

**CONDUCT OF MONETARY POLICY
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**HEARING
BEFORE THE
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CONDUCT OF MONETARY POLICY

TUESDAY, FEBRUARY 7, 1984

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

The committee met, pursuant to call, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Gonzalez, Mitchell, Neal, Patterson, D'Amours, Lundine, Oakar, Vento, Barnard, Lowry, Schumer, Frank, Patman, Coyne, Roemer, Lehman, Cooper, Kaptur, Erdreich, Levin, Carper, Torres, Wylie, McKinney, Leach, Paul, Bethune, Shumway, Parris, McCollum, Wortley, Roukema, Lowery, Bereuter, Dreier, Hiler, Ridge and Bartlett.

The CHAIRMAN. The committee will come to order.

At this time of the year, every 4 years, there is one supply that seems to keep up with the demand, and that is the supply of rose-colored glasses.

During the state of the Union address, the President of the United States probably wore the brightest, most elaborate pair of these glasses—or, perhaps, more correctly, rose-colored blinders.

The formula was the ultimate in political simplicity—declare victory over every conceivable ill and trust that the people won't look too closely at the facts or question how the ills were created.

Some of us doubt that the worker who trudged through the snows and ice of the winters of 1981–83, looking for jobs that were not there, will be so quick to forgive and forget and to suggest that we “try it again.”

Certainly things have improved. From rock bottom, the only direction is up. Yes, we have an unemployment rate of 8 percent—a mere 9 million individuals, *not much to worry about* if you have a handy pair of rose-colored glasses. An unemployment rate of 8 percent is better. But it is obscene to describe it as good.

For black Americans—where nearly one out of five remain without jobs—and for the poverty areas and the hard-core jobless sectors, the ruffles and flourishes about national job aggregates have a particularly cruel and insensitive ring.

And with mortgage interest rates continuing to hover around 13–14 percent we must question how long a recovery in the housing industry can be sustained. The best brand of rose-colored glasses does not hide the premiums that small businessmen continue to pay for credit or the fact that most of the consumer interest rates never did drop from their record levels or the fact that financial

institutions are simply gouging their customers with fees as a back-door move to make up for any loss of interest income.

With red ink poured across the newest Reagan budget in a blood-like torrent, one must wonder how long interest rates will hold even at these levels without heading off into the sky again.

While few of us would want to emulate the Presidential handstands, we are pleased that improvements have occurred since we last gathered for one of these closed retreats over monetary policy. We must continue to question whether these improvements are temporary blips on the chart or truly evidence of a lasting and strong recovery that will spread into every corner.

Before we celebrate those who survived the dark winter of Reaganomics, let us not forget those who perished, hundreds of billions in lost production and income, untold hopes and opportunities destroyed for millions of American families. For the farmer who watched the sheriff tack up the foreclosure notice, the recovery comes too late.

For the steelworker who had to sell his home so his family could survive after the unemployment benefits ran out, the economic rescue did not arrive in time. And for those thousands of small businessmen who tacked up the "Out of Business" signs like tombstones across the Nation, economic recovery is someone else's term.

You cannot have the type of wrenching recession-depression that occurred in 1981-83 without leaving lasting scars; deep wounds for many. For many the results have been terminal. We will be a long time recovering—certainly in human terms—aggregate national statistics notwithstanding.

These semiannual hearings on monetary policy were undertaken 9 years ago with high hopes that they would provide a better understanding of the Nation's economic policy. I have been disappointed that these reports and hearings have not contained the clarity and the specifics that we had hoped for when we adopted the monetary reporting requirements back in 1975.

These hearings do offer the Federal Reserve a great opportunity to demonstrate its vaunted and oft-proclaimed independence. A chance to give the American people a clear picture, drawn in plain everyday terms, of its opinion of economic policy—unconcerned about whether its numbers and analysis were in the same ballpark with the actions of the President's political appointees.

We know now—sadly—that the Reagan administration's projections in 1981 and 1982 did little to warn the Nation that it was headed off the economic cliff. The Federal Reserve—thanks to this committee's initiative—was given repeated opportunities to provide a strong independent analysis of what was happening—to give the warnings. If these signals were given—if there were stark differences with the administration's headlong rush toward record unemployment and record deficits or major differences with the projections—most of the Nation missed them.

True, at times the Federal Reserve suggested its differences by presenting its projections in wide bands of possibilities—pressed by some, it talked about the low side of the bands; pressed by others it mentioned the high side.

This "on the one hand and on the other hand" is not what I call the hardnosed, independent judgment which we need and which the people need to make proper economic policy.

Differences obscured may be no differences at all. The American people should not be required to read tea leaves to understand what one of their public agencies is doing.

Hope springs eternal. Perhaps today we will hear, in specific terms, short, clear statements that will be understood on the 4 o'clock shift, just where the Federal Reserve stands, and how its stance differs or supports the stance of the policymakers in the executive branch.

As a final thought, I want to congratulate Chairman Volcker for taking two important steps toward a more realistic and more open monetary policy. First, I noticed in your prepared statement you say the monetary aggregates will be determined against a backdrop of developments in the economy, current and prospective price pressures and conditions in domestic credits and international markets. This represents another important step back from the deep hole of mechanical monetarism, and is in keeping with this committee's continued suggestions.

Second, I understand Chairman Volcker himself met with the press yesterday to discuss the Humphrey-Hawkins report. This is at least one step toward the 20th-century practice of releasing information when it is available. Again, this is a practice the committee strongly recommended in its 1983 monetary policy report. My only hope is that the Open Market Committee will continue to release its decisions as soon as they are made, as I suggested in my letter to the Fed this past January.

Chairman Volcker, welcome to the committee this morning. Certainly we look forward with eager anticipation to hearing from you. We hope that you can in some manner summarize. We did get your testimony yesterday afternoon, I think about 3 o'clock. Most of us have had an opportunity to go over it. We will put the entire statement in the record. After I hear from Mr. Wylie, we will ask you to proceed.

Mr. WYLIE. Thank you, Mr. Chairman. I am delighted to join you in welcoming our distinguished Chairman Volcker to our semiannual review of monetary policy.

Chairman Volcker, your appearances before us in the past have always stimulated spirited discussion, to say the least. I am confident today will be no different. It seems that the time could be no better for an open airing of where we find ourselves economically and where the Nation is heading. We all know that the U.S. economy had traced an impressive recovery this past year.

I do have a little different view in that regard than our distinguished chairman. Some now contend that the recovery is slow because of an unduly restrictive monetary policy while others believe the Federal Reserve should not relax its grip on the growth of the money supply. I personally look forward to your reaction to the alternatives before us. An early look at the figures summarized in the report suggests a policy of "steady as she goes."

Even more importantly, you have also been in the forefront of those urging Congress and the administration to take the strong

steps necessary to reduce the deficits which have piled up and those which loom ahead.

Last October, Congressman Les AuCoin and I introduced legislation to establish a bipartisan national commission to make recommendations on Federal deficit reduction. The President has now also called for a similar plan, and he has also asked in his budget message for line-item veto power. When it was enacted in 1974, the Congressional Budget Act was viewed by its proponents as the emergency brake on runaway spending. It has turned out instead to be the accelerator.

So while this Member intends to do whatever he can to see that the potentially disastrous deficits we now view on the horizon are brought down, I would welcome your comments on what changes should be enacted, including institutional changes, to bring our Federal budget under better control. I note that the State and local governments as a group have done a much better job and are now running surpluses.

Finally, we are literally being overtaken by events in the rapidly changing financial services industry. We were familiar with your views on the need for retention of regulatory powers by the Federal Reserve in order to conduct effective monetary policy.

But just as I am afraid that Congress has been in the slow lane on dealing with all of the implications of financial services reform, so, too, I am troubled by the possibility that the financial regulatory structure may not be streamlined enough to adequately ensure these orderly changes which may be needed.

The Vice President's Task Force on Financial Services Regulation has now come forth with its recommendations. I know you have your own strongly held views in this area. I am sure all of us would welcome hearing some of them.

Again, Mr. Chairman, welcome to the committee this morning. I look forward to your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Wylie.

Now we may proceed.

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

Mr. VOLCKER. Mr. Chairman, Mr. Wylie, you put me in a bit of a dilemma.

Mr. GONZALEZ. Mr. Chairman, will you yield? I notice there are quite a number of people outside the door that haven't found access to the hearing room. I wonder if there is any way we could allow those that might have some business, say with the press or others, in, even if they have to kind of stand around. There's a couple of chairs there that are open.

The CHAIRMAN. Why don't I ask the staff to do what they can to accommodate as many as possible. The problem is Chairman Volcker is obviously taking over from Robert Redford and people like that, and Bo Derek. His popularity is unbelievable. We will do our best. I will ask the staff to do their best to fill the empty chairs.

Mr. VOLCKER. Would you like me to proceed, Mr. Chairman?

The CHAIRMAN. There aren't too many empty seats. You may proceed, Mr. Chairman.

Mr. VOLCKER. I want to respond to your request to be full in our evaluation of the outlook. Perhaps I can assume, since we did release the material yesterday, that I can skip over the first few pages of my statement, which review the new targets. On page 4, I indicate that, as of a year ago, I do believe that after the many years of pain and instability, to which you referred, Mr. Chairman, we do have an enormous opportunity to sustain growth for years ahead in an environment of much greater price stability. Today, after a year of strong recovery, to me that sense of opportunities before us has only been reinforced.

The simple fact is that the economy moved ahead faster, and unemployment dropped more sharply, than we or most others thought at all probable. At the same time, the inflation rate dropped further, to the point that producer prices were almost unchanged over the year as a whole and consumer prices rose by less than any time over the past decade. The fact that we were able to combine strong growth with good price performance is what is so encouraging. It is the key to lasting success.

With job opportunities, real incomes, and profits all rising, so has the sense of optimism among both families and businesses.

I realize that improvement must be measured from where we started. There was a lot of room to grow, and the early stages of recovery typically see rapid growth and less price pressures. Any satisfaction with what has been happening has to be tempered by the knowledge there is still a considerable way to go to reach satisfactory levels of employment and before we can claim to have restored reasonable price stability.

In particular, should inflationary trends and fears again take hold, prospects for the lower interest rates and orderly credit markets we need to support investment and productivity growth would be shattered.

I hardly need to remind you that inflation has tended to worsen during periods of cyclical expansion. But that need not be inevitable. Out of hard experience, I believe we can shape disciplined policies—indeed, we have already gone a long way toward shaping policies and attitudes—toward dealing with the threat.

What we have not done in this past year is face up to other hazards to our prosperity and to our stability—hazards that are new to our actual experience but which have been long identified. I am referring, of course, to our twin deficits: the structural deficit in our Federal budget and the deficit in our external accounts—both at unprecedented levels and getting worse. Both of those deficits carry implications for the prospects of reducing our still historically high levels of interest rates.

So far, the strains have been masked by other factors of strength and by the rapidity of growth from the depths of recession. But with the passage of time and full recovery, the predictable effects have become more obvious. They pose a clear and present danger to the sustainability of growth and the stability of markets, domestic and international. We still have time to act—but in my judgment, not much time.

Let me summarize why I think the developments of the past year are, in key respects, so promising—why, potentially, what has been going on can be not just another cyclical recovery, but the start of a long process of growth and renewed stability.

Looking back, it is now apparent that the trend of productivity growth had practically stopped in the late 1970's. But productivity began to increase again during the recession and rose rapidly during most of last year. One or two years do not make a new trend, and relatively good productivity growth is typical of the early stages of recovery. But the evidence—quantitative and qualitative—suggests something more than cyclical forces are at work.

That, together with growing markets, accounted for the speed of the rebound in total profits and improvement in profit margins last year from long depressed levels, even as prices for many goods and services tended to stabilize. The cash flow of businesses has been further reinforced by the liberal treatment of depreciation and other tax changes enacted in recent years, and after-tax economic profits, only a year after recession, are approaching the highest levels of the 1970's relative to GNP. Strong expansion in some types of investment during 1983 carries promise for future productivity.

At the same time, we should not claim too much. Profits remain well below rates typical of the prosperous 1960's. Recent employment increases, while highly welcome in themselves, have been so large relative to output growth that they raise some questions about whether rapid productivity growth is being maintained. Long-lived investment—new plant for expansion of capacity—still lags. High interest rates, the uncertainty bred by years of disappointment, and strong competition from abroad all have restrained heavy investment. Already, a few industries are close to, or even at, sustainable capacity. But, on balance, the evidence and the omens are more favorable than for several years.

That is certainly true of the longer term outlook for costs and prices. I am well aware that slack markets and excessive unemployment, the appreciating dollar and the decline in world oil prices all helped account for the rapidity of the drop in the general inflation rate and the degree to which cost pressures have subsided. To that extent, progress toward stability has had a sizable one time, or cyclical, component. But we also now have a clear opportunity to build in that improvement—the best opportunity in many years.

As the increase in average wages and salaries, which account for some two-thirds of all costs, has declined in nominal terms, the real income of the average worker has increased. That reverses the pattern as inflation accelerated during much of the 1970's when escalating wages often lagged behind more rapidly rising prices. The more favorable pattern should be assisted by greater stability in energy prices, and by stronger productivity growth. With real wages again rising on average, and with prices more stable, the logic points toward much more moderate new wage contracts than became the norm in the inflationary 1970's. The competitive pressures associated with the process of deregulation in some important industries also have been a factor working to contain costs and prices, and happily we can begin to see some signs of more re-

strained cost increases in areas, such as medical care and education, that have been slow to reflect the disinflationary process.

To the extent we can build confidence in the outlook for more stable prices, the process could, potentially, feed on itself. Incentives for speculation in commodities, and for speculative excesses, would be greatly reduced and possibilities of another burst in oil prices diminished. It could provide the best possible environment for declines in interest rates over time—nominal and real—and interest rates are themselves an element of costs. Lower interest rates could, in turn, be a powerful factor supporting and encouraging housing and the business investment that we need.

Nonetheless, as I suggested a few minutes ago, the prospects for sustained growth and stability must remain conditional. There is another, and bleaker, reality. We are faced with two deficits—in our budget and in our international accounts—unprecedented in magnitude. Those deficits have multiple causes, but they are not related. Left untended, each, rather than improving, will tend to cumulate on itself, until finally they will undercut, all that has been achieved with so much effort and so much pain.

Looking back, the rising budget deficit did provide a large and growing stimulus to purchasing power as we emerged from recession. It helped account for the vigor of consumption in the face of high interest rates. But the other side of the coin is that financing the deficit last year amounted to three-quarters of our net new domestic savings. That was tolerable—we obviously have tolerated it—for a limited period of time when other demands on those savings were limited. Business inventories actually declined on balance last year, and housing and business investment were recovering from recession lows.

Even then, deficits were a factor keeping interest rates higher than otherwise, and the implications become more serious as the economy grows closer to its potential. The hard fact is that for many years we have succeeded in saving only some 7 to 9 percent of our GNP. Despite the efforts to raise it, the domestic savings rate remains within that range now. If the budgetary deficit absorbs amounts equal to 5 percent or more of the GNP as the economy grows—and that is the present prospect for the “current services” budget—not much of our domestic savings will be left over for the investment we need.

Over the past year, those needs have been increasingly met by savings from abroad in the form of a net capital inflow. That money has come easily; amid world economic and political uncertainty, the United States has been a highly attractive place to invest. But part of the attraction for investment in dollars has been relatively high interest rates. In effect, the growing capital inflow has, directly or indirectly, helped to finance the internal budget, by the same token helping to moderate the pressures of the budget deficit on the domestic financial markets. At the same time, the flow of funds into our capital and money markets pushed the dollar higher in the exchange markets even in the face of a growing trade and current account deficit—and the dollar appreciation in turn undercut our worldwide trading position further.

We simply can't have it both ways—on the one hand, look abroad for increasing help in financing the credits related to our

budget deficit, our housing, and our investment, and on the other hand, expect to narrow the growing gap in our trade accounts. At the end of the day, the counterpart of a net capital inflow is a net deficit on our current account—trade and services—with other countries.

Most forecasts suggest that we, as a nation, will have to borrow abroad about 2 percent or more of our GNP this year to meet projected domestic needs. That pace does not appear sustainable over a long period. Faced at some point with a reduction in the net flow of capital from abroad, the burden of financing the budget deficit would then be thrown back more fully on domestic sources of savings. If our Federal financing needs remain so high, housing and investment will be squeezed harder.

I must also point out that, in the same way that the interest costs of this year's deficit add to next year's requirements—and compound over many years thereafter—the interest and dividend payments related to the net capital inflow builds up future charges against the current account of the balance of payments. Skepticism about our ability to account accurately and fully for all the flows of funds into or out of the country is fully justified; it is nonetheless ominous that the recorded net investment position of the United States overseas, built up gradually over the entire postwar period, will in the space of only 3 years—1983, 1984, and 1985—be reversed. If the data at all reflect reality, the largest and richest economy in the world is on the verge of becoming a net debtor internationally, and would soon become the largest.

Looking at the same development from another angle, it is the exporter, and those competing directly with imports, that have not shared at all proportionately in the recovery. Developments in the fourth quarter illustrate the point. There has been much comment about the slowing in the rate of GNP growth to a rate of about 4½ percent. But, judging from the preliminary figures, domestic demands were quite well maintained, increasing at a rate of almost 7 percent. Much of that increased demand flowed abroad, adding to income and production elsewhere. It was domestic production, not demand, that grew appreciably more slowly.

For a time, as with the budget deficit, that kind of discrepancy is tolerable. Indeed, from one point of view, it has provided a welcome impetus toward stimulating the growth process in other countries of the industrialized world, and the strength of our markets assisted the external adjustments necessary in the developing world. We can take pride in the fact that others find the United States an attractive place to invest; good performance and policies can help sustain those flows.

But we simply can't afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal economy. Part of our domestic industry—that part dependent on exports or competing with imports—would be sacrificed. The stability of the dollar and our domestic financial markets would become hostage to events abroad. If recovery is to proceed elsewhere, as we want, other countries will increasingly need their own savings. While we don't know when, at some point the process would break down.

In the abstract, the ultimate objective of monetary policy is simply to state: to provide just enough money to finance sustainable growth—and not so much as to feed inflation. In the concrete, issues abound. Many of those are technical and they are discussed in our report.

Let me address myself to some of the broader issues and point out there is no instrument of monetary policy that, in any direct or immediate sense, can earmark money only for expansion and not for inflation, or vice versa. The distribution of any given nominal growth of the GNP between real growth and inflation is a product of many factors—the flexibility and competitiveness of product and labor markets, the exchange rate, and internal or external shocks—such as the oil crises of the seventies. Expectations and attitudes developed out of past experience are critically important.

In that respect we have not inherited a sense of stability. Quite to the contrary, the legacy of the seventies was deeply ingrained patterns of behavior—in pricing, in wage bargaining, in interest rates, and in financial practices generally—built on the assumption of continuing, and accelerating, inflation. Starving an inflation of the money needed to sustain it is a difficult process in the best of circumstances; it was doubly so when the continuing inflationary momentum was so strong.

Now, after a great deal of pain and dislocation, attitudes have changed. In this setting, we can assume that, within limits, more of any given growth in the money supply will finance real activity and less rising prices than would have been the case when the inflationary momentum was so high.

But we also have to recognize that the battle against inflation has not yet been won—that skepticism about our ability, as a nation, to maintain progress toward stability is still evident. That is one of the reasons why longer term interest rates have lingered so far above current inflation levels. After so many false starts in the past, the skepticism is likely to remain until we can demonstrate that, in fact, the recent improvement is not simply a temporary matter—that the Federal Reserve is not prepared to accommodate a new inflationary surge as the economy grows. The doubts are reinforced by concerns that the pressures of the huge budget deficit on financial markets may, willy-nilly, push us in that direction, as has happened in so many countries.

The desire to see interest rates lower, or to avoid increases, is natural. But attempts to accomplish that desirable end by excessive monetary growth would soon be counterproductive. By feeding concerns about inflation, the implications for interest rates themselves would in the end be perverse—and likely sooner rather than later. As things stand, credit markets are already faced with potential demands far in excess of our capacity to save domestically; to add renewed fears of inflation to the outlook would only be to reduce the willingness to commit funds for long periods of time and for productive investment. Inflationary policies would also discourage the continuing flow of funds from abroad, upon which, for the time being, we are dependent. In the last analysis, willingness to provide those funds freely at current or lower interest rates is dependent on confidence in our stability and in our economic management. Depreciation of the dollar externally as a result of inflationary

policies will not, in the end, help our exporters, or those competing with imports, because that depreciation would be accompanied by inflated domestic costs.

In a real sense, the greatest contribution that the Federal Reserve can make to our lasting prosperity is to foster the expectation—and the reality—that we can sustain the hard-won gains against inflation and build upon them.

In my judgment, against a background of more stable prices, interest rates are indeed too high for the long-term health of the United States or the world economy. I have repeatedly expressed the view that, as we maintain the progress against inflation, interest rates should decline—and they should stay lower.

Much is at stake. We will need more industrial capacity, and we will need it relatively soon. Even after the sharp declines in interest rates from earlier peaks, many thrift institutions and businesses remain in marginal profit positions and with weakened financial structures; lower rates would bring help much faster progress in repairing the damage. The cooperative efforts of borrowers, banks, and the governments and central banks of the industrialized world have managed to contain the strains on the international financial system, but those pressures are still strongly evident. Both economic growth and lower interest rates are needed as part of more fundamental solutions.

But wish and desire are not the same thing as reality—we have to deal with the situation as it is. In setting the targets for the various monetary and credit aggregates for 1984 as a whole, the Federal Open Market Committee had to remain alert to the danger of renewed inflation as well as to the need for growth. It also decided that, operationally, it would for the time being be appropriate to maintain essentially the same degree of restraint on the reserve positions of depository institutions that has prevailed since last autumn. That judgment reflects the fact that growth in the various measures of money and credit now appears broadly consistent with objectives, that the momentum of economic expansion remains strong, and inflationary tendencies contained. That operational judgment will, of course, be reviewed constantly in the weeks and months ahead.

Those decisions will reflect continuing appraisals of the rate of growth of money and credit, interpreted in the light of all the evidence about economic activity, prices, domestic and international financial markets, and other relevant considerations. All those factors will, in turn, be affected by other public and private policies. In that context, it is the strength of economic activity, the demand pressures on the credit markets, and the willingness of others to invest in the United States that will influence the course of interest rates.

In approaching our own operational decisions, the actual and prospective size of the budget deficit inevitably complicates the environment within which we work. By feeding consumer purchasing power, by heightening skepticism about our ability to control the money supply and contain inflation, by claiming a disproportionate share of available funds, and by increasing our dependence on foreign capital, monetary policy must carry more of the burden of

maintaining stability and its flexibility, to some degree, is constrained.

You know, monetary policy is only one part of an economic program. It is an essential part, but success is dependent on a coherent whole.

I have tried to demonstrate that we have come a long way—that we have much upon which to build sustained prosperity.

Many of the portents are favorable.

Public policy has encouraged greater competition, removed harmful regulatory restraints, and provided greater incentives. There are hopeful signs that productivity is again growing, and a healthy concern about costs and efficiency. Energy prices have stabilized. We have had a strong recovery, and the progress toward price stability has been gratifying.

