think we are in a period where because of institutional change, we have to be very careful in interpreting the shortrun movements in M_1.

These other aggregates are important too. I think we would make a mistake if we just picked out one and said it were of overwhelming importance, because it is just too likely that institutional changes will render the movement of a particular aggregate in one direction or another less meaningful economically.

The British ran into this problem a year or so ago, you may recall, where they put tremendous emphasis on one of the aggregates. They have several aggregates, as we do, but they put tremendous emphasis on Sterling-denominated M_3 which is roughly similar in concept to our own M_3. Their range was 7 to 11 percent, or something like that, as I recall it. For the past year, sterling M_3 ran at about 20 percent. However, there were certain institutional changes in the United Kingdom that were producing a very high Sterling M_3, while M_1, for instance, was quite low. Sterling M_3 was not giving a fair reading of their economic policy.

You point out that M_1 has been running low this year, as I indicated it has. I was interested in seeing one of Milton Friedman's articles in Newsweek a few weeks ago where he said, "Don't forget, M_2 is running quite high." I was well aware of that before reading the article, but it was interesting that he was attaching importance to M_2 as something you had to look at, while he has at other times focused on other aggregates.

Mr. WEBER. On page 12 of your testimony you make mention of the fact there are certain industries suffering from problems of their own making and therefore, should not receive governmental assistance or that sort of thing. Would you care to name what industries you have in mind when making that statement on page 12?

Mr. VOLCKER. We had some discussion—just to pick an industry out at random—of the automobile industry a moment ago. There you have an industry with a great many problems because of change in demand and product mix. I think there have been Government policies that have not been at all helpful in terms of that industry. But they have also had some problems of their own making, I would say both pricing policies and wage policies. You have an industry where, understandably I think, the wage level is higher than the average for very good reasons. But it is much higher than the average and has been rising through the past decade relative to other wages, so it is not entirely an accident that that industry is one that is at the cutting edge of the problems now; their own competitive position has been impaired.

The CHAIRMAN. The Chair would take note of the fact that we have a vote in progress. There are nine members who have not inquired of Mr. Volcker yet. We could go vote and then return immediately, hopefully within 10 minutes. How long can Mr. Volcker stay with us?

Mr. VOLCKER. I think I can stay more or less indefinitely.

The CHAIRMAN. We are all going to lose weight. The committee will be in recess for approximately 10 minutes, and we will recognize Mr. D'Amours.

[A short recess was taken.]

The CHAIRMAN. The Chair recognizes Mr. D'Amours.

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

Mr. Volcker, I welcome you and I thank you for being willing to stay all this time with us.

In the beginning, very quickly, in response to a question Mr. Hubbard asked you, I am not sure, but I think you said something about the advisability of predicating the third year tax cut in the administration's tax package on the performance of the economy. Are you suggesting that it would be wiser to condition the third year tax cut on the economy meeting certain minimal performance standards, as has been and is being discussed around here currently?

Mr. VOLCKER. I think what I said was that, in concept, I understood that point, but I don't know specifically what kind of tests for the economy you would condition the third year cut on. In my own mind, the most critical factor is the degree of commitment and conviction the Congress itself brings to what I see as the implication of that approach; namely, that there also have to be big additional spending cuts. If you are committed to that approach, the outlook is different than if you are not. I wouldn't want a third year tax cut if we don't get that kind of spending performance.

Mr. D'AMOURS. Are you suggesting then that it would be wise to, whatever indices one wants to use, it would be wise to find some credible indices, and condition the third year tax cut upon them? Would that or would that not be a wise move?

Mr. VOLCKER. I am not going to answer that question for you. I think you have to answer it yourself, in terms of balancing the advantages that do exist in a third year tax cut against what you feel is possible and feasible and what will be done on the spending side of the equation.

From the standpoint of pressures on the financial markets that I am most directly concerned with, the smaller the deficit and the more caution in spending, the better, but there are other considerations.

Mr. D'AMOURS. Could you tell me anything that would be wrong with conditioning a third year tax cut upon economic performance?

Mr. VOLCKER. I think there are two considerations on the opposite side. Those people who advocate a 3-year tax cut see a added assurance of stimulating the results they want to get from tax reduction by promising it in advance for an additional year. There are also those who think that if you put that 3-year cut in place, you will have a further assurance that the spending policies will be complementary, but if you don't put it in place, you will not get the spending policies that make it possible.

Mr. D'AMOURS. Don't we get both by passing tax cuts now that are conditioned upon economic performance? Doesn't that solve the problem by giving us both?

Mr. VOLCKER. That doesn't give you both. It is one possible approach, but it doesn't have the additional assurances of that of a promised third year tax cut, which is what the proponents want.

Mr. D'AMOURS. But nobody is suggesting that there should be a third year tax cut if the result is a huge deficit are they?

Mr. VOLCKER. I agree. That brings in the other side of the argument, that a planned 3-year cut will encourage the spending reductions that are needed. I expressed 6 months ago the thought that this kind of thing ought to be examined.

Mr. D'AMOURS. What kind of thing, the conditioning of the third year?

Mr. VOLCKER. Making it conditional on spending cuts, yes.

Mr. D'AMOURS. So you have in the past suggested such a course for consideration?

Mr. VOLCKER. I suggested that that be considered, and it is being considered.

Mr. D'AMOURS. Mr. Reuss earlier suggested the leadership he was looking to Fed for in terms of speaking out and exercising its independence. You responded that in fact you have been speaking out. On the other hand, one of the more critical questions facing this country today is the fact that apparently, the whole burden of monetary policy and of interest rate fighting falls upon the Fed. And that seems to be a policy that is generally being aided and abetted by not only the administration, but by the Ways and Means Committee so far as I interpret their tax proposals.

I haven't heard you say anything today that would give me any guidance as to what your personal feeling is about this. I happen to think that both the Ways and Means Committee and the Reagan tax proposals are very inflationary insofar as they include about $35 billion in personal tax cuts that your predecessor, by the way, thinks is inflationary. Now, if your predecessor, Mr. Burns, can speak out on this, with all of your independence, why can't you?

Mr. VOLCKER. Let me describe the situation as I see it. I think, by the force of events, there is a great burden on monetary policy at this point. There are large deficits. There is a lot of built in momentum in the economy. There are not other instruments that are readily adaptable to dealing with inflation in the short run, and all these pressures are reflected in the financial markets. I don't think it is quite fair to say that no other actions are being undertaken or are in prospect. I don't think that is the case. I think the regulatory side is a clear case.

Mr. D'AMOURS. Let's keep our target on the ball, which is a deficit. You have been ignoring it and the country has been ignoring it and the administration has been ignoring it and everybody has ignored the darn thing. You are not speaking out on it. You are pretending to speak out on it. We are looking to you for leadership. People like what Paul Volcker is saying, they look toward him for leadership. They think he is tough and independent.

You keep saying you are speaking out, but frankly, I know the issues fairly well, because I work with them everyday and I can't hear what you are saying because you are saying a little bit for everybody. You are not enunciating a clear policy in terms of what we ought to be doing about balancing the budget. And it can be done.

Hopefully there is going to be something introduced as a substitute, to the tax bill, to accomplish that purpose, to give productivity tax cuts to business and give personal tax cuts to offset inflation and bracket creep and the like. But that leadership isn't coming from you. Yet you are out there all by yourself fighting the battles with the entire burden on our shoulders.

I know what is being said because you are thinking well, by keeping interest rates high, we are putting pressure on the administration to do something about balancing the budget. I know you are not saying that publicly.

Might I wish you would start saying things publicly, because you are a leader in this field and you are being awfully silent in spite of your protestations to the contrary.

My time has expired. Mr. Volcker, I happen to admire you and happen to like what you are doing, but you are not speaking out on these issues as you say you are.

Mr. VOLCKER. I understand what you are saying.

The CHAIRMAN. Mr. McCollum.

Mr. McCOLLUM. Mr. Volcker, I can assure you that being on the other side of these television cameras may put me out of the limelight but there is just as much heat over here.

I wanted to ask you some questions. Before that, I can't resist commenting on the fact that my judgment is that you are speaking out on the issues.

You have done so very ably this morning and very specifically. We appreciate it very much.

Last week, we had a situation where Chairman Pratt unveiled the proposal to assist thrift institutions in the long run in large part by granting them extensive new asset powers. In answering questions I asked, he specifically said that in the long term, he would like to see the lines just completely destroyed between commercial banks and savings and loan institutions by and large.

I also asked him about the desirability from an equity standpoint of permitting savings and loans to accept demand deposits. He proposed that, as a matter of fact.

The Chairman replied he could understand banks opposing the proposal in their own self-interest. How do you view the matter with respect to savings and loans accepting demand deposits and the entire concept, in the long term at least, of removing the guidelines and separations between commercial banks and savings and loans?

Mr. VOLCKER. In the past, I frankly have been of the view that the idea of some specialized institutions—with the corollary, I think, that they had special regulations which historically have been advantageous to them in some respects and maybe less than advantageous in other respects—was a good idea.

The viability of savings and loans in the present kind of financial environment has obviously been questioned, and the opposite philosophy, that you homogenize the institutions and give them all a lot of flexibility, has come to the fore. I think that argument becomes very powerful, more from the force of circumstances than from any kind of ideal concept of the way in which you would want the financial system to go. I think this is a matter of legitimate debate. It's got all kinds of competitive implications and is something that is going to have to be looked at because of the circumstances that exist, regardless of what my predilections might be in a more ideal kind of world.

I don't think any emergency legislation is needed because I don't think it is particularly relevant to getting out of the current squeeze in the short run. You are talking about a long-term structural reform.

Mr. McCOLLUM. Which you would encourage us to look at?

Mr. VOLCKER. Yes.

Mr. McCOLLUM. In a related matter, regulators recently restricted the ability of depository institutions to offer NOW accounts to business or sole proprietorships. Despite the fact Congress has never narrowed the class of institutions which could offer NOW accounts.

What is the justification for this new regulation particularly in light of what we just discussed?

Mr. VOLCKER. The new regulation is not in effect. I think it is going to come before the Board very shortly. We have had a lot of comment on it, and I can tell you what we have done in putting it out for comment.

The NOW account legislation basically says such accounts are open to individuals and to charitable institutions and to a list of other kinds of nonprofit institutions. Historically, in New England, because of the practical difficulty of making a distinction between a personal account and a single proprietor account, that was interpreted as meaning the single proprietor would not be policed, in effect. As a single proprietor, a person can have a business account, but it is to be counted as a personal account. We got a lot of complaints, frankly, that that was too broad an interpretation, and that we shouldn't allow any business accounts because the plain language of the law said "personal accounts" and "nonprofit institutions."

After listening to that side of the story, we put the regulation out for comment and, I suppose predictably, we had a great many comments—from members of this committee and others—that existing policy was an appropriate policy and certainly was sanctioned by the history in New England.

We will be looking at that issue again very carefully. I think there is a lot to be said for maintaining the historical approach. It is simply a matter of interpreting what those words in the law mean by personal accounts.

Mr. McCOLLUM. With respect to that, the Fed has been considering a proposal to permit commercial banks to acquire savings and loan associations. What is the status of that? Am I correct?

Mr. VOLCKER. This is a question that arises under the Bank Holding Company Act, which the Board of Governors some years ago interpreted as not permitting a commercial bank takeover of a savings and loan, at least in ordinary circumstances.

Language of the statute says that we should permit activities that are related to banking to the extent they are a proper incident thereof. I think the Board at that time arrived at a judgment that savings and loans were related to banking but were not a proper incident thereof because of different regulatory treatment and so on.

The CHAIRMAN. The *American Fletcher* and *Baldwin* cases?

Mr. VOLCKER. Yes, exactly. That decision has been questioned, and it has been questioned increasingly recently. It came up in congressional consideration, perhaps on this side, certainly in the Senate, last year.

In effect, we suggested, that you not do anything about the law, but that we would make a study of what appropriate policy would be and submit it to you. That study is about completed, but I haven't seen it yet. It will be submitted to the Congress fairly soon.

Mr. McCOLLUM. Thank you very much.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Volcker, we do appreciate your staying so we do have an opportunity to visit with you about these important issues.

Mr. Chairman, one of the points that's been brought up is that the new administration, the Reagan administration, has a more relaxed attitude with regard to mergers and deregulations and decontrol.

In my opinion, these administration policies will put them waist-deep in their own economic quagmire. They are creating a situation that has its own problems which they ought to be willing to face up to in my judgment.

Their problems are complicated by the monetary aggregate policy that you have pursued since October 1979. Lately, there has been enough demand by large corporate entities to absorb a disproportionate amount of credit, hence support high interest rates.

In a sense, if we would like to look at it from a qualitative standpoint, they are able to prioritize credits at reduced rates. The chairman went through the scenario in terms of what is a prime rate and what is the actual rate being paid.

You pointed out the tax differences and so forth yourself. The disparity today is created by a very unique phenomena in which the inflation rate is very low and interest rates are very high.

So isn't it really a phenomena in which you have less control with this type of policy when you are pursuing it in an environment in which the Reagan administration is freely permitting or encouraging, I guess overtly, changes in terms of what is going on with corporate mergers?

Your policy really doesn't even speak to that. It doesn't talk about equity with regards to who gets credit and who does not.

Mr. VOLCKER. I think that's right. Our policy does not speak to that question. I don't have any knowledge of administration policy on this point and whether the "whether-or-nots" you posed about that are fair characterizations or not. It is true our policy does not speak to allocating credit.

Mr. VENTO. The point is, the monetary policy you pursue does create a disparity between interest rates and the financial institutions, as an example, or the bond market, can provide a more advantageous rate on a priority basis to those large corporations, a lot of which have immense profits. You know, 40 percent of the profit last year went to oil companies.

I guess we all know the reason for that, but they have large cash balances and certainly are having their impact.

Mr. VOLCKER. I am not sure it is providing a more advantageous rate. I don't know what the rates are on all these arrangements. I assume they are market rates.

Mr. VENTO. I don't think anyone knows.

Mr. VOLCKER. They are perfectly willing to pay the rate.

Mr. VENTO. The point is that because of the monetary policy we are pursuing, the Fed is less involved than before in terms of providing leadership in terms of interest rate, is it not?

Mr. VOLCKER. Less concerned with providing leadership with interest rates, yes.

Mr. VENTO. I think that is important. Maybe we can correspond more about it. Another concern I have is that our high interest rate policy flies in the face of world needs and western European needs. International dialog or agreement on interest rates, and monetary policy, would be helpful, would it not?

I recall the 1978–79 circumstance, where especially West Germany maintained high interest rates. I think almost everyone would agree that the impact on us was negative.

They thought we needed that medicine. In essence, we are telling them the same thing today, that they need the medicine.

Wouldn't we be better off being somewhat sensitive to the problems and concerns expressed today by our trading partners?

Mr. VOLCKER. I think we should be sensitive to those problems, and over a period of time—looking toward a more stable future—I would hope we wouldn't see the kind of thing we see in rather extreme form today. But I think it would really be an illusion to think that, given the state of play today in terms of the economy and markets, that we could manipulate interest rates or fine tune interest rates in accordance with some kind of international standard. I don't think we are able to do that in current circumstances, and our priority has to be to do what is necessary to deal with the basic sources of the instability. If we fail in that job, we will find ourselves constantly in this kind of a state, rather than having achieved anything constructive from either the national or international standpoint.

Mr. VENTO. Let me shift gears now. I am sorry about the rapidity of this, but here is a changed perception. One of the things we face is the different types of depository institutions, different financial institutions, and this whole money market fund phenomenon. Of course money market funds are not the same. You don't multiply money with them. They are a special type of investment, and really I mean we are talking about arguing over the bones back here in terms of the regulatory side of the equation for financial institutions.

On the other side, we are facing a phenomenon in which, I believe, there is a permanent modification in the financial behavior of savers. Consumers have had a taste of money market funds and like what they offer and the brokers have the names of the folks that are interested in them. What I really mean is I think we had better address MMF's in some manner and I am not saying reserves is the answer.

Mr. VOLCKER. That is precisely why we raised the issue and made the policies that we did, and I think it would be constructive to address the issue, considering that these are, I am sure, a permanent part of the financial landscape now.

I won't expect them to grow at the rate that they have been growing. That is partly a phenomenon of the present distortions; in large part their growth is stimulated by the present changes in the market. But not only do I think it legitimate, I would even urge you to sit down and look at it, and ask, "Now we have a new phenomenon here. What is the appropriate regulatory approach, if any?"

The CHAIRMAN. Mr. Wortley?

Mr. WORTLEY. Chairman Volcker, is the money supply your primary criterion in determining interest rates?

Mr. VOLCKER. You say, "in determining interest rates." The money aggregates broadly conceived are a primary influence on our provision of reserves over a period of time. What interest rate comes out in the market is up to the market. That is the nature of the policy.

Mr. WORTLEY. But you are in fact establishing interest rates for the banks and the system, your interest rates, your charges.

Mr. VOLCKER. We establish a discount rate.

Mr. WORTLEY. Right, discount.

Mr. VOLCKER. We don't establish the market rates.

Mr. WORTLEY. But in effect, your actions have a bearing?

Mr. VOLCKER. It has.

Mr. WORTLEY. On the marketplace?

Mr. VOLCKER. It has an influence on it, but the market rates deviate widely, and the margin between the discount rate and the market rate varies widely over time. The discount rate is an influence but——

Mr. WORTLEY. Your discount rate, does it play a primary role in determining what the market rate is going to be on interest?

Mr. VOLCKER. I would not say a primary role. The primary role is played by the interaction of the demand for money and the supply of money, whatever the discount rate is. The discount rate has an influence, but I would not say the primary influence.

Mr. WORTLEY. But everybody looks to the Federal Reserve and says, "Well, their rates are going up."

Mr. VOLCKER. That is right.

Mr. WORTLEY. That is the reason we are for it. The bank says it is costing me money to borrow.

Mr. VOLCKER. Psychological influences apart, the discount rate also has a real influence on the market. I would say that it is not the primary influence.

Mr. WORTLEY. Does inflation and unemployment, budget deficits or your perception of them, play a role in setting the rate, setting your discount rate?

Mr. VOLCKER. Setting the discount rate, no, not in any direct sense. The discount rate tends to be set in the light of some evaluation of what market rates are already doing. That is the most immediate reason for setting or changing the discount rate.

Mr. WORTLEY. Is there anything this Congress or this administration can do that would convince you to lower the interest rates, which are really strangling businesses?

Mr. VOLCKER. You raise the question in such a way that I am inclined to answer "no," because we are not setting the rate in the way that the question implies. There are things that can be done that will reduce the market rates.

Mr. WORTLEY. But the corner banker always blames the discount rate.

Mr. VOLCKER. Yes; the corner banker is going to find it convenient to put the blame elsewhere in talking with his customers. That doesn't mean that his economic analysis is always precisely correct.

Mr. WORTLEY. Don't you think if you lowered your rate he would lower his rate?

Mr. VOLCKER. If we lowered our rate, the market would react, I presume. I am not sure in which direction; let's presume they reacted in the direction of lower rates in the short run. But, over time, what is going to influence the market rates is not whether we have lowered the discount rate by 1 percent or not, but the interaction of supply and demand for money and credit. If we lower the discount rate but do not change the provision of reserves into the market, if everything else is unchanged, that lowering of the discount rate is not going to have a persisting effect on the market.

Mr. WORTLEY. Thank you. Thank you, Mr. Volcker.

The CHAIRMAN. Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman. Chairman Volcker, your patience has been well tested today and the one satisfaction is that there is not much to go. I have been very much interested, and I am sure that most of the Members of Congress have been, in the criticism that our allies have made as to our high interest rates. What are they doing to achieve lower interest rates? Are they achieving lower interest rates?

Mr. VOLCKER. It depends upon the country. In the continent of Europe interest rates have generally been rising over the perspective of some months. In the United Kingdom, over the perspective of months, rates have tended to decline, although there has been some increase recently. In Japan, rates have tended to decline.

Mr. BARNARD. Has this been brought about by their central banks monetizing their deficits, or has it come about because of control of deficits?

Mr. VOLCKER. The countries in which rates are rising have had a variety of problems, I think, and the rise has reflected all of these things. Those countries have large government deficits, by and large, particularly in Germany. Japan does, too, as a matter of fact. They have had depreciating exchange rates; interest rates have had something to do with that, but other factors enter in, too, including, that fact that they have had, by and large, big current account deficits.

We have been pretty much in balance in our current account. There have been some political uncertainties in the background in Poland and elsewhere, and of course France had had a change of government. All those things have influenced exchange rates, influenced the inflationary situation, the inflationary outlook, and, to some extent, those factors have been reflected in increases in interest rates. Among those factors is a desire not to have their currencies depreciate too much.

Mr. BARNARD. Those that are keeping low interest rates, aren't they pretty well traveling the same road that we have been traveling the last 10 years; that is, causing a——

Mr. VOLCKER. Again, you have to look at each country separately. The leading example of a country with interest rates moving lower in the last year or 6 months has been Japan. Japan has had both a sharply improving current account and a very much improving price situation. They had very restrictive monetary policies some time ago, but in the past year their wholesale price index has actually declined a hair. Their consumer prices are going up, but at a rather modest rate of 4 or 5 percent, as I recall. They have had wage increases in the 5 or 6 percent area, as I recall, so their inflationary situation has been looking quite good. Among all the leading countries, Japan has been doing pretty well, and they have combined this with a considerable expansion of the economy.

Mr. BARNARD. They have also, I believe, a very high savings rate?

Mr. VOLCKER. They have a very high savings rate. They have had substantial governmental deficits in recent years, but those governmental deficits don't look as big when you look at a savings rate in the vicinity of 20 percent.

Mr. BARNARD. What about West Germany?

Mr. VOLCKER. West Germany also has a relatively high savings rate, more in the order of 14 to 15 percent. They also have had much larger deficits in recent years, which they are not very happy about, and their economic performance has not been as sterling in the last few years as it was earlier, but they certainly do have, by our standards, a high savings rate.

Mr. BARNARD. We have got enough problems of our own without trying to tell them what to do, but it is interesting to compare their criticism of us when it looks to me that they seem to be somewhat on the same path.

Mr. VOLCKER. There is no question that they have problems of their own, but it is natural and human, and also right, that dealing with their internal problems—which are already difficult—they would not want external influences further complicating their life.

Mr. BARNARD. And back to interest rates again, on table 1 it shows that M_3 has grown at a rate of 11.5 percent through the second quarter of 1981, and in June it was 11.1 percent. Of course this actually means now that that part of the money supply is going into nondepository institutions paying higher returns.

Mr. VOLCKER. Yes.

Mr. BARNARD. And we have heard so much said this morning about how housing has been hurt, how homebuilding has been hurt, how people have not been able to buy automobiles, how small businesses have been hurt, so consequently we just find that this is an unfortunate but normal phenomenon of inflation.

Mr. VOLCKER. I think what you see here, is quite adequate growth of M_2 and M_3, but there are so many credit demands out there on the market, including by the U.S. Government, that somebody is getting squeezed out. The person who says "uncle" first tends to be the home buyer or someone else in the weakest position. How do you deal with that problem? Do you try to create more money and create more credit supply to take care of that? In that case you are going to end up with a prolongation of inflation and more inflation, and you will be in the same situation but at a higher level of inflation. Do you try to deal with the problems that are giving rise to the excessive demands, which in a general sense flow out of the inflationary process?

Mr. BARNARD. I can't help but comment in closing, Mr. Chairman, that if I had been sitting in the seat that you are sitting in, and so many of the criticisms have been about the contention that you are not speaking out, I might ask the question, who is listening. I have been here through three chairmen of the Federal Reserve, and I have heard all three of them talk about being fiscally responsible, the balanced budget, and yet I see so many of our colleagues in the Congress still not understanding that that is the primary problem with the economy today. I think that we need to remind the public time and time and time again, the plight that we are in today is not something that just occurred in the last 5 years. It has been building over the last 12 or 15 years, and it is going to be a long time pulling out of it, but nobody wants to acknowledge that fact. That is my rhetorical statement, Mr. Chairman.

The CHAIRMAN. Mrs. Roukema?

Mrs. ROUKEMA. It is difficult to understand what is being left either to ask or say at this hour, but I am going to ask a couple of questions anyway. I will find them. Mr. Chairman, quite to the contrary to some of the statements that have been made today, there are those who feel that perhaps too heavy reliance has been placed on using monetary policies to correct and control inflation, and that if anything perhaps the Fed hasn't been doing enough or has been required to do too much, but for different reasons than your critics have suggested. Would you be willing to comment or give your own personal view as to whether too heavy reliance is being presented on our present program on your policies.

Mr. VOLCKER. From my point of view, there is no question that too heavy reliance is being placed on monetary policies. If all this reliance were not placed on monetary policies, I would have a more pleasant job in testifying before you. Having said that—and this is the point I don't want any confusion on—and whether the reliance is too heavy or not, I think we have to do what we have to do, and that is to carry out our responsibility to try to deal with this inflationary problem by restraining the growth of money and credit. My job is also to tell you what I think the consequences of that are; and it is true, the higher the deficit, the bigger the problem is.

Mrs. ROUKEMA. I agree with you, and I am sympathetic to that, and I am trying to get to the point of what other ways we in the Congress and the administration can be helpful in terms of resolving the problem. You have stated, and I think these were your words, that there is a responsibility on the part of the Congress to reconcile the tax programs with the deficits.

Mr. VOLCKER. Right.

Mrs. ROUKEMA. I would like to hear any further commentary you might have, particularly since we will be discussing tax policies and voting on it within the next 2 weeks, from the point of view, not the general point of view but from the point of view of being supplementary and complementary to the efforts that the Fed is making.

Mr. VOLCKER. There is obviously a desire to have some tax reduction, and there are, as I have said repeatedly, good, legitimate economic reasons why tax reduction can be helpful in these circumstances. That statement has a few corollaries: First, that the deficit is a problem, so the more tax reduction you do the more spending cutting you have to do; and, since there is a limit as to what spending cutting you can do, I would only want to take that tax reduction that you think has a real payoff in terms of productivity and incentives. There is a great debate about what that is, I recognize that, but I certainly would not add things to this tax bill that did not have a very clear rationale in terms of getting more savings, reducing costs, or other purposes of that kind. If you make tax cuts, to put it very bluntly, that may be nice to have but that are difficult to rationalize in terms of the overall economic situation, then you are making the job of the Federal Reserve—but, more importantly, you are making the pressures on the financial markets—greater, without getting anything in return in terms of economic performance. Maybe you have got other objectives in mind, but then don't complain about the additional burden put on financial markets.

Mrs. ROUKEMA. Aside from the targeting or lack of targeting in the tax program, is the total aggregate number, would you say that that is a number that you could live with, the tax reduction?

Mr. VOLCKER. I am not quite sure what that number is now. Frankly, as I understand it, the program that was being discussed in May or early June—when it still looked like there was some chance of an agreed program—provided for a reasonably modest reduction, a 5-percent reduction, with some of the business tax deductions before the middle of next year. Of course, there was a much bigger reduction in the bill in the middle of next year.

With that coming in about 1 year from now, the question that of course arises is how does that fit in with the expenditure trend at that time? The Congress has done valiant work in cutting back on expenditures. From my point of view, it is probably marginal under that set of circumstances as I know them now. I don't know what has been added to it since then, but it makes me very uncomfortable to see things added to it.

Mrs. ROUKEMA. My time has expired and I never got to the question that no one has covered on the question of income policies in terms of labor contracts that will be coming up. I am sorry for that. Perhaps I could submit that to you.

The CHAIRMAN. Without objection all members will be allowed the opportunity to submit questions in writing to the Chairman. I am sure as always he will be more than happy to receive the questions and reply.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Schumer?

Mr. SCHUMER. Thank you, Mr. Chairman, and thank you for your patience, Mr. Volcker. I don't know if Volcker is a Dutch name, but a number of my constituents see you as the little Dutch boy with your finger in the dike. However, they also see that your playmate down the road on Pennsylvania Avenue is the one who is creating all the waves, and is going to force you to keep your finger in that dike for a longer period of time than you might have to.

My questions relate to how high can you go. Last week I think it was, Helmut Schmidt said that interest rates are higher than at any time since the birth of Christ, and of course when I was in the State legislature, when we used to hear of a 20-percent interest rate, we immediately thought of a loan shark, and so my basic question is if the present tax cut and limited budget cuts don't curb inflation, will you try to push interest rates higher than they are now, significantly higher? How much higher, and if not, what then can we do?

Mr. VOLCKER. We are not trying to push interest rates anywhere, if I may just repeat that point. Interest rates come out in the market. Now you talk about interest rates not ever having been higher. I don't know whether that is true or not in Germany, but if you want to see the relationship between inflation and interest rates, look south of the border, where you have countries that have experienced inflation rates above 100 percent with interest rates exceeding 100 percent. Thus, if you are going to have a high rate of inflation you are going to have high interest rates. Inflation, unfortunately, was not invented just yesterday.

I don't know how I can constructively answer your question. Interest rates are already high relative to the inflation rate. I think they are particularly high relative to the prospective inflation rate. The fundamentals of the situation suggest interest rates should be going lower, but just when that will happen, how that will happen, depends ultimately upon that inflationary trend and the conviction that inflation is going to come down and does come down, combined with action on the deficit and all the rest. Interest rates are already very high, and they are high enough, apparently, to exert a strong restraining effect on the economy, which suggests it is not likely they are going to go a lot higher.

Mr. SCHUMER. That is good news. I hope we are right. My second question relates to a question I have had in my mind, and I haven't heard adequately answered. We have seen, because of high interest rates, dramatic changes in where money is going. You know the money market funds have had such a huge increase, and they in turn buy Treasury notes and CD's. Where does all this money ultimately end up? Is it long-term money that is now turning into short term in terms of corporate borrowing or Federal borrowing? Has the Fed done any studies of that?

Mr. VOLCKER. I don't know if it is possible to do a study to answer all the questions you might raise, because, in a complicated financial market, the effect of one factor is almost impossible to trace. I will just make two comments.

First, the whole inflationary environment, and to some degree the instability in interest rates, I think, has fostered the tendency for more and more borrowing to be short term, whatever the demand is. In any event, the borrowing becomes short term when you put it on a fluctuating rate basis; some of it is literally short term. I think that is unfortunate, in terms of the basic financial structure of the country. It is one of the symptoms of the malaise that we have.

Money market funds grow partly out of that phenomenon. They offer a very short-term liability; people feel that they are not making any long-term commitment and can get a high interest rate. Funds, in turn, put the money in very short-term securities.

It is true that they go around the country at something like a vacuum cleaner or branch office bank. We have nationwide banking without branch offices, through the mail, and the funds move into a central point and tend to be put in a rather selected list of securities, which to a limited extent are Treasury securities and agency securities, and to a considerable extent CD's or market CD's. The credit doesn't disappear, but it gets rechanneled, and it does appear in the wholesale money market instead of in the retail markets where it is sorted out.

Mr. SCHUMER. And where does that lead us to?

Mr. VOLCKER. Presumably competition then spreads the money out again but, all things equal, it is a little less available at the country bank or the S. & L., and it is more available at your friend in New York City.

Mr. SCHUMER. My final question is you know each week when—my time has expired. I will send the last question in writing. Thank you, Mr. Chairman.

Mr. VOLCKER. I will give shorter answers.

The CHAIRMAN. Mr. William Coyne.

Mr. W. COYNE. Thank you also for your patience.

In learning from my predecessors I will try to put out all my questions at the beginning and let you take up the balance after my 5 minutes.

I have heard you called everything from calloused tool of the silver speculators or the bankers or the oil companies, candidate for impeachment or someone who is just crying wolf or trying to put your finger in the dike. More than anything else I think you are being a scapegoat for many of the ills and problems of our country.

I hope a better fate will fall upon you than fell upon the ancient messengers in Greece that were promptly assassinated as soon as they delivered the bad news.

I have several questions that you might be able to help us with the relationship between inflation and interest rates. Four or 5 years ago it was always said that inflation was the cause of high interest rates.

Now I hear you and others saying that high interest rates may be the cure for inflation, so we are obviously seeing different sides of the cause-and-effect or cure-and-effect relationship.

To me it seems more that inflation and interest rates are inevitably coupled together in sort of a self-regulating almost zero mechanism type of relationship.

Mr. VOLCKER. I agree with that.

Mr. W. COYNE. And there is in effect no cause and effect trying to figure out what did what to whom, we will eventually come back to the discipline that you were talking about earlier.

I am especially concerned about the lack of discipline both within our financial institutions and with the regulation and deregulation of many of these institutions, and with regard to the proposals for new fiscal resonsibility here in Congress, and I would like you to address first the issues surrounding the S&L's.

We have heard a lot of comment about how they have been forced into accepting regulation Q for all these years, and how they are victims of Government regulation.

Now, of course, they are crying out for more regulation. Is this inconsistent with your perception of discipline?

Second, we have seen in the Senate a proposal for indexing our income taxes. Many people point to indexing as a form of discipline, at least upon Congress itself.

Do you support that kind of self-regulatory discipline on Congress obviously expensive habits? Some of my colleagues on the other side seem unwilling to accept the 20-year record that we have of consistent deficits or feel that we can somehow believe now that the Democrats are serious about controlling them.

Third, I would like to see your comment or your view about the intense concentration of our financial institutions that has occurred in the last 3 years.

My colleague, Mr. Schumer, alluded to this, and it is very troubling to me. We have had a body to make sure that our financial institutions don't become overly concentrated. Are you now changing the Fed's policies to say no, you are willing to accept more concentration, or do you want to maintain the same vigilance against this that you have in the past?

Fourth, I have a very small question on behalf of one of my constituents regarding your pricing for automated clearinghouse services. Many of my constituents feel you are practicing some predatory pricing, if you will, underpricing the services for the clearinghouse, to the subsequent detriment of some of the private producers in clearinghouse services.

Sorry to give you a lot of questions but I wanted to get them out before my 5 minutes were up.

Mr. VOLCKER. I can't even read my own writing now in answer to your question No. 3.

Mr. W. COYNE. The concentration.

Mr. VOLCKER. It began with a "C" all right. Let me take your questions up in reverse order. On the automated clearinghouse question, very quickly, most of the Federal Reserve Banks do have a role in the electronic payments systems and, in fact, there have been public polls to encourage that as a more efficient, effective, quicker way to make payments. The banking system has generally wanted to go in that direction because of its inherent long-run efficiencies. So, in developing prices, we did consciously say that we would price that particular item—and that is the only one we took this decision on—at a price that will return the cost in what we call a "mature environment," when the volume approaches some kind of a reasonable trend level, which we would expect to reach in, say 4 or 5 years, as I recall it. If you don't do that, that is a high cost operation when the volume is very small. Therefore, we want to price for the economies of scale and efficiency that are inherent in the system when it matures.

The banks have been very alert in policing us, if I may say, to make sure we didn't underprice the services, because they want to compete with us; on this one they want it priced on a long-term basis, because they recognize that otherwise the service isn't going to go forward.

There has been some expression of concern from people printing checks who feel that this will impair the volume of checks. Our own analysis says the check volume is going to go upward, so you are not talking about suddenly decimating the volume of checks in the country. Of course, the long-range problem we face is that at some point these paper payments are going to be impossible to handle, just because of their sheer volume, so I think it is in the interest of efficiency in the country—and it is entirely consistent with pricing—to cover costs, including all those wrinkles of private capital-equivalent costs as the volume increases.

If the volume never increases, if people don't want the service, then this policy won't be appropriate in the long run; but we think people will want the service, and it will be more efficient in the future.

On the question of concentration, I can only give you a very personal reaction. I do not feel that the concentration that I see going on in the financial community has reached a stage where concentration in and of itself is a problem.

There are a great many other things going on technologically that are forcing enormous change and forcing some mergers and takeovers, with existing institutions gong into new fields, but concentration, per se, I do not think is a problem generally in the financial area.

It is a highly competitive area. Interestingly enough, as you probably know, the Federal Reserve has a reputation of being extremely tough on concentration in terms of its regulatory decisions. We have lost a few court cases recently which say we are too tough; and I don't know what that reflects, but it is the fact of the matter.

On indexing, I simply must——

Mr. W. COYNE. I just want to make a remark.

The CHAIRMAN. The time of the gentleman has expired.

Mr. W. COYNE. Then I will not expand upon it.

I thank the chairman.

Mr. VOLCKER. On indexing, I will be very short and say that I am generally opposed to indexing of all kinds. I don't see any reason to exempt indexing income taxes from that general stricture. I could give you a lot of reasons, including technical reason that basically the construction of an extremely imperfect consumer price index doesn't warm the cockles of my heart, but I think there are other public policy reasons for not thinking we can escape our real problems by simply indexing things, that only disguise the real problems.

What discipline or lack of discipline there is in financial institutions is a very interesting question to me, and we could sit here talking about it all day.

Let me just say I don't think it is very fruitful, just as it is not with the interest rate question, to go over history and attempt to specify to what extent the problems of the thrift institutions are of their own making or to what extent they are a reflection of public policy in the past. Like everything else there is some combination of the two. There certainly is an element, of public policy to blame the fact that they were encouraged to undertake long-term assets. Without saying anything more, I think this whole inflationary process during the post world war period, and the fact that we have had an enormously favorable record economically against all the past history—we haven't really had a very serious recession for 40 years, since World War II—changes people's behavior. It changes the way people look at things. I suspect financial institutions are not as disciplined in some ways as a good, conservative central banker would like to see them.

A banker is encouraged to take more risks, to leverage capital more, to have less liquidity, to engage in types of lending that perhaps should be looked at a little more carefully. To some extent, one wonders whether this great willingness to provide all these merger commitments isn't a symptom of that kind of relaxation of discipline.

Financial institutions, I think, like and take great comfort in the fact that their liabilities are insured and that the Federal Reserve sits there as a lender of last resort. I am not sure they always recognize that the logical consequence is that those who get left holding the bag when something goes wrong have a legitimate interest in what is happening before things go wrong.

Mr. W. COYNE. Thank you very much.

The CHAIRMAN. Mr. Frank.

Mr. FRANK. Thank you. Thank you, Mr. Chairman, for your patience. I will try not to repeat questions, but, frankly, I forgot what most of them were. I would like to get back to the tax question, and you have spoken out legitimately and given us advice in part, and here again, saying we ought to be cutting spending and cutting spending is good and I think it is perfectly reasonable for you to make an equal degree of recommendations with regard to taxes.

Now the problem I have is with regard to the future tax cuts we may be doing, and that is what has become controversial. You stressed expectations. You said earlier that in fact interest rates are higher than the fundamentals would dictate, that there appears to be an expectation of continued inflation built in that is keeping rates up, say particularly in long-term bonds that is a real problem for us.

You say on page 9 of your statement that in the long time frame interest rates will depend on confidence that inflation will be controlled.

The President has expressed exasperation with Wall Street and with the failure of interest rates to come down.

You said, and I think a lot of people are surprised that Congress did do the cutting it did, but already there is some slippage. We just came back from voting to restore the minimum benefit, at least a very large majority, about 90 percent of the House did that.

My problem is this: If we were to adopt now, ironclad, a third round of personal income tax cuts, what would you think the effect of that would be on these inflationary expectations, given, as you said, that part of our problem with higher interest rates now is a set of expectations that is really deviling us?

Mr. VOLCKER. Well, it is simply a matter of reporting, I suppose—some people in the market would say that makes them more skeptical as to whether the budget will be balanced.

There is also a strong view in the market, partly offsetting that, that tax reduction will force some additional discipline on spending.

Mr. FRANK. Although as a banker in Massachusetts said to me, that latter viewpoint is one they expressed but the former viewpoint is the one they invest according to. Investment behavior then, it is a fair statement——

Mr. VOLCKER. I think you will find both views reflected in the same manner; that is correct.

Mr. FRANK. And, obviously, investment behavior is what is going to affect us. Particularly, I worry about long-term bonds which have behaved in a way that has puzzled us and caused economic effect.

Am I correct now in saying that your reportorial statement, not a statement of your personal preference, is that locking in a third round of tax cuts now will lead a significant number of people in the financial markets to be more skeptical of our ability to balance the budget, and that will, everything else being equal, lead to higher interest rates than we otherwise have for long-term instruments particularly?

Mr. VOLCKER. You have got to look at it in the context of all the other things you are doing.

If you can do something to get out there and convince people more that you are going to have——

Mr. FRANK. That is not my question.

Mr. VOLCKER [continuing]. Spending cuts.

Mr. FRANK. With respect, Mr. Chairman, we have only a little time. That wasn't my question.

Mr. VOLCKER. As a reportorial statement, I think some people are bound to think that.

Mr. FRANK. So that everything else being equal, again you know, if my aunt was a man she would be my uncle. I mean we are all in favor of certain things happening, but you do say, and I quote from your statement and from what you said earlier, we are plagued by a skepticism on the part of the financial community and perhaps the country at large.

Mr. VOLCKER. It is against that background that I make that observation.

Mr. FRANK. So that it is fair to say that your view is that a third round of tax cuts now, since we cannot take action constitutionally and legally to lock in future spending cuts for fiscal year 1983 and 1984 in a very effective way, a third round of tax cuts will add somewhat to inflationary expectations?

Mr. VOLCKER. I would not put the quantitative importance of that as high.

Mr. FRANK. How high would you put it?

Mr. VOLCKER. That factor alone?

Mr. FRANK. How high would you put it, that high, that high? Let the record show how high your hand is.

Mr. VOLCKER. The decision could go either way without your seeing an impact on the market the next day that you could identify.

Mr. FRANK. I didn't ask for it the next day, Mr. Volcker, and I think that is a strawman. Let me get back to Mr.——

Mr. VOLCKER. I don't have to rely on the next day; if you look at it over a period of months I don't think you are going to be able to look back and say that decision had an important effect.

Mr. FRANK. Mr. Volcker, you don't think that the amount of the deficit, people's expectation of whether or not we are going to balance the budget in 1984——

Mr. VOLCKER. Yes; but I ask for what they read into that particular decision.

Mr. FRANK. Right. And I think this is the frustration that Mr. D'Amours expressed.

Mr. VOLCKER. I understand.

Mr. FRANK. You seem to me to be more willing to speak out on the interest rate implications of spending cuts than of tax cuts, and I would just ask for an equal free willingness, and I think that—it seems to me you can do that legitimately in your reportorial function and also say as a matter of personal preference you would rather cut on the spending side than hold back the tax cuts.

Mr. VOLCKER. I think the effects on the deficit in some sense are similar and that they have similar impacts. Looking at this strictly as an economic matter, in terms of economic policy—not as social policy, which enters into this—the tax reduction in itself has benefits that spending does not.

Mr. FRANK. All tax reductions?

Mr. VOLCKER. Tax reductions do serve a purpose.

Mr. FRANK. All tax reductions, 1,000 barrels a day for the independents?

Mr. VOLCKER. I have repeatedly said to concentrate on those tax reductions that have a favorable effect. You will have a more favorable impact on inflation, a more favorable impact on the performance of the economy—and I am not saying there aren't other considerations, but I am just looking at the overall performance of the economy and of financial markets—from simultaneous tax and spending cuts that will leave you the same or better off.

Mr. FRANK. That is true if you are talking about simultaneously. The problem we have got is constitutionally and in every other way we cannot act simultaneously. We don't have the option now of making either spending cuts or tax cuts for fiscal 1983. We can either make tax cuts that are binding for fiscal 1983 or do nothing. That is the problem from the expectation standpoint.

The CHAIRMAN. Mr. Patman.

Mr. PATMAN. Thank you, Mr. Chairman.

Mr. Volcker, let me just state a few questions here for you and maybe you can go back over them and answer them in as short a way as you can, preferably with a yes or not where that is possible.

First of all, if the present high rates of interest continue, how long can the country go witout a serious depression?

Second, will tax cuts increase the money supply? Will tax increases decrease the money supply? Will decreases in Government spending reduce the money supply?

On the balanced budget, should this have a higher priority for the Congress than would a personal tax cut; a business tax cut; or any tax cut? Do higher interest rates hinder or handicap our country's efforts to increase or improve its productivity?

Do you regard high interest rates as one method of controlling credit?

If you had credit control authority, would you act to restrict lines of credit that would prevent these takeovers, say, of Conoco and other companies, say the flow of $35 billion into that type of activity?

In talking today about whether the Fed will choose to monetize the Federal debt, actually the debt is automatically monetized, isn't it? I mean the Treasury issues, Treasury bills, whatever is necessary in order to put into the market, either money or evidence of debt that in effect monetizes the debt.

Last, you have a target for the money supply. Do you have any targets for interest rates? First of all, how long can we go without a serious depression at these rates of interest?

Mr. VOLCKER. We can probably go a long, long while; I don't know whether we would ever have a serious depression if the inflation rate remained high. We got a dip last summer, but we have had extremely high interest rates for well over a year now, as you know, and the surprising thing is that the economy has, for most of that period, expanded. It declined when we had credit controls, but it hasn't declined otherwise. The enormous thing that stands out is the resiliency of the economy in the face of these high interest rates.

Mr. PATMAN. Will the tax cuts increase the money supply?

Mr. VOLCKER. Both the tax cut——

Mr. PATMAN. Just the tax cut.

Mr. VOLCKER. No; not in the direct sense.

Mr. PATMAN. Yes, no? Your answer is no?

Mr. VOLCKER. If I had one answer, "no," with a lot of footnotes.

Mr. PATMAN. Tax cuts don't increase the money supply?

Mr. VOLCKER. A tax cut does not directly increase the money supply.

Mr. PATMAN. Well, in effect, does it not? You can put the money in the bank.

Mr. VOLCKER. You can discuss this forever. If I had to give one answer, I would say "no."

Mr. PATMAN. Will the tax increases decrease the money supply?

Mr. VOLCKER. No.

Mr. PATMAN. Will decreases in Government spending reduce the money supply?

Mr. VOLCKER. No.

Mr. PATMAN. Should balanced budgets have a higher or priority for us than a personal tax cut?

Mr. VOLCKER. They both should have priority. If you say——

Mr. PATMAN. I am talking about a higher priority, though.

Mr. VOLCKER. It is not an either/or choice, and that is the difficulty. I certainly would not go ahead willy-nilly with tax cuts regardless of the impact on the deficit. The deficit is very important in my mind. You are not going to have a zero deficit next year anyway, so it is not a black and white choice in that sense.

I think you should go ahead with the personal tax cuts only if you think that you can fit that into a program that will eliminate the deficit in 2 or 3 years.

Mr. PATMAN. All right, a business tax cut, do you equate that with a personal tax cut as far as priorities are concerned?

Mr. VOLCKER. As far as what is concerned?

Mr. PATMAN. Priorities are concerned?

Mr. VOLCKER. I think as a matter of priorities, starting from zero and asking what you do first, you do the business tax cut first, because I think it is easier to develop some business tax cuts that will more assuredly have the good effects you want to get from tax cuts; but you can cut taxes with a higher payoff in the business area.

Mr. PATMAN. Do you visualize high interest rates as a method of controlling credit?

Mr. VOLCKER. No; I don't think that puts it in the right perspective. High interest rates are what result from a situation where you are restraining money and credit, and there are big demands for money and credit, particularly when they are growing out of inflation.

You can call that a method of controlling, but we don't go out there and say, "I want a higher interest rate to control the credit." We control the credit and the market produces the high interest rates.

Mr. PATMAN. Do the high interest rates or the controls on credit, as you choose to call them, maybe hamper our trying to increase the country's productivity?

Mr. VOLCKER. Over time, I think the answer is no, if the policy is successful. If you look at it in a snapshot way, would you get more investment right now if interest rates were lower? You would; but you can't answer the question with a snapshot.

Mr. PATMAN. If you had credit allocation authority, would you seek to restrict the takeovers and the use of credit in the manner that we have seen evidenced recently in the movement of $35 billion into some sort of commitments?

Mr. VOLCKER. I haven't yet seen the evidence that would lead me there. It is a very difficult issue.

Mr. PATMAN. You don't regard it as a serious problem?

Mr. VOLCKER. I have considerable concern over what I see going on in a number of directions.

Mr. PATMAN. Would credit allocation power enable you to stop it?

Mr. VOLCKER. No; I think we found out quite clearly last year when we had takeovers on our list of nonproduct uses of credit that, first of all, that shouldn't be done; there are many other ways of financing that other than through the banks that we directly regulate.

The biggest immediate complaint came concerning all the foreign banks that are not under our supervision.

Mr. PATMAN. Do you have targets for interest rates as well as monetary money supplies?

Mr. VOLCKER. No; we don't have any real targets for interest rates.

Mr. PATMAN. Is it true that the Federal debt is automatically monetized?

Mr. VOLCKER. Not by my definition of the word monetized. I don't find that word very useful, because everybody has a different meaning in mind.

Mr. PATMAN. Can you send me the correct definition of that?

Mr. VOLCKER. I don't think it is a useful term, but I think what most people have in mind is purchases either by the Federal Reserve or commercial banks—and it is not usually clear whether they mean either or both—of Government securities.

Mr. PATMAN. Somewhat akin to trying to define prime rate.

Mr. VOLCKER. It is considerably more difficult than trying to define prime rate. I don't think you can say much more than whether the money supply or Federal Reserve credit is going up too much or too little; whether that takes the form of a purchase of Government securities or something else is secondary.

Mr. PATMAN. Thank you, sir.

The CHAIRMAN. Mr. Chairman, we want to congratulate you on your tenacity. There has been a request for a second round of questioning that has been denied. The Chair does have other meetings and a conference coming up at 3 o'clock. I think that all the members have had an opportunity to participate, and I want to thank Chairman Volcker for his patience and for staying so long so that we could allow all the members an opportunity. Again, I repeat those members who so desire may submit questions in writing to the chairman.

The hearing is adjourned until tomorrow morning at 10 o'clock when we will hear from the witnesses previously announced.

[Whereupon, at 2:10 p.m., the committee was recessed, to reconvene at 10 a.m., Wednesday, July 22, 1981.]

[The following additional material was submitted for inclusion in the record: A letter from Chairman Fernand J. St Germain, dated June 12, 1981, to Mr. Anthony M. Solomon, president, Federal Reserve Bank of New York, regarding Federal Reserve repurchase agreement transactions, with Mr. Solomon's reply dated July 7, 1981; news articles from various publications regarding bank mergers, and questions submitted by members to Mr. Volcker along with his responses. The material follows:]

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SEVENTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

June 12, 1981

Mr. Anthony M. Solomon, President
The Federal Reserve Bank of New York
33 Liberty Street
New York, New York 10045

Dear Mr. Solomon:

Federal open market transactions records (Federal Reserve Bulletin, April 1981, page A10) indicate that the Federal Reserve conducted $1.634 trillion in sales and purchases of repurchase agreements (including matched securities) in 1980 through its New York open market desk with governmental securities dealers. (The 34 dealers operating on this market on April 2, 1981 are attached.) These transactions constituted 99 percent of total purchases and sales at the open market desk. In a year in which the Federal Reserve was ostensibly on an aggregates target and when M1-B changed by $25 billion (December to December), the huge amount of repurchase agreement transactions poses some questions.

First, to help answer these questions would you provide me a summary for May and November, 1980, of:

a. Interest rates, amounts and maturities on repurchase agreements and matched sales submitted during the auctions at the desk, indicating which were accepted and which were not;

b. The Federal funds rate in effect at the time; and

c. The average repurchase agreement rates in effect during that time.

Second, would you describe the rationale for the Federal Reserve's 1980 open market desk policy and any changes that are being carried out in 1981?

Third, I assume that you closely monitor the transactions costs to the Federal Reserve and the gross profits to the government securities dealers which result directly from these operations. Would you give me your estimate of the gross profits made by the government dealers from these repurchase agreement transactions during 1980?

I would appreciate your answer as soon as possible so that my staff can study the material prior to receiving the Federal Reserve's July 20 report.

Sincerely,

Fernand J. St Germain
Chairman

LIST OF THE GOVERNMENT SECURITIES DEALERS REPORTING TO THE MARKET REPORTS DIVISION OF THE FEDERAL RESERVE BANK OF NEW YORK

ACLI Government Securities, Inc.
Bache Halsey Stuart Shields Inc.
Bank of America NT & SA
Bankers Trust Company
A. G. Becker Incorporated
Briggs, Schaedle & Co., Inc.
Carroll McEntee & McGinley Incorporated
The Chase Manhattan Bank, N.A.
Chemical Bank
Citibank, N.A.
Continental Illinois National Bank
and Trust Company of Chicago
Crocker National Bank
Discount Corporation of New York
Donaldson Lufkin & Jenrette Securities Corporation
The First Boston Corporation
First National Bank of Chicago
Goldman, Sachs & Co.
Harris Trust and Savings Bank
E. F. Hutton & Company, Inc.
Kidder, Peabody & Co., Incorporated
Aubrey G. Lanston & Co., Inc.
Lehman Government Securities Incorporated
Merrill Lynch Government Securities Inc.
Morgan Guaranty Trust Company of New York
Morgan Stanley & Co., Inc.
The Northern Trust Company
Paine, Webber, Jackson & Curtis Incorporated
Wm. E. Pollock & Co., Inc.
Chas. E. Quincey & Co.
Salomon Brothers
The Securities Groups N.Y. Hanseatic Division
Smith Barney, Harris Upham & Co., Incorporated
United California Bank
Dean Witter Reynolds Incorporated

FEDERAL RESERVE BANK OF NEW YORK
NEW YORK, N.Y. 10045
AREA CODE 212 791-6173

ANTHONY M. SOLOMON
PRESIDENT

July 7, 1981

The Honorable Fernand J. St. Germain
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Your letter of June 12, 1981 referred to the large volume of repurchase agreements and matched sale-purchase transactions undertaken by the Federal Reserve System during 1980, and requested some additional information regarding those transactions which I am pleased to provide to the extent that I can do so. My comments follow the outline of the topics raised in your letter.

First, as requested, I am enclosing with this letter detailed summary information on the repurchase agreements and matched sale-purchase transactions undertaken during the months of May and November 1980. The daily summaries provide data on interest rates, amounts and maturities of both accepted and rejected proposals presented to the Federal Reserve's open market Trading Desk. Also provided is information on the daily Federal funds rate prevailing in the market, and our Trading Desk's estimate of prevalent mid-morning rates in the market for repurchase agreements against Government securities undertaken by dealers apart from transactions by our Desk. The daily summaries, you will note, include not only the repurchase agreements and matched sale transactions conducted with dealers in the market, but also the daily execution of matched sale transactions directly with foreign central banks. (Indeed, the transactions with foreign official accounts would account, during 1980, for $1,071 billion of the $1,634 billion of temporary-type transactions referred to in your letter.)

Second, your letter asks about the rationale for the Federal Reserve's 1980 open market Desk policy and any changes in 1981. Under present reserve targeting procedures, in effect since October 1979, the task of the domestic Trading Desk is to achieve reserve objectives consistent with the money supply objectives adopted by the Federal Open Market Committee (FOMC). At each meeting, the FOMC selects short-term growth objectives for money supply designed to be consistent with the Federal Reserve's annual objectives. The Board staff then works out weekly path values for total reserves and nonborrowed reserves (i.e., total reserves less borrowings from the Federal Reserve discount window) that would be needed to support the monetary growth sought by the FOMC. As the intermeeting period proceeds, adjustments may be made to the path based, for example, on updated information about reserve-to-money multipliers.

While the FOMC sets its growth objectives in seasonally adjusted terms, the weekly path values that the Desk seeks to meet reflect the considerable seasonal movements that are characteristic of the real world. For this reason alone it is often necessary to engage in substantial operations to add or absorb reserves on a very short-term basis, even in the course of pursuing steady monetary growth on a seasonally adjusted basis. Moreover, a large part of the Trading Desk's routine task is to counter the impact on reserve availability of short-term variations in Federal Reserve float, currency in circulation, the level of Treasury deposits at the Federal Reserve, and other factors. Daily projections are made of these factors, and often changes in these factors require sizable revision from one day to the next. Cushioning the impact of such short-term variations in reserve availability explains a large part of the need for substantial activity in the form of short-term repurchase agreements (to add reserves temporarily) or matched sale-purchase transactions (to absorb reserves temporarily). During 1980, the average weekly change in market factors affecting reserve availability was on the order of $1 billion. Meeting a $1 billion reserve need in a week could well entail short-term transactions several times that amount, since it is often prudent to meet reserve needs, which are uncertain, on the basis of providing reserves just a day or two at a time. Moreover, the recorded dollar volume of temporary self-reversing transactions is enlarged because both the purchase and sale sides are counted in the total.

As noted earlier, another element swelling the volume of short-term open market operations is the execution of matched sale-purchase transactions with foreign official accounts. These transactions are arranged on behalf of a large number of foreign central banks which maintain a portion of their reserves in the form of repurchase agreements as a convenient means to deal with short-term fluctuations in their cash requirements. The Desk, by arranging short-term transactions with these accounts, reduces the volume of transactions to be executed daily in the market, leaving the way more clear for the Federal Reserve's own operations to achieve reserve objectives.

The daily aggregate matched-sale transactions with foreign accounts have varied, for the most part, within a range of about $1 1/4 to $2 1/2 billion. Care is taken to avoid letting them build up to a volume that could interfere with attainment of the Federal Reserve's targets. At times, when it suits the reserve objectives, the foreign short-term transactions are executed with dealers in the market rather than with the Federal Reserve's own account, although the latter route is the more common one. When transactions are arranged between the Federal Reserve and foreign accounts, the interest rate is based on prevailing market rates.

Third, your letter asks for our estimate of the gross profits made by Government securities dealers from repurchase agreements during 1980. Unfortunately, I cannot be particularly helpful on this point. While you are right in assuming that we monitor the overall profit and loss performance of the dealers trading with the open market Desk, I know of no way, conceptually or statistically, to separate out the portion of their profits or losses that might be related to trading activity with our Desk, or related particularly to repurchase agreements.

In general, though, it may be noted that because of the keen competition among dealers, and the fact that they often are merely serving an intermediary role between the Federal Reserve and their own customers, Federal Reserve repurchase agreements or matched sale-purchase transactions do not represent a significant source of profitability for the dealers. Dealer profitability, which has been quite variable in recent years, is primarily a function of the dealers' market-making and position-taking roles.

Typically, the rates received or paid by the Federal Reserve on repurchase agreements or matched sale-purchase transactions are closely in line with short-term financing rates prevailing elsewhere in the market at the time. When the dealers serve as intermediaries between their customers and the Federal Reserve in such transactions we understand that some dealers charge a small commission from the customer such as 5 basis points (.05 percent); on a $100 million overnight repurchase agreement this would amount to about $140. In other cases the dealers might impose no charge, reasoning that they are performing a service for their customer that will help to build other profitable relationships.

If we can be of further assistance, please let me know.

