CONDUCT OF MONETARY POLICY

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

HEARING

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

APRIL 12, 1983

Serial No. 98-15

Printed for the use of the
Committee on Banking, Finance and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1983

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

FERNAND J. St GERMAIN, Rhode Island, *Chairman*

HENRY B. GONZALEZ, Texas
JOSEPH G. MINISH, New Jersey
FRANK ANNUNZIO, Illinois
PARREN J. MITCHELL, Maryland
WALTER E. FAUNTROY, District of Columbia
STEPHEN L. NEAL, North Carolina
JERRY M. PATTERSON, California
CARROLL HUBBARD, Jr., Kentucky
JOHN J. LaFALCE, New York
NORMAN E. D'AMOURS, New Hampshire
STAN LUNDINE, New York
MARY ROSE OAKAR, Ohio
BRUCE F. VENTO, Minnesota
DOUG BARNARD, Jr., Georgia
ROBERT GARCIA, New York
MIKE LOWRY, Washington
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
BILL PATMAN, Texas
WILLIAM J. COYNE, Pennsylvania
BUDDY ROEMER, Louisiana
RICHARD H. LEHMAN, California
BRUCE A. MORRISON, Connecticut
JIM COOPER, Tennessee
MARCY KAPTUR, Ohio
BEN ERDREICH, Alabama
SANDER M. LEVIN, Michigan
THOMAS R. CARPER, Delaware
ESTEBAN E. TORRES, California

CHALMERS P. WYLIE, Ohio
STEWART B. McKINNEY, Connecticut
GEORGE HANSEN, Idaho
JIM LEACH, Iowa
RON PAUL, Texas
ED BETHUNE, Arkansas
NORMAN D. SHUMWAY, California
STAN PARRIS, Virginia
BILL McCOLLUM, Florida
GEORGE C. WORTLEY, New York
MARGE ROUKEMA, New Jersey
BILL LOWERY, California
DOUG BEREUTER, Nebraska
DAVID DREIER, California
JOHN HILER, Indiana
THOMAS J. RIDGE, Pennsylvania
STEVE BARTLETT, Texas

CONTENTS

STATEMENT

ADDITIONAL MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

CONDUCT OF MONETARY POLICY

TUESDAY, APRIL 12, 1983

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

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

Present: Representatives St Germain, Gonzalez, Minish, Mitchell, LaFalce, Lundine, Vento, Lowry, Schumer, Patman, Coyne, Roemer, Lehman, Cooper, Kaptur, Erdreich, Levin, Carper, Torres, Wylie, McKinney, Leach, Paul, Bethune, Parris, McCollum, Wortley, Roukema, Lowery, Hiler, Ridge, and Bartlett.

The CHAIRMAN. The committee will come to order.

Chairman Volcker, on behalf of myself and members of the committee, once again I welcome you in your appearance in connection with our joint responsibility pursuant to the provisions of the Full Employment and Balanced Growth Act.

In my letter to you of April 4, extending the committee's formal invitation to you, I advised you of the action by the House of Representatives on March 23, 1983, directing the Federal Reserve Board and the Federal Open Market Committee to report to Congress on the objectives of the Board of Governors and the Federal Open Market Committee with respect to the growth or diminution of gross national product in current and constant dollars, inflation, as well as unemployment for the current and 3 following calendar years.

I strongly urged that the information requested by the House be provided this committee at today's hearing.

From press accounts, it is my understanding that you are not prepared to accept this clear expression of the House intent. Of course, I also read your statement that, I must say, was presented to us on time, and we are most grateful for that.

Mr. Chairman, the Congress must carry out its economic policy functions in the full light of day. The President of the United States as well as his administration must reveal their economic policy to all who wish to read their economic reports.

Neither the Congress nor the President is always successful. Things do go astray in economic planning. However, that does not prevent us from giving the citizens of this Nation a sense of direction.

Of all the economic policymaking branches of Government, only the Federal Reserve Board does not provide any clue about where its policy is designed to lead our country.

Mr. Chairman, is it the case that you and your colleagues do not think the Congress and the American people should know where your policies are leading the Nation? Do you think we are out of place to try and influence monetary policy?

Do you believe that public knowledge of the Federal Reserve's economic goals make it less likely that the 1981-82 high interest rate regime would be repeated?

Mr. Chairman, there are those of us who feel that the time has come for the nameless, faceless mystics who function in absolute secrecy at the Fed, known as those nameless Federal Reserve Board officials, who we usually see quoted in the press, to be informed of the fact that their research and their advice have a crucial effect on the lives and the future well-being of John and Jane Q. Citizen.

Employment and unemployment, as well as inflation and GNP growth objectives, are too meaningful to be ignored in this new era of our economy.

Mr. Chairman, it is my understanding that the Fed and its staff believe that the House, in asking you to report your objectives with regard to employment growth, inflation is asking you to target too many conflicting objectives, but these objectives would be conflicting only if they were set at unrealistic levels.

No one expects the Board to hit its objectives with complete accuracy in all cases. We all understand that it is a complicated world, and the best we can sometimes do is to take our best estimate of what will work.

Mr. Chairman, we simply want to know what your best estimates are. We ask nothing of you that we do not ask of the administration or of ourselves.

At this point, I place the committee's invitational letter—without objection I would hope—of March 29, in the record, with your response of April 7, which addresses none of the requests made to you in the March 29 letter.

[The correspondence referred to follows:]

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-SEVENTH CONGRESS
2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

March 29, 1983

Chairman Paul Volcker
Federal Reserve Board
20th & Constitution Ave., N.W.
Washington, D.C. 20551

Chairman Volcker:

The House of Representatives Committee on Banking, Finance and Urban Affairs will be holding its semi-annual monetary policy oversight hearings on Tuesday, April 12, 1983, beginning at 10:00 AM. The Committee expects your report on monetary policy, and in light of the time which has passed since your report to the Senate Committee on Banking, Housing and Urban Affairs, the report should contain any new policy decisions and economic assumptions made in the March Federal Open Market Committee meetings. We would also expect your reaction to the new economic forecasts disclosed by the Administration this month.