Prospects for extending that success rest in part on continuing discipline by business and labor. We cannot afford to return to the syndrome of the seventies, with prices and wages chasing each other amid fears of inflation, amid erosion of productivity and real incomes. The experiments in the private sector with profit sharing, with quality circles, and with other forms of labor-management cooperation—efforts first born in adversity—can bear fruit in prosperity.

But if they are to do so—if a sense of discipline is to be maintained—those of us responsible for public policy must be able to demonstrate that inflation will not again get the upper hand—that productivity and restraint will be rewarded, not penalized in favor of those seeking inflationary or speculative gain.

The contribution that monetary and other policies make to that environment is critical. As the expansion proceeds, and as some of the temporary factors restraining prices recede, we as a nation simply cannot afford to permit inflation to attain a new momentum. Our monetary policies are, and in my judgment must continue to be, geared to avoid that danger.

But for all that progress and promise, something is out of kilter.

Our commonsense tells us that enormous and potentially rising budget deficits, and the high and rising deficits in our trade accounts, are wrong—they cannot be indefinitely prolonged.

That commonsense is confirmed by simple observation. Some of our proudest industries—potentially capable of competing strongly in world markets—are in trouble, tempted to shift more operations abroad for sheer survival or to demand protectionist walls. Interest rates remain historically high, too high, threatening housing and investment.

And, in this instance, economic analysis bears out, and amplifies, the judgments of commonsense and simple observation. Our two deficits are related. The budget deficit, by outrunning our ability to save, damages prospects for housing and for investment, and makes us dependent on foreign capital. That capital from abroad, for the present, alleviates the pressure on our money markets, but it complicates our trade position. And if and as our trade account improves, the brunt of financing excessive budget deficits would fall back more fully on domestic savings, squeezing domestic capital spending harder.

We can, of course, sit back and wait awhile longer, hoping for the best.

I certainly have some understanding of the difficulties of achieving a consensus on difficult budgetary choices when a sense of immediate crisis is lacking—when for the moment things seem to be going so well.

But I also know that to wait too long would be to take risks with the American economy.

It is already late. The stakes are large. Markets have a mind of their own; they have never waited on the convenience of kings or congressmen—or elections.

The time to take the initiative is now, when we can influence markets constructively—when we can demonstrate that we are in control of our own financial destiny. Real progress toward reducing the budget deficit is needed to clear away the dangers.

I sense a fresh opportunity in the proposals of the President for a joint effort to attack the deficit—for a sizable downpayment on what is ultimately needed.

Certainly, that kind of demonstration that we are beginning to *face up to our budgetary problem would make it easier for monetary policy to do its necessary work.* And, in the larger scene, it would be tangible evidence to our own people that we can do what is necessary to seize the bright opportunities before us.

[The prepared statement of Mr. Volcker follows:]

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

I am pleased to be meeting with this Committee once again to discuss the Federal Reserve's monetary policy objectives for the year ahead. You have before you the official monetary policy report that is required under the Humphrey Hawkins Act. That report, which was released Monday, describes rather fully the current economic situation and sets out our decisions with respect to monetary policy in detail. My prepared remarks this morning will focus mainly on some broader considerations that seem to me to bear crucially on our approach to monetary policy, on the interaction of monetary policy with other policies, and on our economic prospects.

Monetary Policy "Targets" for 1984 and Economic Projections

At its meeting last week, the Federal Open Market Committee essentially reaffirmed the ranges for money and credit growth tentatively established in July of last year. Those new target ranges are set out in Table I attached, against the background of last year's targets.

As there indicated, the target ranges for M3 and for nonfinancial debt were lowered by 1/2 percent from the 1983 ranges to 6-9 and 8-11 percent, respectively, as tentatively set in July. The M2 range was reduced by 1 percent from the 1983 range to 6-9 percent. That is 1/2 percent lower than anticipated in July, reflecting in part technical considerations bearing on the appropriate relationships among the broader aggregates. The M1 range was set at 4-8 percent, 1 percent lower than during the second half of 1983, as had been anticipated.

These targeted ranges envisage that the relationships between the monetary aggregates and the nominal GNP -- that is, "velocity" -- will return to patterns much closer to historical norms than was characteristic of 1982 and early 1983. Developments as 1983 progressed pointed in that direction. At year-end, all the targeted aggregates appeared to be within the 1983 ranges;* a tendency for velocity to rise -- in contrast to historically large declines in 1982 and early 1983 -- was more in line with past cyclical experience. Further experience will be necessary to confirm the validity of that judgment, and the Committee recognizes that recent regulatory and institutional changes may be reflected in some changes in the underlying trends of velocity, particularly for M1.

For that reason, substantial weight will continue to be placed on the broader aggregates for the time being, and growth in M1 will be evaluated in the light of the performance of the other aggregates. All the aggregates will be interpreted against the background of developments in the economy, current and prospective price pressures, and conditions in domestic credit and international markets.

*Subsequent benchmark revisions increased growth of all the monetary aggregates fractionally, bringing M3 slightly above the targeted range during the fourth quarter. The revised data are reflected in Table II and the charts attached.

More detail about the new targets and 1983 performance is provided in the Humphrey Hawkins Report itself, and I will be glad to address any questions you have about them.

In setting the new target ranges, the Committee members generally felt that economic activity would continue rising through 1984 and into 1985 at a more moderate -- and potentially more sustainable -- pace of 4 to 4-3/4 percent. That growth is expected to be accompanied by some further decline in the unemployment rate to the area of 7-1/2 to 7-3/4 percent. Cyclical factors and special circumstances -- including the effects of bad weather -- are expected to be reflected in a little larger price increase on average, following the remarkably good progress of 1982 and 1983.

Taken together, those projections resemble those set out by the Administration and many others, and they suggest a generally satisfactory economic performance is probable in 1984. But those summary forecasts should not divert our attention from certain serious problems that have emerged. As I assess the outlook, there are clear hazards and risks before us. Unless dealt with forcefully and effectively, they will jeopardize the good prospects for 1984 and beyond.

The Opportunity and the Risks

A year ago, in appearing before you on this occasion, I emphasized that, after too many years of pain and instability, we had an enormous opportunity to sustain growth for years ahead in an environment of much greater price stability. Today, after a year of strong recovery, that sense of the opportunities before us has only been reinforced.

The simple fact is that the economy moved ahead faster, and unemployment dropped more sharply, than we or most others thought at all probable. At the same time, the inflation rate dropped further, to the point that producer prices were almost unchanged over the year as a whole and consumer prices rose by less than at any time over the past decade. The fact that we were able to combine strong growth with good price performance is what is so encouraging. It is the key to lasting success.

With job opportunities, real incomes, and profits all rising, so has the sense of optimism among both families and businesses. That widely shared impression is confirmed statistically in the results of "attitudinal" indices that attempt to measure confidence, expectations, and buying plans -- they are mostly at the highest, or near the highest, levels in many years.

I realize that improvement must be measured from where we started. There was a lot of room to grow, and the early stages of recovery typically see rapid growth and less price pressures. Any satisfaction with what has been happening has to be tempered by the knowledge there is still a considerable way to go to reach satisfactory levels of employment and before we can claim to have restored reasonable price stability. In particular, should inflationary trends and fears again take hold, prospects for the lower interest rates and orderly credit markets we need to support investment and productivity growth would be shattered.

I hardly need to remind you that inflation has tended to worsen during periods of cyclical expansion. But that need not be inevitable. Out of hard experience, I believe we can shape disciplined policies -- indeed, we have already gone a long way toward shaping policies and attitudes -- toward dealing with the threat.

What we have not done in this past year is face up to other hazards to our prosperity and to our stability -- hazards that are new to our actual experience but which have been long identified. I am referring, of course, to our twin deficits: the structural deficit in our Federal budget and the deficit in our external accounts -- both at unprecedented levels and getting worse. Both of those deficits carry implications for the prospects of reducing our still historically high levels of interest rates.

So far, the strains have been masked by other factors of strength and by the rapidity of growth from the depths of recession. But with the passage of time and full recovery, the predictable effects have become more obvious. They pose a clear and present danger to the sustainability of growth and the stability of markets, domestic and international. We still have time to act -- but in my judgment, not much time.

Sources of Strength

I can summarize briefly why I think the developments of the past year are, in key respects, so promising -- why, potentially, what has been going on can be not "just another" cyclical recovery, but the start of a long process of growth and renewed stability.

Looking back, it is now apparent that the trend of productivity growth had practically stopped in the late 1970's. But productivity began to increase again during the recession and rose rapidly during most of last year. One or two years do not make a new trend, and relatively good productivity growth is typical of the early stages of recovery. But the evidence -- quantitative and qualitative -- suggests something more than cyclical forces are at work in important areas of the economy. Under the pressure of adversity -- and with the seemingly "easy pickings" of speculative and inflationary gains

diminishing -- management and labor alike have turned their efforts and their imagination toward ways to increase efficiency and to curtail overhead.

That, together with growing markets, accounted for the speed of the rebound in total profits and improvement in profit margins last year from long-depressed levels, even as prices for many goods and services tended to stabilize. The cash flow of businesses has been further reinforced by the liberal treatment of depreciation and other tax changes enacted in recent years, and after-tax economic profits, only a year after recession, are approaching the highest levels of the 1970's relative to GNP. Strong expansion in some types of investment during 1983 -- particularly electronic equipment where technological change has been so rapid -- carries promise for future productivity.

We should not claim too much. Profits remain well below rates typical of the prosperous 1960's. Recent employment increases, while highly welcome in themselves, have been so large relative to output growth that they raise some questions about whether rapid productivity growth is being maintained. Long-lived investment -- new plant for expansion of capacity -- still lags. High interest rates, the uncertainty bred by years of disappointment, and strong competition from abroad all have restrained

heavy investment. Already, a few industries are close to, or even at, sustainable capacity. But, on balance, the evidence and the omens are more favorable than for several years.

That is certainly true of the longer-term outlook for costs and prices. I am well aware that slack markets and excessive unemployment, the appreciating dollar together with the ready availability of goods from abroad, and the decline in world oil prices all helped account for the rapidity of the drop in the general inflation rate and the degree to which cost pressures have subsided. To that extent, progress toward stability has had a sizable "one time," or cyclical, component. But we also now have a clear opportunity to "build-in" that improvement -- the best opportunity in many years.

As the increase in average wages and salaries, which account for some two-thirds of all costs, has declined in nominal terms, the real income of the average worker has increased. That reverses the pattern as inflation accelerated during much of the 1970's when escalating wages often lagged behind more rapidly rising prices. The more favorable pattern should be assisted by greater stability in energy prices, where the outlook (barring political turmoil) appears favorable, and by stronger productivity growth. With real wages again rising on average, and with prices more stable, the logic points toward much more moderate new wage contracts than became the norm in the inflationary 1970's. The competitive

pressures associated with the process of deregulation in some important industries also have been a factor working to contain costs and prices, and happily we can begin to see some signs of more restrained cost increases in areas, such as medical care and education, that have been slow to reflect the disinflationary process.

To the extent we can build confidence in the outlook for more stable prices, the process could, potentially, feed on itself. Incentives for speculation in commodities, and for speculative excesses, would be greatly reduced and possibilities of another burst in oil prices diminished. It could provide the best possible environment for declines in interest rates over time -- nominal and real -- and interest rates are themselves an element of costs. Lower interest rates could, in turn, be a powerful factor supporting and encouraging housing and the business investment that we need to maintain economic momentum and to support productivity growth.

The Problems

Nonetheless, as I suggested a few minutes ago, the prospects for sustained growth and stability must remain conditional. There is another, and bleaker, reality. We are faced with two deficits -- in our budget and in our international accounts -- unprecedented in magnitude. Those twin deficits have multiple causes, but they are

not unrelated. Left untended, each, rather than improving, will tend to cumulate on itself, until finally they will undercut, all that has been achieved with so much effort and so much pain.

Looking back, the rising budget deficit provided a large and growing stimulus to purchasing power as we emerged from recession. It helped account for the vigor of consumption in the face of historically high interest rates. The other side of the coin is that *financing the deficit* last year amounted to three quarters of our net new domestic savings. That was tolerable -- we obviously have tolerated it -- for a limited period of time when other demands on those savings were limited. Business inventories actually declined on balance last year, and housing and business investment were recovering from recession lows.

Even then, deficits were a factor keeping interest rates higher than otherwise, and the implications become much more serious as the economy grows closer to its potential. The hard fact is that for many years we have succeeded in saving (net of depreciation) only some 7 to 9 percent of our GNP. Despite the efforts to raise it, the domestic savings rate remains within that range now and foreseeably. If the budgetary deficit absorbs amounts equal to 5 percent or more of the GNP as the economy grows -- and that is the present prospect for the "current

services" or "base line" budget -- not much of our domestic savings will be left over for the investment we need.

Over the past year, our needs have been increasingly met by savings from abroad in the form of a net capital inflow. That money has come easily; amid world economic and political uncertainty, the United States has been a highly attractive place to invest. But part of the attraction for investment in dollars has been relatively high interest rates. In effect, the growing capital inflow has, directly or indirectly, helped to finance the internal budget, by the same token helping to moderate the pressures of the budget deficit on the domestic financial markets. At the same time, the flow of funds into our capital and money markets pushed the dollar higher in the exchange markets even in the face of a growing trade and current account deficit -- and the dollar appreciation in turn undercut our world-wide trading position further.

We simply can't have it both ways -- on the one hand, look abroad for increasing help in financing the credits related to our budget deficit, our housing, and our investment, and on the other hand, expect to narrow the growing gap in our trade accounts. At the end of the day, the counterpart of a net capital inflow is a net deficit on our current account -- trade and services -- with other countries.

Most forecasts suggest that we, as a nation, will have to borrow abroad (net) about 2 percent or more of our GNP this year to meet projected domestic needs. That pace does not appear sustainable over a long period. Faced at some point with a reduction in the net flow of capital from abroad, the burden of financing the budget deficit would then be thrown back more fully on domestic sources of savings. If our Federal financing needs remain so high, housing and investment will be squeezed harder.

I must also point out that, in the same way that the interest costs of this year's deficit add to next year's requirements -- and compound over many years thereafter -- the interest and dividend payments related to the net capital inflow builds up future charges against the current account of the balance of payments. Skepticism about our ability to account accurately and fully for all the flows of funds into or out of the country is justified; it is *nonetheless* ominous that the recorded net investment position of the United States overseas, built up gradually over the entire postwar period, will in the space of only three years -- 1983, 1984, and 1985 -- be reversed. If the data at all reflect reality, the largest and richest

economy in the world is on the verge of becoming a net debtor internationally, and would soon become the largest.

Looking at the same development from another angle, it is the exporter, and those competing directly with imports, that have not shared at all proportionately in the recovery. Developments in the fourth quarter illustrate the point. There has been much comment about the slowing in the rate of GNP growth to a rate of about 4-1/2 percent. But, judging from the preliminary figures, domestic demands were quite well maintained, increasing at a rate of almost 7 percent. Much of that increased demand flowed abroad, adding to income and production elsewhere. It was domestic production, not demand, that grew appreciably more slowly.

For a time, as with the budget deficit, that kind of discrepancy is tolerable. Indeed, from one point of view, it has provided a welcome impetus toward stimulating the growth process in other countries of the industrialized world, and the strength of our markets assisted the external adjustments necessary in the developing world. We can also take pride in the fact that others find the United States an attractive place to invest; good performance and policies can help sustain those flows.

But we simply can't afford to become addicted to drawing on increasing amounts of foreign savings to help

finance our internal economy. Part of our domestic industry -- that part dependent on exports or competing with imports -- would be sacrificed. The stability of the dollar and our domestic financial markets would become hostage to events abroad. If recovery is to proceed elsewhere, as we want, other countries will increasingly need their own savings. While we don't know when, at some point the process would break down.

The Implications for Monetary Policy

In the abstract, the ultimate objective of monetary policy is simple to state and widely agreed: to provide just enough money to finance sustainable growth -- and not so much as to feed inflation. In the concrete, issues abound.

Some of them are more or less technical -- how we define and measure money and its relationship to the nominal GNP. These questions are dealt with in our formal report describing our decisions on the targets. I want here to concentrate on some broader implications of the current situation for the conduct of monetary policy.

There is no instrument of monetary policy that, in any direct or immediate sense, can earmark money only for expansion and not for inflation, or vice versa. The distribution of any given nominal growth of the GNP between real growth and inflation is a product of many

factors -- the flexibility and competitiveness of product and labor markets, the exchange rate, and internal or external shocks (such as the oil crises of the 1970's). Expectations and attitudes developed out of past experience are critically important.

In that respect we have not inherited a sense of stability. Quite to the contrary, the legacy of the 1970's was deeply ingrained patterns of behavior -- in pricing, in wage bargaining, in interest rates, and in financial practices generally -- built on the assumption of continuing, and accelerating, inflation. Starving an inflation of the money needed to sustain it is a difficult process in the best of circumstances; it was doubly so when the continuing inflationary momentum was so strong.

Now, after a great deal of pain and dislocation, attitudes have changed -- there is a sense of greater restraint in pricing and wage behavior, a greater recognition of the need to improve efficiency, less alarm (at least for the short run) over the outlook for prices, and relative confidence by others in the outlook for the United States. In this setting, we can assume that, within limits, more of any given growth in the money supply will finance real activity and less rising prices than would have been the case when the inflationary momentum was high.

But we also recognize that the battle against inflation has not yet been won -- that skepticism about our ability, as a nation, to maintain progress toward stability is still evident. That is one of the reasons why longer-term interest rates have lingered so far above current inflation levels. After so many false starts in the past, the skepticism is likely to remain until we can demonstrate that, in fact, the recent improvement is not simply a temporary matter -- that the Federal Reserve is not prepared to accommodate a new inflationary surge as the economy grows. The doubts are reinforced by concerns that the pressures of the huge budget deficit on financial markets may, willy-nilly, push us in that direction, as has happened in so many countries.

The desire to see interest rates lower, or to avoid increases, is natural. But attempts to accomplish that desirable end by excessive monetary growth would soon be counterproductive. By feeding concerns about inflation, the implications for interest rates themselves would in the end be perverse -- and likely sooner rather than later. As things stand, credit markets are already faced with potential demands far in excess of our capacity to save domestically; to add renewed fears of inflation to the outlook would only be to reduce the willingness to commit funds for long periods of time and for productive

investment. Inflationary policies would also discourage the continuing flow of funds from abroad, upon which, for the time being, we are dependent. In the last analysis, willingness to provide those funds freely at current or lower interest rates is dependent on confidence in our stability and in our economic management. Depreciation of the dollar externally as a result of inflationary policies will not, in the end, help our exporters, or those competing with imports, because that depreciation would be accompanied by inflated domestic costs.

In a real sense, the greatest contribution that the Federal Reserve itself can make to our lasting prosperity is to foster the expectation -- and the reality -- that we can sustain the hard-won gains against inflation and build upon them.

In my judgment, against a background of more stable prices, interest rates are indeed too high for the long-term health of the United States or the world economy. I have repeatedly expressed the view that, as we maintain the progress against inflation, interest rates should decline -- and they should stay lower.

Much is at stake. We will need more industrial capacity, and relatively soon. Even after the sharp declines in interest rates from earlier peaks, many thrift institutions and businesses remain in marginal profit positions and with weakened financial structures; lower

rates would bring much faster progress in repairing the damage. The cooperative efforts of borrowers, banks, and the governments and central banks of the industrialized world have managed to contain the strains on the international financial system, but the pressures are still strongly evident. Both economic growth and lower interest rates are needed as part of more fundamental solutions.

But wish and desire are not the same thing as reality -- we have to deal with the situation as it is. In setting the targets for the various monetary and credit aggregates for 1984 as a whole, the FOMC had to remain alert to the danger of renewed inflation as well as to the need for growth. It also decided that, operationally, it would for the time being be appropriate to maintain essentially the same degree of restraint on the reserve positions of depository institutions that has prevailed since last autumn.* That judgment reflects the fact that growth in the various measures of money and credit now appears broadly consistent with objectives, that the momentum of economic expansion remains strong, and inflationary tendencies contained. That operational judgment will, of course, be reviewed constantly in the weeks and months ahead.

*In the very short run, account will be taken of possible increases in the level of excess reserves occasioned by the transition to contemporaneous reserve accounting.

Those decisions will reflect continuing appraisals of the rate of growth of money and credit, interpreted in the light of all the evidence about economic activity, prices, domestic and international financial markets, and other relevant considerations. All those factors will, in turn, be affected by other public and private policies. In that context, it is the strength of economic activity, the demand pressures on the credit markets, and the willingness of others to invest in the United States that will influence the course of interest rates.

In approaching our own operational decisions, the actual and prospective size of the budget deficit inevitably complicates the environment within which we work. By feeding consumer purchasing power, by heightening skepticism about our ability to control the money supply and contain inflation, by claiming a disproportionate share of available funds, and by increasing our dependence on foreign capital, monetary policy must carry more of the burden of maintaining stability and its flexibility, to some degree, is constrained.

Toward a Positive Solution

Monetary policy is only one part of an economic program. It is an essential part, but success is dependent on a coherent whole.

I have tried to demonstrate that we have come a long way -- that we have much upon which to build sustained prosperity.

Many of the portents are favorable.

Public policy has encouraged greater competition, removed harmful regulatory restraints, and provided greater incentives. There are hopeful signs that productivity is again growing, and a healthy concern about costs and efficiency. Energy prices have stabilized. We have had a strong recovery, and the progress toward price stability has been gratifying.

Prospects for extending that success rest in part on continuing discipline by business and labor. We cannot afford to return to the syndrome of the 1970's, with prices and wages chasing each other amid fears of inflation, amid erosion of productivity and real incomes. The experiments in the private sector with profit sharing, with quality circles, and with other forms of labor-management cooperation -- efforts born in adversity -- can bear fruit in prosperity.

If they are to do so -- if a sense of discipline is to be maintained -- those of us responsible for public policy must be able to demonstrate that inflation will not again get the upper hand -- that productivity and restraint will be rewarded, not penalized in favor of those seeking inflationary or speculative gain.

The contribution that monetary and other policies make to that environment is critical. As the expansion proceeds, and as some of the temporary factors restraining prices recede, we as a nation simply cannot afford to permit inflation to attain a new momentum. Our monetary policies are, and in my judgment must continue to be, geared to avoid that danger.

But for all that progress and promise, something is out of kilter.

Our common sense tells us that enormous and potentially rising budget deficits, and the high and rising deficits in our trade accounts, are wrong -- they can not be indefinitely prolonged.

That common sense is confirmed by simple observation. Some of our proudest industries -- potentially capable of competing strongly in world markets -- are in trouble, tempted to shift more operations abroad for sheer survival or demand protectionist walls. Interest rates remain historically high, threatening housing and investment.

And, in this instance, economic analysis bears out, and amplifies, the judgments of common sense and simple observation. Our two deficits are related. The budget deficit, by outrunning our ability to save, damages prospects for housing and for investment, and makes us dependent on foreign capital. That capital from abroad, for the present, alleviates the pressure on our money

markets, but it complicates our trade position. And if and as our trade account improves, the brunt of financing excessive budget deficits would fall back more fully on domestic savings, squeezing domestic capital spending harder.