Sincerely,

Anthony M. Solomon
President

Enclosures

Daily Summary
(in millions of dollars)

Date - 5/1/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$3,023.9
Approximate Market RP Rate for Treasury & Agency Securities:	11.85%
Effective Rate for Overnight Federal Funds:	14.07%
Federal Funds Trading Range:	13 3/8 - 17%

Daily Summary
(in millions of dollars)

Date - 5/2/80
Type of Operation - Over-the-weekend Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$1,792.0	$310.1
Range of Rates Offered:	13.52 - 12.50%	13.875 - 13.00%
Amount Accepted:	$ 841.2	$255.1
Range of Rates Accepted:	13.52 - 13.01%	13.875 - 13.16%
Weighted Average Rate:	13.29%	13.48%
Matched Sales with Foreign:	$2,890.2	
Approximate Market RP Rate for Treasury & Agency Securities:	12.40%	
Effective Rate for Overnight Federal Funds:	14.30%	
Federal Funds Trading Range:	8 - 15%	
Estimated Federal Funds Rate at Time of Market Entry:	14 3/4 - 14 7/8%	

Treasury & Agencies

Propositions Accepted

13.52%	$ 51.0
13.50	200.0
13.45	24.2
13.41	50.0
13.26	50.0
13.25	142.0
13.20	14.0
13.16	21.0
13.15	168.0
13.125	20.0
13.06	30.0
13.05	10.0
13.02	21.0
13.01	40.0
TOTAL	$841.2

Propositions Rejected

13.00%	$600.0
12.88	25.0
12.78	50.0
12.77	11.0
12.75	15.0
12.72	5.3
12.65	19.5
12.50	225.0
TOTAL	$950.8

Bankers' Acceptances

Propositions Accepted

13.875%	$ 36.6
13.51	38.8
13.50	63.9
13.40	62.7
13.25	43.6
13.16	9.5
TOTAL	$255.1

Propositions Rejected

13.15%	$15.0
13.05	20.0
13.02	5.0
13.00	15.0
TOTAL	$55.0

Daily Summary
(in millions of dollars)

Date - 5/5/80
Type of Operation - 1-day matched sales

	Round #1	Round #2
Total Propositions:	$4,891.0	$2,069.0
Range of Rates Offered:	11.70 - 13.50%	11.80 - 13.25%
Amount Accepted:	$2,396.0	$1,144.0
Range of Rates Accepted:	11.70 - 12.35%	11.80 - 12.15%
Weighted Average Rate:	12.23%	12.07%
Matched Sales with Foreign:	$2,411.1	
Approximate Market RP Rate for Treasury & Agency Securities:	11.85%	
Effective Rate for Overnight Federal Funds:	12.28%	
Federal Funds Trading Range:	11 - 13 1/2%	
Estimated Federal Funds Rate at Time of Market Entry:	12 1/4%	

Round #1

Propositions Accepted

11.70%	$ 20.0
11.95	25.0
12.00	260.0
12.15	95.0
12.20	123.0
12.23	60.0
12.25	1192.0
12.28	60.0
12.35	561.0
TOTAL	$2396.0

Propositions Rejected

12.36%	$ 50.0
12.37	12.0
12.375	10.0
12.39	50.0
12.40	80.0
12.41	75.0
12.45	515.0
12.49	180.0
12.50	18.0
12.60	60.0
12.62	510.0
12.625	50.0
12.66	75.0
12.69	60.0
12.70	50.0
12.71	50.0
12.72	50.0
12.75	10.0
12.78	25.0
12.99	500.0
13.00	30.0
13.25	10.0
13.50	25.0
TOTAL	$2495.0

Round #2

Propositions Accepted

11.80%	$ 160.0
11.83	10.0
11.90	9.0
11.98	25.0
12.00	50.0
12.03	75.0
12.06	100.0
12.10	30.0
12.14	25.0
12.15	660.0
TOTAL	$1144.0

Propositions Rejected

12.16%	$ 40.0
12.20	75.0
12.22	75.0
12.25	680.0
12.45	25.0
12.50	5.0
13.25	25.0
TOTAL	$ 925.0

Daily Summary
(in millions of dollars)

Date - 5/6/80
Type of Operation - 1-day matched sales

Total Propositions:	$2,956.0
Range of Rates Offered:	10.90 - 12.03%
Amount Accepted:	$1,926.0
Range of Rates Accepted:	10.90 - 11.34%
Weighted Average Rate:	11.09%
Matched Sales with Foreign:	$2,146.6
Approximate Market RP Rate for Treasury & Agency Securities:	11.05%
Effective Rate for Overnight Federal Funds:	11.57%
Federal Funds Trading Range:	9 - 12 1/4%
Estimated Federal Funds Rate at Time of Market Entry:	11 - 11 1/2%

Propositions Accepted		Propositions Rejected	
10.90%	$ 19.0	11.37%	$ 75.0
10.91	23.0	11.375	60.0
10.95	160.0	11.40	35.0
10.99	100.0	11.48	35.0
11.00	327.0	11.49	20.0
11.05	595.0	11.60	20.0
11.10	65.0	11.625	40.0
11.12	30.0	11.70	30.0
11.125	40.0	11.73	40.0
11.17	25.0	11.75	525.0
11.20	10.0	11.85	30.0
11.22	67.0	11.875	15.0
11.24	205.0	11.90	30.0
11.25	85.0	12.00	25.0
11.34	175.0	12.03	50.0
TOTAL	$1926.0	TOTAL	$1030.0

Daily Summary
(in millions of dollars)

Date - 5/7/80
Type of Operation - 1-day Matched Sales

Total Propositions:	$3,859.5
Range of Rates Offered:	10.00 - 11.00%
Amount Accepted:	$1,573.0
Range of Rates Accepted:	10.00 - 10.30%
Weighted Average Rate:	10.18%
Matched Sales with Foreign:	$2,061.5
Approximate Market RP Rate for Treasury & Agency Securities:	9.35%
Effective Rate for Overnight Federal Funds:	9.89%
Federal Funds Trading Range:	1 - 11 1/8%
Estimated Federal Funds Rate at Time of Market Entry:	10 1/2%

Propositions Accepted

10.00%	$ 60.0
10.05	50.0
10.09	50.0
10.12	50.0
10.125	315.0
10.15	300.0
10.17	35.0
10.20	210.0
10.22	40.0
10.23	10.0
10.24	107.0
10.25	76.0
10.29	50.0
10.30	220.0
Total	$1,573.0

Propositions Rejected

10.31%	$ 50.0
10.34	100.0
10.35	100.0
10.37	226.0
10.375	25.0
10.38	50.0
10.39	125.0
10.40	522.0
10.41	75.0
10.47	75.0
10.48	50.0
10.49	70.0
10.50	160.0
10.51	20.0
10.55	122.5
10.60	126.0
10.62	50.0
10.64	10.0
10.75	100.0
10.77	10.0
10.78	110.0
10.81	50.0
10.82	40.0
11.00	20.0
Total	$2,286.5

Daily Summary
(in millions of dollars)

Date - 5/8/80
Type of Operation - 1-day matched sales

Total Propositions:	$5,941.0
Range of Rates Offered:	9.90 - 11.50%
Amount Accepted:	$1,501.0
Range of Rates Accepted:	9.90 - 10.25%
Weighted Average Rate:	10.15%
Matched Sales with Foreign:	$2,112.6
Approximate Market RP Rate for Treasury & Agency Securities:	8.75%
Effective Rate for Overnight Federal Funds:	10.57%
Federal Funds Trading Range:	10 1/4 - 11%
Estimated Federal Funds Rate at Time of Market Entry:	10 3/8%

Propositions Accepted		Propositions Rejected	
9.90%	$ 30.0	10.28%	$ 10.0
9.95	100.0	10.29	55.0
10.00	27.0	10.30	310.0
10.05	10.0	10.32	10.0
10.10	380.0	10.33	10.0
10.11	15.0	10.34	35.0
10.125	50.0	10.36	10.0
10.13	15.0	10.375	1535.0
10.14	60.0	10.45	50.0
10.15	74.0	10.46	100.0
10.16	60.0	10.48	500.0
10.18	75.0	10.50	50.0
10.19	95.0	10.55	100.0
10.20	25.0	10.58	410.0
10.21	20.0	10.60	160.0
10.24	165.0	10.625	5.0
10.25	300.0	10.65	30.0
TOTAL	$1501.0	10.73	5.0
		10.75	10.0
		10.85	10.0
		10.95	10.0
		11.00	1000.0
		11.50	25.0
		TOTAL	$ 4440.0

Daily Summary
(in millions of dollars)

Date - 5/9/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$2,578.7
Approximate Market RP Rate for Treasury & Agency Securities:	9.00%
Effective Rate for Overnight Federal Funds:	10.80%
Federal Funds Trading Range:	10 1/2 - 15%

Daily Summary
(in millions of dollars)

Date - 5/12/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$2,019.0
Approximate Market RP Rate for Treasury & Agency Securities:	8.80%
Effective Rate for Overnight Federal Funds:	10.79%
Federal Funds Trading Range:	10 - 11 1/2%

Daily Summary
(in millions of dollars)

Date - 5/13/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$769.3
Approximate Market RP Rate for Treasury & Agency Securities:	8.75%
Effective Rate for Overnight Federal Funds:	10.92%
Federal Funds Trading Range:	10 1/2 - 11 1/2%

Daily Summary
(in millions of dollars)

Date - 5/14/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$484.2
Approximate Market RP Rate for Treasury & Agency Securities:	8.00%
Effective Rate for Overnight Federal Funds:	11.30%
Federal Funds Trading Range:	7 - 18%

Daily Summary
(in millions of dollars)

Date - 5/15/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$121.7
Approximate Market RP Rate for Treasury & Agency Securities:	8.10%
Effective Rate for Overnight Federal Funds:	11.15%
Federal Funds Trading Range:	10 3/4 - 12 1/4%

Daily Summary
(in millions of dollars)

Date - 5/16/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$178.0
Approximate Market RP Rate for Treasury & Agency Securities:	10.60%
Effective Rate for Overnight Federal Funds:	11.42%
Federal Funds Trading Range:	10 - 12%

Daily Summary
(in millions of dollars)

Date - 5/19/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$395.4
Approximate Market RP Rate for Treasury & Agency Securities:	10.65%
Effective Rate for Overnight Federal Funds:	10.92%
Federal Funds Trading Range:	9 1/2 - 11 1/4%

Daily Summary
(in millions of dollars)

Date - 5/20/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$2,336.4
Approximate Market RP Rate for Treasury & Agency Securities:	9.40%
Effective Rate for Overnight Federal Funds:	10.20%
Federal Funds Trading Range:	5 - 10 5/8%

Daily Summary
(in millions of dollars)

Date - 5/21/80
Type of Operation - 1-day Matched Sales

Total Propositions:	$5,057.3
Range of Rates Offered:	8.60 - 10.00%
Amount Accepted:	$1,166.0
Range of Rates Accepted:	8.60 - 8.99%
Weighted Average Rate:	8.96%
Matched Sales with Foreign:	$2,119.9
Approximate Market RP Rate for Treasury & Agency Securities:	8.50%
Effective Rate for Overnight Federal Funds:	8.44%
Federal Funds Trading Range:	2 - 9 7/8%
Estimated Federal Funds Rate at Time of Market Entry:	9 1/4%

Propositions Accepted

8.60%	$ 10.0
8.74	61.0
8.75	30.0
8.95	40.0
8.97	400.0
8.98	125.0
8.99	500.0
Total	$1,166.0

Propositions Rejected

9.00%	$292.0	9.35%	$ 100.0
9.04	50.0	9.375	120.0
9.07	400.0	9.45	130.0
9.09	207.0	9.48	325.0
9.10	260.0	9.49	60.0
9.125	80.0	9.50	285.0
9.14	235.0	9.55	20.0
9.15	37.3	9.625	5.0
9.16	25.0	9.67	200.0
9.20	415.0	9.70	25.0
9.22	30.0	9.75	5.0
9.23	15.0	9.85	200.0
9.25	160.0	10.00	35.0
9.28	75.0	Total	$3,891.3
9.30	50.0		
9.34	50.0		

Daily Summary
(in millions of dollars)

Date - 5/22/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$1,873.8
Approximate Market RP Rate for Treasury & Agency Securities:	8.50%
Effective Rate for Overnight Federal Funds:	9.51%
Federal Funds Trading Range:	9 1/4 - 9 3/4%

Daily Summary
(in millions of dollars)

Date - 5/23/80 Over-the-weekend
Type of Operation - matched sales

	Round #1	Round #2
Total Propositions:	$3,323.5	$1,424.5
Range of Rates Offered:	7.95 - 10.01%	7.57 - 10.01%
Amount Accepted:	$1,105.0	$1,114.5
Range of Rates Accepted:	7.95 - 8.38%	7.57 - 8.39%
Weighted Average Rate:	8.36%	8.17%
Matched Sales with Foreign:	$1,999.7	
Approximate Market RP Rate for Treasury & Agency Securities:	8.40%	
Effective Rate for Overnight Federal Funds:	8.73%	
Federal Funds Trading Range:	7 - 9 1/2%	
Estimated Federal Funds Rate at Time of Market Entry:	8 7/8%	

Round #1

Propositions Accepted

7.95%	$ 20.0
8.25	7.0
8.30	10.0
8.34	175.0
8.35	88.0
8.375	65.0
8.38	740.0
Total	$1,105.0

Propositions Rejected

8.39%	$106.5	8.85%	$ 105.0
8.40	25.0	8.86	15.0
8.44	45.0	8.90	20.0
8.47	8.0	8.94	25.0
8.48	1,150.0	8.95	20.0
8.49	70.0	8.99	35.0
8.50	34.0	9.00	20.0
8.55	10.0	9.10	25.0
8.59	110.0	9.125	15.0
8.60	15.0	9.24	5.0
8.61	10.0	9.75	25.0
8.62	15.0	10.01	100.0
8.625	10.0	Total	$2,218.5
8.63	25.0		
8.70	30.0		
8.75	65.0		
8.79	30.0		
8.84	50.0		

Round #2

Propositions Accepted

7.57%	$ 5.0
7.74	106.5
7.75	10.0
8.00	110.0
8.05	5.0
8.09	45.0
8.15	35.0
8.25	603.0
8.30	115.0
8.33	5.0
8.35	35.0
8.38	25.0
8.39	15.0
Total	$1,114.5

Propositions Rejected

8.49%	$ 50.0
8.50	30.0
8.79	35.0
8.87	20.0
9.00	75.0
10.01	100.0
Total	$310.0

Daily Summary
(in millions of dollars)

Date - 5/27/80 - Page 1
Type of Operation - 1-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$1,048.0	$112.8
Range of Rates Offered:	9.56 - 8.00%	10.00 - 8.25%
Amount Accepted:	$1,048.0	$112.8
Range of Rates Accepted:	9.56 - 8.00%	10.00 - 8.25%
Weighted Average Rate:	8.72%	9.48%
Matched Sales with Foreign:	$2,135.9	
Approximate Market RP Rate for Treasury & Agency Securities:	7.95%	
Effective Rate for Overnight Federal Funds:	9.55%	
Federal Funds Trading Range:	8 3/4 - 15%	
Estimated Federal Funds Rate at Time of Market Entry:	10 1/2%	

Treasury & Agencies

Propositions Accepted

9.56%	$36.0
9.375	9.0
9.27	22.0
9.13	5.0
9.10	20.0
9.05	40.0
9.02	190.0
9.01	107.0
9.00	79.0
8.90	35.0
8.81	10.0
8.77	15.0
8.75	10.0
8.625	10.0
8.52	40.0
8.51	15.0
8.50	39.0
8.41	62.0
8.30	145.0
8.28	60.0
8.26	15.0
8.25	20.0
8.02	14.0
8.00	50.0
Total	$1,048.0

Propositions Rejected

- 0 -

Bankers' Acceptances

Propositions Accepted

10.00%	$47.6
9.55	42.7
8.25	22.5
Total	$112.8

Propositions Rejected

- 0 -

Daily Summary
(in millions of dollars)

Date - 5/27/80 - Page 2

Type of Operation - 2-day Repurchase Agreements	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$1,596.7	$111.2
Range of Rates Offered:	9.21 - 7.75%	9.01 - 8.25%
Amount Accepted:	$1,582.5	$111.2
Range of Rates Accepted:	9.21 - 8.125%	9.01 - 8.25%
Weighted Average Rate:	8.63%	8.62%
Matched Sales with Foreign:		
Approximate Market RP Rate for Treasury & Agency Securities:	7.95%	
Effective Rate for Overnight Federal Funds:	9.55%	
Federal Funds Trading Range:	8 3/4 - 15%	
Estimated Federal Funds Rate at Time of Market Entry:	10 1/2%	

Treasury & Agencies

Propositions Accepted

9.21%	$60.0
9.17	17.0
9.05	200.0
9.00	247.0
8.89	145.0
8.875	25.0
8.76	13.0
8.67	20.0
8.625	17.5
8.56	15.0
8.53	50.0
8.51	15.0
8.50	3.0
8.30	730.0
8.125	25.0
Total	$1,582.5

Propositions Rejected

7.75%	$14.4
Total	$14.4

Bankers' Acceptances

Propositions Accepted

9.01%	$13.8
8.75	46.8
8.50	28.4
8.25	22.2
Total	$111.2

Propositions Rejected

- 0 -

Daily Summary
(in millions of dollars)

Date - 5/28/80

Type of Operation - 1-day Repurchase Agreements	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$2,617.6	$531.4
Range of Rates Offered:	9.25 - 7.00%	9.76 - 8.25%
Amount Accepted:	$2,597.6	$531.4
Range of Rates Accepted:	9.25 - 8.00%	9.76 - 8.25%
Weighted Average Rate:	8.30%	8.92%
Matched Sales with Foreign:	$2,227.1	
Approximate Market RP Rate for Treasury & Agency Securities:	8.00%	
Effective Rate for Overnight Federal Funds:	12.23%	
Federal Funds Trading Range:	10 3/4 - 15%	
Estimated Federal Funds Rate at Time of Market Entry:	11 3/4%	

Treasury & Agencies

Propositions Accepted

9.25%	$ 15.0
9.18	13.0
9.05	30.0
8.76	15.0
8.75	45.0
8.67	20.0
8.63	20.0
8.625	17.0
8.55	155.0
8.53	13.0
8.52	50.0
8.51	75.0
8.50	475.7
8.40	15.0
8.375	10.5
8.35	10.0
8.31	10.0
8.30	235.0
8.26	210.0
8.25	230.0
8.21	48.0
8.20	55.0
8.16	24.0
8.13	10.0
8.12	12.0
8.05	63.0
8.02	12.0
8.01	10.0
8.00	699.4
Total	$2,597.6

Propositions Rejected

7.875%	$ 10.0
7.00	10.0
Total	$ 20.0

Bankers' Acceptances

Propositions Accepted

9.76%	$ 96.8
9.125	52.5
9.00	116.9
8.77	10.7
8.76	30.3
8.75	83.5
8.50	24.3
8.41	29.3
8.31	61.0
8.25	26.1
Total	$531.4

Propositions Rejected

- 0 -

Daily Summary
(in millions of dollars)

Date - 5/29/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$2,067.9
Approximate Market RP Rate for Treasury & Agency Securities:	8.25%
Effective Rate for Overnight Federal Funds:	10.49%
Federal Funds Trading Range:	9 3/4 - 11%

Daily Summary
(in millions of dollars)

Date - 5/30/80
Type of Operation - Over-the-weekend repurchase agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$3,656.8	$426.1
Range of Rates Offered:	10.50 - 8.60%	10.75 - 9.125%
Amount Accepted:	$3,258.8	$365.9
Range of Rates Accepted:	10.50 - 9.50%	10.75 - 9.70%
Weighted Average Rate:	9.85%	10.10%
Matched Sales with Foreign:	$2,055.8	
Approximate Market RP Rate for Treasury & Agency Securities:	9.35%	
Effective Rate for Overnight Federal Funds:	11.06%	
Federal Funds Trading Range:	10 1/2 - 14%	
Estimated Federal Funds Rate at Time of Market Entry:	10 3/4 - 10 7/8%	

Treasury & Agencies

Propositions Accepted

10.50%	$ 24.0
10.26	29.4
10.25	70.0
10.13	24.9
10.125	230.0
10.07	8.0
10.06	50.0
10.05	20.0
10.03	24.0
10.02	580.0
10.00	287.0
9.88	20.0
9.875	581.0
9.80	48.5
9.76	181.0
9.75	307.0
9.70	19.0
9.625	25.0
9.61	30.0
9.60	70.0
9.53	6.0
9.52	25.0
9.51	57.0
9.50	542.0
Total	$3,258.8

Propositions Rejected

9.50%	$ 10.0
9.35	7.0
9.27	35.0
9.25	25.0
9.10	158.0
9.05	3.0
9.00	5.0
8.75	5.0
8.60	150.0
Total	$398.0

Bankers' Acceptances

Propositions Accepted

10.75%	$ 68.3
10.375	9.0
10.125	127.7
10.01	29.6
9.875	20.0
9.76	29.0
9.75	29.2
9.70	53.1
Total	$365.9

Propositions Rejected

9.51%	$ 35.0
9.50	5.0
9.125	20.2
Total	$ 60.2

Daily Summary
(in millions of dollars)

Date - 11/3/80
Type of Operation - 2-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$3,067.9	$504.9
Range of Rates Offered:	13.41 - 12.75%	13.61 - 13.20%
Amount Accepted:	$883.0	$241.9
Range of Rates Accepted:	13.41 - 13.15%	13.61 - 13.30%
Weighted Average Rate:	13.19%	13.47%
Matched Sales with Foreign:	$2,528.5	
Approximate Market RP Rate for Treasury & Agency Securities:	12.80%	
Effective Rate for Overnight Federal Funds:	14.06%	
Federal Funds Trading Range	13 3/4 - 14 3/4%	
Estimated Federal Funds Rate at Time of Market Entry:	13 7/8%	

Treasury & Agencies

Propositions Accepted

13.41%	$40.0
13.375	27.0
13.32	50.0
13.26	50.0
13.25	22.0
13.16	530.0
13.15	164.0
TOTAL	$883.0

Propositions Rejected

13.13%	$64.0
13.125	135.0
13.12	20.0
13.11	4.0
13.08	20.0
13.07	75.0
13.06	44.0
13.05	665.6
13.03	15.0
13.02	133.0
13.01	112.5
13.00	409.6
12.98	50.0
12.96	105.0
12.92	17.0
12.91	18.0
12.90	208.2
12.875	39.0
12.83	11.0
12.80	9.0
12.75	30.0
TOTAL	$ 2,184.9

Bankers' Acceptances

Propositions Accepted

13.61%	$43.3
13.56	43.6
13.55	14.6
13.50	51.8
13.36	20.5
13.35	46.4
13.30	21.7
TOTAL	$241.9

Propositions Rejected

13.26%	$43.0
13.25	172.0
13.20	48.0
TOTAL	$263.0

Daily Summary
(in millions of dollars)

Date - 11/5/80
Type of Operation - 1-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$1,523.7	$440.8
Range of Rates Offered:	14.25 - 12.90%	14.56 - 13.51%
Amount Accepted:	$1,483.7	$440.8
Range of Rates Accepted:	14.25 - 13.26%	14.56 - 13.51%
Weighted Average Rate:	13.74%	14.15%
Matched Sales with Foreign:	$2,334.6	
Approximate Market RP Rate for Treasury & Agency Securities:	13.10%	
Effective Rate for Overnight Federal Funds:	14.76%	
Federal Funds Trading Range:	13 - 18%	
Estimated Federal Funds Rate at Time of Market Entry:	14 3/4 - 14 7/8%	

Treasury & Agencies

Propositions Accepted

14.25%	$28.0
14.13	73.0
14.11	34.0
14.06	25.0
14.05	75.0
14.03	43.0
14.02	26.0
14.01	5.0
13.91	70.0
13.90	12.0
13.875	95.0
13.85	200.0
13.80	8.0
13.76	80.0
13.75	15.0
13.69	27.0
13.67	45.0
13.65	16.3
13.625	72.0
13.62	5.0
13.60	12.0
13.56	10.0
13.55	54.4
13.53	41.0
13.52	86.0
13.51	5.0
13.50	108.0
13.43	35.0
13.40	88.0
13.35	20.0
13.32	30.0
13.26	40.0
TOTAL	$1,483.7

Propositions Rejected

12.90%	$40.0
TOTAL	$40.0

Bankers' Acceptances

Propositions Accepted

14.56%	$62.4
14.51	56.9
14.26	12.7
14.25	47.8
14.15	14.7
14.10	15.9
14.01	6.4
14.00	121.5
13.90	34.4
13.85	19.5
13.81	22.9
13.71	22.1
13.51	3.6
TOTAL	$440.8

Propositions Rejected

\- 0 -

Daily Summary
(in millions of dollars)

Date - 11/6/80
Type of Operation - 1-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$3,697.1	$718.3
Range of Rates Offered:	14.27 - 13.00%	15.00 - 14.01%
Amount Accepted:	$3,414.1	$718.3
Range of Rates Accepted:	14.27 - 13.625%	15.00 - 14.01%
Weighted Average Rate:	13.97%	14.51%
Matched Sales with Foreign:	$2,392.2	
Approximate Market RP Rate for Treasury & Agency Securities:	13.60%	
Effective Rate for Overnight Federal Funds:	15.35%	
Federal Funds Trading Range:	15 - 15 3/4%	
Estimated Federal Funds Rate at Time of Market Entry:	15 1/2%	

Treasury & Agencies

Propositions Accepted

14.27%	$25.0
14.26	363.0
14.16	50.0
14.15	75.0
14.14	130.0
14.13	84.0
14.125	25.8
14.11	43.0
14.10	5.0
14.07	50.0
14.05	30.0
14.03	25.0
14.01	139.5
14.00	610.6
13.95	165.0
13.93	5.0
13.92	22.8
13.90	210.0
13.88	123.0
13.875	673.0
13.86	28.0
13.85	48.0
13.81	10.0
13.80	125.0
13.79	10.0
13.77	45.0
13.76	33.4
13.75	38.0
13.63	22.0
13.625	200.0
TOTAL	$3,414.1

Propositions Rejected

13.55%	$75.0
13.52	60.0
13.50	55.0
13.42	25.0
13.38	9.0
13.375	10.0
13.31	4.0
13.25	5.0
13.00	40.0
TOTAL	$283.0

Bankers' Acceptances

Propositions Accepted

15.00%	$181.6
14.75	69.5
14.71	25.3
14.56	19.2
14.52	21.0
14.50	7.6
14.46	19.4
14.41	34.7
14.39	28.1
14.36	33.4
14.31	36.1
14.30	16.2
14.20	47.9
14.15	86.1
14.10	34.0
14.05	29.8
14.01	28.4
TOTAL	$718.3

Propositions Rejected

\- 0 -

Daily Summary
(in millions of dollars)

Date - 11/7/80
Type of Operation - Over-weekend Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$2,958.8	$696.2
Range of Rates Offered:	14.26 - 13.25%	14.71 - 13.92%
Amount Accepted:	$1,419.4	$628.7
Range of Rates Accepted:	14.26 - 13.90%	14.71 - 14.05%
Weighted Average Rate:	14.01%	14.37%
Matched Sales with Foreign:	$2,051.9	
Approximate Market RP Rate for Treasury & Agency Securities:	14.00%	
Effective Rate for Overnight Federal Funds:	15.01%	
Federal Funds Trading Range:	14¼ - 15½%	
Estimated Federal Funds Rate at Time of Market Entry:	14 3/4%	

Treasury & Agencies

Propositions Accepted		Propositions Rejected	
14.26%	$40.0	13.88%	$110.0
14.25	35.0	13.875	757.0
14.13	19.0	13.81	26.6
14.125	113.0	13.80	142.0
14.10	76.0	13.76	55.0
14.06	60.0	13.75	131.8
14.05	30.9	13.70	40.0
14.03	35.0	13.69	30.0
14.02	25.0	13.67	15.0
14.01	74.0	13.65	5.0
14.00	569.0	13.63	5.0
13.97	6.0	13.625	25.0
13.96	28.0	13.60	10.0
13.93	19.6	13.55	10.0
13.91	143.9	13.51	84.0
13.90	145.0	13.38	83.0
TOTAL	$1,419.4	13.25	10.0
		TOTAL	$1,539.0

Bankers' Acceptances

Propositions Accepted	
14.71%	$26.0
14.61	31.3
14.51	20.4
14.50	186.1
14.375	41.0
14.30	96.2
14.26	61.4
14.25	87.0
14.20	31.8
14.15	10.7
14.14	26.8
14.05	10.0
TOTAL	$628.7

Propositions Rejected	
14.01%	$30.5
13.92	37.0
TOTAL	$67.5

Daily Summary
(in millions of dollars)

Date - 11/10/80
Type of Operation - 3-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$2,678.6	$703.3
Range of Rates Offered:	14.26 - 13.25%	14.51 - 14.00%
Amount Accepted:	$2,353.1	$664.3
Range of Rates Accepted:	14.26 - 13.875%	14.51 - 14.15%
Weighted Average Rate:	14.05%	14.37%
Matched Sales with Foreign:	$2,187.7	
Approximate Market RP Rate for Treasury & Agency Securities:	14.10%	
Effective Rate for Overnight Federal Funds:	14.57%	
Federal Funds Trading Range:	13 - 15¼%	
Estimated Federal Funds Rate at Time of Market Entry:	14 3/4%	

Treasury & Agencies

Propositions Accepted

14.26%	$141.5
14.20	94.0
14.18	32.0
14.15	89.3
14.13	64.2
14.125	201.0
14.11	24.0
14.10	403.0
14.09	15.0
14.07	73.1
14.06	50.0
14.05	318.0
14.03	22.0
14.02	40.0
14.01	155.0
14.00	52.0
13.95	25.0
13.91	99.0
13.90	40.0
13.875	415.0
TOTAL	$2,353.1

Propositions Rejected

13.87%	$ 5.0
13.86	44.5
13.85	5.0
13.80	5.0
13.76	68.0
13.75	8.0
13.68	17.0
13.625	40.0
13.56	5.0
13.51	10.0
13.25	118.0
TOTAL	$ 325.5

Bankers' Acceptances

Propositions Accepted

14.51%	$51.7
14.50	149.2
14.41	84.9
14.40	36.9
14.39	11.3
14.375	26.2
14.33	51.6
14.32	29.2
14.31	57.7
14.30	28.4
14.26	15.3
14.20	62.4
14.15	59.5
TOTAL	$664.3

Propositions Rejected

14.01%	$28.0
14.00	11.0
TOTAL	$39.0

Daily Summary
(in millions of dollars)

Date - 11/12/80
Type of Operation - 1-day Matched Sales

Total Propositions:	$2,667.4
Range of Rates Offered:	12.86 - 14.00%
Amount Accepted:	$2,167.4
Range of Rates Accepted:	12.86 - 13.28%
Weighted Average Rate:	13.11%
Matched Sales with Foreign:	$2,041.0
Approximate Market RP Rate for Treasury & Agency Securities:	13.40%
Effective Rate for Overnight Federal Funds:	13.01%
Federal Funds Trading Range:	3 - 16%
Estimated Federal Funds Rate at Time of Market Entry:	12 3/4 - 13%

Propositions Accepted		Propositions Rejected	
12.86%	$10.0	13.35%	$20.0
12.95	125.0	13.375	60.0
12.98	40.0	13.40	20.0
13.00	320.0	13.49	30.0
13.02	20.0	13.50	20.0
13.03	175.0	13.51	20.0
13.09	50.0	13.60	55.0
13.10	495.0	13.61	20.0
13.11	5.0	13.625	50.0
13.125	25.0	13.75	25.0
13.14	35.0	13.90	150.0
13.15	225.0	14.00	30.0
13.16	10.0	TOTAL	$500.0
13.19	50.0		
13.20	100.0		
13.24	30.0		
13.25	402.4		
13.28	50.0		
TOTAL	$2,167.4		

Daily Summary
(in millions of dollars)

Date - 11/13/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$2,563.6
Approximate Market RP Rate for Treasury & Agency Securities:	13.40%
Effective Rate for Overnight Federal Funds:	14.00%
Federal Funds Trading Range:	13 1/2 - 14 3/4%

Daily Summary
(in millions of dollars)

Date - 11/14/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$2,158.0
Approximate Market RP Rate for Treasury & Agency Securities:	13.40%
Effective Rate for Overnight Federal Funds:	14.23%
Federal Funds Trading Range:	13 7/8 - 17%

Daily Summary
(in millions of dollars)

Date - 11/17/80
Type of Operation - 3-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$4,933.8	$528.6
Range of Rates Offered:	15.30 - 14.05%	15.61 - 15.10%
Amount Accepted:	$2,517.9	$460.6
Range of Rates Accepted:	15.30 - 15.06%	15.61 - 15.25%
Weighted Average Rate:	15.16%	15.43%
Matched Sales with Foreign:	$2,430.5	
Approximate Market RP Rate for Treasury & Agency Securities:	14.55%	
Effective Rate for Overnight Federal Funds:	16.22%	
Federal Funds Trading Range:	15 - 19%	
Estimated Federal Funds Rate at Time of Market Entry:	16.00%	

Treasury & Agencies

Propositions Accepted

15.30%	$145.0
15.28	95.0
15.27	170.0
15.26	130.0
15.25	47.0
15.20	20.0
15.18	10.0
15.17	50.0
15.16	115.9
15.15	297.0
15.14	50.0
15.13	300.0
15.125	742.0
15.09	100.0
15.06	246.0
Total	$2,517.9

Propositions Rejected

15.05 %	$107.0	14.82%	$10.0
15.03	10.0	14.81	40.0
15.02	33.0	14.80	74.0
15.01	312.0	14.78	5.0
15.00	84.0	14.77	45.0
14.95	45.0	14.76	44.9
14.92	76.0	14.75	325.0
14.91	210.0	14.72	17.0
14.90	75.0	14.55	20.0
14.89	15.0	14.51	5.0
14.88	126.0	14.50	29.0
14.875	673.0	14.05	30.0
14.85	5.0	Total	$2,415.9

Bankers' Acceptances

Propositions Accepted

15.61%	$101.2
15.51	16.7
15.45	48.2
15.41	53.4
15.40	42.7
15.375	102.4
15.36	13.7
15.27	45.7
15.26	23.0
15.25	13.6
Total	$460.6

Propositions Rejected

15.10%	$ 68.0
Total	$ 68.0

Daily Summary
(in millions of dollars)

Date - 11/18/80
Type of Operation - 1-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$2,299.0	$113.0
Range of Rates Offered:	16.375 - 15.10%	16.25 - 15.75%
Amount Accepted:	$2,247.3	$113.0
Range of Rates Accepted:	16.375 - 15.50%	16.25 - 15.75%
Weighted Average Rate:	15.90%	16.08%
Matched Sales with Foreign:	$2,185.3	
Approximate Market RP Rate for Treasury & Agency Securities:	15.50%	
Effective Rate for Overnight Federal Funds:	17.19%	
Federal Funds Trading Range:	16 1/4 - 18%	
Estimated Federal Funds Rate at Time of Market Entry:	17 1/4%	

Treasury & Agencies

Propositions Accepted

16.375%	$ 41.3
16.16	100.0
16.13	17.0
16.125	650.0
16.06	100.0
16.01	20.0
16.00	21.0
15.95	35.0
15.91	29.0
15.88	131.0
15.81	75.5
15.80	29.0
15.78	10.0
15.76	388.0
15.75	219.0
15.74	20.0
15.71	3.0
15.70	37.5
15.69	12.0
15.66	5.0
15.65	40.0
15.63	10.0
15.625	55.0
15.62	5.0
15.60	10.0
15.55	99.0
15.50	85.0
Total	$2,247.3

Propositions Rejected

15.41%	$10.0
15.375	5.0
15.35	21.2
15.26	5.5
15.25	5.0
15.10	5.0
Total	$51.7

Bankers' Acceptances

Propositions Accepted

16.25%	$ 61.6
16.16	1.0
16.01	20.9
16.00	2.0
15.75	27.5
Total	$113.0

Propositions Rejected

\- 0 -

Daily Summary
(in millions of dollars)

Date - 11/19/80
Type of Operation - 1-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$1,447.6	$121.7
Range of Rates Offered:	16.00 - 14.875%	16.125 - 15.50%
Amount Accepted:	$1,288.3	$121.7
Range of Rates Accepted:	16.00 - 15.15%	16.125 - 15.50%
Weighted Average Rate:	15.31%	15.81%
Matched Sales with Foreign:	$2,077.5	
Approximate Market RP Rate for Treasury & Agency Securities:	15.60%	
Effective Rate for Overnight Federal Funds:	16.41%	
Federal Funds Trading Range:	12 - 17 1/4%	
Estimated Federal Funds Rate at Time of Market Entry:	16 3/4%	

Treasury & Agencies

Propositions Accepted

16.00%	$ 2.0
15.76	10.0
15.66	131.0
15.60	10.0
15.56	10.0
15.53	15.0
15.51	59.8
15.50	36.0
15.47	10.0
15.45	41.0
15.40	10.0
15.39	5.0
15.375	37.0
15.35	23.0
15.31	28.0
15.30	210.0
15.27	4.0
15.26	5.0
15.25	161.5
15.18	80.0
15.15	400.0
Total	$1,288.3

Propositions Rejected

15.06%	$ 65.0
15.01	4.3
15.00	85.0
14.875	5.0
Total	$159.3

Bankers' Acceptances

Propositions Accepted

16.125%	$ 37.3
16.02	14.4
16.00	8.9
15.75	7.6
15.61	1.0
15.51	24.4
15.50	28.1
Total	$121.7

Propositions Rejected

- 0 -

Daily Summary
(in millions of dollars)

Date - 11/20/80

Type of Operation - 1-day Repurchase Agreements	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$4,398.7	$412.8
Range of Rates Offered:	16.17 - 15.15%	16.25 - 15.61%
Amount Accepted:	$4,067.9	$380.5
Range of Rates Accepted:	16.17 - 15.50%	16.25 - 15.66%
Weighted Average Rate:	15.68%	15.93%
Matched Sales with Foreign:	$2,329.0	
Approximate Market RP Rate for Treasury & Agency Securities:	15.30%	
Effective Rate for Overnight Federal Funds:	17.01%	
Federal Funds Trading Range:	16½ - 17½%	
Estimated Federal Funds Rate at Time of Market Entry:	17¼%	

Treasury & Agencies

Propositions Accepted

16.17%	$100.0
16.07	50.0
15.92	48.0
15.91	111.3
15.86	10.0
15.82	26.0
15.81	86.0
15.78	12.0
15.77	35.0
15.76	55.0
15.75	825.1
15.70	30.0
15.67	328.9
15.66	80.0
15.65	196.0
15.63	30.0
15.625	906.0
15.61	105.0
15.60	200.0
15.59	200.0
15.57	220.0
15.56	64.0
15.55	5.0
15.53	200.0
15.52	40.8
15.51	63.8
15.50	40.0
TOTAL	$4,067.9

Propositions Rejected

15.42%	$14.0
15.40	48.0
15.39	20.0
15.38	21.8
15.375	48.0
15.35	20.0
15.33	25.0
15.30	25.0
15.25	60.0
15.24	24.0
15.21	5.0
15.15	20.0
TOTAL	$330.8

Bankers' Acceptances

Propositions Accepted

16.25%	$18.5
16.05	18.5
16.01	83.0
16.00	94.5
15.91	43.0
15.86	48.6
15.76	37.6
15.75	8.7
15.66	28.1
TOTAL	$380.5

Propositions Rejected

15.61%	$32.3
TOTAL	$32.3

Daily Summary
(in millions of dollars)

Date - 11/21/80
Type of Operation - Over-weekend Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$3,639.1	$425.5
Range of Rates Offered:	16.85 - 15.70%	17.01 - 16.16%
Amount Accepted:	$3,188.1	$375.5
Range of Rates Accepted:	16.85 - 16.05%	17.01 - 16.26%
Weighted Average Rate:	16.39%	16.67%
Matched Sales with Foreign:	$2,101.1	
Approximate Market RP Rate for Treasury & Agency Securities:	16.05%	
Effective Rate for Overnight Federal Funds:	17.63%	
Federal Funds Trading Range:	16 1/2 - 18 1/4%	
Estimated Federal Funds Rate at Time of Market Entry:	17 3/4%	

Treasury & Agencies

Propositions Accepted

16.85%	$ 35.0
16.60	80.0
16.55	860.0
16.54	35.0
16.53	219.0
16.52	10.0
16.51	31.0
16.50	87.6
16.42	52.0
16.41	30.0
16.40	10.0
16.38	20.0
16.375	165.7
16.35	35.0
16.31	316.5
16.30	435.0
16.29	33.0
16.27	139.0
16.26	166.0
16.25	38.0
16.23	37.0
16.21	48.0
16.17	9.4
16.15	65.0
16.13	10.0
16.125	45.0
16.10	12.0
16.06	30.9
16.05	133.0
TOTAL	$3,188.1

Propositions Rejected

16.01%	$ 40.0
16.00	360.0
15.99	24.0
15.91	4.0
15.90	5.0
15.88	3.0
15.81	5.0
15.75	5.0
15.70	5.0
TOTAL	$451.0

Bankers' Acceptances

Propositions Accepted

17.01%	$ 91.0
16.80	25.3
16.76	28.1
16.75	19.6
16.625	102.1
16.51	27.9
16.41	28.7
16.375	10.0
16.26	42.8
TOTAL	$375.5

Propositions Rejected

16.16%	$50.0
TOTAL	$50.0

Daily Summary
(in millions of dollars)

Date - 11/24/80
Type of Operation - 1-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$2,161.3	$320.3
Range of Rates Offered:	16.625 - 15.625%	16.875 - 16.10%
Amount Accepted:	$2,045.3	$290.3
Range of Rates Accepted:	16.625 - 15.99%	16.875 - 16.26%
Weighted Average Rate:	16.20	16.59%
Matched Sales with Foreign:	$2,199.2	
Approximate Market RP Rate for Treasury & Agency Securities:	16.15%	
Effective Rate for Overnight Federal Funds:	17.11%	
Federal Funds Trading Range:	16 1/2 - 17 3/4%	
Estimated Federal Funds Rate at Time of Market Entry:	17 1/4%	

Treasury & Agencies

Propositions Accepted

16.625%	$ 54.0
16.31	195.0
16.30	40.0
16.27	26.0
16.26	129.0
16.25	554.0
16.21	98.3
16.20	70.0
16.18	68.0
16.17	25.0
16.15	101.0
16.14	35.0
16.13	40.0
16.125	31.0
16.12	21.0
16.10	335.0
16.06	35.0
16.05	92.0
16.01	2.0
16.00	70.0
15.99	24.0
TOTAL	$2,045.3

Propositions Rejected

15.81%	$ 40.0
15.80	10.0
15.78	12.0
15.77	14.0
15.75	5.0
15.65	30.0
15.625	5.0
TOTAL	$116.0

Bankers' Acceptances

Propositions Accepted

16.875%	$ 37.8
16.65	33.9
16.625	120.4
16.60	21.5
16.51	5.3
16.50	25.0
16.36	8.6
16.30	3.8
16.26	34.0
TOTAL	$290.3

Propositions Rejected

16.10%	$30.0
TOTAL	$30.0

Daily Summary
(in millions of dollars)

Date - 11/25/80
Type of Operation - No Market Activity

Matched Sales with Foreign:	$2,848.4
Approximate Market RP Rate for Treasury & Agency Securities:	16.00%
Effective Rate for Overnight Federal Funds:	16.69%
Federal Funds Trading Range:	16 3/8 - 18%

Daily Summary
(in millions of dollars)

Date - 11/26/80
Type of Operation - 2-day Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$1,877.9	$387.1
Range of Rates Offered:	16.39 - 15.01%	17.08 - 15.90%
Amount Accepted:	$1,805.9	$387.1
Range of Rates Accepted:	16.39 - 15.75%	17.08 - 15.90%
Weighted Average Rate:	16.00	16.43%
Matched Sales with Foreign:	$2,061.8	
Approximate Market RP Rate for Treasury & Agency Securities:	16.00%	
Effective Rate for Overnight Federal Funds:	18.33%	
Federal Funds Trading Range:	17 - 27%	
Estimated Federal Funds Rate at Time of Market Entry:	17 3/4%	

Treasury & Agencies

Propositions Accepted

16.39%	$ 216.0
16.375	25.0
16.35	10.0
16.30	30.0
16.21	15.0
16.20	171.0
16.18	20.0
16.16	34.5
16.15	7.0
16.12	46.0
16.06	60.0
16.02	20.0
16.00	173.3
15.90	397.0
15.89	15.0
15.875	85.0
15.81	12.0
15.77	25.0
15.76	58.0
15.75	386.1
TOTAL	$1,805.9

Propositions Rejected

15.72%	$ 5.0
15.60	10.0
15.52	2.0
15.50	20.0
15.01	35.0
TOTAL	$72.0

Bankers' Acceptances

Propositions Accepted

17.08%	$ 5.8
16.75	53.9
16.625	70.1
16.52	23.3
16.50	46.1
16.31	43.7
16.30	9.9
16.26	97.9
16.00	30.5
15.90	5.9
TOTAL	$387.1

Propositions Rejected

- 0 -

Daily Summary
(in millions of dollars)

Date - 11/28/80
Type of Operation - over-weekend Repurchase Agreements

	Treasury & Agencies	Bankers' Acceptances
Total Propositions:	$2,371.4	$525.3
Range of Rates Offered:	16.75 - 15.625%	17.08 - 15.90%
Amount Accepted:	$2,279.7	$523.3
Range of Rates Accepted:	16.75 - 15.80%	17.08 - 16.25%
Weighted Average Rate:	16.12	16.69%
Matched Sales with Foreign:	$2,286.3	
Approximate Market RP Rate for Treasury & Agency Securities:	16.00%	
Effective Rate for Overnight Federal Funds:	18.56%	
Federal Funds Trading Range:	13.00 - 20 1/4%	
Estimated Federal Funds Rate at Time of Market Entry:	18 3/4	

Treasury & Agencies

Propositions Accepted

16.75%	$16.0
16.51	100.0
16.50	160.0
16.36	90.0
16.32	121.0
16.31	35.0
16.28	33.0
16.27	160.0
16.26	83.1
16.25	25.0
16.16	45.0
16.14	27.0
16.13	50.0
16.125	20.0
16.10	32.6
16.07	80.0
16.06	57.0
16.05	94.0
16.02	175.0
16.01	266.5
16.00	167.0
15.90	15.0
15.88	35.0
15.86	22.5
15.80	370.0
TOTAL	$2,279.7

Propositions Rejected

15.78%	$10.0
15.77	6.7
15.76	35.0
15.75	20.0
15.625	20.0
TOTAL	$91.7

Bankers' Acceptances

Propositions Accepted

17.08%	$27.9
17.01	80.7
17.00	62.0
16.80	116.9
16.51	20.0
16.50	89.1
16.41	6.6
16.35	52.3
16.31	53.1
16.25	14.7
TOTAL	$523.3

Propositions Rejected

15.90%	$2.0
TOTAL	$2.0

ARTICLES FROM VARIOUS PUBLICATIONS

(Wall Street Journal, July 30, 1981)

Canada Asks Banks To Reduce Their Loans Used for Takeovers

By a WALL STREET JOURNAL *Staff Reporter*

OTTAWA—In an unusual move designed to aid the sagging Canadian dollar, Canada's finance minister, Allan J. MacEachen, met with senior Canadian banking officials to request a reduction in takeover loans, particularly those converted into U.S. funds.

Emerging from a closed-door meeting late yesterday, Mr. MacEachen said the banking officials "responded to my view quite well and felt that it was a timely action."

However, Mr. MacEachen didn't say whether he had received firm assurances from the banking officials, who weren't identified, or what actions would be taken if takeover loans weren't reduced.

Mr. MacEachen indicated that he had made a broad appeal for reduced lending, not only for take-overs outside Canada but for domestic bids, too. It wasn't disclosed whether specific limits were sought on either the number or the amount of individual loans. Mr. MacEachen said he expected that banks would meet existing commitments.

The Canadian official said he made the unusual request for restraint because of what he called "an epidemic quality" to current conditions. In the past two weeks, the Canadian dollar has fallen almost 1.5 cents (U.S.). On anticipation of a government statement yesterday, the Canadian currency gained 0.33 cents (U.S.) to close at 81.33 cents.

Recent months have marked a wave of Canadian purchases of U.S. assets, in Canada and the U.S. One analysis by Pitfield MacKay Ross Ltd., a Toronto-based brokerage firm, estimates that capital outflows from Canada have totaled $10 billion (Canadian) versus an annual average of $2 billion during the 1970s.

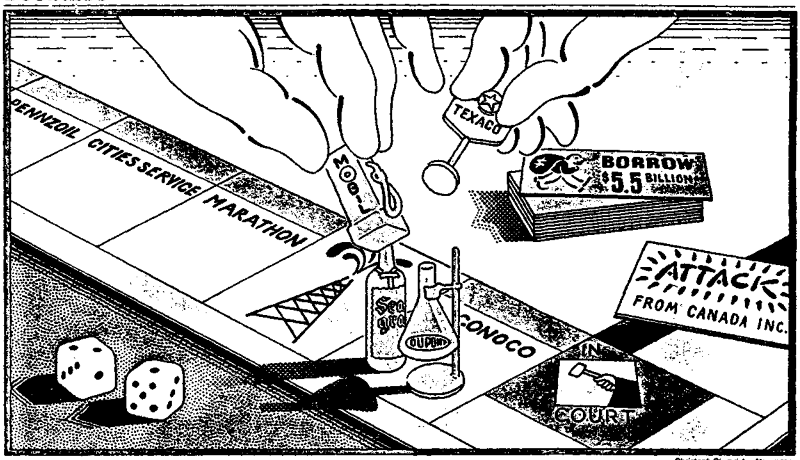
Mr. MacEachen didn't specifically tie such outflows to Canada's nationalist energy policies, but he urged that the policies be applied more slowly. The energy program is designed to encourage Canadian purchases of U.S. assets and has sparked a number of major takeovers, including the $1.46 billion purchase by state-owned Petro-Canada of the assets of Petrofina Canada Ltd., which was controlled by Petrofina S.A.

Concern that these nationalist policies may be extended to other industries isn't merited, Mr. MacEachen said. In a clear appeal to foreign investors, the finance minister said: "Obviously, we still want to encourage the inflow of capital."

"In that connection," he added, "I wanted to assure the Canadian banking community, as well as the population at large, that it is not the intention of the government to extend the policies embodied in the national energy policy to other sectors of the Canadian economy."

(Newsweek magazine, July 27, 1981)

BUSINESS



Christoph Blumrich—Newsweek

Real-life gamesmanship played for superstakes: Almost every day another bid, and another company under the gun

The New Urge to Merge

One prominent banker called it a "feeding frenzy," and last week, as the biggest takeover battle in American corporate history gained momentum, the description seemed right on the mark. Three giant companies—Du Pont, Seagram and Mobil—were battling for control of Conoco, Inc., the nation's ninth largest oil concern, and the bidding was fast approaching the $8 billion level. Meanwhile, other cash-rich corporate giants were eying their own acquisition targets, and frightened companies scrambled to protect themselves. By the end of the week, the hunters and their prey had stocked up war chests of bank credits worth more than $25 billion—enough to buy Detroit's Big Three automakers with $10 billion to spare—and many analysts predicted that the marauders were preparing for a long-term merger binge of unprecedented proportions. "Having had that first taste of blood," said Larry Goldstein, chief economist for the Petroleum Industry Research Foundation, "it is hard to believe they will pull back."

The new merger fever owes much of its fury to the current state of the oil industry. Because of the recent worldwide surplus of crude oil, many companies have watched helplessly as their stock prices fell to levels that did not reflect the true value of their assets. Acquiring those stocks at depressed prices amounts to buying oil at prices as low as $5 a barrel—a bargain that is virtually irresistible to companies that have amassed huge hoards of cash. As a result, analysts think half a dozen small to middle-size oil companies are likely candidates for takeover (page 54), and even some of the giants may be vulnerable if world oil prices stay soft. "People are looking at the oil companies and saying 'to hell with any short-term problems'," says Elliott Fried, an executive vice president at Shearson Loeb Rhoades. "Assets in the ground will go nowhere but up in price, and this might be the last golden opportunity to buy oil cheaply."

> *The fierce bidding battle for Conoco raises fears about whether U.S. business is getting too big.*

But the war over Conoco, in particular, has broader implications. Perhaps most important, it will provide the first major test of Ronald Reagan's antitrust policies, which are widely expected to be considerably more lenient than those of his predecessors. If the Justice Department approves the acquisition of Conoco by another big oil company, many businessmen may feel free to pursue mergers and acquisitions they would never have attempted in stricter times—making big consolidations more than ever a permanent part of the business scene and creating still more revenue for the Wall Street firms that specialize in putting the deals together (page 52). Already, the prospect of the increasing concentration of big business has raised squawks of protest in Congress. And there are even some fears that a tidal wave of mergers will do serious harm to the national economy, as robust corporate demand for merger loans renews upward pressure on interest rates, swells the money supply and fuels inflation.

Stampede: The seeds of the current merger craze were sown early last May, when Canada's Dome Petroleum offered $65 a share for 22 million Conoco shares. Much to everyone's surprise, Conoco stockholders stampeded to unload, offering Dome 55 million shares. Dome wanted only enough shares to force Conoco to turn over its interest in a Canadian company, however, and it stuck to its original terms. But other acquiition-minded companies, excited by the tockholders' response, began poring over he public statistics on Conoco—and quicky realized that they were looking at a bargain. Conoco's domestic reserves of 400 milion barrels of oil, its strong position in North Sea production and its Consolidation Coal Co. subsidiary—the second largest coal producer in the United States—added up to assets worth well over $140 per share of Conoco stock. At the time, Conoco was selling for about $50 on the New York Stock Exchange.

Seagram Co., Canada's huge distiller, was next to make a run at the prize. Conoco's board of directors rejected a "friendly" offer from Seagram chairman Edgar Bronfman to buy 25 per cent of the company's stock—and to refrain from acquiring more for at least fifteen years. But Seagram's move made Conoco nervous. To protect themselves, the company's directors began merger negotiations with Cities Service, another oil company ripe for takeover; by pooling their resources, Conoco and CS managers thought they would become too big for a potential buyer to swallow. But Seagram did not give up. It offered to pay $2.6 billion in cash for a 41 per cent interest in Conoco—and would make no friendly promises about future purchases. With that, Cities Service broke off the merger talks.

Help: In desperation, Conoco chairman Ralph Bailey turned to a "white knight" who had already offered help: Edward G. Jefferson, chairman of E.I. du Pont de Nemours & Co. After a frantic week of high-level discussions between Du Pont headquarters in Wilmington, Del., and Conoco front offices in Stamford, Conn., the two companies announced a deal. Du Pont would buy Conoco for a total of $6.9 billion—$3 billion in cash for the first 40 per cent of the oil company's shares and 1.6 shares of Du Pont for each of the remaining Conoco shares.

But the battle was far from over. Jefferson and his wife, Naomi, were on their way to a golf game early last week when a Du Pont public-relations officer telephoned with disconcerting news: Seagram had just boosted its offer for Conoco, seeking about 51 per cent of the stock for $85 a share in cash. Because investors—disturbed at the idea of Du Pont's prospective transformation into a giant oil company—had bid down the chemical company's stock after news of the Conoco deal, Seagram's new offer topped Du Pont's combined cash-and-stock bid by more than $4 a share—though it was not for all of the stock. Once again, Jefferson convened a round of emergency meetings. By that time, rumors were mounting that Mobil, the second biggest industrial company in the United States, was also considering a bid for Conoco. Du Pont's directors delayed a new offer, hoping Mobil would move first. But they finally took another plunge. They sweetened their offer to $95 a share for 40 per cent of Conoco's stock and pledged 1.7 shares of Du Pont for each remaining share. Conoco's directors quickly approved the new deal.

Insight: Just two days later, Mobil made its move. It offered to buy 43.5 million shares of Conoco—slightly more than half of those outstanding—for $90 a share, and to trade Mobil securities for the rest of Conoco's stock at a rate equal to $90 a share. In announcing the bid, Mobil chairman Rawleigh Warner Jr. calculated that it beat Du Pont's second offer by $3.80 a share, and topped Seagram's by $5. And Mobil vice president Herbert Schmertz provided an intriguing insight into just how hot the contest for Conoco had become. Just hours before Mobil made its offer, the oil company was approached by a representative of Seagram who wanted to know whether Mobil would consider a joint bid with Seagram for Conoco. "We indicated that we would not," said Schmertz.

Most analysts expected that Mobil's offer would set off a new round of bidding for Conoco—and that it may well bring in some new players. Seagram itself may yet find a partner for the higher-stakes game. Another frequently mentioned contender is Standard Oil of California, whose officials were sounded out by Conoco's investment bankers when the Connecticut company was seeking a white knight. Last week, however, Socal spokesmen denied any interest. But

Mobil drilling site, Warner (inset below): Testing Washington

Du Pont's Jefferson, Texas chemical plant: How far can Conoco's 'white knight' go?

Seagram's Bronfman and his product: An unwelcome raider from north of the border

Robert Phillips

Burt Glinn—Magnum

Jacques M. Chenet—Newsweek

First Boston's Wasserstein and Perella: A tense chess game

The Marriage Brokers

The director of mergers and acquisitions for a major Wall Street investment house was chuckling last week over a phone call he had received from the chief executive of a $7 billion corporation. The headlines that day had been full of news of the battle for control of Conoco, Inc., and the caller was worried that his firm might also be vulnerable to a hostile takeover bid. "I was literally pinching myself," the banker recalled. "The chances that that company will have any problems are infinitesimal." But then the banker paused . . . and his voice took on a new note of uncertainty: "I'll probably pick up the paper tomorrow and something will have changed."

Until the current seizure of merger madness abates, about the only thing that remains certain in the highest echelons of merger-making is that more and more fearful executives will be placing similar calls to one of a small group of elite investment bankers who are involved in nearly every large-scale contest for corporate control. "We're members of a club," says Felix Rohatyn, partner of Lazard Frères and one of Wall Street's best-known deal makers. And membership gives the major players the inside track to some huge profits (table). First Boston Corp., for example, stands to gain as much as $15 million if its client, Du Pont, wins control of Conoco.

Newcomers: Merger counseling was for many years an almost incidental service provided by such old-line firms as Morgan Stanley, First Boston, Lehman Brothers, Lazard Frères and Goldman Sachs—but as the trend toward takeovers has intensified, they have expanded rapidly and been joined by fast-rising newcomers to the field such as Salomon Brothers, Kidder Peabody and Merrill Lynch-White Weld. All the club members provide the same range of services, from identifying merger opportunities to directing all-out defensive battles. They even use the same lawyers. Two firms—Wachtell, Lipton, Rosen & Katz and Skadden, Arps, Slate, Meagher & Flom—seem to be in on nearly every big deal. While each firm has its particular strengths and weaknesses, their differences are often as much in style as substance. "It's like choosing your doctor or lawyer," says Rohatyn. "People will choose investment bankers very often on the basis of what particular person they happen to like to work with."

The turning point for the business came in 1974 when International Nickel Co. of Toronto staged a successful attack on ESB, Inc., a stuffy battery maker in Philadelphia. "In our little world of mergers, that was a very big event," says Steve Friedman of Goldman Sachs. "It was the first blue-chip raid." There were many more to follow, and today, says Martin Lipton of Wachtell, Lipton, "I doubt that there are very many companies in the country that, if the opportunity presented itself and the target looked attractive, would not attempt a hostile tender offer." As the battle over Conoco indicates, money is becoming increasingly less of an object. "Eighteen months ago," says Lipton, "it would have been customary to advise a client worth more than $2 billion that it was virtually inconceivable that they would be the target of a hostile takeover offer." But now "a market value of $5 billion or $6 billion is not a deterrent."

Chess: Takeover battles are frequently fought like tense games of chess. Last year, for example, when Pullman, Inc., was threatened by a hostile bid from J. Ray McDermott & Co., First Boston searched around and finally persuaded Wheelabrator-Frye, Inc., a New Hampshire engineering firm one-third Pullman's size, to serve as a friendly "white knight" acquisitor instead. But in more human terms, the battles can exert a real toll on the companies involved. First Boston's Joseph Perella and Bruce Wasserstein directed the Bache Group's successful defense against the Canadian Belzberg brothers—who had gradually been acquiring an ever-greater share of Bache's stock. "It's like slow death," says Perella, "when someone goes into the market and buys 5, then 10 and 20 per cent of your company, and inevitably you have to sell out [to a white knight] or else he's going to buy it cheap." Eventually, First Boston induced Prudential Insurance Co. to step in with a friendlier offer.

As the takeover wave has accelerated, the hours spent on the mergers and acquisitions trade become nearly unbearable. "We're going crazy, and it's just like this everywhere else," says Jay Higgins of Salomon Brothers. "The problem is that when somebody's going to put his career on the line to make an acquisition and pay a lot of money—he couldn't care less about your personal life." With billion-dollar battles being fought every day, says one top participant, "it's not a business in which one plans vacations, or even dinners." It is also not a game for older players: the average age in First Boston's mergers and acquisitions department is 31.

Yet the merger business also has its compensations. First Boston, for example, charged Pullman $1,500 per man-hour to engineeer its rescue, for a total cost of $6 million. "The fees are gigantic," admits one investment banker. Those fees, of course, are a function of the size of the mergers they represent—and with the Conoco takeover alone providing possible bounties of more than $30 million, investment bankers will remain alert to opportunities to keep the boom in big mergers alive.

HARRY ANDERSON with CONNIE LESLIE in New York

Christoph Blumrich—Newsweek

FRUITS OF MATCHMAKING

Wall Street's merger experts often work on their deals for days with little sleep—but a sampling of the fees they have earned recently shows their efforts are handsomely rewarded.

Investment Banker	Deal	Fee (in millions)
Morgan Stanley	Shell Oil/Belridge Oil	$14.6
Salomon Brothers	Elf-Aquitaine/Texasgulf	6.5
First Boston	Wheelabrator-Frye/Pullman	6.0
Smith Barney	Fluor/St. Joe Minerals	3.5
E.F. Hutton	Kraft/Dart Industries	3.0
Lazard Frères	Tenneco/Southwestern Life	3.0
Lehman Brothers	Nabisco/Standard Brands	3.0
Goldman, Sachs	Cooper Industries/Gardner-Denver	2.0
Dillon, Read	RCA/CIT Financial	1.8

erhaps the most likely entry in the Con-co stakes is Texaco. It, too, was ap-roached by Conoco in its flight from Sea-ram, and sources close to the companies eport that Texaco was the source of an nonymous $85-a-share bid Conoco had eported to the Securities and Exchange Commission. Recently, Texaco lined up $6 billion in credit in European markets—the biggest such credit arrangement in histo-y—and oil-industry experts say the com-pany needs to acquire domestic sources of oil and natural gas.

How far Du Pont could go in the bidding is not clear. Last week the company an-nounced that it had arranged for an extra $1 billion in loans—$700 million more than it used to counter Seagram's latest offer. In bidding against the likes of Mobil and Tex-aco, however, the company might find the Federal government on its side. "I don't think any oil company could do this deal," says one key insider. "The antitrust laws would be a joke if that happened." Even if Du Pont loses the Conoco battle, however, not everyone will be sorry. According to high-ranking company sources, some man-agers and members of the Du Pont family, which still owns about 30 per cent of the company's stock, are disgruntled because the additional shares issued in a Conoco acquisition would dilute their interest in the company by about one-third.

The Ante: Just what Mobil's battle plans might be was equally obscure. According to the company's SEC filing last week, Mobil's interest in Conoco preceded the first Conoco-Du Pont deal—and Wall Street experts say Mobil could up the ante to $115 a share. But Mobil's motives may be mixed. Some analysts think that in part, at least, the company is playing spoiler, hoping to blow Seagram, in particular, out of the action.

Canada's National Energy Plan, which was designed to give Canadian companies more control of that country's energy re-sources, has severely cut the value of Ameri-can companies' Canadian holdings. That, in turn, has eroded the companies' stock val-ues, making it even easier for an opportunis-tic Canadian company to try to gobble them up. "Mobil and others have considerable resentment," says Robert Morris of Drexel Burnham Lambert. "There would be a lot of quiet rejoicing in the U.S. oil community if Seagram were defeated." But Mobil also has more practical ends in mind. "Mobil's primary objective is to win," says Sanford Margoshes of Bache Halsey Stuart Shields. "Its secondary objective is to test the politi-cal and legal climate."

The entire business community looks for-ward to that test. And Washington is taking it very seriously, too. Last week the Justice Department and the Federal Trade Com-mission were embroiled in an unusual intra-mural spat over which agency should have antitrust jurisdiction over the Conoco deals. FTC staffers had already started eval-uating both the Seagram and Du Pont bids when William F. Baxter, Assistant Attor-ney General for antitrust, demanded that his forces take charge. Baxter's argument was that Justice has more expertise on ener-gy- and chemical-industry matters—and would be able to act more quickly and deci-sively on the case. Then, having won his way, Baxter turned supervision of the mat-ter over to Justice's patent and copyright lawyers—who have since had to ask the FTC's oil and chemical experts for advice. So far, the agencies have not determined which will examine the Mobil bid, but given Baxter's heavy-handed intervention, the betting is that Justice will investigate that one, too.

If so, all the deals on the table have a good chance for government approval. Reagan's Justice Department, with Baxter in the lead, has made no secret of its belief that bigness in business is not necessarily bad. And just last week, in the midst of the Conoco conflict, Treasury Secretary Don-ald Regan weighed in with an opinion. "Our economy is growing, our nation is growing and the world is growing," said Regan. "So why shouldn't companies grow?"

Overlap: The issues before the antitrust watchdogs are fairly clear. Seagram and Conoco are simply not in competition with each other in any area of their operations. Du Pont and Conoco overlap only because of a minor Conoco chemical division that could easily be spun off as a condition for government approval; otherwise, their combination represents just the sort of "ver-tical" merger—one company's acquisition of another in its supply, production or dis-tribution chain—that antitrust chief Baxter thinks the government should approve.

Bailey briefs Conoco employees: Making light of uncertainty at 'Takeover Alley'

Jacques M. Chenet—Newsweek

The Mobil bid is the trickiest. It repre-sents a "horizontal" merger—an amalga-mation of two companies in the same busi-ness—and even Baxter insists that such combinations deserve close scrutiny to guard against the concentration of too much market power in one boardroom. But Mobil and Conoco are not really direct competitors in any significant markets, even though they are, respectively, the sec-ond and ninth largest oil companies in the country. In announcing Mobil's offer, chairman Warner said that his own com-pany's review of the relevant market shares shows that a merger "should not violate the antitrust laws." And Mobil executives ex-press confidence that the Justice Depart-ment will concur.

Under 1968 guidelines, Mobil and Con-oco may overlap unacceptably only in the production of one chemical and in the sale of gasoline in two states. "If there's no problem under the old guidelines, there's certainly not going to be a problem under Baxter," says one top aide. "The law we've got talks about competition, not size, and that's just a fact."

Many economists agree. Particularly in

the oil business, they argue, there is little danger of too much concentration. Unlike companies such as General Motors, IBM and U.S. Steel, for instance, even the biggest oil giants control relatively modest shares of their complex market: although Exxon and Mobil are the two largest American industrial corporations, their combined share of total U.S. refining capacity is only 14 per cent. Big Oil's power is also steadily eroding. "OPEC wrested away control at the wellhead for much of the supply and is now moving into refining," says Samuel Hayes III, professor of investment banking at Harvard. "The companies no longer have the control they did ten years ago."

In view of the current economic climate, oil acquisitions make particularly good sense. Buying undervalued oil on the stock market is far cheaper than finding it. According to Robert Stobaugh, co-author of the Harvard Business School's best-selling "Energy Future," drillers must count on spending $10 a barrel in the search for oil. Once oil is found, the reservoir must be developed—a process that can add $3 a barrel to the cost. Finally, the electricity to run pumps, transportation costs and other downstream expenses can add $3 more to the total, making stock-market oil at $5 a barrel and less an undeniably good buy.

Economists also dispute the conventional wisdom that plowing investment dollars into acquisitions, instead of pumping them into existing operations, is necessarily an "unproductive" use of assets. Prior to the Conoco bidding war, the biggest acquisition in history was Shell Oil Co.'s $3.7 billion purchase of Belridge Oil Co. in 1979. Using new technology, Shell has boosted the production of its acquired fields from 42,000 barrels a day to 60,000.

Productivity: Even outside the oil industry, most economists think growing concentration is fundamentally neutral. Some worry that executives currently are spending too much time on takeovers and not enough on operating problems. Others fear that as companies get bigger they may become unmanageable. But some big mergers result in economies of scale that actually improve productivity and eventu-

Who's Next at the Altar?

With the acquisition of Conoco, Inc., by *somebody* an almost certain event, the newest game being played in oil-company boardrooms and on Wall Street is "who's next?" Texaco is rumored to have its sights set on either Atlantic Richfield or Cities Service—and those two companies may be shopping around for merger partners of their own as protection against a raid. Meanwhile, Pennzoil chairman J. Hugh Liedtke says that his company has been approached to play the roles of both "white knight" and "black knight" in pursuit of other companies—but Pennzoil itself is reportedly a possible target for Standard Oil of California.

The reasons for the sudden attraction to oil companies as acquisitions are clear enough. Measured by the stock-market prices for their shares, the major energy concerns have long been depressed in relation to the underlying value of their assets. The current oil glut has depressed prices still more—and now, analysts say, many companies have oil and natural-gas reserves that alone are worth three to four times their stock-market value (chart). Even at premiums well above their stock-market prices, acquiring companies can get real bargains. If Seagram were to win Conoco at its current bid, says Harvard Business School professor Samuel Hayes III, in effect it will be buying oil at $3.50 a barrel—a tidy discount from the world crude price of $34.

Strategy: But more is involved than mere fire-sale prices; the current shoppers are also seeking textbook-type business "fits." If Du Pont wins Conoco, for example, the chemicals giant will have bought a steady source of petroleum feedstocks for many of its chemical and plastic products. If crude-poor Mobil carries the day, it will get a massive influx of domestic reserves free from OPEC oil embargoes and sudden price hikes. And for all the potential raiders, beleaguered Conoco provides the lure of a valuable energy alternative: coal. Mobil and other oil giants have fledgling synfuels operations that could draw on Conoco's ample reserves, and Seagram could profit simply by mining the coal and selling it to an energy-hungry market.

Many experts say that the heavy bidding for oil-company stocks may be just beginning. And when the dealing is done, says one Washington-based energy consultant, "Five or six of the smaller integrated domestic companies may have disappeared." The losers in the battle over Conoco, for instance, might tackle another oil company with large coal reserves, such as Pennsylvania-based Sun Co. Smaller oil-production companies like Superior Oil and Louisiana Land & Exploration may be hit next. Although their stock prices are doing better than those of the integrated companies, which also refine and market oil products, their reserves will be bought at relatively higher prices. "And if you can't steal the Conocos and the Marathons, you might go after an even better deal on a natural-gas company," predicts Barry Sahgal, senior energy analyst at Bache Halsey Stuart Shields.

Some strategists suspect that more big foreign-oil companies may soon join in the bidding for American petroleum reserves—and some even think that Exxon, the largest oil company, may enter the takeover game. Exxon, so far, has avoided the purchase of other oil companies on the theory that its sheer size would void any deal on antitrust grounds. But if Mobil's bid for Conoco gets a green light from Washington, Exxon might well be in the market to buy up a competitor too.

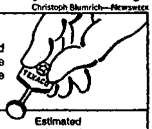
For all the attractions, willy-nilly purchases of oil companies could cause indigestion for some buyers. Much of the industry's operations have been reduced to marginal profitability because of the oil glut. If the trend continues, many raiders may find they have bought lines of business they can't afford to keep. Many analysts are already warning that today's merger spree will lead to an equally intense divestiture binge in the months ahead.

SUSAN DENTZER with bureau reports

Christoph Blumrich—Newsweek

HIDDEN ASSETS

The worldwide oil glut has depressed the stock prices of oil companies to the point where they fail to reflect fully the value of their reserves.



	Market price per share	Estimated value of oil and natural-gas reserves per share
Getty Oil	$72.00	$250
Marathon Oil	68.63	210
Standard Oil (Ind.)	60.25	205
Standard Oil (Calif.)	40.38	172
Atlantic Richfield	50.50	170
Conoco	87.25	147
Cities Service	56.50	130
Phillips Petroleum	45.50	130
Sun Co.	40.75	130
Union Oil	36.75	100
Amerada Hess	32.00	87
Louisiana Land & Exploration	38.25	55

Source: Donaldson, Lufkin & Jenrette Securities Corp.

BUSINESS

ally show up in lower consumer prices. "[It] really depends on the industry and the managerial process itself," says Northwestern University management professor Albert Rappaport.

Certainly not all mergers are made in heaven. Usually, the acquired company has been in trouble of one sort or another that made it vulnerable to takeover in the first place. Especially in acquisitions that involve diversification—a big corporation trying to expand its horizons by absorbing an entirely new kind of business—the troubled target's difficulties sometimes get worse under new management and are sheltered by the owner's ability to pay for mistakes. "Management of the new subsidiary knows it is no longer out there swimming by itself, that it will be protected, and that they are such a small part of such a big company that they will not have the shareholders breathing down their necks all the time," says Drexel Burnham Lambert's Robert Morris. The most embarrassing failure of diversification so far has been Mobil's own 1976 purchase of Marcor for $1.6 billion. Marcor's Montgomery Ward subsidiary has performed so badly that in the past year Mobil has been forced to bail it out with $355 million in interest-free loans.

Shrinking Profits: Despite such problems, almost everyone agrees that the bitter combination of inflation and slow economic growth has fueled the urge to merge among corporate executives. The real rate of return on the value of company assets has dropped significantly in recent years—from 15.8 per cent in 1965 to 9 per cent in 1979—and profits are whittled down by the ever-rising cost of maintaining and building plants and equipment. As a result, companies seek higher returns by investing in other corporations—and they willingly bid high for what they want. Before the merger binge that began in the late 1960s, companies typically paid 28 per cent above market value for a controlling interest in acquisition targets. Today, says Harvard business professor Malcolm S. Salter, they pay 50 per cent or more.

If economists are not particularly disturbed by the merger wave, plenty of politicians are. Democrats Edward Kennedy of Massachusetts and Howard Metzenbaum of Ohio are raising alarms in the Senate about the implications of the Conoco deal and the dangers of the Reagan Administration's permissiveness on antitrust matters. As they see it, the current war is just the start of a dangerous trend toward consolidation that could destroy small business and hurt consumers. "Every corporate boardroom and every lawyer representing a corporation in this country is saying, 'If ever we're going to move, now's the time'," says Metzenbaum. "William Baxter has the wrong perspective, and he ought to go back to reading his law books."

The two liberal senators are urging Judiciary Committee chairman Strom Thurmond to hold hearings on the Conoco situation before the August recess in the hope that such hearings would postpone, if not prevent, a Conoco merger. Thurmond is expected to reject that request—on the ground that he doesn't want to interfere in the free market's play.

There is also considerable displeasure in the House of Representatives. The Mines and Mining subcommittee headed by Nevada Democrat James Santini last week passed a bill that would knock Seagram out of the Conoco game. The measure would impose a nine-month freeze on foreign purchases of more than 5 per cent of U.S. companies with mineral rights on Federal lands. Santini's freeze would be retroactive to July 15 and is aimed at retaliating broadly against Canada's energy policies. A second subcommittee has approved a bill that would force foreign companies to play by the same credit rules that constrain American companies. By prohibiting them from borrowing more than 50 per cent of an acquisition sum, it would remove a distinct advantage foreign corporations have enjoyed in the American merger sweepstakes. It would not affect Seagram, whose borrowing is not even close to the limit.

Bettmann Archive

Bigness in McKinley's era: How permissive will Reagan be?

'Mob Psychology': One influential congressman, House Banking, Finance and Urban Affairs Committee chairman Fernand J. St Germain of Rhode Island, worries that the huge mergers may unsettle the financial markets. The massive credit lines secured by companies in recent weeks could put upward pressure on interest rates, he says, and make it difficult for other sectors of the business community to obtain credit. In a letter to the Federal Reserve Board, St. Germain argued that the merger activity is being driven by a "mob psychology . . . fueled by unlimited credit," and called on the Fed to curb it. The lawmaker's concern is shared by some highly respected bankers. "I think the Administration ought to ask for a moratorium on these takeovers until it develops a clear antitrust policy and studies their impact on the financial markets," says Lacy H. Hunt, chief economist at Philadelphia's Fidelity Bank.