In addition to this information, the full House of Representatives, by majority vote on March 23, 1983 directed the Federal Reserve Board and the Federal Open Market Committee to, "report to Congress on the objectives of the Board of Governors and the Federal Open Market Committee with respect to the growth or diminution of gross national product in current and constant dollars, inflation, and unemployment for the current and three following calendar years." Since this is the last expression of Congressional intent with respect to Federal Reserve Board reporting requirements, I trust that you will provide this information to our Committee at the April 12 hearing.

As you know, I recently introduced H.J. Res. 208, the International Recovery Resolution, to encourage a broad national response to our global economic difficulties. H.J. Res. 208 would require the Reagan Administration to take actions at the Williamsburg Economic Summit to be held in late May, to assure that the assembled nations consider making a multilaterlal commitment to adopting fiscal and monetary policies that would result in renewed growth and employment, to reducing the financial pressures on the developing nations, and to improving the regulatory programs that govern international banking safety and soundness. Your appraisal of H.J. Res. 208, would also be appreciated.

The Banking Committee is also extremely concerned with the continuing international debt crisis, and requests your views and information on the need for legislation which would: augment bank foreign loan disclosures, increase loan loss reserves, prevent undue foreign loan concentrations, change the manner in which banks account for the fees they charge for loan reschedulings, and strengthen the international examination and supervision authorities of the U.S. federal regulatory agencies.

In accordance with Committee rules, you are asked to submit 150 copies of your written testimony to the Committee office, Room 2129 Rayburn, 24 hours in advance of your appearance. Please limit your oral testimony to 20 minutes so that all Committee members may have adequate time for questioning. Your entire statement will be made available to all members prior to the hearing and be printed in the record.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dMh

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

April 7, 1983

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:

Thank you for your letter of April 4 regarding the semi-annual monetary policy oversight hearings.

I am looking forward to appearing before your Committee on Tuesday, April 12, at 10:00 a.m., to present the Federal Reserve's Report on Monetary Policy and address the issues raised in your letter.

Sincerely,

Paul

The CHAIRMAN. A matter of such importance to the Nation's economy should not be disposed of by meaningless meanderings of "employees" of the Fed as quoted in the press.

Mr. Wylie.

Mr. WYLIE. Thank you very much, Mr. Chairman. Chairman Volcker, may I welcome you on behalf of the public and the members of the Banking Committee to these proceedings this morning.

We particularly look forward to a discussion of the role of monetary policy in facilitating the present economic recovery without setting off another round of inflation.

Before turning to the more substantive issues of monetary policy, let me briefly state for the record that I suspect there are Republicans and Democrats alike who feel constrained to disassociate ourselves from the procedure that brings us here today. Let me say emphatically that I do not feel that the First Concurrent Budget Resolution, which has just now only passed the House, is the appropriate vehicle to amend the Humphrey-Hawkins bill.

I guess I am even more jealous, Mr. Chairman, of the jurisdiction of the Banking Committee than perhaps the chairman evidences this morning, but may I conclude on that score by saying that those who chose this procedure for purportedly changing the reporting responsibilities of the Federal Reserve, must have had little faith in their own persuasiveness to evidence their case before this committee or to make a good case before this committee, Mr. Chairman.

The CHAIRMAN. Keep digging yourself in, Mr. Wylie. [Laughter.]

Mr. WYLIE. There may be a need, Mr. Chairman, to amend the Humphrey-Hawkins Act or the Federal Reserve Act. It may be desirable to review the Federal Reserve's operating procedures and current targets, and it would seem worthwhile to discuss the interplay of monetary and fiscal policy.

But these are questions and issues that should be thrashed out in the committee having jurisdiction over monetary policy; to wit, the Banking Committee.

Now, turning to matters of greater substance, if I may, there is a growing body of evidence which suggests that we are launched on a period of recovery, although there appears to be some disagreement among the analysts, the economic analysts, about the strength of the recovery.

The answer to that question depends in no small way on the future behavior of interest rates, and I am sure that is what you are going to say this morning, Mr. Chairman.

Some of our members appear to be of the opinion that the Federal Reserve can, in fact, control interest rates and that it therefore has an important, if not overriding, influence on our economy.

I realize that you have commented on previous occasions on the extent of Federal Reserve control over interest rates, but I urge you to review with us today again the limits of your power to control interest rates to put the issue in perspective.

There are those who argue that lower interest rates, and our economic salvation—depend on an expanded money supply. There are others who feel the Federal Reserve has already gone too far in the direction of monetary ease. It is not easy to please or even answer these critics, but I know you will do a good job of trying this morning.

I would be particularly interested, Chairman Volcker, in your reaction to an article which appeared in the Wall Street Journal on April 7 by former St. Louis Federal Reserve Bank President Larry Roos and the views he expressed about a return to a policy of greater restraint, which it seems to me is also implied by the choice of your money supply targets for 1983.

Mr. Chairman, thank you, and thank you, Chairman Volcker. I look forward to your testimony this morning.

The CHAIRMAN. Now, of course, the gentleman from Ohio realizes that I do have a few little comments in reply to his comments.

Mr. WYLIE. I anticipated that you might.

The CHAIRMAN. Right. Now you have concerns about the substance and the process of the budget resolution requirement that the Fed provide its economic objectives to GNP growth, inflation, and unemployment.

I would like to take a moment to address these concerns.

First, as to the substance of the proposal, I hope my friend will note that the budget resolution language on the Federal Reserve received bipartisan support in the House Budget Committee and is being seriously considered by the Republican majority of the Senate Budget Committee. We welcome this healthy spirit of bipartisanship. We will be happy to do anything possible to assist the House and Senate Republicans in passing this language.