We can, of course, sit back and wait awhile longer, hoping for the best.

I certainly have some understanding of the difficulties of achieving a consensus on difficult budgetary choices when a sense of immediate crisis is lacking -- when for the moment things seem to be going so well.

But I also know to wait too long would be to take risks with the American economy.

It is already late. The stakes are large. Markets have a mind of their own; they have never waited on the convenience of kings or Congressmen -- or elections.

The time to take the initiative is now, when we can influence markets constructively -- when we can demonstrate that we are in control of our own financial destiny. Real progress toward reducing the budget deficit is needed to clear away the dangers.

I sense a fresh opportunity in the proposals of the President for a joint effort to attack the deficit -- for a sizable "down payment" on what is ultimately needed.

Certainly, that kind of demonstration that we are beginning to face up to our budgetary problem would make it easier for monetary policy to do its necessary work. And, in the larger scene, it would be tangible evidence to our own people that we can do what is necessary to seize the bright opportunities before us.

Table I

Federal Reserve
Objectives for Money and Credit Growth in 1984¹

	<u>New ranges for 1984 (%)</u>	<u>Tentative ranges for 1984 set in July 1983 (%)</u>	<u>Ranges for 1983 established in July 1983 (%)</u>
M2	6 to 9	6-1/2 to 9-1/2	7 to 10 ²
M3	6 to 9	6 to 9	6-1/2 to 9-1/2
M1	4 to 8	4 to 8	5 to 9 ³
Domestic Nonfinancial Sector Debt	8 to 11	8 to 11	8-1/2 to 11-1/2

1. Ranges apply to periods from fourth quarter to fourth quarter, except as specified.
2. Range applies to period from February-March 1983 to fourth quarter of 1983.
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

Table II

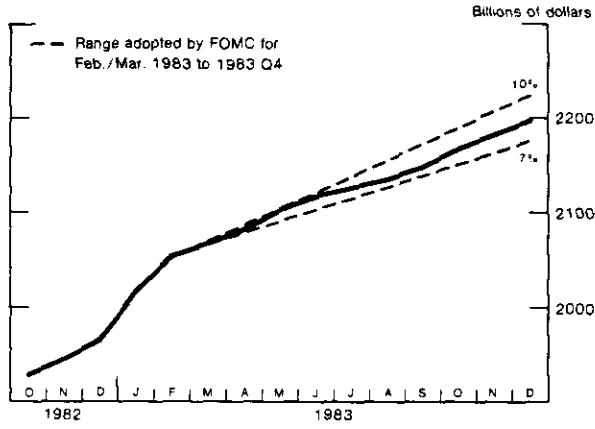
Federal Reserve Objectives for Money and Credit in 1983
and Actual Growth

	Ranges for 1983 established in July 1983 (%)	Actual growth (%)	
		Revised data	Old data
M2	7 to 10 ¹	8.3	7.8
M3	6-1/2 to 9-1/2 ²	9.7	9.2
M1	5 to 9 ³	7.2	5.5
Domestic Nonfinancial Sector Debt	8-1/2 to 11-1/2	10.5	10.5

-
1. Range applies to period from February-March 1983 to fourth quarter of 1983.
 2. Range applies to period from fourth quarter of 1982 to fourth quarter of 1983.
 3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

Ranges and Actual Money Growth

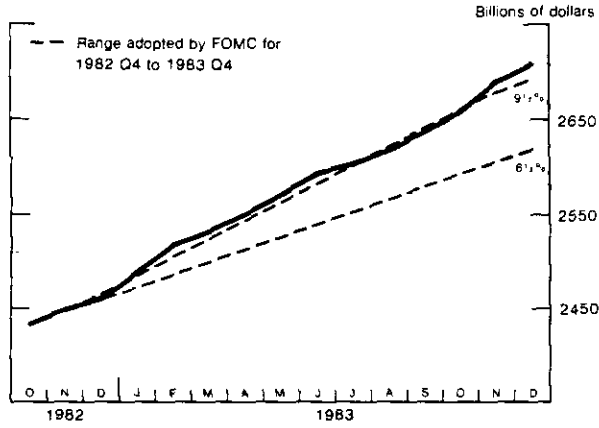
M2



Rate of Growth
(annual rate)

Feb./Mar. to 1983 Q4
8.3 percent

M3

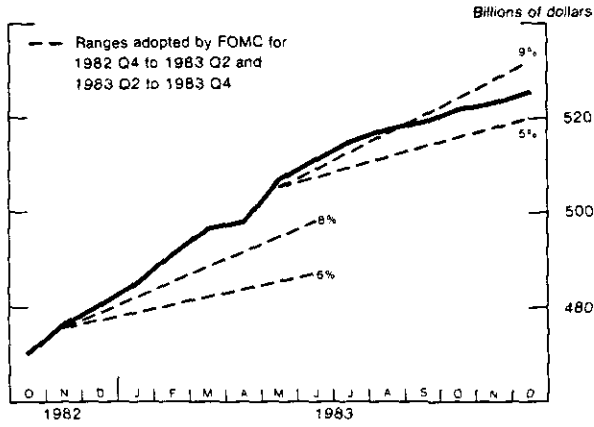


Rate of Growth

1982 Q4 to 1983 Q4
9.7 percent

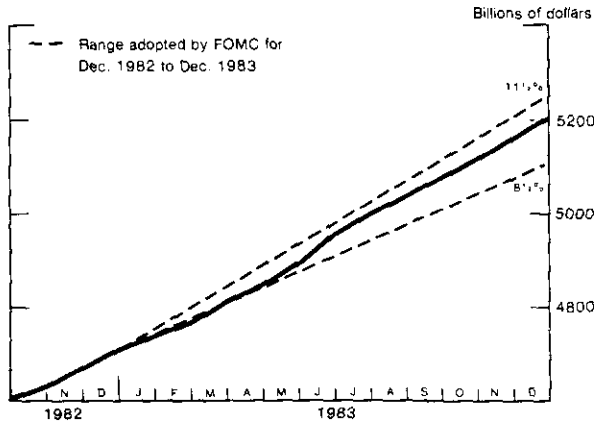
Ranges and Actual Money and Credit Growth

M1



Rates of Growth (annual rate)	
1982 Q4 to 1983 Q2	12.4 percent
1983 Q2 to 1983 Q4	7.2 percent

Total Domestic Nonfinancial Sector Debt



Rate of Growth	
Dec. 1982 to Dec. 1983	10.5 percent

The CHAIRMAN. Thank you, Chairman Volcker.

A few quick observations. On page 20 you state that energy prices have stabilized. You have a gentleman on your staff from Rhode Island who is a northeasterner; he might be able to tell you his family in Rhode Island as well as most people in the Northeast have been conserving fuel, energy, ever since the crisis occurred. So they can no longer turn the thermostats down any longer, and most of them can't insulate any more. They have done that. All right.

So we have a deep-freeze going on in this Nation. I don't know about other sections of the Nation. But in Rhode Island, in a period of 3 weeks, the price of home heating oil has grown from \$1.09 to \$1.25 per gallon. If I said to my people, energy prices have stabilized, they would laugh me out of office.

Other observations. On page 22 you say, "The stakes are large. Markets have a mind of their own; they have never waited on the convenience of kings or congressmen—or elections." I wish you had added Presidents and Federal Reserve Board Chairmen. I think we are all in this game together.

Mr. VOLCKER. I agree with that, but it wasn't as alliterative.

The CHAIRMAN. I don't know which one was the king—the President or the Federal Reserve Board Chairman.

A brief question. For several years the Fed made its projections and published a range of economic assumptions and a central tendency forecast. Given the recent disarray among the administration's or the President's economic advisers, don't you think that the administration should move to the same format rather than issuing one simple administration number?

Second, on page i of the blue book, the monetary policy report, there is a column for administration protections. Is this a reference to (a) the Feldstein administration? (b) The Donald Regan administration? (c) the Ronald Reagan administration?

Those are two brief questions.

Mr. VOLCKER. If I may take a moment on oil prices. Heating oil prices have jumped generally. That is a higher increase than I have seen elsewhere. There is no doubt they jumped in response to the cold weather. I would hope that that would be reversible because it comes against a background—

The CHAIRMAN. Someday explain to me that statement you just explained. They jumped because of the cold weather. Isn't heating oil available because people are cold and they have to heat their homes?

Mr. VOLCKER. Yes. But the demand outran what had been planned or expected for a while. I just was explaining what I think went on in the market in Rhode Island and elsewhere. There was a jump which I would hope would be reversible when those special factors diminish.

The CHAIRMAN. When they don't need it any longer, the price will go down—

Mr. VOLCKER. You had a—

The CHAIRMAN [continuing]. In July.

Mr. VOLCKER. You can still buy heating oil and make sure the tank is filled up as much as possible in July. So far as the numbers are concerned, let me just offer a bit of philosophy. We present a

range of numbers partly because we have 12 members of the Committee and other Presidents making projections. They don't always agree down to the last figure. But I think it is useful, myself, to give a range.

The CHAIRMAN. I agree.

Mr. VOLCKER. Committees are not, through the years, so acute in forecasting the future that a single point estimate is justified. I think that may be misleading.

The CHAIRMAN. Therefore, I asked you which administration numbers we should look to, Reagan, Regan, or Feldstein. Under those circumstances, given your answer, don't you think perhaps the administration should look to doing the same as the Fed does on its projections?

Mr. VOLCKER. I think the administration has a single number and is capable of coming up with a single number. If they gave a range, you might ask them why they didn't have a single number. I repeat, I think a range is a useful signal and warning that the science or art of economics is not precise.

The CHAIRMAN. Last—let me try one more time—of the three, Reagan, Regan, and Feldstein, which numbers do you think you have in the bluebook?

Mr. VOLCKER. We have numbers in the bluebook out of both the budget and economic reports.

The CHAIRMAN. Last week the President submitted a budget calling for a deficit of nearly \$180 billion until the end of this decade. Chairman Volcker, do you think the President is right to lead us toward a deficit this high, all references to another bipartisan rescue committee aside? If not, what size deficit should the President be aiming at in 1985 and beyond?

Mr. VOLCKER. Certainly I would like to see a lower deficit. How much lower it is practical to get is, I think, the question that is being debated. The \$180 billion already includes some measures proposed within the President's budget, but I think dissatisfaction with that kind of outlook is widespread, within the administration and outside.

It gave rise to the proposal for a joint effort to get together and see what could be negotiated to improve that outlook. I would be strongly supportive of that effort, as I suggested in my statement. I think that is precisely what is needed.

The CHAIRMAN. Let's get back to the question, which was, What do you think the target should be for 1985 and beyond, as opposed to the \$180 billion since you feel it should be lower?

Mr. VOLCKER. My target may be out of reach. I am greedy in a sense as to what I would like to see done. I have said before what I think would make a significant impact—I don't think it takes care of the full job. Looking over a period of time, if one could cut the prospective deficit on the order of \$50 billion for a year—I am not talking about a collection of years—one would then have made an appreciable step toward what is ultimately necessary. I think that would be taken as a very full and forceful approach.

I am not sure that much is necessary. I can't tell you that that much is absolutely required. You asked me what my druthers would be. I would like to see a big bite.

The CHAIRMAN. Thank you, Mr. Chairman.

Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

First, let me compliment the chairman. I think your opening statement was remarkably good. I support it 100 percent. I compliment you on an excellent job.

Beginning at page 21, Mr. Volcker, you describe what I would call an interest rate gridlock. You say that it is vital for interest rates to go down. Certainly, I couldn't agree with that more. But then you suggest that if interest rates do go down, foreign investors would put their money elsewhere, meaning that financing the deficit would immediately create upward pressures on interest since more domestic savings would be absorbed by the deficit. I get the feeling the Fed feels helpless to reduce interest rates or that it wants to hold rates up enough to keep the foreign money rolling in. Do you feel helpless?

Mr. VOLCKER. I think the term gridlock that you used at the beginning of your statement is apt. I think we are, for the moment, in a position where, because of the dependence on foreign capital, it is difficult to get a mechanism to push rates down. As you say, and as I tried to emphasize in my statement, if monetary policy just created more money, I don't think ultimately that would bring interest rates down; and, it would create dangers, among other areas, on the international side with respect to the capital inflow, as you mentioned.

But gridlocks can be broken. The thrust of what I am trying to say is a constructive way to break this gridlock is to take the initiative on the budget side. Let me just illustrate that in budgetary terms. You can see different kinds of budgetary estimates, all high, running out to 1987, 1988, and 1989. The Congressional Budget Office will project very high deficits if nothing is done, running out to the end of the decade, because of the compounding interest effect. They are assuming a higher interest rate than the administration.

You have a similar problem internationally. All those figures run against you, the way things now sit. But if you can break through this and get interest rates down, beginning with some action on the budget deficit, then the compounding begins to run in your favor.

If you get lower interest than is expected, when you get out in 1988, 1989, 1990, you can see a lot more progress on the budget than you might imagine at the moment, once that process gets started, if it is accompanied by lower interest rates, you will see progress.

Why don't we get the process started? How do we get out of the gridlock?

Mr. GONZALEZ. Your answer is indeed you are helpless?

Mr. VOLCKER. To a degree. In terms of maneuvering interest rates at the moment, I think that is right.

Mr. GONZALEZ. You obviously believe it is imperative to reduce the deficit. Again, I couldn't agree more. Do you think such a thing is possible as long as a President refuses to consider tax increases or reductions in the defense budget or even a combination of those? In other words, do you consider the President's stonewalling either prudent or responsible?

Mr. VOLCKER. It looks to me like the President has taken an initiative; he is presumably willing to put ideas on the table and he is asking for ideas the Congress may want to put on the table and negotiate. I am going by the public statements. That is all I know about it.

Mr. GONZALEZ. You mean you have read public statements in which the President has said he is willing to accept increases in taxation or a combination of reduction of defense spending instead of an increase in his budgetary request to \$315 billion? Now, look here, Mr. Volcker, I know the history of the Federal Reserve Board. I know what your predecessor did in 1972 to help Mr. Nixon. I know you are consecrated to doing the same thing this year for Mr. Reagan.

But I am asking you, for the record, if you believe that the President's present position, which I think is uncontroverted—he has at no time I know of said publicly he is willing to consider the possibility of a tax increase or, much less, any reduction in defense spending because he is asking us now in his budget request for an increase from \$256 billion to \$315 billion in defense.

Now, all I am asking—maybe you can't do it. If so, I would like the record to reflect you can't answer. But let's answer on the facts, not evasively by attributing to the President a position he has yet to take publicly, unless he has confided to you in a secret meeting something we don't know.

Mr. VOLCKER. Let me first, for the record, say that I disagree with the implications of your comment about 1972 and certainly your comment about this year.

Mr. GONZALEZ. Well, the record is there.

Mr. VOLCKER. On the substance of your question, you can, I am sure, find spokesmen for the administration on the administration position. My understanding is that the President has made a proposal for his people and for representatives of the Congress to sit down together, to look at a range of proposals or issues that could arise with respect to the budget. I am not aware that he has put any particular limitations on that discussion. His views and his reluctance to raise taxes are well known, but he has invited, as I understand it, congressional representatives to sit down with his representatives.

Mr. GONZALES. Well, you are talking about a presidential pattern of behavior that is similar to sitting down to a conference with such fine friends as the Russians.

You really mean to try to convince us that the President has intimated that he would at any time, bipartisan or not, stand for publicly increases in taxation. He has categorically said the opposite.

The question is, do you think that the President is stonewalling, in view of your equally adamant position on the reduction of the deficit is prudent and responsible. On the question of raising taxes or reducing the defense budget you talk about commonsense in your statement; certainly commonsense would tell us that you can't have it both ways.

Now, if the President can find a compromise like he did last year and call a tax increase a revenue enhancement, anything but a tax

increase, I'll guarantee you, maybe that is what he's talking about. But, let's not kid each other.

My time has expired. I'm sorry, Mr. Chairman.

The CHAIRMAN. The distinguished minority ranking member, Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I want to followup on that. I would respectfully disagree with the gentleman from Texas that the President is stonewalling on the matter of the budget deficit. I might get into it a little different way.

Your testimony is replete with warnings about future budget deficits. When you appeared before the Joint Economic Committee, I asked you what you thought about a joint commission, similar to the bipartisan commission which was formed to help on social security problems.

I think you were somewhat lukewarm at that time about this so-called bipartisan commission; but I have been promoting that as a concept whereby we might come to grips with this problem, knowing it is difficult for the administration to make hard choices, knowing it is hard for individual members to make some of the choices that have to be made to reduce the deficit; but the President did allude to a bipartisan panel in his state of the Union message and has suggested that he get together with the speaker and the majority leader in the Senate.

Apparently you think that that has some prospect and maybe has a little bit more appeal. Would you like to comment further on that, Mr. Chairman?

Mr. VOLCKER. Obviously I welcome that step as a means of arriving at some consensus and agreement upon concrete budgetary actions. We all understand that this creates excruciatingly difficult political problems. There has to be a sense of compromise and agreement that is quite broad.

It seems to me the President has not proposed a commission in the sense you put it—that would be rather formal and take a long period of time—but rather a working group from the Congress, from the administration, that together could attack our problem.

I would certainly hope that that initiative be reflected in follow-through and action, because I think we need some action. We need some action this year. I do hope that initiative will be taken up.

Mr. WYLIE. The point you are making and the point I am making is, it will have to be a cooperative venture?

Mr. VOLCKER. No question about that.

Mr. WYLIE. It can't be laid at the doorstep of the administration. Congress has to be in the act. We authorize and appropriate money. If deficits remain, we make them.

Mr. VOLCKER. I don't think there can be any progress without both.

Mr. WYLIE. Thank you.

I would like to make a point of clarification. There was an article which appeared in the Columbus Citizen Journal this morning, a paper which is circulated in my district, the headline says, "Reserve Board Sets New Money Targets. The Federal Reserve yesterday announced a new set of targets for the Nation's money supply consistent with slower economic growth."

That isn't quite the way I read your statement here this morning. It doesn't seem to me that that is quite accurate. Does that summarize your policy, or is it more—

Mr. VOLCKER. The targets that we set at this recent meeting were very similar to the targets we had tentatively announced last July. There was just one-half a percent change in one target for partly technical reasons. Essentially, I would say we reaffirmed the tentative targets we set for last July.

It is true that those targets are from one-half to 1 percent lower than last year's. We anticipate, I think, good growth in the economy, but at a slower rate of speed than last year.

Mr. WYLIE. It is not quite accurate to say they are new money targets?

Mr. VOLCKER. I think it might convey the right sense if you say we reaffirmed the tentative targets we set last July.

Mr. WYLIE. Thank you.

The argument is sometimes made that the Federal budget deficit can be met by borrowing from investors just as by increasing taxes on the public. Leaving aside the higher cost of debt servicing associated with borrowing, what macroeconomic consequences do you see for each of these approaches in meeting the deficit?

What I have in mind there is a reference that you have on page 13 about, "We can't afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal economy."

As I understand it, about 13 to 20 percent of Treasury borrowing now goes to foreigners to pay them interest on debts which we have with them. It seems to me as if that should cause us some concern. Can you comment on that?

Mr. VOLCKER. I wouldn't attribute undue importance to the amount of Government securities that the foreigners hold or buy in the course of a year. I think it is better to look at this on an overall basis, that the Government deficit is part of the total demands on credit markets and the capital inflow from abroad meets part of the total demand. In effect, it is indirectly financing the budget deficit, whether or not government securities are bought directly. But, of course, they are buying Government securities as well.

Many of the forecasts suggested that the foreign capital inflow this year will have to be about double what it was last year when it was in the neighborhood of \$40 billion. Many estimates suggest it will be in the neighborhood of \$80 billion this year. It is getting up to more than 2 percent of our GNP. You can take that for a year or so, but I don't think we want to get ourselves in a position where we have to rely upon that every year.

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

The CHAIRMAN. The Chair is going to exercise a prerogative here to keep a little continuity and ask the indulgence of the committee.

Chairman Volcker, you said in answer to me you would like to see a bite of \$50 billion from the deficit.

Mr. VOLCKER. Just to throw out a number.

The CHAIRMAN. That was a figure you threw out in answer to Mr. Gonzalez. You seem to have heard something from the President he and I have not heard, that he was willing to compromise on the matters of defense spending and taxation.

If that is the case, what did you hear him say? How much do you think he'd go for a tax increase and how much on defense?

Mr. VOLCKER. I have no idea.

The CHAIRMAN. How much would he reduce that?

Mr. VOLCKER. I think you would have to talk to him.

The CHAIRMAN. Where did you ever see or hear the statement, he's willing to compromise on taxes and defense spending?

Mr. VOLCKER. I think there have been statements—

The CHAIRMAN. Not by others. Talking about the President.

Mr. VOLCKER. I frankly don't recall the exact words the President used in commenting on this proposal.

The CHAIRMAN. Do you think you might be in error on that, the fact he stated he's willing to compromise?

Mr. VOLCKER. I do not remember the words he used exactly. I think some administration officials have used words such as, "bring anything to the table," words to that effect.

The CHAIRMAN. He used those words in 1982, and then they walked away from the table.

Mr. VOLCKER. Find out.

The CHAIRMAN. Mr. Mitchell.

Mr. MITCHELL. Thank you, Mr. Chairman.

This is an election year. I know the Federal Reserve is an autonomous body that does not get into the political fray.

My concern is, whatever you do during the course of this election year can be construed by unthinking people to mean that you are taking a partisan position in your policy. I certainly want to protect you from that. I wouldn't want anyone to think you are making policy that would be designed to reassure the election of the President.

You did recently, however, increase the money supply. We just talked about that a moment ago. You are going back to targets that were predated, and those were the targets you are going to put into effect.

In order to dispel the notion that even a modicum of political consideration went into that discussion, could you set forth for me the one, two, three, four factors that entered into the decision to do that?

Mr. VOLCKER. You say we increased the targets. We didn't increase the targets.

Mr. MITCHELL. Increased the money supply.

Mr. VOLCKER. I don't know what period you are referring to. The money supply in the last 6 months has been running at substantially lower levels than it had been running earlier. The other money supply numbers have been broadly consistent with our targets. M-2 during most of this period has been running relatively low.

Mr. MITCHELL. What I am referring to are the articles that appeared in the press. I think this morning's Post carries a story you were going to be easing the money supply. Is that inaccurate?

Mr. VOLCKER. It must be inaccurate.

Mr. MITCHELL. All right.

Mr. VOLCKER. I have no sense of that.

Mr. MITCHELL. If that is inaccurate, tell me what are the discrete factors that entered into your discussion to change the money supply, to go back—to go to a different set of targets.

Mr. VOLCKER. We have a one-half to 1 percent lower set of targets this year than in the latter part of last year. I think that reflects most broadly a feeling that the real growth in the economy will be somewhat less and should reasonably be somewhat less this year, because we are through the early stages of recovery.

We now want to settle into a sustainable pace that takes account of both the outlook for inflation and the need that we feel to maintain restraint against inflation arising again. Those are the broad considerations.