Privately, one Federal Reserve official acknowledges that the enormous credit caches could cause macroeconomic trouble. Much of the money is apparently being secured in European credit markets, where some $735 billion in greenbacks have piled up subject to no U.S. banking regulations. The unexpectedly massive infusion of these funds into American financial markets could complicate the Fed's efforts to control the U.S. money supply. If so, the central bank's only recourse would be to put even stiffer brakes on domestic money growth. Over time, says the Fed official, the effects of this temporary jolt to the Reagan monetary policy would be smoothed over—but not without some sharp short-term pressure on interest rates.

One Winner: In testimony before the Joint Economic Committee late last week, Fed chairman Paul A. Volcker tried to calm those fears. He pointed out that much of the more than $25 billion in credit lines arranged in recent weeks have been lined up by companies that want to bid for Conoco—and since only one of the Conoco suitors can win in the end, not all the credit commitments will necessarily be drawn down.

But that assumes that after Conoco the losers will stop their prowling—something that is by no means certain. So far, for example, Texaco has remained absolutely silent on its own plans for using about $3 billion in ready cash and its historic $6 billion line of credit. Although Bache's Margoshes, among other analysts, thinks there is a "50-50 chance" that Texaco will move in on Conoco, it is just as possible that the company will take a run at another undervalued property. The same holds true for the other bidders in the Conoco stakes.

Perhaps sensing the growing danger, Gulf Oil—the nation's fifth largest oil company—announced last week that it was purchasing 5.1 per cent of its own outstanding shares. Company spokesmen explained that Gulf's stock prices, which have been hovering around $35 a share, reflect less than one-third the value of its assets. This meant that buying its own stock was a good investment, but the $350 million purchase should also shore up the stock price—and help prevent Gulf from falling prey to a Conoco-like raid.

While it seems likely that the company in the eye of the storm—Conoco—will end up being acquired by someone, it is still far from clear just who that will be. Although Mobil's offer appears to be the most attractive on the table so far, the other competitors have certain advantages. Du Pont, for instance, has the full support of Conoco's management, which has put together $3 billion in credit lines of its own, presumably in order to buy some of its own stock to stave off an undesirable coup.

Du Pont also has an ace up its sleeve in the form of an option to buy millions of unissued shares of Conoco, thereby frustrating Seagram and Mobil efforts to gain majority control. For its part, Seagram is offering to pay entirely in cash for the 51 per cent of Conoco stock it seeks—and to some shareholders, the promise of an immediate payoff may outweigh a long-range gamble on a higher price.

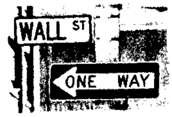
Nervous Wait: Not surprisingly, the siege of Conoco has thrown the company's employees into a state of high uncertainty. The company's top officials protected themselves well before the latest bidding round took off: the board of directors gave Bailey and eight others new employment agreements guaranteeing their salaries through mid-1984—no matter what. Lower-level employees have no such protection, although it is unlikely that either Du Pont or Seagram, which are involved in such drastically different primary businesses, would have much cause to interfere or chop heads. Mobil is another matter. One big oil company swallowing another might well decide, for efficiency's sake, to consolidate certain operations. While they await the outcome, Conoco employees are trying to make the best of things. They have renamed the bar at Brock's, a local restaurant near headquarters, "Takeover Alley."

Almost all observers predict that the bidding for Conoco will go much higher—perhaps to as much as $115 a share—before a winner emerges. If so, some losers could still claim a victory: if they succeed in buying big blocks of stock from the shareholders during the auction, they may be able to sell them at a hefty profit to whomever wins the prize. But there is at least one group of sure winners on the sidelines. Conoco's 70,000 stockholders have already watched the value of their shares soar from less than $50 last spring to $87 last week. By almost every estimate, the stock will be worth much more by the time any deal is consummated. In the meantime, all they have to do is sit back and enjoy the cutthroat fun.

MERRILL SHEILS with ERIK IPSEN in New York, CHRISTOPHER MA and DIANE WEATHERS in Washington, RICHARD SANDZA in San Francisco, DAN SHAPIRO in Boston and bureau reports

(Economist magazine, July 25, 1981)

Poor little rich banks



America's banks can raise $38 billion overnight, but in some ways they are now unhealthily weak

The huge loans mobilised in America's latest takeover battles—$38 billion promised at last count—may seem to be a tribute to the enormous financial power of America's big commercial banks. Actually, the way in which those lending consortia are organised is a worrying sign of the extent to which big American banks have seen their power eroded by their largest customers.

Big corporate borrowers with good credit ratings rarely have any difficulty in raising such loans. The bank organising the finance phones up its sister banks and ropes them in ("We've put you down for $200m for Megalopolis Oil. All right?"). Some of the big borrowers are now flatly refusing even to tell the providing banks what their money is to be used for. When the details of the lending consortia and takeover bids were announced, at least one big bank discovered that it had financed an attempt to do down one of its best customers. "We won't be getting much business from them for the next few months", wailed its spokesman. That experience was not unique. In the bidding war a number of banks have found themselves—by accident or design—on both sides of the fight.

Gilded cage

These banks appear in different consortia because, says one corporate banker, "in this business, you no longer have clients, just customers." American banks—forbidden to become investment bankers, cut off from expanding their business with personal customers by the ban on interstate banking, trapped by usury laws and nagged by competition from such new rivals as money-market funds—are fighting fiercely for corporate business. America's biggest firms have not been slow to take advantage.

Despite this tough competition, the big New York, Chicago and San Francisco banks have held on to their pre-eminent positions as corporate bankers. They say this is because of their expertise. It is also because of the magical qualities of their names. A takeover bidder, or a potential victim rounding up funds for defence, wants to have his lending consortium headed by Chase Manhattan, Citicorp, Manufacturers Hanover, Morgan Guaranty or whomever. A consortium headed by a regional bank or a foreign bank might be able to raise just as much money, but it would not strike the same chill of fear into the beholder. Corporate America, now run predominantly by colourless business school graduates, likes its bankers to possess the inherited trappings of the great barons of finance.

These barons, though imprisoned by their customers, find that the cage in which they are trapped is a gilded one. The $38 billion of potential loans arranged by the takeover participants in the past few weeks have yielded the banks some $150m in commitment fees, before a penny actually changes hands.

Once any of that potential money is turned into real loans, the banks will get their usual spread on the money they lend. Some banks are cross that the very biggest corporate customers have asked for a discount from prime rates, to match the finer distinctions of company credit-worthiness made by the commercial paper market. But the banks have duly if reluctantly offered such discounts, and have undermined their bargaining position further by agreeing to lines of credit to back up a company's commercial paper operations, should the market prove temporarily difficult. With margins on corporate lending shrinking, commitment fees have come to play an increasingly important part in the banks' profits.

In all these ways, America's fragmented banking system now suffers from comparative weakness when dealing with the great corporations who are its principal customers. That is one reason why bank shares languish on Wall Street. The top ten biggest American banks have a stock market capitalisation of $17 billion, while America's 10 biggest industrial firms have a capitalisation of $154 billion. Outside America, the banks are stronger. But even in countries where banks have been able to retain higher levels of profitability, to keep their retail networks growing, and to remain financial equals of the companies they deal with, competition (sometimes from American banks hoping to escape from their crowded domestic market) is beginning to reduce the banks' relative clout.

Elephants aren't controllable

Is this bad news? In many ways, no. Some analysts are saying that the $38 billion so easily raised for takeover finance could threaten America's control over its money supply or prevent a repetition of (eg) the $40 billion lent by the commercial banks to poorer countries last year. Since only a portion of the takeover bidders' new $38 billion—perhaps a quarter—will be turned from commitment into loan, these arguments are at present being exaggerated. But if the American antitrust authorities allow a merger between two giant oil companies, the stage will be set for a rapid burst of industrial concentration. In such a merger wave, the bidders will finance much of their acquisition with bank loans rather than bonds (too weak a market at present) or equity (too expensive, since oil firms believe their shares are undervalued, and dividends must be paid out of post-tax income while interest payments qualify for tax relief). A series of mergers between very big companies *might* make some of the worries about inadequate control of money supply come true.

Even a monetary control system as mechanical and legalistic as America's present one relies on the assumption that commercial banks act independently, in their own interests, responding to internal pressures of profit and loss. In the long term, this assumption must be true, or the banks would collapse one by one. But in a fierce competition for corporate customers, in which they deal from weakness with their giant customers, the banks are quite capable of acting perversely for short periods, to oblige arm-twisting customers or fight for market share. And the markets increasingly judge the success or failure of monetary policy in the shortest of short terms. The shifts of power in America's financial system provide yet another reason for questioning whether Mr Paul Volcker, who is concentrating the Federal Reserve's policy more and more intensely on the control of short-term monetary movements, can be confident that his aims are very clear.

(Business Week magazine, August 10, 1981)

Editorials

Mergers are not growth

There is nothing inherently wrong with mergers, even the giant combinations that have been proposed in the U. S. over the past month. But mergers that size contain the seeds of giant risks, too. Pan Am's merger with National Airlines has not only failed to produce the synergism that was expected, it has brought the resultant airline to the brink of financial disaster.

Even worse from the standpoint of promoting the growth of the economy, when Seagram, or Du Pont, buys Conoco, and when Penn Central buys Colt Industries, not a single new job will be created in the U. S. If Mobil Oil buys Conoco, not a single new barrel of oil will be discovered.

What is hard to understand is why these companies with huge cash or borrowing resources and unrestrainable urges to grow cannot or will not grow their businesses internally, developing new products and upgrading manufacturing facilities. Last year, for example, RCA—once a premier high-technology company—explained to BUSINESS WEEK that it did not have the $200 million necessary to develop a videocassette recorder of its own, even though recorders have turned out to be the fastest-growing appliances of the decade. But RCA had no difficulty borrowing $1.2 billion to buy a lackluster finance company.

The rationale for some of today's giant mergers becomes even less clear when the buyer is using borrowed money, raised at today's record-high interest rates. When Fluor Corp., with a net worth of about $500 million, paid $2.7 billion for St. Joe Minerals, it had to borrow $1 billion. Because it bought 45% of the company for cash, paying $60 a share, it is forking over $12 a share to the banks, just for interest on the loans until the merger is consummated. That interest is hardly offset by the 90¢-a-share dividend it received. Fluor ended up pouring virtually all its cash flow in the first half of 1981 into interest payments.

Although there is nothing illegal about such mergers—in fact, an attempt to bar them would only be institutionalizing bad management at some companies—the U. S. will never solve its difficult economic problems by following this kind of pattern. What U. S. industry needs is giant investment in new products and modern manufacturing processes. It needs to shed its preoccupation with short-term earnings and be concerned with growth that also helps the economy to grow.

(Wall Street Journal)

Overlapping Shareholdings Pervade Competition for Control of Conoco

By CHARLES J. ELIA
Staff Reporter of THE WALL STREET JOURNAL

If anybody wins the bidding battle for control of Conoco Inc., some people won't wind up losers—the shareholders of Conoco.

By sheer coincidence, perhaps, many of the biggest of those shareholders are also among the biggest shareholders of Du Pont Co., which is bidding big dollars against Seagram Co. and Mobil Corp. for Conoco.

Many of the big Conoco-Du Pont shareholders are also among the biggest shareholders of Mobil. In fact, through institutions such as banks' trust departments, insurance, pension and public retirement funds, at least partial control of all the companies involved, is concentrated.

The battle for Conoco is putting all those big shareholders into the glare of a spotlight they'd probably rather avoid. It again raises questions about the concentration of stock ownership in relatively few hands, and about whether the price of oil-company control reflects rational economics, or the self-interest of a few rich shareholders.

"In effect," says Michael Locker, president of Corporate Data Exchange, New York, a research concern, "the same shareholders will be deciding the fate of this merger on both sides of the transaction." Mr. Locker's firm has just published a stock-ownership directory listing the largest holders of stocks in 456 of the Fortune list of the 500 largest industrial companies.

In Washington, Rep. Berkley Bedell, an Iowa Democrat and chairman of the House Small Business subcommittee on energy, says the Conoco bidding "illustrates how incestuous the relationships' have become" among big companies. "Thirty-six of the top 65 holders of Conoco stock also are listed among the biggest investors in Mobil or Du Pont," he says.

"The problem is a situation where shareholders are able to sit on both sides to vote on purchases at higher than market prices to benefit themselves," Rep. Bedell says. "I'm greatly concerned about what appears to me to be a significant drain of capital resources away from more productive uses. It's raising interest rates and it impinges on the small-business segment of society."

The most recent available figures show that the 34 largest holders of Du Pont hold nearly 23% of Conoco's outstanding shares. Of those 34 holders, 24, mostly bank-trust, insurance, pension and public retirement funds, also are among the 34 largest owners of Mobil stock, controlling nearly 17%.

Rep. Bedell has asked the Federal Trade Commission to investigate the role of institutional investors in the current wave of mergers among major corporations. In a letter to the FTC, he expressed concern that "in the case of some of the largest banks, the question is compounded by the fact that some of the same institutions are deeply involved in the financial arrangements attendant to pending mergers."

Mobil, Gulf Oil Co., Texaco Inc., Du Pont and other would-be acquirers have raised billions of dollars in bank credit lines recently to pursue takeover plans. But the banks insist that normal lending relationships with customers exist completely uninfluenced by the trust or investment-management departments that oversee the same banks' investment operations.

The accompanying table listing large institutional owners of Du Pont, Conoco and Mobil, is drawn from data compiled by Corporate Data Exchange, whose listings go beyond the ownership information filed by financial institutions with the Securities and Exchange Commission.

It draws, as well, on corporate disclosures in insider reports, proxy statements, registration statements and other public documents. Institutional holdings in the table are as of last Dec. 31 and for the most part, are managed assets in which the institutions have sole discretion but aren't the beneficial owners.

In the case of Bankers Trust, all but a fraction of the holdings of Mobil, Conoco and Du Pont stocks are employe plans that give beneficiaries first rights to voting the shares on corporate proposals, Mr. Locker says. Those shares haven't been included in the total percentages listed as held by institutions with crossholdings.

The 13.3 million Mobil shares managed by Bankers Trust include about 12 million shares owned by two employe plans. Three Conoco employe plans account for more than five million Conoco shares under Bankers Trust management.

Paradoxically, although Mobil and Du Pont, along with Seagram, are slugging it out for Conoco, CDE finds that Du Pont owned 744,000 of Mobil's 212 million shares outstanding at last count.

CDE's Mr. Locker says new data on crossholdings reflect a higher degree of concentration of stock ownership across the board than was reported in CDE's earlier listings.

In the 50 largest U.S. companies, for example, an average of 49 stockholders control 41% of the stock, with an average of 30% of the stock concentrated in the hands of the top 20 holders.

Marc Rosenberg, staff director of Rep. Bedell's subcommittee, says the pattern of crossholdings found in the Conoco-Du Pont-Mobil triad "applies in nearly all cases throughout the energy sector." That is one reason, he says, that Mr. Bedell in his letter to the FTC, also raised the broader issue of the institutions' role in other mergers.

Mr. Locker's research firm didn't include Seagram in its largest-holders directory, but other data, from Computer Directions Advisors, Silver Spring, Md., show a number of institutional owners of Conoco, Mobil and Du Pont also had holding on March 31 of Seagram.

For example, client assets managed at Citicorp included 348,800 shares of Seagram; at J.P. Morgan 177,000 shares, at U.S. Trust Co. 107,275 shares and at Wells Fargo 129,800 shares. Harris Trust, which was listed by Mr. Locker's firm as owning 742,000 shares of Conoco and 915,000 Mobil shares, had 662,000 shares of Seagram on March 31.

Aside from the matter of crossholdings, the Corporate Data Exchange listing show

Interested Parties

	Stock Ownership (Shares)		
	DU PONT	CONOCO	MOBIL
Prudential Insurance	2,144,900	762,800	2,060,000
Manufacturers Hanover	2,005,478	1,512,616	1,389,397
J.P. Morgan & Co.	1,765,000	424,000	4,864,000
Teachers Insurance Annuity - College Equities Retirement Fund	1,454,087	1,187,700	1,450,000
Citicorp	1,341,253	2,390,000	1,393,014
N.Y. State Teachers Retirement Fund	1,163,000	871,000	522,200
California Public Employes & Teachers Retirement System	992,700	1,051,300	430,000
Girard Trust	847,264	377,320	728,379
Wells Fargo	762,500	636,385	1,267,296
Provident National	741,585	473,038	616,162
Chase Manhattan Bank	627,508	501,859	2,450,438
U.S. Steel Pension Trust	624,906	917,760	544,410
First Union Bancorp	578,748	398,289	638,711
Bankers Trust*	510,314	5,629,206	13,337,329
Fidelcor	504,456	283,601	739,083
Walter E. Heller International	496,449	414,707	741,770
Batterymarch Financial	427,500	225,100	536,368
U.S. Trust Co.	422,701	616,204	785,589
Texas Teachers Retirement System	385,200	233,700	556,884
Metropolitan Life	347,775	229,250	432,500
Ameritrust	338,082	394,822	862,525
First Pennsylvania	324,613	227,841	797,981
Bank of N.Y.	318,541	729,291	816,563
N.Y. City Teachers Retirement System	256,200	222,800	466,632

* *mostly employe plan holdings*

Source: CDE Stock Ownership Directory

that the 20 largest holders of Conoco control 27.5% of the stock. In all, CDE found 74 holders, each with more than 0.2% of the stock, and these 74 held about 46% of all of Conoco's 108 million shares.

One of the largest is Newmont Mining with 3.5 million shares. Another is Capital Guardian Group, a Los Angeles bank and investment-management concern, with nearly 3.5 million shares. Capital Guardian also showed up as one of the largest holders of Du Pont, with 2.6 million shares. Du Pont's largest holder, by far, is the Du Pont family, with 35% of its 148 million shares.

Similarly, the Rockefeller family interests remain among the major owners of Mobil, accounting for 4.2 million of its 212 million shares. CDE also lists Internorth Inc. with three million shares of Mobil, Banc-Oklahoma with 2.6 million, Fayez Sarofim & Co., an investment management firm in Houston, with 2.2 million shares, and National Detroit Corp. with nearly 2.1 million shares.

Among other large oil companies, concentration of stock varies. The 20 largest stockholders account for 16.9% of Exxon shares, 23.7% of Mobil, 17.1% of Texaco, 24.8% of Standard Oil of California, 27% of Gulf Oil, 25.3% of Standard Oil (Indiana), 20.9% of Atlantic Richfield, 49.6% of Sun Co., 26.4% of Phillips Petroleum.

(Wall Street Journal)

Analysts Expect More Mergers Among Oil Companies

Huge Credit Lines May Presage Acquisitions

By PAUL BLUSTEIN and STEVE MUFSON
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK – During the two-month chase for Conoco Inc., five major oil companies arranged lines of credit totaling $24.7 billion.

The money is still available. It could still be used to buy other companies. Analysts and merger specialists on Wall Street suspect what is past may be prologue: The $7.5 billion acquisition of Conoco could be just the beginning of an extensive takeover spree.

"I've talked to the chief executives of four or five of these big oil companies," says an investment banker. "They're saying, 'If assets can be bought, I want to be ready. I don't want to be left behind.' "

Constantine Fliakos, an oil-industry analyst for Merrill Lynch, Pierce, Fenner & Smith Inc., says he believes merger activity will continue, particularly in the energy field. "Nothing has changed," he says. "The oil stocks are still undervalued." Merger specialists at investment-banking firms on Wall Street say several major transactions are being discussed, "especially," says a veteran dealmaker, "in the natural-resource business, including oil and gas."

Among the companies that have arranged big lines of credit are Texaco Inc., Gulf Oil Corp., Marathon Oil Co. and Cities Service Co. Of course, Mobil Corp. still has available several billion dollars of credit that it didn't get to spend for Conoco. In addition, other oil companies are understood to have arranged large credit lines, but with less fanfare.

"Everyone is squaring off," says an investment banker with years of experience making petroleum-industry deals. Merrill Lynch's Mr. Fliakos predicts "more testing of the waters" by companies that want to find out how much oil-industry consolidation the Reagan administration will allow.

In Wall Street takeover rumors, oil companies often mentioned as possible targets are "second tier" companies with market values of as much as $7.3 billion (see accompanying chart.)

But the chances that one oil company would suddenly make a hostile takeover bid for another seem remote. Wall Street specialists say top executives in the energy business simply aren't so inclined, although the situation could change quickly if a company in another industry were to make an unwelcome bid for an oil company.

Mobil, for example, apparently has decided that "if someone else starts a takeover for an oil-and-gas company, Mobil is free to come in and bid, on the theory that the company will be sold anyway," says an investment banker. Gulf, Marathon, Texaco and other potentially acquisitive concerns aren't likely to make unfriendly bids for their oil-industry competitors, either, he says, "but they're willing to be white knights. The question is whether a spark will set things off."

Mobil, however, is keeping mum about its intentions. Asked what the company expects to do with the $6 billion of credit raised for the Conoco battle, a Mobil spokesman says, "we're counting it."

Such a spark could come, merger specialists say, from an attempt by a relatively small company to buy a minority interest in one of the medium-sized oil companies that are considered vulnerable. After all, Conoco didn't become a plausible takeover target until Dome Petroleum Ltd. made a tender offer for part of Conoco shares. Similarly, Cities Service has been a subject of takeover speculation ever since Nu-West Development Corp. Ltd. started trying to buy a stake in it.

Cities Service president Charles Waidelich has been trying to dispel the speculation. "Cities Service is not a merger candidate," he recently told securities analysts. "We are not planning any mergers. No discussions are being held with anyone, and we will resist with every means at our disposal any attempt at a raid."

'Second Tier' Oil Companies

Company	Annual Sales 1980 (Billions)	Common Stock Market Value Aug. 5, 1981 (Billions)	Oil and Gas Reserves * 1980 (Millions of barrels)
Phillips	$13.38	$6.85	2,143**
Sun	12.96	5.48	1,499
Occidental	12.48	2.25	913**
Getty	10.15	6.36	2,391
Union	9.98	7.31	1,922
Marathon	8.18	4.39	1,796
Amerada Hess	7.87	2.82	1,190**
Cities Service	7.79	4.79	845
Kerr-McGee	3.48	2.18	306
Pennzoil	2.48	2.78	294
Superior	1.50	6.10	973
Louisiana Land	1.04	1.54	177

**Natural gas converted to oil equivalent*
***Majority of reserves outside U.S.*

In Pittsburgh, Gulf says the outcome of the Conoco contest doesn't change its acquisition strategy. Gulf, which recently negotiated a $5 billion credit line for acquisition financing, has narrowed its list, says James E. Lee, president, without homing in on "any one company" as a candidate. Gulf chairman Jerry McAfee adds that his company "isn't interested in being a party to an unfriendly takeover" or to "an acquisition for acquisition's sake."

Of course, Wall Street speculation about takeovers has to be viewed warily, because some of the people spreading the word are also the stock-speculators and deal-makers who stand to benefit if the rumors come true. And there are other factors that could slow things down.

Theodore Eck, chief economist for Standard Oil Co. (Indiana), considers the Conoco fight the result of "a temporary situation" in which oil shares have been depressed in relation to exploration costs. As oil-company stock prices rise again in recognition of the value of underlying assets, Mr. Eck argues, the stock-market bargains won't last. "The mere fact that one deal succeeds makes the next one more difficult."

Questions Submitted to Mr. Volcker by Committee Members

QUESTION SUBMITTED BY CONGRESSWOMAN ROUKEMA

Question. On page 11 and 12 of your statement, you make clear the importance of "greater caution and restraint in both wage and price behavior." This point is emphasized by your further comments about a "crucially important round of union wage bargaining (which) begins next January, potentially setting a pattern for several years ahead."

Are you suggesting that we institute an incomes policy? If so, what kind of incomes policy would you suggest?

Can you envision a carrot and/or stick approach which efficiently accomplishes your goal of "greater caution and restraint?"

What is the proper role of government, if any, in such a policy?

What suggestions do you have for both labor and management as they enter this round of union wage bargaining? Please be specific.

Answer. I do think that it is critically important for labor and management alike to exercise restraint in their wage settlements and pricing decisions in the months and quarters ahead. So far the encouraging signs have been mainly on the price side, although fairly recently there have been some tentative indications of easing in wage pressures in some sectors of the economy. I am hopeful that as time passes the collective bargaining process—left to its own devices—will confirm these indications, and I consequently do not endorse an incomes policy at this time.

The plain fact is that incomes policies have never worked very well during peacetime in this country, in contrast to most European countries where they have been tried much more frequently and with somewhat more success in some instances. I think there are basic reasons for this difference in experience: Ours is a more heterogeneous workforce, and the wage-setting process in the United States is much more decentralized. Moreover, the tradition of private decisionmaking on economic matters, including wage determination, is more deeply entrenched here than it is in Europe. And, the approaches we have tried in incomes policy have tended to be less comprehensive.

It seems to me that any policy that is successful must take account of these differences. This means, for one thing, that the role of government should not be one of direct involvement and intervention in private decisionmaking. This is one reason why I have long been intrigued by the so-called carrot-and-stick approach, as illustrated by the tax-based incomes policy (TIP) proposals, which reward and penalize decisions on the basis of how they are made in the private sector. However, such policies entail significant administrative complexities, and I have yet to see an imaginative plan that also is workable.

Absent such a solution, I believe we have little choice but to point out the consequences of inflationary behavior by wage and price setters and encourage the forces of competition bearing on price and wage decisions. The impact of import controls, regulation, and such legislation as Davis-Bacon are all relevant in that connection. The heavy calendar of collective bargaining now slated for 1982 will constitute a litmus test for national economic policy. By that time the parties sitting down to the negotiating table will have witnessed more than two years of systematic efforts to slow monetary growth, and quite possibly a significant improvement in general price trends. If you ask me what specific advice I would have for them, I would suggest that they look hard at that evidence, assess realistically the determination of national policy in unwinding inflation and then adjust their expectations accordingly. We at the Federal Reserve have repeatedly indicated that we will not supply enough money to finance both high inflation and strong economic growth; firms or groups of workers that attempt price or wage increases inconsistent with that fact will be acting in a way that is contrary to both their own and the national interest.

QUESTIONS SUBMITTED BY CONGRESSMAN LOWERY

Question 1. For the past year inflation has been declining from double-digit rates, yet interest rates remain at unprecedented high levels. There are several theories as to why this is happening. What circumstances do you feel are responsible? How long do you expect this situation to exist, assuming a scenario in which other economic factors remain essentially the same?

Answer. Despite favorable signs on the inflation front, interest rates, particularly long-term rates, remain at high levels. One reason is that market participants have partly discounted recent easing of price pressures as reflecting some reversal of the "special factors" in the energy, food and commodities sectors that had raised inflation rates in 1979 and 1980. Thus, recent easing in the underlying rate of inflation is viewed as being less pronounced than the moderation of increases in the various price indexes. In addition, market concerns about the prospective size of the federal deficit may be contributing to high interest rates. Even so, as the next several answers indicate, when inflationary expectations begin to respond to the more permanent lessening of inflationary pressures that I believe is in train, interest rates will begin to move down.

Question 2. One of the theories used to explain the inflation/interest rate relationship that we are presently experiencing is that of "inflationary expectations." If this is in fact the cause of our current interest rates, how can we best turn around the psychology of inflationary expectations?

Answer. One element in turning around inflationary expectations is public recognition that a commitment to monetary and fiscal restrain underlies governmental policies. Another element involves a response to such policies in private sector wage and price decisions that shows through in sustained declines in the observed rate of inflation. As actual price behavior provides a confirmation of the government's commitment to long-run price stability, a reduction of inflationary expectations will naturally tend to occur.

The fundamental prerequisite for this process to unfold is having governmental policies in place that in fact resist inflationary pressures. In this regard, the Federal Reserve is pursuing growth rate ranges for the monetary and bank credit aggregates this year—and has announced ranges for next year—that we believe are consistent with a deceleration of inflation over time. Of course, a wide range of fiscal and regulatory policies also have important roles to play in an overall anti-inflationary strategy.

Question 3. Besides having a significant impact at home, interest rates have a great impact abroad. How do high interest rates here affect the economic policies of our principal trading partners? Of the international economy as a whole?

Answer. Because the economy of the United States is so large, high interest rates in this country have important effects on other countries. The basic thrust of our policy—to achieve a lasting reduction in our inflation rate—is widely appreciated abroad. However, the short-run effects of this policy, in terms of output and employment, are transmitted to other countries and, in some cases, exacerbate an already-weak demand situation. Efforts by foreign authorities to support the value of their currencies in the face of a strong dollar intensify these effects. Moreover, high U.S. interest rates impose financial burdens on countries, including some hard-pressed developing countries, who are borrowing in international markets.

However, the level of U.S. interest rates is not the only factor putting downward pressure on the currencies of our trading partners of imposing burdens on developing countries. All countries—including the United States—must guard against a temptation to assign undue responsibility for economic problems to external forces.

On July 16, I presented my views on this subject in more detail, before the Joint Economic Committee. A copy of that statement follows:

For release on delivery
9:00 A.M., E.D.T.

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

July 16, 1981

I appreciate the opportunity to appear before this Committee to present the Federal Reserve's views on the international implications of U.S. macro-economic policies, and particularly monetary policy.

Inevitably questions arise abroad, as they do in this country, about particular techniques and implications of U.S. ecomomic policies. After all, nearly all of the nations represented at the Ottawa Summit, and most others, are faced with difficult problems and choices in developing economic policy, and external influences on their interest rates and exchange rates inevitably raise new complications for some -- just as at times external developments complicate our own policy-making. However, the expression of such concerns should not be taken as disagreement with the basic intent or thrust of our policies, certainly not among those most closely concerned with financial policy. I base that judgment on my own discussions with central bankers and finance ministers abroad as well as on the conclusions reached in May at the meeting of the IMF's Interim Committee in Gabon and more recently at the OECD Ministerial meeting.

Accordingly, I expect that the President will hear a general endorsement of the broad purposes and objectives of U.S. economic policies when he meets next week with other heads of state and governments. Specifically, I believe that the priority the United States has attached to the fight against inflation is widely appreciated. Indeed, the leaders of these very nations, along with many others, have long urged us to adopt rigorous and convincing anti-inflation policies, and I do not believe they will change that attitude now.

Foreign officials do rightly stress that, in our interdependent world, U.S. economic developments and policies have ramifications for the policies and performance of other economies. Our weight in the world economy, while relatively smaller than in the early postwar years, is still very significant, and leaders abroad have to take U.S. economic policies into account when they formulate their own programs. They do want us to be aware of the external implications of high dollar interest rates and a rising dollar, as we should be. The short-run effects -- abroad as well as at home -- can indeed be discomforting. But we should also have a sense of proportion about those effects.

The United States should not and can not assume the responsibility for all the economic difficulties of particular countries. In some instances -- for example, countries with sizable balance-of-payments deficits -- some depreciation of their currencies relative to the dollar may have been natural, and a number of countries have internal reasons for following firm monetary policies. Changes in exchange rate relationships within Europe have been relatively small recently, and most of the trade of those countries is not affected by the substantial appreciation of the dollar. The point is often made in the context of the dollar's appreciation that oil and other commodities are priced in dollars, but it should also be pointed out that monetary restraint in the United States has contributed importantly to squeezing out inflationary excesses in those markets.

In general, it is rarely easy to trace through the relative weight of different forces impacting on the economic policy problems of different countries. We all -- certainly including the United States -- must guard against a temptation to assign undue responsibility to external forces. I would remind you that any exchange rate involves two national currencies; a change in that exchange rate may reflect policies or developments in either country, or more likely both at the same time. The recent "strength" of the dollar vis-a-vis some currencies headlined in the press has been relative; it may be -- indeed has been -- influenced by conditions abroad, as well as in the United States. I would note that short-term interest rates in the United States are a bit lower today than at the turn of the year, and interest rate differentials are narrower with respect to continental European currencies. Yet the dollar has appreciated substantially against those currencies over the past six months.

Because of the potential for misunderstanding, and because developments and policies here do have effects on other countries whose leaders face difficult economic problems and choices, we have a clear responsibility to listen closely to their views, to explain our policies carefully, and to respond to constructive, substantive criticism. Prolonged misunderstanding is always dangerous, for economic and political friction could impair the fabric of the open international economy that serves us all. My perception is that, fortunately, there is broad understanding of our objectives and policies -- combined, of course, with a good deal of impatience in awaiting results, just as is sometimes the case at home.

The essential point about U.S. economic policies -- monetary, fiscal and other -- is our commitment to reducing inflation. Most of the foreign leaders with whom I have talked readily agree that it is in their countries' fundamental interest, as well as ours, that the United States make significant progress against inflation. Because of the dollar's role in world financial markets and because of the U.S. prominence in the world economy, a necessary condition for the restoration of stability in currency markets and for the resumption of sustained, worldwide economic growth is the restoration of greater price stability in the United States.

Obviously, they, as we, would like to see lower and more stable U.S. interest rates and less variation in exchange rates. Everyone would agree that reduced inflation and a clear sense of movement toward price stability must be the basis for maintaining such stability over time. Against that background, international discussions raise questions of means, not ends.

As you know, Federal Reserve monetary policy has been directed at restraint in the rate of growth of the monetary aggregates. Some observers -- and they are not confined to those outside our borders -- believe we are following a policy deliberately directed at achieving high interest rates and dollar appreciation. Such views are mistaken; the Federal Reserve has neither an interest rate nor an exchange rate objective. We do take the view that persistent restraint in the growth rates of the monetary aggregates is necessary to ensure lower inflation -- and therefore lower interest rates -- over time. I find no disposition among my colleagues abroad to question that necessity.

In the short run, interest rates are a function of the many factors that influence the demand for money and credit, including the budgetary position of the government, the strength of business activity, and the inflationary momentum. So long as actual and expected inflation and nominal demand remain strong, high interest rates should not be surprising. Only when inflation slackens significantly, and markets believe the slowdown will be sustained, can we look forward to meaningful, sustained declines in dollar interest rates, consistent with growth in real activity.

Relative interest rates can and do influence exchange markets. But that influence has to be judged in the context of other influences working at the same time. As I have already suggested, it would be a mistake to attribute the roughly 20 percent weighted-average appreciation of the dollar since December of last year primarily to the behavior of nominal interest rates on dollar assets. The differential between U.S. interest rates and short-term interest rates on average in foreign industrial countries has declined about 2-1/2 percentage points since the end of 1980. U.S. short-term interest rates are now about 1 percentage point less than their December average. Interest rates on the continent of Europe are appreciabl higher, yet their currencies have depreciated substantially relative to the dollar. Interest rates in two of the Summit countries -- Japan and the United Kingdom -- have declined so far this year, and in one of those countries -- Japan -- the depreciation of its currency relative to the dollar has been smaller than that of the continental European currencies. The yen, as well as the Canadian dollar, has experienced a weighted-average appreciation so far this year.

Obviously, one must look beyond absolute or relative interest rates to explain the dollar's appreciation this year. Among the other relevant factors in the United States have been the first signs of some improvement in our relative inflation performance, a continuation of a relatively favorable U.S. current-account position, and favorable assessments of the potential of the new Administration's economic program. On the other side of the Atlantic, balance-of-payments deficits have been large, and there has been a sense of greater political change and uncertainty.

number of foreign observers, while not questioning the need for monetary restraint in the United States have suggested that monetary policy should not carry so much of the burden of the stabilization effort either here or in their own countries. As you know, I have also often emphasized the importance of fiscal restraint and regulatory and other policies, alongside firm restraint on the money supply, in a comprehensive program to reduce U.S. inflation. At the same time, we all have to recognize the difficulties in changing these policies dramatically and quickly. We are in fact making progress in reducing the strong upward trend in government expenditures -- and I would remind you that the Administration has emphasized that more will need to be done in future years, particularly if we are to reap the benefits of tax reduction in a context of reduced budget deficits. The closer the budget is to balance, all else equal, the less pressure will be felt in financial markets, the lower interest rates will be, and the danger of abnormal exchange rate pressures will be lessened. But it would be unreasonable to expect a balanced budget overnight, and I believe there is a growing understanding abroad, as at home, that fiscal policy cannot easily be shifted in the short run. After all, most other governments are grappling with fiscal problems at least as difficult as our own.

It is equally important to recognize that there are no "quick fixes" available through monetary policy to lower or fine tune interest rates. If the Federal Reserve, for example, were to deviate from its policy of monetary restraint in an effort to lower interest rates, any seeming short-run relief would have to be balanced against the substantial risk -- for the United States and the rest of the world -- of excessive credit growth, a further hardening of inflationary expectations, and still greater interest rate pressures in the future.

"Like others, I shall applaud lower interest rates in the United States any day if they signal success in the battle against inflation. But I would look upon lower rates with mixed feelings if they promised more inflation and hence higher interest rates for the future." Those words are not mine, but those of a central bank colleague in Europe.* It seems to me they capture the essence of our policy problem.

Of course, as I suggested earlier, there is impatience for results. Monetary restraint is painful, and it cuts unevenl at home as well as abroad. Moreover, the burdens are not restricted to the industrial economies; developing countries are affected as well. Some are experiencing slower growth in their exports because of slack demand in the industrial world. They are all facing much stiffer borrowing terms in internationa markets than those to which they have been accustomed. It may be of little comfort to suggest that, in some cases, those terms may well have been too easy in the past -- internationally as well as domestically nominal interest rates have frequently

*Remarks by Karl Otto Pohl, President of the Deutsche Bundest June 12, 1981, before the Roundtable of the International Ba Institute in Cannes.

been exceeded by actual inflation rates, encouraging excessive indebtedness and the postponement of needed adjustments. What we would all like to see is a reasonable middle ground, and more stability and predictability; we will not succeed unless we keep at it.

If we cannot promise instantaneous and easy results -- the answers do not lie in "fine tuning" fiscal or monetary policies -- we can and must make the effort necessary to explain our policies, formally and informally, in all the forums available to us, and to consider carefully the views of others. In that connection, I have long felt that the economic summits can help assure that our mutual economic concerns are fully discussed and addressed at the highest level, and the success of those meetings over time can be measured less by any concrete agreements than by the degree of understanding reached about our mutual problems and purposes.

Certainly we must all avoid the temptation to become inward looking during this difficult period. Intensification of trade restrictions would be damaging to the interest of all countries. Together we must seek effective ways to help developing countries cope with their own serious adjustment problems, not the least by maintaining and strengthening our commitment to cooperation and dialogue in the IMF and World Bank.

Most of all, it is crucial that we not fail in our basic purpose of restoring stability and laying the base for sustained growth. One wise foreign official, widely experienced in international affairs, recently put it to me roughly as follows: You cannot expect us to be enthusiastic about the effects of your policies; we will all have different opinions about just how you are going about it; but the fact is we have no agreed better alternatives to offer you. We can only wish you success.

I would only add that with success the present international concerns will fade in memory. We would do no one a service, at home or abroad, if we were to take actions that would jeopardize the prospects for that success.

* * * * * *

Question 4. What is the impact of monetary policy on GNP?

Answer. Economists generally believe that a policy of monetary restraint places broad limits on the growth of nominal GNP—that is, the combined result of changes in real output and the price level. The Federal Reserve's policy of monetary restraint is directed toward reducing inflation. But unfortunately, this policy does not work directly on prices, and its initial effects often fall on real output and employment. So long as inflation continues near its current rate and inflationary expectations remain imbedded in economic decisions and institutions, pressures on interest rates will be intense and real activity is likely to be constrained, particularly in credit-sensitive sectors such as housing and automobiles. Over the longer run, however, the gradual reduction in the expansion of money and credit will lead to an easing of inflation and inflationary expectations. This will set the stage for stronger—and sustained—real growth, lower interest rates, and reduced unemployment.

Question 5. What is the impact of federal budget deficits on monetary policy?

Answer. In an environment of restrained monetary growth, the size of the federal budget deficit is an important determinant of credit market conditions and interest rates. New borrowing by the federal government, whether to finance budget deficits or off-budget programs, competes with private demands for a limited supply of credit and inevitably aggravates interest rate pressures. The demands of the government are insensitive to interest rates and thus will always be met. However, if private demands for credit are strong, rates for other borrowers often will be pushed up in the process. Thus, it is essential that fiscal policy and monetary policy work together in the effort to achieve noninflationary economic growth.

Question 6. There are several important wage contract negotiations coming up next year. What are the implications for inflation? What role, if any, should the government play in this process?

Answer. In 1982, collective bargaining negotiations will take place in major industries including petroleum refining, trucking, rubber, electrical equipment, automobiles, and agricultural equipment. Altogether, about 3½ million workers will negotiate major new settlements. However, to the extent that these highly visible settlements are reflected in other wage decisions, their eventual importance in the overall inflation picture looms much larger than the number of workers involved might suggest. Negotiations in 1982 are important for another reason. Over the past decade, wages in many of these industries have been rising more rapidly than productivity. Consequently, rising labor costs have put upward pressure on prices. A fundamental issue that must be faced by both labor and management is whether workers can continue to receive real wage gains in excess of productivity growth without adverse consequences to firms, industries, and the nation as a whole.

With regard to the role of the government, I believe it is fundamentally to foster and maintain a competitive economic environment. Regulatory policies affecting wage- and price-setting should be critically reviewed. These and other governmental policies aimed at protecting incomes and insulating markets from competitive pressures merely will delay tough decisions that need to be made at the bargaining table. To the extent that these decisions ease pressures on costs and prices, the result will be greater economic growth, more jobs for American workers, and a speedier return to stable prices and lower interest rates.

QUESTIONS SUBMITTED BY CONGRESSMAN BEREUTER

Question 1. Commerce Department figures indicate that the ratio of fixed capital to output in the farm sector is three times that in manufacturing. The ratio of inventory to output also is approximately three times that in manufacturing. Of course, this means a heavy reliance on credit in the agricultural sector.

Vice Chairman Frederick Schultz, of the Federal Reserve Board of Governors, recently told the House Agriculture Committee that a change in resources of agricultural banks (i.e., a shift from heavy reliance on passbook and low-cost savings instruments to money market certificates) is tying formerly local agricultural banks into national credit markets and therefore into higher national rates.

What answer does the Federal Reserve have for my farm constituents who fear that high interest rates will bankrupt them any day now?

Answer. High interest rates have unquestionably had an adverse effect on farmers, as indeed they have on other credit-sensitive sectors such as housing, automobiles, and small business, But, it is important to bear in mind that interest rates are high because inflation and the demand for credit have remained high. The Federal Reserve would do the agricultural community no service in loosening its resolve to slow monetary growth; in all probability interest rates would soar to new highs as inflation worsened. As current efforts by the Federal Reserve to control the money supply and by the Administration and Congress to cut Federal spending and reduce the Federal deficit take hold, we should be able to look forward to sustained reduction in interest rates.

As discouraging as the current situation may seem, there are some reassuring aspects to the condition in which farmers find themselves. For example, while the Commerce Department figures you cite on capital and inventories relative to output are correct, it may surprise many to find that farmers' debt relative to total assets—somewhat less than 20 percent—is much lower than for the manufacturing sector. This is because farmers hold a lot of land, which has appreciated greatly in value over the years. Although appreciation hasn't alleviated the squeeze that inflation has put on cash flow, it certainly provides a somewhat different picture of their overall financial position.

Perhaps because of this, farmers have not, in general, experienced difficulty in obtaining credit over the last year or two. Indeed, as Vice Chairman Schultz pointed out in his testimony, loan deposit ratios at rural banks are currently in a comfortable range, indicating reasonable credit availability and the rates paid on loans at these banks, while high, are somewhat under the national average.

Question 2. A recent study released by the International Monetary Fund urges use of an "incomes policy" as well as monetary and fiscal policy to fight inflation. The Reagan Administration opposes such a suggestion. Do you have any views on an appropriate incomes policy, if any, which we should pursue? Please elaborate.

Answer. I do not support an incomes policy to supplement current monetary and fiscal policy, as explained more fully in my response to Representative Roukema's question. As also indicated in that response, if any incomes policy were implemented, I would favor a carrot-and-stick type of approach, like TIP, presuming that administrative complexities could be ironed out.

Question 3. A June 29 *Businessweek* article suggested that the government should shift to short-term debt to take the pressure off long-term markets in the private sector. Do you agree? Please explain.

Answer. There is a presumption underlying this question that relative supplies of securities, particularly Treasury debt, are the principal determinants of the shape of the yield curve. While I do not dispute the notion that a significant shift towards shorter-term Treasury financing would influence rate relationships, I think that other fundamental factors are at work holding long-term rates high. The chief one, in my view, is that the evidence of progress in controlling inflation is as yet inconclusive; market participants thus expect interest rates in general to remain quite high for some time to come. I think also that the prospect of heavy Treasury financing needs in coming quarters, regardless of the form of this borrowing, has taken its toll all along the maturity spectrum. Besides, to the extent that a shift towards shorter-term borrowing did relieve pressures in long-term markets, it would merely shift these pressures into shorter-term markets which already are under considerable strain.

CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 22, 1981

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

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

Present: Representatives St Germain, Reuss, Gonzalez, Minish, Annunzio, Mitchell, Neal, LaFalce, Evans (Ind.), D'Amours, Oakar, Vento, Lowry, Schumer, Frank, Patman, W. Coyne, Hoyer, Stanton, Leach, Weber, McCollum, Carman, Wortley, and J. Coyne.

The CHAIRMAN. The committee will come to order.

Yesterday the Chairman of the Federal Reserve Board presented his report on the conduct of monetary policy and the targets being set for the growth of money and credit for 1982.

We all know what the Chairman said. He said that we can look forward to even tighter money in the upcoming year, which I believe will result in continued high and volatile interest rates. I will use Mr. Volcker's own words to describe the impact of that policy:

> High interest rates undeniably place a heavy burden on housing, the auto industry, small business, and other sectors especially dependent upon credit. The thrift industry, in particular, has come under heavy stress as its costs of funds exceed returns on fixed-rate assets acquired when interest rates were much lower. The high level of U.S. interest rates also has repercussions internationally, complicating already difficult economic policy decisions of some of our major economic partners.

He is right. His policies are placing an unbelievable burden on housing, the auto industry, farmers, small businessmen, and consumers.

Yet the large oil companies and other giant corporations barely notice what he is doing: $40 billion worth of takeover lines of credit to Gulf, DuPont, Mobil, and Pennzoil can be granted in days to allow them to engage in bidding wars—$40 billion. Think what that amount of credit could do for home building, for our farmers, for the people of this country.

Despite all of this, the administration and the Federal Reserve remain wedded to policies which do not spread the burden of our fight against inflation equally. Whenever banking legislation comes before this committee, we all hear a lot about the "level playing field."

Unfortunately, when it comes to people, to farmers, to small businessmen, and to workers, there is no level playing field. With us today are representatives of some of these sectors to tell us about their experiences under current monetary policy.

You may have seen some of the press this morning. Yesterday's hearing was unbelievably well attended. The participation by the membership on both sides of the aisle was most gratifying, and I think most indicative of the concern that each and every one of us on this committee has about the effect of monetary policy and resultant high interest rates that have been failing for such a long sustained period of time.

So, you should take heart in the fact that the membership is responding.

Mr. Turner, we will ask you to begin. We will put your full statements in the record. You may now proceed.

STATEMENT OF J. C. TURNER, INTERNATIONAL UNION OF OPERATING ENGINEERS, AFL-CIO; ACCOMPANIED BY CARL COAN, LEGISLATIVE COUNSEL, NATIONAL HOUSING CONFERENCE; ROBERT MULLINS, DIRECTOR OF LEGISLATION, NATIONAL FARMERS UNION; PAUL FRY, EXECUTIVE ASSISTANT DIRECTOR OF FINANCE AND ADMINISTRATION, AMERICAN PUBLIC POWER ASSOCIATION; WILLIAM STAFFORD, EXECUTIVE ASSISTANT TO THE MAYOR OF SEATTLE, U.S. CONFERENCE OF MAYORS; AND HOWARD SAMUEL, PRESIDENT, INDUSTRIAL UNION DEPARTMENT, AFL-CIO

STATEMENT OF J. C. TURNER, INTERNATIONAL UNION OF OPERATING ENGINEERS, AFL-CIO

Mr. TURNER. Thank you, Mr. Chairman.

We are all very grateful to you, Mr. Chairman, and to your committee, that you have seen fit to give us this opportunity to appear.

We were greatly encouraged a few weeks ago when you were kind enough to come over and address our group at a breakfast. The things you said were pretty much the things that we believe. And we, of course, read about what happened yesterday, and that, too, is very encouraging—that is the reaction of your honorable committee.

We also were very pleased that Chairman Reuss of the Joint Economic Committee has been moving ahead, I understand, with the joint resolution of the House and Senate, going into this very important matter. And we do hope that the resolution will get a lot of attention, and certainly it will have the support, I think, of most of the American labor movement, if not all of it.

Today we have several groups, all of whom have their own views perhaps as to what ought to be done in terms of solving the problem. But what we are going to try to do is to tell you the way looks from our point of view.

And we have with us Carl Coan, the legislative counsel for the National Housing Conference. And we have Robert Mullins, director of legislation, for the National Farmers Union; Paul Fry, executive assistant director of finance and administration for the American Public Power Association, William Stafford, executive assistant to the mayor of Seattle, representing the U.S. Conference of Mayors, and Howard Samuel, president of the AFL-CIO Industrial Union Department.

I would like to read to the committee the opening paragraphs of our statement. And then we will go on to the other speakers, who will each present their point of view, Mr. Chairman.

We would like to thank the chairman, as I said, and the members of the committee for this opportunity. We represent a broad range of organizations, including the Industrial Union Department, AFL-CIO; the American Public Power Association; and the various other organizations, whose names I read.

[The joint prepared statement of J. C. Turner on behalf of the International Union of Operating Engineers; Carl Coan on behalf of the National Housing Conference; Robert Mullins on behalf of the National Farmers Union; Paul Fry on behalf of the American Public Power Association; William Stafford on behalf of the U.S. Conference of Mayors; and Howard Samuel on behalf of the Industrial Union Department of the AFL-CIO, follows:]

STATEMENT OF

J.C. Turner, International Union of Operating Engineers, AFL-CIO

Carl Coan, Legislative Counsel, National Housing Conference

Robert Mullins, Director of Legislation, National Farmers Union

Paul Fry, Executive Assistant Director of Finance and Administration, American Public Power Association

William Stafford, Executive Assistant to the Mayor of Seattle, U.S. Conference of Mayors

Howard Samuel, President, Industrial Union Department, AFL-CIO

before

COMMITTEE ON BANKING, FINANCE & URBAN AFFAIRS, U.S. HOUSE OF REPRESENTATIVES

July 22, 1981

We would like to thank the Chairman and members of the committee for this opportunity today to discuss a very important issue. We represent a broad range of organizations including the Industrial Union Department, AFL-CIO, American Public Power Association, International Union of Operating Engineers, U.S. Conference of Mayors, National Farmers Union and the National Housing Conference. We have come together today out of a common concern about the ravaging effects of high interest rates.

While the country's attention in recent months has been directed toward the budget and tax proposals being debated in Congress, interest rates in our nation's financial markets have once again approached unprecedented levels. It is our belief that, if unchecked over time, the current tight money policy of the Federal Reserve will result in continued high and volatile interest rates, and wreak havoc on the nation's economy.

As you well know, in October of 1979, the Fed embarked upon a new experiment in monetary policy that marked an historic change in the object and method of open market operations. Under Paul Volcker's leadership, the Fed was to begin concentrating strictly on controlling the money supply rather than controlling for interest rate targets. This new approach to monetary policy, although begun under the Carter Administration, is still being followed today. By clamping down hard on the money supply, the Fed hopes to rid the economy of rapidly rising prices by restricting demand and dampening people's expectations of future inflation.

This so-called monetarist approach, we believe, is an ineffective remedy for the disease of inflation. It is also destructive to our economy, with a debilitating impact on capital spending, productivity, economic growth and our ability to compete in the international marketplace. In addition, high interest rates have a disproportionate impact on certain key sectors of the American economy, including the automobile and auto parts industry, all kinds of small business, construction, utilities, state and local government, and agriculture--industries and sectors that, by and large, form the backbone of economic life in the United States. We would like to outline in greater detail these damaging effects that the Fed's tight money policy has had--and the effects that it is likely to have in the future.

The first and most apparent effect of extremely high interest rates is to choke off demand for goods and services. As money becomes increasingly expensive, businesses and consumers in general tighten their belts and reduce borrowing and consumption. In addition, high interest rates artificially inflate the international value of the dollar, thus further eroding the demand for American goods in foreign as well as domestic markets. The end result is idle productive capacity which exacts a high cost in lost output and increased unemployment. Certain interest-sensitive sectors of our economy bear an exceptional burden of high interest rates. Such basic American industries as automobiles, construction, and agriculture as well as small businesses, utilities and governments at all levels are buckling under the pressures of rising interest costs. A brief description of some of the damage follows:

HOUSING & CONSTRUCTION

High interest rates have all but knocked the foundation out from under the housing industry. Although the industry needs to produce roughly 2.5 million units per year to satisfy underlying housing demands and replacements, the average annual production of new housing units during the last three calender years was under 2 million, including regular new housing units and mobile home shipments. With mortage rates now above 16 percent, the outlook for the housing industry is extremely bleak. New housing starts in June registered a meager annual rate of 1.0 million units. Unemployment in the construction industry is running at 16.6 percent.

As we well know, high interest rates have also had a severe impact on savings and loan associations--the institution that has provided the bulk of home financing in this country. With portfolios dominated by long-term, low yielding assets, thrift institutions have been squeezed by having to pay high market rates of interest to stem the outflow of deposits. In 1980, for example, survey data from the U.S. League of Savings Associations indicate that the S&L business had more than 65 percent of its mortgage portfolio in loans at interest rates of less than 10 percent. Yet new mortage rates during the year never fell below 12 percent —and were usually much higher. Severely weakened balance sheets will likely make affordable mortage money harder to come by in the future--especially if the S&Ls place more of their deposits in short-term investments to take advantage of high short-term interest rates.

Shortages of mortgage money and housing, brought on by high interest rates, fuel inflation and deprive many people of an affordable and adequate home. The median prices of existing homes sold increased by 12 to 14 percent in each of the past three years. The prices of new homes during this period increased by comparable percentages. Thus, not only do high interest rates in themselves cause housing inflation, but they also contribute to housing shortages which fuel inflation even more.

The construction and construction-related industries are obviously hard hit by rising interest costs. Because of their major role in our economy, these industries have traditionally played an important part in leading the rest of the economy into both recessions and recoveries. For this reason, it is unlikely that we will see a significant economic recovery as long as high interest rates keep the housing and construction industries in a state of virtual paralysis.

SMALL BUSINESS

High interest rates are dealing America's small businesses a heavy—and often fatal--blow. Because smaller firms are more dependent on short-term debt than are large corporations, the unusually high short-term interest rates are creating a great deal of stress among small and medium-sized businesses. The number of small business bankruptcies is soaring. Small firms, because they are considered to be higher risk borrowers, must pay higher rates of interest than larger corporations. And because these firms operate within a more competitive environment, they are less able to pass on higher interest costs. Some analysts suggest that it is not so much the cost of capital that prevents small businesses from obtaining the financing they need, but rather the availability of capital. When credit is tight—and particularly when local banking markets are highly concentrated--banks become more risk-averse and avoid making loans to small firms altogether. Instead, they tend to favor doing business with larger corporations which are easier and less costly to deal with.

AGRICULTURE

Record high interest rates are also having a severe impact on American agriculture, and in particular on family farmers. Because farmers shoulder a very heavy burden of debt, any rise in interest rates squeezes farm profits more. Debt has soared from 6 percent of overall farm cash-flow in 1970 to 19 percent today. And farmers' debt-to-asset ratio has doubled since 1950 from 8.5 percent to 17 percent in 1980. As of January 1, 1981, the outstanding debt of American farmers stood at a staggering $180.5 billion. And in 1981 alone, farmers will have to pay out more than $20 billion just to service this mountain of debt.

The financial vise in which farmers find themselves is especially alarming in light of the role that agriculture plays in boosting our sagging economy. Last year, for example, the United States ran a $23 billion agricultural trade surplus, helping to offset the massive $51 billion deficit inccured in our international trade in other merchandise. Blessed with a temperate climate and rich soil, and buttressed with advanced farm technologies, U.S. agriculture occupies a premier position in the international marketplace. The strength of it is not only felt in a reduced deficit and more farm jobs, but also in ancillary industries such as transportation and commodity processing and trading.

Although the future demand for American agricultural products is expected to expand rapidly, farmers will have to make huge new investments to expand and modernize their productive capacity. Farm profits, from which these new investments must be financed, are being severely squeezed by the increasing costs of all inputs—especially energy and money. Last year, net farm income plunged nearly 30 percent. The less capital that farmers are able to generate internally, the more they must depend on debt to finance their operations. Tight money and high interest rates may prove to be one of the primary factors that leads to the loss of yet one more market for American goods.

AUTOMOBILES

The U.S. automobile and auto-related industries are in a crisis. Fierce competition from abroad and rising energy prices have exacted a heavy toll. The Big Three have begun to re-position themselves by introducing new lines of fuel efficient cars in an attempt—albeit a belated one—to meet the challenges of their foreign competitors.

High interest rates, however, have stifled their efforts. Because most people finance the purchase of a car with short-term loans, fluctuations in interest rates have a major impact on auto sales. This fact is borne out by monthly domestic auto sales figures. Auto sales began to recover from the recession last summer when they increased from an annual rate of 6 million units in May to 8 million units in September. This recovery was aborted, however, by a resumption of the climb in interest rates. The prime rate rose from about 12 percent in September to more than 20 percent in December. And auto sales quickly plunged in January to 5.6 million units.

The high price of credit has not only kept customers away from the showrooms; dealers have become overstocked and some have gone under due to the increasing financial pressures, as they have had to pay more than 20 percent per annum to finance their unsold floor inventory. The auto industry's problems are, to be sure, the result of many factors. High interest rates, though, have further compounded the difficulties facing the industry and will continue to hamper their efforts to regain the market position lost in recent years.

UTILITIES

The electric utility industry is our economy's most capital intensive industry. It requires three to four dollars of investment for each dollar of revenue. The current total capitalization of the electric utility industry including the investment of the federal government is in the neighborhood of $300 billion. The annual new money requirements of the industry are in the range of $15-20 billion.

Unstable financial markets and high interest rates are particularly disruptive for electric utilities and impose very heavy cost burdens on their customers. The local, publicly-owned sector (utilities owned by municipalities or other political subdivisions of states) of the electric utility industry accounts for about $35 billion, or 12 percent of the industry's total capitalization. As public entities, these utilities raise capital in the tax-exempt municipal bond market. Interest rates in the municipal bond market have literally doubled in the past 3½ years. Although the bond market was quite stable over the 30-year period following World War II, it has become extremely volatile in recent years. The Bond Buyer 20-Bond Index varied only 48 basis points between its 1977 high and low. In 1978, however, the variation between high and low was 109 basis points; in 1979, 130 basis points; and in 1980, a volatile 345 basis points. For the first time, informed observers are beginning to doubt that local, publicly-owned electric utilities will be able to issue long-term bonds at affordable rates with which to finance the necessary expansion of their facilities.

The additional costs imposed on these utilities, and hence on their consumers, have already been substantial. The doubling of interest rates since 1977, for example, will add approximately $250 million to the costs of local publicly-owned electric utilities this year.

GOVERNMENT

High interest rates also have a deleterious impact on government at all levels. The net interest paid by the federal government is estimated to be more than $80 billion in Fiscal Year 1981, or over 12 percent of total federal outlays. The interest paid on the public debt has far outstripped the growth in the debt itself. Between 1954 and 1980, the public debt tripled while the interest paid on it increased twelve times. As high interest rates are sustained, interest outlays will continue to escalate.

Rising debt service costs will frustrate efforts to hold down federal expenditures and reach President Reagan's goal of balancing the budget. In fact, Treasury Secretary Reagan has recently revised the projected budget deficit for FY 1981 upwards to take into account rising debt service costs. An Administration that is committed to reducing non-defense spending and balancing the budget will find itself forced to make additional cuts in non-defense programs to move toward budgetary balance, as federal revenues are used to pay ever-increasing interest payments.

Although state and local government can raise capital in the tax-exempt bond market, rising interest rates have also squeezed their operating budgets. Interest costs for the average state and local security have risen 450 basis points since 1977—or almost doubled in dollar amount in the last four years. Even this dramatic growth underestimates the magnitude of the problem as interest rates have skyrocketed in recent months. Current rates on municipal bonds have been above 11 percent recently, compared to near 8.5 percent only one year ago. In addition, federal spending cuts will add to the fiscal woes of state and local governments and force their bond ratings still lower, making it more expensive to borrow money. As the public infrastructure of our cities deteriorates, the efficiency of private sector economic operations will also decline.

PRODUCTIVITY

Faced with declining real wages, increasingly scarce natural resources and fierce international competition, the United States desperately needs to restore its sagging productivity. Between 1965 and 1973, productivity in manufacturing industries increased by 2.4 percent a year; from 1973 to 1980 the rate of gain fell to a scant 1.2 percent. And for the economy as a whole, the figures are worse because productivity gains in the labor-intensive service industries are hard to achieve.

High and volatile interest rates have a debilitating impact on productivity. To begin with, by restricting demand and creating idle capacity, high interest rates exact a stiff price in slower productivity growth--whatever the merits of idle capacity in fighting inflation. Plants are designed to operate most efficiently at full capacity. Yet during the last decade, our economy was operating at an average capacity utilization rate of 82 percent--far below the 90 percent rate considered to be the approximate point at which resources are most efficiently utilized. One economist suggests that nearly one-third of our productivity slowdown can in fact be attributed to idle capacity.* This decline in productivity can only be abated by monetary and fiscal policies that move our economy toward full utilization of the nation's resources.

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*Lester Thurow, The Zero-Sum Society.

Over the last few years, a near-consensus has emerged that the United States must increase the level of productive investment if it is to revitalize the flagging American economy. Accordingly, there is a lot of talk about the need to provide the appropriate incentives to stimulate business investment. The Congress is now in the process of deliberating on the various proposals that have been put forward to achieve these ends.

High and volatile interest rates, however, impede productive investment. To begin with, by creating idle capacity high interest rates actually weaken the incentives for business to invest. With existing idle capacity and uncertainty about future demand for their product, business people are understandably reluctant to commit funds for the expansion or modernization of their facilities.

High interest rates in themselves are also a powerful investment disincentive. A recent Business Week article cited the fact that "many corporate officers say they are waiting for assurance that there will actually be demand for their products as well as a significant drop in the cost of money before they make their move [to increase capital spending]."

The dangerous structure of interest rates today affects the composition of investment. Usually, at this phase in the business cycle, yields on long-term securities are high relative to the yields on short-term securities. This encourages investors to commit their funds for long periods of time. However, what we find today is that the yield curve is "negatively sloped," i.e., the yield on short-term securities is higher than on long-term securities. With an interest rate structure like this, why should an investor or a corporate treasurer put his funds into projects that might pay, say, an 18 percent return when he can get a guaranteed 18 percent—or more—return in short-term, highly liquid, financial instruments?

INFLATION

Although the Fed's tight money policy is being pursued with the intent to restrict the demand for credit and thus dampen down inflation, the money supply today is, at best, difficult to control. Large corporations now turn with ease to overseas credit markets such as the Eurodollar system or to the U.S. commercial paper market. Additionally, the spectacular growth of money market funds is making it increasingly difficult for the Federal Reserve to regulate the supply of money flowing through the economy. Only a long-term major recession or depression would slow the economy down to the point at which prices would begin to fall, and the economic and social costs of such a policy would be traumatic.

Although high interest rates are supposed indirectly to bring inflation down, they in fact contribute directly to inflation. High interest rates become wrapped up in the costs of all industrial and consumer goods and services. In 1980, the interest expense of America's corporations totaled a record high 45 percent of net profits before taxes, compared with only 14 percent during the 1960s. Additionally, as mentioned before, interest payments add a heavy burden to the federal budget. In 1981, federal outlays for debt service costs are expected to top $80 billion, or 12 percent of total government expenditures.

By creating idle capacity, high interest rates further exacerbate inflation. As plants move away from operating at full capacity, unit costs rise and profit margins are squeezed. To the extent that companies are able to pass higher costs on to consumers, high interest rates, albeit indirectly, cause prices to rise.

FOREIGN EXPERIENCE

Margaret Thatcher's Britain has pursued a tight money policy similar to that of the Fed in this country. And if the British experience is any indication of what we can expect, the United States has little to look forward to. Unemployment in England has risen to more than 10 percent, its highest rate since the depths of the Great Depression. In the construction industry alone, more than 300,000 workers are unemployed, despite the fact that the waiting list for public housing has grown to more than 1 million people. High interest rates have crippled industry and played an important role in slowing the British economy down to a virtual standstill. Yet they have not brought inflation under control; figures for June indicate that British prices are still rising at an annual rate of 11.3 percent. The recent riots that have raged on throughout England are no doubt a somber reflection of the country's sour economic performance.

CONCLUSION

This inventory of damage wrought domestically by excessive interest rates for productive investment matches the chronicle of international repercussions expressed at the Ottawa summit meeting. Leaving for another day any comments on the international side, the inescapable conclusion of our stories is that the vital sectors of our society which we represent cannot endure a protracted experience of these crushing levels of interest rates. Yet independent economists of all inclinations seem agreed—uniquely and disturbingly so—that high and volatile interest rates will be a burden on our economy for the forseeable future. The signals from the independent Federal Reserve Board, to the extent they can be deciphered, seem to indicate yet a further tightening in the growth of the money supply—and that means a further tightening of the noose of high interest rates around the interest-sensitive productive sectors of our economy.

Mr. Chairman, we will be working to frame solutions to this challenge. We know that calling for lower interest rates alone is not enough. But describing the damage caused by the current destructive practices of our monetary authorities is a vital step in beginning that process.

Mr. TURNER. We have come together today out of a common concern about the ravaging effects of high interest rates. While the country's attention in recent months has been directed toward the budget and tax proposals being debated in Congress, interest rates in our Nation's financial markets have, once again, approached unprecedented levels.

It is our belief that, if unchecked over time, the current tight money policy of the Federal Reserve will result in continued high and volatile interest rates and wreak havoc on the Nation's economy.

As you well know, in October 1979, the Fed embarked upon a new experiment in monetary policy that marked an historic change in the object and method of open market operations.

Under Paul Volcker's leadership, the Fed was to begin concentrating strictly on controlling the money supply, rather than controlling for interest rate targets. This new approach to monetary policy, although begun under the Carter administration, is still being followed today.

By clamping down hard on the money supply, the Fed hopes to rid the economy of the rapidly rising prices by restricting demand and dampening people's expectations of future inflation. This so-called monetarist approach we believe is an ineffective remedy for the disease of inflation. It is also destructive to our own economy, with a debilitating impact on capital spending, productivity, economic growth, and our ability to compete in the international marketplace.

In addition, high interest rates have a disproportionate impact on certain key sectors of the American economy, including the automobile and auto parts industry, all kinds of small business, construction, utilities, State and local governments, and agriculture, industries, and sectors that by and large form the backbone of economic life in the United States.

We would like to outline in greater detail these damaging effects that the Fed's tight money policy has had and the effects that it is likely to have in the future.