Now, I would also like to direct my friend's attention to articles by senior conservative Republican economists—Herbert Stein, Rudolph Penner, William Feller, Philip Kagan—that support the notion of Federal Reserve objectives for GNP growth and inflation.

Now, it is clear that this proposal has brought bipartisan support, and I hope my colleague will see his way eventually to support the proposal.

Now, you state your concern. You say you are more concerned about the jurisdiction of this committee than I am. Not so, my dear friend, not so. [Laughter.]

Now, as I stated, let's look back a little bit. Go back to 1981. I wish you had been as concerned with the jurisdiction of the committee in 1981 as you seem to be today.

Now, back in 1981 the Budget Committee violated House rules. It used the strong arm of reconciliation to force the Banking Committee and most other committees of the House, except for Armed Services, to make drastic and ill-considered cuts in programs under their jurisdiction. Remember that?

I guess my friend forgets or perhaps was not upset when, through that budget process, we invaded the jurisdiction of the Housing Committee and cut housing to the bone. We took housing from the homeless; we kept jobs from the jobless. I guess it was OK in 1981, but it is not all right to have a little something in that budget resolution today that may clear things up for John Q. Citizen as to what his and her future are going to be.

I guess it is more important to protect the inviolate secrecy of the Federal Reserve Board—as I stated earlier—those nameless mystics, staffers, that operate in utmost secrecy. I guess that is far more important as far as jurisdiction is concerned than the invasion of our jurisdiction in 1981.

I didn't vote for that reconciliation where they invaded our jurisdiction, but I think—if the gentleman would check, I think he voted for it.

Now, I am happy to yield.

Mr. WYLIE. Thank you very much, Mr. Chairman, for yielding.

May I say I am somewhat upset—just as the chairman is—about the apparent usurpation of jurisdiction of the various standing committees vis-a-vis budget reconciliation bills or vis-a-vis supplemental appropriations bills.

Last year we did not pass a housing bill. You are correct on that score. And the funding for the housing bill was provided for in the so-called supplemental appropriations bill.

The CHAIRMAN. Excuse me, but the House passed the housing bill. It was contained in reconciliation and cut the living daylights out of housing programs.

Mr. WYLIE. In 1982——

The CHAIRMAN. How about 1981? You are going to forget about 1981?

Mr. WYLIE. You are going to forget 1982? We passed a bill out of the Housing Committee. It came out of Rules Committee. It never came before the House, never came to the House floor.

The CHAIRMAN. Because we couldn't get bipartisan support for it, remember? We tried.

Mr. WYLIE. Well, I mean, did you need bipartisan support at that time? I thought there were more members of your party——

The CHAIRMAN. The gentleman might look at the facts, and he will find that this Congress is a little different from the last Congress.

It is good to have you with us, Chairman Volcker. We will get to you pretty soon. [Laughter.]

But you know the situation has changed in this Congress, I would say to my colleague. Yes; we reported a bill out 2 years ago. We wanted to go to the floor with it, but we knew full well, even if we did get to the floor with it, we had no bargaining power, nothing whatsoever to convince the Senate to do anything.

We will face the facts of life. We faced the facts of life.

Mr. WYLIE. You faced the facts of life. The banking—the housing bill was $28 billion over the budget, for one thing.

But getting back to Humphrey-Hawkins and why we are here this morning, Mr. Chairman, what I am suggesting is that this is a question which should have been addressed by this committee first. It should not have been addressed by an ancillary proceeding through the First Concurrent Budget Resolution, which I submit has not been passed by the Senate yet. So, it is really not a part of the law.

Now, I don't see anything wrong with having some hearings on it, but to suggest that the reason we are here is the First Concurrent Budget Resolution and the language in there, which I objected to at the time as asking for projections or assumptions which I don't feel that the chairman is going to want to make, is the proper procedure.

So, I still submit, Mr. Chairman, that your working with the chairman of the Budget Committee is just fine; getting this language in the budget resolution is just fine. But I do think that we should have had some preliminary discussion on it before the Banking Committee.

And with that, Mr. Chairman, I would be glad to hear from you.

The CHAIRMAN. I want to make one thing clear. My letter to Chairman Volcker, as well as my opening statement, made it clear that I was asking for comments and objectives because of the action that the House took on the budget resolution. I didn't say that it passed the Senate. I asked if Chairman Volcker would be good enough to give us these facts, because I still think it's important to the American people to know what those objectives are.

Mr. WYLIE. So do I.

The CHAIRMAN. Chairman Volcker, I would like to say to you that the chairman of the Domestic Monetary Policy Subcommittee extends his apologies for not being here. But I think we both understand why he's out today. He's engaged in a very important endeavor.

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

Chairman VOLCKER. I understand very well.

Mr. Chairman, I feel a little bit like I'm here under false pretenses. I shouldn't have my name tag in front if I'm going to be a nameless, faceless mystic.

The CHAIRMAN. No, no. That doesn't refer to Chairman Volcker. That refers to the people on your staff and to others, like the editorial writers in the newspapers. Try to find out who they are.

I'm talking about those people who have been on the Federal Reserve Board, like monks in a monastery with their hoods on for all these many years and no one knows who they are.

We keep reading statements in the press about nameless officials, not meaning members of the Board but the professional staff, God bless them.

Chairman VOLCKER. I try to speak for the Board, Mr. Chairman. And those hoods on those other people mean that their comments—when I'm speaking officially—have to get filtered through the Board of Governors. It isn't nameless or faceless, I hope.

Let me proceed.

You mentioned requests that you had made in your letter. And you've got a routine letter of reply saying I would appear. I hope we sucessfully address those questions in the testimony itself, with one exception. You asked for some comments on the resolution that you introduced with respect to Williamsburg, and I have written you a separate letter on that because it seemed to be a little bit out of context in this area.