There are many technical judgments that arise as to what is happening to velocity, how velocity is likely to change over the future. We have gone through a very difficult and confusing period, in terms of velocity moving outside of its normal ranges historically. These targets are, in that technical sense, based upon a judgment that velocity will behave more normally in 1984. If that does not prove to be the case, those targets would have to be reviewed.

Mr. MITCHELL. OK. Then basically it was those—basically it was the general state of the economy that you are projecting will not grow as rapidly as it has grown over the last 6 months?

Mr. VOLCKER. We believe it should grow at a very satisfactory pace but slower than—

Mr. MITCHELL. You are reporting to us on the Full Employment and Balanced Growth Act of 1978. As I read your statement, there is one brief passage reference to employment in your statement. I think that is on page 4. As I read your statement, I saw no other reference to the matter of unemployment, which now stands at something like 9.5 million people out of work. Is it that ignoring the unemployment problem in your statement means to suggest you have nothing within your power to help out with this situation?

Mr. VOLCKER. In a broad sense, I would like to think that whole statement is about unemployment. It is about growth in employment, how to keep the momentum of expansion going; that is what it is all about in the end. That statement is about unemployment, employment, real income, because that is what we are after in the end.

Mr. MITCHELL. Yes. That may well be, but I just, Mr. Volker, find it a little difficult to see a report that deals with full employment and balanced growth and see one sentence that directs itself to the employment picture, just one.

Mr. VOLCKER. I think the employment picture is referred to at several points, but I think it is that concern which underlies all of our economic policies.

Mr. MITCHELL. Do I have time for one more question? You say you would like to see \$50 billion taken out of the deficit.

Mr. VOLCKER. I was pulling a figure out of the air.

Mr. MITCHELL. You said you were greedy. The honest man in the administration, David Stockman, has said that there can be no further cuts in domestic programs. Now he's been sent back to the woodshed again for having said that, for being honest. But I am inclined to agree with him.

I don't know whether you agree with him or not, but if we have cut domestic programs to the bone in the last 3 years, imposing some significant pain on some 77 million Americans, don't you think we need to look at other areas in terms of reducing the deficit?

What are your personal feelings about what—and I want to be objective, I started to call it absolutely bloated defense request, but that would be biased—a rather large request for the military. What are your feelings about that?

Mr. VOLCKER. I am not sure I am entitled to have feelings.

Mr. MITCHELL. Even I am allowed to have feelings.

Mr. VOLCKER. That is, there are other objectives. There are security objectives, social security objectives of the sort you are concerned with.

I have said on many occasions, from a strictly economic standpoint I think the economy would benefit relatively more from reductions in spending than increases in taxes, but if you can't do it by spending—because of the other priorities that you mentioned—then you have to look at the revenue side. I would look at everything.

Mr. MITCHELL. I am saying I agree with honest David who said you can't cut domestic spending any more. That leaves only one large area to be looked at. That is the military budget. Just as you gave us a ballpark figure in terms of \$50 billion, would you give us a ballpark figure—

Mr. VOLCKER. I can't. The point is perfectly right. Every area should be looked at, in my opinion. But I can't give you any kind of estimate about the security needs of the United States. That is just not my business.

Mr. MITCHELL. Thank you very much for your forthcoming answers.

The CHAIRMAN. Mr. Patterson?

Mr. PATTERSON. Thank you, Mr. Chairman.

Welcome, Chairman Volcker.

I would like to ask you a few questions about the deficit. Four years ago the President campaigned on a balanced budget amendment, which could not have taken place under the way we pass constitutional amendments for probably 6 years. This year he has proposed the line item veto which some States have, and that, of course, if it is done by constitutional amendment, will not happen this year and maybe for 5 years to come or never. Then he mentioned the deficit downpayment which—

The CHAIRMAN. Would the gentleman yield for a moment?

Mr. PATTERSON. Yes.

The CHAIRMAN. I would like to apologize for Chairman Volcker. However, the committee is before the House Administration Committee on its budget this morning. Mr. Wylie left a few moments ago. I must get over there immediately.

Mr. Mitchell is going to take over. I apologize for having to leave. I hope I can get back expeditiously.

Mr. PATTERSON. With that as kind of background, Mr. Volcker, some of us are concerned that there may not be a legitimate effort to reduce the deficit on the part of the President of the United States.

For example, the President prepares the budget. He could present—could but didn't—present a balanced budget to Congress. Now asking for a line item veto, he is saying, "I can come in later and trim it back down."

Maybe that is a fine idea, but the concern I have, as has been put forward by some in the press, is that maybe you have been drawn into this deficit downpayment idea as an agreement with the Secretary of the Treasury, perhaps to keep interest rates from going back up for the balance of this election year.

Mr. VOLCKER. No.

Mr. PATTERSON. That is not the case?

Mr. VOLCKER. No.

Mr. PATTERSON. Evans and Novak are wrong?

Mr. VOLCKER. Yes.

Mr. PATTERSON. Usually?

Mr. VOLCKER. No.

Mr. PATTERSON. OK. Is Jack Anderson right?

Mr. VOLCKER. I didn't recognize the picture.

Mr. PATTERSON. So you have made no agreement or discussed or given reassurances to the Secretary of the Treasury or anyone in the administration, including the President, that you would keep interest rates down—that you would not tighten money any further for the balance of this year?

Mr. VOLCKER. No. But I made the point repeatedly that I make in public, that I make in this statement; which is that I think if there were strong action on the budget, it would help the interest rate picture. I think that is obvious.

Mr. PATTERSON. That certainly is obvious. Strong action on the budget is critical. In proposing the deficit downpayment the President is suggesting that he will negotiate with Congress.

But let's talk about what is negotiable. Defense budget? Not negotiable. Up 18 percent this next fiscal year, growing to nearly 30 percent of the budget. Social security? Settled issue last year. Twenty-two percent of the budget. Deficit? The interest payment on our deficit, 13 percent. Medicare? Ten percent.

If you add these things up, and the things that nobody is apparently willing to cut—at least the President's indicated he's not willing to cut back the defense increase—and you are left with the maybe 20 percent, 25 percent of the budget.

Do you think you can cut that \$50 billion out of that 20-some percent that is left of the budget—that portion which has been repeatedly cut over the past 3 years?

Mr. VOLCKER. As a practical matter, no, you couldn't get that much out of that portion of the budget.

Mr. PATTERSON. Where is the room for negotiation with Congress that has been referred to? Many of us in the Congress don't feel that there's a good faith effort on the part of the administration to negotiate with us. If there is no room, how does Congress cut the budget without the President vetoing it?

Mr. VOLCKER. I am not the negotiator. I guess all I can say is I hope there will be some mechanism where you can find out and they can find out what you are all willing to do. You can get together and do something significant. We spoke about gridlocks earlier. We seem to have a negotiating gridlock.

Mr. PATTERSON. We certainly do.

Mr. Volcker, I have one final question regarding the assumptions upon which you base your economic forecasts. In your analysis did you make an assumption that the budget will be reduced this year? Or do you feel the gridlock indicates that we are not going to have a reduction? Is your forecast then to be based on that later assumption—which I assume would mean that interest rates will commence to rise within the next year? I would like to ask you to comment on that.

Mr. VOLCKER. I wouldn't make that assumption.

Our estimates, in general terms, were based upon only limited budgetary action, a pragmatic judgment. We made an estimate which on the surface looks quite satisfactory, if it comes out that way.

The point I would make is that we take increasing risks, which you can't capture in any economic forecast of this type. This may be the most probable outcome for 1984, but that isn't absolutely assured.

What are the implications for the years ahead?

In my judgment, those risks become greater and greater if there is budgetary inaction. The responsible thing to do, it seems to me, is try to reduce those risks as far as possible. If you could do what I say about the budget—and I say I am greedy—I think it would eliminate many of these risks.

As a practical matter, expectations are going to be less than that. You can move in a direction of significantly reducing the risks. I would urge you to do so.

Mr. PATTERSON. The President's own budget—and my time has expired—projects that by 1989, even with the large outyear deficits, 5 to 5½ percent. What do you think of that projection for 1989?

Mr. VOLCKER. I think that comes back to the interest rate gridlock question we referred to earlier. If you want to get that kind of interest rate, then I think taking the initiative on the budget will be the best kind of assurance you can have that this situation will begin raveling instead of unraveling; that kind of interest rate would then become quite a reasonable proposition. It is not going to happen by itself. It is not going to happen, in my judgment, by sitting back and hoping; that will aggravate the problems.

What we need is some way to get a constructive, positive approach. We have an awful lot of good things going for us now, in my judgment; a lot of progress has been made. But we don't have the budget going for us at this moment in time. If you are not going to do anything about it, at some time it will jump up and bite us. Nobody can say whether that will be in 1984, 1985 or whenever.

Mr. MITCHELL [presiding]. Mr. McKinney.

Mr. MCKINNEY. Thank you, Mr. Chairman. I think we all know what we need to do. We just don't have the nerve to do it. We need to cut defense, ludicrous retirement policies, and entitlement programs. We need to get rid of eight and a half inches of tax law.

Mr. Chairman, it is good to see you again.

I am starting to have nightmares again. I talk to you once in a while, while we shuttle on Eastern Airlines about my nightmares.

My persistent nightmare deals with the usual conventional wisdom around here that we are minting money. But I am even

more terrified of what I think we are doing now. We are importing money. We are importing money at such a rate that when you, Mr. Chairman, in your judgment decide that the dollar has got to be readjusted, we are going to be powerless.

I have this horrible vision of our friends in Japan and Germany and a few other countries coming to us and saying if you, in fact, drop your currency, Mr. Chairman, we are going to withdraw all of our deposits that are due and we are going to do it tomorrow morning at 9 a.m.

You, Mr. Chairman, are going to have to go to the President of the United States, to say, "Mr. President, we have two choices: a massive recession in about 6 months or, in fact, double-digit inflation and interest rates almost immediately."

I would like your comments on the dangers we face because of our dollar being as high as it is. That strength No. 1, as we know, has contributed greatly to the \$100 billion trade deficit, but also it has attracted so much money that I feel we put our entire financial structure in terrible jeopardy.

In fact, I feel we have put your entire department on a bed of quicksand, and it bothers me.

Mr. VOLCKER. I don't think the situation is quite so dramatic as you suggest, Mr. McKinney, but the general problems you are discussing are precisely the concerns that underlie much of my own statement.

Let me note that it is only now that we are becoming heavily dependent upon this inflow of foreign capital. A couple of years ago we had more or less a balance in our account. It moved into deficit, but a relatively small one. During the course of 1983, it began rising rapidly.

Of course, it is projected to continue to rise. Indeed, in 1984 we will be dependent—to the extent of something like 2 percent of the GNP—on a continuing inflow of foreign capital. They are not going to wake up some morning at 9 a.m. and announce they are withdrawing it all, but I think we are in danger of becoming so dependent upon it that a change in psychological attitude, concern about our economic policies, concern about inflationary trends, make us vulnerable. It is not clear why moods change, but we are vulnerable to a change in mood that might change the value of the dollar more suddenly than anyone would like to see it and have implications for the money that comes in freely now to help finance the budget deficit and our other needs.

Mr. MCKINNEY. May I interrupt for a moment?

I agree, we are not going to wake up at 9 a.m. and they are going to say, "We are going to do it."

But let's take the moderate course. Can't they get to a position of power where they could suggest to the Chairman or the President or the Secretary of State that they don't like our monetary policy and demand that we change it?

Mr. VOLCKER. You are personalizing it. They are not going to write a letter. The market has the message. The medium is the market, whatever the term ought to be.

And I don't like being that dependent for that long.

Of course, up to now the tendency has been in the other direction. The money has continued to come in. It comes in at a higher

rate of speed, not just for economic reasons, I think, but because of uncertainties, concerns elsewhere.

If those concerns got worse, we might have a big further inflow of capital. It might go on for some time. Again, this is not an area where you can make an accurate prediction of what is going to happen at any point in time.

As you are suggesting, and I agree, we are more vulnerable to the whims of fortune.

Mr. MCKINNEY. My time has expired. Thank you.

Mr. MITCHELL. Mr. Lundine?

Mr. LUNDINE. Thank you, Mr. Chairman.

Mr. Volcker, I am as concerned about the Federal budget deficit problem, as anyone. As you know, I made one of the first proposals for some kind of concerted action in that area.

This morning, you have made a very enlightened and incisive analysis of the relationship of that deficit to our exchange rates and to our trade situation, but I would like to explore just a little bit out of that context the question of the trade deficit. As you know, the merchandise trade deficit for 1983, was just about \$70 billion.

The Economic Report of the President—I don't know if you have had a chance to look at that, but it was sent to the Congress very recently—indicates that they believe that the dollar is overvalued by 33 percent when compared to the 1973-79 period.

They state that the high mobility of capital in international markets and the dollar's attractiveness as an asset, because of our high interest rates and relatively low inflation, are the reasons which underlie the dollar's appreciation; but then they conclude that it will take a period of 10 years for the dollar to depreciate to its longrun value.

Do you agree that there is little deliberate action we can take and that it will take a decade for the dollar to find its proper international value—whatever it is, whether it is a 33-percent or 20-percent adjustment or whatever?

Is there any action in this area that we could take to bring the dollar more in balance relative to other international currencies?

Mr. VOLCKER. Let me say that I haven't read the Economic Report in its entirety. I have read small parts of it. I did look at that little part that you referred to.

As I read it, that analysis was illustrative in a sense. It says if the interest rate differential is a true measure of the expected depreciation over time, and if that expected depreciation comes about, this is the kind of answer you get. It is one approach toward trying to make a conceptual measurement.

You asked what we can do constructively. I think the whole weight of my remarks is that the one thing we can do really constructively, from this standpoint and from the domestic standpoint, is to reduce the demands on our credit markets.

How do you do that constructively? You don't want to do it by reducing homebuilding, by reducing business investment, and all the rest.

The obvious way to do it is to reduce the budget deficit, take some of the pressure off our markets. To the extent that that is influencing the market artificially in a sense, a reduction in the defi-

cit will be effective. It may have an effect on the exchange rate of the dollar, but in a constructive way, in terms of confidence in the longer term outlook for the dollar and our economic management.

I can think of ways to affect the dollar in a non-constructive way. We can inflate. We can announce we are going to go on an inflationary binge. That will affect the dollar all right, but it won't be constructive for anybody; it will undermine all our domestic objectives.

I do think there is a kind of clear lesson that grows out of this. This is what my statement tried to suggest, that whether looked at from the international or domestic viewpoint, the way to break this gridlock, and do it in a way that is consistent with reasonable stability of the dollar over time and a fair market value of the dollar, is to cut the deficit.

Mr. LUNDINE. So you are saying that the relationship of the deficit to interest rates, and interest rates to the currency exchange is the only answer to this problem?

Mr. VOLCKER. It is the only constructive answer, broadly speaking, that I see at the moment.

Mr. LUNDINE. Is there anything of a lesser nature that the Federal Reserve can do, more than it has been doing?

Mr. VOLCKER. Two things.

There is always the question of *intervention policy*, and whether the United States cannot become more active; whether, during this period when the dollar was rising fairly steadily in value, there could not have been more intervention. That issue has been debated.

I think there is a considerable feeling that, particularly if it is not done on a massive scale, the benefits from that would be limited and not lasting, unless they were accompanied by changes in other policies, such as budgetary policy.

Looking at Federal Reserve policy more directly, what can we do by means of domestic monetary policy?

There you are left with this kind of dilemma. You might argue—and one does look at this as a consideration—that if the dollar is very strong, that in itself is probably an argument for being easier than you would otherwise be. But you have to take into account all the domestic and other considerations that bear upon that. An attempt to be easier in the interests of the dollar, just like an attempt to be easier in the interests of getting interest rates down directly, has to be appraised against a judgment as to whether you are going to be counterproductive 3 or 4 months down the road, if the result of that policy is to raise doubts about the inflationary future.

That is the dilemma that we have been in. That is why I think that during this period monetary policy has not had a lot of flexibility to do what it theoretically might do in that direction, because the constraints came at us from the other direction.

Mr. LUNDINE. Thank you.

Mr. MITCHELL. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Volcker, in the President's document, I guess the state of the Union—I take these things at their word. We have a formal process.

While others may walk away from them, we have to look at this as the President's proposal. He takes the credit for cutting taxes. We get blamed for spending. I guess that is politics, as usual.

One of the statements in the document is the fact that interest rates in 1985 will be 7.7 percent to fund the Treasury notes. Do you believe that that is based on a policy path we have before us?

Mr. VOLCKER. What year?

Mr. VENTO. 1985. Do you agree with that particular conclusion? Would monetary policy be supportive of that particular goal? Have you met with the President? I know Donald Regan and in this morning's paper agreed generally with what you said.

Mr. VOLCKER. 1985 is, in terms of projecting an interest rate, pretty far off. We have no projections going out that far. I haven't any particular expectations.

Mr. VENTO. Would you give us a range?

Mr. VOLCKER. I would feel more comfortable about a projection of that sort if there were budgetary action.

Mr. VENTO. I am talking about the budget he has presented to us, Mr. Chairman. That is what we have to go on. It isn't something floating around. I wonder if you could give us a range.

Mr. VOLCKER. I don't think that is impossible. I would feel more comfortable about it if there were budgetary action.

I say it is not impossible. It is not particularly the estimate I would make at this point in time, perhaps, but I try to avoid making those projections at all.

Mr. VENTO. Is it on the high or low side? We are trying to make decisions with regard to this. We are interested in you. You are a leading policymaker with regard to monetary policy. It would be instructive to the committee and general public.

Mr. VOLCKER. It might be instructive, but I religiously refrain from trying to forecast interest rates.

Mr. VENTO. Mr. Chairman, that is apparent, I guess, from what is going on.

The past few years housing, consumer products, small business, farmers, we talk about prime rate. We can talk about discount. They have been sort of dynamic in terms of moving around. But as you are aware, housing loans have not had the same type of reductions. They have been higher, they have been lower, but they have been consistently above 13 to 15 percent. The same is true—

Mr. VOLCKER. They are a lot lower than a year or two ago. They have been drifting recently.

Mr. VENTO. I think the concern is we have gone from a high inflation period in, for instance, 1980. We all recognize that. We have gone into one of the deepest recessions. We have gone now into some sort of recovery; in other words, change. Yet, the interest rates seem to be remaining stable. I guess maybe that is one of your goals, but I think they are almost unresponsive. We would expect more changes. In other words, the real interest rate, if we measure that, has been at one point lower than the inflation rate. For a long time there was a great gap between it.

Do you expect there to be more parity?

Mr. VOLCKER. I agree with what you are saying. I think these interest rates are high. There are a number of paragraphs in my statement about this.

My view is that both the nominal and real interest rates are high.

I make an assumption when I say that. I say we are going to be able to maintain this progress on prices. If we maintain the progress toward more stability, then I agree with you these interest rates are high. I would expect to see them coming down. One ask oneself why haven't they come down more rapidly?

I think you can cite a number of reasons, but two of them stand out. One is that we have this great pressure of credit demands in toto, and a large portion of these credit demands—40 percent of the total—is from the U.S. Government these days, even during a period of business expansion. That is part of it.

Another part is that people haven't forgotten about the seventies. They have a concern, and it is quite understandable, that we may be doing a lot better on prices now, but to a key degree there is a certain amount of disbelief about it.

They say, "It may be true of last year, this year; it may be true of 1982; but I am a little worried about 1985 and 1986."

If we succeed in showing the American public that we can maintain this improvement on prices, I fully agree with you; these interest rates are too high and should come down. And in those circumstances, that interest rate forecast shouldn't be out of the ball park.

Mr. VENTO. Your policy path is going to restrict monetary aggregates. I think in a macrosense these interest rates have not demonstrated a responsiveness to the market in terms of economic conditions.

I think that—maybe that is the success of monetary policy. I think it is somewhat of a failure in terms of not responding to the market.

In my opinion—and I am not attributing that to your opinion, Mr. Volcker. One of the problems is this interest rate imbalance with the high dollar, now we are facing a prospect where the stock market will no longer—apparently—provide a great deal of liquidity.

Almost every front we look at, we are trying to restore the balance of the dollar. That would cause a flood of Eurodollars, the imported dollars of my friend from Connecticut; I agree totally that that is a problem. I do have the same nightmares.

We are talking about the inability of the stock market to provide credit. That will be more pressure. We are talking about a bigger Federal deficit. We are talking about, I think, in my judgment, higher rates than the President is predicting for 1985.

You are talking about tightening up of monetary aggregates which seems to me to be to build a certain amount of pressure for higher interest rates, Mr. Chairman.

I am concerned about that, especially when we have what I think is a very soft recovery.

Mr. VOLCKER. What choice do we have? I think that is the question.

If we were loose on monetary policy in some general term, then you would get the inflationary pressures that are not going to make that lower interest projection feasible or reasonable.

It seems to me all you are saying—and I agree with your concerns—points in the direction of using that tool that is under our

control; that the administration, the Congress, all of us who are responsible for the Federal budget, should go to the root of the difficulty. All the kinds of problems you are describing will be eased by progress on the budget. I just don't see any other constructive way to do it.

We can run an inflationary monetary policy, but I tell you that will not do it.

Mr. VENTO. I think that there are some different benchmarks. They have to work together. My time is expired, but I don't think you are weighing in with your own benchmark in terms of monetary policy by dumping it all on the fiscal side, which is, I admit, problematic.

Thank you, Mr. Chairman.

Mr. MITCHELL. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. I would like to switch gears a little bit, Mr. Chairman.

The Fed has a number of responsibilities. One relates to the money supply—another to supervision of the banking industry.

On the second issue, particularly considering Third World debt, would you care to comment on the safety and soundness of the banking system? Do you predict any wrenches in the international monetary system this year?

The doomsayers apparently are a bit quiescent at this time, but certain countries seem to be in a little more difficulty than they were a year ago, particularly the Philippines, Argentina, and conceivably even Brazil. Do you see the likelihood of any countries in real difficulty? Is the Fed prepared with any contingency plans either with regard to our banks or with regard to any specific countries, and, if so, could you give this committee any inkling of what you think is going to develop over the next year?

Mr. VOLCKER. Let me just give you a general evaluation of the situation first, and then return to your question about the banks.

I think a lot of pressures remains. While the situation differs from country to country, and in some cases you can see clear signs of progress—Mexico is the biggest debtor, together with Brazil, and you can see clear signs of progress—you can also cite a number of other countries—you cited them—where there aren't those same signs of progress and much remains to be done.

Again, I would point out that that situation is aggravated by the current level of interest rates and is one reason why you would like to see interest rates lower.

I think that situation will remain difficult, remain under pressure, but it can be contained with a lot of continuing effort as for growth and lower interest rates have enough time to work a more fundamental solution.

You say what if that doesn't happen? I think we have, through our various techniques, the means for coping with anything that I could see arising in that area. We have got means of providing liquidity to the banks. We have means of providing a degree of protection on the capital side, through the FDIC, if this were necessary.

Am I suggesting that there would not be strains and uncertainties involved?

There obviously would, which is why we want to contain the situation at its source, rather than have to pick up the pieces afterwards. I think it is terribly important that we continue to contain the situation, and I ought to say, appearing before this committee, that the role that many of you had in passing the IMF legislation was absolutely essential to that effort.