The first and most apparent effect of extremely high interest rates is to choke off demand for goods and services. As money becomes increasingly expensive, businesses and consumers in general tighten their belts and reduce borrowing and consumption. In addition, high interest rates artificially inflate the international value of the dollar, thus further eroding the demand for American goods in foreign as well as domestic markets.

The end result is idle productive capacity, which exacts a high cost in lost output and increased unemployment. Certain interest-sensitive sectors of our economy bear an exceptional high burden of high interest rates. Such basic American industries as automobiles, construction, and agriculture, as well as small businesses, utilities, and governments at all levels, are buckling under the pressures of rising interest costs.

Now, we also know that in addition to the domestic impact in the area of foreign affairs, we find that our usual allies, normal allies, are very critical of our high interest rates, claiming that it is helping to upset their economies.

I must say that I was over in England 2 weeks ago for a week, attending some conferences, and under the so-called supply side or monetarist approach of economics, we find that the entire construction industry is down over 300,000 people.

We find 2,600,000 people out of work. I think over 11 percent is out of work over in England. Despite all of the promises, by cutting taxes and going to the other monetarist approaches, that investment was going to follow, and high levels of employment, growth, et cetera, just hasn't happened over there. And God forbid that the same results occur here.

So, Mr. Chairman, we will now turn to our next speaker, which is Mr. Carl Coan, from the National Housing Conference.

STATEMENT OF CARL COAN, LEGISLATIVE COUNSEL, NATIONAL HOUSING CONFERENCE

Mr. COAN. Thank you.

My name is Carl Coan, and I am here on behalf of the National Housing Conference. Leon Weiner, its president, wasn't able to attend today.

It is almost like carrying coals to Newscastle to tell you what the housing situation is. You are very aware of it. I have been sitting in your conference on the housing legislation for the last 2 days for this year.

As part of that consideration, you are confronted with a result—the result of the high interest rate situation, and that is a very sharp decrease in the amount of section 8 and public housing funds that will be available next year, as mandated by the various actions of the House and Senate on the budget resolution and the reconcilation bill.

I believe that interest rates are one of the prime causes of this. They have driven up the cost of housing, all housing—subsidized, as well as unsubsidized—to the point we are now confronted with cries that it is just too expensive to provide housing for the poor, for the low income, for the moderate income. That is just one indication of what has happened.

Housing starts and permits for new buildings, new housing, interestingly enough, I notice—I checked it on the way up here this morning in the cab—started dropping in October or November 1979, which is the time that the present policy of the Federal Reserve was put into place. And they have been down ever since.

There have been a few occasional blips upward, but we have never reached the level of housing production at which we were in September 1979. That is almost 2 years now.

That effect has been felt throughout the economy. It is not only new housing, it is the sale of existing homes. All you have to do is try to sell a house today to see what you're confronted with. Much of the market for new homes comes from people upgrading themselves either because they would like a little better house and they can now afford it in normal times, or they've got more children or other needs that they have to meet. And when they are looking for a new home, they can't sell their existing home—if they can't sell their existing home, they're not going to buy a new home.

In the rental area, there is practically no new apartment construction going on today for rental purposes, unless it is under some subsidized program, tandem, or section 8 with or without tandem.

We have a high need for additional housing in this decade. And we are producing at a level in June of just barely over 1 million units on an annualized basis. That is at best one-half what we need.

The low-income programs are being destroyed, I'm afraid, as rents go up, as the cost of construction goes up, playing into the hands of those who don't want to spend Government money and who tend to say, "Let's hold these programs down". They are just in serious, serious trouble.

Another problem area is that of the thrift institutions, which have been the prime supporter of the single-family home market for the last 40 years. You read some of the stories. One-third of them are going down the tube. I don't suspect it's quite so bad that they're going down the tube, but people are scared.

My wife says:

> Tell me when you think there is trouble in one of those Maryland state insured associations so I can get my $900, or whatever it is, out of that savings account which is paying me such good interest.

I suspect there are those kinds of concerns all over the country.

At the same time, people are going for the maximum dollar for the moment. The maximum dollar for the moment is not helpful to housing. It is good at the moment, but what does it mean for your children and for yourselves when you go to find a house or your children need a house?

I have children in their early twenties who are at that stage of life now where they will soon be out looking for homes. I don't see them being able to buy a house as I was able to at their age, 20-some years ago.

It has not only affected housing, it has affected all construction. Unemployment is at 16 to 17 percent in the construction trades—a totally unacceptable situation.

We are, once again, confronted with a problem of workers leaving or intending to leave or having to leave the construction area. And once again, when we start building again, we're going to find that the supply of skilled workers—both union and nonunion—are going to be down, because people are going to have to go out and find other jobs if they can't get jobs in that area in which they're used to working.

I think there is another area which has not really been thought about too much in the housing area. There is a large industry which produces materials for housing and nonresidential construction—concrete, lumber, gypsum board, steel, brick, and all of those materials that are essential to building and construction. These industries are operating at a very reduced capacity or a very low percentage of their potential capacity now. And yet if we were to turn around and get back to, in the housing area, a construction level, or a starts level, of 2 or 2.1 million units, many of these manufacturers would have inadequate capacity. This is a problem that occurs time and time again as we go through these housing recessions. They have that inadequate capacity, and they recognize it. But they don't feel that it makes sense to invest the money to increase that capacity because of the slumps that have incurred time and time again, every 2, 3, or 4 years.

As a result, when we reach a housing construction level which comes near to what we need, we find that we have inflation occurring because prices get very high. If the demand is for a million bricks a week and the industry can only produce 500,000 or 700,000 or 800,000 bricks a week, then there is going to be price bidding and more costly houses being built, more costly office buildings being built, more costly stores and warehouses and industrial plants being built.

It seems strange to me that the only way in which we can control inflation is by causing more inflation. And yet I feel—and I have felt for many years—that is what we're doing.

The high interest rates have to go throughout the economy. The effect in the area in which I'm familiar—and that is the construction and housing area—is that we have more inflation because of the big swings in production levels. And yet we are saying we are curing a problem. I think we are making the problem worse.

Thank you, Mr. Chairman.

Mr. TURNER. Now, Mr. Chairman, we would like to hear from Robert Mullins, director of legislation for the National Farmers Union.

STATEMENT OF ROBERT MULLINS, DIRECTOR OF LEGISLATION, NATIONAL FARMERS UNION

Mr. MULLINS. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before this committee with this panel.

As you may know, the National Farmers Union is an organization representing independent family farmer and ranchers throughout the United States.

I would like to very briefly outline several points of concern that we have and the impact of these record interest rates on the family farm economy.

First of all, farmers will pay more than $20 billion in interest in 1981 on their current debt of $180.5 billion, compared with outlays in 1980 of $16.5 billion. The current Commodity Credit Corporation interest rates on commodity loans is at 14½ percent, almost double what it was 2 years ago.

At the existing 1981 rates, it is going to cost farmers 46.4 cents a bushel to put wheat in the loan. It's going to cost almost 35 cents a bushel to put corn in the loan. On top of this, with the waiver of interest being terminated on the farmer-held reserves, it's going to cost farmers almost 51 cents a bushel to put wheat into the reserve program and 37 cents a bushel to put corn in the reserve.

The effect of this is going to be to discourage use of the reserve program. And that will impact next year and the year after, both on producers and consumers, particularly if we move into a tight supply situation.

At the start of this year, it was predicted that farm exports would set a new record value of about $48½ billion. Now, because of the high interest rates affect the cost of handling grain inventories, we are already projecting that that record will be reduced by at least $2½ billion, to $46½ billion.

As far as farmers are concerned, high interest rates are a crude and very ineffective way of discouraging credit use. At the end of March of this year, farm borrowings from commercial banks was running 10 percent above a year ago. At that time, farmers were borrowing at the rate of $5.4 billion a week, compared to $4.9 billion the year before.

Interest rates are also affecting the ability of farmers to generate capital internally. In 1970, U.S. farmers relied on loans, or a net increase in loans, for only 5 percent of their cash sources of income. This year they are substituting credit for income at what we consider a rather alarming rate, with borrowing accounting for 23 percent of their cash sources of operating funds.

We feel that the tripling of effective interest rates since 1977 on consumer loans has diverted about $30 billion in purchasing power from food, housing, and other necessities and indirectly, therefore, lowering the demand for American agricultural products.

With these high interest rates have also come a proliferation of money market funds and other investment opportunities which have severely drained funds from country banks. We are feeling the impact of that in the availability of loanable funds out in the country. Such record interest rates coming at a time when farm debt is also ballooning to record levels, it is just extracting a fearful price from farmers. We maintain that had the basic interest rate remained at reasonable levels, the net income of U.S. farmers would have been substantially higher over the past several years.

According to our calculations, about $12 billion has been diverted from the income side to the cost side because of these interest rates. If this diversion of income continues, we maintain that the future for many of our family farms is bleak indeed, and if that happens, Mr. Chairman, the food supply of this Nation and consumer costs are going to continue to increase.

Thank you.

[Mr. Mullins' prepared statement, on behalf of the National Farmers Union, follows:]

STATEMENT OF

ROBERT J. MULLINS
DIRECTOR OF LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

PRESENTED TO THE

BANKING, FINANCE & URBAN AFFAIRS COMMITTEE
U. S. HOUSE OF REPRESENTATIVES

CONCERNING

"THE IMPACT OF CREDIT POLICIES ON
AMERICAN AGRICULTURE"

WASHINGTON, D. C.

July 22, 1981

Mr. Chairman and Members of the Committee:

I am Robert J. Mullins, Director of Legislative Services for the National Farmers Union. I appreciate the opportunity to appear before the Committee today on behalf of the members of the National Farmers Union and commend the Chairman for holding this hearing on a subject which is of immediate concern to the farmers and ranchers of this country.

Credit availability, federal credit policy and record high interest rates are having a severe impact on America's farmers.

The high cost of farm borrowings is the most obvious and staggering of the effects of the extraordinarily high interest rates being maintained by the Federal Reserve Banking system despite a lack of apparent beneficial effects. But the direct cost to farmers is only one of the many damaging impacts of the high interest levels which have bounced around between 17% and 21% for most of this year. The latest reports average interest rate paid by farmers for such things as livestock, feed, farm operations, machinery, etc., is 17.92%, almost four points higher than a year earlier, an increase of 27% in the going interest rate. The net effect is that as farmers borrow more, they have less ability to repay the loans.

-- FARM INTEREST OUTLAYS. Farmers will pay more than $20 billion in interest in 1981 on their current debt of $180.5 billion compared with their outlays of $16.5 billion in 1980.

-- CCC LOAN RATE COSTS. The current CCC interest rate on commodity loans is 14½%. At the existing 1981 crop loan rates, that is a cost to farmers of 46.40¢ a bushel on wheat and 34.80¢ a bushel on corn for 1981 regular loans. If the first year waiver of interest is terminated on farmer-held reserve loans, it will cost farmers 50.75¢ a bushel on wheat and 36.98¢ a bushel on corn.

-- REDUCED PROSPECTS FOR GRAIN EXPORTS. At the start of this year, it was predicted that U.S. farm exports would set a new record value of $48.5 billion in 1981. Now, because high interest rates affect the cost of handling grain inventories and due to other factors, predictions are that exports will have a value of only about $46 billion.

-- NO REDUCTION IN CREDIT USE. High interest rates are a crude and ineffective way of discouraging credit use, at least as far as farmers are concerned. At the end of March this year, farmer borrowings from major commercial banks was running 10% higher than a year ago, at a rate of $5.4 billion in loans per week, compared to $4.9 billion a year earlier.

-- INFLATION RATE IS ACCELERATED BY HIGH INTEREST RATES. Since high interest rates become wrapped up into costs of all industrial and consumer goods and services, they tend to aggravate inflationary pressures, rather than reduce them.

-- COST OF GOVERNMENT SHARPLY INCREASED. High interest rates inflate the cost of government at all levels. For the federal government alone, interest outlays for fiscal year 1982 will be $106.5 billion, up from $94 billion. The interest outlays in fiscal 1982 will be $65 billion higher than in 1977 when the basic cost of money was about 6%.

-- GOVERNMENTAL DEFICITS ARE AGGRAVATED. The $65 billion cited above would be enough by itself to bring the fiscal 1982 federal budget into balance. It is a waste which should no longer be tolerated.

-- ABILITY OF FARMERS TO GENERATE CAPITAL INTERNALLY IS REDUCED. In the year of 1970, U.S. farmers relied on new loans, or a net increase in loans, for only 5% of the cash sources of funds for their operations. In 1981, farmers are substituting credit for income at an alarming rate, with borrowing accounting for 23% of their cash sources of operating funds.

-- PURCHASING POWER OF CONSUMERS DIVERTED FROM FOOD, OTHER NECESSITIES. The tripling of effective interest rates since 1977 on consumer loans has diverted $30 billion of purchasing power from food, housing and other necessities. Indirectly, therefore, high interest rates depress the effective demand for products of American farms.

-- COMPETITION FOR FUNDS SIPHONS MONEY AWAY FROM THE FARM SECTOR. With the advent of high interest rates has come a proliferation of money market funds and other investment opportunities which are drawing several billion in loanable funds from agricultural purposes. The adverse effect upon country banks, which normally service farm borrowers, has been particularly notable.

Early in 1977 -- about four years ago -- the prime interest rate was at 6.25 percent. The prime rate, which is the pace-setter for interest rates generally, advanced to 11.75 percent by the opening of 1979, and since then we have seen the prime rate rise to as high as 21½ percent.

Such record interest rates, coming at a time when farm debt is also ballooning to record levels, is extracting a fearful price from farmers. We maintain that had the basic interest rate remained at reasonable levels, the net income of U. S. farmers would have been substantially higher the last several years.

According to our calculations, about $12 billion in income has been diverted from the income side to the cost side of farm balance sheets due to the impact of the higher interest rates.

As we attempt a general overview of the money and credit crisis, we recognize that as important as these overall statistics and trends may be, there is always the possibility that we may lose sight of the human element -- the farmers and the farm wives and family members and the manner in which they feel the effects of the debt burden and the high interest rates.

We call your attention to the dimensions of the credit crisis in ATTACHMENT "A".

On January 1, 1981, the outstanding debt of U. S. farmers was $180.5 billion -- an increase of $23 billion or 15 percent in a year's time. That is twice what it was five years ago and more than seven times what it was in 1960.

In ATTACHMENT "B", we show the annual average prime rate for the past 31 years together with the monthly figures for the past five years.

The prime rate is now almost ten times higher than it was in 1949 and about three times what it was early in 1977.

In ATTACHMENT "C", we show the interest outlays by farmers over the past 20 years, from a grand total of $1,269 million in 1960 to $16.5 billion for 1980. That is more than a 12-fold increase from 1960 and more than a doubling in just four years.

It is sometimes maintained that the changes in interest rates do not make themselves immediately felt. The interest rates in some mortgages and many promissory notes are fixed, and so the new rates do not become an immediate problem. However, that assumption can be misleading.

In referring to ATTACHMENT "D", we show that only about 36 percent of real estate debt and only 12 percent of short-term debt is not immediately affected by interest rate changes.

About 31 percent of the outstanding real estate debt each year is new borrowing -- so that will be affected by the new rate. The Federal Land Bank system, which accounts for one-third of the real estate lending, is now largely on a variable interest rate basis. The rates float according to prevailing market conditions and so these loans are affected soon, if not immediately, by the new rates.

On the short-term loan side, almost all of the debt on many farms is rotated every year. It is paid off and new loans are drawn. There are some loans, for example, on farm machinery purchases, which may run three to five years in duration. But, as best as we can calculate, these longer-term "short-term" loans make up only about one-eighth of the non-real estate debt burden.

In ATTACHMENT "E", we show the farm debt-to-asset ratio over the past forty years.

While the ratio looks modest -- about one dollar of debt for each six dollars of assets -- the figure is still on the high side.

The January 1, 1980, ratio of 18.1 is the most unfavorable since 1941.

A more meaningful measurement is the rate of substitution of credit for income which we show in ATTACHMENT "F" relating to the cash sources of funds of farm operators.

What this shows is that farm operations are not generating internal capital as they have or as they should but instead are increasingly dependent on borrowed funds for cash operating money.

In 1970, new loans -- or the net increase in loans -- represented only five percent of the cash sources of funds of farmers.

By 1975, this figure had risen to 12 percent, and in 1978 and 1979, it has amounted to more than 17 percent. In 1980, farmers were borrowing money for 20 percent of their cash sources of operating funds.

In ATTACHMENT "G", we look at several measures of the ability of farmers to handle their debt burdens.

The first of these is the U. S. parity ratio -- currently at 63 percent of parity. What it means is that farms are able to pass through only 63 percent of their operating costs (including interest) in the price of their products.

The second item shows the per capita income of farmers from farming compared to the per capita income of non-farmers. The ratio of

62 percent is not a good omen of the viability of farming as an economic enterprise.

In the third item, we show the return to farm equity compared to the rates of profits in selected manufacturing industries. Again, the 3.6 percent farm rate in 1978 does not compare well with the 24 percent rate in all manufacturing enterprises. A rate of 4.1 indicated only slight improvement in 1979.

It is sometimes contended that the growth of farm debt and the high interest rates are offset by the spectacular growth of the value of farm assets.

However, item four is worth some study. It shows that from 1975 to 1979, if inflation is deleted, farm real estate values have actually declined.

Now, of course, the higher land values do make it possible to incur larger debts.

But what it does is increase farmers' ability to borrow, without increasing their ability to repay.

Repayment depends on income -- and we should never lose sight of that.

It is important to understand that the Nation's farmers are also affected by what high interest rates do to the remainder of the national economy. Obviously, the higher interest rates are diverting consumer purchasing power which could be used for food, for housing, for automobiles and other manufactured goods.

Should anyone be surprised that the housing construction industry is ailing with housing mortgages at interest rates of 16 percent and more?

Should anyone be surprised that American cars are not selling with car finance costs where they now are?

You have all been told many times that these tight-money, high-interest-rate policies are justified on the basis that they will reverse inflationary pressures and save the value of the dollar.

Perhaps farmers would be willing to go through the wringer, workers to be unemployed, and other citizens to forego purchases of a house, a car or other major items, and our whole society to accept a lower standard of living, if it achieved anything in the war on inflation.

But that policy is not succeeding -- it never has without precipitating depression -- and it probably never will.

A BETTER ANTI-INFLATION STRATEGY IS AVAILABLE
In the Emergency Credit Control Act of 1969
(Title II of Public Law 91-151)

In early 1980, the Carter Administration attempted half-heartedly and largely ineffectively to use the credit restraint provisions of

P.L. 91-151 to help curb inflationary pressures.

The effort was abandoned a brief two months later without ever making use of some of the very significant tools which were available.

Later, the Congress voted to terminate the Emergency Credit Control Act of 1969, but made the termination effective June 30, 1982. Therefore, the authority still is available to the President and could be used by the President to direct the Federal Reserve Bank board to take certain constructive actions in the campaign against inflation.

We acknowledge that credit controls and credit allocation are drastic tools, but conditions are desperate and the strateqies of the Federal Reserve under the Carter Administration and under the Reagan Administration, up to this time, have been entirely ineffective in curbing inflation.

We see no prospect that the super-tight money policies of the Federal Reserve system will bring about the needed economic cure.

One may not like the prospects of credit controls or credit allocation, but the alternatives are absolutely intolerable --

-- Runaway inflation is worse,

-- Recession is worse,

-- High unemployment is worse, and

-- Hardship for those at the dawn of life, or those at the twilight of life, or those in the shadows of life (the disadvantaged, the handicapped and the poor) is worse.

These alternatives are not viable alternatives for the American society and they should make way for an effective, though stern, medicine of credit controls and allocation.

The language of Title II of the 1969 Act deserves close reading since it provides broad powers for the President:

Section 205 of the law provides that:

"Whenever the President determines that such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extension of credit in an excessive volume, the President may authorize the Board to regulate and control any or all extensions of credit."

Section 206 lists the actions which the President may direct the Federal Reserve Board to take, including:

"Prescribe the maximum amount of credit which may be extended,

"Prescribe the maximum rate of interest, maximum maturity, minimum periodic payment, maximum period between payments, and any other specification or

limitation of the terms and conditions of any extension of credit.
"Prohibit or limit any extensions of credit under any circumstances the Board deems appropriate."

As we read this statute, we believe it contains authority for a roll-back of interest rates to any level which the President may direct. It contains authority to allocate credit to productive uses such as farming and food distribution, to housing, to basic industries and to small business.

It contains the authority to prevent the flight of capital to foreign countries to avoid the effects of the domestic credit controls.

If the White House would use this authority to roll back the cost of money even to the then relatively-high level of 6¼% which prevailed in April, 1977, it would result in these savings to the American people:

-- A $12 to $14 billion reduction in annual interest rate outlays for American farmers;

-- A $60 to $65 billion reduction in annual interest outlays by the federal government (enough alone to balance the fiscal 1982 budget);

-- A $200 billion reduction in interest outlays by American households, individual consumers, and other borrowers.

THE NEED TO EXTEND THE ECONOMIC EMERGENCY LOAN PROGRAM
Authorized in the
EMERGENCY CREDIT ADJUSTMENT ACT OF 1978
Public Law 95-334

On many American farms in 1981, interest outlays will be the single largest expense item, exceeding even the cost of feed purchases and the cost of purchased livestock.

The outstanding debt of U.S. farmers (which began this year at $82.5 billion) is now thought to be approaching $200 billion. Farmers depend on commercial or independent financial sources, such as commercial banks, life insurance companies, federal land banks and individuals for 91% of their real estate loans. They depend on commercial or independent sources such as banks, Production Credit Associations (PCA's) and individuals for 77% of their short-term borrowing (non-real estate).

About 15.4% of the non-real estate borrowing is from the Farmers Home Administration (FmHA) and 3.3% from the Small Business Administration.

Yet for farmers, who cannot get financing from other sources, the 9% of the real estate loans and the 18% of the short-term loans which they get from federal government sources, are vital to their survival in farming. Disaster loans are such last resort loans.

Responding to a severe crisis in 1978, Congress and the President approved the "Emergency Agricultural Credit Adjustment Act of 1978", Public Law 95-334, which included a new economic emergency loan program.

Under this section, USDA is authorized to insure and guarantee loans to family-scale farmers not able to obtain sufficient credit from normal sources to finance actual needs at reasonable rates and terms due "to national or areawide economic stresses, such as the general tightening of agricultural credit or an unfavorable relationship between production costs and prices received for agricultural commodities."

P.L. 95-334 authorized up to $4 billion in such economic emergency loan programs through May 15, 1980. Subsequently, in March, 1980, the law was extended with another $2 billion in loan authority through September 30, 1981.

From early 1979 through June 10, 1981, some 115,823 economic emergency loans have been made, totalling $6.3 billion. Since some repayments have already been made, a total of $404 million in unobligated funds are available for loans in the remainder of the year ending September 30th.

In view of the current projection that total net income of U.S. farmers may be as poor as the disaster year of 1980 and because of the huge debt load of farmers and the extraordinary interest rates, it is important that the Congress act to extend the economic emergency loan program for at least two years beyond the scheduled expiration on September 30th.

The House Agriculture Committee has recommended a one-year extension of the economic emergency loan program, but without any additional loan authority.

We think that the extension should be for two years with at least another $4 billion in loan authority.

Neither the Reagan Administration nor the preceding Carter Administration recommended a continuation of this program, but we regard that position as short-sighted and mistaken.

The economic emergency loan program has helped 115,000 farmers stay in farming. Without such a program, the end of the road could come in late 1981 or early 1982 for many thousands of efficient and productive farm operators, who are in economic difficulty through no fault of their own.

Since the program functions through the insuring or guaranteeing of loans by the FmHA, the net costs of the program to the U.S. Treasury (and to taxpayers) will be negligible. But to the farm operators who are helped, it will mean survival.

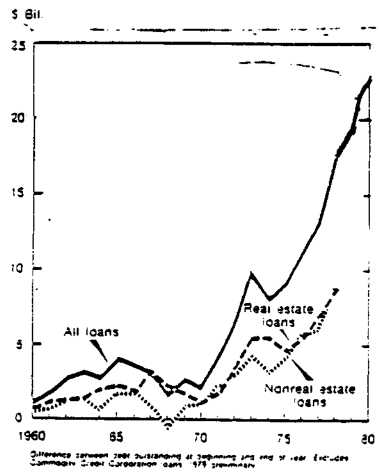
ATTACHMENT "A"

OUSTANDING FARM DEBT, ANNUAL CHANGE IN DEBT AND THE COMPOSITION OF FARM DEBT

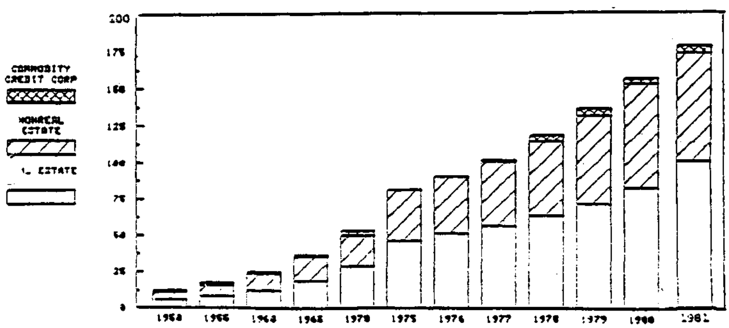
Outstanding Farm Debt
As of January 1

Year	Debt in Bil. $	Increase in Bil. $	Increase in %
1960	24.8		
1970	53.0	28.2	113.0%
1971	54.5	1.5	2.8%
1972	59.1	4.6	8.4%
1973	65.3	6.2	10.4%
1974	74.1	8.8	13.4%
1975	81.8	7.7	10.3%
1976	90.8	9.0	11.0%
1977	102.7	12.1	13.3%
1978	119.3	16.6	16.1%
1979	137.5	18.2	15.2%
1980	157.8	20.3	14.8%
1981	180.5	22.7	15.0%

Annual Change in Farm Debt



REAL ESTATE, NON-REAL ESTATE AND OTHER FARM DEBT



1980 and 1981 Projected

ATTACHMENT "B"

THE PRIME INTEREST RATE --- NOW ALMOST 8 TIMES HIGHER THAN IN 1949

Year	Prime Rate *
1949	2.00
1950	2.07
1951	2.56
1952	3.00
1953	3.17
1954	3.05
1955	3.16
1956	3.77
1957	4.20
1958	3.83
1959	4.48
1960	4.82
1961	4.50
1962	4.50
1963	4.50
1964	4.50
1965	4.54
1966	5.63
1967	5.61
1968	6.30
1969	7.96
1970	7.91
1971	5.72
1972	5.25
1973	8.03
1974	10.81
1975	7.86
1976	6.84
1977	6.83
1978	9.06
1979	----

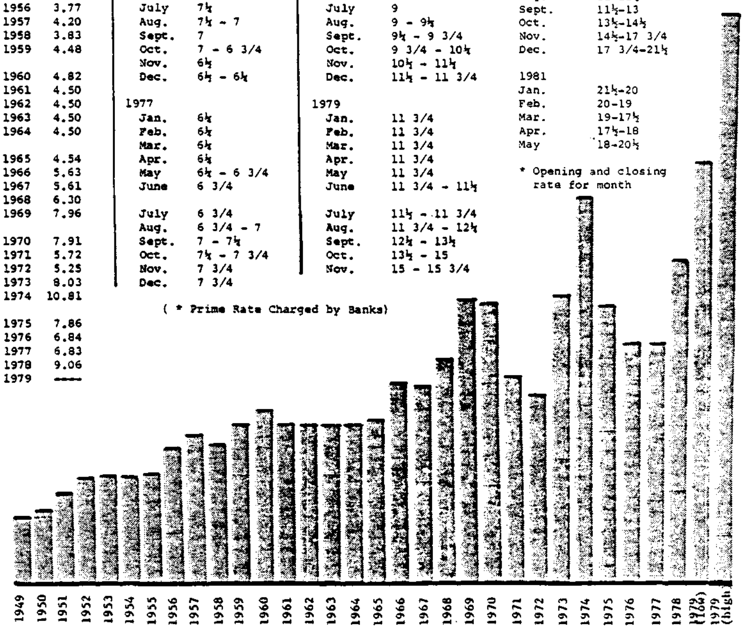
Year & Month	Prime Rate
1976	
Jan.	7½ - 6 3/4
Feb.	6 3/4
Mar.	6 3/4
Apr.	6 3/4
May	6 3/4
June	7 - 7½
July	7½
Aug.	7½ - 7
Sept.	7
Oct.	7 - 6 3/4
Nov.	6½
Dec.	6½ - 6½
1977	
Jan.	6½
Feb.	6½
Mar.	6½
Apr.	6½
May	6½ - 6 3/4
June	6 3/4
July	6 3/4
Aug.	6 3/4 - 7
Sept.	7 - 7½
Oct.	7½ - 7 3/4
Nov.	7 3/4
Dec.	7 3/4

Year & Month	Prime Rate
1978	
Jan.	7 3/4 - 8
Feb.	8
Mar.	8
Apr.	8
May	8 - 8½
June	8½ - 9
July	9
Aug.	9 - 9½
Sept.	9½ - 9 3/4
Oct.	9 3/4 - 10½
Nov.	10½ - 11½
Dec.	11½ - 11 3/4
1979	
Jan.	11 3/4
Feb.	11 3/4
Mar.	11 3/4
Apr.	11 3/4
May	11 3/4
June	11 3/4 - 11½
July	11½ - 11 3/4
Aug.	11 3/4 - 12½
Sept.	12½ - 13½
Oct.	13½ - 15
Nov.	15 - 15 3/4

Year & Month	Prime Rate*
1980	
Jan.	15½
Feb.	15½-16 3/4
Mar.	16 3/4-19½
Apr.	19½
May	18½-14
June	14-12
July	12-11
Aug.	11-11½
Sept.	11½-13
Oct.	13½-14½
Nov.	14½-17 3/4
Dec.	17 3/4-21½
1981	
Jan.	21½-20
Feb.	20-19
Mar.	19-17½
Apr.	17½-18
May	18-20½

* Opening and closing rate for month

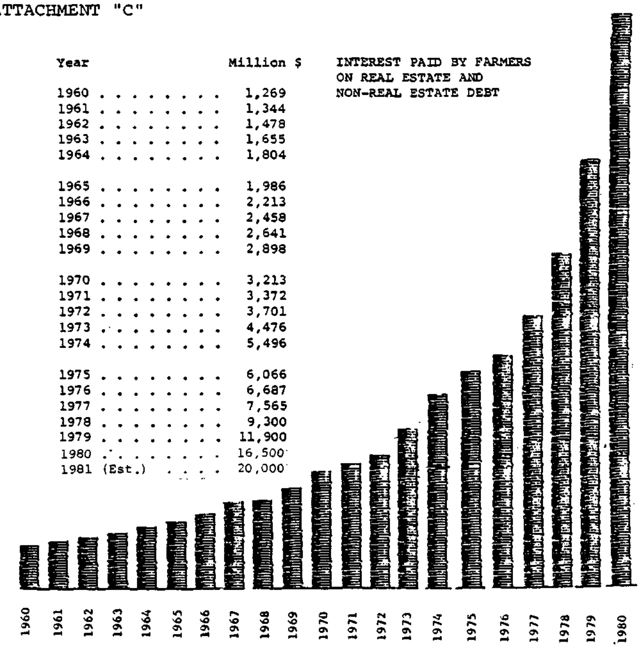
(* Prime Rate Charged by Banks)

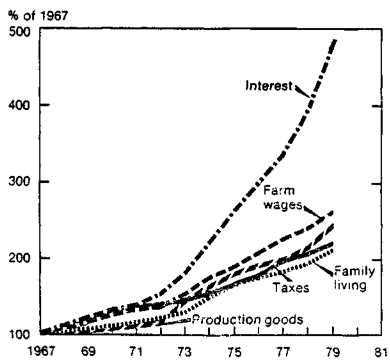


ATTACHMENT "C"

INTEREST PAID BY FARMERS ON REAL ESTATE AND NON-REAL ESTATE DEBT

Year	Million $
1960	1,269
1961	1,344
1962	1,478
1963	1,655
1964	1,804
1965	1,986
1966	2,213
1967	2,458
1968	2,641
1969	2,898
1970	3,213
1971	3,372
1972	3,701
1973	4,476
1974	5,496
1975	6,066
1976	6,687
1977	7,565
1978	9,300
1979	11,900
1980	16,500
1981 (Est.)	20,000





1979 January–July average. Taxes include State and local property taxes on farm real estate.

FARM INTEREST OUTLAYS

UP 5 TIMES SINCE 1967

UP 11 TIMES OVER 1960

Prices Farmers Pay

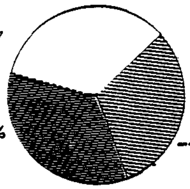
	1975	1976	1977	1978	1979[1]
	Percentage of 1967				
Production	182	193	200	216	240
Interest[2]	262	299	339	396	487
Taxes[3]	166	178	195	207	221
Farm wage rates	192	210	226	242	262

[1] January-May average. [2] Interest on farm real estate debt. [3] Taxes on farm real estate.

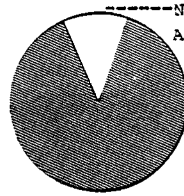
ATTACHMENT "D"

ESTIMATED SHARE OF FARM DEBT BURDEN EXPOSED TO CHANGES
IN EFFECTIVE INTEREST RATES

REAL ESTATE DEBT



NON-REAL ESTATE DEBT



ATTACHMENT "E"

FARM DEBT TO ASSET RATIO
1940 - 1979

Year	%	Year	%	Year	%	Year	%
1940	18.9	1950	9.3	1960	11.8	1970	16.8
1941	19.1	1951	8.5	1961	12.4	1971	16.7
1942	16.6	1952	8.6	1962	13.0	1972	16.8
1943	13.4	1953	9.6	1963	13.8	1973	16.6
1944	10.6	1954	10.3	1964	14.6	1974	15.5
1945	8.9	1955	10.5	1965	15.1	1975	15.8
1946	7.6	1956	10.8	1966	15.6	1976	15.7
1947	7.2	1957	10.6	1967	16.0	1977	15.7
1948	7.2	1958	10.7	1968	16.5	1978	16.7
1949	8.4	1959	11.3	1969	16.7	1979	16.8
						1980	18.1

ATTACHMENT "F"

INCREASE IN BORROWING BY FARMERS AS SOURCE OF CASH FUNDS

Cash Sources and Uses of Funds in the Farm Sector 1970-1979

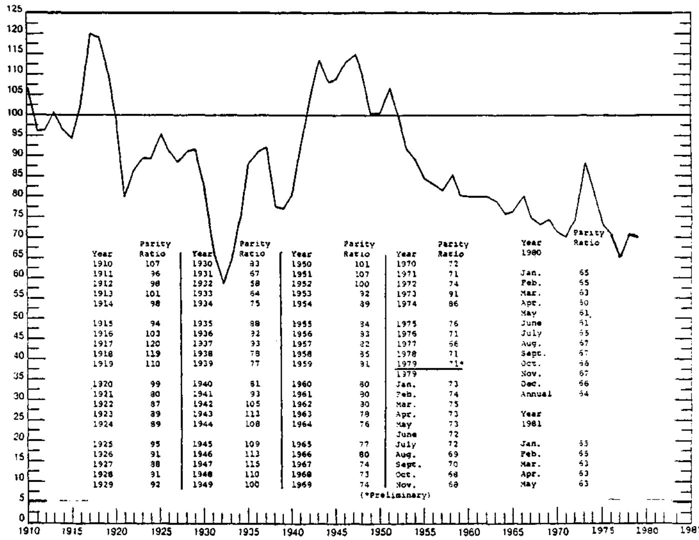
Items	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Cash Sources of Funds:	Billion dollars										
1 Net cash income from farm and nonfarm sources	37.9	39.7	48.2	56.3	63.4	60.3	64.3	64.3	79.1	96.3	87.0
2 Net flow of real estate loans	1.0	1.7	3.2	4.3	4.5	4.3	4.9	6.3	7.7	9.5	14.0
3 Net flow of nonreal estate loans	1.1	2.4	3.2	4.3	3.1	4.2	5.7	6.0	8.9	10.2	9.0
4 Total cash sources of funds	40.0	43.3	54.6	76.0	71.0	69.3	75.4	76.3	95.7	116.6	110.0
Proportion of Cash Funds (%)	5.2	9.3	11.7	12.1	10.7	12.2	14.0	16.0	17.3	17.0	20%

ATTACHMENT "G"

MEASURES OF ABILITY TO REPAY FARM INDEBTEDNESS

Item I

U.S. FARM PARITY RATIO



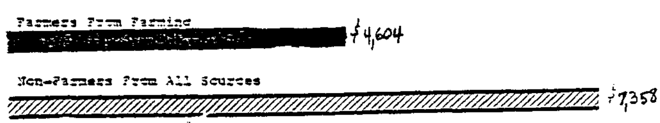
Year	Parity Ratio	Year	Parity Ratio	Year	Parity Ratio	Year	Parity Ratio	Year	Parity Ratio
								1980	
1910	107	1930	83	1950	101	1970	72		
1911	96	1931	67	1951	107	1971	71	Jan.	65
1912	98	1932	58	1952	100	1972	74	Feb.	65
1913	101	1933	64	1953	92	1973	91	Mar.	63
1914	98	1934	75	1954	89	1974	86	Apr.	60
								May	61
1915	94	1935	88	1955	84	1975	76	June	61
1916	103	1936	92	1956	83	1976	71	July	65
1917	120	1937	93	1957	82	1977	66	Aug.	67
1918	119	1938	78	1958	85	1978	71	Sept.	67
1919	110	1939	77	1959	81	1979	71*	Oct.	66
						1979		Nov.	67
1920	99	1940	81	1960	80	Jan.	73	Dec.	66
1921	80	1941	93	1961	80	Feb.	74	Annual	64
1922	87	1942	105	1962	80	Mar.	75		
1923	89	1943	113	1963	78	Apr.	73	Year	
1924	89	1944	108	1964	76	May	73	1981	
						June	72		
1925	95	1945	109	1965	77	July	72	Jan.	65
1926	91	1946	113	1966	80	Aug.	69	Feb.	65
1927	88	1947	115	1967	74	Sept.	70	Mar.	63
1928	91	1948	110	1968	73	Oct.	68	Apr.	63
1929	92	1949	100	1969	74	Nov.	68	May	63

(*Preliminary)

Item II

COMPARISON OF PER CAPITA INCOME OF FARMERS FROM FARMING WITH PER CAPITA INCOME OF NON-FARMERS

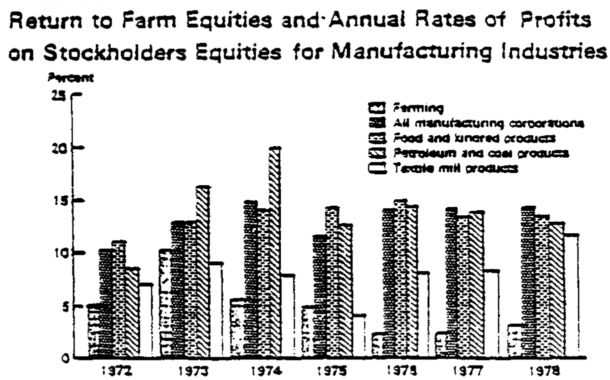
1979



Per Capita Income of Farmers from Farming as a % of Non-farm 62%

ATTACHMENT "G" (Continued) MEASURES OF ABILITY TO REPAY

Item III



RETURN TO FARM EQUITIES AND ANNUAL RATES OF PROFITS ON STOCKHOLDERS' EQUITIES FOR MANUFACTURING INDUSTRIES, BEFORE INCOME TAXES

[Percentage]

Year	Farming: Current value	All manufacturers	Food and kindred products	Petroleum and coal products	Textile mill products
1972	5.3	13.4	20.2	11.0	13.8
1973	10.6	21.1	22.3	14.9	18.5
1974	5.9	23.0	23.8	25.8	15.4
1975	4.9	18.8	24.5	17.4	3.0
1976	2.5	22.7	24.9	23.3	15.1
1977	2.5	23.2	22.0	19.9	16.4
1978	3.6	24.0	22.2	19.0	21.0
1979	4.1	—	—	—	—

Item IV

VALUE OF FARM ASSETS IN 1967 DOLLARS
1975-1979
(Jan. 1)

	1975	1976	1977	1978	1979
	Billion dollars				
Physical assets:					
Real estate. . . .	197.7	197.4	197.3	197.2	197.2
Nonreal estate:					
Livestock[1]	22.2	21.4	20.3	19.3	19.2
Machinery and motor vehicles	30.9	30.9	31.1	31.1	31.3
Crops stored on and off farms[3]	9.6	11.5	11.4	14.5	15.5
Household equipment and furnishings.	9.9	9.5	9.8	10.9	12.0
Financial assets:					
Deposits and currency	3.6	8.3	8.0	7.8	7.2
U.S. savings bonds	2.5	2.3	2.2	2.1	2.1
Investments in cooperatives	6.9	7.0	7.2	7.4	7.3
Total .	288.3	288.3	287.8	290.3	[illegible]

Mr. TURNER. Thank you, Mr. Chairman. Now we have Mr. Paul Fry, the executive assistant director of finance and administration for the American Public Power Association.

STATEMENT OF PAUL FRY, EXECUTIVE ASSISTANT DIRECTOR OF FINANCE AND ADMINISTRATION, AMERICAN PUBLIC POWER ASSOCIATION

Mr. FRY. Thank you, Mr. Chairman. We appreciate the opportunity to appear with the panel this morning.

The American Public Power Association represents about 1,750 local publicly owned electric utilities throughout the United States, principally in small communities. The electric utility industry is our economy's most capital-intensive industry. It requires between $3 and $4 investment to generate $1 of revenue. The current total capitalization of the electric utility industry, including the investment of the Federal Government, is in the neighborhood of $300 billion, and the annual new money requirements of the industry are in the range of $15 to $20 billion.

Unstable financial markets and high interest rates are particularly disruptive for this industry, and impose very heavy burdens on the electric utility industry's customers. The local publicly owned sector of the industry, those utilities owned by municipalities and other political subdivisions of States, service about 14 percent of the industry's customers and has about $35 billion of net electric plant, or about 12 percent of the industry's total capitalization. As public entities, these utilities raise capital in the tax-exempt municipal bond market. Interest rates in the municipal bond market have literally doubled in the past 3½ years. This is illustrated by the Bond Buyer 20-Bond Index, which stood at 4.45 percent in November 1977 and last week reached 11.09 percent.

Not only have interest rates doubled in a very short period of time, but the market has become highly volatile as well. The municipal bond market was quite stable over a 30-year period following World War II, and investors were quite willing to commit funds at fixed rates for long terms. This situation has now changed. The Bond Buyer 20-Bond Index varied only 48 basis points between its 1977 high of 5.93 percent and its low of 5.45 percent. In 1978 that variation between high and low was 109 basis points; in 1979, 130 basis points; and in 1980, 345 basis points. Already this year the variation has reached 310 basis points.

The annual municipal electric utility debt financing is going from about $750 million in 1970 to over $5 billion in the late 1970's and about $4.7 billion last year. This represents about a threefold increase in its share of the total tax-exempt bond market since 1970. It is clearly the fastest growing sector of the tax-exempt bond market. Local public power systems plan about $5.5 billion in capital expenditures this year, much of it to be financed with long-term debt.

The cost of money has simply overwhelmed all other factors which collectively determine the retail price of electricity. This causes many deferrals and cancellations of powerplants and much higher electric rates to consumers. Interest costs today, in some cases, represent nearly 50 percent of wholesale power costs and as much as 20 to 25 percent of retail consumers' bills. It would appear that inflation's intended remedy, tight money, is seriously aggravating the inflation of electric power costs.

Thank you, Mr. Chairman.

Mr. TURNER. Next, Mr. Chairman, we have with us the executive assistant to the mayor of Seattle, from the U.S. Conference of Mayors, William Stafford.

STATEMENT OF WILLIAM STAFFORD, EXECUTIVE ASSISTANT TO THE MAYOR OF SEATTLE, REPRESENTING THE U.S. CONFERENCE OF MAYORS

Mr. STAFFORD. Thank you, and I represent the U.S. Conference of Mayors here today.

I think we are all aware that for the cities of this country these are very complex times, and it is very difficult for management of city governments to plan, to decide what we should do for the future, in terms of many of the kinds of capital, particularly capital projects which we are facing to get through the 1980's. The budget cuts, the uncertainty in terms of how programs will come out, the questions of funding level of the programs and then the secondary decisions that will have to be made by State governments, leave the management of our cities in a virtual chaos which would seemingly continue for the next at least 12 to 24 months.

We seem to be moving toward a period where we are going toward local self-help, where the local governments will have to make your own plans, do your own investments, and make your own local decisions using more and more local funds. Therefore, the discussions today in this committee fit right into the question of if we are no longer going to have Federal moneys to make and do certain capital projects in terms of sewers and water systems and roads, that what we can borrow money for, borrow money locally gives us what our—the amount of risk that people want to take in their borrowing, lets us know what we can do in terms of the future.

Let me take just the impact of interest rates on cities, which fall in two different ways. One, on the corporate community. The city of Seattle, as a government, as a corporation measured by employees or measured by sales versus the size of our municipal budget, would be listed in Fortune's 500 if it were a private corporation. Now, just to give you a good few examples of the impact of the interest rates on the city, the high interest rates, the interest rates for municipal bonds have doubled in the past 3½ years. The Bond Buyers Index has risen from 5.45 percent in November 1977 to 11 percent in July. Moreover, the municipal bond market is extremely volatile, further complicating borrowing by State and local government.

Since 1979 the State and local government bond market has been under severe pressures and many borrowing plans have been sidetracked. We, in Seattle for example, have just had to put off decisions in our Metropolitan Sewer and Transit Agency, where in the spring we were going to adopt our plans through the eighties, because of the zeroing out of the program for the coming year and the calculations that the sewer plan for 1990 would have required a tripling of the sewer rates. Local officials decided for the county and the suburban cities to put off the decision until later this year.

The same thing happened with our capital program for 1990, which was to be adopted in the spring. Again, those decisions have been deferred until the fall and next spring, until we get more certainty in terms of what Federal moneys will be available for the capital program and how that mixes with the interest rates and with our inability to bond locally. It has thrown our entire planning for the next 10 years almost out the window.

About one-third of local capital projects are financed by long-term, and to a lesser extent short-term borrowing. According to a recent survey of the Joint Economic Committee, long-term borrowing will rise as a source of financing for cities making capital investments, especially given the decline I just mentioned in local assistance. Now, this gets to other uncertainties which are in the local markets, and one example of this which, just to quote a paragraph in a letter to Congressman Rostenkowski on the All Savers Certificates, a recent study by the Municipal Finance Officer Association shows that All Savers Certificates could draw away $10 billion investment from local bond markets and drive up borrowing costs for States and local governments from $620 million to $1.1 billion in the first year. One reason is because individuals now buying 55 percent of new issues, historically they have comprised only 20 percent of the bond buyers and the interest rates on the All Savers Certificates would be nearly 2.5 to 3 percentage points higher than the short-term tax-exempt rates, and about equal to the long-term rates. In addition, the savers certificates would be federally insured, and consequently a more secure investment than State and local notes or bonds.

The new tax-exempt federally insured investment given to a nongovernment entity, besides being unprecedented, could not come at a worse time for the bond market. The tax-exempt rates are already at alltime highs, and only 80 percent of taxable rates, far above the historical average of 67 percent. Cities can ill afford these high interest costs at a time when they are being hit with the severe cutbacks in Federal and other local aid.

I think some of the major questions, if in fact—and the theory is, to let local bonding take care of some of the infrastructure. We just had another case in our State where Fairchild and Hewlett-Packard companies both wanted to locate not in the city but outside the city limits. In both cases, the small communities could not afford the infrastructure cost that accompanied two major plant investments. Luckily, we have our legislature meet 2 months out of the year. They were in session and they rushed through an emergency package to try to cover some of the costs of these two small communities.

That is the impact on the corporate city. The impacts of the high interest rates on the border city are a summation of a lot of the things you've heard today. Housing, we're involved in some of the higher risk housing like 312 loan program. If that moves through to extinction, the ability of the city to, working with high risk parts of the city to get local funds at any kind of a rate that would cancel out. We just did close an SBA deal, our development director told me this week, for a little tortilla factory and it closed at $500,000, central part of our city, a minority area. And it closed at 18-percent average between the SBA loan and the local financing.

The cities have—the country, in David Burch's study done over a year ago, showed that the birth of small businesses is very critical to a city; that you have the birth and you have the death of businesses. And in a growing city, a healthy city, the small businesses that come in offset those businesses which die. Presently, we are seeing the death rate of small businesses being pressured by their inability to borrow going up, and at the same time it is more and more difficult for small businesses, particularly in high-risk parts of the city, to get funds, particularly with the Federal programs now being pulled out.

I think that as cities—that these are times in which we aren't going to be able to, and have to do more things locally, then the Congress is going to have to look at the fact of things like the high interest rates make it very difficult for the cities to do that.

Thank you.

Mr. TURNER. Mr. Chairman, next we have the president of the Industrial Union Department, AFL-CIO, the department which represents approximately 6 million members of the AFL-CIO, Howard Samuel.

STATEMENT OF HOWARD SAMUEL, PRESIDENT, INDUSTRIAL UNION DEPARTMENT, AFL-CIO

Mr. SAMUEL. Thank you.

Mr. Chairman, I have been asked to say a few words first about the automobile industry, which is a well-recognized victim of the current program of high interest rates. May I add that I say these words with the endorsement of the United Automobile Workers, the union which represents workers in the automobile industry, and also of a number of unions which represent workers and industries that make components and parts for the automobile industry.

This industry, in total, is one of our most important and employs about one out of six of all our manufacturing workers in this country. Obviously, its problems have been caused not only by high interest rates, but at least earlier by the pressure of competition from abroad. The fact is, though, that a couple of years ago the automobile industry began to pull itself by its own bootstraps out of the situation. There are small-model cars now available—made in this country—for domestic purchasers. But it hasn't accomplished its goal of bringing the automobile industry back to its previous highs of employment and profitablity.

The cause, of course, has been high interest rates. They have been seen very visibly, during the course of 1980 when sales in this industry, sales and productivity began to rise early in the year throughout May. Then, as interest rates began to accelerate during that period there was a direct, almost one-to-one relationship to sales and productivity of the automobile industry, until sales have gone down, and as you know, they have stayed down. And that industry still represents a very serious problem for this country. It has caused unemployment probably involving several hundred thousand workers in a wide spectrum of industries, not only in automobile assembly but in steel, glass, rubber, chemicals, textiles, and a number of others.

Let me also take a moment to discuss with you two other principles regarding interest rates, and one has to do with productivity and one inflation. All of you are aware that this country faces somewhat of a crisis with respect to our productivity. The figures are quite clear. Through about 1973 our productivity improvement rates were climbing quite satisfactorily, and we led the world. And the payoff was a dominant position in the world market, as well as domestic growth.

Starting around 1973, those increases began to go down. They are still down. Let me talk only about the productivity rates, incidentally, of the manufacturing industries which are relatively easier to measure. Productivity rates in the service industries seem to be worse, but are much more difficult to measure, to quantify satisfactorily. But the fact is that in the manufacturing industries, productivity has not kept up and represents a substantial problem now for us.

The Congress has taken recognition of this and all of you have spent a good deal of time, recently, trying to develop a tax bill, one of whose purposes would be to provide investment for a new technology to improve productivity. And so the problem of productivity is one that is well recognized.

There are a number of causes. I am not here to give a lecture, nor could I, on the causes of low productivity growth, but there is no question that high interest rates are a major cause. Professor Lester Thurow, one of our most distinguished economists, claims that high interest rates cause as much as a third of the failure of productivity rates to go up; really, in effect, almost the major factor. The reason, of course, is that high interest rates bring down our capacity utilization and when a factory does not have full capacity utilization, no manufacturer or very few manufacturers are going to invest money in new machinery. It is far more sensible to try and bring up capacity utilization using existing machinery, existing capital equipment, and not try and invest in new machinery against an unknown future.

I might add, by the way, that the effect of high interest rates is particularly felt, as all of you know, on long-term investment, long-term bonds. What has happened in the bond market is too well-known to reiterate here, but obviously that has a major effect on investment for new technology and for productivity.

Now, what is the effect of high interest rates on inflation? We are told by Mr. Volcker, among others, that without high interest rates we will not be able to defeat inflation. I would like to suggest to the members of this committee that with high interest rates, we will not be able to defeat inflation. In effect, high interest rates are a major component of our inflationary problems. If we have had any easing at all in inflation recently, certainly I think it is sheer folly to give any of the credit to high interest rates. I would turn, rather, to OPEC and to the declining cost of energy, which could well be temporary.

Interest rates, we believe, have very little effect on inflation except to make it worse, and I think this has been too well proven to require very much emphasis, except simply to realize, as you all do, the effect of interest rates on our Federal budget. You and others are making a valiant effort to bring down our Federal budget, to make it a more reasonable reflection of our national growth; and yet you are dealing with something like 12 percent of our national budget are interest payments, and that figure is going up. It is not going down.

Finally, in conclusion, this inventory of damage wrought domestically by excessive interest rates for productive investment matches the chronicle of international repercussions expressed at the Ottowa summit meeting. Leaving for another day any further comments on the international side, the inescapable conclusion of our discussion this morning is that the vital sectors of our society which we represent cannot endure a protracted experience of these crushing levels of interest rates. Yet independent economists of all inclinations seem agreed, uniquely and disturbingly so, that high and volatile interest rates will be a burden on us and our economy for the foreseeable future. The signals from the independent Federal Reserve Board, to the extent they can be deciphered, seem to indicate yet further tightening in the growth of the money supply, and that means a further tightening of the noose of high interest rates about the interest-sensitive productive sectors of our economy.

You heard about it yesterday, Mr. Chairman. We will be working to frame solutions to this challenge. We know that calling simply for lower interest rates alone is not enough, but describing the damage caused by the destructive practices of our monetary authorities is a vital step in beginning that process and we are exceedingly grateful to you, Mr. Chairman, and the members of this committee for giving us this opportunity to do so.

Thank you.

The CHAIRMAN. Thank you, gentlemen. I want to commend you not only for your statements but for the fact that on the one hand you tell us about the problems that are created by the high interest rates, yet you also very responsibly recognize that the solution to the problem is a multifaceted one with no one magic solution.

Mr. Turner, as we have been reading in the press the past week or so, enormous lines of credit are being granted to some of the major corporations of this country for corporate takeovers. In some instances, those obtaining the lines of credit don't even really know what they want to take over, but they figure they want to play in the ballgame. They want to be part of the act; they want to be ready. Of course, this is tying up a great deal of money once these lines of credit are granted.

The Chairman of the Federal Reserve Board yesterday indicated that he is concerned about what is occurring in this takeover situation. Do you believe, Mr. Turner, that we should attempt to develop a policy that directs the scarce credit resources that are available into productive investment and away from this game of big time monopoly that is being participated in by so many of our major corporations? And if you do feel that way, how do you think the Federal Reserve Board and the administration could effectuate such a program to insure that those resources go into productive investment?

Mr. TURNER. Well, Mr. Chairman, I certainly believe that we need to see to it that the Fed and the President activate the powers that they have under the 1969 act which allowed them to allocate credit and to give favorable treatment to different sectors of the economy. I think in particular, they were looking at these problems of corporate takeovers where people have funds available or they are able to get funds much more easily than people at a lower level in the economy. Of course, there are some things in the economy such as housing and the financing of activities in cities and a lot of other activities which are much more important to the economy and will do more for full employment and also for fighting inflation than these uses that are being put to it.

The law is there and the Fed can do it, with the approval of the President. I would think that the initiative should come from the President. I think you ought to ask the Fed to move ahead with this sort of thing. I believe the idea of trying to pass a joint resolution of the House and Senate on this whole matter, which I think you and Mr. Reuss have been working on, I think that could be very helpful, but the law is there.

You will recall that in March 1980 the Carter administration applied some parts of that law, and right away the interest rate went down, I think, to around 11 or 12 percent. And then for some reason, it was never quite clear to me, they withdrew the credit restraints. I think it had something to do with fear of recession, or something, and they withdrew the credit restraints. And, if you will recall, then, the interest rates began to move rapidly up again.

Now I am interested in low-cost electric power. Five years ago or 4 years ago—nuclear power, I think, is the cheapest power that is available—3 or 4 years ago, the first 5 years of a nuclear plant, there was a cost of—50 percent of the total cost was for interest rates.

I think today that if you try to build a nuclear plant, you're talking about 60 to 70 percent of the cost for the first 5 years as being interest. Now how are we going to meet these power needs?

So I would hope, Mr. Chairman, through some kind of a joint resolution or through some way of prodding the White House, something could be done.

It is unfortunate, of course, that the Fed is so independent. I don't know of any other modern industrial society where the monetary authority has such independence as we have in this country.

Now, you know, you elect someone President, and you elect a Congress. The Congress and the President both are somewhat—well, I would say hog-tied, perhaps, in terms of acting because the Fed has so much independence. And you can talk to them, you know—here is on television last night, I saw Mr. Volcker, and here is—a big part of this committee was certainly in complete disagreement with what Volcker was doing, and someone even threatened to impeach him. And he said, "Well, somebody else will be there anyway."

Well, here is an organization—when you are elected to Congress, you are elected to the Presidency, you wanted to do something to maintain a full-employment economy. You want to have an economy with low rates of interest. You want to have an economy with low rates of inflation. But here is a man in a tremendously important position. You can do something about your fiscal policy, but your monetary policy is in the hands of something—of an organization which in effect flaunts your authority, and which is what happened yesterday.

So, Mr. Chairman, I would hope that we would do something to get the 1969 act extended.

The CHAIRMAN. That's what I thought. You know, you were almost as good as Paul Volcker and Arthur Burns and Bill Miller, because our time has expired. I asked you one question, and there goes the time. [Laughter.]

Maybe someday you will be the man, because that is a sine qua non—to take one question.

Mr. ANNUNZIO. Mr. Chairman, will you yield? When you say that someday Mr. Turner will be the man, at least he will have to run for office and get elected. He's not looking for an appointed job. [Laughter.]

The CHAIRMAN. Mr. Leach?

Mr. LEACH. Thank you, Mr. Chairman.

I think interestingly a good deal of what I think the whole panel has said is in conformance with what Republicans and Democrats alike think in terms of the effect of interest rates, and I was particularly appreciative of your comments, Mr. Samuel, that you appreciated our valiant effort to reduce the budget, and you pointed out what a high percentage of the budget our deficit financing has determined.

Does that indicate that the AFL-CIO is moving in the Republican direction?

Mr. SAMUEL. I don't think that is a conclusion that is warranted by anything I said.

Mr. LEACH. Fair enough.

One of the things I would like to ask, because it wasn't covered much, and that is, when we look at society, we all know there are different pushes to costs. Republicans sometimes like to dwell upon the labor cost, and everyone dwells upon interest cost, and other people dwell upon other types of cost.

But to put this all in perspective, could you provide for us the relative position of labor, let's say over the last 3 or 4 years, in relation to inflation and particularly the relationship of labor not only to inflation but with the higher tax brackets that the average person is being put into? Has labor gone forward or backward as a general rule?

Mr. SAMUEL. The level of average wages has gone down; real wages have gone down. It has gone down for almost 10 years. Most of that loss has been in the last 2 or 3 years. Workers now—the average worker has less disposable income in real dollars than he did in the early 1970's. This is hardly true, of course, of interest rates.

Mr. LEACH. Well, then would you say that—I mean, just as a general rule, that Government policies of the status quo would seem relatively unacceptable for labor and that we ought to be changing direction in one fashion or another?

Mr. SAMUEL. I think that is the gist of the comments that were made by all of us here today, that we have only approached the subject of interest rates, and probably it wouldn't be appropriate for me to discuss other activities and the other range of activities that I think would be called for. But certainly one of the things that we feel most strongly about is to do something about high interest rates which are such a major contributor to inflation.

Mr. LEACH. Fine. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman. And I heartily congratulate this panel for the very, very able job they've done and their addressing what is the primary economic problem right now, the murderously high interest rates.

I note that your panel consists of leaders of labor and small business and housing and farmers and utilities and the mayors of our great cities, and that is a very impressive coalition.

I might point out that there are several other groups which really ought to be included in your panel, and I am sure before very long, they will be. One is American industry as such. Nothing could be more destructive for the goal of investment in plant and equipment, which everybody concedes is needed, than these murderously high interest rates. Also at your table should be American exporters. The tremendously high interest rate policy of the Fed and the administration means that the international dollar is inordinately high, and I am very much afraid that very shortly, if this keeps up, those American industries which have been able to compete worldwide in the export field will find themselves priced out of the market by a hyped-up, overvalued dollar. And that means more losses of jobs and more misery for your industrial workers, Mr. Samuel and Mr. Turner, and your farmers, Mr. Mullins.

Then there is still another group that in essence ought to be on your panel, too. The great organizations that you represent—labor and the farmers and the mayors and civic organizations, for example—have always taken what I think is a good world view, the view of world brotherhood, that in our economic policy we have got to look at what happens to our friends.

And it is significant that even though they were somewhat cowed into obsequious silence yesterday at Ottawa, the leaders of Germany and France and Japan and Italy and Canada and all of the other industrialized democracies are deeply upset at our wholly unnecessary high interest rate policies. There are a few who do speak out, and in that connection, I commend to you the New York Times story of this morning, setting forth what Otto von Lumsdorf, the German Minister of Economics, had to say at Ottawa.

He said—I'm quoting from this story—that "overloading monetary policy was driving interest rates in the United States and Europe higher than needed." And he said "the United States was conducting its monetary policy in too rigid and doctrinaire a way." And he very clearly made the same point that you are making. So that while you have got a marvelous pantheon of injured interests at your table, I am suggesting that there are several others who ought to be there, too.

Reference was made to the joint resolution, H. Con. Res. 160, introduced earlier this week by Chairman St Germain and Chairman Fauntroy and myself, and shortly numerous others. In that resolution, we suggest that there is a way out of the high interest rate morass that we are in that doesn't involve turning on the printing press and doing foolish things, that that way out consists first, of the Federal Reserve not overdoing tight money. After all, last year's targets produced 20-percent interest rates. There's no point in turning the screws even tighter, as Mr. Volcker and his associates now threaten to do.

Second, the resolution points out that as long as you give out huge tax bonanzas to people that don't need them, you are going to have the Treasury driving up the price of money and further adding to the misery, and that that isn't a necessary act of Government at all to make for future budget deficits.

And, finally, we make the point that has been made numerous times this morning that monetary policy doesn't just involve dribbling out a supply of new money. It also involves attention to demand. It is demand for new money which is produced by the commodity speculators, the Bunker Hunts of this world, by the corporate takeover artists, and by the foreign lending experts, that drives up interest rates.

The Federal Reserve and the administration have all sorts of existing powers by which they could dampen that demand, and thus see that money available for farmers and small businessmen and the housing industry and utilities and consumers and construction was available.

Other countries do it. Other countries are pointing the way. I don't see why we can't. And it is good to have you here.

I haven't gotten around to asking my question yet, but let me thus spend my 5 minutes in grateful appreciation of your testimony. My time has expired, Mr. Chairman.

The CHAIRMAN. Mr. Weber?

Mr. WEBER. Thank you, Mr. Chairman.

Gentlemen, the most important part of your presentation, to me, is on page 13 where you say, "We will be working to frame solutions. We are all concerned about high interest rates." The problem, of course, is how do we get interest rates down in the best way. I am extremely interested in the solutions that you men are able to frame for us.

As I understand it, interest rates contain a time discount factor and an inflation factor. If people are going to be paid back in cheap dollars, then they're going to charge a premium as part of that interest.

Do you believe that inflationary expectations will be raised or lowered by yet another tightening of the money supply?

Mr. TURNER. In my opinion, there would not be as much inflation if we were to loosen up the money supply, particularly if we were to allocate it to those areas which are most in need and which are, I would say—have a greater right to lower interest rates. I think that farming, I think that new types of utilities, I think a lot of areas—housing, that sort of thing—I think they all require a lot more attention and better credit rates in accordance with the 1969 act than, say, the money that might be required by a corporation to take over another corporation.

Now that legislation is on the books. It simply is not being implemented. As I mentioned in my earlier statement, it was implemented briefly in the Carter administration. Exactly why it was dropped, I'm not clear. But I think in the whole approach of the Fed, I think the fact that we don't have farmers on the Open Market Committee, the fact that we don't have any businessmen on the committee except some bankers—I mean, by the banking industry—is completely overweighting the Open Market Committee. And I think that the 14-year term that the members of the Board have, I think that is entirely too long. I think the Chairman's tenure—the Chairman of the Fed—should be completely in conformity with the term of the President, so that there would be, perhaps, greater rapport. I think that generally it ought to be more open in terms of what it is doing, and I think in terms of the methods of selecting the Chairmen of the various Federal Reserve banks that those boards ought to be opened up to more people.

It seems to me that so many times when bankers say, "Well"—you know, it reminds me of putting the fox in charge of the henhouse—when bankers with a great air of unctuousness say, "Well, unfortunately we have to raise interest rates again", as the thing goes in the beginning, it's not a bad game for the bankers, but as time goes by the whole economy gets out of kilter, and they find that they are not in such good shape.

Mr. WEBER. But I want to get back to the problem of expanding the money supply, which we would all love to do if that was going to cure the situation. But every time in the past when we have expanded the money supply, we have had inflation increase, resulting in higher interest rates. Last week M1B grew by $6.9 billion; short-term interest rates increased on Monday and the stock market fell.

Given those kinds of facts, how is faster growth of the money supply going to help to bring down interest rates?

Mr. SAMUEL. Congressman, if I may respond to that, if I can, we are not here to suggest that the money supply be expanded, certainly in a major way. I'm not here either to defend the particular level which the Chairman of the Federal Reserve Board discussed yesterday. But I'm not sure that is really what the key issue is.

Interest rates can be dealt with in a way apart somewhat from the money supply. We're suggesting that the allocation of credit can make a major contribution to reducing the level of interest for those areas that need it.

Let me point out to you, we are all being subject now to the very unedifying spectacle, the spectacle which I think is of absolutely no benefit to any possible area of our country, of some major corporations in a rather grotesque competition for credit in order to buy Conoco. I have no idea what possible benefit, as I say, this is giving to any of us—Dupont and Mobil and the rest of them forcing up the price of interest rates so that we don't have enough credit for utilities, for farms, for construction, for the purchase of automobiles, but instead, so that one company can gobble up another. It doesn't help productivity; it doesn't help inflation; it doesn't help the United States.

But until we do something about the allocation of credit, which is the real answer, not the money supply, you're not going to be able to cure it.

Mr. WEBER. Thank you. My time has expired.

The CHAIRMAN. Mr Gonzalez?

Mr. GONZALEZ. Thank you, Mr. Chairman.

Yesterday, Mr. Volcker in his statement again went back to this old litany about the fact that labor, most labor was responsible for the high cost factors, and he said so specifically on page 3 of his testimony. And I guess that was what kind of made me irk more than anything else, because he went back to the same old thing, and that is the corporate blames the victim. And it's just that I have, through 28 years, watched this—the argument that is advanced. Very seldom have I seen it very positively rebutted officially.

Now, especially Mr. Turner, I would like to know what, if anything, in the way of studies, other than at one time when we had hearings on housing, has been conducted. Naturally, labor is a factor, but the insinuation is that it is a disproportionate factor because it is unrestrained in its wage demands and has been, according to Mr. Volcker's testimony.