I want to discuss that issue.

I do have a relatively short statement. Shall I proceed to read it or not?

The gist of it is that the economy is recovering. We had indicated to the Senate in the earlier material that we had released that we thought that a recovery was beginning. We certainly have further evidence now that a recovery has begun. While it's been uneven and not particularly strong by past standards, I think there are reasons to think that it can persist.

We have made remarkable progress on the price front, as reported. We've had very little increase in either consumer or producer prices over a good many months. That, of course, has been affected by some temporary factors, including the decline in energy prices.

While we can take a good deal of encouragement, I think, from the price performance, from the productivity performance, I don't want to suggest that the inflation problem is behind us.

As I note in the statement, there have been a few recent wage settlements, it seems to me, widely out of keeping with recent favorable price trends. While there may have been special considerations in those particular settlements, if we reverted to a kind of 1970's business-as-usual it would not bode well for the future in terms of inflation.

Certainly, we have to keep that problem very much in mind. I think it's got implications for financial discipline, whether in the budgetary process, which is under consideration now in the Congress or in monetary policy.

We set out our monetary targets, as you know, a few months ago. We have not changed those in the subsequent meeting that we have had. We have had a period of a few months where most of the monetary numbers have been running relatively high, in varying degrees.

The most recent evidence in March shows some welcome slowing down, and we will be watching that closely.

It will certainly make us uncomfortable if some of those aggregates continue to rise at a pace more rapidly than our targets suggest, but those targets, I think, remain reasonable in terms of our assessment of the outlook.

There are certainly distortions in some of these figures in the narrow sense of institutional change. There are questions about more basic changes in the trend of some of these numbers relative to economic activity. I discuss that with respect to M_1 in particular on page 5 of the statement.

Certainly we have had less emphasis on M_1 in our implementation of policy over the short term. But as I just indicated, we have prolonged growth at high levels. And particularly if the increases are spread out among the various components of M_1, that would be a source of concern.

We had an innovation in terms of presenting our targets this year when we use a number for total credit that we feel is consistent with appropriate monetary expansion. We want to watch that as kind of confirming or nonconfirming evidence of what goes on in the monetary aggregates themselves.

The data collection is not quite as quick or as full for the credit aggregates as it is for the monetary aggregates. But what evidence we have suggests, in the first quarter, that credit growth was well within the range that we cited, and probably in the lower part of the range that we cited, for the year as a whole.

In general, taking account of that credit number, as well as monetary behavior and the indications that the burst of growth in at least the broader monetary aggregates may be subsiding, we believe our policy has been broadly consistent with the specific objectives we set out in February.

Obviously, that does imply an expectation that monetary growth will subside in coming months, particulary for M_2 and M_1.

The larger question concerns the development of economic activity and prices. I would point out, in that connection, that we have presented estimates from the members of the Open Market Committee for GNP growth, inflation, and other variables for 1983.

If there is a question of presenting estimates, those are already before you. They are now 2 months old. We have not updated that particular process of collecting the forecasts of various members. My own guess would be it wouldn't be substantially different today, but some people might be inclined to show a bit of strong growth and less inflation.

I would also point out that those forecasts of the Open Market Committee members are broadly consistent with the assumptions used by the administration and the CBO in connection with the budget.

I would just make a few comments about the sense of Congress provision included the House version of the first budget resolution, pointing toward the Federal Reserve establishing numerical objectives with respect to certain key economic variables over years ahead.

In the broadest sense, the Board and the Open Market Committee, of course, share the common objective of contributing, insofar as monetary policy can, to a growing, fully employed economy in a framework of reasonable price and financial stability.

I would emphasize my own belief that the stability objective is an essential complement of the growth objective over any reasonable period of time. But we are also very conscious of the limitations of monetary policy alone in achieving and reconciling those goals.

We do now provide relatively short-term projections or forecasts of several economic variables. Those are comparable to the assumptions made for the purposes of forecasting the budget outcome. Those Federal Reserve projections already provide a means of assessing the budget forecast in the light of our assumptions as to economic activity.

While I am not certain of the intent, the proposed budget resolution language seems to suggest something more; that the Federal Reserve agree upon some combination of growth, inflation, and unemployment as a kind of idealized path toward longer run objectives and attempt to manipulate monetary policy to stay on that particular path.

The possible implications of that approach seem to me to need consideration.

I believe economic analysis strongly suggests that monetary policy over longer periods is particularly relevant for prices and that, in any direct or short-term sense, the division between real and nominal GNP growth is not susceptible to monetary manipulation.

To suggest otherwise, by requiring the Federal Reserve to establish short-term objectives for a variety of nominal and real variables, seems to me to encourage a degree of fine-tuning and, indeed, overreaction to current deviations from trend that could well be counterproductive in terms of our and your basic continuing goals.

Moreover, experience amply demonstrates that economic conditions for even relatively short periods of a year or so cannot be forecast or estimated with the precision suggested by point forecasts. That's one reason why I'm presenting our own forecasts, which are a collection of individual forecasts. We haven't attempted to force an artificial consensus as to a single number.

I am concerned that attempts by the Federal Reserve to express objectives in precise statistical terms, year by year, would encourage a false belief in the controllability—certainly by monetary policy alone—of an enormously complicated economy, subject to a variety of strong forces, internal and external.

Obviously, we do need to be concerned about whether the economy is developing reasonably satisfactorily in terms of our continuing longrun objectives and to consider whether policy adjustments are desirable. But there's more than one pattern consistent with the longrun objectives.

Our policy judgments depend upon assessments of the composition of nominal GNP between real growth and inflation, the implications of short-term deviations from anticipated trends, the source of the disturbances, and other factors that need to be weighed, one against another.

None of this can easily, if at all, be captured by a limited series of statistical macroeconomic objectives at a single point in time, and I believe the end result of the effort would be misleading to the Congress and the public alike.