Mr. LEACH. But no predictions today?

Mr. VOLCKER. I am not going to wave a flag.

Mr. LEACH. On another matter, there is a vacancy on the Federal Reserve Board. Would you care to comment on whether you expect it to be filled soon and whether you have any candidates in mind?

Mr. VOLCKER. I am neither the one responsible for filling it nor the one that produces the candidates, but I understand that the administration is obviously aware of this, and I would hope the President would make a nomination soon, but I have no information about that.

Mr. LEACH. I raised this simply to underscore the feeling of some of us who have given some thought to the matter that a very appropriate candidate might be a gentlelady from the good State of Iowa, that being her main qualification for office. Her name is Susan Phillips. She is the current Chairman of the Commodity Futures Trading Commission and an economist who is very knowledgeable, particularly in agricultural economics. As you know, the Hill is concerned that small business and agriculture be represented on the Board. She is a frustrated administrator, and if there is anyone I think should be seriously considered at this time, I would hope those who might have something to do with filling the position might remember her name.

Mr. VOLCKER. I certainly have the capability of bringing names to the attention of the administration, and I will do so.

Mr. LEACH. Fine.

Let me ask one other policy question that is a little oblique to the discussion at hand. With all the talk about trying to restrain the budget, there is a very serious proposal that will expand the Federal budget in an area that has philosophical implications for the credit community, and that is the new national industrial policy. Would you care to make any comments on whether you think Congress at this time should be involved in a major venture in this area?

Mr. VOLCKER. I must say I am a bit confused about the talk about an industrial policy. It seems to come in different versions, and when I attempt to identify a particular version, I am usually left in some doubt as to what precisely is meant.

My instinct is, it is not a promising approach.

Mr. LEACH. Thank you very much.

Mr. MITCHELL. Mr. Barnard.

Mr. BARNARD. Mr. Chairman, many times in your comments this morning you have come back to the fact interest rates are too high.

I would like to ask you if you would comment on the financial market's current inflation expectations, and how they tie into long-term interest rates in particular.

Are the market expectations unrealistic and clearly out of line, and should we expect some revision in these expectations in the months ahead to contribute to lower interest rates?

Mr. VOLCKER. I hope they are too high. My feel for the situation, broadly paralleled by some of the surveys you see about expectations, is that 1 year or 18 months ago inflationary expectations began coming down quite noticeably; they have kind of gotten stuck at a lower level, and some of the surveys show expectations around the 6 percent area.

I think if you survey the general public, interestingly enough, you will get a slightly lower inflation projection than when you survey the presumably sophisticated people in the financial markets.

We will see who is more sophisticated in the end, but I think it is clear that there is a note of reservation—a strong note of reservation in much of the financial market thinking—that much of the improvement in inflation, if not all of it, will be temporary; they are not banking upon that, but they are expecting some relapse to a degree.

I am sure there is a variety of opinion. I think that comes back and feeds upon their willingness, the degree of eagerness they have to buy longer term bonds at interest rates that otherwise would look even more attractive than they look now; and that, of course, reflects again upon the interest rate level. It affects the borrowers, too; they are willing to borrow at levels that they otherwise wouldn't be willing to borrow at.

When I suggest that interest rates are higher than I would like to see them, and higher than I would expect they would be if we are successful on the inflation front, of course, I am looking forward. If you look back in 1983, I suppose it is hard to say interest rates were too high because the economy had a very good expansion, with a lot of purchasing power being pushed out by the Federal deficit; it is hard to say that that level of interest rates last year was so high that it restrained good economic growth. It didn't.

We had a recovery that was of normal, cyclical recovery proportions, and the internal dynamics in some ways looked good. But looking ahead I think that is a very heavy burden to have to carry.

Mr. BARNARD. Don't we have some catching-up to do, though, in the area of investment?

Mr. VOLCKER. Yes.

Mr. BARNARD. It doesn't appear to me that the markets are permitting us to catch up.

Mr. VOLCKER. Yes, I agree. Look at the internal structure of corporate finance. We have seen some improvement in the balance sheets, some improvement in liquidity, some improvement in equity. They did a lot of stock financing in the beginning of this year, beginning of last year, but it is so far a quite limited development. When one looks ahead into 1984, I think one can question how rapidly that process will go, given current credit market conditions. That is a step prior to doing heavy investment, although it is the same kind of phenomenon.

You are quite right that there hasn't been any great eagerness that I can see to invest in new plant. There has been a lot of investment and rapid increase in relatively short-lived investment. A lot of that is data processing equipment, cars, trucks, that sort of thing. When it comes to really expanding capacity, it has been

pretty limited, and I think in a sense you are right; we have a net deficit in that area.

With another year of expansion, we are going to be at the point where we need that capacity, and it is reasonable to ask whether it is going to be there when we need it. That is one of the reasons why I would like to see lower interest rates.

Mr. BARNARD. Won't this factor have something to do with the Fed's policy on money supply, the fact that financial markets seem not to be taking into consideration the good job that the Fed has done on inflation?

Mr. VOLCKER. I suppose it affects us in two ways, and they cancel each other out. On the one hand, you like to see interest rates lower. Then you have to ask yourself what are you going to do to inflationary tendencies and expectations; if we simply feed that skepticism about inflation, we will be counterproductive. I think we have to gauge our policy in terms of what we think is appropriate in terms of the growth of the economy in a context of keeping inflation under control.

That is precisely what we are trying to do in setting forth these targets. They are targets that in our judgment will permit growth, will encourage growth, without reviving inflation. Whether or not they are consistent with declines in interest rates I think depends upon other things, and again I come back, of course, to the big contribution that the Federal Government makes to the demand on the credit markets.

We go around in circles; where can you break into the circle? You can't break into the circle, in my judgment, by inflationary monetary policies. What measure can you take to get interest rates down that is consistent with price stability over time?

That is the kind of measure we want. I think the answer to that is obvious.

Mr. BARNARD. Mr. Chairman, someone has said that the Vice President's Task Force on Regulatory Reform was much ado about nothing. Now that they have made that report, would you care to comment on that?

Mr. VOLCKER. I think that there is a compromise of different considerations that are inherent in this area; from our point of view, from my personal point of view, it is satisfactory.

It would realign our responsibilities to a degree, but it would retain the kind of influence that we think we appropriately need over the evolving structure—and particularly the safety and soundness—of the banking system. I think it also includes some measures that could work toward simplifying the process, so we can combine at least those two considerations.

There are others. There is a desire, insofar as possible, to permit more initiative and more supervisory authority on the part of the state to simplify the way the banks must respond to regulations and comply with them; there are a variety of considerations.

The report is a complex balance of all these interests from the standpoint of the Federal Reserve. I think it is a satisfactory balance. It is not terribly simple.

Mr. BARNARD. My time has expired, Mr. Chairman.

The CHAIRMAN. Later on you will tell me what you found out.
Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Chairman Volcker, right now Rudy Penner is testifying before the Budget Committee on the CBO forecasts. One thing I noticed in reading that last night, that they have a chart that shows that if the same revenue and outlay policies were in effect in 1984 that were in effect in 1980, the deficit would be \$100 billion lower at this time. It would be in the 80's rather than the 180's, and that, of course, because the outlays are 24 percent of GNP now as opposed to 22 percent in the 80's, and revenues, to get to my question, revenues are a little under 19 as opposed to 20.

Can our economy stand an increase in Federal revenues to 20 percent of the GNP again from the approximately 19 percent where I was looking at it in the forecasts?

Mr. VOLCKER. Can our economy stand it? Sure our economy can stand it. But you ask me the very general question where would you rather see movement toward balance on economic grounds.

Mr. LOWRY. Right.

Mr. VOLCKER. Would you rather see movement toward balance on the spending side or the tax side? You would rather see it on the spending side, but the economy isn't going to collapse with a small increase in revenues relative to GNP.

Mr. LOWRY. In essence, we can reduce the outlays back down to about 22 percent and get the revenues up to about 20 percent. We would double the figure you are talking about?

Mr. VOLCKER. That is right.

Mr. LOWRY. But when we talk about going from 19 to 20 percent, 1 percent of GNP is what, \$35 billion?

Mr. VOLCKER. Yes.

Mr. LOWRY. That has gone a long way toward that \$50 billion figure you were forced to pull out of the air?

Mr. VOLCKER. Yes, that is right. This is getting into quite another, but related, area.

One has the impression that our tax system has problems, and I think those problems are aggravated by marginal tax rates. I have no doubt in my mind about that, but the leakages seem to have become larger rather than smaller, and it is perhaps feasible—and the administration has made some proposals along this line—to deal with some of the so-called loopholes in the system which would raise revenues without raising tax rates.

Mr. LOWRY. I must have a short 5 minutes. Is that correct, 41 Members of Congress voted against repealing the withholding on interest income and there weren't a heck of a lot of people in this committee that were 1 of those 41? I think it is supported by the banking association in my race. When we talk about picking up \$33 billion to \$35 billion over getting that, whatever we call these, equities, within the tax code, one of our problems is, we never get that done, and so we will sit here in 1986 with the 18.7-percent revenue, if we always answer the revenue question that we are going to patch these holes that we never get patched, but anyway, as I understand your answer, our economy, looking at our deficit figures and so on, are at 20 percent of GNP revenue figure is something balanced with the correct outlay figure is something that would work in our economy.

Mr. VOLCKER. Yes, I believe so, but again, as a matter of economic preference, I would like to see it done as much as possible on the other side. You have got to balance that against a lot of—

Mr. LOWRY. We have to cover both ends and I think we all realize that. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Mr. Volcker, you state in your report that we still have long-term interest rates higher than you would like to see them, and part of the reason is that the Nation is still very skeptical about whether or not inflation is under control and whether we are in a stable period. You see your role in the Federal Reserve as that of trying to foster expectations so that interest rates will come down, even though right now we are not in any serious price inflation.

I see this as a noble goal, but I also see it inconsistent with the system that we are forced to work with.

For instance, if that is the goal of the Federal Reserve, it is very hard to explain how you can get stability if you go through a period of time, a 10- or 12-month period, during which the money supply is increasing at a 13-percent rate, and then policy suddenly shifts to increasing the money supply at a much slower rate. I would say that you have bred into the system the reason for the skepticism that you criticize. If economic laws hold true, which I believe they generally do, I think we are kidding ourselves if we think that a 13-percent rise in the money supply over a period of 12 months doesn't offset the market this year, with a lot of high prices, no matter what we do. It is easy for us to think that the system that we now have can really create the stability that we all want, but the policy is that of discretion.

I think it is a pretty good rule that if monetary policy can be changed, it will be changed, and the markets know that. I think that is what the markets are telling us.

Something is unstable. We have a stock market drop of 100 points, and see great concern about the deficits, but the monetary system really never changes, and there are several explanations for this as far as I can see. There are some in this Nation who would accuse the Fed of being deliberately malicious and political, and that these booms and busts are done for some sinister reason.

Others claim it is just plain incompetence, that the technicians are incapable of providing stability.

Then there is another thesis that says that this whole monetary system is uncontrollable. I tend to accept that third thesis, that we have a system that is inherently unstable; that we are trying to use monetary policy to give stability to our country, and yet we never address the fact that the currency, the unit of account, the medium of exchange, is unstable. We have the cart before the horse, and until we get things turned around and have stable money, you can't have a stable monetary system.

I think that it is high time that we concern ourselves about the stability of money, the honesty of money, real money, rather than saying that we can successfully improvise. We can't possibly give stability to a monetary unit that is not only difficult to define, but totally indefinable. Our monetary experts don't even know what the unit of account is.

Would you make a comment?

Mr. VOLCKER. I suppose my comment would have to be that that is an old debate in monetary theory and practice; whether to use rules or discretion. I understand that argument, I think, and I would have some sympathy for a rule, if I knew a good rule that I thought would give reliable results and that you could enshrine for all time in the Constitution or in legislation.

I don't know of any rule that I have that degree of confidence in at the moment, so while I sympathize with your concern and the objective, I can't bring myself to make a practical proposal, because I don't know of a practical proposal in that direction.

Mr. PAUL. But a monetary rule still doesn't address the subject of stability of the unit.

Mr. VOLCKER. I think you could go even further and ask how you change the structure of the system.

Again, I presume you have in mind, let's say, going back to, circulating gold coins? I am not sure that history on that point is unambiguous to say the least. You refer to fluctuations in the money supply. If you tried to go to a gold standard, I am sure that people would immediately try to invent, as they have historically, substitutes for holding gold.

Mr. PAUL. But what were the interest rates under the gold standard? Three to five percent over hundreds of years?

Mr. VOLCKER. That is right; you didn't have much inflation. You had lots of problems for many years, years that went on long enough so they were of great political significance, but it is true, over the sweep of 100 years you had ups and downs but ended up pretty much where you started in terms of prices.

Mr. PAUL. Thank you.

The CHAIRMAN. Mr. Frank.

Mr. FRANK. Mr. Chairman, on the question of budget deficit preliminarily I was struck with your comments about how encouraged you are that the President wants to make the downpayment. My problem with that though is that given your sense that it is important to reduce the deficit, I don't understand why if the President has got ways to reduce it, he didn't include those in the budget he sent us.

I understand that he wants an item veto over legislation we pass. Is it your impression from conversations with him that he thinks he needs an item veto over Mr. Stockman?

I mean, if he has got ways to reduce the budget, why is he withholding them? Why didn't he simply put them into the budget he sent us?

Mr. VOLCKER. I think you are asking questions that are outside of my area of competence. I don't know the answers to those questions.

Mr. FRANK. I only raise it because you said you were encouraged by his report. I would not have asked you about the President's budget had you not volunteered it. Having volunteered it, I just wondered how far you were willing to go.

Mr. VOLCKER. My impression, as I said earlier, is that there is a widespread concern with the budget, a widespread desire to reduce it.

Mr. FRANK. Let me ask you specifically, since you said you like the President's notions of attacking the budget, would you urge all of us who have proposals to reduce the deficit to just put them forward at whatever opportunity we have?

Wouldn't it be better if he included those proposals in the budget he sent us to reduce the deficit?

Mr. VOLCKER. I think we are at a stage where we probably need a variety of proposals. How they can be put forward in a way that can constructively result in a compromise is at issue here.

Mr. FRANK. There is no economic issue you can think of for withholding them until we all get together?

Mr. VOLCKER. I think this is basically a political question of how one can arrive at a compromise that everybody can live with.

Mr. FRANK. The other question had to deal with industrial policy. You have expressed some uncertainty about it, and I think we all have that, but it seems to me there are two strains. One is an overall approach to stimulating the economy and I share your skepticism about some of that, but there has also been some industrial policy used to describe policies that would aid particular sectors, and I think you give part of the rationale where many of us think something like that is necessary on pages 12 and 13, particularly on page 13 when you point out, given the monetary situation internationally, it is the exporter and those competing directly with imports that have not shared at all proportionately in the recovery.

On the other hand, I think what we agree on is that, given the particular mix of policies we have followed, where we had the deep recession and now we have a recovery, that recovery has not been equally shared in by all sectors, and in fact while it is never always equal there is even less equality than before because of the international effects. As long as the Nation as a whole has consciously decided to follow this set of policies, and as long as we understand that this is going to have, as you point out, a differential effect, and it is going to be particularly disadvantageous to those who compete with imports, that is what suggests to me if we are going to keep doing this that those people who have been unfairly hurt have some claim on us, and I wonder what your comment would be on that?

Mr. VOLCKER. Let me respond to that. When you talk about directing actions toward particular sectors of the economy, I find—and I don't pose as an expert or having read all proposals on industrial policy—but I get some sense of confusion as to what—

Mr. FRANK. Forget other proposals. What do you think about some effort to redress the imbalances that you yourself talk about here when you talk about the unfair effect on sensitive imports?

Mr. VOLCKER. The way to redress that balance is, in my judgment, to have a balanced set of so-called macropolicies, where those particular strains would not arise.

I don't think the way to—

Mr. FRANK. Is that what we tell people, that because the country as a whole can't get its act together then they are going to have particular problems?

Mr. VOLCKER. What are you going to tell these other people? You are going to turn to protectionism. I don't think that is a good idea.

Mr. FRANK. We might do something about the specific problems they have got in terms of losing their homes. We might do something about job training. We might do something about Government contracting.

I am not sure what we do, but I ask you, do we tell them, because what you are saying here is, well, the country as a whole is following policies which result in your bearing an unusual, a disproportionate share of the problem you concede, because of national fiscal and monetary policies, people who are in import-sensitive industries no matter how hard they work, no matter how productive they are, they are going to get hurt.

I don't think it is acceptable to say to them until and unless the whole country gets together, you are going to suffer.

As you point out, many people in the country are doing better. The problem is, when you have policies which affect people disproportionately, people have different incentives to improve it.

I don't think it is fair to say to these victims that we are not going to do anything about that particular stress until we settle the whole problem.

Mr. VOLCKER. I guess I look at that through the other end of the telescope and conclude it is a very hard thing to tell them that we are just not going to change those national policies——

Mr. FRANK. I am not advocating that.

Mr. VOLCKER [continuing]. To give those results. I understand you are not advocating it, but I think what you are suggesting——

Mr. FRANK. No.

Mr. VOLCKER. What are you going to do in practice?

Mr. FRANK. Try to do both.

Mr. VOLCKER. What can you do in the period of time that you have that is going to be a practical and lasting help to them over a period of time?

If you can find things of that sort, I am not opposed in principle.

Mr. FRANK. I think to make the opposition and say that one versus the other I think is unfair, I think we agree we have got a very big budget and a big country, and I think what I am saying is that comes to the policy mix. There is some concern.

Mr. VOLCKER. If you can find practical things that are going to be helpful in a limited time?

Mr. FRANK. During the period while we work these things out.

Mr. VOLCKER. That is very hard to do in and of itself, to find something that is effective. It is going to be effective——

Mr. FRANK. Should it be a national policy goal to try and help those who have been disproportionately hurt by the national policy?

Mr. VOLCKER. I certainly think we ought to try and be as fair as we can on all of these things. I would put most of the emphasis on getting the broad policy mix right.

Mr. FRANK. Don't be surprised when you encounter on the part of those people unhappiness, a lot of unhappiness.

Let me say practically I think you are underplaying this. The opposition of these people who, as you say, are being denied a proportionate share in the recovery that is going to undermine the kinds of policies you are talking about, so if you don't respond to that dis-

tress, you are going to make them more opponents than they ought to be to the overall policies.

Mr. VOLCKER. I happen to agree with your conclusion. If you get these very disproportionate effects, it is going to undermine the political viability of the whole.

Mr. FRANK. I am going to quit. We have agreement.

The CHAIRMAN. Mr. Patman.

Mr. PATMAN. Mr. Chairman, when the Fed makes its projections on M, and its economic targets, its monetary targets, does the Fed make certain assumptions about the deficits that are anticipated?

Mr. VOLCKER. We make certain assumptions, yes.

Mr. PATMAN. If the President's budget is adopted by the Congress as it has been set forth with \$180 billion in deficits, will that have a severe economic, adverse economic impact on the Nation?

Mr. VOLCKER. It wouldn't be unlike the assumptions that we made in arriving at those forecasts. What we are saying as the most probable result for 1984 is what we set out on broadly that kind of an assumption. But I am telling you, as a matter of judgment, I think that we are taking continuing risks for the sustainability of the expansion and stability of the economy over time.

Mr. PATMAN. Does this deficit by itself pose a substantial risk for this Nation's economy?

Mr. VOLCKER. Yes, I believe it does, as it is in place now—not just in 1984, but as that would play out over the years.

Mr. PATMAN. In fiscal year 1985, for which the budget has been offered, do you anticipate that to be a severe economic blow to this Nation? Is that true?

Mr. VOLCKER. When you say a severe economic blow, I think we are dealing with—

Mr. PATMAN. In your judgment?

Mr. VOLCKER. We are dealing with probabilities and risks, and in my judgment those risks get greater and greater as time passes.

Mr. PATMAN. Do you know of any secret plan to deal with the budget after 1984?

Mr. VOLCKER. No.

Mr. PATMAN. It has been mentioned about industrial policy. Don't you think that the Fed itself sets forth the most significant industrial policy in this Nation when it makes its decisions about interest rates, about monetary supply, money supply, and so forth?

Do you see the way that the Fed impacts upon the industrial policy in the industries of this Nation?

Mr. VOLCKER. I think we make important decisions. I would not call it an industrial policy, which conveys a different sense to me, of a deliberately differential impact.

Mr. PATMAN. Tell me, would you describe to the committee what you mean by the techniques of alleviating the situation in the event of a world crisis on debt, specifically on increasing the liquidity of banks?

What will you do in that case to increase the liquidity of banks?

Mr. VOLCKER. In the first instance, of course, we can lend to them through the discount window, in large amounts if we had to, but we have our general tools of policy, too, that affect liquidity of the markets generally.

Mr. PATMAN. Such as, if you don't mind?

Mr. VOLCKER. There are principally two tools, the discount window and open market operations.

Mr. PATMAN. In order to get money to the specific banks?

Mr. VOLCKER. If you are going to get it to a specific bank, it has got to be through the discount window.

Mr. PATMAN. Would you give a special rate to a bank that was in trouble?

Mr. VOLCKER. No.

Mr. PATMAN. What would be the adverse effect upon the economy if you had to employ those techniques, if any?

Mr. VOLCKER. It would be very difficult, probably, to provide the right amount of liquidity to deal with the situation without providing too much to give rise to subsequent inflationary problems.

It would present a very difficult test of monetary management.

Mr. PATMAN. Mr. Chairman, I have seen figures that indicate, that show that the interest-bearing debt of this nation in 1981 in September was something like \$996 billion and that had risen in June 1983 to \$1,318 billion.

Do you assume any responsibility for the increase in that debt in the Fed? Personally or as a member of the Fed?

Mr. VOLCKER. I don't think I take personal responsibility for the increase in the debt, Mr. Patman.

Mr. PATMAN. Do you see the actions of the Fed as aggravating that debt, causing it to cost the taxpayers more, causing the debt to increase by virtue of all the high interest rates that you have put into effect going directly into the debt?

Mr. VOLCKER. That assumes that we are the cause of the high interest rates. I would like to think that over time we are a part of the solution, not the cause, Mr. Patman.

Mr. PATMAN. But you also have had the power to increase interest rates, have you not?

Mr. VOLCKER. I think our actions certainly influence interest rates, but they influence them in a variety of ways. They influence rates in an immediate sense of putting money into the market or taking it out. They influence rates more profoundly over a period of time by what that does to the economy, and particularly to inflation.

Mr. PATMAN. But in your bag of tools on economic policy and monetary policy you specifically employ tools which you would reasonably expect and do expect result in higher interest rates to the public, do you not?

Mr. VOLCKER. Sometimes in the very short run you can anticipate that. Sometimes you can anticipate the opposite, but what really makes a difference is the environment that is created over a period of time. The more stability we have in prices, the lower and more stable interest rates we will have.

Mr. PATMAN. During 1981 and from that time, during the recession and during the period which caused the recession, would you not say that the Fed employed what would be called reasonably a high interest rate policy?