Is that the record actually?

Mr. TURNER. The record is just the opposite, Mr. Congressman. All through the 1970's, I don't know of an economist who is worth his salt who has said that this was a wage-push inflation. The wages have followed the price increases. They have lagged behind the price increases right along. And, certainly, it is true today, it has been true for the last 10 years, and as a matter of fact in the area of housing, whereas you go back to, say, 1949, my recollection is that the cost of labor at that time might have been running in the maybe 20, 25, 28 percent—something like that. Today it is down to 17 percent. That is the cost of onsite labor.

Now some of that is due to work that has been done, putting the elements together before they arrive on the job, prefab and so forth. But still there has been a tremendous drop.

There have been any number of studies made on this, and I'll be happy to have some copies sent over to you for your to peruse.

Mr. GONZALEZ. I would be most grateful to you, because there is a lot of linkage here. You have the Bacon-Davis issue pending and which, of course, I might point out that critically—and I don't mean to be embarrassing or anything, and it is certainly not personal, any more than I meant it to be yesterday with the Chairman of the Board, because it is really not a one-man corporate thing.

Mr. TURNER. I thought you were very good with him.

Mr. GONZALEZ. Well, I did restrain myself. [Laughter.]

I must say that really sincerely. But you know, it was the hardhats, the industrial construction unions, that went for Mr. Reagan. I am very intrigued by the approach Mr. Reagan has taken to his commitment with respect to Bacon-Davis in which he really returns to the Nixon dictum: "Don't listen to what we say; just watch what we do." And what he is doing is saying, "Well, we're not going to fight the congressional attempts to do away with Bacon-Davis; we will just remain neutral there. But in the meanwhile, we will give positive instructions through the administrative branch for rules and regulations through the Labor Department that in effect will vitiate Bacon-Davis." So there is a linkage there. There is a linkage between productivity, as Mr. Volcker was bringing out and did bring out in his statement yesterday.

Now everything that I see and read in the international financial journals—for instance, the reports from Germany, France, England—especially England with your Thatcher Toryism which is converted into Reaganomics Toryism in this country, because what we have is not conservatism, it is Toryism—and they show that their productivity is not as high as the American labor productivity. Their restrictive economic policies in England and in some of those adopted previously in Germany did not address themselves nor did they even partially solve the problem which we are confronted with, the worldwide problem. And it just seems to me that, given those facts, we in the Congress have been derelict in not confronting an administration that is basing its headstrong course of action, undeviatingly, on policies that actually are being proven to us as not working—in fact, so counterproductive that such a great nation as England is facing civil rights crises, social crises, and labor crises. And in England, labor was blamed for the reaction that give us Thatcherism.

Mr. Turner, I can understand everything but labor having supported Mr. Reagan. It seems to me, now, that we ought to get some real good, straightforward answers on all of these three levels: productivity, Bacon-Davis, and inordinate wage demands by labor.

Mr. TURNER. Well, I meant—No. 3 I talked about before, in regard to the monetary policy. What is happening here, of course, is that—going back to those great dynamos of economic action, Mr. Hoover and Mr. Coolidge. And of course, they are saying the "invisible hand," as defined by Mr. Adam Smith, is going to take care of everything; and if we put enough money in the hands of the rich, they will invest it in the appropriate places, so that jobs will be developed and the economy will work, et cetera, et cetera. But if we don't do that, why things are going to continue as they are.

Now, the whole history of the United States, going back to at least the advent of FDR, has been that we had to look at the demand side of economics. The consumption of a low- and moderate-income laborer is so much greater than that of a higher income laborer that he will spend almost 100 percent of his money.

Based upon that, the Wagner Act was passed—the right to organize. The Unemployment Compensation Act was passed. Social security was passed. And of course, they came along with another part of Lord Keynes' theory, which was that we had to prime the pumps; so we had the PWA and the WPA, which I remember very well.

And of course, coming up into the 1950's and 1960's, we had medicare, we had medicaid, we had all of these things which were intended to try to take care of the problem of demand. And Mr. Reagan comes along with a completely opposite philosophy, skipping back 50 years of history, and saying, "Now we're going to go back to Coolidge and Hoover, and all we're going to do is, we're going to make sure that the dough gets in the hands of the rich," and everybody else will get by on a trickle-down theory.

In a few simple words, that is exactly what is trying to be foisted on the American people. The American labor movement, with very few exceptions, fought extremely hard against Mr. Reagan's election. We felt that his economics were wrong, his views were wrong, even though he kept reminding everybody that he is a former president of a union, et cetera, et cetera.

On the matter of Davis-Bacon, he promised that he was not going to repeal Davis-Bacon. I don't know yet that that promise has been broken. I have seen no real evidence that it has, but there is this effort being made to change the regulations. Now, I think the regulations are very dangerous, very crippling. I mean, if you take away the regulations or the enforcement of the law, you might as well not have the law. I mean, that is the kind of shell game that is involved.

But, I certainly can't accept the idea that labor per se has supported Mr. Reagan. I have checked out, with some of our local unions down in Texas, particularly in the Texas City area, and I find that whereas in the highly organized areas—it may have been the same thing around San Antonio; I don't know—but we found that working people in those unionized areas voted like 58 percent for President Carter and voted perhaps 74 or 73 percent for other Democratic candidates.

Mr. GONZALEZ. I guess I was referring mostly to the New York area where, I believe, during the campaign there were some reports about the hard hats supporting Reagan.

In my area, let me point out San Antonio is an anti-labor area. We have minimal organized labor presence. I have been about the only political office-holder upholding the right of unionism, even though I myself—I have never been a member of a union.

Now, when you speak of Texas City, you're talking about the Golden Crescent, where you have the heaviest presence of organized labor in Texas, the southeast part, the Jack Brooks area. But we must never forget that in Texas, out of a work force of some 4 million or more, you don't have 350,000 card-carrying union members. Nevertheless, though, I feel that being a faithful witness to history would make us realize that the free trade union movement has been an indispensable factor in what is being challenged now and eroded, which is our American way or American standard of living. It is inextricable.

I see it under direct attack here, with very little defense. And this is the reason I am very concerned. Because we see involved in this is the wholesale, massive transfer of wealth. This is the first attempt—and it is succeeding thus far, a massive transfer of wealth from the poorest element and the working element to the most affluent.

Not only a reversal to Coolidge, which is what it is—it isn't even to Hoover, according to Stockman. Stockman says he doesn't believe the Government has any responsibility. Well, that was a Calvin Coolidge doctrine, not Hoover. Hoover at least appointed study commissions, recognizing there was a responsibility.

But certainly, we can't stand here supinely, and watch this wholesale transfer, the whole reversal of the American process—which is mass production based upon mass consumption, supply, and demand.

But, I want to thank you very much, and I will appreciate getting these statistics.

Mr. TURNER. I will get them. Thank you.

The CHAIRMAN. Mr. McCollum?

Mr. MCCOLLUM. Mr. Turner, don't you think that the creation of more and more dollars, the printing press creation of dollars, actually is the primary source of inflation?

Mr. TURNER. Well, I don't think so. I think there are a lot of factors. It is a very complex kind of phenomenon. But, I certainly believe that high interest rates are a cause, and not a cure, of inflation. I do believe that it can—when you tighten up credit too much, that it—by means of using the interest rates, why you tighten up and you cause more inflation.

I think if we could allocate credit in accordance, as I say, with the 1969 act, we could do a lot better. If we could have an open market committee that was more representative of the American people, instead of just representing the bankers, I think we could get a better result, in terms of their policies on the interest rates.

Mr. McCollum. Mr. Stafford, one of the primary measures of inflation is the rise in prices, in one form or another. In order to control inflation, we're going to have to control prices, in some form or another, it seems to me, however you consider the source of the problem.

There is a reasoning in the statement that was given jointly—including, I assume, yourself—that only a major recession would cause prices to come down, and the social and economic cost would be traumatic.

I am curious as to what basis there is for that statement, in your judgment.

And if there is an alternative to that, to bring prices under control, what would you suggest that we do?

Mr. Stafford. I am on the panel, as one of the people who—it's like going to a doctor when you're in pain and you're sick. And the doctor says, "How would you cure your illness?"

I'm not sure. I don't know whether, in fact, we would have to go through a major recession to, in fact, control prices. I mean, I believe that—personally, that the Conference of Mayors—in fact, one of the major contributors to inflation in this country is energy, and that resource pricing which is beyond even the control of this country.

And therefore, those measures which we can take—and we are taking in the city of Seattle—in terms of we control our own public utilities—so we are doing various kinds of programs with homeowners, to weatherize homes. We are doing things in city hall, in terms of weatherization, changing our fleet, anything that we can, in terms to cut down on the amount of energy that the city and the citizens of our city use, and therefore the investments that we have to make in utilities.

I am not sure whether we as a country have to go through a major recession, and that unemployment and the personal disruption in people's lives that that would create. I guess, going back a long time ago to my economics class, that would be the theory of things—that if you got enough people on the street, prices would fall, whether in fact—and prices—people's labor, I suppose, the prices of people's products. That doesn't seem to be the case any more in our society, that we go through high unemployment.

The State of Washington's unemployment now is 9 percent—over 9 percent. A lot of that is the lumber products industry, which is tied to the housing market. How will we get housing back up again, to get the work products back up again, to get employment back up?

Mr. McCollum. You know, the Federal Government goes out and borrows a lot of money to spend for deficit financing and pays high interest rates on it, which are part of the interest rates you discuss in the statement. In essence, then, the Federal Reserve comes out and historically, under Keynesian concept, creates dollars and increases the money supply, in order to replace those the Federal Government has taken away from the private market system.

It seems to me that this is a primary force in causing inflation, and that by controlling deficit spending and by stopping some of the creation of these dollars, we could get some degree or some measure of control on it.

Is that a factor in your thinking, or do you disagree with that premise?

Mr. STAFFORD. I think that the Federal Government—my personal feeling is that—on the part of the Conference of Mayors—is that the deficit spending of the Federal Government has been a contributing factor to the inflation of this country.

I have sat through a couple of panels where people have argued that the inflation rate is—1 percent, 2 percent, 3 percent of it comes from the deficit in the Federal budget. I think the mayors of this country are in the process, whether they like it or not—and the cities are going through a substantial pain—of adjusting to very major domestic spending cuts, and taking a large share of the grief, in attempting to balance the Federal budget, to in fact—to cut down on that share.

I guess my own feeling is that—and this is probably a bit biased, being a supply officer in the Army for 2 years—that the Defense Department might take a bit more of the cut themselves. And I would be willing to give up my tax break, whatever that will be, for the next 2 years, so that if, in fact, a balanced budget was the objective of this Government—and, in fact, I think we all agree that inflation is a major problem in our society and in our cities—that in fact we go out and solve it this year, and do it, and moderate the defense increase. And I will be willing to give up my tax cut.

I think our city will take a lot of pain, in terms of implementing the cuts that are coming in domestic aid. And let's get it over with and do it. I'm not quite sure that is the real objective of everything that is going on.

Mr. MCCOLLUM. Thank you.

Mr. COAN. Mr. McCollum, could I respond to that?

Mr. MCCOLLUM. Yes.

Mr. COAN. If you have the Government taking too much money out of the economy, and then replacing it with dollars that chase goods that are not available yet, you have inflation. We certainly don't have that now.

High interest rates are restraining the ability of the housing area to meet the demand that is there. To say that we are creating printing-press money is, I think, a simplistic approach to the matter. We're talking about interest rates. Inflation is a composite of many things; and probably the most severe part of it has been in energy and food prices—food prices now have moderated.

We are not printing money and giving people money that they can't find things to spend it on, and therefore driving up the price of everything. Our industrial plants are not at a capacity where we can't meet the demands of the people. We are not enabling that capacity to function. That is very true in the housing area and in many other areas. Our plant capacity is underused in this country. Our need for housing—which can be built—is not being met. We are not chasing after things that are not there.

Mr. McCollum. Thank you.

The Chairman. Mr. Annunzio?

Mr. Annunzio. Thank you, Mr. Chairman.

I know you have another meeting scheduled for 11:30 a.m. I want to congratulate and commend Mr. Turner and the panel for their views this morning.

I echoed some of those views yesterday, when Mr. Volcker was here. After Mr. Gonzalez got through with him, I asked Mr. Volcker why he never explained—on page 3 of his testimony, he talked about wages, which was really a ploy. He never criticized the line of credit of $30-some-odd-billions that has been established for large corporations. But he continually criticizes any time there is a wage increase. Anybody who has had any experience in a labor union knows that wages follow prices; as prices go up, union leaders go in and negotiate for an increase in wages. But the wages never catch up to prices.

On the other hand, I would like to say to the panel that this is not a simple problem. You just can't say, "Let's get the housing industry started." I've introduced legislation that is called a savings certificate. My bill has more in it than the All Savers Act that is coming out of the Ways and Means Committee.

I can remember back in 1968, when Mr. Patman almost had an epileptic fit when the discount rate went from 4 to 4.5 percent.

What are you going to do with your own members? You tell me about housing. The minute the money market funds got going, they are paying 15 and 16 percent. Everybody took their money out of commercial banks, thrift institutions—$40 billion, $100 billion went over to the money market funds; and they're not insured.

There isn't a Congressman on this panel who will tell you that he got less than 1,000 letters not to touch money market funds.

What are you going to tell the union member who comes to you and complains about 12 and 14 percent interest and who also says, "But don't touch my interest that I am earning now. I want that 17 percent."

You see, this is another problem we have. You've got that. How do you educate the people? How do you get interest rates down when the national debt is $914 billion; and the interest alone is $65 billion. If I were one of these international bankers, I wouldn't want the national debt to come down. The $65 billion a year is a fixed revenue.

We are coming out with a tax bill. Everybody is going along with it. We all know it is absolutely wrong to decrease taxes at this time. There should be a surplus, so you could reduce the national debt. Everybody knows that the Government is in the money market, competing with private industry, bidding up the interest rates for money. We all know that.

Chrysler comes in here for a loan, and we have to look at the balance sheet and see what the assets are, like we did with Lockheed, to make sure we don't lose any money. We could never lose any money on Lockheed, because their assets were greater than the $750 million that this Government guaranteed on the loan, you see.

The point that I make to you is that our Government has trillions and trillions of dollars of assets. Somebody better come up with a new idea. We have got to figure out the assets that we don't need in the national interest, and we have got to sell them. We have got to sell these assets, just like a corporation, so that you can bring down that debt of $914 billion.

If you reduce it to $500 billion, it will cut the fixed indebtedness of the Government that the international bankers and people invested in the Government have.

These are things we have got to start thinking about. We can't go along year after year, because we are going to run into a stone wall. Already are running into that wall. You can't go year after year with the same old tax bills. We have got to have a tax bill like they have in other countries of the world.

We need a tax bill where everybody pays a flat rate, across the board. All of these gimmicks to put people in jail—who is going to jail? The poor guy. Capital gains, no capital gains, taxes on interest earned, double taxation, triple taxation, real estate taxes, you can go on and on and on. You don't need all of this hocus pocus. They have got a tax bill, that Ways and Means Committee, that benefits two people: lawyers and the people who make out the taxes, the accountants; that is all. They are going to make a fortune.

Who writes the tax bills? Lawyers and accountants. This is what we are up against unless we reduce what we owe, unless we can make up our minds that we just can't take a tax cut. We have got to be true to ourselves. We must educate our membership. You holler when you pay 12 percent interest on a car loan, but when you invest your money, you want 17 percent. So that's your problem and my problem.

I thank you very much for your testimony this morning.

The CHAIRMAN. Mr. Wortley?

Mr. WORTLEY. Thank you, Mr. Chairman.

Gentlemen, I have listened to you tell us what is causing inflation. But I wonder if you can tell us what organized labor's program is to control inflation?

Mr. TURNER. We feel that—first of all, we have felt for a long time that the tremendous increase in energy costs has been the most important factor in the growth of inflation. We have advocated that the Government set up a corporation which would purchase all foreign oil, and would thereby, we hope, try to cut down some of the problems that exist there. We think we can probably work out a better rate along those lines.

Mr. WORTLEY. You think the Government could purchase oil cheaper?

Mr. TURNER. We think a corporation that would be set up to buy all foreign oil and reallocate it to the different companies which wanted to buy it—but it would be done through a government corporation—we believe it might be a way of trying to reduce some of the impact of OPEC on the market.

We also believe that in terms of hospital costs, health costs, that we need to concentrate on ways and means of trying to contain the increases that we are getting in hospital costs and health costs. We certainly believe that in regard to interest rates—that interest, as I said—one of the greatest economists in America, Leon Koslick [phonetic], says that we ought to have at least a 4 percent increase in the money supply, growth rate in the money supply each year, and higher than that to achieve, in that year, an annual growth rate——

Ms. OAKAR [presiding]. Mr. Turner, would you yield for just a moment? Your Congress Member, Jack Brooks from Beaumont, Tex., wanted to just drop in to say hello. And I think it's only appropriate.

Mr. TURNER. That's my hometown. I'm glad to see Jack Brooks.

Ms. OAKAR. I'm sorry to interrupt you.

Mr. TURNER. But Mr. Koslick says that 4 percent in any year is required to achieve an annual growth rate of the real GNP from not less than 4 percent.

I would subscribe to what he says. I think that we have a growth rate of about 2.5. The trouble with this whole program of the Federal Reserve is it is great for some industry and some people, but it is terrible for the kind of groups that are represented here at this table this morning. It is terrible for local governments, it is disastrous for housing, the construction industry.

I represent a union of 425,000 members: 16 percent of them are out of work today, which is a very high percentage of people who are out of work.

I believe that if money could be available to move ahead with the numerous construction projects that are needed, if we had interest rates in some reasonable area, these projects could go forward. There is a tremendous amount of work that is on the shelf that can't move forward.

Mr. WORTLEY. But if we limit the growth of the money supplies, isn't that going to force the interest rates up?

Mr. TURNER. I believe that the present level of 2.5, as I recall it, is limiting the money supply too much, yes. I believe that if we were to get up to 4 percent, as is advocated by Koslick, I believe this would make money—more money available to do the things that need to be done. But the money needs to be allocated in terms of what is needful, what is appropriate for the economy, as is contained in the 1969 act, which could be applied.

I think these are some of the things that could be done to fight inflation.

Mr. WORTLEY. Yesterday Mr. Volcker suggested some wage restraints. In fact, I think he alluded to the fact there is a 4.8-percent cost-of-living adjustment for Federal employees. Would organized labor agree to something like that?

Mr. TURNER. I don't know what his proposal was in regard to government employees. I would say this, that 4 or 5 years ago—I guess it was 1975 or 1976, the AFL-CIO passed a resolution. It must have been 1978. The AFL-CIO Executive Council, of which I'm a part, passed a resolution in which—which we sent over to President Carter, in which we advocated the application of controls across the board.

Speaking for myself personally, I would go for that, but include rents, dividends, profits, et cetera, et cetera. I don't think just wages ought to be controlled. It ought to be across the board.

Mr. WORTLEY. You are urging wage and price and rent controls?

Mr. TURNER. Wages, prices, profits, everything. If we're going to have controls, let's have it across the board.

We passed that kind of a resolution. It didn't get anywhere with Carter.

Mr. WORTLEY. I would like pursue the dialog with you, but my time has expired.

Thank you.

Ms. OAKAR. Thank you.

Mr. Lowry.

Mr. LOWRY. Thank you, Madam Chairman.

I'm glad that my friend, Bill Stafford from Seattle, spoke. He is the first person I have heard on the panel voluntarily bring up the defense budget and the attacks decrease. I don't know how we're going to get a handle on the capital needs in this country for housing and energy and everything else when we spend $1.6 trillion in the next 6 years on defense.

The defense increase is $34 billion next year over this year. It is a $150 billion increase 3 years from now, over this year's spending.

People come before this Congress to talk about these very costly capital needs, but if we're just going to have blinders on defense spending, I just don't see how we ever are going to get to where we can help.

We have an opportunity, before we leave this August, though, to do something about interest rates.

I would like to ask any member of the panel: What do you think the effect on the financial market and the interest rates would be if we passed an amendment to the tax bills that are coming before us that said defer tax cuts and defer perhaps, other tax cuts, until the budget is balanced? If we did that, what do you believe the effect on the interest rates and financial markets would be?

Mr. MULLINS. Well, I would assume, if you deferred those and brought the budget into balance, that it would definitely impact with lower interest rates. It would have to.

You would get, No. 1, one of your biggest borrowers out of the money market, the Federal Government. You would release funds into the private sector that could be applied to the housing industry, the construction industry, agriculture—put that money to work in places where it is productive and not in deadend spending, like the Defense Department.

Mr. LOWRY. Thank you.

Mr. Fry, what do you believe the effect of that vote, before we left here, on the tax bill would be?

Mr. FRY. Well, I think it is indisputable. The accomplishment of a balanced budget would reduce the competition for funds in the money market and lower everyone else's interest rates. I think that is clear.

Mr. LOWRY. Mr. Turner.

Mr. TURNER. Well, first of all, I believe that the increase in the defense budget ought to be along the lines of perhaps 3 percent real increase, which is what we have asked our allies to do in Western Europe.

I think the request of the President is far beyond the 3 percent, and so I would want to limit to that. I have no need for a tax cut. I would not object to some writeoffs or favorable tax treatment in terms of the new plant and equipment, which I think is probably needed, which—it has been adopted much more in Western Europe than it has been here.

Mr. LOWRY. Mr. Samuel.

Mr. SAMUEL. I would support that.

Mr. LOWRY. Mr. Coan.

Mr. COAN. That is an interesting concept. I don't know whether it is a realistic one to consider. I agree that there is no sense in cutting taxes if the result of those tax cuts is either an expanded deficit or the elimination or gutting of necessary Federal programs to help those who are not able to help themselves.

However, if by doing so we can achieve the preservation of a reasonable level of necessary housing and other programs, then forgo the tax cut.

Mr. LOWRY. If there were to be a vote by this Congress that defers the tax cut in general, maybe with a few investment incentives still being possible, until we have a balanced budget—what do you think the effect would be on the interest rates?

Mr. COAN. I suspect it would tend to bring them down. I would wonder what Mr. Volcker and the Federal Reserve would do about the money supply, though. We have no assurance that such an action is necessarily going to convince them to loosen up the money supply, given their approach and view that the basic issue is how much money is out there.

Certainly if the Federal Government reduces its demand, that leaves a little bit more. But what are we talking about? $20, $30, $50 billion out of hundreds of billions of dollars? I mean, we're talking about a relatively small percentage of the total, are we not?

Mr. LOWRY. Well, we're talking about $50 billion right now, which is approaching a third of the amount of money available to be loaned.

Mr. Stafford.

Mr. STAFFORD. Well, we would certainly find out if a balanced Federal budget would solve the inflation rate. We might find out that, in fact, there are other factors in this society which are causing inflation. And I think then we would convince 90 percent of the American people that, in fact, the unbalanced budget is the primary, if not the the only, cause of inflation.

I think we might find out next year we still have inflation and a balanced budget. And I think we would really be in trouble.

Mr. LOWRY. Of course, my question was interest rates. My question was, what is the effect on interest rates, not inflation.

Ms. OAKAR. Mr. J. Coyne.

Mr. J. COYNE. Thank you very much.

I would like to focus, if I may, on a question that has been raised about your feeling that we should be allocating credit. I suppose I should be very flattered. It seems that many of you gentlemen think that we here are the ones best qualified to make the decisions of allocating the credit. Apparently you feel that the freedom of the American marketplace has made these decisions unwisely. It seems to me that we have had a 200-year history in this country of the American voter, the American investor and saver making these decisions about the allocating of credit. And you would prefer to replace this freedom of the American with, I suppose, the political wisdom of the assembled panel here.

I suspect you are pleased with the way Congress allocated credit to Lockheed and Chrysler. And I am curious whether you think that the political wisdom of Congress would always make allocation decisions wisely? What is it in your mind that makes the American Congress and our political motivations better suited to allocate credit than the free decisions of the American voter, the American consumer, buyer, saver, and investor?

I'm especially concerned, about what might happen after this Government-allocated system is in place. Let's say that Mr. Turner would like to get money for the construction of nuclear powerplants, and he goes to his bank and he is told that the American Congress has reached the political decision that credit should not be allocated to nuclear powerplants; or that Mr. Samuel goes into his bank and finds that the American Congress has decided that credit should not be allocated for the construction of new housing in cities that have rent control; or that Mr. Stafford goes to American Congress and finds out that they have decided, in their political wisdom, to allocate credit to the hard-hit Northeast and not to the prosperous Northwest. Would all then feel equally that the wisdom of Congress is sufficient to make these decisions?

Mr. TURNER. There seems to have been some misunderstanding, Mr. Congressman. My position was that the 1969 act which was passed by the Congress provides that the Federal Reserve Board, with the approval of the President, either initiated by him or by the Board, has the authority to allocate credit, to put restraints in certain areas and not in others. In fact, they did utilize that power in March of 1980 under Carter. And the interest rate dropped down from almost 20, down to about 11 or 12.

Mr. J. COYNE. I wasn't asking for a discussion of that act. I was asking for a discussion of the wisdom.

Mr. TURNER. I do not believe that the Congress of the United States ought to perform that duty. I believe that the Federal Reserve Board should do it in accordance with the law.

Mr. J. COYNE. The Federal Reserve is somehow more intelligent or wise or capable to make these credit allocation decisions than the American people themselves. If the Fed told you that, "No, we're going to respond to the overwhelming pressures upon us not to allocate credit to the construction of new water projects or new nuclear powerplants." Would you accept that decision?

Mr. TURNER. I feel, sir, that the present application of the law divides the Nation. It is great for big corporations. It is great for a lot of organizations. It is hell for the construction industry, for the housing industry, for municipalities, for States, for people that have to get money. It is killing the nuclear industry. We are trying to become independent, in terms of energy, of the Middle East. But we can't become independent unless we develop our own nuclear power, our own power, and exploit our other areas.

And let me finish answering your question.

And so, Mr. Chairman, as far as I am concerned, I believe that the Federal Reserve Board would be—as an expert, in accordance with the law that is passed, would be appropriate to do this. I don't think the Congress—it is at all feasible for them to do it. And I don't see how it could be done.

My good friend here wants to add a few words.

Mr. SAMUEL. I would just like to comment, Congressman. I think any Member of Congress who thinks that the people now have the free choice of credit—probably also believes in the tooth fairy. The fact is that we don't have the free choice of adequate credit.

My son would like to buy a house right now but can't afford the mortgage payments. Why is that? Because the real choices are being made by giant corporations and conglomerates who are busy gobbling each other up. They are bidding up the price of credit to the point where the average worker, the average consumer cannot afford it. That is where the choice is being made.

Are you telling me that the conglomerates are better able to make that kind of decision than the elected representatives in our democratic society? I think our democratic society has worked pretty well over the last 200 years. I'm not afraid of giving our leaders, who can be elected or dis-elected if we don't like what they are doing, to make that choice—better than the conglomerates, who are elected by nobody.

Mr. J. COYNE. I just heard two completely different positions. Your colleague to your left says let the Federal Reserve, which you know is not elected, make these decisions. And you're saying, Don't let the Congress make the decision.

Mr. SAMUEL. You're talking about administrative arrangements, Congressman. I think the act already indicates areas in which credit can be directed. And I think Congress can do that. I think the specific day-to-day decisions obviously will be made by——

Mr. J. COYNE. I wanted to clarify the allocation of credit to our private sectors—not made by collection of 19 or 10 or 15 corporate executives. It is made by probably the most diverse set of financial institutions in the world, which includes tens of thousands of corporations, stockholders, investors, savings institutions, and what have you. And I appreciate your paranoia of a conspiracy theory, but I would be far more afraid of 10 or 15 Federal Reserve Commissioners than I would of the diversity of the American financial institutions.

Mr. COAN. Mr. J. Coyne, we have credit allocation now by the Federal Reserve. It is credit allocation by the decisions they make on the money supply. It is an allocation by price.

Is this society of ours one in which the benefits go only to those who pay the highest price? If that is so, then I don't think we should have any government whatsoever. We have allocation now; it is a price allocation.

Mr. J. COYNE. I would love to answer your question. I have to get leave from the Chairlady to do it. My time has expired.

Ms. OAKAR. You can respond, in about 30 seconds.

Mr. J. COYNE. In no way do I support the allocation of credit by the Federal Reserve as they currently exist. Of course, Congress, in its wisdom, responding to the request of many of the savings institutions, demanded that the Fed be given that authority. That authority was wrong. We are beginning to pay the price for that artificial constraint of free market forces in a competitive marketplace.

Mr. COAN. And then you would do away with the Federal Reserve?

Mr. J. COYNE. I would certainly not do away with the Federal Reserve, but I would suggest that their artificial controls, telling people that they are only allowed to earn 5 percent on their passbook savings account, telling them that they are only going to get 70 percent of the Treasury bill rate, is a very, very artificial restraint. We should give the true American marketplace the right to determine those rates. That would be far more effective than trying to give the Federal Reserve or elected politicians such authority.

Mr. COAN. Well, I would say, unless the Federal Reserve has some function, then it should be done away with. And that function it is exercising right now—and what we're saying is that it is exercising that function in a fashion that hurts, unjustly and disproportionately, important segments of this economy—housing, small business, agriculture, the ability of communities to build their infrastructure.

Ms. OAKAR. I'm going to have to interrupt.

Mr. Frank.

Mr. FRANK. Thank you, Madam Chairman.

I'm not sure if I should address my questions to my colleague or the panel, so I will try the panel.

I apologize for missing the initial presentation. I did get a chance to read the statement. There has been a lot of emphasis on the Federal Reserve's decision to make the money supply very tight and some question about whether they have that much independence.

The Congress is not, on the whole, participating in that decision to tighten, but it does seem, in fairness to Mr. Volcker, that the responsibility for that decision ought to be shared.

My understanding—and I would like your comments on it—is that, in fact, the Federal Reserve was under pressure from the administration earlier this year because it wasn't being tight enough, that Mr. Sprinkle was, in fact, beating Mr. Volcker over the head fairly regularly, until some kind of a peace treaty was worked out.

We heard Mr. Volcker yesterday. The logic of his testimony, the thrust of his testimony was, in fact, to argue against at least a third round of tax cuts and perhaps more.

In answer to what somebody raised before, Mr. Volcker made it very clear, after a lot of work, that that third round of tax cuts in particular locked in, without any commensurate ability to cut spending in that way in advance, and it would have upward pressure on the interest rates. And my sense is that there has been sort of accommodation between the Fed and Mr. Volcker. Mr. Sprinkle won't criticize Mr. Volcker's monetary policy, and Mr. Volcker won't criticize Mr. Reagan's tax policy. But I think we ought to understand that this proposal to tighten the money supply and that the excessively high interest rates we now have is not really wholly the Fed's decision. It was—wasn't there an awful lot of Reagan administration pressure to reach, in fact, that goal?

Mr. TURNER. It was a decision made by Mr. Volcker before Reagan came in as a matter of fact. Some 4 weeks after Mr. Volcker had taken office, I was speaking to a high administration member of the Carter administration, and I said, "What has happened here?" And he said, "Well, Volcker is out of control; he's out of control." Actually the Federal Reserve, as we said—as I said, at least, in my earlier statement here, I think is entirely too independent of the Congress, too independent of the executive. And anyone who is charged with the responsibility of trying to have a full-employment economy needs to have control over their monetary policy as well as their fiscal policy, which you don't have.

Mr. FRANK. I understand that was the general direction, Mr. Turner, and I guess it is one of many commentaries on the Carter administration, that 4 weeks after making that major appointment, they were professing total lack of responsibility or accountability.

But it is true, wasn't it, that during this year, the Reagan administration, to the extent that it was pressuring the Federal Reserve, was pressuring them to tighten up on the money supply?

Mr. TURNER. Yes, that is correct. But they are appointed for 14 years, and the pressures of the President sometimes don't work very well. There have been a number of cases where, beginning about 1953, where there has been disagreement and conflict between the President of the United States as well as the Congress and the Chairman of the Federal Reserve. Normally, the Federal Reserve Chairman seems to be able to dominate the Board.

Mr. FRANK. I don't think there's any question about that.

With regard to what we are getting now, I would just like to follow up a little bit on what Mr. Lowry was asking. The Reagan administration does seem committed—and let's focus in part on them, because they're going to have the decisions—to the extent that we're going to get any anti-inflationary policies, to the extent we're going to get restraint in trying to wring some of the inflation out of the economy in the next couple of years, as I look at the proposals for spending—some social cuts, but also some defense increases and with really very large tax cuts—it looks as if, to the extent there is anti-inflationary policy at all in the next 2 or 3 years, it is going to be monetary policy.

What is the effect likely to be on various sectors you represent of an almost total reliance on monetary policy? In fact, as we look at what's going to be going on with the budget, it is going to be a reliance on monetary policy to offset what looks to almost everybody to be somewhat stimulative fiscal policy. What do you think the impact is going to be on the sectors you represent?

Mr. TURNER. The sectors we represent are going to be adversely affected, and I think that is why we are here—because we in particular, whether it is the intent or not, people who need a lot of credit are the ones who are hurt the most by this policy. And of course there are so many industries like, as we've talked about, the auto industry, we talked about construction, we talked about housing, we talked about farmers, we talked about municipalities, States, et cetera—it isn't only the cost of the loan, but it is the carrying of the loan. It is just like with the Federal Government—

$85, $96 billion, whatever it is, for the cost of interest on the Federal debt.

Mr. FRANK. If I could interrupt, I really would like to ask everybody to respond to this. The independence of the Federal Reserve Board is a fact, at least, for the foreseeable future. The question is, as you said, Congress has a choice, the Fed having made it clear that they're going to keep the money supply tight and interest rates consequently quite high, as long as that deficit persists and in fact grows in some ways—Mr. Volcker made that clear—would you propose some effort to change that tradeoff over the next few years?

It looks as if, as I said, we're going to be told it's going to be all monetary restraint over the next few years, and the only way we're going to be able to effectively lessen that is by some moderation of the fiscal crunch which seems to me to be some lowering of the proposed tax cuts and some reduction in defense spending.

I would like all of your opinions on that tradeoff.

Mr. COAN. I would endorse lowering the tax cut and reducing defense spending.

Mr. STAFFORD. I would do the same. Also, I think, as representatives of the public, if we go with the free-market approach to credit allocation, if you continue as you have in the past, agencies like EDA in the Department of Energy and so forth to have credit and SBA to have credit allocation tools for those high-risk parts of our society where the public and local governments need help.

Mr. FRY. Speaking only as a private individual, I would endorse both of those moves.

Mr. MULLINS. I would also.

Ms. OAKAR. Thank you, Mr. Frank.

Mr. Coyne?

Mr. W. COYNE. Thank you, Madam Chairman.

I would like to commend Mr. Stafford for being, first of all, the one on the panel—it may be because he was the first to have a chance to recommend that maybe we do forego the tax cut as a way of reducing the deficit and ultimately reducing inflation and hopefully reducing interest rates. But I would like to ask Mr. Samuel if there are any conclusive studies that your organization has done that could be submitted to this committee that indicate that a higher interest rate structure in the country ultimately leads to higher unemployment.

Has your organization done any studies at any time that would show that?

Mr. SAMUEL. We have not. I think such studies are available. We are not a research organization. But studies have been available which certainly link high interest rates to unemployment and inflation. And I think—I'm not sure you were a Member of Congress at that time, but during the consideration of the Humphrey-Hawkins bill a good deal of discussion was devoted to this subject, and I think the consensus of Congress and the administration at that time was—that is why it is called the Humphrey-Hawkins Full Employment and Balanced Growth Act—recognizing the links between those aspects and stating as public policy in this country that full employment makes more sense in terms of a rational economy rather than unemployment, which is a direct consequence of high interest rates.

Mr. W. COYNE. Well, I understand that you are not a research organization. I just thought that the American labor movement being committed to a full employment economy might have somewhere in their files that kind of a study. But as you indicate, that may have been submitted during the debate on the Humphrey-Hawkins Act.

Thank you.

Ms. OAKAR. Mr. Hoyer?

Mr. HOYER. I want to join my colleagues in thanking everybody on the panel for the work that has gone into this study. I am particularly concerned, as I know Mr. Turner is and particularly Mr. Coan, with the depressed nature of the housing market.

Other than high interest rates, Mr. Coan, what specific actions would you suggest that Congress take with respect to the housing industry?

Mr. COAN. Well, partly as a result of high interest rates, we are confronted with a destabilization of the principal source of mortgage financing for housing. The savings and loans and mutual savings banks, the principal lenders for the single-family house are not in the business of making many loans these days.

I don't know an answer to that, other than bringing the rates down and therefore bringing the cost of their money down. Until that happens, you're not going to get much money out there.

Certainly, one thing we should do is look to other sources of money for mortgage credit, and one of those is the pension funds—an idea and a subject that has been discussed at great length in this committee and other committees of this Congress for—well, I've been involved in those discussions for 12 years, and I'm sure they took place for many years before I got involved in them.

There are $300 to $400 billion in the pension funds. I would subscribe to the theory that they have a social responsibility to put some percentage of their funds into housing investment. And if they don't do it, they should undergo a penalty under the tax laws or something because of that.

We need some time to try to balance out these great wild swings or wide swings that take place in housing. Unless and until that is done, you are going to continue to have shortages and bidding up of prices on housing, when we are not producing enough. Then you are going to have shortages of materials and capacity in the plants that produce those materials when you get up at the top of the cycle. We never seem to be able to get anywhere near an even production level. Certainly some variation would be all right, but if the savings get too wide, they're just outrageously harmful to that industry and to the people that are looking for housing and to the whole economy of the country.

Mr. HOYER. Thank you. One more question, if I might.

I think it was pretty much a universal view of the panel, as I understood it, that we forego the tax cut. Now is that an across-the-board foregoing of the tax cut? Obviously, there are two aspects to the tax cut—essentially the personal tax cut and the business incentive, if you will, aspect of the tax cut.

I would like just briefly if each one of you could say whether or not you perceive them to be separate.

Mr. TURNER. Well, as an individual, I would say that I favor the—I'm against any tax cut for individuals. I think in terms of the business tax cuts, as I indicated later, that I think that we ought to look at incentives in the tax structure that will cause a greater investment in new plant and equipment. And so to that extent, I would be in favor of some tax cuts for business.

Mr. SAMUEL. Could I just add one comment which, perhaps, will amplify that? Incentives, we hope, which would lead to useful investment, unlike 10-5-3 where 40 percent of it will go to the oil companies and regulated public utilities.

Mr. HOYER. Would anyone else like to respond?

Mr. COAN. Well, I think I would somewhat share the view of Mr. Samuel that certainly those tax incentives that produce a real result are the ones that should be encouraged. I have a somewhat jaundiced view as to whether that is a successfully achievable thing. And I also have a jaundiced view as to whether it is achievable to forego the tax cut, at least to some extent. Certainly, the 3-year proposal, going so far out in the future, doesn't make sense.

Mr. HOYER. We are apparently all suffering from that jaundice.

Thank you, Madam Chairman.

Ms. OAKAR. Thank you, Mr. Hoyer.

Mr. Patman?

Mr. PATMAN. Thank you, Madam Chairman.

Let me just address the entire panel, and if you could make your answers as short as possible, I would appreciate it.

Is the prevailing high interest, the one that we have had over the last couple of years, artificially high by reason of the actions of the Federal Reserve?

Mr. TURNER. In my opinion, that is true.

Mr. PATMAN. Do you have any idea of what it would be, absent the actions of the Federal Reserve?

Mr. TURNER. I do not. But I think that entirely too much emphasis has been placed upon it. And I know that some people have been recommending that Congress enact legislation requiring the Federal Reserve Board to do all it can to reduce interest rates by 2 percentage points a year, instead of increasing them, until interest rates are at least 50 percent lower than they are now.

The problem here now is that the Fed has such great independence that it acts pretty much the way it sees fit.

Mr. PATMAN. Do you see the interest rate as being lower, were it not for the Federal Reserve's actions in raising the discount rate and other actions?

Mr. TURNER. Yes.

Mr. COAN. Mr. Patman, I agree that it is artificially high. It is interesting that another member, Mr. Weber I believe it was, talked about the interest rate reflecting an inflation factor plus a standard earning on money, which I think is around 3 percent. If that were so, we would have lower interest rates today with the inflation rate having come down somewhat in the last several months.

Mr. PATMAN. What portion of our present inflation rate is a result of the artificially high interest rates that we have had in effect over the last couple of years? Does anybody care to make a stab at that?

Mr. COAN. I don't think anyone can say specifically.

Mr. PATMAN. But you feel that—is it correct to say that each one of you feels that the inflation rate that we now have is higher because of the high interest rate policy?

Mr. SAMUEL. Let me venture a response to that. Not specifically, because I don't think that is possible, Congressman. But it is, I think, by a number of economists assumed that something like 60 percent of our inflation is caused by microfactors—energy, interest rates, and food costs being the principal ones.

Mr. PATMAN. Is it true then—I assume that it is, and one of you alluded to it a moment ago—that interest rates, high interest rates, are being used as a form of credit allocation intentionally?

Mr. TURNER. I think they are intentional in the sense of trying to cool off the economy, but the result is not that way. There is no evenhanded impact. And those of us at this table feel that we are being impacted unduly, whereas other sectors of the economy are not being impacted. Or if they are being impacted, it probably is favorable rather than nonfavorable.

Mr. COAN. I don't think it is being done with the intent—the action of the Federal Reserve is intentional—to put the money into the hands of this set of borrowers as opposed to that set of borrowers.

Mr. PATMAN. I'm talking about when you raise the price. Then you exclude a lot of people who cannot obtain credit.

Mr. COAN. Commonsense tells you where it's going to go when you raise it as high as it is today.

Mr. PATMAN. Well, you have kind of an odd situation with the short-term rates being higher than the long-term rates. And that is one of the fundamental problems in the whole situation, isn't it?

Mr. TURNER. Well, eventually the long-term are going to continue to go up. Of course, there is the expectation that they will go down eventually.

Mr. PATMAN. Well, the question that I really have now—and I'm really running out of time—is, who on behalf of the President last year, President Carter's policy, got him to lay off the Federal Reserve when they started boosting the rates back up? Who got the administration to sit on the sidelines while they were tightening the screws? That sort of led this country toward possibly a deep depression or at least a severe recession.

Ms. OAKAR. In other words, do any of you gentlemen take credit for that?

Mr. PATMAN. Well, if you will tell me about that, I would like to know for my own personal information just what happened on that.

Mr. COAN. I think Mr. Carter wanted a person in as Chairman of the Federal Reserve who had credibility and respectability in the financial community, and Paul Volcker did have that. I think that if you could have looked back at Paul Volcker's past views and philosophies that you could have predicted to some extent the degree or the route which the Fed has taken.

I think it is also fair to say, as Mr. Frank has pointed out, that the Federal Reserve is doing what this administration wants them to do right now, to some extent, maybe not always to the same degree they would want, but that has just pushed the Fed even further into this approach.

Mr. PATMAN. Well, I don't doubt that it is working hand-in-glove with the administration now. But in the previous administration, I'm surprised that they were able to do what they did without some complaint from the administration.

Ms. OAKAR. I think your time has expired, Mr. Patman; I'm sorry.

Mr. Vento?

Mr. VENTO. Thank you, Madam Chairperson. I appreciate your indulging me in a couple of questions. I will try to be brief.

I appreciate your coming forth. I think it rather unique to have a statement put together by various sectors from labor, utilities, the farming sector. It almost looks like part of my State, the DFL.

But, Madam Chairman, it is interesting to listen to the discussion that we've had, and I'm sorry I was not here for all of it, but one of the points was, the October 1979 monetary aggregate policy really leaves the Fed with less control over the interest rate. In other words, they are targeting the monetary aggregates, whatever they are—M1A, B and so forth and so on. And the fact of the matter is, that they are looking less at the interest rates, and claiming that monetary control is actually being accomplished by virtue of a free marketplace. That is to say, the banks and others are making those determinations on their own. So we have sort of this pulling and pushing in terms of the prime rate.

Now of course, you are probably aware of the fact that the prime rate has been a major issue under the leadership of Chairman St Germain. The chairman has pointed out that the prime rate, whatever the psychological effect of it is, is not uniform and there are many disparities between what any two customers might pay at a bank. So the fact is that we do have today, for instance, a circumstance where it isn't really the Fed that is making the determination as to who is getting credit, but it is financial institutions, and very seldom does anyone pay exactly what the prime rate is.

But what is the effect or what has been the effect of that in the various sectors? Utilities, I think we see an example here where we have just about destroyed the long-term bond market. With housing, we see the number of starts suppressed for the second consecutive year with this policy. And you see the Federal Reserve Board really exercising no control over this. They are dealing with monetary aggregates; they are not keying to interest rates.

Do you think that the Fed ought to focus more on what the interest rate is again, as they had prior to this October 1979 change, Mr Turner?

Mr. TURNER. Well, the result is the same. I mean, when they try to limit the money expansion to 2.2, which they are doing now, as against what a lot of economists ought to be about 4-percent monetary growth each year, why anyone can predict what the results are going to be.

And this tightening down of money, I think, has obviously become a cause and not a cure for inflation. And of course, as it cuts across the economy, there are so many in small business, construction, the groups represented at this table and others who are not here who are adversely affected, while other groups seem to do quite well with it. Money is available; large corporations have the money, and so it is a discriminatory type of a program in terms of the business world. It certainly is as far as workers are concerned.

Mr. VENTO. But I think, though, when they were keying to interest rates, they had more direct control over it, and there was less of these disparities than we are seeing today. In fact, the disparities have grown under the Fed's policies. And so I would hope that we would look at those policies try to bring the Fed along, so that they would not use the system that they have been using. I think that the Fed has failed miserably in terms of what it has been doing in terms of credit extension and the cost of credit. I hope that we on this committee, at least, with Mr. Patman's help and others, can get the administration to recognize the shortcomings of the particular policies, both fiscal and monetary, that they have been advocating.

I would yield back the balance of my time.

Mr. TURNER. If Mr. Patman's father were alive today—well, he is probably turning over in his grave now.

Ms. OAKAR. Let me just conclude by asking my few questions. There have been a lot of articles, one I have in front of me that makes some recommendations and reference to the Federal Reserve Board. Apparently some people feel they have been given awesome powers that initially they were not supposed to have. Because the term of the Board members is so long, combined with the failure of the Board to really represent a cross-section of individuals who are so dramatically affected by their decisions; such as business, labor, farmers, consumers, et cetera, do you feel that we ought to change the manner by which Board members are appointed in terms of the length of term and background? Does anybody have any views on that?

Mr. TURNER. I think the term ought to be 7 years instead of 14 years. I believe that the chairman's term ought to be concurrent with that of the President. I think that we need to have a much broader base in the composition of the Federal Reserve Board of Governors. They are restrictive and limited in their experience and orientation and economic views, as coming from the banking community primarily, almost entirely. And I think we ought to see to it that business, labor, farmers, consumers are represented on the board. I feel it is just like putting the fox in charge of the henhouse to let the bankers determine what the interest rates are going to be. And I think that the Open Market Committee itself ought to be much more representative of a cross-section of the economy that being as it is now, five members drawn from the banking institutions, and then you have—I think you have a total of 19 on there, but they all come out of the banking institutions. Even though they may wish to be completely objective, when every time the interest rate is going to be raised, presumably you are going to get more profit, I just wonder how objective they can be.

And I think on the matter of, well, we mentioned before that there is a law on the books from 1969 that ought to be applied, but which was applied briefly in March, April and May, I believe, of 1980, which did result in a drop in the interest rates. But then that was changed very quickly. I think really the Federal Reserve Board in the United States is more independent of the Congress or the parliament and the executive than at any other ones of the modern industrial societies.

I don't know how Congress or a President can be held responsible for a full employment economy when they can't control their monetary policy. They may be able to control their fiscal policy, but they can't control their monetary policy under the kind of independence that we have given the Federal Reserve Board. It has been in effect since 1912, 1913 and it is high time for an overhaul of that law.

Ms. OAKAR. Mr. Mullins?

Mr. MULLINS. I just wanted to make one comment. During the confirmation hearings of the last member of the Board, in the Senate report that accompanied that confirmation, the Senate made it very clear, at least their feeling was that the next member of the board should come from the community representing either small business, or agriculture, and be a little bit more representative of the populace as a whole. I do hope, when and if this administration gets an opportunity for the next member of the Board, that they will pay heed to that Senate report.

Ms. OAKAR. Thank you. We had about 350,000 bankruptcies filed in 1980. What percentage of those do you think are small businesses? I know in my own area I am very concerned about developers and builders. On the outskirts of northeast Ohio there are small farmers who are going bankrupt. That seems to be a problem, doesn't it? And to what extent can we blame interest rates?

Mr. TURNER. Well, we have been told by our staff that the number of small business bankruptcies is soaring. We will ask our people, our staff people, to try to get some information on that, but the percentage is much higher than it was, as you indicate.

Ms. OAKAR. Did you want to comment, Mr. Mullins?

Mr. MULLINS. Well, I can't attribute a number to bankruptcies, but you know we are losing several thousand farmers a week. When you consider that this year interest will be the single largest expenditure in the budget, that has to impact on particularly the new, beginning entry farmer that has every little equity. So it certainly impacts when interest makes up that big a portion of your cost sheet.

Ms. OAKAR. Let me ask one last question, and then we will feel you have really done your duty today. We had, in my city of Cleveland last Friday, the Commissioner of Social Security who was supposed to talk to a group of people about social security, but he got into the whole program of economic recovery. One of the comments that he made to the audience was that if the economic recovery package, the interest rates obviously a part of it, is successful and if Congress does not obstruct Reaganomics, we will have so many jobs that we are going to have to look to the foreign market to full positions. We won't have enough Americans to fill those jobs.

Now, you are chuckling. It sounds preposterous, but that is one of the comments that was made by someone in the higher echelons of the cabinet, and I wonder if that is your projection with this so-called economic recovery package which we have before us.

Mr. STAFFORD. I think in Seattle we are trying to, and we've done quite a bit of work on the entire program as far as its not only geographic impacts, because all things will not happen the same in every location. What the impacts will be in Cleveland will be different than Seattle. Second, the timing of things. And I think, you know, maybe there is, I think, what we have been saying, a sunny day coming. But it's at least a 2 to 3 year gulf in talking to our local corporations as to when that will hit, and I think even right now, how do you get over the next 2 to 3 years?

Boeing, the largest corporation in the State, is laying off. The largest employer in the city limits of Seattle is our University of Washington and they are laying off because of the cuts in the education budget, the tuition increases and the student loan cuts. Our health industry is a major factor in Seattle; that is going down. The Port of Seattle Airport, we have had the first decrease in years in the people coming through. Tourism is a major industry in our State, and that is going down because of the airline situation and the Amtrak and the cost of fuel. And so when you look at the local sectors of one economy, Seattle's economy which is supposed to be the booming west, you know, we keep hearing we're the winners of this whole thing and the mayor keeps shaking his head and saying, "I'd hate to meet one of the losers."

You really wonder when it is going to come and where. And we have been unable, in our local economy, to see anything in the next 2 or 3 years, even if things work. Boeing tells us even if the defense contracts come they are not going to be hiring major numbers of people, at least for 3 to 4 to 5 years. The B-1 bomber is in the late 1970's, and so when you take that, the timber industry sees nothing for 2 to 3 years. It is—I don't know, I hope it comes.

Ms. OAKAR. Your futuristic projection is not quite the same as the Commissioner's?

Mr. STAFFORD. We know it is better than Cleveland's, and we hope you send us some of the largesse.

Ms. OAKAR. My Republican mayor opposes the package too, I want you gentlemen to know.

Mr. Samuel?

Mr. SAMUEL. Ms. Oakar, I just wanted to comment briefly. Almost every prediction made by almost every economist of whatever hue, suggests that where the employment situation is going to get far worse before it gets better. I think the point that has to be made is that it is already bad, and has been for several years.

Ms. OAKAR. So you don't see that in the future we are going to be importing all of these people to fill jobs, as the gentleman who came to my city told our senior citizens? One of the rationales for all of the social security cuts was that the savings would stimulate the economy and balance the budget. While I thought it was a preposterous statement, it was made nonetheless.

Mr. SAMUEL. It sounds as if he's trying to lay the groundwork for either the administration's guestworker program, which is not needed now, or the social security program which would keep people at work until age 68. Neither of those programs are warranted by the circumstances we face today.

Mr. STAFFORD. Of course, we're already bringing in 168,000 Southeast Asian refugees into the third largest State in the country, and we see those refugees in our schools now. They represent about 10 percent of the student body.

Mr. TURNER. If I could just put in one word here. A speech made the other day by Mr. St Germain, the chairman, said that, "The monetarist theories remind me of nothing so much as a great medical practictioners of the middle ages who used to treat illness by bleeding their patients."

Ms. OAKAR. Well, on that happy note, let me thank you on behalf of the chair for being here, and since the committee's schedule for tommorow is in flux, the hearings on monetary policy will continue subject to the call of the chair.

Thank you very much, gentlemen. The committee is adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned to resume on Thursday, July 23, 1981.]

[The following additional material was submitted for inclusion in the record. A statement of Dr. Jack Carlson on behalf of the National Association of Realtors, and a letter from Douglas A. Fraser, president, United Automobile Workers, dated July 22, 1981, with attachment, regarding the restrictive monetary policy of the Federal Reserve Board. The material follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
for
MONETARY POLICY HEARINGS
to the
HOUSE COMMITTEE ON BANKING, FINANCE
AND URBAN AFFAIRS
by
DR. JACK CARLSON
July 24, 1981

Chairman St. Germain, Congressman Stanton, and members of the Banking Committee, my name is Dr. Jack Carlson. I am Executive Vice President and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS®. I appreciate the opportunity to submit this statement on monetary policy in behalf of the 700,000 members of the NATIONAL ASSOCIATION OF REALTORS®.

Summary

Since October 1979, we believe the Federal Reserve Board has attempted to fight inflation including offsetting inflation fiscal policy followed by the Congress and the Administration. This has resulted in very limited growth in bank reserves and high interest rates.

o In pursuing this tight monetary stance, the Federal Reserve Board has moved away from moderating excessive fluctuations in short term interest rates toward attempting (with mixed success) to control the growth of credit aggregates. As a result, we have experienced wide swings in short term interest rates which directly reduces investment activity, particularly in sensitive areas such as housing. For example, we estimate that as much as 20% of the

decline in housing activity last year was due to excessive fluctuations in short term interest rates and 80% was caused by record average interest rates over the period.

o The uncertainty created by the new techniques of monetary control of the Federal Reserve Board, the very slow overall growth targets for credit aggregates and a continuing failure of both Congress and the Administration to demonstrate the ability to bring down inflationary deficits have all pushed up the real rate of interest--the premium for saving and cost of funds above expected embedded inflation. Whereas real long term interest rates averaged 2 to 3 percent over most of the post World War II period, they have averaged 5 to 6 percent over the past two years.

o Together with the marked acceleration in inflation, this has pushed interest rates to record levels, with conventional mortgages currently costing over 16.5 percent and the prime loan rate over 20 percent.

o These persistently high interest rates together with the transition to deregulation of commercial banks, savings and loan associations, and mutual savings banks, as specified under the Depository Institutions Deregulation and Monetary Control Act of 1980, are placing severe strains on the thrift institutions. High yields on competing credit instruments are causing outflows of savings at the nation's savings and thrift institutions and reducing the supply of mortgage funds. For example, so far this year, savings and loan associations have suffered a net outflow of savings of over $5 billion.

o To prevent even larger outflows of funds, thrifts have increasingly been forced to fund new and existing mortgage loans by issuing short term instruments such as 6-month money market certificates.

o Since in many cases the cost of funds to these institutions is greater than the yield on existing assets, the viability of many thrifts is threatened. Problem cases being monitored by the FSLIC have risen from 79 eighteen months ago to 263 in May 1981. The figure could reach 1,600 (or 1/3 of all S&L's) by the end of the year.

o The difficulties of many savings institutions, record high interest rates and slow growth in people's incomes have also caused severe downturns in the housing industry and other interest rate sensitive sections of the economy. Housing is currently suffering from the deepest and largest recession in post-war history, with starts at a one million unit annual rate (less than 50 percent of the demand for new housing) and sales of existing homes at a 2.6 million unit annual rate (or 60 percent of the demand of households to upgrade to more adequate housing or to find housing where better jobs are located).

o Bringing down inflation is a necessary step before lower interest rates can be achieved. We agree with Chairman Volcker that an effective program to restore price stability requires a long term policy reducing growth in money and credit over time to rates consistent with the growth of output and employment at stable prices. However, the current targets are too restrictive given the underlying rate of inflation and continuing high deficits.

o Even with a continuation of the Federal Reserve Board's tight credit policies, inflation and inflationary expectations are not likely to fall substantially below 8 percent over the next two years without slower growth in federal spending and smaller deficits. Trying to squeeze out more inflation with a too severe restriction of credit growth only stifles real growth and continues to place a disproportionate share of the burden of the inflation fight on housing and other interest sensitive investment.

o We believe that the Federal Reserve Board should allow a slightly faster growth of credit during the remainder of this year and in 1982 and that this can be achieved without jeopardizing the fight against inflation. Specifically, we believe that the Fed's target range for growth in the broadly defined money stock (M2) be increased to 7 to 10 percent for both 1981 and 1982 (up 1 percentage point from the levels announced by Chairman Volcker on July 21) and that other credit growth targets be adjusted accordingly.

o Consistent with these targets, the Federal Reserve Board should also attempt to reduce excessive fluctuations in short term interest rates. In other words, the monetary authorities should move to include dual targeting system (of interest rates and credit growth) used for monetary policy before late 1979.

o Inflation cannot properly be brought under control by restricting money supply alone. Federal deficits must be reduced. The Administration and Congress have begun the process of turning the tide of increasing government spending, but it must do more if the federal deficit is to be reduced. We advocate further slowdown in government spending and that any additional tax relief must be tied to lower spending so that the federal deficit will trend downward each year towards balance over the next 4 years. Also a larger share of any future tax relief should be devoted to increasing savings and investment.

o Although the proposed Tax Exempt Savings Certificates will provide some relief to thrift institutions, the short term nature of the plan reduces its effectiveness in stimulating savings and meeting long term housing and industrial needs. The proposed expansion of the Individual Retirement Account and Keogh provisions, while a step in the right direction, are also insufficient to provide the needed long term boost in personal savings.

o A slightly less restrictive monetary stance and a tighter and better directed fiscal policy would more evenly and fairly place the burden of fighting inflation, would be more effective in lowering inflation and interest rates, would better encourage investment in housing and industry, would prevent a renewal of long run inflation in the future from capital housing shortages and would lend to stronger growth overall.

The Impact of Monetary Policy on Thrifts and Housing

Excessive and sole reliance has been placed on monetary policy in the fight against inflation rather than monetary policy being used in concert with fiscal policy. The result of this predominant use of monetary policy has been record interest rates causing disproportionate suffering by small business, the nation's savings institutions, and credit sensitive industries such as housing and autos.

The impact of the housing industry has been severe. The housing industry is currently suffering from the deepest recession in post-war history. Housing starts are at a 1.03 million unit annual rate currently, and expected to average only 1.27 million units for 1981--virtually the same as last year. We expect only 1.66 million starts in 1982 and 1.86 million starts in 1983. Since the underlying demand for replacement and new housing is about 2 million units per year, housing supply is expected to continue far below the underlying housing demand. The implication is for housing to be in short supply throughout the 1980's as industry capacity will not be able to both supply the growing needs of expected demographic demands and the leftover unsupplied demand of the current housing recession. This will only add to future increases in housing prices and rents, and increase upward pressure on the long term rate of inflation.

Housing prices account for 10% of the consumer price increase. Inasmuch as the growing shortage will likely cause 1 to 2 percentage points faster use in housing prices as the average of all prices, we can expect the CPI will increase by 0.1 to 0.2 percent each year just from this source alone.

Resale activity has also dropped from its November 1978 peak of 4.02 million units to a low in May 1980 of 2.35 million units. The level of resale activity has not recovered to the 1978 level even as of this June. This 32-month old protracted housing recession is therefore not only the steepest, but also the longest housing downturn since statistics have been gathered on the resale market (see Table 1).

TABLE 1

PERIODS OF DECLINE IN EXISTING HOME SALES
(Seasonally Adjusted Annual Rates, Million of Units)

Housing Recession	Peak	Trough	Recovery to Prior Peak	Percent Decline Peak to Trough	Total Duration Peak Through Recovery
1969-1970	Dec. 1968 1,710,000	Mar. 1970 1,370,000	Aug. 1970 1,720,000	-20%	20 months
1974-1975	Feb. 1973 2,500,000	Jan. 1975 2,040,000	Sept. 1975 2,600,000	-18%	31 months
1979-1981	Nov. 1978 4,020,000	May 1980 2,350,000	???	-42% (?)	32 months so far

This exceedingly long housing recession has had wider economic impact than new starts and resale activity. The slow sales pace during the current housing recession has certainly been having a tremendous impact on the overall economy and on the economies of local communities throughout the country. When an existing home is sold, many people besides the buyer, seller, mortgage lender and real estate practitioner gain from the transaction. There are a host of businesses that depend on a healthy housing market for their livelihood. Some businesses benefit directly at the time of sale (household movers, attorneys, appraisers, insurance and title companies, etc.); some before the sale (local merchants and contractors selling supplies or services to fix up the home for sale); and some after the sale (businesses selling supplies, services, furniture and appliances to the new homeowner to customize his or her new home).

It is estimated that these direct expenditures (again excluding expenditures going to real estate practitioners and mortgage lenders and the sales price of a home) generated prior to, during and after a home is sold may typically amount to $5,000 to $7,000 for each home. The impact is even greater when the subsequent rounds of spending that are generated are considered. These indirect expenditures may add an additional $10,000 to $15,000 for each home sold. Thus, the estimated economic benefit derived from each resale transaction may range from $15,000 to $20,000. With sales of existing single-family homes off about 1.2 million units in 1980 and a similar loss expected in 1981, the loss to the local business each year is $18 to $24 billion, excluding purely real estate and financial services. This is equivalent to about one-half million jobs just from this limited estimate of harm created by disproportionate harm to existing home transfers.

The current problems of the housing industry are to a large degree the result of the inability of our nation's thrift industry to cope with the high and volitile interest rates that result from overreliance in restrictive monetary policy to fight inflation. The thrift industry, due to high market interest rates, and new deposit opportunities for small savers, has suffered large outflows from deposit accounts which had regulated fixed interest rates ceilings.

These accounts represented more than 50 percent of savings and loan deposits in the past and ensured a stable cost of funds for thrifts. This stability in borrowing costs had allowed the thrifts to offer long term fixed rate financing for home purchases and allowed the proportion of American families owning their homes to grow from less than 48% in 1930 to more than 65% today. Now, however, the regulated rate accounts represent only 20% of savings and loan deposits, and the predominant share of deposits are in market rate yielding accounts with 6 months maturity. The result has been that the cost of mortgage credit continues to be staggering. Mortgage interest rates have remained record high throughout the first half of 1981, keeping many potential home buyers on the sidelines waiting for more favorable times. The average effective commitment rate on

80 percent, 30-year mortgages stood at 16.8 percent in June, up from the 15.6 percent average it had been holding during the first five months of the year. Mortgage rates are expected to decline gradually through the next few months and should drop below 15 percent by late summer. However, without a dramatic decline in interest rates and the average cost of funds at thrifts, currently at 10 percent, it is unlikely that mortgage rates will drop much below 14 percent in the near future.

Average Effective Commitment Rate
On Conventional Home Mortgages
(80 Percent Loans with 30 Year Term)

	Rate	Change in Percentage Points
1978	9.78	0.76
1979	11.35	1.57
1980	14.02	2.67
1981: Jan	15.40	0.45
Feb	15.36	-0.04
Mar	15.50	0.14
Apr	15.59	0.09
May	16.16	0.57
Jun	16.81 (Record)	0.65

Source: Federal Home Loan Bank Board

The transition to deregulation of commercial banks, savings and loan associations, and mutual savings banks, as specified under the Depository Institutions Deregulation and Monetary Control Act of 1980, along with persistently high interest rates are placing severe strains on the thrift institutions. The ability of these institutions to attract and keep deposits is obviously a key factor in maintaining a viable housing market as together they account for nearly 75 percent of all mortgage loan originations. The health of the S&L's is of particular importance since these institutions alone originate nearly half of the total dollar volume of mortgage loans.

Unfortunately, in today's money market environment the S&L's are in desperate condition. High interest rates offered by competing investments and the federal government's tight credit policies have led to substantial deposit outflows from these traditional mortgage lenders. After a huge outflow in March, net deposit outflows from savings and loan associations hit a staggering $4.6 billion in April, followed by a much smaller decline in May. Money market mutual funds have been the chief competitor for these deposits--since the beginning of the year these funds have gained an average of $2.7 billion per week. Deposits are not expected to exhibit the strength of previous years until a noticeable reduction in the yields offered by the money market funds.

	Net New Savings Received at Federally Insured S&L's (Millions of Dollars)		Money Market Mutual Fund Shares (Millions of Dollars)	
	Amount	Cumulative Amount	Amount	Increase
1978	$23,462	-	$ 10,300	$ 6,500
1979	15,030		43,600	33,300
1980	10,669	-	75,800	32,200
1981: Jan	559	599	80,700	4,900
Feb	879	1,478	92,400	11,700
Mar	-2,137	-659	105,600	13,200
Apr	-4,638	-5,297	117,100	11,500
May	-161	-5,458	n/a	n/a

Source: Federal Home Loan Bank Board

Source: Board of Governors of the Federal Reserve System

The thrift institutions, the housing industry, small business, and all other credit sensitive industries will remain depressed until both inflation and interest rates are brought down.

Since October 1979, the Federal Reserve Board has been attempting to fight these inflation causing loose fiscal policies with very limited growth in bank reserves and high discount rates. In pursuing this tight monetary stance, the Federal Reserve Board has moved away from moderating excessive fluctuations in short term interest rates toward attempting (with mixed success) to control the growth of credit aggregates. As a result, we have experienced wide swings in short term interest rates which directly reduces investment activity, particularly in sensitive areas such as housing. For example, we estimate that as much as 20% of the decline in housing activity last year was due to excessive fluctuations in short term interest rates rather than the high average interest rates over the period.

The uncertainty created by the new techniques of monetary control of the Federal Reserve Board, the very slow overall growth targets for credit aggregates and a continuing failure of both Congress and the Administration to demonstrate the ability to rein in spending growth and bring down future deficits have all pushed up the real rate of interest--the premium for saving and cost of funds above expected inflation. Whereas real long term interest rates averaged 2 to 3 percent during the post-war period, over the last 2 years they have risen to 5 to 6 percent and higher.

Together with the marked acceleration in inflation, this has pushed interest rates to record levels--20 percent or more for the prime loans, 16.8 percent for new mortgages and 15 percent for six-month money market certificates. With interest rates this high, the thrift industry could lose $4 to $6 billion in 1981, forcing many savings and loans to fail. The problem cases being monitored by the FSLIC has increased from 79 in December 1979 to approximately 263 in May 1981, and could reach as many as 1,600 or 1/3 of all S&L's, according to the FHLBB chairman, by the end of the year.

The impact of a large number of thrifts in distress on the financial industry, housing and economy in general should not be underestimated and would require expensive government aid. The impact on the housing industry would be nothing less than catastrophic.