I realize that, in a world that has been characterized by a great deal of economic uncertainty and interest rate instability, there is an understandable desire to, in a sense, pin down monetary policy in a way that can reduce the uncertainties about our economic future. The relevant question is how best to approach that and in a way that is truly productive and would encourage confidence while retaining necessary flexibility.

In that connection, I believe it is especially important, in the case of monetary policy, to approach the question in a way that will maintain an appropriate longer term prospective, looking beyond the passing pressures of the day.

Certainly there should be no misconception that, in approaching our long-range objectives, monetary policy can relieve the need for difficult choices on the budget and other areas of economic policy.

All of this is a large subject of fundamental significance for the formulation and implementation of monetary policy. It should be carefully and deliberately considered and debated before this committee and other appropriate forums. I would urge that any proposed legislation in this area be taken up in that general framework.

Thank you.

[Chairman Volcker's prepared statement follows:]

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

I welcome the opportunity to meet again with this Committee to discuss the objectives and conduct of monetary policy. The Federal Reserve's official monetary policy report to Congress was submitted in February. Given the extensive nature of that report, my earlier testimony before the Senate Banking Committee, and your request to be brief, my comments today will be limited largely to updating the previous report.

When the Federal Open Market Committee was considering its annual growth ranges for money and credit in early February, incoming economic data were suggesting that a recovery was probably beginning. Price data had for some time been showing an encouraging drop in inflation, and a significant downward adjustment in petroleum prices appeared highly likely. The general view of the FOMC was that a moderate expansion in activity was likely this year and that this upturn would be consistent with continuing progress against inflation.

Subsequent developments have been consistent with that outlook. The pace of recovery has been uneven from month to month, but this is not out of the ordinary and production, employment, and spending all have moved up significantly. The size of the pickup in home building has been especially notable, coming as it has in the context of mortgage rates that are still high by historical standards. Inventory liquidation, which took place at a high rate in late 1982 and in January, appears to be subsiding, providing short-term impetus to activity.

The major sector that is continuing to lag is business capital spending, and exports remain depressed. Sluggish capital spending is not unusual during the early stages of an upturn, and exports are reflecting in part relatively slow economic performance abroad. But developments in those sectors also emphasize the remaining risks and uncertainties in the medium-term outlook, related in substantial part to the actual and potential pressures on interest rates and financial and foreign exchange markets growing out of the prospects for continuing huge Federal deficits and remaining inflationary concerns.

Currently, price performance has, if anything, been better than anticipated. Consumer prices were essentially unchanged between December and February, while producer prices declined about 1 percent over that period. I recognize that declines in energy prices have been a major factor in this recent price behavior, and the data clearly overstate the progress that has been made in reducing the underlying trend of inflation. But in recent quarters wage increases overall have moderated further to annual rates of four to five percent, providing, together with increases in productivity, a base for further slowing in unit labor costs.

At the same time, however, it is a troubling fact that a few recent wage settlements seem widely out of keeping with recent favorable price trends. Special considerations apparently influenced those settlements, but a tendency toward generalization of cost-increasing wage bargains would clearly impair longer-term inflationary prospects and ultimately the sustainability of recovery.

The simple fact is that we have come a long way in setting the stage for non-inflationary expansion in which unemployment will decline and workers can again enjoy lasting increases in real income. But that process needs to be nurtured with care and discipline.

In no area is that discipline required more than in the Federal budgetary process. I take encouragement from the successful effort to reach a compromise on the Social Security legislation, helping to re-establish the financial viability of that system. But that is only a small step toward dealing with the structural budget deficit that looms ahead. The coming weeks will be critical to that effort, and your decisions are bound to have a large bearing on the outlook for interest rates.

Our monetary targets for the year were set out in detail in my earlier statements. As indicated earlier, after a period of considerable institutional and other distortions in monetary relationships, those objectives will be reviewed as necessary in the light of all the evidence about the relationships between money and credit growth, on the one hand, and economic activity and inflation, on the other. Deposit flows in response to the advent of the money market deposit and Super NOW accounts have been massive. As expected, these inflows have had a major impact on the growth rates of some of the aggregates -- particularly M2.

More broadly, for much of 1982, and continuing into 1983, movements in "velocity" have deviated significantly from past patterns. Necessarily in these circumstances, we have put a greater premium on judgment and less on "automaticity" in our operational decisions in responding to movements in the aggregates in recent months.

Starting with the broadest monetary aggregate, M3 growth appears to have been relatively little affected by the new instruments, as banks and thrifts responded to the stronger inflows into the new accounts included in M2 by running off a portion of their large CDs. In addition, declines in the money fund component that is included only in M3 also have offset part of the strength in M2 balances. Taking account of somewhat slower growth in March, its current level is very near the upper end of the FOMC's 6-1/2 to 9-1/2 percent annual range.

M2 has been most distorted by the impact of the new accounts. Precise calculation of the amount of funds diverted into that aggregate from assets not included in M2 is simply not feasible, and for that reason the target range set in February for that aggregate pertains to the period after the first quarter, by which time the distortions are expected to abate. Based upon what estimates of shifting are available, underlying M2 growth appeared to have been fairly strong for the first two months of the year, but some slowing seems to have developed in March.

Looking ahead, the annual growth range for actual M2 of 7 to 10 percent measured from the average of February and March still appears reasonable. That range allows for some limited residual shifting over the remainder of the year.

The impact of the new accounts on M1 also has been difficult to assess, but, in recent months, probably has been largely offsetting. Obviously, M1 has been growing at a rate substantially above that implied by the annual 4 to 8 percent target, and faster relative to GNP than would be suggested by past relationships. To some extent -- but it cannot be measured with any degree of certainty -- the decreases in "velocity" may reflect the changing nature of M1; with interest-bearing NOW and super NOW accounts making up an increasingly large proportion of M1, this aggregate may be influenced by "savings" behavior as well as by "transactions" motives. That is a longer term factor, and the growth in M1 over the shorter run may have been affected by the reduced level of market interest rates -- particularly relative to interest-bearing NOW accounts -- and slowing inflation, as well. The range of uncertainty on these points is substantial, and has led the Federal Open Market Committee to place less emphasis on M1 in its implementation of policy over the short term. Nonetheless, prolonged growth at high levels, particularly if the increases are spread among its various components, would be a cause for concern.