Mr. VOLCKER. We restricted the increase in the money supply. We had a lot of demands, and interest rates went up.

Mr. PATMAN. Right. You would expect demand to go up and cause interest rates to increase.

The CHAIRMAN. Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

Mr. Volcker, to quote from a recent statement in an editorial in a major metropolitan newspaper in this Nation, it says in part that:

In 1981-82, when the Fed screwed down unexpectedly hard on the money supply, it triggered a deep recession. Now Mr. Volcker may be repeating the mistake. The money supply has again been tightened and some of the blame has gone out of the markets and the economy and the Fed may have swung *too far* in the direction of austerity.

My question, Mr. Volcker, is, in your recent targets for monetary supply, are they in your view consistent with the healthy and vigorous economic growth?

Is it possible that the Fed has been overly restrictive, and is in danger of hampering the real economy at a sensitive stage?

Are your monetary targets intended to reduce levels of economic activity in this Nation?

Mr. VOLCKER. Our monetary targets are thought to be broadly consistent with the kind of economic outlook that we set forward, which shows continuing growth at a good rate of speed, slightly higher prices in 1984 than in 1983, but within a context of what we think could be continuing progress over a period of time.

We think our targets clearly are consistent with very satisfactory economic performance.

Mr. PATMAN. So you think that the doomsayers are overreacting?

Mr. VOLCKER. You know, there is always debate about monetary policy, but I give you my judgment.

Mr. PATMAN. Just one other very quick question, Mr. Chairman.

To return to the line of questions pursued by the gentleman from Connecticut and Mr. Lundine from New York, that is on foreign exchange rates, the undervaluation, and particularly the stability of the exchange rate of the Japanese yen, in face of economic pressures that many of us think should produce a different result has been an extraordinary coincidence, and has created, as you have indicated earlier in your comments, contributed significantly to some serious domestic problems.

You said earlier in response to a question, Mr. Volcker, that the policy of intervention was a possible solution, but that it had been rejected as inappropriate, or words to that effect: I wonder if you would just tell us what might an intervention policy take us to, if it were utilized?

How would you do that, and why was it rejected as a postule in this current situation?

Mr. VOLCKER. What you would do directly is rather simple. You go into the market and buy foreign currencies. There is a lot of debate about how effective that is over a period of time in affecting a market where many, many billions of dollars run through the market every day.

I think the basic problem we are dealing with is that the fundamental forces were in the direction of a capital inflow into the United States.

In effect, when we are intervening, we re-export some of that capital and, in an immediate sense, reduce the pressures on exchange rates, but whether they stay reduced in some sense depends

upon whether the underlying forces are affected or not. If all you do is intervene, unless you change expectations, you are not doing anything to change the basic incentives in the market, whether they arise from interest rates, from uncertainties about political circumstances abroad, or from questions about the economic outlook abroad; all these forces that affect the exchange rate are not directly changed by intervention. We can ship some of the money back home again through intervention, but it won't stay there if you don't change either our policies or the other circumstances in a more fundamental way.

I think that is the basic argument against it.

It is not an issue upon which I have any strong religion. I think at times intervention is useful, but I don't think it is fundamental to dealing with the broad kind of problem that we have been dealing with over the past year or so and prospectively into the future.

To the extent it can be useful, it could be looked at.

Mr. PATMAN. Would you agree that we just simply cannot tolerate a \$90 to \$100 billion trade deficit in payments?

Mr. VOLCKER. I don't think it is sustainable over a long period of time. I say that for two reasons. One is the impact that it does have on particular industries; you build in a dependence on foreign imports that isn't healthy over a period of time, and you also build in a dependence on foreign capital flows, which come rather easily now, but at some later date may only come with great difficulty. I think you can be sure that in a world subject to the changes of this world, being dependent upon that amount of capital inflow continuously is going to prove troublesome at some unknown point in the future.

Second, it builds up the indebtedness of the United States, and as that indebtedness gets larger and larger, you get more and more vulnerable. At some point people lose confidence. You begin to have to borrow to pay the interest, just like a lot of these other countries have had to do.

Mr. PATMAN. And we are approaching that point.

Mr. VOLCKER. We are not there yet because we started out in a very strong position, but that is the ultimate.

Mr. PATMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Roemer.

Mr. ROEMER. Thank you, Mr. Chairman, and thank you, Mr. Volcker, for coming today. It was an important meeting for me. I turned 40 last October 4th. I hate to admit that, and I quit smoking after 25 years, and I set four tests for myself.

Mr. VOLCKER. I only began when I was 40.

Mr. ROEMER. I understand. The first test was could I make it through the first week. I did that. The second test was could I play poker for a substantial period of time without smoking. I have done that. Third, could I live through a Louisiana election. We had a gubernatorial election 2 months ago. I did that. The fourth was could I survive a 4-hour Paul Volcker hearing at the Banking Committee. I am 3 hours into that final test.

Mr. VOLCKER. That is the test I failed.

Mr. ROEMER. It is nip and tuck for me.

The CHAIRMAN. If the gentleman would yield, the chairman smoked for longer than he did, smoked more than he did, and he

has been able to survive 7 hours, so I think you will be in good shape.

Mr. ROEMER. It is nice to have you and I think your testimony is excellent. I don't often say that to you and I mean it this time, very well presented.

I sense in your testimony a great deal of frustration. I share it. I guess Stu McKinney hit it wisely and well when he said we all know what we ought to do. I am reminded when I look at Congress, I have been here this is my fourth year, and this President, of a Louisiana bullfrog, all mouth and no guts. We know exactly what we ought to be doing, and we are not doing it.

I see the Congress vote spending bill after spending bill. I see this administration didn't veto a single appropriation bill last year, and when they presented a budget to us a few weeks back, they had space labs, foreign aid, \$8 to \$9 billion for Central America and all. All mouth and no guts.

Where you sit, I would like to know if the cynical view of 1984 will come to pass, and you have heard it on the street just like I have. That is interest rates will artificially be pushed down by you this year for political reasons. Should we accept that, Mr. Volcker, or will you let interest rates reflect market conditions?

Mr. VOLCKER. I think interest rates are going to reflect the market conditions. That comment that you make—and you are quite right; I hear it all the time—is a source of great frustration, but I don't know what you can do about it. It is a deeply held belief on the part of a lot of people that our actions are politically motivated.

The only comfort I take is that the direction in which we are politically motivated seems to vary from commentator to commentator, and they all can't be right.

Mr. ROEMER. Let's try to pin you down. If we adopt the President's budget, last year's budget by the President got not a single vote in the House, but let's assume through some miracle this budget passes. I hope not, but it might. If the President's budget is adopted, will interest rates be up or down?

Mr. VOLCKER. I do not know.

Mr. ROEMER. You don't have any idea.

Mr. VOLCKER. No. Again, I hate to return to the same theme. His budget is for 1985. We are still in 1984; That isn't going to change much, whatever you do. The rest of it is all expectations at this point.

Mr. ROEMER. No. Paul, I am asking you—you have already made a presentation that uncertainty and psychological factors do play a part in the marketplace?

Mr. VOLCKER. Right.

Mr. ROEMER. I am asking for your expertise and give us some guidance. If we adopt the President's budget, do you expect interest rates in this calendar year to be up or down?

Mr. VOLCKER. To the extent that budget affects expectations, I would assume that something like that result is already built into market expectations; in terms of the current market it is already there.

Of course, that offers an opportunity; to the extent things look better than that, you can get a favorable market reaction. We

could be better off than if the market were already counting on that, and I doubt that they are. I don't see any particular reason why it hasn't already been discounted in the market, and is part of the reason that interest rates are as high as they are; I don't think that is a reason for interest rates necessarily rising through the year.

Whether interest rates rise or fall during the year I think is going to depend upon a variety of factors. I suppose most broadly how much thrust is there in the economy. If demand is advancing very strongly, you will have more pressure on interest rates than if demand is fairly weak. In the latter case, interest rates would tend to subside, and that in itself would tend to push the economy up, but it would be in response to a weakening in other forces in the economy.

Mr. ROEMER. Quickly, and we are both out of time, quickly there are three myths about budget-making that bother me. I think I know your answer, but let me ask you quickly if you agree or disagree. My time is up. No. 1, growth is what we need. We can grow out of this deficit. Will growth alone take us out of the deficit?

Mr. VOLCKER. I do not believe so.

Mr. ROEMER. No. 2, large deficits are not really that important, and there is no relationship between the size of the deficit and interest rates. Do you believe that?

Mr. VOLCKER. No.

Mr. ROEMER. Finally—

Mr. VOLCKER. Not when deficits are as big as they are now.

Mr. ROEMER. I have got you. Finally, no worry, the President has plenty of time. We can wait until next year to approach the deficit.

Mr. VOLCKER. I think that is a gamble.

Mr. ROEMER. Thank you, Mr. Chairman.

The CHAIRMAN. Ms. Kaptur.

Ms. KAPTUR. Yes.

Mr. Chairman, welcome back.

Mr. VOLCKER. Thank you.

Ms. KAPTUR. I wanted to ask you on the money supply growth targets that you have set, to what extent did they reflect the President's most recent budget?

Mr. VOLCKER. As I indicated, I think they were based broadly on the idea that the budget would come out somewhere in the neighborhood that he has projected or maybe even a little higher if you take his budget document—some place between the budget document and the current service budget.

Ms. KAPTUR. So you see your own targets as directly influenced by the budget that you eventually produced.

Mr. VOLCKER. No, I don't think the targets were influenced by the budget. I think the market will be influenced by the budget. The way those targets interact with the economy will be affected, but I don't think we would have had a different target with a different budget.

Ms. KAPTUR. You don't?

Mr. VOLCKER. No.

Ms. KAPTUR. Assuming you are targeting—

Mr. VOLCKER. If you make an extreme enough assumption maybe they would have been modified, but the targeting is not very sensitive to that assumption.

Ms. KAPTUR. Assuming you are targeting projections and the budget that he submitted to us a week ago, and going back to your monetary policy report to us this year, if you look at the charts following page 18 that deal with real personal income and consumption, what would you project for this year and next year, just ballpark, percent change in the real disposable personal income and the real personal consumption expenditure, that top bar chart there, assuming your targets and—

Mr. VOLCKER. I can't give you a precise answer to that question. These overall economic figures that you are given are based upon individual forecasts by all the members of the Open Market Committee and other bank presidents, and we don't ask them for these underlying figures.

Presumably, individually, they may or may not have them in making up their forecasts, but we don't have any official estimate of these numbers. Broadly, you would expect personal income to rise more or less in line with the gross national product.

That is not based upon a fine look, and I have to go back and review my own views, but broadly that's what you'd expect.

Ms. KAPTUR. Retail sales in December and January and looking at these figures for 1983 though, could you say, would your inclination be that it would level off somewhat?

Mr. VOLCKER. It will grow less rapidly than last year. These are in real terms. We are projecting 4 percent plus—4.5 percent—GNP, by and large. I don't think there is anything in those projections that would suggest a big change in the savings rate, which implies—

Ms. KAPTUR. That was my next question.

Mr. VOLCKER. Again it would depend upon each individual's forecast, but my impression is that by and large people are not assuming a big change in the savings rate, which would imply that disposable personal income would rise more or less in line with the GNP and that consumption would rise more or less in line with the GNP.

Ms. KAPTUR. So it would be at about the same level as 1983?

Mr. VOLCKER. Or a little lower, I would think.

Ms. KAPTUR. Or a little lower?

Mr. VOLCKER. Because the total economy is growing more slowly. But again, we don't have that figure, and I see that as substantially less than the overall economy last year.

Ms. KAPTUR. How do you explain what has been happening in the stock market lately, and the 1,200 level being broken?

Mr. VOLCKER. As J.P. Morgan once said when asked that question, "stocks fluctuate."

Ms. KAPTUR. How do you relate what happened, however, to the budget that was submitted and what market is anticipating over the next year or two? Do you see any connection?

Mr. VOLCKER. I am telling you what I think, that there is some connection in the sense that a continuing preoccupation, a continuing concern of the stock market is over the outlook for interest

rates, the outlook for credit markets, and, in turn, the outlook for the budget, so I think those are all factors.

Ms. KAPTUR. If you go to the charges on page 17, following page 17 that deal with interest rates, short-term interest rates and long-term interest rates, assuming everything we have been talking about before in terms of your own targeting and the President's budget, where would you think that 3-month Treasury bill rate and the 30-year Treasury bond rate might be? With personal consumption maybe it will be about the same, maybe it will be a little bit lower, or how do you feel?

Mr. VOLCKER. Anything I say about the outlook for interest rates is likely to be misinterpreted, and I will refrain from making a forecast about interest rates.

Ms. KAPTUR. If you go to the trade volume figures, following page 21, what would you assume would happen with trade volume?

Mr. VOLCKER. We would assume that the trade deficit would increase. I think there is a general expectation that during the course of this year the trade deficit will increase—at a slower rate of increase than last year, I hope—and that both imports and exports may improve, but imports are likely to improve at a greater rate of speed than exports. That reflects a judgment about what is going on abroad, in part. It reflects an assumption that foreign economies will be growing, but at a rather moderate rate of speed.

Ms. KAPTUR. Thank you very much. My time has expired.

The CHAIRMAN. Mr. McCollum.

Mr. McCOLLUM. Thank you.

Mr. Volcker, last year when you were testifying I asked you some questions which you responded to regarding the factors the Fed considers when it is determining whether to loosen or tighten the money reins. You indicated at that time that equal consideration was given to the M_1 , M_2 , M_3 targets and to other factors such as price index and so forth.

Most of the discussion today, aside from a few questions about employment, has been centered on these targets, M_1 , M_2 , and M_3 . Is the statement you made last year still accurate, that you give equal consideration to those target ranges that you have given us today and to other factors such as price indexes?

Mr. VOLCKER. I don't recall saying "equal," and I don't know how to state it quite in your terms, but it is certainly true that we will evaluate the growth in the actual money supply and its various measures, not only against the targets, but cross-check it, so to speak, against what seems to be going on in the economy, with respect to inflation, with respect to credit markets, with respect to international markets. In that sense, yes, I would reiterate what I said last year.

I do think that we have some evidence, but it is not conclusive yet, that velocity the relationship between these aggregates and the nominal GNP—may be looking more normal again. At the time we talked last year, we were in the midst of severe abnormality.

Velocity had continued to decline for a few months very rapidly, outside the norms of historical experience, so at that point we were particularly concerned not to give undue weight to a particular aggregate.

We were right in the middle, then, of these institutional changes that gave an enormous surge to M_2 for M_2 , M_3 , or M_4 months; that is, the introduction of the money market deposit account.

We haven't got quite that degree of uncertainty about the targets now that we had then, but we will continue to evaluate them and evaluate the movements in the aggregates against these other factors.

Mr. McCOLLUM. So you are saying though that you are much more pleased with the target this year and looking to the other factors are not quite as significant as they might have been last year since the velocity factor has calmed down?

Mr. VOLCKER. You might look a little harder at the targets before modifying them.

Mr. McCOLLUM. Mr. Chairman, is there any floor, any ceiling for commodity price index for the price of gold which the Fed would not allow to be violated as a matter of policy before you changed your money supply and your credit policies?

Mr. VOLCKER. Clearly we haven't got any figures in mind. We look at commodity prices—I look at them anyway; I will just speak personally—both as an indicator of current and prospective inflationary pressures, and also as something of an indicator in some cases as to the state of expectations and speculation about future prices.

Commodity prices generally have been rising in 1983 and running into 1984; that was a recovery from a very depressed level at the bottom of the recession.

I don't think commodity price increases of the magnitude that we had in 1983 are necessarily disturbing, although they were going up as part of a cyclical force, but I think one could imagine them going up at a rate of speed that could be disturbing.

Mr. McCOLLUM. What would trigger you? What would cause you to increase the availability of credit other than, and I assume that you would increase the availability of money and credit if the M_1 , M_2 , M_3 target rate that you set the supply of money fell below those ranges?

Mr. VOLCKER. Unless there was greatly contradictory evidence someplace else; as a presumption that is certainly true.

Mr. McCOLLUM. What else would trigger it besides falling below the ranges?

Mr. VOLCKER. If velocity seemed not to be developing in the way we anticipate; in other words, if it doesn't increase, but decreases. That would be one way of looking at it. Within the framework of the targets, that is what you would be looking for, but beyond that, obviously if the economy weakened greatly, or seemed to be weakening greatly from the trend that we expect, that would be a consideration. If price performance were unusually favorable compared to what we are projecting, that would be a factor. Of course, all those things can work in reverse, too.

Mr. McCOLLUM. You are talking about things like the GNP flash index falling, things like that?

Mr. VOLCKER. That is a reflection of the economy weakening. The GNP numbers themselves are not the first numbers you get.

Mr. McCOLLUM. Thank you, Mr. Chairman. My time has expired. I yield back.

The CHAIRMAN. Mr. Erdreich.

Mr. ERDREICH. Thank you, Mr. Chairman.

Chairman Volcker, on page 10 of your statement you comment upon the rather depressing savings rate that we have in this Nation, and you comment that you see for the foreseeable future that it is going to keep a rather low level of savings.

I recall in 1981 in the hallowed Halls of this Congress apparently we cheered through tax changes that I thought were going to encourage individual savings. I wasn't one of the cheerers because I wasn't here at the time, but I would like you to just comment on what has happened. Why do we not have a better rate of savings, and how does it impact on our economic future?

Mr. VOLCKER. I think it is very hard to change the savings rate. That is the evidence of experience, that it gets locked into a general range and stays there. I think, broadly, that reflects not only economic but social conditions around the country; how much people want to save, how important they think it is to save for their old age, what the effects of social security are, what the incentives to save for old age are, as well as, more directly, economic incentives.

I refer in the statement to the overall savings rate. If you just take personal savings, that has been running between 4 and 6 or 7 percent, I guess, for some years. There is a big difference between 4 and 7, but it has stayed in that general channel. It hasn't shown any tendency to go up to the 10- or 12-percent level that is quite common in Europe or the 20-percent level that is common in Japan. It is likely to take very powerful changes in attitude to produce a marked change in the savings rate.

Mr. ERDREICH. You also got into earlier testimony about how dependent we are on the continuation of the flow of funds from abroad. In essence, as I read it, we are financing our deficit in great part by that inflow of funds from abroad, but do you have any fix or can you quantify that? I mean, how much are we financing our deficit by the inflow from abroad?

Mr. VOLCKER. There are various ways of looking at it. The deficit is running something under \$200 billion this year. The inflow of funds from abroad may be in the neighborhood of, by most people's estimates, \$80 billion. Forty percent of the deficit is being financed abroad, but of course that savings inflow—which is about 2 plus percent of the GNP—I think properly should be compared to the overall savings rate, which is running about 8 percent I guess.

Two out of 10 percent is 25 percent or 20 percent of the GNP. That is obviously a very significant addition to our savings in this economy.

You can look at how many Government securities people abroad are buying directly. I don't have that figure right in mind for 1983, but it was sizable. But I don't think that gives you the best economic perspective, because some of it may flow in other forms: it relieves the pressures on the market and then Americans buy the Government securities or vice versa.

I think a better way of looking at it is to measure what proportion it is of our total savings.

Mr. ERDREICH. What do you see if the trade deficit, the imbalance we have this year, is at \$69 billion or \$70 billion, and the ex-

pectation would be \$100 billion the next year? If those sorts of numbers continue, won't it ultimately end up in weakening the dollar?

Mr. VOLCKER. Yes.

Mr. ERDREICH. And the reverse of the circumstance will come around rather rapidly.

Mr. VOLCKER. Yes, right now I believe that. I think ultimately it will wind up there. When is the big question. A lot of people expected that last year; they saw the trade deficit getting worse and said the dollar would weaken.

The dollar strengthened, because we had even more capital inflow than we had had; apparently, there was more eagerness and more money put here than the trade deficit was taking out. It is a very hard thing to project, but ultimately I would agree with you.

Mr. ERDREICH. Would the Fed react in any way by taking action to keep the dollar stronger, if that occurred?

Mr. VOLCKER. That in itself would not only have impacts on the exchange rate, but it could also have impacts on this flow of capital and therefore on interest rates. It depends upon how it came back. It could be destructive or harmful depending upon when and how it came about.

In the first instance, there is no clear reason to change the growth in the money supply. One result of a decline in the value of the dollar would be additional inflationary pressures---

Mr. ERDREICH. Thank you, Mr. Chairman.

My time has expired.

Mr. VOLCKER. If the dollar declined, just to finish the point, you get an inflationary pressure on the economy, and you get more demand on the economy. All other things equal, that in itself would make interest rates go higher.

Mr. ERDREICH. Thank you.

The CHAIRMAN. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Mr. Chairman, when you set your monetary and credit targets for 1984, do you make any assumptions about 1984 into 1985?

Mr. VOLCKER. The general assumption that was made is that we are going to have a reasonably even growth pattern in 1984 and that would extend into 1985. We didn't attempt to make a precise forecast for 1985 or 1986, but I think it is fair to say that, in this year at least, the forecast was that we were not going to fall off a cliff sometime in 1984.

Mr. LEVIN. So there is a projection in 1985?

Mr. VOLCKER. There is a presumption anyway, yes.

Mr. LEVIN. On page 3 of your testimony, you say that in setting the new target ranges, "the committee members generally felt that economic activity would continue rising through 1984 and into 1985."

Mr. VOLCKER. That is partly an assumption on my part, but I think it is well founded. That was the sense I got from their forecast.

Mr. LEVIN. Well, then, don't you also have to make some projection or make some assumptions into 1985 as to what interest rates will be? That is so related to the rate of economic growth, so isn't it true, and the reality is that you are making some projections?

Mr. VOLCKER. Again, this reflects a composite of the projections of 19 people. I am sure you are right, that many of these people, or all of them, had some thought broadly at least—as to whether developments in interest rates were likely to be consistent with this kind of pattern of economic activity, but we could not collect projections of interest rates and, as you well know, we are reluctant to make projections of interest rates.

Mr. LEVIN. I know, but there are some assumptions. Isn't it really a fair question to ask of you whether the 7.7 assumption in the administration's budget as to 3-month Treasury bill rates is reasonable? I don't see why—

Mr. VOLCKER. You are talking about 7.5 on the average; that was their figure.

Mr. LEVIN. 1985, as you know, their assumption is a 7.7.

Mr. VOLCKER. I don't remember what their assumption was. I just wanted to make sure. It is an average for the year. The Treasury bill rate has been fluctuating around 9 percent or a little lower in the recent period—a little higher rate today, or this morning. Seven point seven, you know, is not wildly different from where we are. It is obviously significantly lower, but it is not a figure that is just out of sight. I could imagine conditions in which that might well be a fair estimate. I think it would—

Mr. LEVIN. What was your assumption when you set the monetary targets for 1984, as to what the interest rate would be in 1985?

Mr. VOLCKER. We just—

Mr. LEVIN. Your own estimate. I think that is a fair question to ask.

Mr. VOLCKER. It may be a fair question to ask, and I feel a little—

Mr. LEVIN. But you don't want to answer it.

Mr. VOLCKER. I understand your asking it, but I hope you will understand my not answering it.