We agree with Chairman Volcker that an effective program to restore price stability reuires a long term policy reducing growth in money and credit over time to rates consistent with the growth of output and employment at stable prices. However, the current targets are too restrictive given the underlying rate of inflation and continuing fiscal indiscipline. Given current and expected conditions, the targets leave too little room for real economic growth.

Even with a continuation of the Federal Reserve Board's tight credit policies, inflation and inflationary expectations are not likely to fall substantially below 8 percent over the next two years. Trying to squeeze out more inflation with a too severe restriction of credit growth only stifles real growth and continues to place a disproportionate share of the burden of the inflation fight on housing and other interest sensitive investment.

We believe that the Federal Reserve Board should allow a slightly faster growth of credit during the remainder of this year and in 1982 and that this can be achieved without jeopardizing the fight against inflation. Specifically, we believe that the Fed's target range for growth in the broadly defined money stock (M2) be increased to 7 to 10 percent for both 1981 and 1982 (up 1 percentage point from the levels announced by Chairman Volcker on July 21) and that other credit growth targets be adjusted accordingly. Consistent with these targets, the Federal Reserve Board should also attempt to reduce excessive fluctuations in short term interest rates. In other words, the monetary authorities should move partially back towards the dual targeting system (of interest rates and credit growth) used for monetary policy before late 1979.

Inflation cannot properly be brought under control by restricting money supply alone. Federal spending must be reduced to bring government deficits down. The Administration and Congress have begun the process of turning the tide of increasing government spending and deficits, but much more must be done. We advocate further slowdown in government spending than has so far been proposed and that tax relief must be tied to lower spending so that the federal deficit will trend downward each year towards balance over the next 4 years.

In particular, we are concerned that the spending slowdowns proposed by Congress may not be realized, especially in FY1983 and FY1984. This failure to achieve targeted spending slowdowns has already begun. The spending slowdowns were originally expected to result in total spending cuts of about $46 billion, limit FY1982 spending to $695 billion (up 6.1 percent from FY1981) and result in a deficit of only $28 billion. However, the mid-year budget estimates have revised the budget upward to $705 billion. The subsequent "re-estimates" are likely to increase the budget to $715 to $725 billion. This would increase the deficit from $28 billion to $50 to $60 billion, no lower than the FY1981 deficit.

While overall, tax relief should be smaller than spending slowdown, a larger share of tax relief should be devoted to increasig savings and investment than is proposed in the bills currently before Congress. The Administration and Congress have moved to improve the depreciation portion of the planned tax relief by eliminating the discriminatory treatment on rental housing proposed earlier--all real property would at least be subject to uniform tax lives under the new plan.

However, the plans call for little direct stimulus to savings and housing beyond the first 15 months. Although the proposed Tax-Exempt Savings Certificates will provide some relief to thrift institutions, the short term nature of the plan reduces its effectiveness in stimulating savings and meeting long term housing and investment needs. The proposed expansion of the Individual Retirement

Account and Keogh provisions, while a step in the right direction, are also insufficient to provide the needed long term boost in personal savings.

A better mix of federal economic policies--with a slightly less restrictive monetary stance and a tighter and better directed fiscal policy--would more evenly share the burden of the inflation fight, would be more effective in lowering interest rates and inflation, would better encourage increases in investment and housing, would prevent a renewal of long run inflation in the future from capital housing shortages and would lend to stronger growth.

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INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA-UAW

DOUGLAS A. FRASER, PRESIDENT RAYMOND MAJERUS, SECRETARY-TREASURER

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July 22, 1981

The Honorable Fernand J. St. Germain
Chairman
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D. C. 20515

Dear Chairman St. Germain:

I deeply regret that I was unable personally to attend your hearings on current monetary policy. The restrictive monetary course pursued by the FRB — with the Reagan Administration's blessing — is among the most important and most harmful public policies affecting the 1.3 million members of the UAW, and their families, today.

For the last two years the Federal Reserve has conducted a disastrous monetarist experiment. Its sustained policy of tight credit has no precedent in American history, as Table 1 (attached) demonstrates.

The expansion and contraction of money and credit regulate the growth of our economy. As we have learned from bitter experience during these last two years, when credit is prevented from expanding in consonance with the underlying momentum of the economy, that momentum is slowed or even shifted into reverse. As soon as brakes on credit are applied, sales of items normally purchased on installment are hurt: money for buying homes, cars and other durable goods dries up. When these credit-sensitive sectors are forced to reduce output, they drag the rest of the economy down with them.

Sowing the Seeds of Future Inflation

The monetarist experiment has had results that should disturb anyone concerned with investment and inflation. No sector of the nation's economy has escaped unscathed. Recessionary clamps on the growth of credit have pushed interest rates to all-time highs, even in relation to inflation rates. As financial institutions have expanded new forms of credit, the Fed has hit the brakes even harder on the forms of credit under its control.

The restriction of credit has two related effects on investment. First, as the reduced supply of credit depresses the entire economy, companies no longer want to expand production capacity. Second, high interest rates lead firms to abandon projects they would have undertaken at lower rates. The reduction in productive investment now will mean more inflation later; no doubt, that will be used to justify the next round of monetarist travesty — if we let it.

The instability of interest rates — both real and nominal — has taken its toll as well. The rollercoaster path of interest rates has created a bizarre feedback effect: borrowers accelerate their demand for credit when interest rates spurt because they expect them to rise still more, and postpone borrowing as rates fall because they expect them to fall yet further! The uncertainty that surrounds future borrowing costs has made it impossible for firms to evaluate the desirability of all but the shortest-term investments.

The Impact of Tight Money on UAW Members

The UAW represents literally hundreds of thousands of workers in credit-sensitive industries, including auto and auto parts, construction equipment, farm implements, and commercial aircraft, among others. Production and employment in all of these industries have been clobbered by tight money. Since these industries all manufacture durable goods, the great bulk of their sales are financed with credit.

In the case of two producers' goods that UAW members build — construction equipment and heavy trucks — tight credit has pummelled sales and employment, as potential buyers have lost access to credit, or have been able to obtain it only at exorbitant rates. Even more important has been the derivative effect: many buyers of construction equipment and heavy trucks have found it unnecessary to add to or replace equipment to handle their shrunken volume of construction or freight business. As a result, sales of medium- and heavy-duty trucks during the first six months of 1981 stood 41 percent below the level for the same period in 1979. Similarly, after seasonal and inflation adjustments, shipments of construction equipment were down 24.4 percent in the first quarter of 1981 from the third quarter of 1979. Employment in that industry dropped apace: more than 25,000 workers — fully 15 percent of the total workforce — lost their jobs.

Tight credit has also hit the demand for agricultural implements. The volume of shipments in that industry fell 20.3 percent from the fourth quarter of 1979 to the first quarter of 1981, putting 18,000 workers (11 percent of the workforce) on the street.

Parts supplier companies, especially smaller ones, have been hurt in unprecedented fashion by the credit crunch at a time when they have been forced to borrow heavily for working capital purposes, to finance new investment, and to develop the new products demanded by their customers. Thousands of jobs have been lost as many of these companies have cut back their operations or gone out of business. Business failures among transportation equipment companies rose from 38 in 1978 to 55 in 1979 and 92 in 1980.

To the extent that tight money has contributed to an unwarranted surge in the value of the dollar in recent months, there has been a further depressing effect on these basic industries as imports have been stimulated and U.S. exports have become less competitive in world markets.

Tight Money Crushes Auto Sales and Employment

The Federal Reserve's restrictive credit policies have played an important role in the nation's worst auto crisis since the 1930s. That crisis, now in its 28th month, continues unabated. Relative to the same period in 1978 — the industry's last healthy year — domestic car and truck sales are down 32%. In the big car companies alone, over

150,000 auto workers remain on indefinite layoff; that is down only two-fifths from the 1980 jobless peak. By contrast, three-fourths of laid-off auto workers had been called back within a year of the 1975 jobless peak. Countless thousands more remain unemployed in the supplier sector, where in the last 18 months we estimate that at least 180 plants have permanently closed.

While our nation's tragically misdirected trade policies clearly played a greater role than did tight money in permitting the current disastrous crisis to develop, restrictive monetary policy has been a critical factor in deepening and prolonging the crisis. The oil crunch of March 1979 swelled small car demand, to the great advantage of imported models. The downturn in auto, coupled with a tightening of monetary policy, threw the economy into recession. As real incomes fell, the usual recesionary switch in demand toward smaller, cheaper vehicles swelled import demand further still. Tight money also reinforced this switch through its effect on credit cost and availability. As Table 2 and Chart 1 of the Appendix show, tight money choked off sales recoveries in the spring months of both 1980 and 1981. Domestic sales had responded to the loosening of credit in December 1979 and January 1980, only to be slammed by the severe tightening of February-April 1980. Similarly, the rebound of Summer 1980 was stalled by the credit tightening that began in the Fall of 1980.

The most recent, further tightening of the monetary screws has doubtless been a significant cause of the latest disastrous automotive sales news. For the first ten days of July — 28 months after the onset of the current crisis — General Motors' sales were down 13.8% from their already-depressed year-ago level. Ford was down 34.2%; American Motors was down 18%; and even Volkswagen of America was down, by 14.6%. Only Chrysler showed a gain over its horrible previous year, with sales up 13.6%.

Compared with 1978, the declines were across-the-board at the Big Three, and even more severe: GM, down 40.3%; Ford, down 42.6%; Chrysler, down 24.4%. The annual sales rate for domestic new cars during the first ten days of July was 5.6 million — far below the 8.8 million annual rate of the comparable period in 1978.

The adverse effects of restrictive monetary policy on the automotive market are so serious that I want to cover them at some length, detailing the separate effects on consumers, manufacturers, and dealers. Most important, tight money does what its advocates intend it to do: it recesses the economy and holds down purchasing power. This affects all consumer expenditures, but postponable items — such as autos — are particularly hard hit. The purchase of consumer durables such as cars and trucks is also made more difficult by higher average monthly payments on loans and by the restricted availability of credit.

High interest rates raise the manufacturers' unit interest expense, which must be recouped in the sales price. Tight money also forces dealers to choose between losing sales due to inadequate inventory and risking bankruptcy by holding adequate inventory.

All of these effects are well documented. Real per capita disposable income declined 7.5 percent from the second quarter of 1979 through the second quarter of 1981. Over the same two years, the average new car finance charge rose a whopping 46.5 percent, while the average loan-to-purchase price ratio dropped — another indication of credit stringency.

The impact on cost and availability of new vehicle financing has been accompanied by tight money's devastating impact on manufacturers' financial condition and costs. Between 1978 and 1980, for example, Ford Motor Company experienced a 122% increase in interest expense despite a dollar sales decline of 13 percent. Between the same two years, Chrysler Corporation reported a 114 percent increase in interest expense; dollar sales tumbled 32 percent. The unprofitable position of these companies (itself caused in part by tight money) compelled them to take on more debt; moreover, higher interest rates contributed greatly to the skyrocketing of their interest expenses. Countless supplier companies have found themselves in an even worse predicament. Their auto company customers resist price increases necessitated by higher interest expenses that have been swollen by higher bank and finance company charges, sometimes in excess of 5% above "prime."

Borrowing costs have been rising just as the need for new debt has been at its peak. High interest costs are making an already painful "auto transition" unnecessarily expensive. This transition is vital to restoring our industry's competitiveness; yet the high cost of financing that transition threatens further erosion of U.S. automotive competitiveness, vis-a-vis Japanese and other foreign carmakers who have access to credit in their home countries at far lower rates.

High interest rates also expose dealers to unprecedented risk. In 1978, according to Automotive News, domestic auto dealerships closed their doors at an average rate of 8 per month. As interest rates rose, the monthly failure rate increased to 56 in 1979 and to 134 in 1980. In total, an astounding 2,537 auto dealerships — 10.6% of the total — disappeared between January 1979 and March 1981.

Conclusion

We have documented the havoc wreaked by a policy of tight money on industries employing UAW members. Others have testified eloquently about the effect of high interest rates on construction and other sectors of our economy. Western leaders, who met earlier this week in Ottawa, are lambasting the Reagan Administration — and the Federal Reserve policy it backs — for recessing the entire developed capitalist world economy in a misguided attempt to bring down inflation.

The only way that tight money policies fight inflation is by halting the growth of the real economy. The Administration and the Fed apparently are so concerned with lowering the inflation rate that they are willing to risk perpetual economic stagnation. This path is cruel, short-sighted, and inequitable. Moreover, it carries phenomenally high political and social costs. Monetarism, after all, came two years earlier in Britain than in the U.S.; one of the lessons to be learned from the British experience is that engineered austerity can undermine even the most stable society.

So long as monetary policy continues to depress the durable goods and construction industries, economic prosperity will elude our grasp. When the Fed once again permits normal credit expansion, those industries should rebound and give a vital lift to the American economy.

Sincerely,

Douglas A. Fraser
President

APPENDIX

TABLE 1
Real Prime Interest Rates

	Nominal Prime	GNP Deflator, Annual Rate	Real Prime
1973			
I	6.1%	5.5%	0.6%
II	7.0	7.3	-0.3
III	9.1	8.3	0.8
IV	9.8	8.6	1.2
1974			
I	9.3	12.3	-3.0
II	10.9	9.4	1.5
III	12.0	11.9	0.1
IV	11.0	14.4	-3.4
1975			
I	9.0	10.1	-1.1
II	7.3	4.5	-2.8
III	7.6	7.0	0.6
IV	7.6	7.1	0.5
1976			
I	6.8	3.2	3.6
II	6.9	5.2	1.7
III	7.1	4.4	2.7
IV	6.5	5.8	0.7
1977			
I	6.3	6.0	0.3
II	6.4	7.7	-1.3
III	6.9	5.1	1.8
IV	7.7	5.5	2.2
1978			
I	8.0	7.2	0.8
II	8.3	11.0	-3.7
III	9.1	6.9	2.2
IV	10.8	8.2	2.6
1979			
I	11.8	8.4	3.4
II	11.7	7.8	3.9
III	12.1	7.8	4.3
IV	15.8	8.1	7.7
1980			
I	16.4	9.3	7.1
II	16.3	9.8	6.5
III	11.6	9.2	2.4
IV	16.7	10.7	6.0
1981			
I	19.2	9.8	9.4
II	18.9	8.5e	10.4e

SOURCE: Department of Commerce, Business Conditions Digest, various issues.
e = estimated

TABLE 2

Prime Interest Rate		Retail* Sales of New Domestic Cars and Trucks (seasonally adjusted annual rate)		Auto Industry Unemployment Rate	
7/79	11.54%	8/79	11,200,000	9/79	8.5%
10/79	14.39	11/79	8,800,000	12/79	12.7
1/80	15.25	2/80	9,900,000	3/80	15.7
4/80	19.77	5/80	6,900,000	6/80	24.6
7/80	11.48	8/80	9,200,000	9/80	21.6
10/80	13.79	11/80	9,200,000	12/80	17.5
12/80	20.35	1/81	8,600,000	2/81	18.9
4/81	17.15	5/81	7,900,000	6/81	NR
5/81	19.61	6/81	7,600,000	7/81	NA
6/81	20.06	7/1-10/81	7,300,000	8/81	NA

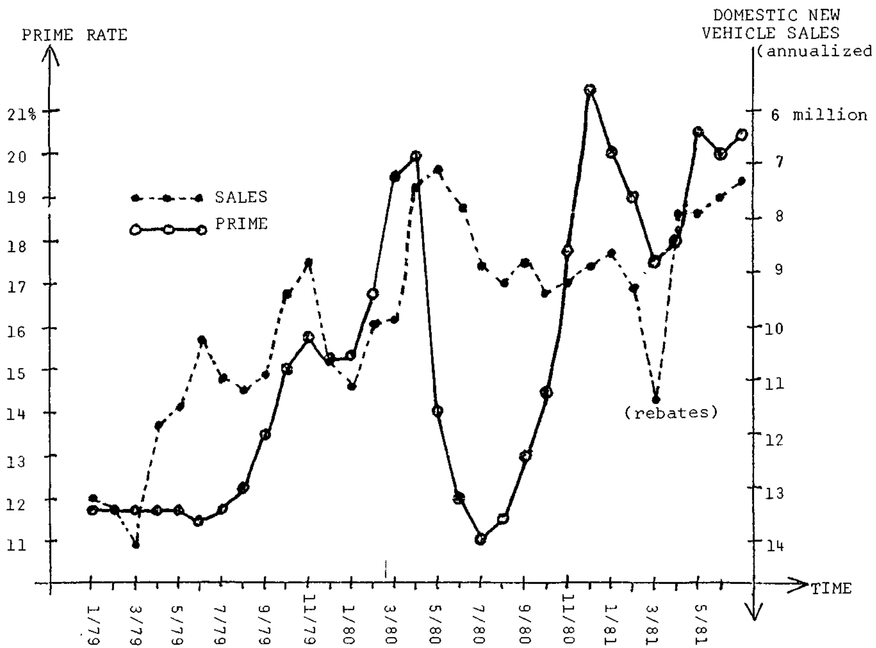
NR = not relevant: callbacks for GM model changeover dominate other effects.

NA = not available.

* Imported vehicles are excluded because indications are that most are not bought on credit. This is partly due to the age and income distribution of import buyers, and partly to the fact that banks are getting out of the car loan business and import carmakers lack U.S. credit subsidiaries.

SOURCE: Ward's Automotive Reports; U.S. BLS.

CHART 1


PRIME RATE
DOMESTIC NEW
VEHICLE SALES
(annualized)
21%
20
19
18
17
16
15
14
13
12
11
6 million
7
8
9
10
11
12
13
14
SALES
PRIME
(rebates)
TIME
1/79
3/79
5/79
7/79
9/79
11/79
1/80
3/80
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7/80
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CONDUCT OF MONETARY POLICY

THURSDAY, JULY 23, 1981

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, D.C.

The committee met at 10:20 a.m. in room 2128 of the Rayburn House Office Building; Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Gonzalez, Annunzio, Fauntroy, Neal, LaFalce, Evans (Ind.), D'Amours, Vento, Barnard, Garcia, Schumer, Patman, Hoyer, Stanton, Wylie, Hansen, Leach, Paul, Shumway, Weber, McCollum, Carman, Wortley, Roukema, Lowery, and J. Coyne.

The Chairman. Now, back to the realities and difficulties of life in these United States of America.

This morning the committee continues its semiannual review of monetary policy. Our review began with testimony from the three depository institution insurance agencies. They cautioned that continued high interest rates could hurt savings and loan and mutual savings bank safety and soundness. We then heard from Federal Reserve Chairman Paul Volcker who told us it would be imprudent to expect interest rates to decline in the near future. Yesterday we heard from a variety of witnesses who told us, in unambiguous terms, of the profoundly harmful effects of the administration's monetary and fiscal actions on small businesses, farming, housing, the cities, and employment generally.

No one disputes the need for a noninflationary monetary policy. The ravages of inflation must be brought under control. On that point we all agree. We differ, however, in the execution of that policy. The administration's approach to monetary restraint places unbelievable burdens on the housing, auto, and farming industries and is starving small businesses with a lack of credit. In contrast, big corporations can raise $40 billion overnight for speculative bidding wars, despite high interest rates. Every morning you pick up the paper and the bidding for at least one company keeps going higher.

Chairman Volcker told us that only one of those credit lines would be exercised and would have virtually no effect on credit availability. However, even as he was speaking, Mobil Oil was reportedly exercising its $6 billion line of credit and transferring the funds to London.

We are told that this is for the national good. We are even expected to believe that defense spending increased to the levels of the Vietnam War, a tax cut, and the inevitable recession resulting from the administration's approach to monetary control is going to reduce the deficit.

Where will it end? When will the administration realize and take steps to minimize the enormous risks it is imposing on small business, financial institutions, and local economies? When will the administration understand that one of the reasons interest rates are so high is because uncertainty is so high? We in Congress are uncertain; the financial markets are uncertain; and increasingly the public is uncertain whether the vast economic and social experiment the Reagan administration has involved us in is really going to turn out to be in the country's best interests.

We hear so much about the need for level playing fields. Where is the level playing field in our fight against inflation? What I see is a policy that decimates small business, housing, farming, and local economies across the country that depend on them. I see a policy that raises the giant corporations to positions of unprecedented power.

Last spring this committee was asked in the most urgent terms by the Federal Reserve Board, the FDIC, the Home Loan Bank Board, and the NCUA for broad merger and acquisition authorities and for increased deposit insurance resources to assist in the preservation of financial services and local markets. The Reagan administration scuttled that legislation and to date has offered nothing in its place.

The administration's approach to monetary control is increasingly risky, inequitable, and destabilizing. If monetary policy does not contribute to improved production, employment, and price stability on the local level, it will fail to be beneficial nationally. When the health of local industries, including financial institutions, is jeopardized, economic conditions deteriorate, production declines, and unemployment rises whether we are talking about auto dealers, homebuilders or the banks, credit unions, mutual savings banks and S. & L.'s on which they depend. If the economies of towns and cities across this country are to remain strong, these institutions must remain viable.

Mr. Stanton?

Mr. STANTON. Mr. Chairman, I wonder if we can interrupt just a minute. The clerk is over here, and if we can just record those who are here now for quorum purposes; it might accelerate matters as we go on. Would that be all right, just to record those who are here?

The CHAIRMAN. The clerk will call the roll.

The CLERK. Mr. St Germain?

The CHAIRMAN. Present.

The CLERK. Mr. Reuss?

[No response.]

The CLERK. Mr. Gonzalez?

Mr. GONZALEZ. Here.

The CLERK. Mr. Minish?

[No response.]

The CLERK. Mr. Annunzio?

Mr. ANNUNZIO. Here.

The CLERK. Mr. Mitchell?

[No response.]

The CLERK. Mr. Fauntroy?
[No response.]
The CLERK. Mr. Neal?
[No response.]
The CLERK. Mr. Patterson?
[No response.]
The CLERK. Mr. Blanchard?
[No response.]
The CLERK. Mr. Hubbard?
[No response.]
The CLERK. Mr. LaFalce?
Mr. LAFALCE. Here.
The CLERK. Mr. Evans of Indiana?
[No response.]
The CLERK. Mr. D'Amours?
Mr. D'AMOURS. Here.
The CLERK. Mr. Lundine?
[No response.]
The CLERK. Ms. Oakar?
[No response.]
The CLERK. Mr. Mattox?
[No response.]
The CLERK. Mr. Vento?
Mr. VENTO. Here.
The CLERK. Mr. Barnard?
[No response.]
The CLERK. Mr. Garcia?
[No response.]
The CLERK. Mr. Lowry?
[No response.]
The CLERK. Mr. Schumer?
[No response.]
The CLERK. Mr. Frank?
[No response.]
The CLERK. Mr. Patman?
Mr. PATMAN. Here.
The CLERK. Mr. Coyne?
[No response.]
The CLERK. Mr. Hoyer?
[No response.]
The CLERK. Mr. Stanton?
Mr. STANTON. Here.
The CLERK. Mr. Wylie?
Mr. WYLIE. Here.
The CLERK. Mr. McKinney?
[No response.]
The CLERK. Mr. Hansen?
Mr. HANSEN. Here.
The CLERK. Mr. Hyde?
[No response.]
The CLERK. Mr. Leach?
Mr. LEACH. Here.
The CLERK. Mr. Evans of Delaware?
[No response.]

The CLERK. Mr. Paul?
Mr. PAUL. Here.
The CLERK. Mr. Bethune?
[No response.]
The CLERK. Mr. Shumway?
Mr. SHUMWAY. Here.
The CLERK. Mr. Parris?
[No response.]
The CLERK. Mr. Weber?
Mr. WEBER. Here.
The CLERK. Mr. McCollum?
Mr. MCCOLLUM. Here.
The CLERK. Mr. Carman?
[No response.]
The CLERK. Mr. Wortley?
Mr. WORTLEY. Here.
The CLERK. Mrs. Roukema?
Mrs. ROUKEMA. Here.
The CLERK. Mr. Lowery?
Mr. LOWERY. Here.
The CLERK. Mr. Coyne?
[No response.]
Mr. MCKINNEY. Mr. McKinney, here.
The CHAIRMAN. Did the clerk call Mr. LaFalce?
The CLERK. Mr. LaFalce is recorded as present.
The CHAIRMAN. We have how many members?
The CLERK. Twenty present, sir.
The CHAIRMAN. And we need?
The CLERK. Twenty-three.

Mr. STANTON. Would it be possible, Mr. Chairman, as we go along in the hearings that we would interrupt for the purpose of establishing a quorum?

The CHAIRMAN. We will keep the rollcall open. The Chair will interrupt as members arrive. As soon as we hit the 23, the magic number, we will strike.

Mr. Stanton, would you be heard?

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

I certainly join you, Mr. Chairman, in welcoming two of the newer members of the Reagan administration's team at the Treasury Department to these hearings. We have expanded, obviously, the hearings on the Humphrey-Hawkins bill this year, to hear from outside witnesses. I believe this is good, Mr. Chairman, because of course, we are involved with the future economic well-being of the Nation. While the Federal Reserve plays a prominent part in the overall goals and operations and aspirations of the Humphrey-Hawkins bill, certainly the administration, the Congress, and the private sector as well, contribute to the economic well-being of our country.

I wish to make one quick observation, having read the testimony. I am pleased to see the degree to which the witnesses have understood and have done their homework. They obviously have prepared well, in reading the back history of testimony before our committee, and I, for one, appreciate that. I have only one other comment, Mr. Chairman, in the light of the overall operations of the Humphrey-Hawkins Act. Mr. Sprinkel has just returned with the President from Ottowa. I am sure this committee would appreciate enlightening information which he could give us on the Ottowa conference with regard to the international economic situation in which this committee is always interested. We would appreciate your doing that, Mr. Sprinkel.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. I certainly agree that that would be most welcome to the committee.

At this time I would take advantage and advise the clerk to note the arrival of Mr. Hoyer and Mr. Schumer, bringing us much closer to the magic number. We're now at 22; 1 to go.

The Chair now recognizes the genial gentleman from Idaho.

Mr. HANSEN. Thank you, Mr. Chairman.

I wonder if it would be in order, as ranking member of the Subcommittee on Domestic Monetary Policy, for a brief statement before Mr. Sprinkel proceeds?

The CHAIRMAN. Well, whether it is or not, you're going to give it, so go ahead.

Mr. HANSEN. Thank you, Mr. Chairman. I thank you for the opportunity we have of hearing these witnesses regarding this very significant problem of monetary policy.

I have faithfully supported the Reagan economic package from its inception during the last year's election and to date, and the program in total I feel offers long-term hope for the future. But I do feel that there are short-term problems such as painfully high interest rates, which I feel that we need to address. I believe there are solutions in the short term. I'm not talking about phony money from the Federal Reserve and I'm not talking about credit allocation, which many of my colleagues on the other side of the aisle seem to flirt with from time to time.

Chairman Paul Volcker of the Federal Reserve Board has presided over that institution for the past 2 years, and during that time, for whatever reasons, we've been plagued by double-digit inflation, 20-percent-interest rates, and M_{1B}, which the Federal Reserve pays the most attention to, has been wandering and rambling all over the place for the past several years. Although the Federal Reserve may hit a particular target during that particular quarter, more often than not the Fed has failed to hit its targets during the past several years and this committee repeatedly has urged the Federal Reserve to lower its targets, and more importantly, to achieve its targets.

Secretary Sprinkel, I believe you correctly point out in your testimony, and I urge you in your behind-the-scenes discussions with the Federal Reserve, to keep their feet to the fire to meet their targets. I would hope that, Secretary Sprinkel, you would take this message back to the Treasury Department with you today and put your best economists to work to find some immediate help to take the hardship out of high interest rates.

Chairman Volcker has admitted in the press today that the policy of the Fed creates an uneven impact. I take it it is this uneven impact that we have to address ourselves to; that on the one hand, you have the oil companies announcing unprecedented profits and the housing industry and the automobile industry dead in the water, so to speak. I like to think of our economies in terms of medical analogies. The Reagan administration, I believe, is on the right path to achieve a long-term cure for the cancer of inflation. I fully support you in these efforts. But what we need, I feel, is some simple, fast-acting, quiet relief aspirin for the immediate and painful headaches of high interest rates.

Our economy has been hooked on the heroin of deficit spending and today we are suffering from the DT's of this addiction. What we are looking for is an interim painkiller made up of moral confidence and certain available relief measures so that these temporary convulsions in our economic patient will in fact be relieved.

I can point to a dear colleague letter from such people as my colleague, Mr. McKinney, and others, who stated that for instance, the administration could issue certain regulations that have been longstanding with regard to HUD regulations so that we could get moving on construction of certain section 8 housing units and this type of thing. I think there are things that can be done to help keep this part of the economy going so that we don't have a gangrenous arm drop off in the Federal economy while we're waiting for the overall cure.

There are many quack doctors around today, and perhaps many witch doctors that will prescribe various types of medicine for these maladies. Some would like to operate on the economy. To do this, some would like to perform an autopsy, or whatever. Before we know it, our economy would soon become a cadaver, drawn and quartered with such devices as credit allocation by many well intentioned people in the Government. If we are successful in dividing a basically cohesive economy, we will be left as a disjointed carcass by the side of the road.

Mr. Secretary, I think it's time for us to get to work to try to address ourselves to the areas where we are having this tremendous impact. When you have the bigs, as Mr. Chairman has stated, able to get interest rates at much lower rates than the people who are suffering this severe dislocation when they're talking about multibillion dollar mergers, then I think there is something wrong. And the rest of the statement I'll put in the record.

I think it is absolutely important that you address yourself to the unevenness of what's happening, so that we don't lose the patient while you are trying to achieve the cure.

The CHAIRMAN. Without objection, the gentleman's statement will be placed in the record.

[The complete opening statement follows.]

OPENING STATEMENT OF HON. GEORGE HANSEN
HEARINGS ON THE CONDUCT OF MONETARY POLICY
JULY 23, 1981

MR. CHAIRMAN:

LET ME BEGIN BY EXPRESSING MY APPRECIATION FOR YOUR TESTIMONY TODAY ON THE CONDUCT OF MONETARY POLICY. I WANT YOU TO KNOW THAT I HAVE FAITHFULLY SUPPORTED THE REAGAN ECONOMIC PACKAGE FROM ITS INCEPTION DURING LAST YEAR'S ELECTION TO DATE. THE PROGRAM IN TOTAL OFFERS US LONG-TERM HOPE FOR THE FUTURE.

THERE ARE, HOWEVER, SHORT-TERM PROBLEMS--SUCH AS PAINFULLY HIGH INTEREST RATES--WHICH I FEEL THAT WE NEED TO ADDRESS. I BELIEVE THERE ARE SOLUTIONS IN THE SHORT-TERM. I AM NOT TALKING ABOUT MORE PHONY MONEY FROM THE FEDERAL RESERVE, AND I AM NOT TALKING ABOUT CREDIT ALLOCATION, WHICH MANY OF MY COLLEAGUES ON THE OTHER SIDE OF THE AISLE SEEM TO FLIRT WITH FROM TIME TO TIME.

CHAIRMAN PAUL VOLCKER OF THE FEDERAL RESERVE BOARD HAS PRESIDED OVER THAT INSTITUTION FOR THE PAST TWO YEARS. DURING THIS TIME, FOR WHATEVER REASONS, WE HAVE BEEN PLAGUED BY DOUBLE-DIGIT INFLATION AND 20 PERCENT INTEREST RATES. M1-B -- WHICH THE FEDERAL RESERVE PAYS THE MOST ATTENTION TO -- HAS BEEN WANDERING AND RAMBLING ALL OVER THE PLACE FOR THE PAST SEVERAL YEARS. ALTHOUGH THE FEDERAL RESERVE MAY HIT A PARTICULAR TARGET DURING ANY PARTICULAR QUARTER, MORE OFTEN THAN NOT THE FED HAS FAILED TO HIT ITS TARGETS DURING THE PAST SEVERAL YEARS. THIS COMMITTEE REPEATEDLY HAS URGED THE FEDERAL RESERVE TO LOWER ITS TARGETS AND MORE IMPORTANTLY TO ACHIEVE ITS TARGETS. SECRETARY SPRINKEL, YOU CORRECTLY POINT THIS OUT IN YOUR TESTIMONY, AND I URGE YOU, IN YOUR BEHIND THE SCENES DISCUSSIONS WITH THE FEDERAL RESERVE, TO KEEP THEIR FEET TO THE FIRE TO MEET THEIR TARGETS.

SECRETARY SPRINKEL, I WOULD HOPE THAT YOU WOULD TAKE MY MESSAGE BACK TO THE TREASURY DEPARTMENT WITH YOU TODAY AND PUT YOUR BEST ECONOMISTS TO WORK TO FIND SOME IMMEDIATE STEP TO TAKE THE HARDSHIP OUT OF HIGH INTEREST RATES. I LIKE TO THINK OF OUR ECONOMY IN TERMS OF MEDICAL ANALOGIES. THE REAGAN ADMINISTRATION IS ON THE RIGHT PATH TO ACHIEVE A LONG-TERM CURE FOR THE CANCER OF INFLATION, AND I FULLY SUPPORT YOU IN THESE EFFORTS. WHAT WE NEED, HOWEVER, IS SOME SIMPLE,"FAST-ACTING, QUIET RELIEF" ASPIRIN FOR THE IMMEDIATE AND PAINFUL HEADACHES OF HIGH INTEREST RATES.

OUR ECONOMY HAS BEEN HOOKED ON THE HEROIN OF DEFICIT SPENDING. TODAY, WE ARE SUFFERING FROM THE DTS OF THIS ADDICITION. WHAT WE ARE LOOKING FOR IS AN INTERIM PAINKILLER MADE UP OF MORAL CONFIDENCE AND CERTAIN AVAILABLE RELIEF MEASURES SO THAT THESE TEMPORARY CONVULSIONS IN OUR ECONOMIC PATIENT WILL, IN FACT, BE RELIEVED.

THERE ARE MANY QUACK DOCTORS AROUND TODAY AND PERHAPS MANY WITCH DOCTORS THAT WILL PRESCRIBE VARIOUS TYPES OF MEDICINE FOR THESE MALADIES. SOME WOULD LIKE TO OPERATE ON THE ECONOMY TO DO THIS, AND SOME WOULD LIKE TO PERFORM AN AUTOPSY TO DO THAT. BEFORE WE KNOW IT, OUR ECONOMY WOULD SOON BECOME A CADAVER, DRAWN AND QUARTERED, WITH SUCH DEVICES AS CREDIT ALLOCATION BY MANY WELL-INTENTIONED PEOPLE IN THE GOVERNMENT. IF THEY ARE SUCCESSFUL IN DIVIDING A BASICALLY COHESIVE ECONOMY, WE WILL BE LEFT WITH A DISJOINTED CARCASS BY THE SIDE OF THE ROAD.

MR. SECRETARY, WE MUST GIVE THE PATIENT THE MORAL AND ECONOMIC WILL TO LIVE. WE CANNOT AFFORD TO LET HIM SLIP OUT OF THE HOSPITAL AND TO GO OUT ON ANOTHER DEFICIT SPENDING BINGE. I AM CONFIDENT THAT YOU CAN DEVISE THE MEANS TO RESUSCITATE THE PATIENT TO ACHIEVE THE FINAL NECESSARY CURE.

For example, to help bring interest rates down I believe that additional stimuli with little or no Treasury outlay can be given for business and construction activity through selective advancements of commitment dates on obligations the government is already planning to undertake. If procurement contracts or building commitments are in the pipeline, let's get them moving and put people back to work. Such activity would provide a meaningful signal without any early drain on government resources.

Second, I would urge you to abandon all government debt operations in the medium and long-term issues and concentrate all necessary borrowing in short-term securities. This accomplishes two things: First, it emphasizes the Reagan Administration's determination to defeat inflation, because it anticipates lower interest rates and thus borrowing costs that would flow from reduced inflation rates in the foreseeable future. Second, it takes pressure off the parts of the credit markets which are especially important to the housing industry and for car buyers, two particularly depressed and interest-rate-sensitive sectors.

Mr. Secretary, these are just a few suggestions, which I would like to discuss with you further. It is time that the Federal Reserve learned that the gyrations of its roller coaster policies are creating chaos in the countryside. Why should we expect people in America to have confidence in the Federal Reserve, when the Federal Reserve can't control the money supply? Your appointment as Undersecretary for Monetary Affairs should send a clear signal to the Federal Reserve that the Reagan Administration expects results.

Mr. Chairman, you know as well as I do that it is time that we do away with big leaps in money supply and higher and higher interest rates. It is time to start to think about the little guy from middle America who pays the majority of taxes in this country. It is time to save America and the American dream of affording a home or starting up a small business. We can do this only by declaring war on high interest rates.

The CHAIRMAN. The clerk will note the arrival of Mr. Barnard, Mr. Evans, and Mr. Gonzalez, thereby giving us a quorum.

[Recess.]

The CHAIRMAN. At long last we are happy to recognize today's witnesses. We will ask Under Secretary Sprinkel to proceed—we'll put your entire statement in the record, and you may summarize if you wish. Naturally, in conjunction with the request of Mr. Stanton, we would hope you would make a few remarks on the Ottowa Summit Conference. The Chair at this time would ask that there be a little order and decorum up here. I would ask the staff if they're going to talk with members to whisper, and that the members do likewise.

Under Secretary Sprinkel?

STATEMENT OF HON. BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. SPRINKEL. Thank you, Chairman St Germain, Congressman Stanton, and distinguished members of the Banking Committee. Roger Mehle and I are very pleased to participate in your hearings as you requested. If it is agreeable with your wishes, we would prefer having questions after each of the presentations because I will be concentrating primarily on monetary policy, Roger Mehle will be concentrating primarily on the problems in the thrift industry.

The CHAIRMAN. Secretary Sprinkel, I appreciate your request and your logic, but by the same token, we have a 5-minute rule. That would mean that the members would have to wait around if they want to ask one question of you and one question of Secretary Mehle, and it is just impossible to operate in that way. So we, unfortunately, cannot honor that. We are going to have to pick and choose, and I am sure that both of you can handle it admirably.

Mr. SPRINKEL. You win. Thank you, sir.

The fight against inflation has begun in earnest. The first step has been taken and, contrary to other efforts over the past 15 years, this administration is determined that this not be a false start. The attack on inflation can be successful only if we stay on the course of persistent slowing in the rate of money growth, with the ultimate goal of a permanent, steady, noninflationary rate of monetary expansion.

There is no alternative: long-run inflation can only be beaten by restricting the growth of the Nation's money supply to match the trend rate of increase of aggregate production. The budgetary, tax and regulatory portions of our program are designed primarily to stimulate the growth of production but, while significantly raising real output, this would contribute only modestly to an easing of inflationary pressures. To eliminate inflation, a permanent reduction in money growth is absolutely necessary.

On several occasions since 1965, money growth was slowed in response to concerns about inflation. But, in each case, the effort was soon abandoned and the rate of monetary expansion subsequently was accelerated further. In each instance, the economy suffered the immediate costs of monetary restraint, but was denied the lasting benefit of reduced inflation. The result was a steadily rising long-term rate of money growth, which was punctuated by several short periods of monetary restraint. The rising trend resulted in an ever worsening inflation, while the brief bouts of restraint generated or intensified economic recessions. These episodes eroded confidence in the willingness or ability of the Government to carry out its planned monetary policies and led to a strengthening of inflationary expectations. This psychology is reflected today in the level of interest rates in the financial markets and in the momentum of inflation. Like everyone else, we abhor high interest rates and are determined to avoid the expansive policies which make high interest rates inevitable. The current level of interest rates is not the cost of an anti-inflationary monetary policy—instead, high interest rates are the cost which the eonomy now bears for repeated failure to fight inflation in the past. The first task is to break the strength of inflationary expectations. That requires establishing the credibility of the policy of long-term monetary control.

There has been a strong temptation by governments to pay their bills and to react to each immediate economic problem in the cheap and easy way—by running the printing press. As the new dollars are pumped into the economy, however, the initial applause of the recipients soon gives way to the cries of pain, even from those who benefited originally. At best, money creation provides cosmetic relief, which may temporarily cover up fundamental economic problems. That kind of policy is deceitful, especially when the Government claims credit for the initial benefits, and later points an accusing finger at others when the ultimate costs become evident. This administration is determined to break this vicious cycle and to concentrate on providing permanent solutions to the problems in the economy. Actions which provide temporary relief, but which aggravate the underlying problems, are rejected. Thus, we are quite pleased with the stated policy and apparent determination of the Federal Reserve to reduce the long-term rate of money growth.

THE IMPORTANCE OF MONETARY POLICY

Restoring economic growth and broadening individual opportunities requires increased incentives to save, invest, and work. Encouragement of real savings and real investment requires that savers and investors, lenders, and borrowers, be convinced that the dollars which they expect to receive in the future, either through wages or investment income, will not be rapidly taxed away by inflation or by high marginal tax rates.

Inflation aggravates distortions within the economic structure, reducing economic efficiency, growth, and employment. For example, at a 10-percent inflation, the $3.35 minimum wage would have to rise to $22.50 after 20 years, just to maintain constant before-tax purchasing power. At that rate, even individuals who work full time at the minimum wage would be in the current 50-percent tax bracket. Employers would face steadily rising labor costs, while workers would find the purchasing power of their wages, after taxes, steadily eroding. Not only would total employment be restricted, the burden would fall progressively more on the unskilled.

With a 10-percent inflation, a college tuition of $1,000 soars to $6,700 in 20 years; a $50,000 house rises in price to $336,000, with property tax liability increasing accordingly; and an expected retirement income of $20,000 declines in purchasing power to $3,000. With continued inflation, changes in the tax law that go far beyond the current proposals would be required simply to offset such distortions.

What do these calculations tell lenders—people who lend their current purchasing power to others by buying debt instruments such as bonds? The message is clear: If you expect inflation to persist, you must cover yourself by increasing the interest rate charged on these loans. But here again, taxes are imposed on the additional nominal interest income, further distoring the situation. In short, inflation not only raises nominal interest rates, but also works through the current tax system to reduce the real rate of return on many investments. This adds up to a decrease in the incentive to save.

High interest rates are the rational reaction of credit markets to the unlegislated tax which inflation imposes on the lending of money. Even a balanced budget would have only a small effect on this tax in the face of inflationary money growth.

The Federal Reserve cannot reduce interest rates with new regulations on credit markets or faster money growth. More money signals more inflation. Any dip in rates which might result from faster money growth would be temporary and rapidly dissipated. Interest rates would rise to an even higher level as lenders, now well trained on and highly attuned to the effects of rapid money growth, would demand even higher rates of interest. The experience of the past 2 years indicates that this reaction would occur very quickly, as market interest rates rose almost simultaneously with each reported increase in the money supply. Since May of last year, reports of rapid increase in money growth have led almost immediately to higher long-term rates of interest, which are good indicators of the market's perceptions about future inflation.

	Annual rate of change M1B[1] (percent)	Change in long-term interest rate[2] (basis points)
February 1980 to May 1980	−5.5	−139
May 1980 to November 1980	14.7	+198
November 1980 to January 1981	0.0	−16
January 1980 to April 1981	10.7	+107
April 1981 to June 1981	−6.9	−13

[1] Not adjusted for shifts into NOW accounts from savings and other interest bearing accounts.
[2] Rate on corporate Aaa bonds (Moody's).

Interest rates also tended to decline quickly in the instances when money growth has been slowed for several weeks. But these decreases have been much smaller than the prior rises, indicating strong skepticism about the long-term prospects for money growth and inflation. This ratcheting upward of interest rates is a prime example of the importance of establishing the credibility of the policy of reducing the long-term rate of money growth. While short-run variations in money growth probably have little direct effect on economic activity, such volatility can create uncertainty about the long-term prospects for keeping money growth on target, especially when the record of meeting previous targets has been poor.

I believe that the phased deceleration of money supply growth which we presented in February—M_{1-B} growth of 7 percent in 1981 and 1 percent less each year through 1986—is the maximum rate of monetary expansion which is consistent with eliminating inflationary pressures. Any success in achieving a more rapid slowing of money growth would be welcome.

All of us are thankful for your past support of this policy of long-term monetary control. For several years, the monetary reports of this committee, pursuant to the Full Employment and Balanced Growth Act of 1978—the Humphrey-Hawkins Act—have strongly supported a gradual deceleration of the money supply to noninflationary levels. The money stock had expanded by more than 8 percent in both 1977 and 1978, prompting this committee in 1979 to speak out forcefully for a slowing in the rate of money growth. In your March 12, 1979, and July 27, 1979, reports you recommended a gradual decline in the growth of the basic medium of exchange, from about a 7.5 rate of growth which was expected in 1979 to a 3-percent rate by 1983. There was only one dissenting view in each report.

Unfortunately, you did not get what you wanted, and the Nation suffers the consequences. Instead of the 5-percent growth in 1980, which would have occurred under the Banking Committee's schedule, the basic money supply (M_{1-B}) grew at 7.3 percent.

This administration strongly supports the type of monetary policy which this committee has recommended. We are confident that the Federal Reserve shares this desire. The deceleration of money growth over the last several months clearly demonstrates this policy in practice.

THE ISSUE OF MONETARY VARIABILITY

Separate from the policy issue of the appropriate monetary targets is the question of the best method for achieving a particular target. While there is general agreement that a slowing of money growth is desirable, controversy remains about which monetary control procedure is best suited to the task. I have spoken out on this issue, with recommendations for some technical adjustments which I feel would improve the precision of monetary control. However, this position has often been misrepresented by others and it is important that we clear up the confusion.

Comments on the dangers of variations in money growth, of the type that have been experienced since early last year, have been misinterpreted as implying that the Federal Reserve should attempt to be more precise in controlling money growth in the short run. Usually, this interpretation has been followed by the argument that tighter control of money in the short run would mean significantly more variation in interest rates. In short, this view reduces the issue of monetary control to a tradeoff between variations in interest rates and the precision of short-term monetary control. However, that view avoids the real issue.

The task in any long-term program, such as targeting the annual growth of money, is to tailor the short-term actions to maximize the probability of hitting the long-term target. In the context of monetary policy, that involves more than consideration of precision of monetary control on a monthly or weekly basis. In the short term, money would be expected to deviate from the long-term target path for a variety of reasons, including shifts among various classes of deposits, unforeseen slowdowns in the clearing of checks, and irregular seasonal influences. There are two basic approaches to handling this short-term variability of money.

One. A short-term monetary control procedure would attempt to anticipate these deviations and take actions to prevent them. Unforeseen deviations would result in explicit action by the Federal Reserve which would attempt to bring money back to the long-term target path.

Two. A long-term monetary control procedure would supply reserves on a fairly steady basis, expecting short-term deviations of money to be random or self-correcting. The key to this approach is an institutional structure in which short-term variations in money set in motion forces which bring money back on track automatically.

The first alternative which I have presented—attempting to control money in the shortrun—is not only less likely to provide sufficient longrun control of money, but would also increase the shortrun variations in money and interest rates. That approach would involve the Federal Reserve in a process of continuous tinkering in financial markets, in response to recent and expected variations in money. Market participants are then encouraged to concentrate on the shortrun money data, seeking information about the likely actions of the Federal Reserve in the near future. In this type of environment, the Federal Reserve would often be reacting to the shortrun expectations in the market. In addition, the focus of public attention on short-term movements in money would detract from the more important long-term target.

For these reasons, the ultimate success of long-term monetary control is enhanced by moving away from efforts to control money in the shortrun and instead by strengthening the automatic corrective forces within the long-term control procedure. It is in this context that I have discussed the benefits of moving to a system of contemporaneous reserve requirements and more flexible administration of the discount rate. In my opinion, these technical modifications would enhance public confidence that a particular growth of reserves would result in achievement of the desired long-term growth of money, with only random variations in the shortrun.

These factors are particularly important for the current control procedure, which sets targets in terms of nonborrowed reserves. The modifications would be less important, but still helpful, under a control procedure which set targets for a broader reserve aggregate, such as the monetary base. Recent evidence, for example, indicates that much of the short- and long-term variations in money in 1980 would have been eliminated by more precise control of the monetary base.[1] According to that evidence, the monetary base continues to provide an effective constraint on money growth, even with the prevailing policy on reserve requirements and the discount rate.

More precise longrun control of money growth would eliminate the kind of interest rate volatility that has occurred in the last 2

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[1] Anatol B. Balbach, "How Controllable is Money Growth?", Review, Federal Reserve Bank of St. Louis, April 1981, pp. 3–12.

years. The inflation premium and the uncertainty premium that results from erratic monetary growth would be greatly reduced. Interest rates would again reflect the interaction of real saving and real investment, adjusting to allocate funds efficiently in a noninflationary economy.

THE EFFECT OF MONEY ON THE ECONOMY

With the long-term rate of money growth on course, the growth of aggregate demand over the longrun will be restrained as indicated last year in the excellent report submitted by Congressman Parren Mitchell of your Subcommittee on Domestic Monetary Policy.[2]

This evidence relates to total demand in the economy and to the price level, not to real output. That phenomenon is called inflation. The main impetus for increased real output in the administration's program comes from the budget, tax, and regulatory proposals. These programs would increase the total supply of goods and services in the economy, while the monetary policy will bring growth of demand back into line. Monetary policy is a necessary complement to the other elements of the program.

We will not weaken in our support of these proposals. Obviously, we too would prefer that the budget be balanced immediately, as the necessary changes in marginal tax rates are put into place. However, the tax cuts, like the administration's policy of harnessing runaway budget expenditures, cannot wait. There will be no better time in the future. The permanent detrimental effect of the current tax structure on incentives for saving, investment, and work would only get much worse and require even larger remedial action in the future. The issue of the budget deficit would arise again, and the numbers would be much larger than those that now face us. The administration intends to move steadily toward a balanced budget and believes that we can accomplish the task by 1984. This means that we and the Congress must maintain budgetary discipline in the coming years.

In the meanwhile, deficits of the magnitude which are contemplated in the budget plan would not inhibit the ability of the Federal Reserve to control money growth. With a steady deceleration of money growth, any effect of the impending deficits on interest rates would be more than offset by the reduction of inflationary expectations. The major portion of today's high interest rates is the inflation premium, which would decline steadily as the trend of money growth is reduced.

With other things unchanged, financing deficits through borrowing would tend to raise the inflation adjusted cost of capital. However, this effect must not be viewed in isolation. We are moving to cut the size of the deficit further and to increase private sector saving. The beneficial effects of the administration's tax and budget programs will allow us to move more quickly toward our mutually shared goals: A fully employed, inflation-free, competitive economy, as is described in the formal objectives of the Humphrey-Hawkins Act.

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[2] "The Impact of the Federal Reserve Systems Monetary Policies on the Nation's Economy," December 1980.

WHAT IS THE ALTERNATIVE

Many years of rapid money growth and high interest rates have injured all sectors of the economy. Industries such as housing and automobiles, small business, the Nation's farmers, and the thrift institutions have been pushed hard by this inflationary policy. The policies and actions that led to high interest rates and rapid inflation have also severely hurt those in the work force, both those with jobs and the unemployed. Purchasing power has been reduced for those who have little room to economize. Employers who face this environment of fast money growth, high interest rates, and inflation, do not rush out to make longrun plans for expansion of productive capacity and more employment. Instead they cut back. Inflation and high unemployment go hand in hand. The old idea that it is possible to buy more employment through accelerated money growth, embodied in what has been called "The Phillips Curve," has been sharply contradicted by events.

Where is the sentiment for rapid money growth? This was the preferred policy of many in 1977. For example, the Joint Economic Committee's midyear report in 1977 contained the following estimates: Maintaining a constant Treasury bill rate—it was 5.3 percent in 1977—would require the growth in the basic money supply to accelerate to at least 11 percent in 1978 and 1979. The report claimed, however, that this would cause a modest inflation, full employment, and a balanced budget by 1980.[3]

In fact, money growth accelerated to 8.5 percent in 1978 and 7.5 percent in 1979. Interest rates? They rose into the double digits. Inflation—which had been described as built in at somewhere around 5 or 6 percent in 1976 and 1977—was not expected to rise significantly. However, the consumer price index rose at a 9.5-percent annual rate in the 1978–79, period compared to a 6.5-percent increase in 1976. The GNP deflator reported an acceleration from 6.0 to 8.1 percent over the same period.

The American public does not need more experience with fast money growth. They have literally had enough.

This administration is committed to policies which will bring a permanent end to high inflation, high interest rates, and high unemployment. We recognize there are some immediate costs, but we recognize the inevitability of much higher costs, if effective action is delayed. The alternative to moving now—a continuation of fast money growth, higher tax rates, and spiralling Government spending—poses much higher costs; namely, the destruction of our economy. Rapid money growth would drive interest rates, inflation, and unemployment far above present levels.

I am convinced that most Americans, together with the members of this committee, join with the administration in firm support of the Federal Reserve's noninflationary monetary policy.

Participants in the domestic and international financial markets will soon get the message: Expectations of continued rapid inflation in the United States are wrong. However, expectations are not brought down by equivocating on monetary policy, or searching for other means to reduce inflation. There are no alternatives to this

[3] The 1977 midyear Review of the Economy, Report of the JEC together with Minority and Additional Views, September 30, 1977, pp. 35–37.

administration's economic recovery program, and the public knows it.

We are off to a good start and we shall stay the course.

Mr. Chairman, if I may turn for a few moments to the Ottawa summit, I'll be very pleased to touch upon the major issues that we're discussing.

Mr. SPRINKEL. I will touch on the microeconomic aspects and concentrate on the macroeconomic issues.

We were very pleased, frankly, with the results of the summit. They provided President Reagan, Secretary Regan, and Secretary Haig an opportunity to meet and work with their counterparts.

It was very clear that the point of view expressed by the American delegation had a major impact upon the contents of the communique that was issued. It was very clear that we set our course straight, and we were determined not to deviate from it. We intend to get this inflation down.

As you remember, there was a sentence or two in the communique, indicating that all seven countries at the meeting agreed that the effective way of getting inflation under control was to reduce the rate of growth of the money supply.

There also was recognition that money alone isn't enough. And no one argues that it is, least of all the monetarists.

There was important emphasis placed on budget restraint: getting deficits under control and slowing the rate of rise in Government spending. And again, all governments agreed to that particular point of view.

There was a very pleasing emphasis on the desirability of encouraging free flows of capital between nations and encouraging free trade. There has been great concern expressed by the participating countries that because of the poor performance not only of the U.S. economy but in the economies abroad that there will be great pressure to move toward protectionism, leading to the results that occurred in the late twenties and the early thirties, when "beggar-thy-neighbor" policies were pursued around the world with disastrous results.

All governments have pledged to do their utmost to resist such pressures in our present solution of the problems. There was considerable discussion of energy, with primary emphasis on utilizing the marketplace to increase the production of energy, as well as to discourage consumption.

There was emphasis placed on the desirability, moving in the direction this Congress has moved, to increase the stockpiling of oil so that in the event we encounter problems in the future, we will not be as seriously exposed as previously.

There was a great deal of discussion, as you are well aware, of not only interest rates, which we will be discussing today, but also exchange rates.

Many of the countries have argued that high interest rates make it very difficult to pursue the policies domestically in their own countries that they prefer. Therefore, there was some discussion as to what could be done to bring then under control.

There clearly was a widespread recognition that slowing the rate of growth in the money supply and getting our budget under control was critically important, both in getting the inflation down and getting interest rates down.

Finally, on the subject of exchange volatility, it was recognized in the communique coming out of Ottawa that volatile exchange rates were very unfortunate. There was an implicit statement to the effect that the way to eliminate great volatility in exchange rates, was, of course, to get inflation under control.

I assure you that we are urging our counterparts in other countries to take the same medicine that we're trying to take at home: namely, get inflation under control.

We prefer stable exchange rates. The only way to make it lasting is to have low rates of inflation among all important trading nations.

That is a brief summary of what went on. We were very pleased.

The CHAIRMAN. Thank you, Secretary Sprinkel.

Now, with the consent of the committee, again, we'll place your entire statement in the record, and you may proceed, Mr. Mehle.

STATEMENT OF ROGER W. MEHLE, ASSISTANT SECRETARY OF THE TREASURY FOR DOMESTIC FINANCE

Mr. MEHLE. Mr. Chairman and members of this distinguished committee, I appreciate this opportunity to review with you the present condition of depository institutions, their ability to deliver credit to all sectors of the economy and the contingency plans available to deal with any problems confronting the institutions. Since Dr. Sprinkel has presented the administration's views on monetary policy, I will not deal with this subject except to indicate the importance of lower inflation and lower short-term interest rates to financial institutions.

I would like to review the condition of depository institutions in the context of how we should be structuring and modernizing them in the future. Every action we take must be in the best interests of the public as consumers of financial servicers. We must build a strong and competitive framework that will give our institutions the flexibility to respond to a changing financial environment and shifting market forces with the best and most varied financial services for years, indeed, for decades to come.

THE FINANCIAL CONDITION OF DEPOSITORY INSTITUTIONS

Despite enormous inflationary pressures, our financial markets and financial institutions have generally been performing well. The one problem area involves thrift institutions—savings and loan associations and mutual savings banks—and to a lesser extent, small commercial banks whose primary business is financing housing. These institutions have structural problems in their asset and liability portfolios that make it difficult for them to cope with very high interest rates, but once this difficult period is passed, they should resume their valuable role as vehicles for savings and for housing finance.

Consumers justifiably have confidence in thrift institutions. It is our job to enhance that confidence by making this industry stronger and more effective in the future. Despite the industry's current difficulties, the administration is quite optimistic on the long-term outlook for thrift institutions.

At the moment, the distortions and uncertainty caused by inflation, in interaction with continuing asset regulation, are forcing thrift institutions to use an increasing amount of deposit liabilities with interest rates that vary with market rates to make long-term mortgage loans or to carry long-term mortgages made in prior years. The remainder of the institutions' deposits are under Federal deposit interest rate ceilings and have rates that vary with market rates only below the ceilings.

However, most thrift institution mortgages have fixed interest rates set when the loans were made, often years ago at rates substantially below current market levels. The ratio of variable rate mortgages to total thrift industry loans is much smaller than the proportion of rate-sensitive deposits relative to total deposits.

This imbalance between increasingly rate-sensitive liabilities and long-term relatively rate-insensitive assets is central to the thrift industry's current problems. In the present inflationary environment, short-term interest rates exceed both the rates on most of the institutions' existing mortgages and the long-term rates on new mortgages—an inverted yield curve. As a result, thrift institutions are paying more for their liabilities than they are earning on their assets, which means they are operating at a book loss and thereby eroding their net worth.

Decontrol efforts have not gone far enough in reducing the vulnerability of this industry to high short-term interest rates because inflation and high rates have constantly exceeded everyone's expectations. Decontrol of thrift institution liabilities has always been catching up with the need of the industry to remain competitive in acquiring at least enough deposits to carry existing assets, that is, meet minimum liquidity meeds. Actually thrift institutions in the first 5 months of 1981 retained sufficient deposits which, coupled with other items of cash flow, enabled them to increase their assets 5.6 percent on an annualized basis.

In terms of what they regarded as their fair share of available money, however, the institutions were less successful in meeting competition from alternative investment instruments with market interest rates. In the first 5 months of 1981 money market mutual fund assets increased about $43.2 billion, while total deposits at insured savings and loan associations increased approximately $6.5 billion and at mutual savings banks $.1 billion.

One proposed solution to this competitive shortfall would be to moderate the ability of money market mutual funds to pay high interest rates. Several proposals have been advanced to achieve this objection, but these would merely penalize the public and not create a competitive balance; even if severe restrictions were enacted to drive investors out of money market funds, they would only seek other high interest yielding alternatives—Treasury securities, commercial paper, bankers, acceptances, and so forth and raise the demand for still more restrictions. Imposing new controls on our financial markets would be the wrong approach to assisting the thrift industry. It would be treating only a sympton of the industry's real illness which is high-interest rates. What the industry meeds most at the moment, along with the entire economy, is less inflation and lower short-term interest rates. But any long-term solution to the industry's problems must also deal with the asset regulatory structure that so limits the ability of thrifts to deal with changing economic circumstances.

APPROACHES TO THRIFT INDUSTRY PROBLEMS

Mr. Chairman, we think that the President's economic recovery program of balanced tax, budget, and monetary policy features will work collectively to further reduce the rate of inflation which has already begun to decline. This, in turn, should lead to lower interest rates and a normal yield curve. The tax program, by increasing the return on savings, should also lead to greatly increased savings rates. All these elements should improve the position of the thrift industry.

Currently, the thrift industry does have ample cash flow with which to conduct its business and meet its obligations to depositors. Interest income, mortgage principal repayments, and Federal Home Loan Bank borrowings more than offset withdrawals of thrift industry deposits in the first 5 months of 1981. The excess funds have been invested in new higher yielding assets, mostly mortgage loans. Nevertheless, it must become more competitive in acquiring the deposits it needs to insure its continued growth.

To enable all depository institutions to be more competitive in obtaining funds, the Depository Institutions Deregulation Committee on June 25 adopted a 4-year phaseout schedule for deposit rate ceilings. In the first phase, beginning August 1, rate ceilings are removed on all deposits with maturities of 4 years or more and ceilings on deposits with maturities of 2½ years to 4 years are tied to the yield on 2½ year Treasury securities. This further deregulation of liabilities should make depository institutions immediately more competitive with other intermediaries paying market interest rates. Insofar as thrift institutions benefit from this action, so should homebuilding for which these organizations are the primary source of credit.

But while thrifts must be able to pay market interest rates on deposits in order to attract sufficient loanable funds, they must also have the ability to invest in a portfolio of assests which will provide greater stability and allow a sufficient rate of return during all phases of the business cycle. There is a schedule now for the phaseout of deposit rate ceilings but asset power deregulation is lagging. Earlier this year substantilally liberalized alternative mortgage instruments were authorized by the Federal Home Loan Bank Board and the Comptroller of the Currency. The Congress is currently considering legislation to preempt State usury ceilings on consumer loans. The Depository Institutions Deregulation and Monetary Control Act of 1980 preempted State usury ceilings on mortgage and commercial loans, if the State legislatures do not reinstate the ceilings within 3 years from the effective date of the act. We favor the preemption of usury ceilings on consumer loans in the same manner.

The regulators have developed proposals for broader deregulation of thrift industry asset powers which the administration is still considering. In general, we support these efforts and are preparing detailed views on these proposals which we will express shortly.

I should point out that expansion of the industry's asset powers does not imply that we believe thrift institutions will significantly dimish their attention to housing. The new mortgage instruments and the industry's existing familiarity with housing should substantially enhance its role as the major supplier of credit to homebuyers. Whatever other powers thrift institutions exercise should supplement these activities and reduce the cyclicality of the industry's earnings.

We are confident that these liberalizations are the key to addressing the thrift industry's long-term structural problems.

However, until short-term interest rates decline, thrift institutions also will have the immediate problem of operating losses eroding their capital. The decline in net worth is important because at some point the industry's depositors and lenders may become troubled by the erosion of an account regarded as a mark of an institution's financial soundness. (Depositors of $100,000 or less generally will not have the same level of concern since their funds are insured by the Federal deposit insurance agencies.)

In addition, some State regulatory officials and others concerned with the industry's condition have come to accept net worth declines below some arbitrary minimum level as tantamount to insolvency. This is true despite the fact that such a decline in net worth will not necessarily inhibit the institutions' day-to-day operations based on cash flow. This rule-of-thumb "insolvency" concept bears no relationship to the customary concept of insolvency, that is, the inability to meet money obligations when due. I think it is important to note that during the first 5 months of this year when the net worth of savings and loan associations declined an estimated $1.4 billion their assets increased approximately $14.4 billion. This is hardly characteristic of an industry with no money to pay its bills. Nevertheless, the decline is net worth presents a problem for the reasons outlined above. The best solution, of course, to the problem of eroding net worth world be lower short term interest rates. Then the industry would realize earnings with which to rebuild its depleted capital.

In the meantime, the Federal deposit insurance agencies are considering financial instruments and other means to bolster thrift institutions' net worth where such assistance is needed and merited. Since this type of action will reinforce some of the traditional measures of capital adequacy, it will enhance acceptance of these institutions as going concerns, independent of arbitrary definitions of insolvency. We believe the Federal deposit insurance agencies and other regulators with whom we have been in close contact can deal adequately with any seriously troubled depository institutions that may need special assistance before short term interest rates decline.

Thank you, Mr. Chairman; that concludes my testimony. I will be pleased to answer any questions the committee may have.

The CHAIRMAN. Thank you, gentlemen.

If you would, we'd ask your indulgence while we go to vote. We'll be back promptly and begin the question and answer and colloquy section.

[Recess.]

The CHAIRMAN. Secretary Sprinkel, we'll get the questioning going here. The other members will be back within moments, I'm sure.

In your testimony, you acknowledge, point out, and agree with most members of the committee and a lot of people around this nation that at the present time the automobile industry manufacturer, the car dealer, the car purchaser, the home building industry, the home purchaser, and the small businessman is severely impacted by inflation and in particular by high interest rates.

Now, in the past week or so, we've seen some unusual goings on here. Major corporations in this country are seeking enormous lines of credit. Within the past seven days, it has zoomed to about $37.2 billion.

Pennzoil has a line of credit of $2.5 billion. They don't even know what they want to bid on, but they figure they want to be part of this game.

Many of the others are involved in the Conoco war. The bids again this morning went up dramatically.

Mobil has drawn down its money, and we're informed, perhaps accurately, perhaps not, that they have deposited this money in some London banks. That's $6 billion.

And you know, the odd thing is here's Mobil, they draw down $6 billion, and they're paying right now to have that money at hand.

Now, here you are following a tight money policy to attempt to cure the long-term ills of the economy. And you and many others say, "Well, a lot of people are suffering, but in the long run it's to their benefit. It's like taking a cure. The short-term cure is difficult, unpalatable; but the long-term benefit is worth what you have to go through."

But when you're the small businessman who needs $50,000 or $100,000, and you look at these major corporations who are taking money, as in the case of Mobil, not because they have to buy a house, or to educate a son or a daughter, but just to play the game, the monopoly game. It makes one wonder about what is happening.

Does the administration have any thoughts whatsoever of speaking to these people and saying, hey, wait a minute now, you are supporting—and Mobil is supporting your program. By the way, those ads are fantastic.

Now, how can they, on the one hand, support your program with those ads—you know, "This plant has been closed for many years, but now it will reopen under the new economic policies"—when they are acting contrary, it would seem to me, to your policies?

Are you going to talk to those people? Are you going to jawbone them a little bit?

You know, a lot is based on psychology. Paul Volcker and his predecessors have testified that a lot of it is based on psychology—what do people expect? Does these events help the psychology of the nation at large?

Mr. SPRINKEL. I share your concern about the damage being done by all sectors of the economy with high interest rates. My father used to be a small farmer, and I remember what high interest rates did to him in the Great Depression, so it's not as if I'm not aware of the damage.

Let me say first that tight money policy does not cause high interest rates. The easy policies of the past brought on the high interest rates. If I could wave a magic wand and erase the errors of the past, obviously we would do so. We can't. We have to face reality. And the reality is that today we still have very high rates of inflation, very high rates of interest. We are exerting every effort in cooperation with the Congress and the Federal Reserve to get those interest rates down.

Now, turning to the question of allocation of credit, as you are well aware, there is a difference between commitments and loans. There have been some of each, but there have been many more commitments than there have been loans.

The CHAIRMAN. Secretary Sprinkel, when there's a commitment, the bank that makes the commitment has to be ready to fulfill the commitment; therefore, that's stagnant money. It's not available to the automobile dealer who has to finance his floor plan.