The Committee also decided to take explicit account of the growth of total credit in judging the appropriate rate of monetary expansion. While full data are not yet available for the first quarter, preliminary indications are that the aggregate debt of domestic nonfinancial sectors grew well within the 8-1/2 to 11-1/2 percent range projected by the FOMC. Within the total, Federal borrowing remains particularly strong, accounting for around 45 percent of the growth. Maintenance of growth in Federal borrowing at that proportion of the total would be without parallel in peacetime. For the time being, nonfinancial corporate borrowing has been moderate, largely reflecting reduced needs for external financing of inventory and capital investment. But, with the budget deficit projected to fluctuate around recent rates, an obvious question arises as to the capacity of the credit markets to absorb a resurgence of private credit demands as the recovery gathers momentum.

Taking account of credit as well as monetary behavior, and some indications that the burst of growth in at least the broader monetary aggregates may be subsiding, we believe our policy posture has been broadly consistent with the specific objectives we set out in February. Obviously, that implies an expectation that monetary growth will subside in the coming months, particularly for M2 and M1.

The larger question concerns the development of economic activity and prices during 1983 and beyond. The FOMC has presented the estimates of its members for GNP growth, inflation, and other variables for 1983; while those estimates are now two months old, my sense is that the general contour anticipated today would be similar, perhaps, given recent data, with a bit stronger growth and less inflation. Those estimates, given the range of uncertainty in any forecast, are not out of keeping with the assumptions of the Administration and the Congressional Budget Office.

Mr. Chairman, you have requested some comment or response to the "sense of Congress" provision included in the House version of the first Budget Resolution pointing toward the Federal Reserve establishing numerical "objectives" with respect to certain key economic variables over several years ahead. The Board and the FOMC of course share the common objective of contributing -- insofar as monetary policy can -- to a growing, fully employed economy in a framework of reasonable price and financial stability. I would emphasize my belief that the "stability" objective is an essential complement of the "growth" objective over any reasonable period of time. But we are also very conscious of the limitations on monetary policy alone in achieving and reconciling those goals.

We now provide relatively short-term projections or forecasts of several economic variables -- comparable to the "assumptions" made for purposes of forecasting the budget outcome. Those Federal Reserve projections already provide a means of assessing the budget forecasts in the light of our assumptions as to economic activity. While I am not certain of the intent, the proposed Budget Resolution language seems to suggest something more -- that the Federal Reserve agree upon some combination of growth, inflation, and unemployment as a kind of ideal path toward longer-run objectives and attempt to manipulate monetary policy to stay on that particular path.

The possible implications of that approach need consideration. I believe economic analysis strongly suggests that monetary policy over longer periods is particularly relevant for prices, and that, in any direct or short-term sense, the division between real and nominal GNP growth is not susceptible to monetary manipulation. To suggest otherwise -- by requiring the Federal Reserve to establish short-term "objectives" for a variety of nominal and real variables -- would be to encourage a degree of "fine tuning," and indeed over-reaction to current deviations from trend, that could well be counter-productive in terms of our (and your) basic continuing goals.

Moreover, experience amply demonstrates that economic conditions for even relatively short periods of a year or so cannot be forecast or estimated with the precision suggested by "point" forecasts. I am concerned that attempts by the Federal Reserve to express "objectives" in precise statistical terms year by year would encourage a false belief in the controllability -- certainly by monetary policy alone -- of an enormously complicated economy subject to a variety of strong forces, internal and external. Obviously, we do need to be concerned with whether the economy is developing reasonably satisfactorily in terms of our continuing long-run objectives -- and consider whether policy adjustments are desirable. But there is more than one pattern consistent with the longer-run basic objectives. Our policy judgments depend upon assessments of the composition of the nominal GNP between real growth and inflation, the implications of short-term deviations from anticipated trends, the source of the "disturbances," and other factors that need to be weighed, one against another. None of this can easily, or at all, be captured by a limited series of statistical macroeconomic objectives at one point in time, and I believe the end result of the effort would be misleading to the Congress and the public.

I realize that, in a world that has been characterized by a great deal of economic uncertainty and interest rate instability, there is an understandable desire to, in a sense, "pin down" monetary policy in a way that can reduce the uncertainties about our economic future. The relevant question is how best to approach that end in a way that is truly productive and would encourage confidence, while retaining necessary flexibility. And, in that connection, I believe it is especially important in the case of monetary policy to approach the question in a way that will maintain an appropriate longer-term perspective, looking beyond the passing pressures of the day. Certainly, there should be no misconception that, in approaching our long-range objectives, monetary policy can relieve the need for difficult choices on the budget and other areas of economic policy.

All this is a large subject of fundamental significance for the formulation and implementation of monetary policy. It should be carefully and deliberately considered and debated before this Committee and other appropriate forums. I would urge that any proposed legislation in this area be taken up in that framework.

The CHAIRMAN. Thank you, Mr. Chairman. I would like to explain something to you. You know, this term "faceless mystics," et cetera, came to me during Holy Week. [Laughter.]

I don't know whether it was the Dominican influence or the Jesuit influence, but that's where it came from. Now, Mr. Chairman——

Chairman VOLCKER. I'm not sure that I am offended by thoughts of the Federal Reserve that come up during Holy Week, Mr. Chairman.

The CHAIRMAN. Well, I'm going to tell you something. I'm a good Catholic and I take the mystery of the Holy Trinity on faith, but that's where it ends. [Laughter.]