Mr. LEVIN. I do, and I don't. Let me say, I think that the force of your testimony about these matters, including the deficit, is undermined by your, I am not saying vitiated, but undermined, by your unwillingness to be specific, to talk about the piece of the package including assumptions about interest rates.

Mr. VOLCKER. I accept your comment, but all I can say is there is no doubt in my mind—and I think this would be the general attitude of the Federal Open Market Committee that deficits of this magnitude put pressure on interest rates, keep them higher than they would otherwise be, and that implicitly there is a risk there that they might rise. But there are other forces that are pushing them in the other direction, including the inflation rate itself.

The question has arisen here quite understandably—it arises all the time—why are interest rates already so high relative to the inflation rate?

I think part of the answer is that deficit. It is already built into the market. Since it is already built into the market, I don't think it follows that it necessarily will bring higher interest rates, but it sure doesn't make the situation any more stable or comfortable in that respect.

Mr. LEVIN. But you see, that kind of soft testimony, I think it doesn't help the administration and the Congress to gear up.

I will finish by then asking this question. If we adopted the President's suggestion of a \$30 billion, as he calls it, downpayment on the deficit, *would you bet much on a 7.7 interest rate for 1985?*

Mr. VOLCKER. What is the timing and amount that you are thinking of?

Mr. LEVIN. He has talked about \$100 billion over 3 years. That is a \$30 billion reduction a year or \$33 billion.

Mr. VOLCKER. I think a \$30 billion reduction per year, beginning soon, from the numbers in his budget, would make a noticeable impact, in my judgment, for two reasons.

First of all, it is \$30 billion less. It is 1 percent—or not quite 1 percent; three quarters of the GNP—less. Second, I think if you could get together—the Congress and the administration—and enact that kind of a program, it would augur well for dealing with the budget deficit down the road.

Mr. LEVIN. Those would be, under his approach, the easy ones, you see.

Mr. VOLCKER. None of it seems very easy to me, frankly. I do think it would be encouraging. Presumably, it would be easier than what would have come later, but also easier in the sense of picking out some specific things as opposed to doing something a little more across the board, which might come later, I suppose. Yes, I think it would be significant.

If you tell me the budget changes by \$10 billion or so in an estimate for late 1985 or 1986—or even \$20 billion—you are getting in the area where it is small enough so it is going to be lost in all the noise. If you tell me \$30 billion 6 months from now, that would be very hard to do, but if you could do it, it would make an impact.

Mr. LEVIN. A lot of your colleagues in the economic profession—a lot of us think that the situation is more alarming than that.

Mr. VOLCKER. Well, look—

The CHAIRMAN. Excuse me, Mr. Wortley is next.

Chairman Volcker, his time has expired before he asked that last line of questioning. I have got to look toward the *other members* here. You can expand on your answer for the record, with unanimous consent accorded.

Mr. WORTLEY. Mr. Volcker, I would like to jump to three different areas not totally related.

First off, the revised monetary aggregates frequently vary substantially from the old rate, making some people a little bit skeptical on the figures that may be used in setting monetary policy. What is the lag time from the original figure until you get a revised figure?

Mr. VOLCKER. For better or worse, we revise the figures at the end of a year, when we get so-called statistical benchmarks, and we redo the seasonal adjustments. We may revise them again in the following year, but the revisions get small.

If you are asking me the complete lag time, it is from a week or so or 10 days to a year later. I only mention that because we have some fairly significant restrictions in the seasonal patterns this year that change the pattern during the year and that we didn't know about until a couple of weeks ago.

Mr. WORTLEY. Is there a better system of collecting that?

Mr. VOLCKER. I tell you, when I saw the size of those revisions, I began wondering.

Mr. WORTLEY. We all did.

Mr. VOLCKER. Revisions came both from the benchmark and the seasonal adjustments. There has been some thought of revising the seasonal during the year, but you can make so many revisions that it gets confusing.

Some of the so-called benchmark revisions result from data from very small banks or thrift associations that we only pick up on call reports; there are thousands of them. They are so small, it is quite an administrative burden on them and on us to collect the figures, and ordinarily it doesn't make much difference. And, of course, these things have to be kept in perspective. If the sensitivity of our actions is dependent upon such small changes in the monetary supply, we are in trouble for all practical purposes.

Mr. WORTLEY. Are you trying to perfect the system?

Mr. VOLCKER. We have a very elaborate system now and spend a lot of money collecting these figures weekly. That is why I was a little surprised we had changes of this magnitude, even though they are not big enough to be significant in appraising policy. I want to make that clear; it just doesn't make any difference whether the money supply went up 9.5 or 10 percent.

Mr. WORTLEY. How much time do we have before the deficit effectively crowds out the private sector?

Mr. VOLCKER. It is crowding it out now. It is always a matter of degree. You always have this mental image when you talk to people that at some point 6 months from now somebody will knock on the door and say, "Here is the deficit, and you are crowded out."

It doesn't work that way. It is a continuing process in the market. The interest rates are higher now than they otherwise would be. I will just volunteer, in answer to this question, that we are taking a very great risk that that will take the form of a process of actually rising interest rates or pressures on the market of the kind that nobody wants to see. Do I predict that? I don't know. I can predict interest rates are going to be significantly higher than otherwise.

Mr. WORTLEY. You are predicting interest rates significantly higher?

Mr. VOLCKER. Higher than they would otherwise be if we didn't have the deficit. That, in itself, is the crowding out phenomenon.

What is happening? We are not getting as much housing as we would otherwise get. We are not getting as much business investment, and we are getting a lot more imports of foreign capital at the expense of our trade position. The main thing being squeezed out right now is exports.

Mr. WORTLEY. Can I jump to just one last question? This committee is considering a national industrial policy. Basically, I do not favor that program, but there is one interesting facet of it; namely, the secondary market for industrial mortgages. Do you think that there is a need for a Government entity to set up a secondary market for industrial mortgages, or can the private sector do it on its own?

Mr. VOLCKER. I have not felt any urgent need, but I haven't looked into it.

Mr. WORTLEY. You don't believe we need a secondary—

Mr. VOLCKER. I haven't been aware of any need for it, no. I haven't looked into it. I just am not aware that people have brought that up as a problem.

Mr. WORTLEY. Could you take a look at it sometime and let us know what your feelings are on it?

Mr. VOLCKER. I hope you will give us some idea what the nature of the proposal is.

Mr. WORTLEY. I think you will be seeing a proposal in the relatively near future.

I thank you, Mr. Chairman.

The CHAIRMAN. Is the gentleman from New York going to send a copy of the proposal to the chairman, so he will know what he is commenting on?

Mr. WORTLEY. Right, I will do that.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Chairman, it seems to me that we are living in a period of great uncertainty concerning our economy. That has been referred to in a number of different ways today. But it would seem to me that it might be useful if we had certainty about at least some elements of our economy. I just wonder if, in your own estimate, you would think that monetary policy will remain fairly constant.

And I guess I mean by that, no matter what happens with the budget deficit, that is, if there is complete inaction, as appears to be likely on the part of the President and the Congress, would you then think it a wise policy, and do you think other Members of your Board would think it a wise policy, to continue to fight inflation?

Mr. VOLCKER. Yes.

Mr. NEAL. With monetary policy?

Mr. VOLCKER. Yes; no question.

Mr. NEAL. That would be more important to you than trying to make some adjustments to monetize debt?

Mr. VOLCKER. Yes.

Mr. NEAL. Or intervene in foreign exchange markets and all that sort of thing?

Mr. VOLCKER. Yes.

Mr. NEAL. So we could count on that as being a constant in public policy?

Mr. VOLCKER. Yes.

Mr. NEAL. I think that is a correct policy.

As I understand, it there is a fairly good and well known relationship between money growth and inflation, generally with a lag of about 2 years. I wonder if you would agree with that relationship, No. 1, and, No. 2, based on money growth for 1983, would you think it would be likely that in 1985 we would be experiencing some inflation as a result of the 1983 money growth?

Mr. VOLCKER. First of all, let me say that I think there is a relationship between money growth and inflation. I don't think it is quite as mechanically tight as some of the analysts suggest, either in lagging or in amount. The question has been raised as to whether that bulge in the money supply will necessarily give rise to a great acceleration of inflation in 1984 or 1985; I do not believe so.

I think we had some extraordinary things going on in that period, institutional and economic, that required, in effect, an adjustment; you can think of it perhaps in the nature of a one-time adjustment to a higher desired level of money holdings, and therefore, it should not be considered in the same light as an increase in the money supply might be under other circumstances. I don't believe it follows that we are going to get a great inflationary burst 2 years later.

Mr. NEAL. I noticed during the year that velocity has been down, and that is different.

Mr. VOLCKER. That is correct.

Mr. NEAL. But by any measure, it looks like money growth was higher for the year.

Mr. VOLCKER. No question; money growth was high historically, and velocity was very low historically. And while velocity has begun to increase again, so far there has not been evidence that it is making up for the shortfall. It is not even rising as fast as you might expect it to rise in a normal expansion so far at this stage, so I think the best evidence we have is that that was something of a once and for all adjustment. The proof will be a few years from now, but I think that is the best evidence we have.

Mr. NEAL. It has been brought to my attention that there is in the OECD economic survey of the United States for 1983-84, a section devoted to estimates of M_1 using a little bit of a different approach.

The author of this particular study, whom I don't know, but whose name is Mr. Spindt, says that money is what money does, which seems to me to make sense. I don't fully understand what the study suggests, but it sort of suggests that there might be a better measure of M_1 . I know you are constantly trying to improve your own measure of it, but he suggests that using a little different estimate of what transactions really are—

Mr. VOLCKER. I am informed by my staff, Mr. Neal, that the gentleman to whom you refer is on our staff.

Mr. NEAL. Oh, he is?

The claim for the approach in this chart that I have before me suggests that what he calls demand or the percent of error is much less using this particular measure than the others. That is rather fascinating.

Mr. VOLCKER. I am frankly not familiar with that particular analysis, but the staff has been doing some experimenting with weighted measures of the money supply or velocity adjusted measures of the money supply, and I think what you are reading is some of the results of that work.

It may be that some of the people immediately involved are more enthusiastic about the results so far than their supervisors, but my understanding is that it does not provide enough reliability to substitute for the more straightforward look we have been doing. It is worth looking into this and continuing to experiment, and we are doing so.

Mr. SCHUMER. Thank you, Mr. Chairman. Your performance this morning has been a tour de force, as was said about one of the political leaders in Brooklyn. You have danced on the head of a Charlotte russe without denting the cherry.

Let me ask you a couple of questions.

First, suppose the economy really begins to slow down. Let's say consumer spending just dies all of a sudden. Let's say that there isn't any uptick in industrial investing, and exports continue to be clobbered, and it looks like Ronald Reagan is going to lose the election.

Would you keep to the money supply targets and keep money tight, even if it should mean that the President would lose the election?

Mr. VOLCKER. Let me answer in less loaded terms.

If all those things happen that you are talking about, the natural response in the market, consistent with money growth within our targets, would be declining interest rates. I don't think any of those events, in themselves, in the short run, would suggest that the money growth necessarily ought to be changed.

If you got some continuing evidence that the experience of 1982 and 1983 with velocity that Mr. Neal just referred to was persisting, you would have to look at the monetary targets again, but that is the kind of soft economy that naturally brings about lower interest rates.

Mr. SCHUMER. Although it didn't for quite a while, not low enough?

Mr. VOLCKER. Maybe not low enough, but certainly it brought a lot lower interest rates.

Mr. SCHUMER. Let me pose another, one little analysis of the budget deficit which is shared by some of us, and ask what you think of it. On the spending side we are not going to get any reductions. The President is adamantly committed to increasing defense spending. The Congress is just as adamantly convinced that social spending shouldn't be cut any further, therefore the only way we are going to reduce the deficit is with a tax increase, revenue enhancement, call it what you will.

That, furthermore, since the business community has been letting all of us know, and I think with good reason, that the deficit is really the No. 1 danger to the economy, they ought to be calling loudly, clearly, and strongly on their ally, the President of the United States, to support some tax increase, and that that is our only real way out of this budget deficit dilemma, whether it be this year or next year. Comment?

Mr. VOLCKER. My comment is going to be basically the same as the comment I made earlier. I am not going to accept your presumption at this stage. It is up to you and the administration, but I don't accept the presumption that *nothing* can be done about spending. I have also always said if you can't do it under the spending side—if that is so then you have to face up to doing it on the revenue side.

Mr. SCHUMER. I guess my question is do you think the business community has not spoken out strongly enough for tax increase, given the leverage that they have this year?

Mr. VOLCKER. I think many businessmen have some reluctance on that side; that is correct. I think many others are willing to accept and support some tax increase. They haven't been leading the charge in that area for understandable reasons.

Mr. SCHUMER. Thank you. I have two other questions on different areas.

On money brokers, which has been a minor controversy but one that has been raging around for a while, at one point you commented that money brokers provide, or some money brokers provide, a useful function. What do you think of the proposed rule by the FDIC and Home Loan Bank Board on money growth?

Mr. VOLCKER. I think there is a real problem in the area of money brokers brokering these deposits in \$100,000 lots in weaker institutions, and I think the insurance agencies are right to be concerned about it. They propose very stiff medicine, relying upon uninsured the deposits, which raises some question. I think it probably takes some strong medicine.

I am glad, in a sense, that they brought forward the proposal. I think there may be an alternative way of achieving the end through a supervisory approach, and insofar as we are concerned on the supervisory side, I think we would be cooperative in approaching it that side, if that ultimately seems more desirable. But I have sympathy with what they are trying to do.

Mr. SCHUMER. Do you think their proposal is too strong, too sweeping?

Mr. VOLCKER. I think it will be interesting to see whether it can be done more effectively through the supervisory approach. If it can't be, I would accept their proposal.

Mr. SCHUMER. The next question, we have had a continuing and I think productive dialog on the Third World lending crisis, and particularly on the interest rates and fees that were charged by U.S. banks to Third World countries. And, as you know, I sent you a letter saying that I thought the Mexican loan was a marked change from that, because interest spreads were lower, fees were lower, and indeed, the time of repayment was stretched out.

Do you see that continuing to happen, as negotiations occur with other Third World countries, Brazil in particular?

Mr. VOLCKER. I think it is desirable and should happen where the country has not only made a good faith effort to get its own house in order, but, in fact, can show progress and stick-to-itiveness. I think that is what was so encouraging about the Mexican situation and that is what laid the groundwork, for moderation in terms, and I would hope to see the process continue in that framework.

Mr. SCHUMER. Do you think Brazil, has made the same efforts as Mexico?

Mr. VOLCKER. I don't think Brazil is anywhere near as far along, unfortunately, as Mexico is. They took much longer to get their program together. They had a program and slipped out of compliance. It took them a long time to get back. I would hope in the coming months that Brazil will get in that position.

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

The CHAIRMAN. By no means—I hope my colleagues will listen to me are—you rejecting or saying that you would physically or totally reject the money broker proposals put forward by the FDIC and—

Mr. VOLCKER. No, no, I was glad to see them.

The CHAIRMAN. What I think you said was that they could possibly be improved upon, but absent an improvement—

Mr. VOLCKER. That is right.

The CHAIRMAN. The medicine was necessary.

Mr. VOLCKER. Yes.

The CHAIRMAN. I just want my colleague to understand. I didn't read Chairman Volcker as saying there was anything really that wrong with it.

Mr. VOLCKER. No, no, no. There may be a better way of going about it, but I am glad they brought it to a head. And there may not be a better way in which case—

The CHAIRMAN. I am grateful myself because, as I recall, it just came about as a result of Penn Square, but it was bothering this Member for many, many years since Sharpstown in 1965.

Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman.

Chairman Volcker, in a New York Times article this morning, there was a paragraph relating to the minutes of your December meeting in the Federal Market Committee and the paragraph goes this way:

With the minutes of the December meeting in the Federal Open Market Committee, the body that sets Federal Reserve policy, indicates that the members were worried that the committee might be growing too fast, which would lead to renewed inflation.

I wonder if you might tell us in your definitions what is too fast and what is too slow, and what is about right?

Mr. VOLCKER. Let me preface, my answer by saying I think too fast is something that is unsustainable in the sense that we would run into a wall of capacity or labor or other constraints, and that would bring in its wake or bring along with it the kind of price movements that will be unsustainable.

It is a matter of judgment as to what too fast is, and I don't think any of us is wise enough to have a very precise feeling about that. But I think you can say that in an economy rising, let's say, at 6 percent or more, as it did last year, you haven't got the room to do that for very long without the risk that you are going to run into that kind of wall and ultimately be destabilizing. You would rather see growth taper off from that kind of rate to a rate that can be sustained consistent with progress against inflation.

I think the general range of forecast that we have, the administration has, CBO has, many private forecasters have, which continues to show a pretty healthy rate of growth in 1984, is certainly reasonable.

Mr. HILER. Many are concerned that your targeting of the M_1 in particular would not be consistent with achieving your definition of what is a sustainable good rate of growth. There are some folks like Milton Friedman, for instance, who question that the monetary targets that you have had or that you have been able to achieve, particularly in the last 6 months, led to a marked slowing down in the economy, and that with a further tightening of the money supply figures, that it will be very difficult to achieve that 4 to 4½ percent that you target.

How would you respond to that?

Mr. VOLCKER. The technical answer is that we make certain presumptions about velocity, that we have got a pretty wide range for M_1 , and we feel that that encompasses what is probable, given the evidence that we have as to developments in velocity recently.

More generally, let me say that when one looks at the economy in the second half of 1983, as I mentioned in my statement, demand was very low and maintained right through that period, right through the final quarter. What we had was more and more of the demand seeping out abroad, which raises questions about sustainability. It also raises questions about what policy adjustments can be made so you don't get that growing imbalance, which is reflected in the trade deficit.

But it is hard to say that domestic demand was not rising at a very healthy clip right through 1983 and, of course, the early numbers for 1984 show continuing strength.

Mr. HILER. You mentioned you led into the deficits there as a policy consideration. I wonder, do you have a pen? You might just write down three figures here so you can be looking at them when I ask you the questions on them. Write down 1.648, 1.230, and 1.068.

Mr. VOLCKER. It sounds like the national debt with a trillion sign on it or something.

Mr. HILER. Well, that is close, but the first figure, 1.648, is what the current service budget deficit for the years 1983 through 1988 was projected to be in last year's budget. The 1.230 is the current service budget for the years 1983 through 1988 as projected in the 1985 budget, and the 1.068 is the budget deficit predicted for the years 1983 through 1988, if the President's budget program were implemented.

That is a drop of \$418 billion in the current service budget in 1 year, due to faster economic growth, and a further drop of nearly \$170 billion, if the President's budget were implemented. I don't think anyone would say that the Congress did a particularly good job in controlling spending last year.

It is a \$600 billion drop on \$1.648 trillion deficit.

Do you think that is a good figure? Do you think it is a misleading figure? Do you think it is a possible figure?

Mr. VOLCKER. I am glad this question arose. I can clarify, I hope, another point.

You have some cyclical component of the deficit, and that growth takes care of that part of it. Unfortunately, the so-called underlying deficit or the structural deficit, the deficit that would remain even when we are at something that people would call full employment is getting bigger, and the decrease in your figures may be in large part influenced by the fact we came out of the recession more strongly than was projected a year ago. That is reflected in this series of 5-year numbers. But, during this same period, the deficit apparently has grown in terms of what it would be at full employment. It has gotten worse, not better, and the projection is that it will get worse over the next few years. It is not a \$200 billion problem, as I have said. It is more like a \$100 billion-plus problem. That may not bring us in the actual ball park, but pretty close to it at the moment. It is a \$100 billion problem getting bigger. It is not a \$200 billion problem, and that makes it much more manageable.

You don't have to go out there and cut expenditures or raise revenues by \$200 billion to cure the budgetary problem.

I would repeat a point I made before. If you can make a good start on this, the momentum of the thing begins running in your favor rather than against you, because you do get interest rates running lower. That makes the administration's interest estimate look more plausible as compared to the CBO's estimate, which is much higher, and it makes a big difference in what the deficit looks like 5 years from now.

If you can take some action now to make the lower interest rate forecast that I keep getting asked about look more likely, you begin compounding the gains.

Mr. HILER. If I might just beg the indulgence of the Chair—

The CHAIRMAN. The gentleman's time has expired.

Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

Welcome back, Chairman Volcker.

I want to start off by saying that several of my colleagues have suggested this morning that the Fed has adopted what might be termed a somewhat more accommodative monetary policy, perhaps, with an eye toward assisting the President's reelection. I have looked over what I believe to be the objectives that the Fed has adopted for money and credit growth in 1984. They don't appear to be more accommodative.

Would you just comment briefly on that?

Mr. VOLCKER. We made no change from what we said last July, except reduced one of the ranges by one-half percent.

Mr. CARPER. Second, when you are asking questions at the end of the session as I am, it is tough to touch on anything that hasn't been worked over pretty well. I don't think we have really talked too much about some of the Third World nations with heavy debt problems.

Could you just mention those few that you think are still most troublesome and provide us with a brief update on their status?

Mr. VOLCKER. The two biggest ones are Mexico and Brazil, and we have referred to those a bit. Mexico has made considerable progress. They have by no means cured or even ended their problem because they have made financial progress in the short run at the expense of a recession and at expense of growth. They are going to have to begin growing, and there is some prospect they may begin growing mildly this year, which would be healthy, and enable them to maintain a kind of external equilibrium. I think you can see definite signs of progress there, even though it is not finished. Those signs of progress are reflected in at least preliminary arrangements for new financing at lower interest rates, and I think there are some prospects for refunding some of their debt that is coming due in the next few years, there are definite signs of progress.

Brazil, with more or less the same amount of debt, with great effort put together a program late last year, and the banks, with considerable effort, have now committed to provide financing of about \$6.5 billion, together with all the other financing that is available. It should be adequate to see them through the year, but they are at the stage now where a tough program has to be imple-

mented in a steady, constructive, disciplined way over some period of time, both to restore confidence and to make the results come out right.

Argentina and Venezuela have both had recent elections, as you know, and I suppose in some sense—suspended animation isn't quite the right phrase—are at a point where new governments have had to appraise the problem, take account of the problem, develop their own particular approach toward it. Neither country is in agreement with the IMF at this stage, and the challenge lies ahead for those countries of developing a coherent economic program that does receive IMF approval and does lay the way for clearing up some arrearages in their present debt, and for doing whatever restructuring or new financing they need; they are at an inbetween stage.

Mr. VOLCKER. There are many other countries to talk about. There are problems in Africa and, to a limited extent, in the Far East. There are other problems in Latin America that are in varying degrees of correction or failure to correct so far, so it is a situation which is by no means in my judgment comfortable, and it is going to take a great deal of continuing effort.

The growth in our economy helps. A decline in interest rates would help even more immediately, because it feeds through pretty quickly to other countries' financing needs.

Mr. CARPER. Thank you.

One last question a little bit closer to home. Some of my colleagues have said this morning, and I think we all realize, at least most of the Members of the House, and I think some of the more enlightened people at the White House realize, that the key to beginning to reduce the deficit has to be restraint on the spending side and there has to be some changes on the revenue side, as well.