Mr. SPRINKEL. Mr. Chairman, I spent 28 years in the banking business, and I assure you, we did not lock up that money down in the vault because we'd made a commitment. That is, it's a commitment that must be honored; it's an insurance policy for the borrower, and the banks makes a commitment to stand ready to make it. But that doesn't mean that they do not continue to utilize the money that exists in the institution.

Now there have been some borrowings under those commitments.

The CHAIRMAN. Secretary Sprinkel, I know you spent a lot of time in the banking industry, but when you're looking at the numbers involved here, I'm sure you made a lot of commitments for $1 million, $2 million, $5 million, $50 million, but when you're talking billions of dollars, I think those bankers scratch their heads and say, "Well, we've got to be prepared."

Mr. SPRINKEL. They are typically commitments between a group of banks, and they are prepared. I have no doubt what, if called upon, the banks that made that commitment will perform according to the contract. But that does not increase credit in the commitment form. When it becomes a loan, there is an increase in total credit.

So that what you're really suggesting, it seems to me—and correct me, if I'm wrong—is that the Congress or the administration should set down a list saying:

> These are good things to do, and these are bad things to do. This is the efficient way to use that credit; this is the inefficient way to use that credit.

And frankly, I have much more confidence in the free market's allocation of credit than I have in my ability to decide what's good or in the Congress ability to decide what's good.

We have a very efficient credit system out there where individuals spend full time deciding what is the most efficient way of allocating money.

The CHAIRMAN. Therefore, you have no problem with this monopoly game that's going on at the present time?

Mr. SPRINKEL. I have no problem of avoiding the experiment that was attempted in 1980, which was overkill of the most gross kind, which led to serious problems in monetary control; and which was followed by massive increases in money growth. We do not want to engage in a credit control experiment. It has been tired many times in this country and abroad, and we do not intend to go down that road.

The CHAIRMAN. You know, Paul Volcker expressed grave concern this week when he appeared before this committee; before the JEC, he wasn't that concerned. But it's accelerated. He came before this committee the day before yesterday and expressed concern.

You have no concern?

Mr. SPRINKEL. I have concern about high inflation and high interest rates.

The CHAIRMAN. That's not my question, you know. My question is, do you have concern about the fact that these major corporations, these large corporations, are playing the game of takeover and going forth and obtaining these large commitments from financial institutions.

You have no concern about that?

Mr. SPRINKEL. No, sir. It's the policy of this administration that bigness is not necessarily bad. What we are concerned about is monopoly, and we will pursue vigorously those areas where monopoly threatens. We will not just automatically assume that a merger is a bad thing.

The CHAIRMAN. You've answered the question. Thank you.

Secretary Mehle, less than 90 days ago, the regulators went before the administration with legislation to address the problems of thrift institutions. Incidentally, when you listed the problems of thrifts, you listed the S. & L.'s, the mutuals, and some commercials. You did not list or mention the fact that there are credit unions that are suffering at this point in time as well.

I take it, you agree that that situation exists, does it not?

Mr. MEHLE. Well, there are some that are suffering, but on the whole, they are in reasonably good condition, as I think Mr. Connell testified in his appearance before this committee recently.

The CHAIRMAN. All right. In any event, the legislation that was advocated by the regulators was given thumbs down by the administration.

Last week, the agencies came before us and they did indeed say that the performance differs under varying interest rate assumptions. They gave the committee computer runs. The projections indicate that if the interest rates don't decline from their present levels in the next 12 months, the resulting volume of thrift institutions failures could cripple the Federal deposit insurance funds.

The Home Loan Bank Board's Mr. Pratt said on July 8, that S. & L. losses could reach $60 billion and completely decimate the Federal Savings and Loan Insurance Corporation Fund.

Chairman Volcker said it would be imprudent to expect that rates will decline significantly in the near future.

Now it's all well and good to tell us that you're reviewing Mr. Pratt's recommendations. But that doesn't address the present problem and the problem that will exist if there is a persistence of high interest rates.

My question to you is, do you, the administration, have any contingency plans? Or do you just expect to come to us and say, "Well, the insurance fund has run out, so we're going to have to appropriate more funds for the insuring agencies"?

Mr. MEHLE. The insurance funds right now, as you know, are large—$11 billion in the case of the FDIC, about $6 billion in the case of the FSLIC.

The CHAIRMAN. The market value is about $4.4 or $5 billion the FSLIC, depending on which way you slice it.

Mr. MEHLE. So far as the administration is concerned, those funds are adequate right now, together with the back-up lines that each of these two funds has to borrow from the Treasury.

The CHAIRMAN. $750 million on the part of FSLIC. One institution. Whammo, it's gone, one big one.

Go ahead.

Mr. MEHLE. Adequate to cover the problems that may exist with any given institution. I think it might be worth a moment to elaborate on the point raised that you alluded to that was raised in the testimony of the other regulators. That's the question of thrift institutions running out of net worth.

I talked about this a little bit in my prepared remarks. It's terribly important to be able to distinguish between a depository institution's financial condition when it is losing money and that of an ordinary nonfinancial corporation.

As I mentioned, while the thrift industry in the first 5 months of 1981 has lost about $1.4 billion of net worth, this is out of a total amount of net worth of about $30 billion. During the same time, the footings, the assets of the industry, have grown about $14.4 billion. This means that during a period of experienced losses—negative earnings—the industry has not only been able to fund the cash flows out of the institutions because of those losses, but also has been able to add net to its asset base.

There's a very good reason for that and one that often escapes public understanding. That is that the thrift industry's expenses which are of course charges to income and charges to net worth, by and large are noncash expenses, whereas the industry's income is virtually, entirely cash income. So while there will be or can be booked a loss during an accounting period as the result of a negative difference between cash income and accrual expenses, there is in fact a growth of the institution during that period of time.

This is different from the ordinary corporation's status which experiences a loss of cash when it has an earnings loss—negative earnings—because all nonfinancial institutions largely pay their bills in cash. Depository institutions, though, generally pay the major part of their bills by crediting the account of their depositors. That essentially leaves the funds on deposit and enables the institution to finance its growth. You might call it a forbearance of lenders, which is, of course, how the industry is designed to work.

I want to emphasize that point, because while the industry is having an earnings problem which is decreasing net worth and causing it in some cases to go to some low number or to zero, which has been the subject of much writing and discussion and alarmed views, constituents of the industry by and large are continuing not only to fund any withdrawals of deposits from them, but also net to make new mortgages.

Now they are not doing that at the same rate that they did it in the past. And as I said, the industry does not consider that it's getting a fair share of the deposit funds that it should have. Certainly, it's not happy at all with the negative earnings, which I thoroughly understand and sympathize with. But this is very different from an industry group that is on the verge of bankruptcy. It simply isn't.

And I think we should all be very grateful that it isn't, because obviously if we had to fund the payment of depositors, all depositors in, let's say, savings and loans and mutual savings banks, there is not enough money right now in the insurance funds to do that. But we do not look for that as a likely outcome.

One very important thing we must do, though, is to reassure the public that the industry can continue to do business, can continue to make new mortgages, and can fund any withdrawals that may be made by depositors.

Something else that must be done—that has been done, thankfully, on June 25—is to give the thrift industry the ability to bid for funds, so that it will be able to attract money that would otherwise fly away to money market funds or some other open market alternative, even if the industry were as sound as the Rock of Gibraltar, because it can only offer 5.25 percent to depositors. Although it might have a very handsome net worth, the depositors would simply say:

> We're not interested. We think you're very sound and rock solid, but you're only offering 5.25 percent, so we're going to go to the alternative that yields 15 percent.

On June 25, DIDC, created by this Congress in 1980, took an important step in permitting the industry to bid in the open market for funds. Effective August 1, the first effort under that deregulation schedule will take place, and I, for one, hope that the industry will be able to offer much more vigorous competition to money market funds and attract deposit funds to a greater extent than it's been able to in the last several months.

Mr. STANTON. Mr. Chairman, excuse me. We are going to have to go vote in a minute. Before I leave —and I will be right back—I wanted to make sure, Dr. Sprinkel, our staff has told us that you have a previous commitment at 12:30; is that correct?

Mr. SPRINKEL. 12:30. I'm due at 12:45.

Mr. STANTON. It is obvious that if this keeps up, you will not be able to give the members an opportunity to ask you questions, and I would hope that you will raise a time, Mr. Chairman, soon that Dr. Sprinkel could come back, because we have no control over these calls. The members have been looking forward to asking you some questions.

Mr. SPRINKEL. Yes, sir. I'll be very pleased to return after that commitment, if you would tell me when.

The CHAIRMAN. Secretary Mehle, No. 1, you haven't told me yet whether or not you have a contingency plan. I assume since you went through a very complete answer without mentioning any contingency plan, the answer is that you don't have a contingency plan; is that correct?

Mr. MEHLE. I think that all the contingency plans that are now in place are adequate to the task of dealing——

The CHAIRMAN. In other words, you don't have anything beyond what is in place today.

Mr. MEHLE. No, not in the way you suggest as a plan.

The CHAIRMAN. And you don't contemplate anything.

Mr. MEHLE. Not a plan.

The CHAIRMAN. But, you know, you say June 25 was a great day. You're going to let the industry bid for funds. But in your own testimony, you also brought out the fact that these institutions have low yielding assets—assets yielding about 9½ percent.

How can they go up against the money market funds?

Mr. MEHLE. How can they? Well, it's a simple thing to do.

The CHAIRMAN. How can they pay their depositor a higher rate than they're getting on their assets, which is 9½ percent?

Mr. MEHLE. This is part and parcel of what I was discussing about their noncash expenses. If they offer a depositor—let's say, a passbook account depositor—5 percent, and let's say the ceiling is kept on and that it is lower than 9½, that would mean that they would not have any negative carry.

If the depositors all take their funds out, it doesn't matter whether you offer 5 percent because you will have to liquidate your assets in order to pay off the depositors, which is the worst kind of situation to be in.

On the other hand, if you offer 15 percent and you carry mortgages of 9½, because in large part the interest expense is not cash but instead is an accrual which is credited to the depositor's account and there is no departure of funds from the institution. For example, in your experience and certainly in my own, if you have a passbook account, you periodically take your passbook in and the institution credits your interest. At that time, you don't draw it out; you draw it out when you feel like drawing it out. However, it is credited to your account as of then, and it shows up as an expense to the institution at the time they credit it to you.

But fortunately for them—and this is part of the business of banking—you leave it with them, and you only take it out if you think you've got a better opportunity elsewhere or you're scared that unless you take it out then and there, you may never get it back again. The latter concern I think we ought to put completely out of mind, because I don't think the thrift industry is in that position. The former concern, we are trying to deal with with the DIDC.

The CHAIRMAN. Well, we are obviously coming from different directions here. I've been sitting up here for a while, and I've now had three Home Loan Bank Board Chairmen come in and tell me that the situation is grave and that contingency plans are necessary. That's Mr. Pratt; that's Mr. Dalton; that's Jay Janis—all three of them, in my opinion rather levelheaded people, not alarmists in any way, shape, manner, or fashion.

You know, a statement was made about an institution in New York last week. As a result of that statement, there was $7 million that went out of that institution in 1 day. So you know, they just didn't take the interest out; they took the deposits, the principal, out.

I just find it difficult to conceive that—difficult to conceive that we shouldn't look to an effective contingency plan here, have it in place, rather than have it come up to us overnight and say, "Pass this overnight," because if you do, I'm going to cite this testimony. I can't cite private conversations, but I'll cite this testimony.

Mr. MEHLE. That's certainly fair, but let me talk about the plan for 1 minute. I think there are a number of contingencies that are already available which don't necessitate the creation of any new plan or scheme or anything of the kind. For one thing, importantly, there are the insurance funds which at the level that they are funded are not insubstantial. For another, there are the Treasury borrowing lines which are now in place. For a third, there are the Home Loan Banks themselves which routinely make advances to thrift institutions. A fourth is the idea that the Savings and Loan Insurance Corporation and the Home Loan Bank Board are studying right now, to bolster the thrifts' net worth, which would treat the problem of public confidence which might be shaken somewhat in the event of a decline in net worth. The development of this means of assistance, I understand, is underway and will be soon available as needed and merited. A fifth alternative is lending for liquidity purposes that the Federal Reserve is able and prepared to do.

The CHAIRMAN. We asked Chairman Volcker about that. That's still not in place. I've been advocating that since last October, because the Monetary Control Act required it.

Mr. MEHLE. That is right.

The CHAIRMAN. It's still not in place. I hope the Treasury encourages the Fed on that one.

Mr. MEHLE. I think, to the best of my knowledge, that while there may be some aspects to be sorted out procedurally, the Federal Reserve would be prepared to make any liquidity loans it might have to make or might feel it is in order to make, to members of the thrift industry. So there are five fallbacks, if you like. I don't think we would ever foreswear any legislative initiatives, as the Secretary of the Treasury mentioned in his April 28 testimony before the Senate Banking Committee. We are watching the situation very carefully, and if it seemed that new measures ought to be taken, we would certainly endorse their being taken.

The CHAIRMAN. Let me just make this statement. I called the regulators and the Fed up to my office last October. I said, "Get your heads together and let's find out what we need and let's put it into place ahead of time; not wait until you have to do it overnight." The reason for that was that the situation back then was not as severe as it is today, so we could have adopted the legislation and have it in place.

But if you come in and look for overnight relief, then you say to the people at large and it becomes very apparent to the people out there, that there is a severe situation. That's the instance wherein what happened in New York this past week can happen again—a great deal of funds can be withdrawn within a 24-hour period. That's why I'd hoped that we could get together on something ahead of time, rather than rely on that which you have enumerated. It's not my idea that more was needed. It's the idea of the regulators who work in this area every day of the week.

Mr. Fauntroy?

Mr. FAUNTROY. Thank you, Mr. Chairman.

Mr. Sprinkel, I am very pleased to have the opportunity to hear you and to just raise a couple of questions that have been of great interest to me. During the past week, we have had an opportunity, as you know, to talk with the Chairman of the Federal Reserve, and my primary concern has been focusing on the cost of tight money policy where there is no adequately supported or appropriate fiscal policy. My concern is that the administration's policies—fiscal policies and tax policies—will impose such a severe burden on the Fed that it will ultimately accommodate inflation caused by those factors or allow the economy to enter into a prolonged recession.

In your view, does slower monetary growth have any effect on output in the short run or the long run?

Mr. SPRINKEL. It depends on how quickly inflationary expectations decrease. Almost certainly they will not decrease instantaneously. Therefore, under most circumstances, one would expect that a slowdown in monetary growth would not only slow the growth in nominal income, but would lead to poor performance in the short run on real income.

If you remember our recently released numbers for the last half of this year, our planning numbers and our best guess show, I believe, as Chairman Weidenbaum said, a very spongy performance, or some such phrase. That is, we are not ignoring the possibility that we will have a quarter or two of negative real growth. The alternatives are worse. If we were to move back to stimulus, we'd get some good news in the short run on real output. Very probably, at least, since that's been the history. But almost certainly as day follows night, we will move into higher rates of inflation and even higher interest rates. So I see no alternative to pursuing the kind of policy that's been enunciated by this administration, and certainly agreed to by the Federal Reserve Board. It is not a high interest rate policy.

Again, you indicated that we had a tight policy causing high interest rates. Tight policies at the Fed cause low interest rates. It's easy money policies in the past that caused the inflation and the high interest rates.

Now, the burden is on the Fed. I understand they have a very difficult problem and I don't want to make their difficulties worse. We want to work with them; we are doing so; and we are quite supportive of their general strategy and the way they are going about getting money under control.

However, I would point out that there is no correlation between the size of deficits and the rate of money growth. We did a study recently on this issue. It turns out that you can find periods of large deficits with low money growth and with high money growth; periods of low deficits or no deficit—we've had only 1 in 20 years—with high money growth, and a few periods of low money growth. There is no technical relation nor any necessary causal relation between the size of the deficit and the rate of money growth.

It is also true that there is no relation between the size of the deficit and inflation. It all depends upon how that deficit is financed. If you finance the deficit with new money creation, as we have often done in the past, we end up with higher inflation and high interest rates.

This administration had pledged to avoid asking the Federal Reserve to pump in a lot of money to finance our deficits. We are, at the same time, pursuing a policy on taxes and spending designed to supplement that recommended monetary path; namely, with the cooperation of the Congress, together we have already succeeded in cutting planned outlayed something on the order of $38 to $40 billions. That won't be the last time we try. With your help we plan to continue to keep restraint on spending.

In addition to that, again, hopefully with the cooperation of the Congress, and we expect with the cooperation of the Congress, we have a tax package designed to encourage savings, encourage work, and encourage investment. That's a deflationary philosophy, increasing the long-run capacity of this economy to grow and at the same time avoiding inflation.

Now, am I saying I think deficits are a good thing? I certainly am not. The sooner we can get rid of them, the better.

Mr. FAUNTROY. I am pleased to hear that, because while my time is running out rapidly and while I was tempted to engage you in a discussion of whether or not the deficit is a problem, I really wanted to focus more precisely on the short-term effects on output. You have indicated that in all probability there will be some short-term effects. I wondered if you could tell us how long? Is it 1 month, 3 months, 6 months, 9 months, 1 year, 2 years? What would be the period we can expect, given your projections at this point?

Mr. SPRINKEL. If we knew for sure we would certainly inform you and other members of the Congress. We don't. It's our belief that it will be a relatively short period of time and that the pain in the short run will be more than offset by the benefits as we move into 1982 and 1983. I do not know how long it will last, but I assure you, as we get inflation expectations down, the impact will be where we want it to be, namely, on inflation and not on employment where we don't want it to be.

Mr. FAUNTROY. Since you can't tell us any time frame, how much of a turndown do you think a public official ought to be willing to accept? You, in response to the chairman's question about the precision with which credit decisions can be carried out in the most efficient manner by the market, failed to take note that we as politicians have to be concerned about the social effects. How much of a turndown should we, who are public officials, ought to be willing to accept to end inflation through monetary policy—2 years of 8 percent unemployment? Three years at 7.5 percent? What if unemployment reaches 10 to 15 percent?

Mr. SPRINKEL. I understand the pressures on the Congress and the administration, I am sure, much better today than I did 7 months ago. I am sympathetic to your concerns not only for your constituents but also for the Nation as a whole. If there were one thing that I could change as an economist it would be a very simple thing. That is, when we pursue restrictive policies we get the good news in the short run and the bad news later on. Or conversely, when we pursue easy policies, that we get the bad news immediately and the good news much later. Unfortunately, it works in reverse. And I understand the concern that you have about paying short-run costs. In my judgment, the American people are fed up with inflation, all of the damage that it does to the poor, to the middle class, and to the upper class. They voted to get this inflation under control and I urge you to support our efforts that are directed precisely at that direction. We do not expect massive, long-lasting unemployment.

Mr. FAUNTROY. You've given us a promise of misery without really an assurance of a cure, however, Mr. Secretary. It's most distressing to me that I see no sign of sensitivity for the concern about how inequitable a policy and social troubles an induced recession creates.

Mr. SPRINKEL. I am very sympathetic.

Mr. FAUNTROY. I yield.

The CHAIRMAN. Mr. Stanton?

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

Dr. Sprinkel, I've reread your statement three times. I did that because you do put the case for the fight against inflation as well as I've seen it in a long time on page 4, when you reiterate the damages of 10 percent inflation. Your testimony clearly spells out the problems, of course, of where we are and where we would be down the road 5 years from now with this 10 percent continuous inflation. I think the first man ever to do this was Alan Greenspan a few years ago. He used at that time a 6-percent inflation rate to determine where we would be. I remember well at the year 2000 the average income would be something like $69,000 or $70,000 per year under Mr. Greenspan's scenario.

You also did a very good job with regard to discussing the importance of the money supply and the need to control the money supply. Moreover, you tied it in with the goal of this committee and especially our former chairman, to keep control of money supply growth to noninflationary levels. The message seems to be getting out to the point where everybody may believe it, but I was surprised and somewhat disappointed to see the drastic market reaction to 1 week's change in the money supply, up $7 billion. I stated to Chairman Volcker that there was far more reaction to 1 weeks' money supply than there will be to the reconciliation bill of the Congress, in which we reduce Federal spending by billions of dollars.

I said that to one of my financial writer friends. He said that's true, and he said further that that is what the administration preaches. I looked at him and he said, yes: they put far more emphasis on the supply of money than they do on a balanced budget. And your statement this morning sort of leans in that direction. You did an excellent job in explaining the need to control inflation by controlling the growth of the money supply, but it is important to put this issue into proper perspective.

Not only that, but also I think, that the marketplace thinks that the tax bill is inflationary, and so there may be a contradiction here. This may be a temporary problem that will resolve itself, but it is a general layman's feeling of the problem.

Mr. SPRINKEL. Thank you, Congressman Stanton. Let me address the two issues that you raise and I will try to do it briefly. I want to make very clear that I do not disregard deficits. I do not think they are a good thing. They absorb savings; they must be financed; and if we are not going to finance them with new money, we have to finance them by absorbing savings. That means those savings cannot be going into the productive sectors of the economy. This is why this administration has pledged that we will get that deficit to zero as quickly as possible. I wish it were zero today. But we inherited this deficit and we are going to get it down with the cooperation of the Congress. We're going to do it through, on the one hand, restraining spending and, on the other hand, encouraging real growth through tax adjustments, which does increase savings.

Now, the reason so many believe that a tax cut is inflationary is that, to put it one way, they look at the world through Keynesian-colored glasses. If you go back and read the Keynesian textbooks, they will tell you that a cut in taxes leads to an increase in income, which in turn leads to more spending, which leads to more income; and you get that marvelous multiplier soaring. For each $1 cut in taxes you get a multiple increase in spending.

That's indeed true, if you finance that tax cut with new money. If you don't finance it with new money, that spending multiplier stalls out but you do get an increase of incentives at the margin to save, to invest, and to work. And that's exactly the heart of this program. We will not permit that tax cut or monetary policy or other policies to lead to the sorry state of inflation that we've been suffering over the last decade.

Mr. STANTON. Thank you, Mr. Sprinkel. Mr. Mehle, quickly, two questions to you. First, you did state in the very last paragraph of your statement that you are in touch with the Federal deposit insurance agencies? Do you believe the Federal Deposit Insurance Corporation and other regulators with whom we've been in close contact can deal adequately with any depository institution needing special assistance before short-term interest rates decline? In testimony last week, the regulators still said they would like to have the so-called regulators' bill. They still would like to have that passed, except for the Federal Home Loan Bank Board, which claims now that it did not go far enough.

My first question: Is the administration in favor of the regulators' bill?

The second question is: Does the administration plan to abandon the financial savings and loan industry, or will they help them? They are convinced that they have a problem. Moreover, they are convinced that you don't think they have a problem. That would be underscored by your statement here this morning.

Mr. MEHLE. Mr. Stanton, as to your first question, the so-called regulators' bill was shown to the administration about 6 weeks or so ago. It had three principal parts to it. Two of the parts the administration did not favor; one of the parts the administration was unopposed to—was sympathetic to, in fact.

The two parts that the administration did not favor were the increase in borrowing lines from the Treasury, on the belief that they were unnecessary, and the expansion of capital assistance powers for the regulators, which the administration felt were already in the hands of the regulators. That is to say, those powers already existed in substance.

The third part which provided for interstate and later industry mergers and acquisitions of troubled thrift institutions, the administration felt was fine, and we so communicated to this committee and to the comparable committee in the Senate.

As to abandonment of the thrift industry, I think the administration is just about as far from that as it can possibly be. What it is attempting to do is to give the industry more tools to compete and to be able to stay healthy and viable in this environment, which we have been dwelling in now for the past several months and which it is possible we will dwell in for a while longer. The institutions must be able to bid for funds so they can have the raw materials they need to do business with; that is, to reinvest in high-yielding instruments. Second, we endorse an expansion of asset powers for the thrift institutions, so that they may be able to go head to head in some more profitable areas that currently they're not able to operate in.

So what we want to do is help the industry out, stand behind it. I will say—and Secretary Regan has also said—that it is totally unacceptable as an option for the administration to let the thrift industry or any other depository institution industry simply go out of existence. That's not an option, and we don't expect that to take place.

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

The CHAIRMAN. Dr. Sprinkel, I've got to tell you that the millworkers and textile workers of Rhode Island who think the tax cuts are inflationary don't know Keynesian economic theory from beans, so they ain't looking through those glasses.

Mr. Neal?

Mr. NEAL. Thank you, Mr. Chairman.

Secretary Sprinkel, I quite agree with you that there's no way to control inflation without controlling money growth. In expressing my concern, it is necessary that we review for a moment what we've done in relation to what I see as the problem coming next year.

Starting with the current services level of about $711 billion, we exempt $200 billion for defense, $100 billion interest on the national debt, $264 billion for the social safety net; and out of the remaining $147 billion, we cut $37 to $40 billion, leaving $110 billion for everything else that the Federal Government does in the areas of education, nutrition, welfare, trade, agriculture—everything that we do.

Now at this time next year, if your figures are correct, we're going to face a deficit of about $40 billion. There's a good deal of evidence indicating that that spending has been considerably underestimated, so the deficit will probably be higher. If we pass the tax cut bill before us, either of them, we'll have added another roughly $75 billion in personal tax cuts for 1983 in addition to the targeted personal tax cuts and the business tax cuts which will be permanent. So it looks to me like that we run a high likelihood of facing a deficit next year about this time of somewhere between $60 and $100 billion, unless we have some real good luck. It could be worse than that.

Our options are going to be limited. We could cut defense spending, but I don't think that we will do that. We can't cut the interest on the national debt; it looks like we'll be increasing it. And so the remaining options will be to cut deeper into what the Federal Government does—the nondefense element of the Federal budget—to let the deficit continue, or to raise taxes.

I don't think we will want to raise taxes in an election year. I think you'll discover that we will all find it very difficult to cut further Federal spending, even though I believe you'll think that's what we should do. And I'm concerned that if we let the deficit ride, that the competition for a limited supply of money—I agree with you that the Fed is dedicated to keeping that supply limited—the competition for that limited supply of money between the private and public sectors is going to drive interest rate levels back to the rates we have now.

That's my concern. And I think in the studies that you did in attempting to link deficits with the rate of inflation, you're right. I've seen your studies, and there's no correlation there. There is, though, a correlation between interest rate behavior in an expanding economy and deficits. If there's real competition for money, that certainly can drive up interest rates, and, in fact—I see you nodding your head—I would say that's what's happening right now.

Right now the rate of inflation, by any measure, is considerably under 10 percent, yet the prime rate is 20, 21 percent. The only way I can understand that is in terms of competition for money and a certain element of inflationary expectation. But it appears that there really is competition for a limited amount of money.

I've just rambled on, but I'd like to see if you don't share that concern.

Mr. SPRINKEL. Well, I appreciate your concern, widely shared in the financial markets, that despite the fact that slow money growth is promoted, nonetheless a sizable deficit, which we estimate to be considerably lower, as you are aware, than the one you mentioned, would nonetheless put upward pressure on interest rates.

Now there is one thing that's forgotten, it seems to me. Namely, if we slow the rate of growth in the money supply as we are planning and as the Federal Reserve is planning to do, with our support; this will slow down the rate of rise in nominal spending. This monetary policy will also slow down aggregate credit demands because the inflation will be abating.

You mentioned we couldn't get interest on the public debt down. We will get interest on the public debt down if inflation comes down further and interest rates come down further. I do not know of a period in history when most of the interest rate variability wasn't explained for a long period of time by changes in inflation rates. The real rate over the long run has not varied much.

I grant you that in the last 12 months and especially now, the real rate is one of the highest in our history. I notice that the Chancellor from Germany indicated that the real rate of interest in Germany was the highest since the time of Jesus Christ. There's no doubt that worldwide there is one of the highest real rates in history.

Now the question is, how do you get it down? The only way I know to get it down is to get inflation down. That's the way it's always came down in the past; that's the way it will come down this time. And if we continue to pursue our policies, as we are dedicated to doing, I am certain it will come down. I don't know when; that's the difficulty.

Mr. NEAL. The policy that's troublesome, though, is the deficit policy, and I'm sorry to say, you still haven't addressed the other point.

The CHAIRMAN. Excuse me. I'm sorry, Steve, but we have a limited amount of time, and your time's expired.

George?

Mr. HANSEN. Thank you, Mr. Chairman.

The CHAIRMAN. You can reincarnate your carcass.

Mr. HANSEN. Thank you.

I understand that you have to leave shortly, Mr. Sprinkel, so I'd just like a couple of quick questions.

I wonder if you could address why interest rates are so high when the inflation rate seems to be subsiding. I think you and I appeared jointly on a radio program recently. Normally, the two seem to pair off, going in the same direction. But we seem to have a little problem at this point.

I was wondering if you could explain in such a manner so that the farmers and the builders and the small businessmen in my State and other States across the country could understand why this thing doesn't seem to be working as normally indicated?

Mr. SPRINKEL. This is not a direct response to the concern of your friends and mine. Let me say, that as an economist, when you look at long-term charts; they tend to fit beautifully if you're a sensible chooser of data. When you live through it, minute by minute, day by day, week by week, month by month, it seems an eternity.

I suspect when we look back on this experience, we'll say that the lag in the adjustment of interest rates and inflation was no more than really has happened on many other occasions. But right at the moment, it's extremely painful.

I just have no doubt that it's going to come down. I cannot explain how long it's going to stay up. I can assure you that if we move back to an inflationary policy, interest rates will get worse. Therefore, we must hang on to the dedication to get this inflation under control.

Mr. HANSEN. Do you think the high interest rates can be laid at the foot of the Federal Reserve in any way? Now I realize they're the device for trying to deal with the crisis that we have as far as inflation is concerned. But there has been a considerable amount of criticism about the erratic course they've taken to try to realize their targets. And I guess I'm wondering if some of that could be cause for the high interest rates that we're experiencing.

Mr. SPRINKEL. The real reason for the high interest rates is the highly inflationary policies that have been pursued in both fiscal and monetary policy in recent years. I wasn't in Government, but I was very critical at the time because of the fear that what has happened would happen.

Now the Federal Reserve over those years, as I indicated in my testimony, much of the time accelerated the rate of growth in the money supply. There were occasional periods when we had restraint, which usually resulted in recession, and we began to get the benefits on the inflation. We threw them away. We pledged not to do that this time.

Now one additional observation is that a portion of my testimony was devoted to a discussion of how we can avoid highly erratic fluctuations in money. I don't think we can avoid them completely; there is no perfect solution. All we can do is say, "Can we improve monetary control?" There are some very simple moves that can be made that, in my judgment, would improve the confidence of the public in the marketplace by reducing the high degree of volatility in money that we've had in the past.

Up to the present time, there's been no change in that mechanism, but I'm hopeful the Federal Reserve System is studying the issue.

Mr. HANSEN. I hope so too. I'd like to just reemphasize one thing, and that's the fact that this administration has been in the saddle now for some 6 months, and whatever has happened in the past is not your baby or ours as part of the same, I guess, side of the politics. But I guess I'm concerned, as I expressed in my opening statement, about the fact that the long-term cure on one hand might turn out to cause convulsions that could dislocate your efforts and also possibly create a problem for the solutions we're all hoping for.

So what I'm asking is, is there some way that the Treasury Department, HUD, some of the other agencies of Government, can start looking to terms of where the Federal Government in programs that it's sponsoring, that it hopes to fund at some time or another, might start helping to bring balance into this thing?

Mr. Volcker admitted that this policy is creating an uneven impact. We've talked about it. We've seen the disparity in interest rates. We've seen all of these things.

I guess I'm wondering if there isn't some way that you can, through the administration, give some kind of short-term relief while you're trying to realize your long-term policies, particularly to these dislocated areas?

Mr. SPRINKEL. Well, the deficit numbers that Congressman Neal and I were discussing—at least the ones I was discussing, and I believe his—were on-budget numbers. There are also off-budget numbers. Most of the programs that you referred to would involve increasing the off-budget deficit. This makes the matter worse. We must get the demand for funds down. We must get the inflation down. And I don't know how we can do it by encouraging more borrowing under Government programs of one kind or another. We're doing our very best to slow the increases in the off-budget items, not increase them.

Mr. HANSEN. Thank you.

The CHAIRMAN. Dr. Sprinkel, I understand that you have to leave, but I also understand that you would be gracious enough to return at 3 o'clock, because quite a few of the members have indicated a desire to ask questions.

Mr. SPRINKEL. I will be very pleased to return.

The CHAIRMAN. There's a lot of interest.

Mr. SPRINKEL. I appreciate your willingness to permit me to depart. I am going over to the IMF to discuss their review of our economic policies, so it will be another interesting 2 hours. But I'll be back.

Mr. D'AMOURS. Mr. Chairman, did I hear 3 o'clock is the time?

The CHAIRMAN. Yes.

Mr. Gonzalez?

Mr. GONZALEZ. Thank you, Mr. Chairman. I had a question for Mr. Mehle.

In your testimony on page 9, you state that the FDIC, the Federal Deposit Insurance Corporation agencies, are considering financial instruments, I believe you call it, and other means to bolster thrift institution net worth.

What I'd like to know is three things. What precisely do you mean by that? How will these instruments show on the books of the insurance funds? Will they increase the money stock and have to be offset by Federal Reserve open market operations?

Mr. MEHLE. Mr. Gonzalez, the financial instruments that are referred to were the subject of a bit of discussion by the regulators in their earlier appearance before the committee. In principle, the way that a financial instrument would operate on the balance sheet of a thrift institution would be that on the left side of the balance sheet, a financial instrument—for example, a note of the FSLIC or the FDIC, with a face value, let's say of $250,000—would be booked as an asset. On the right-hand side of the balance sheet, the entry would be to credit capital and surplus, thus increasing that account. A note could be presented to the FDIC or the FSLIC at the insistance of the institution and would be redeemable upon presentation for its face amount, $250,000 in our example.

Mr. GONZALEZ. Isn't that the same as kiting?

Mr. MEHLE. No. It's what our whole financial commercial establishment is based on. It's an obligation of an entity such as the FDIC or FSLIC that can be redeemed upon presentation, just like a note or an instrument of General Motors or the Federal Government or Oshkosh, Wis.—the same kind of thing. Insofar as the money supply is concerned, it has no effect because it's a financial instrument.

Now you note that I pointed out earlier that the thrift industry does not have any cash problem. Their asset growth was $14.4 billion for the first 5 months of 1981. And that is even after they have paid net withdrawals that depositors have asked to have.

Mr. GONZALEZ. You're saying they don't have any liquidity problems?

Mr. MEHLE. That's correct. Accordingly, the furnishing of any cash to the institutions doesn't really do them any good except in a very marginal sense, to the extent that the cash would offer some capacity to generate earnings. However, what they are really troubled by is this decline of net worth.

The decline of net worth arises from the negative earnings that they experience. The net worth account goes to zero. Because of conventional notions of, shall we say, solvency, people tend to think of a zero net worth as the time to close the doors—you're out of money, you are broke, something of that kind. That just isn't the fact here.

I might point out to you to underscore this concept that right now, if you were to value on a liquidation basis any particular thrift institution, it's quite likely that in so doing you would find out that the assets, when valued at market, were worth less than the liabilities. But that's once again not a matter of consequence when you're talking about a going concern.

So if you bear that in mind, you can see all the more, the concept of net worth should not be the one that controls the disposition of a thrift institution.

Mr. GONZALEZ. I don't mean to be disrespectful or anything, but you're the first one to testify officially that there is no disintermediation problem with the thrift institutions.

Mr. MEHLE. It's not that there's no disintermediation problem, but that is a question of deposits and withdrawals.

Mr. GONZALEZ. Everything, I would say, has to do with deposits and withdrawals. If you get more withdrawals than you have deposits, certainly you have a liquidity problem, certainly you have disintermediation.

Mr. MEHLE. No. Because there are other cash flows that are not often cited or discussed, different from deposits and withdrawals, namely cash flow from operations. Interest income, for example, is very large.

Mr. GONZALEZ. You mean the thrift institutions that are under the shadow that the regulators refer to, are aware of this that you're saying?

Mr. MEHLE. Certainly they're aware of it.

Mr. GONZALEZ. Why don't they admit it?

Mr. MEHLE. It's not a nice thing to have net withdrawals from month to month, but that doesn't mean you can't cope with them. And the way that they're financed, the way that those depositors are paid, is from the very large cash flows that arise from the collection of interest income, mortgage principal repayments and servicing fees.

Mr. GONZALEZ. But it seems to me—and this I just don't understand—that it's no different from the Billy Sol Estes operation. Isn't that what he did?

Mr. MEHLE. I don't know what he did.

Mr. GONZALEZ. Well, I guess it's because I'm older than you. It just seems to me that this is startling.

Mr. MEHLE. I admit that it is not a simple concept, because a financial institution is ordinarily thought of as being in peril if it has more withdrawals than deposits. Usually we expect the deposits to grow from month to month. It's healthy if they grow from month to month.

But I would like to point out that even if they decline from month to month problems only arise if you cannot fund those withdrawals. And what I am suggesting is that not only have the withdrawals been funded during the first 5 months of 1981—and there were net withdrawals, by the way, of about $5.5 billion—but that assets have also been funded. There has been a growth in the balance sheet of the industry of about $14 billion.

Mr. GONZALEZ. Then Mr. Pratt, who was here last week, in his statement to us, underlining the urgency of quick action on legislation, said if we didn't—the Congress didn't act expeditiously, that there were ominous things that would happen. In fact he did.

I thank the gentleman from Georgia. He reminds me that the word he used was "crisis."

Now how would you define a crisis, in view of your interpretation of the financial health or well-being of thrift institutions?

Mr. MEHLE. I would define a crisis as withdrawals from the institutions that they could not finance from their cash flow.

Mr. GONZALEZ. It seems to me that this is an absolute contradictory, by any difinition, evaluation of what the regulators were telling us was the matter, and the sense of urgency, just last week, sir.

Mr. MEHLE. Well, I would like to point out——

Mr. GONZALEZ. This is why I have been so critical, when we've had the Subcommittee on Oversight and Negotiation, with the regulators and the GAO, in reporting to us and revealing that actually the Congress never has accountability. We just don't get any accountability—the Congress.

I see this as a very, very serious matter, Mr. Chairman, because we are being put under the gun for quick action, based on a crisis emergency—which, by any definition, shows that the concept of the regulators and their definition of the health and status of these institutions is very different from what the Assistant Secretary here is advancing.

I would point this out. I want you to be right.

Mr. MEHLE. I want me to be right, too. [Laughter.]

Mr. GONZALEZ. Don't get me wrong. I don't want anybody to fall on his face. I might want them impeached. [Laughter.]

But I don't want them to fall on their faces.

The CHAIRMAN. Henry, if my members would indulge me half a second.

You just said a $14 billion growth in assets, right?

Mr. MEHLE. Right.

The CHAIRMAN. Now, are you including here the advances by the Home Loan Bank Board that were, a month ago, at $37 billion.

Mr. MEHLE. During that period of time, advances funded about $4 billion worth of the growth.

The CHAIRMAN. But what are the total advances for the Home Loan Bank Board now?

Mr. MEHLE. The totals outstanding, as of the end of May, are $50.8 billion.

The CHAIRMAN. $50.8 billion. That's at 15 to 17 percent, right?

Mr. MEHLE. It depends on the terms.

The CHAIRMAN. What do they do with that money?

What do the S. & L.'s do with those funds?

Mr. MEHLE. It's fungible, after all, but some of them have been using it to make mortgages with.

The CHAIRMAN. Why aren't many mortgages being made? Don't they reinvest at a higher rate? They're arbitraging it.

Mr. MEHLE. You can't really say that, because you can't trace the dollars.

The CHAIRMAN. I'm impinging on other members' time.

Mr. MEHLE. If I could, I would like to underscore one point that may help in this analysis. If you had the healthiest thrift institution that there was, earning profits from month to month, hand over fist, and all the depositors decided that there was something better to do with their money and came and asked for their money, the fact that that institution was earning, and had been earning, and had a very high net worth would be a matter of complete irrelevance as to its ability to exist under those circumstances.

The converse is also true. What I'm pointing out is that a crisis arises in a financial institution not when it has negative earnings, but when it has withdrawals which cause liquidity problems.

I did answer directly a question of yours, whether I thought there was a liquidity problem in the industry. I have to say that if the industry's assets grow this amount, then there is not a liquidity problem. Should there be one, I believe we'd have the adequate means to deal with it.

The CHAIRMAN. Mr. LaFalce?

Mr. LAFALCE. Thank you, Mr. Chairman.

Mr. Mehle, first of all I want to thank you for the comments you made regarding the Federal preemption of restrictive State usury laws. As you well know, I share your sentiments on that issue.

Second, I call to your attention the bills that I introduced last week, a package of eight bills that present various options for dealing with the McFadden and Douglas laws. It was unfortunate that the Carter administration took 4 years, and then rendered a report only in January of 1981. I would hope that the Reagan administration would take up the issue, and make some recommendations shortly—perhaps you can look at my bills—but take it up, so that we'd have enough time then to consider your opinions on it, as we discuss the issue, as one further means of enhancing the whole concept of competition within the larger financial industry.

My third point—in so far as the problem of thrifts are concerned, Mr. Gonzalez makes a very good point. We're getting dire reports from the regulators, and you're coming before us as a representative of the administration; and you are painting the other side of the coin. You're saying, well, the glass is half full; the others have said, it's half empty.

As a matter of fact, they have said more than, it's half empty; they have said, it's like about 90-percent empty. So we've got not only a difference in nuance or perspective, but perhaps in factual interpretation.

But I also suspect there's differences of opinion within the administration, too. I'm chairman of the Small Business Subcommittee, and Dr. Tiray came before me and said that we have a greater problem in the financial markets right now than at any time we've had since before the Great Depression. I think I'm quoting him fairly accurately.

I don't think you convey that message today. And those were his statements. I am really disappointed in the position that the administration took on the so-called "regulators' bill." Really, all we would have done there is facilitate the ability of the regulators to give capital infusion, to give loans. This would not have been an increase of money; this would not have been expensive money; this money would have been paid back.

Particularly with respect to the savings banks—and you know, 50 percent of the savings banks are in New York State. If we don't give the FDIC the ability to assist individual savings banks, without saying that those savings banks are absolutely essential to the particular community, they might not be able to act, even though they've got a basket case on their hands.

I call your attention to the regulators' bill as a vehicle. Perhaps there's a very good reason for you to reconsider, too. You didn't come up with any alternative to the regulators' bill. Neutrality on the merger and acquisition—let's not even get into that now.

Mr. MEHLE. I think it's more than neutrality.

Mr. LaFalce. OK. But in any event, I consider the most important part facilitating the ability of the regulators to assist the thrifts. But you did so at a time before the birth of the all savers' act, and you didn't want to loan Federal money. And now you are confronted with a situation where the U.S. Senate, led by the Republicans, or the House Ways and Means Committee, led by the Democrats, and where the minority on the House Ways and Means Committee, the Republicans, are all going to come out with some version of the All Savers' Act.

You know, I'm a cosponsor of that—at least I was. I took my name off after I studied it. We are now going to give away maybe $5 billion a year, with minimum benefit in return. I don't think it's going to increase savings. It could destroy some institutions, such as credit unions, depending upon the version. It's going to benefit some institutions that really don't need assistance, such as commercial banks. And it's going to give outright subsidies to all thrifts, whether they need it or not. And it's going to happen unless you not only vehemently oppose it, but say, faced with that alternative, maybe we will support something like the regulators' bill.

So, what are you going to do, Mr. Mehle? What's the administration going to do?

You're going to increase the two by about $5 billion. You have to tie this into deficits. And you're going to get almost nothing in return for it.

Mr. Mehle. That is the most cogent expression of opposition to the all savers' bill that I've heard. But I must say I think the administration joins in with that wholeheartedly.

Mr. LaFalce. But it's going to pass. It's in the Senate bill. It's in the House Ways and Means Committee bill. It's in the Republican substitute. And primarily because the administration has not come up with support of the regulators' bill, or something akin to it.

You know, the blame will be on the administration's shoulders, primarily for not coming up with an alternative. Now, maybe you don't think that's quite as cogent an analysis as my other analysis, but please comment.

Mr. Mehle. I guess you're suggesting it's a Hobson's choice.

Mr. LaFalce. I'm not suggesting it's a Hobson's choice. I am suggesting, if you are opposed to both, that there's the lesser of two evils, and you can proceed on that theory. Now, that's not a Hobson's choice.

Mr. Mehle. I do think there is a principle involved here. And as I stated, the administration expressed its opposition to the two aspects of the regulators' bill. I don't really think that that opposition in principle should be changed, based on some other almost unrelated activity. I mean, unrelated in the technical sense.

Mr. LaFalce. We live in the real world, Mr. Mehle. We're involved with trade offs. For the all savers', one of the other tradeoffs is we're eliminating or we're not going to continue the $200, $400 exclusion. So the little guy is really going to get hurt, because he can't benefit from the all savers'; and the little guy is going to be hurting because he's not going to get the benefit of the $200 or $400 exclusion.

That's the real world, and this regulators' bill is part of that real world. You know, comment.

Mr. MEHLE. I suppose if you approached it that way——

Mr. GONZALEZ [presiding]. The time of the gentleman has expired.

Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

I'll be brief. I appreciate Mr. Mehle's staying on hand.

Mr. Mehle, I think that your statement with regard to S. & L.'s reminds me of the story of the king's new clothes. I mean, if the suit isn't invisible on the S. & L.'s, at least it's badly tattered. They have some problems.

Mr. MEHLE. Indeed they have.

Mr. VENTO. And deregulation of that—in so far as, you know, my colleagues here, working on that particular proposal—has not straightened out their problems. In fact I think, in some respects, it might have contributed to them. But I guess it's a rather unique environment in which deregulation is taking place.

I suppose the judgment on that may be something that we want to look and monitor very closely. But I'm not so all convinced that Frank Annunzio, in his railing against deregulation, is not—maybe there was something we missed, in terms of that, that we might ought to look at more carefully, in terms of the mission of these various financial institutions, at least in terms of whether they're like brokers.

And I don't think the answer necessarily is to put reserves on money market certificates, as has been suggested. Because I think we've got a real phenomenon, in which there has been some change of attitude, at the very least. I think the names are now in the computers of the brokers, of the folks that have a few dollars to save or to invest or to spend, or however you want to characterize it; and they're not going to lose them. So they're over there now—I think there's some questions as to what's going to happen, and where we ought to be going, and what the institutions do.

We can probably insure, with the regulators' bill, with a tax change, that perhaps we could preserve the institutions. But the focus I'd like to look at—What are they there for? What are they supposed to be doing? And what are they doing under the present discipline?

What is this tax bill, if anything, going to do for them? I don't see very much. I see some direct things that can be talked about here. Some of that benefit goes back to the taxpayers. But I think the fact of the matter is that the administration's tax bill, if anything, lacked any type of discipline whatsoever, in terms of where it was going with the dollars, in terms of the initial proposal—of course, I quickly retreated to include some of these other savings aspect.

I guess, considering where we are going with the money prior to that, as opposed to making someone jump though a hoop, in terms of saving, to get the money is probably somewhat of an improvement, even though it may benefit S. & L.'s to some extent.

But once we get beyond this—and assuming this—the real assumption is that the mortgage rates are paying 15, 16, 17 percent; and people stop buying homes; they can't afford them.

High interest rates have not curtailed corporate borrowing power to the same extent. I think that's somewhat clear. The demand out there is very, very great for these dollars, and with the type of tax program that you're proposing, it's bound to increase. We have, in essence, been heading for somewhat of a collision.

But are you saying that this administration expects homeowners and other small businesses to compete with the Mobils, DuPonts, and others for loans? Is that what you're saying?

Is that really what you're trying to attain?

You don't believe in any type of differentiation with regard to credit?

Mr. MEHLE. I don't think the homeowner ever has competed, or ever will compete with Mobil, Exxon, and so forth for credit because the lending decision and the sources of funds for single family mortgage loans are very different from the lending sources for corporate unsecured long-term or short-term or intermediate-term obligations.

We do believe that the competition for credit ought to take place in essentially an unfocused or unrestrained environment such that if a thrift, for example, would like to specialize in the mortgage lending field, it may do so, but is not compelled to do so.

Mr. VENTO. Let me interrupt you, because I want to be brief. On that question, I assume you mean by that that thrifts ought to have the 80 percent of their money that goes to mortgages reduced.

Is that what you mean by that?

That the 80-percent figure ought to be further reduced, in terms of thrifts, that they now have to set aside for mortgages?

Mr. MEHLE. They only have to do that if they seek a certain tax advantage. Most of them do do it. But I would expect that if thrifts are given additional complementary powers, but if you kept on a tax restraint, it would effectively render unusable those additional powers that they were given.

Mr. VENTO. I think, you know—I agree. I think the effect is the same. I think money is the present phenomenon that you see in whatever the amount credit is, and the type of incentives that you're building to the market place.

In other words, that homeowners will be competing for some time, with the Mobils, with the others, the DuPonts, and so forth, for money in the future, in the near future, as far as I can see. And I don't see a decline.

So, are there any special things that you're considering, any programs you're considering, any means you're considering, of focusing on what I perceive is a very significant consensus goal—that is, housing mortgage money.

Mr. MEHLE. You know, there are a number of specialized programs which the administration does favor.

Mr. VENTO. Maybe you'd like to do this in writing?

I don't want to take up my friend's time from Georgia, who's waiting impatiently. But I would appreciate your help.

Mr. MEHLE. Maybe I can just briefly mention that the HUD programs are of direct assistance to the housing industry.

Mr. VENTO. I'm very familiar with those programs. In fact, I've seen a major demise in those programs.

But if you'd like to provide a fuller answer. I'm on the Housing Subcommittee.

Mr. MEHLE. I certainly will.

Mr. GONZALEZ. Thank you, Mr. Vento.

Mr. Barnard, you've been very patient.

Mr. BARNARD. Thank you, sir.

You've somewhat sidetracked my direction of questions by deemphasizing the plight of the savings and loans. But I don't want to get into that any further than we've already gone into it.

I might suggest that the thrift institutions of this country would like to talk with you, because they are convinced that they've got problems. When they saw their deposit base erode to the tune of over $100 billion in a very, very short period of time, it gives them reasons to believe that they've got problems.

Mr. MEHLE. They do, indeed. It's just that they're not unmanageable. That's the point I want to make. They're not unmanageable problems.

Mr. BARNARD. Some of the thrifts are finding them difficult. Some of them send me their financial statement each month. They're losing half a million a month, and I'm talking about little ones.

We've got savings and loans in my area that no other ones want to acquire. They can't do it because of the lack of profitability. These thrifts are locked in with their interest rates. They've already eroded their surpluses, and they're just absolutely insolvent.

I'm awful confused by your testimony, which minimizes the plight of the savings and loans. I just don't quite understand that.

But I would like to pursue another line of questioning for just a few minutes.

In your testimony, on page 2, you say—

> We must build a strong and competitive framework that will give our institutions the flexibility to respond to a changing financial environment and shifting market forces with the best and most varied financial services for years.

Well, let me see if I can interpret that.

"To respond to a changing financial environment"—what do you mean by that? Do you mean the movement of money market mutuals into the traditional financial markets?

Mr. MEHLE. I mean the upsurgence of any number of new competitive institutions or new instruments from the same competitive institution.

Mr. BARNARD. What about different institutions? What about the nonfinancial markets? Are you talking about that, too?

Mr. MEHLE. Yes.

Mr. BARNARD. But you primarily then are looking inwardly to the existing financial institutions to change the financial environment of other and weaker existing financial institutions?

Mr. MEHLE. I'm talking primarily about financial institutions.

Mr. BARNARD. Let's talk about nonfinancial institutions. Let's talk about insurance companies.

Mr. MEHLE. I count those as financial institutions.

Mr. BARNARD. They're not financial institutions in the known terminology of "depository institutions."

Do you consider Merrill Lynch a financial institution?

Mr. MEHLE. Yes, but not a depository institution.

Mr. BARNARD. But we're talking about how these highly regulated institutions, banks, savings and loans, credit unions, and mutual savings banks—is the administration at all concerned about the infiltration into these areas by nonfinancial institutions?

Mr. MEHLE. Absolutely.

Mr. BARNARD. Then question number two: What are you doing about it?

Mr. MEHLE. Well, Mr. LaFalce requested that the administration might proffer some suggestions. I think he spoke particularly about McFadden, which is a financial institutions competition question.

I was about to hark back, but I didn't get an opportunity to, to the Secretary of the Treasury's testimony before the Senate Banking Committee on April 28, at which time he pointed out that he hoped, in time, to develop a position that would have the administration's stamp of approval on it, that would address the question of both financial and nonfinancial institutions in their competitive posture, particularly as they are regulated differently or excessively. That, I would think, will be forthcoming.

Mr. BARNARD. Mr. Mehle, in your testimony, the only solution that you have brought up to help financial institutions has been one thing, and that's the administration's efforts to control inflation. And yet, between you and Dr. Sprinkel this morning, we haven't yet—and I know that you cannot—put a date certain as to when we're going to get a handle on this. We talked about maybe 1 year, 2 years, or 3 years.

But the financial institutions, are so regulated that they've got every form of restriction the Government can devise. They've got restrictions on how much interest they can pay, and that's not improving to much degree.

I'm delighted to see the DIDC wake up and propose an interest deregulation plan, which happens to be patterned after my bill, which I introduced in November 1979. But the point we've got to address, I believe, is some much more significant factors as far as competition is concerned.

I am specifically speaking about the Glass-Steagall bill. That is the most obvious legislation that is being abrogated today that I know. We've got American Express, who owns a stock brokerage and a bank.

We've got banks in the West who are operating in half the States west of the Mississippi, while others are limited to single States. We are not really interested in financial institutions to the degree that we're going to unshackle them with the prohibitions of their marketplace.

Let's talk about one little incident. That is banks' underwriting of municipal revenue bonds. You've been in there, you've been on the side of the table that has argued that this is an improper activity for banks. At the same time, we've got brokerage firms writing money market mutual funds to the degree that they're damaging the banks. Now, how consistent can that be?

How can you say, on the one hand, that a simple little service of underwriting municipal revenue bonds, although banks can underwrite other revenue bonds is wrong, but total lack of controls on money market mutual funds is right. You're going to do the financial institutions in. I have never seen anything so inconsistent in my life.

Now, I want you to tell me, what is the position of the administration? Are they going to be consistent or inconsistent?

Mr. MEHLE. Well, I hope they're going to be consistent.

Mr. BARNARD. This is why I say let's prove it. Let me hear you tell me that you all are going to support H.R. 2828, just a simple little change so that banks can underwrite municipal revenue bonds?

Mr. MEHLE. Well, I can't tell you that.

Mr. BARNARD. Why not? Don't you believe in fair play?

Mr. MEHLE. Because the administration has not developed its position on it.

Mr. BARNARD. Don't you believe in fair play though?

Mr. MEHLE. Do I? Well, I don't think that my personal view might be——

Mr. BARNARD. I think your views have got a lot to do with it. You're sitting there making policy. You're making administration policy. I'd like to know what you think about that.

Mr. MEHLE. As I say, the administration hasn't developed a position on it, and therefore, I'm not in any position to say.

Mr. BARNARD. Let me ask you this: What have they been doing since April 28 on the McFadden-Douglas situation?

Mr. MEHLE. There are studies underway. And when the tax bill gets out of the way, I expect that the administration will take this up. But that has consumed a great deal of energy.

Mr. BARNARD. I'll tell you what worries me. We're going to see—in spite of what you say, we're going to find financial institutions which, I again want to emphasize, are shackled with more regulations, shackled with all the CRA, all the Home Mortgage Disclosure Act restrictions, shackled with all these prohibitiions. We're going to see them suffer with no relief.

It reminds me of Nero fiddling, Mr. Chairman, while Rome burns.

And who's going to get the blame for it? The Banking Committee is going to get the blame for doing nothing for the banks. And that's not fair. We're looking for leadership from the administration.

Mr. MEHLE. I think you'll get it, Mr. Barnard.

Mr. BARNARD. Well, we need it fast, because I feel that the whole competitive framework of the institutional markets has been destroyed.

I compliment money market mutual funds. They have addressed themselves to the marketplace. But it is absolutely unfair to still shackle the depository institutions, who are doing their part from the standpoint of giving credit.

We talk about, Mr. Chairman, local banks giving credit to local communities—who does that? It's not the money market mutuals. They're putting their money in New York and Chicago and Los Angeles. They're not putting it back in the local communities. So the local communities are suffering.

I think the administration must act, and hopefully you will very soon. I'll give you something to go on.

Look at H.R. 4040—a very simple bill. It permits, No. 1, banks to underwrite all types of bonds.

No. 2, it addresses the question of insitutions offering mutual funds.

Then, No. 3, it asks the administration for a real study as to the marketplace of different types of financial institutions today. I think it's very, very serious.

Mr. GONZALEZ. Thank you, Mr. Barnard.

The Chair was very patient, because you've been very patient. Your observations are of great value.

Mr. Patman.

Mr. PATMAN. Thank you.

Mr. Mehle, on page 5 of your statement, when you make the comment "I think it's important to note that during the 5 months of this year the net worth of savings and loan associations declined an estimated $1.4 billion and their assets increased approximately $5.5 billion."

At that time the assets were increasing $5.5 billion, were their liabilities increasing by $5.5 billion?

Mr. MEHLE. Mr. Patman, you may not have been here earlier when I corrected that number. The number is not $5.5 billion, it is $14.4 billion, just for the purposes of our discussion.

Mr. PATMAN. Fine.

The illustration is the same. Then the liabilities increased by $14.4 billion, too, do they not?

Mr. MEHLE. Yes, of course.

Mr. PATMAN. So, that does not really seem to put them in a whole lot better shape, does it?

Mr. MEHLE. Well, when your assets increase, your liabilities usually have to increase. And the business of banking is all about that. That's how you get more assets, by getting more liabilities.

Mr. PATMAN. You mentioned about withdrawals not being too great a problem because of the cash flow. That would be unobligated cash flow, would it not? You'd have to have an obligated cash flow that's going into taxes, wages, or rent, or something like that, to meet some obligation in the way of a withdrawal if you're paying for it out of cash flow.

Mr. MEHLE. I'm not sure I understand the concept of obligated cash flow.

I will say that the cash flow that I am referring to is all cash taken in as the result of operations or as the result of borrowing or as the result of net deposit inflow. Then there is all the cash that goes out, which may be used to pay the salaries of employees, to pay interest expense to the extent it's cash, or to fund any net withdrawals there are during the period.

Mr. PATMAN. Obviously, it would have to be cash flow that wasn't needed in order to pay some of their obligations.

Mr. MEHLE. Sure.

Mr. PATMAN. You mentioned something about an FDIC certificate, an FSLIC certificate that would go in the asset column and also be part of the net worth. Is that a part of your plan, to beef up the solvency of the financial institutions?

Mr. MEHLE. It's something that's being considered by the depository institutions' insurance agencies right now, and it is something that they would sponsor and manage and so forth, not the Treasury.

Mr. PATMAN. And they borrow this thing, or they get it free, or what?

Mr. MEHLE. They issue an obligation of their own.

Mr. PATMAN. That's a liability then, would it not be?

Mr. MEHLE. It's their liability, right.

Mr. PATMAN. Yet it goes into net worth, it beefs up the net worth part?

Mr. MEHLE. No. It's the liability of the insurance fund, and it's an asset of the recipient. The recipient would be a thrift institution, let's say.

Mr. PATMAN. So it's a loan to the savings and loan?

Mr. MEHLE. In essence.

Mr. PATMAN. They don't carry it as an obligation they have to repay, is that what you're saying?

Mr. MEHLE. It's not an obligation of theirs, it's an asset of theirs.

Mr. PATMAN. So it's given to them; is that what you mean?

Mr. MEHLE. Yes.

Mr. PATMAN. Then, by reason of that gift then——

Mr. MEHLE. I didn't know you meant "give" as a gift—"giving" as in "gift."

I mean it would be given to them. They would have some obligation to liquidate it over time, presumably.

Mr. PATMAN. It is simply an asset of theirs that contributes to their net worth, they have no obligation to repay it?

Mr. MEHLE. I didn't say that. I said over time it probably would be that they would have to liquidate it.

Mr. PATMAN. Now, if they're going to get that asset, that would increase their liability, would it not?

Mr. MEHLE. No, it would increase their capital and surplus.

Mr. PATMAN. It only would if there's no obligation to repay it, wouldn't there?

Mr. MEHLE. If there is a strict obligation to pay it back, as you would pay back a debt, it would be a liability. But it has to be designed, of course, so that there is no obligation, there's no liability that arises. And that can be done.

Mr. PATMAN. Why not make it a liability?

Mr. MEHLE. It wouldn't do any good.

Mr. PATMAN. Why do we have an obligation to give them more net worth? Why should that be a liability of theirs, to where they have to acknowledge payment back?

Mr. MEHLE. Well, I think——

Mr. PATMAN. Or are we just trying to fool ourselves into thinking that it's not a gift? When they receive this thing, that increases their net worth and their assets; is that true?

Mr. MEHLE. That's true.

Now, the purpose for all that——

Mr. BARNARD. Would the gentleman yield?

Wouldn't you say, in that illustration then, that the FSLIC becomes a part owner of that financial institution?

Mr. PATMAN. Not if it doesn't have any control over it, not if it doesn't have—well it should, yes. That's part of the ownership equity. That's what you're talking about, the ownership equity as far as net worth.

Mr. BARNARD. Why should a regulator though own a bank?

Mr. MEHLE. If they have some equity share, which is not expected to be the case.

Mr. PATMAN. They just have all the bad features and none of the good, I should say.

Mr. MEHLE. I think one of the things that you might want to focus on is that right now the Federal Savings and Loan Insurance Corporation is authorized to make contributions, outright contributions, to a thrift institution that might be distressed.

So, currently, if it chose, it could make a contribution of cash to the thrift institution. The cash would be booked as an asset, cash. And there would be a credit to the capital and surplus accounts. So it already has those powers.

Mr. PATMAN. And who suffers if there's a loss?

Mr. MEHLE. Well, there's a whole list of people who suffer. First would come the stockholders.

Mr. PATMAN. And Uncle Sam suffers, I suppose.

Mr. MEHLE. Uncle Sam is certainly one of those who will suffer, because he is insuring all the depositors of the institution to begin with. So if he has to pay all of them off, he definitely will suffer.

Mr. PATMAN. My time has expired.

I appreciate your answer.

Mr. GONZALEZ. I'd like to thank the gentlemen.

Thank you, Mr. Secretary. We deeply appreciate the time you have devoted.

The committee will stand recessed until 3 p.m., at which time Secretary Sprinkel will return.

[Whereupon, at 1:20 p.m., the hearing was recessed, to reconvene at 3 p.m., this same day.]

AFTERNOON SESSION

Mr. NEAL [presiding]. Mr. Secretary, we have just been notified that there will be a vote on the floor. We have about 15 minutes. We might take a few minutes.

I'd like to call the committee back to order. I've been asked to chair the committee for a while. The chairman is incapacitated with a bad case of sun poisoning, as I understand it. I'll chair it for a while and other members will be drifting in. We will probably, if it is the will of the committee, rise at the next bells and catch the vote and come back, and pick up our deliberations in a few minutes.

I'd like to recognize Mr. D'Amours at this time and see if he'd like to question the witness.

Mr. D'AMOURS. Thank you, Mr. Chairman. I didn't hear the bells right. I don't know how much time I have before the next bells.

Mr. Sprinkel, first of all, I want to thank you for coming back. It was gracious of you. I appreciate it, and the other members of the committee who have questions also appreciate it.

I would like to direct your attention to page 5 of your testimony. There is a graph on page 5, and on pages 5 and 6 of your testimony you develop the thesis that the current high rates of interest are due to market uncertainty about the long-term prospects for money growth and that this uncertainty is due to the wide short-run variations in money growth tolerated by the Federal Reserve. As I look at the table, I don't see that fact demonstrated. You show, for instance, that February through May in 1980, there was a 5.5-percent decline in M_{1B} accompanied by a 139 basis point decline in long-term interest rates. And then from May 1980 to November 1980, a 14-percent increase in M_{1B} was followed by a 198 basis point increase in long-term interest rates. So, as you said in your testimony, that's tracking the rise and fall of money growth with interest rates.

As I read your figures, the only remarkable difference or aberration to occur occurs in the April 1981 to June 1981 period, where a 6.9-percent decrease in M_{1B} was accompanied by a relatively insignificant 13 point decrease in the long-term interest rates.

Now, I have difficulty subscribing to your theory that this is due to the Fed's erratic performance in controlling the money supply because, in point of fact, throughout this entire period we have the same Fed implementing the same monetary control policies. The only thing that changed is a new President with new fiscal policies, and I would suggest that the reason for this problem, is not any change in policy on behalf of the Fed or any lack of faith in the Fed's policy by the business community. You yourself, at page 3 of your testimony and page 7 of your testimony, state very clearly that this current Fed and certainly this current Chairman of the Federal Reserve Board has gotten great believability and great credibility in his tenacity and his willingness to stick to tightening money supplies.

So I would suggest that the reason for this change is that the current administration is ignoring budget deficits and their impacts upon the bond markets, which these figures are based upon, and that that's the reason for the fact that we're having this refusal of interest rates to track money supply. So what you people are doing is giving Paul Volcker a job to do that he can't do by himself, and when anything goes wrong you blame the Fed for what's gone on. I'd like your reaction to that.

Mr. SPRINKEL. First, there hasn't been any change in modern times on the direction of change in interest rates and their relation to the direction of change in money. However, if you'll backup a decade or so, you will find that, inevitably, when money supplies goes up—under the same Federal Reserve as today and before President Reagan came into office—whenever you've got an overshoot in the money supply, interest rates rise. When you've got an undershoot interest rates decline. That's still the pattern.

It's also been the pattern that during the last several years it tended to rachet upward; that is, the market acted as if it wasn't convinced that any slowdown was for real and that the slowdown would be continued. And each time we had an overshoot, we had to do it again. You tend to get an uncertainty premium built into interest rates, and the more erratic the money growth the greater that premium.

It is true, if you'll back up approximately 15 years, a friend of mine who has testified before this committee, Phil Cagan, did a study on trying to determine the length of the so-called liquidity effect. That is, commonsense tells me that if you pump in more money, that ought to reduce interest rates. So there's additional money in there bidding up Treasury bills and presumably pushing down rates. In fact, that's the way it used to be, Mr. Cagan's study indicated. He looked over some periods prior to 15 years ago. When more money was pumped into the economy for a period of about 5 or 6 months, interest rates typically declined, which is what commonsense would sort of suggest.

All I am saying is that in the last 10 years or so, there has been increasing concern about inflation, inflation potential, and consistency of policy; that each time the money supply overshot, so did interest rates. The most recent occurrence was last Friday, when we had a $6.9 billion increase in the money supply which was more than the market expected. Their estimate was $3 or $4 billion. It turned out to be $6.9 billion. Instantaneously interest rates went up.

I am not saying that's the way the market ought to work. I am just saying that's the way it does work. The reason it works that way, in my opinion, is the concern about the inflation potential resulting from the rapid increase in the money supply. And let me add that we are not oblivious to concerns about deficits.

Mr. NEAL. Excuse me, Mr. Secretary. Let me stop you here. I am sorry to interrupt, but if we are going to make this vote we will have to leave now and come back. We'll be back in about 10 minutes.

Mr. SPRINKEL. I'll wait.