Beyond that I want facts, proof.

Now, Mr. Chairman, a senior Federal Reserve official, one of those—we don't know whose name it is, what his name is or who he is—was recently reported to consider it dangerous for Congress to deal with concepts that are easily understood such as inflation and unemployment rather than being submerged in very sophisticated technical language about money supply numbers M_1, M_2, velocity, blah, blah.

Now, that senior Federal Reserve official went on to worry that if the Fed were required to report its objectives for GNP growth, unemployment and inflation, it could become a way station to telling the Federal Reserve what policy should be.

Now, Mr. Chairman, I hope that that statement does not reflect the attitude of the members of the Federal Reserve Board toward congressional oversight of monetary policy, and so I would like to ask you if you think that the Federal Reserve Board has an impact on the level of economic growth, inflation and unemployment in this Nation.

Now I know the Board is not the only influence, and as you keep reminding us, fiscal policy is very important, but do you think your Board has at least some influence on the above-mentioned economic matters?

Now if you do believe your Board has some influence, then isn't it only right in a democracy such as ours that the people and the people's representatives should be able to understand, comment on and participate in the setting of monetary policy? If you don't believe that the Fed has any effect on economic growth, inflation or unemployment, then the question is, what is the function of the Fed?

Chairman VOLCKER. I think we have some influence, we can have a very important influence, and I think it's perfectly appropriate and useful that our policies be presented in public, be debated in public. Indeed, this hearing is obviously part of that continuing process.

I don't think that those two considerations are at issue in this case, they're not an issue in my mind.

The CHAIRMAN. Mr. Mitchell.

Mr. MITCHELL. Thank you very much, Mr. Chairman. I hesitate to ask any questions because the area over which they range is of such esoteric high intellectual quality, that a little lowly Member of Congress should not dare raise such questions.

Chairman VOLCKER. I have never asserted that, Mr. Mitchell.

Mr. MITCHELL. I didn't say you did, did I? Don't be so sensitive.

Chairman VOLCKER. I'm perhaps unduly sensitive.

Mr. MITCHELL. No, I didn't say you said that, please, but I have temerity, Mr. Chairman, so I have one or two little naive questions, if it's all right.

We have had many meetings together and you have always downplayed the role of the Federal Reserve with regard to impacting on unemployment, and unemployment is obviously one of the most serious problems that we confront today.

You have constantly, in past hearings, evaded the Fed's role in helping to reduce unemployment. Is there any way that monetary policy can be used to reduce unemployment without imposing some major problems and pains on other groups of people?

I know you always rely on the budget and the spending of the Congress, but is there anything that the monetary policy can do to help reduce unemployment?

Chairman VOLCKER. Yes, indeed, I think there is over a period of time, and I think this is very important in terms of our policy considerations. It is a central point.

What I would say in that respect is that I think the role of the Federal Reserve in that connection has to be, importantly, to set a financial climate—a lack of inflationary climate, if I may put it that way—that is conducive to the effective performance of the economy over a period of time, including a low level of unemployment and a satisfactory level of growth.

Our particular area of responsibility through the years has been to protect the stability of the financial system, to protect the stability of the economy generally. I think that is conducive to low levels of unemployment and sustainable growth over a period of time.

What control we have over that in the short run is at issue, I think.

Mr. MITCHELL. That's what I wanted to get to you, project long-term possibilities. Is there anything that you can do in the short term, because the pain of unemployment is so devastating, I'm willing to use any possible technique that we can to reduce it.

Chairman VOLCKER. But it all depends upon the circumstance, so let's take the present circumstance.

Unemployment is far too high now, we would all like to see it reduced; I think we can readily agree upon that.

The question is how to go about that most effectively in a way that unemployment is not only reduced in 1983, but that we can look forward with some confidence to its continued reduction in 1984, 1985, and the years beyond.

In reaching our policy decisions, we try very hard to keep in mind not only the immediate impact, with some judgment as to what that short-range impact may be, but what the implications may be over a period of time.

Mr. MITCHELL. All right. If I may in my own naive and uninformed way, as a little lowly Member of Congress, put another question to you. I want to go back to a discussion that you had with our chairman and a statement that is in your testimony this morning.

You say that the Federal Reserve Board should not attempt to provide objectives for economic growth because the world is too complicated to pinpoint objectives.

Admittedly, that the world is very complicated, but it seems to me that the American people know what general policy direction the Supreme Court is taking, and that is a complicated arena for discussion.

We know what objectives the military is taking. Mr. Reagan has announced a Buck Rogers approach to prevent nuclear warfare, and yet you are saying that the Federal Reserve can't begin to specify objectives.

Chairman VOLCKER. I'm not saying that at all in the terms in which you raise your question. The basic goals of the Federal Reserve should be discussed. The basic goals of the Federal Reserve I think are the same as those the Congress would have; you direct us in a longer term sense as to what those goals should be in terms of stability and employment.

You use the word "general objective." I have no hesitation at all about discussing our general objectives.

Mr. MITCHELL. What specific objectives?

Chairman VOLCKER. I think a much more limited point is at issue here, whether such a proposal is useful. We already give you forecast assumptions, projections using our best judgment of what the near-term business developments will be, in the light of our policies and everybody else's policies.

I think the issue here is what this proposal means, and I am genuinely not sure about this. By taking what we present as a forecast and making it a point objective in a numerical sense over the next year or 2 years or 3 years, what useful information are we providing you?

Is it on balance misleading or useful? My feeling is that it's misleading. We provide a nice, simple, well-recognized number; and the number doesn't come out just the way we have set it down as an objective. That's just going to be true most of the time, given the complications I refer to in the economy.