I was pleased to see one of the major business leaders of the country, Ed Jefferson, chairman of the Du Pont Co., called yesterday for not only spending restraint but also increases in taxes, and he would have us focus on not a very specific but a sort of broad-based consumption tax.

The President and other people in the administration have said that tax increases now would pose the danger of snuffing out the economy or economic recovery, short circuit it. Would you just comment for us, please, on the effect of consumption tax against not a real, clearly defined but some kind of broad-based consumption tax would have on first, the economic recovery and second, on rekindling inflation.

Mr. VOLCKER. Let me say, first, that I don't think a broad-based consumption tax, whether or not it is a good idea, is going to help you this year. It is too complicated a thing to be part of the present discussion, in my judgment. It is too fundamental a thing.

Looked at into the future, my sense is that if indeed further substantial steps can't be made toward reducing the level of spending relative to the GNP, that some form of a consumption tax may prove to be the only efficient way to get there. And it has some economic advantages. I think that is quite clear.

The one drawback you put your finger on, from my perspective, is that in the process of imposing some types of consumption taxes, because of the way we compute the consumer price index, and so

forth, it feeds into the apparent inflation. It is kind of a silly thing, in my mind, that collecting taxes one way instead of another way, somebody has still got to pay the taxes.

One way you calculate it, it affects the price indices, and then can feed back into inflation, but that seems to be the way it is. I think that is manageable, if it is not done all at once. It is a drawback, but I don't think it is the absolutely critical factor in deciding yes or no. It is a factor.

Mr. CARPER. My time has expired. Again, thank you.

The CHAIRMAN. The Chair recognizes Mr Wylie for a unanimous-consent request.

Mr. WYLIE. Thank you, Mr. Chairman.

I will take the opportunity to congratulate you, Chairman Volcker. I think you have handled yourself most adeptly again this morning in a reassuring way. My attention was called to an article in the Wall Street Journal this morning by Congressman Kemp in which it had six questions for Chairman Volcker.

Mr. Chairman, I would like unanimous consent to submit those for the record. I suppose that the Chairman's answer to those questions could help us understand monetary policy a little bit.

Mr. VOLCKER. I would be glad to do that.

The CHAIRMAN. Without objection. Since you don't object, without objection.

Mr. WYLIE. Thank you, Mr. Chairman.

[In response to the request of Congressman Wylie, the following letter with attached answers to questions of Congressman Kemp referred to above was received from Chairman Volcker for inclusion in the record:]



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

February 14, 1984

PAUL A. VOLKER
CHAIRMAN

The Honorable Chalmers P. Wylie
House of Representatives
Washington, D. C. 20515

Dear Mr. Wylie:

During the hearing before the House Banking Committee on February 7, you asked that I answer the six questions posed by Congressman Kemp that appeared in the Wall Street Journal on the day of the hearing.

For your information, I am pleased to enclose my responses to Congressman Kemp's questions. I am also sending a copy of my responses to the Committee for inclusion in the record of the hearing.

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

Sincerely,

Paul

Enclosures

Q1. Is there some rate of economic growth which he regards as inherently inflationary or "unsustainable"? If so, does the Chairman believe he has a mandate to bring growth down to "sustainable" levels?

A1. I don't have in mind a particular growth rate that is inherently inflationary, regardless of the prevailing circumstances. Clearly, however, growth in real output that is well in excess of the growth of the economy's productive capacity is unsustainable in the sense that eventually the pressures of aggregate demand on supply will result in a resurgence of inflation. The Full Employment and Balanced Growth Act of 1978, by enunciating the dual national objectives of high employment and low inflation, in effect directs the Federal Reserve to do what it can to prevent such inflationary conditions from arising.

Q2. Assuming Fed monetary actions affect market interest rates, is Chairman Volcker offering to trade lower interest rates in return for a congressional agreement to make a "downpayment" by raising taxes?

A2. While the Federal Reserve obviously has an important role to play in determining the course of interest developments, its powers in this regard are limited. Consequently, no Federal Reserve Chairman could responsibly offer such a "trade." In the natural course of events, however, if the System were to seek to maintain an appropriate course of monetary expansion, an action to reduce appreciably current and prospective federal deficits would tend to lower market interest rates--the degree to which rates actually decline being dependent in considerable measure on how strongly interest-sensitive components of demand in the economy (such as housing and long-term business investment) respond to any incipient easing of rates.

Q3. Since the real interest rate is measured by the difference between nominal rates and expected inflation, is it not true that keeping the federal funds rate between 9% and 10% for eight months is a policy that in fact has represented steadily higher real interest rates because, as the Chairman says, expected inflation has fallen? Has the Fed pursued high real interest rates in order to slow down economic growth?

A3. It is not clear that inflation expectations have diminished over the past several months, when the economy has grown more rapidly than most people expected. The gauging of real interest rates is a difficult matter, however, and I would want to avoid putting too fine a reading on any set of numbers. We watch interest rates, along with many other economic indicators, in judging the appropriateness of our policy actions, but it would not be fair to say that we have "pursued high real interest rates" as a policy.

I should add that, despite interest rates that seem to me too high for the long-term health of the economy, and assuming inflation remains under control, we are in fact seeing rapid economic growth currently.

Q4. Under what economic conditions would the Fed increase the availability of credit? Would the Fed wait for a decline in quarterly GNP flash numbers, for instance? For joblessness figures to turn up?

A4. I must emphasize first that the actions of the Federal Reserve are only one influence on conditions in the credit markets, and the level of interest rates reflects both supply and demand forces. Setting technical considerations aside, and addressing what I perceive to be the crux of the question, there is no particular economic number that alone determines our actions. Each must be assessed in the light of other confirming or contradictory information. The data cited are, along with others, significant, but success or failure in reaching our objective will not be determined by a jiggle in a single economic curve, but by whether we can contribute to sustained growth in an environment of greater stability. As this implies, among other things, measures of price pressures are important, and we of course look to the various monetary and credit aggregates for guidance.

We certainly have no desire to see real GNP decline or the unemployment rate to rise, and we believe that our policies are consistent with continued growth of business activity, sufficient to bring about a lower jobless rate by the end of this year.

Q5. Is there any floor or any ceiling for any commodity price index, or the price of gold, which the Fed will not allow to be violated as a matter of policy?

A5. The general price level--defined as the "average" level of prices on those goods and services ultimately absorbed in final consumption and investment--is a major focus of policy. We are seeking to bring about an environment of rough stability in the general price level, along with healthy growth of the economy.

Movements in commodity prices can be one sensitive indicator of price pressures, current or prospective. However, they also can reflect passing or special influences in agricultural or other markets, some of non-economic origin. More generally, sizable cyclical fluctuations around the trend of broader price indices can be expected.

Integrated in that general context, general swings in commodity prices may well be an important signal of actual or imaginary price and speculative pressures. I am not, however, able to cite a specific "threshold" level, either as a floor or ceiling, that, absent other considerations, should never be violated.

Gold prices, while also subject to more particular influences, certainly do reflect speculative conditions and the degree of confidence about the future stability. For more than a decade, those prices have fluctuated widely. While well below earlier peaks, they are still high relative to more general price indices, and we have no fixed points, or range of prices, that in themselves represent policy guides.

Q6. Does Chairman Volcker think a stable exchange rate, which he has consistently supported, means the dollar hitting record highs week after week? If not, can the dollar's rise be halted by Fed action to lower interest rates?

The strong rise in the dollar over the past year has reflected a combination of influences, including the pressures in our financial markets, in turn related to the huge current and prospective deficits in the federal budget. The strength of the dollar has directly reflected large capital inflows, and it has also been accompanied by severe erosion in our trade and current accounts which, in my judgment, cannot be sustained indefinitely.

A more stable dollar would serve us and the world well. The question is how to achieve that end. An aggressive expansion of reserves to increase monetary growth and push down interest rates, with inevitable inflationary consequences, would not be constructive in terms of long-term exchange rate stability, which must rest on domestic stability. An entirely constructive approach would be to reduce the imbalances in federal fiscal policy and, by cutting the federal deficit, to ease the pressures in our credit markets that have tended to buoy the dollar on exchange markets even in the face of an unsustainable current account trajectory. It would serve both domestic and international objectives.

The CHAIRMAN. Mr. Chairman, repeatedly this morning, as in the past—this is not the first time—when you have been asked to predict interest rates, you have declined to do so. Now, certainly you are in possession of as much knowledge as anyone about those factors that do indeed impact upon interest rates, and I think it is fair to conclude that the Fed and the Chairman of the Fed probably are the most knowledgeable and have the most access to those pertinent facts that are determinants of what interest rates might be in the future. Yet you have always declined.

Now, am I not correct in assuming that despite all the knowledge you have, and all the facts at your disposal, there is still a reluctance to predict interest rates? Is it because you still have a problem with the accuracy of your prediction?

Mr. VOLCKER. I think there are two reasons. You put your finger on one, conceptually anyway. I ought to be in as good a position as anybody to assess—

The CHAIRMAN. Let's say better.

Mr. VOLCKER. All right, then, let me say better. My own conception, whether or not that is true, is that I am very conscious of the fallibility of interest rate forecasts. Whether interest rates go up or down is going to depend upon a variety of influences that I may anticipate one way or another, or I may get the mix a little wrong. I think I know what influences interest rates, but I don't know what is going to develop in every sector of the economy over the next year.

The fact that people think I know more about it—given that even my forecast is going to be fragile—means it will get a particular weight on it that isn't helpful.

The other thing is quite obvious, that in predicting interest rates, people will attach to that some policy significance, and some market significance, that I don't think would be helpful.

The CHAIRMAN. Well, by the same token if you could predict with accuracy, you wouldn't have any problem with policy or monetary—

Mr. VOLCKER. Suppose I knew perfectly accurately that interest rates were going to jump up by 2 percent or drop down by 2 percent next November. If I announce that this morning, whatever projection you might have made before my announcement, the market would behave a little differently after it, just by calling it a projection.

The CHAIRMAN. But the fact of the matter is, if you knew with accuracy, you should have no problem with telling us that. But the reason you don't is—

Mr. VOLCKER. I keep saying I can't know it—

The CHAIRMAN. Fallibility.

Mr. VOLCKER. The mere fact the Federal Reserve says it changes the market.

The CHAIRMAN. But by the same token if you knew for a fact that that was going to be accurate, then you shouldn't have any problem telling us?

Mr. VOLCKER. I suppose that is right.

The CHAIRMAN. That gets to my next problem.

Mr. VOLCKER. The Moon is made out of green cheese.

The CHAIRMAN. There is a dilemma in my mind, and that is this. If you, with all the knowledge you have available to you, are reluctant to make this type of prediction, I am wondering why those people with high-paying jobs in all the big financial institutions in this country and the brokerage houses can speak and the market reacts. God, if you don't know, how in God's name do they know?

Mr. VOLCKER. I wonder about that myself occasionally. What I always wonder about is an awful lot of those people have been trained in the Federal Reserve, and they always seem to know more when they get out than they knew when they got in.

The CHAIRMAN. While they were there.

Mr. VOLCKER. They always carefully explain they can't understand what the Federal Reserve is doing. I mean, they just came out of the Federal Reserve. We all have our frustrations. But if I may make one point in this connection, which only comes to point—

The CHAIRMAN. This is make-a-point time.

Mr. VOLCKER. Make-a-point time. Mr. Levin was telling me I wasn't being frightening enough. I think you have a catch-22 situation here. Let me put it this way: if the economy turned out to be weak, as Mr. Schumer was suggesting, interest rates would go down, but they would still be higher with this deficit than if you didn't have the deficit, and it would inhibit the investment, the foreign trade balance, the housing, in a context of interest rates not falling enough in a weak economy.

If you take the opposite assumptions that he made, and you said we would have a very strong economy, that is going to produce pressures on interest rates—potentially anyway—and you have got this budget deficit on top of it, you have got yourself a real problem. In a way, the better the economy is, the more the dangers are on the interest rate front, and that is not a happy situation in which to be.

The CHAIRMAN. You were going to get that in.

During the course of your testimony this morning, you mentioned the fact, I think to Mr. Wortley, that you had to revise your benchmarks once you got the call reports from a lot of the smaller banks around the Nation.

Mr. VOLCKER. Right.

The CHAIRMAN. Now, I follow that up with this one. We have been reading quite a bit about money laundering through U.S. banks, and I wonder if the Federal Reserve has any statistics or estimates about the level of laundering activity that goes on through our financial system.

I am also curious to know if the Fed has any estimates about the potential effect that this laundering has or might have on the money aggregates or on other economic indicators, particularly in the Florida region, where the laundering seems to be highly concentrated.

Mr. VOLCKER. I think the general answer is we don't have the kind of information that would provide an intelligent answer to your question. We have looked into this from time to time, and I would be glad to send you any information we do have. My memory is, when we have tried to look into this, the basic judgment is we just don't know.

The CHAIRMAN. But it is not an insignificant factor?

Mr. VOLCKER. No; I was about to say I think it is our feeling that this kind of activity does not in any significant way distort the overall numbers that we use, in terms of their direction or level. There is no evidence that it would be big enough or change rapidly enough to change those numbers in any important way.

The CHAIRMAN. Now, a continuation of make-a-point time. The New York Times recently carried an article where they contended that the Federal regulators often times do not check the character of applicants for bank charters. They cited a case of a Federal Reserve approval of a bank purchase by a Colombian—not only chartering but purchasing by a Colombian in the same week the Colombian Government arrested him on bank fraud. Have you taken any steps to assure the character of potential purchasers?

Mr. VOLCKER. I am not aware of that. We don't charter banks.

The CHAIRMAN. I said and I included the word "purchase."

Mr. VOLCKER. I have never heard of that.

The CHAIRMAN. Or controlled.

Mr. VOLCKER. I would be glad if you could give me some facts about it so I can respond. In holding companies—the only cases we get—we certainly try to be aware of the background. I am not saying we do it perfectly, but I would be glad to check with you. Our normal pattern is, if there is an applicant involving a foreign citizen, we check with the foreign country.

The CHAIRMAN. Incidentally, I will have that article provided to your staff.

[In response to the question by Chairman St Germain regarding the article printed in the New York Times of an approval of a bank purchase by a Colombian citizen arrested by the Colombian Government, the following letter was received from Chairman Volcker for inclusion in the record:]



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

February 13, 1984

PAUL A. VOLCKER
CHAIRMAN

RECEIVED

FEB 15 1984

Banking, Finance & Urban Affairs Committee

The Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairman St Germain:

I am writing in response to the question you raised at the Humphrey-Hawkins testimony regarding the article printed in the New York Times of Sunday, February 5, 1984, regarding the Board's handling of the application by Mr. Jaime Mosquera to acquire a bank in Georgia. The article suggested that in the case of applications by foreign nationals, the Federal Reserve and other bank regulatory agencies acted in haste and without thorough investigation.

The record of Federal Reserve review of such applications indicates that this is clearly not the case. While we are under statutory time constraints--sixty days under the Change in Bank Control Act and ninety-one days under the Bank Holding Company Act--the Board makes full use of all relevant sources of information to do a thorough background check. Contacts are made with other federal banking agencies, state and foreign bank regulators and the State Department, as well as with all appropriate law enforcement authorities, including the Justice Department, the U.S. Customs Service, the Drug Enforcement Agency, and the FBI. And, where the case warrants it, and the statute allows time for extensive investigation--as in the case of the Bank Holding Company Act--the time allowed by statute is fully used.

The Board's careful analysis of applications by foreign nationals is fully demonstrated by the case referred to in the New York Times article.

In May 1982, Grupo Financiero del Estado, S.A., Bogota, Colombia, a holding company controlled by Mr. Jaime Mosquera, applied under the Bank Holding Company Act to the Federal Reserve Bank of Atlanta to acquire The First National Bank of DeKalb County, Decatur, Georgia. As part of the routine processing of an initial application by a foreign investor, the staff of the Atlanta Reserve Bank, working with the Board staff, contacted the other federal banking agencies, the Superintendent of Banking in Georgia, the Superintendent of Banks in Colombia, the Department of Justice, the Department of State, the U.S. Customs Service, the Drug Enforcement Agency, the FBI, and the

CIA, to inquire regarding the background, financial resources, and managerial experience and integrity of Mr. Mosquera and Grupo Financiero del Estado. The Superintendent of Banks of Colombia responded that Mr. Mosquera and Grupo Financiero del Estado adequately performed their functions according to the laws and regulations of Colombia. However, by a letter dated July 28, 1982, the Office of the Comptroller of the Currency stated that it could not at that time recommend approval of the application due to various questions and uncertainties that had not yet been resolved regarding the financial strength of Grupo Financiero del Estado. There were no adverse comments received from any of the other agencies contacted.

During August and September, attempts were made to verify the financial condition of Grupo Financiero del Estado as well as newspaper reports that several large banks in Colombia, including several in which Grupo Financiero del Estado held a significant interest, were experiencing financial difficulties. In late September 1982, the American Embassy in Bogota reported that Mr. Mosquera had testified in closed hearings in Bogota and was placed in jail.

In early October 1982, the U.S. office of Banco del Estado confirmed that its Colombian parent bank, the chief asset of Grupo Financiero del Estado, had been nationalized by the Government of Colombia. Subsequently, the application for the Georgia bank was formally withdrawn in December 1982.

At the time the application was withdrawn, the Reserve Bank and Board staff investigation was still open and at no time was this application ever scheduled for action by the Board. Under normal ninety-day processing procedures, the application would have been presented for Board consideration in August. The application was not acted on at that time because of the ongoing inquiry into the applicant's managerial resources.

I hope this information is responsive to your question.

Sincerely,



The CHAIRMAN. Mr. Patman?

Mr. PATMAN. Just a short one. Mr. Volcker, you replied in answer to a question by Mr. Carper that your monetary aggregate projections embodied in your report today are substantially the same as they were for last year. Is that correct?

Mr. VOLCKER. They are substantially the same as we announced for this year last July, and they are a little lower than the ones we actually had last year. They are lower than the ones that were in effect in 1983. They are substantially the same as what we announced in 1983 for 1984.

Mr. PATMAN. Are your projections for velocity also the same, virtually?

Mr. VOLCKER. I would say for our projection for velocity in 1984, yes, our assumptions would be similar.

Mr. PATMAN. They are pretty much the same as they were for last year?

Mr. VOLCKER. Yes; we have an economic forecast that is not very far from what we announced or forecast in the middle of 1983. We are starting from a higher level, because we had more growth in 1983 than we anticipated, but the rate of growth in 1984 is similar.

Mr. PATMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Chairman Volcker, do you understand inflation to be essentially a monetary phenomenon? That is, in general terms.

Mr. VOLCKER. In some long-range sense, yes, but where I may differ from some monetarists is that I think the inflationary process is a very complicated process that arises and is influenced by many things in the structure of the economy and in attitudes. You can squeeze that all out by being still tighter on money, but with what pain and suffering.

Putting it another way, I don't think you can ignore the process by which one gets to price stability and how much unemployment you have when you get there. You can always, theoretically, squeeze it all out by money, but if you do so, under certain conditions, you have got a lot of other problems.

Mr. NEAL. Let me put it this way. Would you think that it would be possible to control inflation or to bring down the rate of inflation without exercising restraint?

Mr. VOLCKER. No.

Mr. NEAL. In money?

Mr. VOLCKER. No.

Mr. NEAL. Is there any way to inflate the economy without creating an excess amount?

Mr. VOLCKER. Not over a long period of time, no.

Mr. NEAL. Well, I have noted that President Reagan over the last couple of years, and with a great emphasis recently, has been claiming that he brought down the rate of inflation in this country. I can't see for the life of me that he has had anything whatsoever to do with it. I would think that you would have to say—you may not want to say it; it might be entering into application—but if inflation is a monetary phenomenon, if you can't create it without increasing money excessively, and if you can't control it without bringing down the rate of growth in money, how in the world could

the President have had anything to do with controlling inflation whatsoever?

Mr. VOLCKER. I am not sure I can usefully extend this discussion too far, but I do think, consistent with the comment that I made first, that many other factors, particularly in the shortrun period, bear upon the speed and effectiveness with which inflation can be drained out of the economy. Let me just give you one example.

I am not putting this in any political context, obviously. The process of economic deregulation of some industries I think has had an effect in putting more pressure on the efficiency of those industries, the productivity, the restraint on wage and other costs.

The fact that that has been going on has certainly assisted the disinflationary process. Now it has happened in a limited number of industries, but it is the kind of thing that can assist in the restoration and maintenance of stability. That is not at all contrary to the fact that in the long run it is a monetary phenomenon. We wouldn't be successful in keeping inflation down without money under control, but the speed and manner with which you get there is important, too.

Mr. NEAL. What you are referring to there is economic deregulation?

Mr. VOLCKER. Right. I am talking---

Mr. NEAL. In the late seventies, the regulations---

Mr. VOLCKER. That is right, the trucking industry, the airline industry, and others, yes.

Mr. NEAL. But, again, this administration hasn't done that.

Mr. VOLCKER. I didn't say that as a political statement.

Mr. NEAL. I just think if we maintain the pretense that inflation has been conquered because the President was able to cut a few people off food stamps or something like that, it is just absolute nonsense. We ought to set the facts straight so we can deal seriously with the problem in the future.

In fact, I think that you would have to say that big budget deficits make your job even tougher, and the big budget deficits are clearly a result of the President being able to get his policies through the Congress.

Mr. VOLCKER. I think that is true, but at the same time, let me say that I think the administration, very broadly, has been supportive of what has been necessary to deal with inflation through monetary policy.

Mr. NEAL. Well, what can they do otherwise? You are an independent agency.

Mr. VOLCKER. That is right.

Mr. NEAL. Presumably you would continue to exercise your independence even if they hadn't?

Mr. VOLCKER. I think so.

Mr. NEAL. And what I think you will see them doing pretty soon, as Congressman Kemp is doing now, is trying to find some scapegoats for a bad economy. So I would hope you would remain constant. I would anticipate that you would start hearing some of that as the election approaches.

Mr. VOLCKER. I understand that comment.

The CHAIRMAN. Mr. Chairman, you should not be so humble. We are trying to give you a little more credit than you are willing to

take. I want to compliment you on your stamina and your staying power, and we want to reassure you that as a result of your appearance here this morning, that has been carried on international networks, that you have managed to do the same thing today as you always do.

Your testimony will have no effect whatsoever on the market, because you have not divulged any supersecrets that are going to in any way upset the applecart, and so stability will remain as it was before you started this morning at 9:30, and I would note for the record that it is now 1:15.

Mr. VOLCKER. It is a measure of success. Is that true in the market today? I don't know.

The CHAIRMAN. What is that, staying power?

Mr. VOLCKER. Stability.

The CHAIRMAN. And stability. Well, I gave you stamina and staying power and kudos for not upsetting the applecart with any statements that might have been a surprise to anyone.

Mr. VOLCKER. I don't want to leave any implication that you have not received the complete range of our thinking; there is no thinking back on the kickpad that we haven't given.

The CHAIRMAN. We are going to check with your staff back there at the Fed. Thank you very kindly. There may be questions submitted from some of the members. I would ask you to assist there as well.

Without objection, that can be done, and at this time the committee stands adjourned.

[Whereupon, at 1:20 p.m., the committee adjourned.]