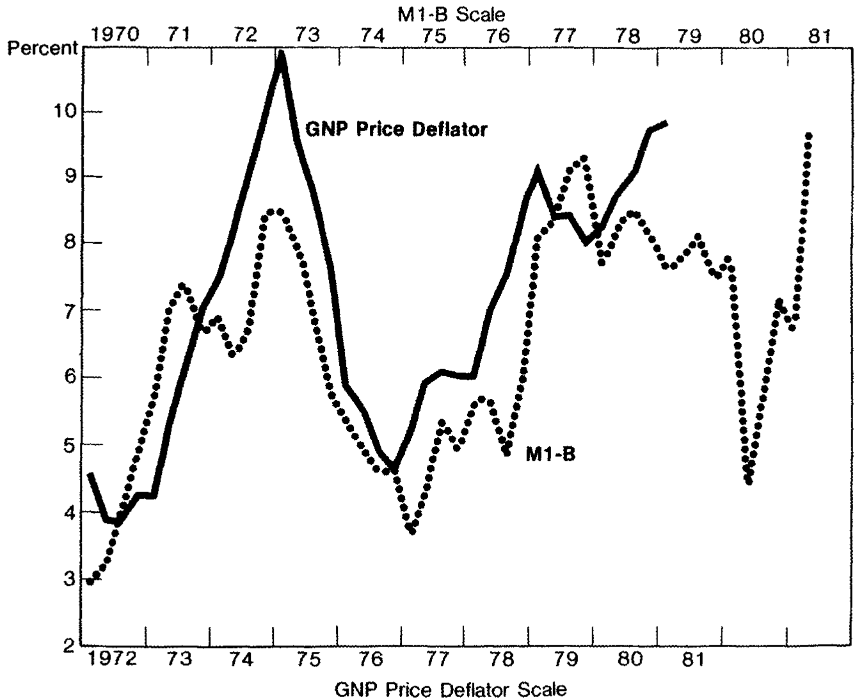
[Recess.]

Mr. NEAL. I call the subcommittee back to order and apologize again for the interruption, Mr. Secretary. Please proceed with your answer.

Mr. SPRINKEL. I guess I was about to say that we were, indeed, concerned about the deficit, and we will make every effort to balance it during the first 4 years of this administration. But that still leaves the first question as to whether deficits cause inflation. The evidence is very clear that they do not. Excessive money growth causes inflation. I have a chart showing that relation historically. It's not a perfect relation but it's a very good one, and there are good theoretical reasons to believe it's true.

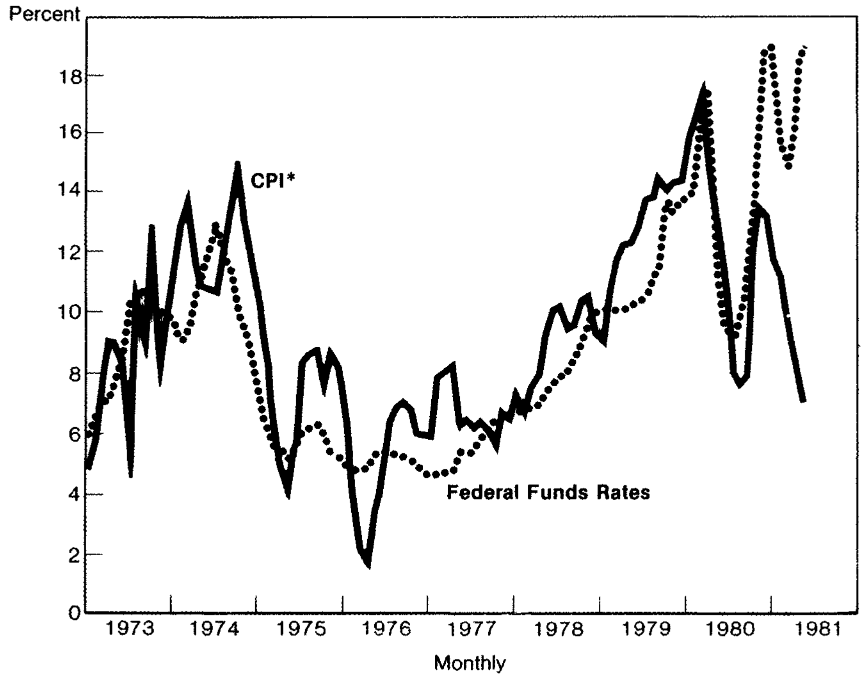
Second, do deficits cause high interest rates? To test that you must try to find a period where you didn't have a deficit and you had high rates of money growth, and did you get high interest rates? We can find one of those. That was the only time we balanced the budget in the last 20 years, and that was really by accident in 1968–69, I believe. We cannot find the opposite sort of situation where we had a significant deficit, monetary restraint, and declining interest rates. So you can't be absolutely certain; but you can be certain that if you slow money you will slow interest rates, because we have a lot of evidence on that front.

Money Leads Inflation by Two Years
Growth Rates in GNP Price Deflator and Money Supply (M1-B)*



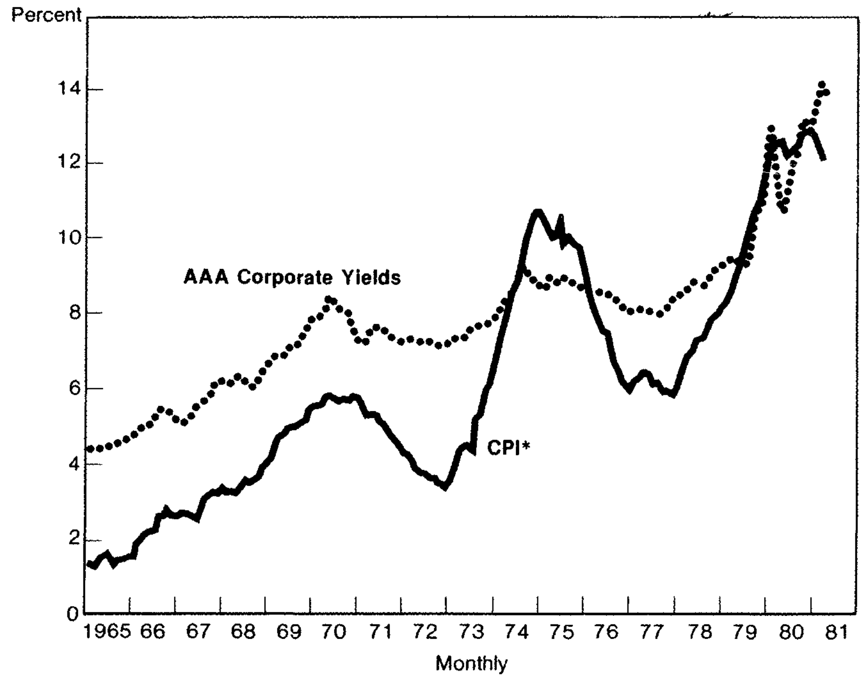
*Quarterly figures. Growth measured from one year earlier.

Interest Rates and Inflation
Federal Funds Rate and Rates of Change in Consumer Price Index



*Growth measured from three months earlier, at annual rates.

Interest Rates and Inflation
Yields on AAA Corporate Bonds and Rates of Change in Consumer Price Index



*Growth measured from 24 months earlier, at annual rates.

The chart showing interest rates and inflation, indicates they track very well. The higher the inflation the higher the level of interest rates. You will notice very recently there's been a parting of the ways, and one of the two is going to change, and I will tell you what my guess is. It's going to be interest rates, not inflation. Or, if you look at the longer term trend, you can see that longer term rates are also influenced by inflation rates.

We are also concerned about the deficit. I hope I have destroyed that myth that I am unconcerned about the deficit, because I have been quoted a few times as saying I don't care about deficits. That's dead wrong. I want to get rid of them. They are an unadulterated evil either because they result in too much money growth or because they absorb savings that could otherwise go into productive investment.

Mr. D'AMOURS. I didn't want to interrupt you. That was a pretty long answer and it raises several issues that I would like to pursue, but I am limited as to the time I can ask questions. Therefore, I want to get back to the original question, because I don't think you answered it.

You gave me a chart that I think rather clearly shows that this ratcheting, as you call it, of interest rates begins to occur in the period April to June 1981. Your chart clearly shows that in April to June and in all the other periods, there's a tracking, as you suggest, of interest rates to money growth, and that the ratcheting of that tracking only occurs in the period April to June.

Am I not correct in saying that that's what this chart you gave us shows?

Mr. SPRINKEL. It doesn't appear that way to me, but perhaps you are interpreting it correctly. The way it appears to me is that in earlier periods of monetary restraint——

Mr. D'AMOURS. Excuse me, now. I am going to have to interrupt you because I am running out of time. Earlier periods may or may not be relevant to our discussion. I happen to think they are not, because in point of fact, the tracking in charts prepared by the Domestic Monetary Policy Subcommittee's staff demonstrates—and I'll get you one of those charts—shows that the tracking of interest rates to monetary growth does not begin to occur until October 1979 when the Fed changed its policy. And I will send you—you're shaking your head no. I'll send you a chart. Somebody from the staff will give you a chart showing you that point. But I still think that that tends to be somewhat irrelevant, because you gave us a chart. I'm asking you to explain your own chart, not my chart. Your chart shows the ratcheting occurring in April to June 1981, does it not?

Mr. SPRINKEL. It also shows it on earlier occasions.

Mr. D'AMOURS. Where?

Mr. SPRINKEL. In the earlier period.

Mr. D'AMOURS. No; I'm talking about your chart. The period covered by the table.

Mr. SPRINKEL. You mean the table?

Mr. D'AMOURS. Chart, the table on page 5.

Mr. SPRINKEL. It shows that when you have rapid growth of money, you get a larger increase subsequently than you get when money slows down on the decrease side; so that you tend to get higher and higher interest rates on average, even though they come down when you have slow money growth. And it shows that throughout that table, I believe.

Mr. D'AMOURS. But the heavier ratcheting that you referred to in your testimony occurs in the April to June period of 1981, right? There you have a 6.9-percent decrease in money growth followed by a relatively insignificant 13 basis point drop in interest rates. Isn't that the significance of this?

Mr. SPRINKEL. That's one of them. November 1980 to February 1981, we've got only 16 basis points.

Mr. D'AMOURS. OK. Let me just follow with this. The Wall Street Journal, Monday, July 20, 1981, says that bond traders are all deficit oriented. They are still focusing on deficits and large Treasury borrowing that will keep credit tight. And that is assigned as the reason for high interest rates.

Now, I know that the administration, Mr. Niskanen recently admitted that the administration was confused about high interest rates. They don't want them to have anything to do with the deficit. So I see you coming in here and saying well, they really don't, and assigning a reason that I find somewhat unexplained by your own chart and contradicted by the bond people who are setting the rates, who are helping to determine the rates that we're referring to, that you're using for the basis of your chart.

I raised this point with Mr. Volcker. I don't think we can whistle by that graveyard. I know the monetarists, including Mr. Friedman, are saying that deficits that just a year ago they thought were anathema aren't so bad now if you don't monetize them, if you don't do this or you don't do that. All the evidence is that those deficits are exactly what's causing the high interest rates that we have today, and that does not fit with this administration's scheme of things and they're saying that in fact, the king is very well clothed, when we know he isn't.

I'm sorry I took more time than I perhaps should have, Mr. Chairman, but the vote rather confused things, and I appreciate the Chair's patience.

Mr. SPRINKEL. May I make one brief response?

Mr. D'AMOURS. Of course, I want you to reply. I don't want to cut you off.

Mr. SPRINKEL. I can't speak for Mr. Niskanen's, but I don't feel confused on this issue, because what I've been saying, it seems to me, is consistent with the facts as I see them.

Mr. D'AMOURS. Maybe you'd better take Mr. Niskanen's place on the council.

Mr. SPRINKEL. What I'm saying is the only way we are going to get interest rates down is to slow money. It isn't a day-to-day relation, but it's very clear that over a long period of time when you have rapid growth in money you have high and rising interest rates. When you have slow growth of money, you have decelerating rates. Look at Japan today.

Mr. D'AMOURS. And when you eliminate deficits, you have declining interest rates.

Mr. SPRINKEL. I would appreciate it if you could show me the evidence on it, because I have looked and I can't find it. That doesn't mean it doesn't exist. I would be very pleased to look at your evidence.

Mr. NEAL. Thank you.

Mr. Paul?

Mr. PAUL. Thank you, Mr. Chairman.

Dr. Sprinkel, I had a brief comment to make and then a question for you. In your written testimony on page 6 you refer to the support you have gotten for your policy from the committee. But you mentioned that there has been, on two reports, only one dissenting view. It probably won't take too much guessing to find out who did the dissenting on the overall policy that we've been following. Not only have I dissented on those two views, but in every chance I've had in these past 3 years, beginning with July 1979, two more in 1950, and one in 1981. I assume that the conditions will be the same this time and the report will be the same, and I again will complain about the policies that we have been following.

On the last page of your testimony you state that participants in the domestic and international financial markets will soon get the message: "expectations of continued rapid inflation in the United States are wrong." I wish I could share that optimism with you, and I am hoping you are right and that I am wrong. But for some reason I place a lot of confidence in the marketplace in making these judgments, because I feel the market is efficient and wise.

I complain about the overall policy because I think that we're approaching it the wrong way. The system is wrong. It isn't that the Treasury officials and the Federal Reserve officials are incompetent or that they have the wrong plan; that is, of reducing the growth of the money supply; because I certainly think that's a good intention. But the technique and the system needs to be changed. I think it's impossible to have proper money management of a monopoly system of money which is an irredeemable paper standard. That's what we're trying to do.

It's like asking a good businessman to come to run the post office. You get a good businessman and you call the post office a corporation, and you expect him to be efficient and turn out profits. Government doesn't operate that way. Now, that might not be a perfect analogy, but in many respects it is similar. We cannot expect the monopoly management of money to be successful because it's never been successful before for any significant period of time.

We do not have anything other than short periods of history where money management of a fiat currency has been successful. I think we're seeing the same results in England today, and I am afraid we'll see similar results here. I complained 3 years ago and predicted the results we're having today. The committee was well intended, as they delivered the message to the Fed. And the Fed, I am sure, intended to follow the advice. They didn't do it, and I am afraid we're going to have these same problems in the future.

For instance, you do not like the idea and blame the markets and say they're wrong in their expectations. Yet, in our budget resolution this year, which is certainly an improvement over what we'd have had if Gramm-Latta had not passed, but inside that resolution, buried for the first time, we passed an increase in the national debt for next year of $80 billion. That's not inconsequential, and I think the markets are paying attention to that.

When we tell the American people we're going to double the defense budget, and the administration is urging an increase in Export-Import Bank funding and foreign aid, and the power of the Congress to decrease the welfare spending is minimal, I think we will increase all the expenditures. I am pessimistic in this sense. We have a tremendous problem here not only fiscally, but monetarily.

Back on page 2 you state again that the "costs which the economy now bears for repeated failure to fight inflation in the past." I agree with that, but you follow up and say that the first task is to break the strength of inflationary expectations. That requires establishing the credibility of a policy of long-term monetary control.

This is leading up to my question. My question is: What is the policy of the Treasury to help break these inflationary expectations? I would suggest it contradicts your overall theme, because in May 1981, if my information is correct, the Treasury issued 30-year U.S. Government bonds, noncallable, for 13⅞ percent, which means that you must be anticipating a lot of inflation or you would have borrowed this money short term, and reborrowed it later on when you get inflation under control. I happen to think in a few years those bonds are going to be greatly discounted, because the inflation rate and the interest rates are going to be much higher for we don't have any control over the money supply. But why does the Treasury issue noncallable bonds at 13⅞ percent interest and think that that does not add to inflationary expectations?

Mr. SPRINKEL. Could I first comment on some of the other observations very briefly, and then I will go to that one? One is that the international markets are reflecting an expectation of decreasing inflation, as I interpret it. If we look at the dollar, it clearly has improved very sharply since we took office. It had begun slightly before we took office, but it became reinforced. We are more credible in the international markets than we were previously. I think it is due fundamentally to the fact that we have an anti-inflationary program underway vis-a-vis the rest of the world.

If you look at commodity prices, which are very sensitive to inflation, they have been going down, not up. They do very well in periods of accelerating inflation; they do very poorly in periods of decelerating inflation. If you look at the metal markets, the same is true. Gold is about to break $400. It does extremely well in a period of accelerating inflation. We did a lot of work on that. It does very poorly in a period of decelerating inflation. The same thing is true of silver. It has not happened yet in the money markets, and I do not want to say that people in the markets are irrational. I also believe in efficient markets.

I think I am more convinced about the dedication of this administration than some of the people in those markets, and we'll find out who is right.

You mentioned monopoly money. I studied under Professor Hayek. He was one of my favorites. He taught at the University of Chicago. I'm well aware he's written a book on a different kind of money. You and I are involved on a Gold Commission that's going to look into that and related issues. But there are some examples—

not many, but a few examples—of managed currencies that have done pretty well. I point out the Germans. They went through two miserable inflations in the last half century, but in modern times they have done extremely well, as have the Swiss, and since 1974, the Japanese.

How do they do it? They did it by doing exactly what we intend to do; namely, slow growth in money. The Japanese money supply is barely dribbling upward. Their inflation, which when I was there in 1974, was running at about 30 to 35 percent, is down to 3 or 4 percent; that's what it is today. It's not zero, but it's a lot better than us.

Now the question that you asked specifically had to do with financing the Federal debt. Shortly after I came into Treasury, I initiated an investigation on that very fundamental issue. Were the financing techniques used during the period of accelerating and rising interest rates the same set of techniques that we should use if we're right and we're entering a period of decelerating inflation and declining interest rates?

We have not completed it, but we're well along. One of the important issues that I'm looking at currently is the one you mentioned: Should we continue to sell long-term debt in this market? It has not been resolved, but if you'll hang on, I think it will be resolved.

Mr. PAUL. I just have a very fast follow-up. Could you give us the dates on the Germans' managed currency and the Swiss' managed currency—the rough dates?

Mr. SPRINKEL. They have managed currency now. They both have a monetary target. They both work on the monetary base. The Swiss—I don't have a chart in front of me—but I would suspect that the Swiss have had the lowest rate of inflation, on average, for 15 or 20 years. The Germans had their monetary reform, I believe, in 1948. Over the last 10 or 15 years, they haven't had perfect results, but they've had very low rates of inflation.

We used to be No. 3; we're no longer in that category. We're up sort of on the high end of average.

The Japanese really began to do it in 1974 when they came from that 25 to 30 percent inflation rate, and then, I think, it got up as high as 35 very briefly. Since then it's been low single-digit.

It can be done. But that doesn't mean that everybody is going to do it.

Mr. PAUL. Which again is a short period. Of course, I think the Swiss keep in their reserves, about 70 percent of their reserves in gold, if I'm not mistaken.

Mr. SPRINKEL. They do have some gold. There was one period a few years ago when the Swiss went off their monetary targets and started defending their exchange rates. They had a big jump in their money supply. A year or two later they suffered an accelerating inflation, up to about 12 percent. But then they got back on target and it came right down.

If you don't live with discipline—whether it be a gold standard, a managed system, a commodity system, or whatever—if you don't stick to the discipline, you're going to suffer, and that's why we're suffering. We didn't stick to the discipline. The U.S. voter did not insist that their administration, their Congress, their Federal Reserve perform in a way designed to get inflation down.

We were elected to make sure that happens, and we will do our best, with the cooperation of the Congress and the Federal Reserve.

Mr. NEAL. I'd like to recognize Mr. LaFalce, but I'd just like to set the record straight on at least one thing, if I may.

I agree with much of what you're saying. I mean this in no negative way concerning what the administration is trying to do in the area of money growth. I just want the record to show clearly, in case someone's forgotten it, that it was the Carter administration that named Paul Volcker to the Federal Reserve System and that it was made clear at that time that Mr. Volcker was going to follow a restrictive money growth policy. And even though he hasn't done a perfect job of it, he's been moving in that direction for a long time.

We also, it seems to me, have to be clear on the fact that neither the administration nor the Congress controls the Federal Reserve's policies. I don't think you'd want there to be any doubt about that, because there may be an administration in the future that doesn't share views on the important role of money growth as regards inflation and so on. And we certainly don't want to start setting any precedents concerning the administration's control of monetary policy, or that of the Congress either.

Mr. SPRINKEL. No, sir. I believe in the independence of the Federal Reserve from the administration. I think it's very important that they should not be directly controlled by an administration. That doesn't mean that they don't live in Washington, that they don't talk to whatever administration exists, and they're not influenced by it. But I think it's important to maintain that independence. I've always supported that, and I still support it.

However, independent of whom? Not of the American people. They are part of the Government. You delegated to the Federal Reserve the monetary authority; therefore, they're not independent of the Congress. I think oversight hearings can be a very useful device for checking on performance, on targets. Therefore, I'm a strong supporter of the hearings we're going through today and earlier this week.

Mr. NEAL. Of course, I would have gone one step further and had the Congress set the money growth targets for the Fed. I've had a bill in for several years that would do just that.

Mr. SPRINKEL. We could use your numbers.

Mr. NEAL. So I'm not absolutely a purist. But I'm not trying to say by that that I think they ought to be controlled by the administration, because I've seen what the administration, when they've been able to exercise a little control, has done with it in the past. I would not put it past any adminstration to do that again.

Mr. SPRINKEL. I agree with you. I had planned to go back to the private sector as soon as we get this mess straightened out, so I want to be sure there's some independence when I leave.

Mr. NEAL. Mr. LaFalce.

Mr. LAFALCE. Thank you very much.

Mr. Sprinkel, help me understand a little bit better a few difficulties that I have.

I see the administration made up of some supply-siders, some monetarists. I don't want to say that they're in conflict, but sometimes the emphasis is a bit different.

I remember hearing from the supply-siders first, and they're big thing was, we've got to have a lot of tax cuts, and that tax cut is going to get all sorts of economic feedback. And then they changed the tune a bit and said, "Well, it really isn't going to work with just the tax cuts; we're also going to have to have the spending cuts, and we're going to have to have a combination of those two to have this economic recovery package."

And then, you know, I remember some of the individuals, yourself, saying, "Well, wait a minute, it's not going to work just with tax cuts and just with spending cuts. We also have to have this monetary control, restrictive monetary policy, if you will. We need all three to make it work."

Now I've got a lot of thoughts about that or questions.

First, it seems to me that I'm now beginning to hear that there's a fourth element to that. Not only do we need those three elements, but we need a fourth. And that's return to the gold standard.

So one of my questions is going to be, do we need a return to the gold standard? Do we have four-legged table rather than a three-legged table? If you take out one of them, what's the story there?

The second point is, let's suppose that there was a mandate. It's not quite as narrow as you've been talking about. It's not to control inflation, but to bring about economic recovery. And so, you know, we can't just emphasize controlling inflation. We've got to emphasize economic recovery, too, and controlling inflation in the process. But if we want to control inflation, we can easily do that with tremendous tradeoffs: high unemployment and an intentional policy of high interest rates, et cetera.

So let's suppose that we do get the tax cuts and we do have a continuation of this restrictive monetary policy, but we take one of the other legs, the spending cuts, out. Then what happens?

The reason I'm so concerned about this is because it now looks virtually certain that we're going to get the tax cuts. It looks probable that we're going to have a continuation of the restrictive monetary policy under Volcker, with your strong influence, if you will. But I am not certain at all that we're going to get the magnitude of spending cuts that would be necessary, given the areas from which we have to take those spending cuts—primarily income transfer programs, primarily social security and/or defense—of tremendous magnitudes.

And these are some of the things that disturb me.

Mr. SPRINKEL. Well, they're reasonable disturbances. Let me say first, it is a four-legged program now, including deregulation. You name the first three, and the fourth one is deregulation.

Now let's suppose we get all of those, which is your question, except we continue to get sharp increases in Government spending. Will the program work?

Mr. LAFALCE. Don't forget the gold question, too.

Mr. SPRINKEL. I'll get back to the gold question, if I may.

It won't work. I hesitate to use the word "crafted" because that suggests a bunch of geniuses designed it, and they were just normal humans like you and me. But it's a carefully tailored program designed to do exactly what you suggested—get growth going and inflation down.

Mr. LaFalce. OK, now. If it won't work and if we have not yet identified the spending cuts for fiscal 1983 and fiscal 1984, when are we going to identify them, and what's going to happen between now and the time we identify them? What's going to happen between now and the time the general public and the markets believe that we have not only identified them but will, in fact, be able to implement them?

Mr. Sprinkel. I guess it boils down to the fact that I have more confidence in the Congress than perhaps you do.

Mr. LaFalce. It's not a question of your confidence or my confidence, Mr. Sprinkel. It's a question of the entire American public and the stock markets and really when is the administration going to identify these cuts? Will they be social security cuts? And then what is the probability when the Senate voted 96 to 0 to propose Reagan's suggested cuts in social security, when almost every single Republican who voted for Gramm-Latta II this week voted for a resolution that says, "And let's make sure, although we voted to cut in the overall Gramm-Latta II bill the social security minimum benefits, let's try somehow not to eliminate the minimum benefits."

Mr. Sprinkel. Did you anticipate that in the first 6 months working with the Congress that we could cut $38 to $40 billion out of spending, out of the Carter budget?

Mr. LaFalce. Oh, yeah.

Mr. Sprinkel. You must have been alone, because it was a surprise to a lot of people. But I'm convinced you mean business, and we mean business. And when the President says he's going to continue to pull down the rate of growth in spending, I believe him. He has demonstrated he can do it with your help, and I think he will do it with your help.

Mr. LaFalce. The problem is—and I pointed out to Dave Stockman—the easiest cuts were made first; the toughest cuts remain. And that's the point.

Therefore, should we have a 3-year tax cut program? Don't we foreclose the option of financing a portion of social security benefits, especially medicare or disability benefits, from general revenues if we go to a 3-year tax cut?

Come on, Mr. Sprinkel, I doubt that you believe in the 3-year tax cut.

Mr. Sprinkel. I certainly do believe in a 3-year tax cut.

Mr. LaFalce. Assuming all the other things. But you probably would have preferred not to go to a 3-year tax cut now until those other things were pretty much in place.

Mr. Sprinkel. I have long believed that the more money that flows into this city, the more spending occurs; that the way we get the discipline that the American people want is to slow the growth in revenues. The further out we can slow the growth in revenues and create the expectation that we really mean it, I think the better the results.

Mr. LaFalce. If you really want to do something on interest rates, then, why don't you identify those spending cuts now? And why don't we call upon the Congress to commit themselves now, and then maybe we'll bring interest rates down overnight?

Mr. SPRINKEL. Are you arguing that cuts 2 to 3 or 4 years from now are going to have a major effect on interest rates today? I wish that were true. If there were an easy way to do it, we would do it. The only way to do it is to get inflation down with less money. That's what we're doing.

I still haven't answered your gold question. I'll go back to it when you're ready.

Mr. LAFALCE. OK.

Mr. SPRINKEL. To amend your statement slightly, you said, "Is the fifth leg a gold standard?"

What I said was, regardless of the system we adopt, it's very clear we must accept monetary discipline. One way of going about that is a gold standard. I've been directly involved in this effort from the very beginning, other than what the Congress did. We have had the first meeting. The representatives from the Congress in the House of Representatives and the Senate, from the public, the Federal Reserve, the Council of Economic Advisors all participated, with Secretary Regan as chairman. We are dedicated to doing a very serious job on investigating the forms of monetary discipline that can be achieved by various forms of international payment systems, possibly including variants of the gold standard, other forms of a commodity standard, and a managed currency standard. If you have another one, we'll look at that one also.

When the Congress charged us with spending our money, you didn't provide any money. It comes out of our budget. I'd appreciate it if, next time, you would provide the funds for the study. In any event, we're going to do it, and we're going to do it seriously. We're spending our money, the Treasury's budget. We have selected a very capable researcher. We have all ranges of view, to my knowledge. We have monetarists; we have gold standardists; we have advocates of various kinds of gold standards; we have managed money people, commodity money people, private money people. We're going to look into each one of them and point out the pluses and the minuses and how they worked out historically and try to identify what is the sensible way for us to organize our monetary discipline.

But regardless of which we choose or what the Congress chooses, it's very clear that what we really need is monetary discipline. There are many ways of getting that, and we haven't had monetary discipline until recently. I think we have it now. That's why I'm confident we're going to get the inflation down.

Mr. LAFALCE. One last question. Clearly, you opposed the March 1980 position of credit controls and would oppose it again and probably at all times. But Paul Volcker did something, I'm not sure when it was—in 1979 perhaps, as opposed to 1980—he sent a letter out to all the chief executive officers of the major banks in the United States of America, and he exhorted them to be careful about how they, themselves, allocated credit.

In particular, he said, "Be careful about financing unproductive investments such as mergers and acquisitions." And he delicately called in the top 40 CEO's in the country to his office and just had a conference table discussion with them. After that, there was a general reluctance to finance mergers and acquisitions.

Now is that the type of leadership that can be exerted, but without direct credit allocation, but just perhaps gentle guidance as to what should or shouldn't be done by the private markets in not permitting the financing of what could be deemed nonproductive investments, such as acquisitions and mergers?

Mr. SPRINKEL. Sir, that is credit allocation.

Mr. LAFALCE. You opposed his doing that letter at that time, and you would oppose that type of letter in the future?

Mr. SPRINKEL. I believe that bankers allocate credit based on the bottom line. That is, they're risking stockholder funds. I have great confidence they are, on average, going to allocate them in the way that's most efficient, from the standpoint of accelerating real growth in this economy.

The real reason that we see such a massive tendency, of late, for acquisitions is very simple. It's cheaper to buy than to produce.

Why is it cheaper to buy than produce? The major reason is that we have high and soaring interest rates. No one in his right mind will make long-term investments committed to increased capacity out there when we have high and accelerating rates of inflation and high and accelerating interest rates.

We are going to get them down. And you will find that acquisition game gradually moving back into the background. I've read a lot of literature in that field, and that is by far the most important factor.

Given the present environment, it may well be economical in some cases to have acquisitions. In the long run, we want to encourage productive investments. The way you encourage people to do it is to create an incentive. They've had a disincentive with our accounting system and all the other problems.

Mr. PATMAN [presiding]. The Chair recognizes Mr. McCollum.

Mr. MCCOLLUM. It's indeed a pleasure to have Chairman Patman up there, with the distinguished heritage you have in that chair.

Mr. PATMAN. It's going to take some time.

Mr. MCCOLLUM. I imagine it will, but it's still a pleasure.

Mr. Sprinkel, I want to ask a short series of questions to you, if I could.

In 1980, the Federal Reserve's target was 4.5 to 7 percent for M_{1B} growth, yet M_{1B} grew to 7.3 percent by year end. M_{1B} growth was even higher in 1978 and 1979.

Why has the Federal Reserve missed its targets? I'd like for you to be specific.

Will they meet their announced targets in the future, in your opinion?

How can we in Congress make or encourage the Federal Reserve to hit its targets, preferably at the low end of the range? If you'd please elaborate.

Mr. SPRINKEL. Some of those questions I obviously can't answer. Your facts are correct. In fact, in the past 5 years, they've exceeded their targets three out of five times.

Why? I don't believe it was by design. I don't believe for a moment that the Federal Reserve, made up of intelligent human beings, responsible human beings, sat down and designed inflation for us, with all the pain that it's brought. But I do believe that, given the present control procedure, it's very difficult to hit the targets.

I have previously stated—and stated again today—that there are some simple things that could be done, that would improve their ability to hit the targets. They're studying them. I'm optomistic that they're going to change, and if they do, my confidence in their ability to hit the target at the middle or lower end of the range will improve enormously.

I believe the same would be true in the market place.

What can the Congress do? It seems to me that you have delegated to the Federal Reserve power over money. That means that Congress has the responsiblity to have rigorous oversight hearings. Insist that we compare objectives with results. This is what we have to do in the business world. It's what you, as a Congressman, must do.

You must go back and meet your constituents. Did you perform, or didn't you? That's what Presidents have to do. I think that's what the Federal Reserve will do. It's up to the Congress. They're independent of us, and they should be.

Mr. McCollum. In line with the suggestions you've made to them, I understand the administration has suggested that the Federal Reserve focus more on controlling the monetary base, rather than on reserves.

First of all, I would like to know why. What would be the advantages?

Second, is there any indication they're going to do that?

Mr. Sprinkel. They have these and other proposals under study, and I do not know whether they'll do it or not. You should ask them. I know of no direct evidence that they're going to do it.

The reason I prefer the base is that it's much less affected by the institutional changes that were underway this year. I am convinced shifts in funds between accounts will be underway in future years, where there are varying incentives, and where an individual and corporations can decide on their own. They don't have to ask the Treasury or the Federal Reserve how they allocate their liquid funds. They'll move in those directions where they get the optimum return, given the nature of the account that they want.

I don't care whether they put it in M_{1B} , M_{1A}, M_2, money market funds, M_3, et cetera. That should not be my concern. We should give the market options to allocate their liquid funds.

What I do care about is that we control the basic ingredient of the money supply. That, clearly, is either the monetary base or reserves, because without growth in the base and reserves, the aggregate inflationary forces cannot get underway.

The base is much less disturbed by these institutional changes than are the individual M's. The Federal Reserve does a heroic effort to try to estimate how much M_{1B} is affected by each change, but they don't know for sure until hindsight. You know, after it's all over. We'll be able to go back and say, OK, it looks like this happened. But in foresight, it's extremely difficult.

This is why I urged, in my first testimony, that the concentration should be on the base. Now, they've done pretty well on the base. We wanted a base growth something on the order of 7 percent—I'm talking about of late—in the first year; and it's running very close to 7 percent versus a year ago. If we can gradually pull that growth rate in the base down, I am convinced we will pull the inflation and interest rates down.

And what happens to M_{1B} , M_{1A}, M_2 will depend on the institutional changes that occur, and the decisions left to the holders of liquid funds.

Mr. McCOLLUM. It doesn't matter to you if they merge M_{1A} and M_{1B} together, as they've proposed?

Mr. SPRINKEL. No; I think there's a problem of multiple targets, because you can always hit one of them. I would like to see them concentrate on the fundamental ingredient of money—either reserves or the base. But so far, they have concentrated on nonborrowed reserves, and I think that creates some problems.

Mr. McCOLLUM. If I may ask one last question. I would like to know your views about several important wage contract negotiations that are coming up next year, as to what the implications are for inflation?

What role, if any, the Government should play in the process of these wage negotiations?

We've had some earlier discussions about that with other witnesses.

Mr. SPRINKEL. Well essentially, I think it's the duty of this administration and this Government to make certain that the participants in those contracts understand that we're pursuing policies that are going to decelerate the inflation. I do not believe it's our role to walk in and tell a particular company or a particular union what they should negotiate for. They're perfectly able to determine their own best interests.

If they choose a wage adjustment and the company permits a wage adjustment that's too high, in an environment of decelerating inflation, the company's profits will get pinched, and we're not going to bail them out. We're going to decelerate inflation. In that kind of an environment, I expect a slowing in the rate of rise in wages.

Now, wage increases have not been enormously high, as you're well aware, in relation to inflation. They have been below inflation much of the time in recent years. I'm not one who believes that either business or labor causes inflation. Inflation is made right here in Washington, and with your help, it's not going to be made here in the future.

Mr. McCOLLUM. Thank you.

Mr. PATMAN. Thank you.

I believe it's my turn next, if you don't mind, Jim, because we're liable to have some bells, and I'm going to have to leave myself, in that case, unless you're in a particular hurry.

Mr. Sprinkel, I was very interested in your testimony earlier, when you said that there's no alternative; long-range inflation can only be beaten by restricting the growth of the Nation's money supply, to match the trend rate of increase of aggregate production.

The money supply—would you measure that by M_1, M_{1B}?

What's your favorite measure of that?

Mr. SPRINKEL. Given the institutional change, I would prefer to measure it by the base. Now, I have done a lot of work on trying to see which of the various definitions is most closely related to changes in spending and inflation. Prior to this last move, when we permitted and encouraged NOW accounts, which I certainly favor, M_{1B} had a slightly better correlation with inflation and economic activity, as the Federal Reserve indicated in their studies.

But now we've destroyed it temporarily. I expect it to come back in. So if you want an M, I'll pick M_{1B}, even though I know it's giving noise at the moment.

Mr. PATMAN. Have you tried to observe that from time to time, to see how it relates to the trend rate of increase of aggregate production?

Mr. SPRINKEL. The ultimate objective is to get the growth in the trend rate of increase in production in line with trend rate of growth in production. That's correct.

The long-term trend of real growth in this economy has been on the order of 3 percent. I guess in the later 1950's and early 1960's it was running above that. Of late, it's been much closer to 2 percent. That means, if we're going to get back to low rates of inflation, we want to accelerate the trend rate of real growth, getting it back into the 4-percent range, and decelerate the trend of money growth. If we do that, we'll get back to minimal inflation. That's where we used to be.

I've been around long enough to remember when an inflation of more than 1 percent was scary. I would love to go back to 1-percent inflation at this stage.

Mr. PATMAN. All right. Well, the trend rate of increase of aggregate production—where do you find those figures?

Mr. SPRINKEL. What I'm referring to is real GNP, published by the Commerce Department. By "trend rate of growth," I mean over a number of years, rather than over a quarter or two. As I suggested, the real rate of GNP growth over the long-term history of this Nation, as far back as we can find the data, is very close to 3 percent. For a while it was above that; and lately it's been well below it. The last decade is closer to 2 percent.

Mr. PATMAN. Is that what the Federal Reserve takes into consideration when it sets its monetary targets?

Mr. SPRINKEL. I'm not certain. But I am positive that they subscribe to the idea that to get inflation down, they must get money growth in line with real output. So I presume they would use real GNP growth.

Mr. PATMAN. When they publish the figures for a rate of monetary growth—M_{1A}, M_{1B}, and that sort of thing—should they also publish the base figure that they're using to compare that to?

Mr. SPRINKEL. The monetary base?

Mr. PATMAN. No; I'm talking about the aggregate production index.

Mr. SPRINKEL. It is published by the Commerce Department.

Mr. PATMAN. But it's not observed too closely by the bond buyers that I know—not that I know a lot of them.

Mr. SPRINKEL. Well, yesterday I believe it was. They revised downward the real GNP for the second quarter, and bond prices went up, I was told. So I think they do pay some attention to it.

Mr. PATMAN. The people are just simultaneously—to look at both the increase in the money supply and the other thing that you mentioned, the GNP? Is that true?

Mr. SPRINKEL. Yes, sir, only if the Federal Reserve puts new reserves into the system will they have an effect on the money supply. Federal policy will have an effect on incentives to save, and thus to work. That's why we're strongly behind the administration's proposals.

Mr. PATMAN. These decreases in Government spending that we talked about—will they decrease the money supply?

Mr. SPRINKEL. No, sir; not unless the Federal Reserve restricts growth in reserves. That is, they can make the money supply dance pretty much to their tune; not daily, not weekly, not monthly, but certainly over the period of a quarter.

Mr. PATMAN. When you talk about the importance of stable exchange rates, you're also talking about the importance of keeping stable interest rates, aren't you? Because aren't they the basic reason for unstable exchange rates?

Mr. SPRINKEL. It's been a contributing factor in recent months, in particular. However, in the long run, that isn't the major factor, in my opinion. The major factor is the rate of inflation of one currency vis-a-vis another currency.

Let me give you a little example to explain what I mean. The three countries I was mentioning earlier, in modern times, that have done the best job of keeping their inflation under control have had the lowest interest rates in the developed world. But they have the strongest currencies. That is, low interest rates resulted in a strong currency, not vice versa.

Our objective is to get our inflation down. Our interest rates will come down. We would still expect to have a firm currency, although in the short run there may be some weaknesses, as our rates decline.

Mr. PATMAN. Thank you very much.

Mr. Coyne?

Mr. J. COYNE. Thank you very much, Mr. Chairman.

Mr. PATMAN. If I may ask——

Mr. J. COYNE. We have a 15-minute vote, followed, by a 5-minute vote.

Mr. PATMAN. Followed by 5 minutes? All right. Shall we adjourn, then, as soon as you're finished?

Mr. J. COYNE. Yes; I'm going to have to leave.

Mr. PATMAN. Shall we reconvene, if I may inquire about that?

Mr. J. COYNE. I'd be happy to complete my questioning in the next 2 or 3 minutes. I'm sure Mr. Sprinkel has more important things to do than answer my questions.

Thank you very much.

I'm very happy to see you again, and appreciated your introduction to monetary policy, even in the face of all the questions about fiscal policy.

I am especially concerned about the impact of foreign acquisitions of assets in the United States. I'm not talking about the export-import situations, but purchases of a whole host of small- to medium- and even large-sized corporations, which result in ar infusion of capital, and therefore an artificial increase in our money supply outside the control of the Fed or the Congress.

What is the impact?

Have these impacts subsided, as our dollar has strengthened in the past several months?

And to what degree have they been a factor, especially because of an underpriced dollar over the past 4 or 5 years?

Mr. SPRINKEL. Well, on the international front, movement of Eurodollars into and out of the United States has no effect on our money supply. I realize a lot of people believe the contrary, and perhaps you do, but the evidence is very clear. If you'd like, I'd send you a couple of articles that go through it in detail.

What does happen is, we get a change in the ownership of the existing money supply. The total cannot change unless the Fed changes reserves. Under our monetary system, there is no change in reserves as Eurodollars slosh in and out.

Mr. J. COYNE. I'm talking about the relationship between monetary supply and inflation, or the CPI.

Obviously, our inflation measures are entirely within the boundaries of the continental United States, Alaska, and Hawaii. And our monetary supply, in international terms, includes billions and billions—and perhaps trillions—in the Eurodollar market.

You're mixing apples and oranges. And it seems to me when you say it doesn't have any effect on the monetary supply—right. But, it affects the larger monetary supply than the one we use to define the inflationary forces within our own country.

Mr. SPRINKEL. There are some economists, who are very sensible people, that are friends of mine, that argue the world's money supply is what determines the world's inflation. And I think there is some relevance to that statement.

However, you cannot explain the disparate rates of inflation between countries with the total world money supply, and that's what I'm interested in. You can explain why Germany has a much lower rate of inflation than we have, by looking at their money supply per unit of output versus our own. You can explain why the Swiss and the Japanese have done a much better job, by looking at their money supply versus our own.

I think it's really a question of what issue do you want to address. There have been studies that indicate if you include Eurodollars with our domestic money supply, for some kinds of questions, you get slightly better answers than if you constrain yourself strictly to the domestic money supply. But it cannot be used to explain relative changes in inflation between nations; and hence, it can't be used to explain why the dollar goes up and some other nation's currency goes down.

Mr. J. COYNE. I wasn't trying to get you to make those answers, but rather to determine the extent to which we do not have control over one of the levers which affects our domestic monetary supply. We cannot control the barriers to the flow of Eurodollars into the continental United States very easily, or at least we haven't.

Mr. SPRINKEL. But we're back to the initial point. That is, the flow of Eurodollars in and out. Eurodollars are not controlled. I agree with that. But the flow of Eurodollars into and out of the United States has zero impact on our domestic money supply.

That is, we do have control of our money supply, by controlling reserves and the monetary base.

Mr. J. COYNE. Once again, though, that is therefore a multinational dollar supply.

We're not talking about multinational inflation. We're worring about the relationship with monetary supply and inflation. So, just as you can have a zero inflation rate and have the cost of cars go up 10 percent and the cost of TV sets go down 10 percent; so, too, you can have a very high inflation rate in our dollar pool on the continental base, and in fact have a negative inflation rate in the Eurodollar geography outside the United States.

And the flow between the two, it seems, would divide—or at least skew—inflation plus or minus for the economy. I don't want to get into too technical a discussion of this, but I thought I'd seize the opportunity to ask you a few questions on it while you were here.

Mr. SPRINKEL. I think we cannot conclude that the flow of uncontrolled Eurodollars removes control of the money supply from the Federal Reserve. It does not.

Mr. J. COYNE. I didn't mean to imply that.

Mr. SPRINKEL. Therefore, we can get our inflation down if we do our homework properly.

Mr. J. COYNE. I was wondering if there were international banking opportunities there for us to somehow mitigate the sudden flows of international Eurodollars into the United States at a time when the dollar is relatively under-priced versus other international currencies?

Mr. SPRINKEL. There was a member of the prior administration who said something one time that I thought was well worth remembering. He said: When it ain't broke, don't fix it. It turns out that the Eurodollar system has worked very efficiently without controls. It has discipline as the bottom line.

I'm not in favor of moving from control of domestic money to a group of central bankers or treasury officials trying to control Eurodollar markets. These markets are working beautifully.

Mr. J. COYNE. OK, I'll take your word for it.

Thank you, Mr. Chairman.

Mr. PATMAN. Thank you, Mr. Sprinkel.

This ends the July 1981 House Banking Committee hearings on the conduct of monetary policy.

Mr. SPRINKEL. Thank you, sir. I appreciate the opportunity to meet with the committee.

[Whereupon, at 4:25 p.m., the hearing was adjourned.]

[The following written questions were submitted to Mr. Sprinkel by committee members and appear with the responses of Mr. Sprinkel:]

QUESTIONS SUBMITTED BY CONGRESSMAN HANSEN

Question 1. Why are interest rates so high when the inflation rate seems to be subsiding? Please explain in such a manner so that my farmers, builders and small businesses in Idaho will understand.

Answer. Interest rates remain high because the financial markets are not yet convinced that the Congress, the Administration, and the Federal Reserve will persevere in the fight against inflation. Continued high long-term interest rates, despite the news that inflation is beginning to decline, imply that the financial markets expect inflation to resume in the months ahead.

That is why it is vital that the Federal Reserve persist in its policy to reduce money growth and that the Congress and the Administration maintain budgetary discipline in the months and years ahead. We must signal to the financial markets and to the public that we will not reverse our course before the real, long-term benefits of controlling inflation are appreciated.

Question 2. Do high interest rates track and follow increases in the money supply? Please elaborate and supply me with any charts or other data which you might have.

Answer. Excessive money growth causes inflation and, as we are all aware, inflation and the expectation that it will continue causes interest rates to rise. This can be seen in the charts appended to my written testimony. Money growth is closely associated with inflation approximately two years later and interest rates are closely related to current and past rates of inflation.

In addition, the financial markets, with years of rapid money growth and inflation fresh in their memory, have become so sensitive to the money-inflation linkage that even weekly increases in the money supply cause interest rates to rise. Recent experience indicates that this reaction now comes very quickly. This is demonstrated in the table on page 5 of my testimony.

Contrary to the popular view that more money leads to lower interest rates, more money, by causing inflation and generating inflationary expectations, causes interest rates to rise. In the current environment, any decline in rates associated with faster money growth would be temporary, if it happened at all. Ultimately, more money leads unavoidably to more inflation and would prolong or raise already high interest rates.

Question 3. How is the Federal Reserve responsible for high interest rates?

Answer. The high interest rates we have experienced for the past two years or so are the result of four years of excessively rapid money growth. When the money stock grows more rapidly than real aggregate output, the result is inflation. Inflation causes interest rates to rise in order to compensate lenders for the decline in the purchasing power of their money during the life of a loan. Moreover, the expectation of continued inflation causes interest rates to be bid up.

Excessive money growth, by generating inflation and inflationary expectations, therefore causes high interest rates. The Federal Reserve is responsible for high interest rates because it previously followed a path of too-rapid money growth. The slowdown in money that has occurred in recent months is a good first step toward reversing the cycle of fast money growth, inflation and high interest rates. The benefits, in terms of reduced inflation and lower interest rates, will not be realized, however, unless the policy of slower money growth is adhered to over the long run.

Question 4. People think that the Reagan Administration in its first six months in office is responsible for high interest rates. Is this possible?

Answer. No. First of all, interest rates were high when the Reagan Administration took office.

Second, the important psychological factors that are helping keep rates high—deeply entrenched expectations of inflation and pessimism that the Government can or will take effective action to curb inflation—have not grown up in response to Reagan Administration policies. They are the result of years of inflationary money growth and repeated, broken promises to control inflation.

Question 5. In 1980 the Federal Reserve's target was 4½ to 7 percent for M1-B growth, yet M1-B grew by 7.3 percent by year end. M1-B growth was even higher in 1978 and 1979. Why has the Federal Reserve missed its targets? Be specific. Will they meet their announced targets in the future?

Answer. In most cases the Federal Reserve has missed its money supply targets because it has abandoned close control of bank reserves in order to try to affect interest rates. Interest rates fluctuate in response to changes in credit demand and general economic activity and, if the Federal Reserve tries to prevent or soften movements in market interest rates, it sacrifices close control of money supply growth. It is not possible for the Federal Reserve to maintain close control of the money stock and also attempt to manipulate interest rates.

For example, in the Spring of 1980 the combination of credit controls and a contracting economy caused a sharp decline in the demand for credit and interest rates fell rapidly. The Federal Reserve, apparently unwilling to allow interest rates to fall as fast as market forces dictated, slowed the rate of growth in bank reserves and allowed the money supply to decline, even though the economy was contracting. Once credit controls were removed in the summer and the economy began to expand again, interest rates rose in response to increased credit demand. Again, the Federal reserve tried to ameliorate the upward pressure on interest rates coming from market forces. They injected reserves into the banking system and the result was an explosion of money growth in the second half of 1980.

Question 6. How can we in Congress make or encourage the Federal Reserve to hit its target ranges, preferably the low end of the range? Please elaborate.

Answer. While the Federal Reserve is an independent agency, and I believe that independence should be maintained, its independence does not mean it is not answerable for its actions. It is accountable to the Congress and these oversight hearings are the best way for you to make your opinions and concerns, and those of your constituents, known to the Federal Reserve.

It is important for you to emphasize to the Federal Reserve that this Committee expects it to hit its announced targets. That message can be conveyed during these semi-annual hearings and subsequent Committee reports, as well as in your informal dealings with Federal Reserve officials. If the targets are not met, I think that the Federal Reserve should be required to provide a detailed explanation of why they failed, what they intend to do to bring money growth back on target, and what they intend to do to avoid similar future failures.

As I mentioned in my prepared testimony, there are a number of procedural changes readily available to the Federal Reserve which I believe would improve the precision of monetary control. The Federal Reserve is considering these changes and I hope they are adopted as soon as possible.

Question 7. How can we expect to get results from the Federal Reserve to lower interest rates?

Answer. The only way the Federal Reserve can facilitate permanently lower interest rates is to persist in its policy to reduce the rate of money growth. Although it is popular to blame high interest rates on the recent slowdown in money growth, this is incorrect. Faster money growth will always lead ultimately to even higher interest rates. Recent experience shows that financial markets translate fast money growth into higher interest rates almost simultaneously.

We, therefore, have no alternative. To lower interest rates, we must achieve and sustain a lower, non-inflationary rate of money growth. I urge you and your constituents to support the Federal Reserve's policy of slower money growth for it is the only route to the lower interest rates we all seek.

Question 8. Since the inflation rate—measured either by the Consumer Price Index or the GNP price deflator—seems to be declining from record levels in the past few years, doesn't it stand to reason that interest rates will soon begin to decline as well? When will we see this happen? My constituents can't wait much longer.

Answer. Yes. Market conditions should allow for a decline in rates soon, but it is difficult to say exactly when or by how much. Continued high long-term interest rates, in the face of lower current inflation, reflects skepticism in the financial markets that money growth and inflation will be controlled over the long run. Once the markets are convinced that this is not another false start in the fight against inflation, once they learn that we will persevere until that fight is won, inflationary expectations will abate and interest rates will fall.

Question 9. What short-term solutions, if any, are available to take the pain out of double-digit inflation?

Answer. I know of no easy remedies for the distortions caused by inflation. Years of rapid money growth and inflation have caused fundamental changes in the American economy and psyche. The distortions and uncertainties of inflation are reflected in wage settlements, speculative activity, pricing decisions, savings behavior, and government programs as well. They are also reflected in high interest rates.

The attitudes and habits that have grown up over a decade cannot be reversed overnight. Particularly when previous Administrations have repeatedly promised to bring inflation under control, but have failed to do so. Returning the economy to a non-inflationary path of real growth is not an easy or painless task. Hopefully, our experience with double-digit inflation is behind us.

Questions Submitted by Congressman Lowery

Question 1. For the past year inflation has been declining from double-digit rates, yet interest rates remain at unprecedented high levels. There are several theories as to why this is happening. What circumstances do you feel are responsible? How long do you expect this situation to exist, assuming a scenario in which other economic factors remain essentially the same?

Question 2. One of the theories used to explain the inflation/interest rate relationship that we are presently experiencing is that of "inflationary expectations." If this is in fact the cause of our current interest rates, how can we best turn around the psychology of inflationary expectations?

Answer. Despite the recent slowdown in money growth and the decline in inflation rates, interest rates remain high. They remain high because the financial markets are not yet convinced that the Congress, the Administration, and the

Federal Reserve will persevere in the fight against inflation. Continued high long-term interest rates, despite current inflation rates, reflect skepticism in the financial markets that money growth and inflation will be controlled over the long run. The expectation that inflation will resume in the months ahead is maintaining upward pressure on rates.

High real estate interest rates are attracting considerable public attention and some have called for an easing of monetary policy to alleviate the pressure on interest rates. This confuses a symptom (high interest rates) with the disease (inflation). Easier monetary policy would only generate renewed inflation and eventually, if not immediately, even higher interest rates.

There is, therefore, no alternative to sustaining the slowdown in money growth. It is also vital that the Congress and the Administration maintain budgetary discipline in the months ahead. We must signal to the financial markets and to the public that we will not reverse our course before the real, long-term benefits of controlling inflation are appreciated.

After a decade of inflation, the distortions and uncertainties associated with inflation are deeply embedded in the American economy and psyche. Reversing the momentum of an inflationary economy is not an easy or painless task. But the long-term benefits of returning the economy to a non-inflationary path of real growth should not be sacrificed because of short-term discomfort.

Question 3. Besides having a significant impact at home, interest rates have a great impact abroad. How do high interest rates here affect the economic policies of our principal trading partners? Of the international economy as a whole?

Answer. Nominal interest rates are observed in the market. They are very high. Foreign investors look at real interest rates. Real interest rates are nominal interest rates corrected for the expected depreciation in the value of the expected returns from an investment. In other words, the real interest rate is the nominal interest rate minus the rate of inflation. That is why an 8 percent nominal interest rate in one country can be consistent with a 20 percent interest rate in another country which has a higher rate of inflation.

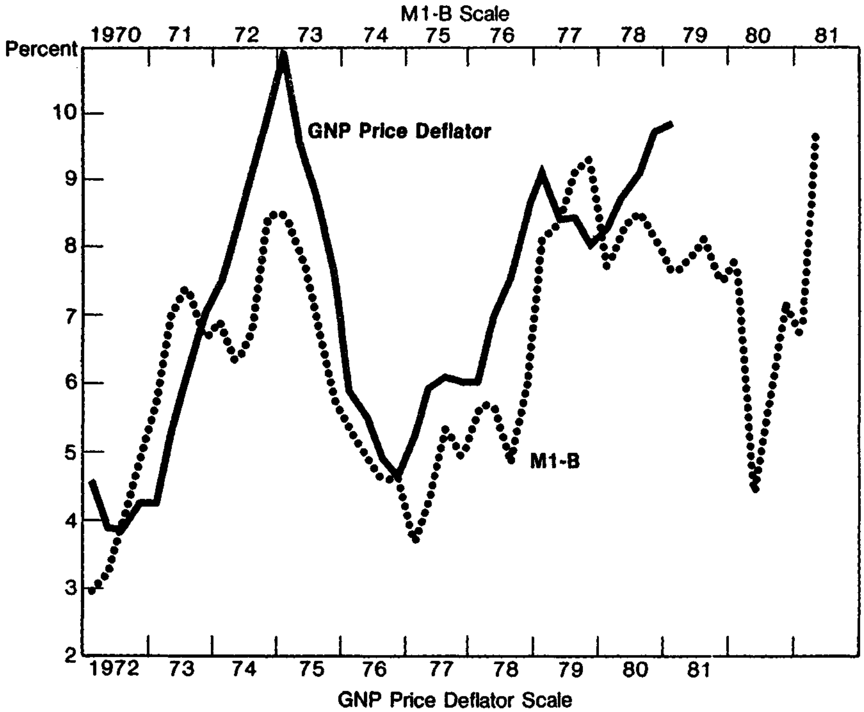
I do think high interest rates have an effect on the policies of our trading partners. I think they agree that real rates of return can be raised by reducing their own rates of inflation as some of them have done quite successfully.

Question 4. What is the impact of monetary policy on GNP growth?

Answer. The growth in the money supply is closely associated with the level of spending as measured by the estimate of nominal GNP.

Nominal GNP is, in turn, composed of the multiple of the price level (the GNP deflator) and real output (plus real depreciation). As the enclosed chart indicates rates of growth of the money supply have had a fairly close relationship with the rates of change of the GNP deflator. Real output responds to abrupt changes in money growth with a much shorter lag (3–9 months).

Money Leads Inflation by Two Years
Growth Rates in GNP Price Deflator and Money Supply (M1-B)*



*Quarterly figures. Growth measured from one year earlier.

Question 5. What is the impact of federal budget deficits on monetary policy?

Answer. Federal budget deficits may be financed either by borrowing (increasing the national debt) or by running the printing press (monetary expansion). This Administration intends to keep the money supply on target regardless of the size of the deficit so that budget deficits will have no effect on our monetary policy.

Question 6. There are several important wage contract negotiations coming up next year. What are the implications for inflation? What role, if any, should the government play in this process?

Answer. The Administration is making it crystal clear that monetary policy will be geared to non-inflationary levels. Employees and unions should closely consider this policy in their wage negotiations. These negotiations should be in the best tradition of collective bargaining in a free society. Except in exceptional circumstances the government should not be involved.

QUESTIONS SUBMITTED BY CONGRESSMAN CHALMERS P. WYLIE TO MR. PRATT

Question 1: In communities which have a single bank and a competing Federal S&L association, could the sharing of demand deposit balances threaten the profitability of the bank?

Answer: It should be noted that in a community with only one bank and one savings and loan association, the two institutions are sharing the total deposit base in the community, even in the absence of power on the part of the S&L to accept demand deposits. After the granting of demand deposit authority to S&Ls, of course, this would continue to be true; a community which could support two financial institutions before the granting of such power certainly could continue to do so thereafter. Given that demand deposits of the commercial banks are highly profitable, this in our view reinforces the idea that savings and loan associations should have equitable access to the market in question. It would appear to further the interest of the local community to have its local thrift and mortgage lending institution utilize the maximum possible sources of funds, particularly those, such as interest free demand deposits, which would allow lending at the lowest possible rate.

Question 2: If we followed your suggestion, could it be said that Congress would be simply recreating the national banking system at significant cost and without provisions requiring home financing?

Answer: No. Suggestions contained in the Thrift Institutions Restructuring Act of 1981 would not recreate the National Bank System. It would give thrift institutions essential tools for competing with national banks and other depository and nondepository institutions basically in terms of allowing additional asset and liability flexibility. We nevertheless expect that the great bulk of thrift institutions will retain their home finance specialization, for this is the area with which they are most familiar. The enormous demand for housing finance that we expect to characterize the 1980s, as well as the availability of a truly interest rate sensitive mortgage instrument, should reinforce this tendency, as should the continuing availability of the favorable bad debt deduction. Accordingly, we do not believe that given new bank-like powers, thrifts will become national banks but rather will continue to focus on real estate finance. It must be borne in mind that, at the present time, housing finance and mortgage credit are in fact being disadvantaged by the statutory and regulatory structure which locks thrift institutions on a mandatory basis into a limited set of options with respect to their assets and liabilities. The mismatches which this background has created has in fact resulted in a lack of mortgage funds during periods of increasing interest rates. The recent mandates of Congress and the inevitable forces operating in money and credit markets have removed nearly all forms of protection from the deposit gathering functions. If thrift institutions are to survive and continue to provide housing credit, great freedom must be granted on the asset side. American homeowners are entitled to have mortgage finance institutions capable of accessing all sources of funds, including those which may be among the lowest cost, such as noninterest bearing commercial checking accounts.

In terms of the possible cost of the proposals which we have presented, there should be no explicit cost associated with implementing these powers; both the institutions and regulatory framework are presently in place. In fact, society should be spared substantial cost as a result of a return to viability of thrift institutions. In the absence of restructuring, widespread problems and potential failures in thrift institutions may present substantial cost to the american public. We believe that the more costly approach would be legislatively to lock thrifts into their current asset posture, for that course would run the strong risk of forcing very large numbers of thrifts out of business, at great cost to the FSLIC and those institutions' uninsured creditors, and to the detriment of those seeking housing and other forms of credit in the future.

To reiterate, if thrifts are to be able to pay market rates to depositors, they must be able to pursue flexible investment strategies to generate earnings adequate to pay those rates. Compelling a home-finance speciality for thrifts in a world without rate control would simply eliminate the ability of large numbers of institutions to compete successfully for deposits on a sustained basis.

Question 3: Will the restrictions on overdrafts and insider activities contained in FIRA and applicable to banks be applied to S & Ls under these provisions?

Answer: The Bank Board has not proposed applying the overdraft and insider activities contained in Public Law 95-630 to S&Ls in connection with the new powers that would be extended by the Thrift Institutions Restructuring Act of 1981 (TIRA). The Bank Board has been successful in preventing abuses in this area through the promulgation and enforcement of regulations under existing authority contained in the Home Owners' Loan Act and the National Housing Act. We would extend existing restrictions to any new investments authorized under TIRA, and, to the extent investments potentially more subject to insider abuse, such as unsecured commercial lending, were allowed, the Bank Board would consider imposing tighter limitations than now apply to S&L real estate finance. Given the effectiveness of our regulatory approach in the past, and in the absence of any demonstrated record of abusive practices by the S&L industry, the Bank Board does not believe there is any need to link imposition of rigid statutory insider loan restrictions to the extension to thrifts of the new powers contained in TIRA.

Question 4: Will restrictions placed on national banks in their lending and investment activities apply to S&Ls (e.g., single borrower limits)?

Answer: The Thrift Institutions Restructuring Act would require federal associations to observe national bank loan-to-one-borrower restrictions with respect to investments in commercial paper, corporate debt securities and commercial loans. In other respects, however, the Bank Board has not sought to track National Bank Act restrictions. We would prefer to use our overall regulatory powers under the Home Owner's Loan Act to develop appropriate limits in light of the particular needs and problems of the institutions under our jurisdiction, rather than be forced to adopt standards designed for commercial banks.

Question 5: If service corporations are to be truly that, shouldn't they be limited to doing what S & Ls can do for themselves, as with bank service corporations?

Answer: While it is true bank service corporations statutorily are more limited than S&L service corporations, we do not believe it would be good public policy to reverse 15 years of development and force S&L subsidiaries to adhere to the more rigid requirements applicable to bank service corporations. Such action would ignore the fact that national banks, through affiliates that are not labeled as bank service corporations, can perform a wide variety of functions that in an S&L hierarchy are placed within a service corporation. It also would result in depriving many S&Ls of an important source of income at a time when the industry as a whole is in the red. If parity in this area is a concern, we strongly urge that bank service corporations be given increased authority, instead of limiting the options open to S&L subsidiaries.

Question 6: Does section 212 mean that investments in state-chartered, non-Federally insured institutions would count toward liquidity requirements?

Answer: Section 212 would permit the Bank Board to authorize Federal Home Loan Bank members' deposits in institutions without FSLIC or FDIC insurance to count toward satisfaction of liquidity requirements. Such institutions would have to be eligible, however, for Federal Home Loan Bank membership.

RESPONSES TO QUESTIONS FROM REPRESENTATIVE LOWERY

1. QUESTION: Under Section 210 of your proposed legislation, you suggest that federal institutions be allowed to invest up to 10% of their assets directly in real estate. Do you feel enactment would hinder traditional residential mortgage lending activities?

ANSWER: As I indicated in my testimony, the Bank Board believes that, in light of the de facto deregulation of thrift institutions' liability side, it is imperative that thrifts' asset side be deregulated, as well. Because thrifts must now purchase funds on a deregulated basis, they likewise must be free of constraints in the sale of those funds. Clearly, the broad liberalization of investment authority we are proposing would result in some thrifts becoming less involved in mortgage finance. On the whole, however, we fully expect the great majority of thrift institutions to remain housing specialists. Real estate lending is the area they are most familiar with, and, given the availability of flexible mortgage instruments and the enormous demand for housing projected for the 1980s, we expect there will be strong, positive incentives for these institutions to maintain their housing focus. With respect to your specific concern about our proposal for expanded direct, real estate investment power for federal associations, it is our expectation that such authority would be utilized in a manner complementary to traditional residential mortgage lending activities Rather than stimulating a drift away from these activities, it would tend to focus attention on them, for it would allow a more flexible and profitable approach to such investments.

2. QUESTION: If, in the near future, the distinctions between different depository institutions become blurred to the point of non-recognition, what proposals would you make to change the regulatory structure into a system more in touch with the state of modern financial intermediation?

ANSWER: At such time as thrift institutions generally are essentially indistinguishable in their actual operations from commercial banks, it would be completely logical to effect a consolidation of federal thrift and banking regulators. In our view, however, such a consolidation would not become desirable simply by virtue of the bare statutory provision of bank-like investment powers to thrifts. Necessarily, there will be a significant transition period before meaningful utilization of the powers occurs for the bulk of thrifts. Moreover, it is likely, as we have indicated, that traditional real estate finance will continue to be the focus of investment activity for most thrift institutions. To the extent most thrift institutions, regardless of their legal powers, tend to operate mainly in traditional areas, rather than on the commercial bank pattern, it probably would be more efficient to have the existing regulatory structure intact. Given the general unfamiliarity of bank regulators with traditional thrift operations, transfer of thrift regulation to a unified bank regulatory agency during the transition period would result, in our view, in no efficiencies, for those institutions would have to be separately regulated within the agency structure. Rather than involving a merger of agency functions, the transfer would simply involve reestablishment of the Bank Board as an administrative subunit within a larger body.

3. QUESTION: You suggested that removal of the rate differential on money market certificates in May 1980 was premature. Could you describe the circumstances under which the elimination of the differential would be appropriate?

ANSWER: It was the clear intention of Congress that the rate decontrol process, including actions affecting the differential, was to be implemented in a manner consistent with the safety and soundness of depository institutions. The removal of the differential on MMCs has diminished the ability of thrifts to attract savings at a time when their collective financial condition is extremely poor, and, thus, in our view, has been premature. We would regard the elimination of the differential on such accounts to be appropriate only when thrift earnings are sufficiently recovered to permit effective competition for deposits without this artificial preference.

4. QUESTION: On page 10, you state "we believe that the FSLIC, when adverse financial conditions exist such as those we currently are experiencing, should be empowered to authorize any FSLIC-insured institution in danger of default to merge with any other FSLIC-insured thrift, or to be acquired by such an institution, or by any savings and loan holding company."

On page 11, you state " by giving us this authority, Congress would vastly increase the universe of institutions potentially able to acquire a troubled thrift. . . . it would avoid the development of a pattern of liquidations occasioned as a result, not of selection of the least costly of alternative approaches . . . ."

In view of the trend toward the homogenization of depository institutions, why should merger prospects be limited to FSLIC-insured institutions?

ANSWER: The question of cross-industry takeovers is one that is of intense concern to many members of Congress and the financial community. It is widely believed that the nation is best served by a financial system composed of large numbers of specialized intermediaries, and that allowing cross industry acquisitions will lead to a great shrinkage of the number of institutions, and a loss of the specialized services they now provide. Because of the strong sentiments on this issue, the Bank Board, in order to avoid controversy that might unduly impede passage of legislation providing emergency tools to the FSLIC and vital new investment and other authority for thrift institutions, elected not to deal with the cross-industry issue in its draft bill.