What are the implications of that? I mentioned that we are not only interested and must not only be interested in what happens over the next 6 months or 12 months in the economy, because our policy actions are going to have continuing effects over a longer period of time. Reaching those judgments, whether they are correct or incorrect, I think is not basically dependent upon some particular numerical formulation of an objective for 1983 or 1984. There are a lot of combinations that might be reasonable, given all the other circumstances over which we have no control, in terms of a path toward our basic continuing objectives—objectives with which I think we would have no disagreement at all.

Mr. MITCHELL. Thank you. My time has expired. Thank you for sharing information from Mount Olympus enlightening we Members of Congress who are a little slow and disadvantaged in our way of thinking.

Chairman VOLCKER. As I said before, I don't associate myself at all with those comments. I personally find these dialogs very enlightening and useful.

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Mr. Chairman, I want to follow up on what Congressman Mitchell said about objectives. Basically where I'm coming from, Mr. Chairman, is that I think it is very important to maintain the independence of the Fed.

I think Congress has done a poor job on fiscal policy and I can't see us trying to control monetary policy.

Now I'm not sure that's where we're coming out, but several bills have been introduced in Congress to have the Fed Reserve target interest rates as well as monetary aggregates, and I would like your comment on those bills, Mr. Chairman.

Chairman VOLCKER. Let me make a general comment. I was this anonymous Federal Reserve official commenting in the newspaper. I was presented with a proposition from a letter of the chairman; that is, a question about it was raised; I haven't received the letter yet because of some problems.

I responded in the context of a number of these proposals that you referred to, Mr. Wylie: Interest rate targeting proposals, targeting specific GNP number; proposals to target a particular price of gold.

We've had a number of these proposals coming from different directions in recent years, and in recent months in particular. We had this budgetary resolution proposal presented, so far as we knew, overnight. It was put in the budget resolution without any chance to consider the issue, debate the issue.

I frankly don't know what the implications of it are because it hasn't been aired at any length in a forum like this or any other forum.

When I hear the chairman of the committee speak about presenting estimates, that's something different than presenting objectives, and apparently that word was a point at issue in the resolution.

I am cloudy about what the implications are, and I do have some concern along the lines you suggested, Mr. Wylie, that all of these could be interpreted as one means or another of giving directions to the Federal Reserve as to the substance of policy.

Congress of course has the right and the power to do that if they want to, but I think that is something that should be very carefully considered; that is, if you want to give us directions, what is the best way to do it.

We've had, as I said, a variety of proposals, all of which suggest somewhat different techniques. Maybe we ought to sit down and discuss it at length—if you want to rewrite the Humphrey-Hawkins Act or rewrite the Federal Reserve Act—that's all I'm suggesting.

Mr. WYLIE. I think that was the point I was trying to make a little earlier, but Chairman St Germain in his letter to you mentioned attempts by the Fed to express objectives or suggested that the Fed express its objectives.

You have mentioned estimates here and in your report on monetary policy; you talk in terms of economic projections.

Now may I say that that is a litle bit confusing to this member. What is the distinction between economic projections and economic objectives and estimates?

Chairman VOLCKER. I think we're getting into a semantic area that confuses me a bit, too.

We made some modifications in this most recent report after long colloquy with Mr. Reuss. Particularly, you will remember that we agreed to be a little more precise—to try to be—in presenting to you the central range of what I might call forecasts by individual committee members as to what they thought the most likely outcome would be in the course of the year—in this instance, 1983—given what they knew about our policies, about budgetary policies, economic circumstances, and all the rest. We do that with a very lively awareness that forecasting of this sort, whether by the Federal Reserve, by the administration, by the Congressional Budget Office, by private forecasters, has a very considerable range of error.

This may be useful to give some sense of the outcomes thought to be likely. Indeed, the Congress has to do this as part of the budgetary process.

I don't know quite what is meant—it's in quite a different context—when you say "The Federal Reserve set down some specific numbers; they are an objective."

The implication, as I read it—now the chairman said he didn't necessarily agree with that—is that the Federal Reserve has all the tools necessary to reach that objective. The implication is "You set it down, now reach it."

Even in a relatively short-term context, I don't think that's the way the world works. If the proposal creates that impression—that we can set down a number and objective and reach it through the tools of monetary policy alone—I think potentially we're in trouble.

Obviously, if it were as simple as all that, why not put down as an objective a very high rate of growth, a very sharply declining rate of unemployment, and low prices at the same time. I don't know how to achieve all those things reliably in the short run, and my concern is—rightly or wrongly, the way I read the budget resolution—that this proposal may lead to that impression.

Mr. WYLIE. Mr. Chairman, I know my time has expired, but I ask unanimous consent to ask for more questions as a followup on that.

Speaking of forecasting—and the key words in all of this discussion are interest rates; given the fact that inflation has dropped dramatically in the past 2 years from double-digit levels, why are interest rates, particularly long-term rates, still high relative to their past historical levels?

Chairman VOLCKER. Mr. Wylie, while I could cite a variety of reasons as to why I think we have an influence, there are two, or two and a half, that I would want to emphasize.

One is a consideration that we have discussed many times in the past: That inflation is much better, but there is a residual—or more than a residual—concern that the improvement will be temporary and that such fears and concerns, not just in financial markets but by men and women throughout the United States, that inflation may return, is a factor in their investment decisions, their savings decisions, the kind of securities they buy. It is reflected in higher levels of interest rates than would be the case if there were strong confidence that the recent price data were going to persist.

That is the first factor. The second factor is that the Treasury this year is issuing something like three-quarters of a billion dollars' worth of securities a day on the average.

When the Treasury is issuing three-quarters of a billion dollars' a day worth of securities, you would expect some reflection of that in current market pressures. There is an expectation which affects what is going on, it's an expectation that that security issuance will continue into the indefinite future. Let me put that alongside the uncertainties of the inflation picture.

The half that I had in mind—maybe it's only a quarter—is that I think the process of financial system deregulation, if you will, has changed the environment in which we operate, in which the economy operates over a period of time, so that all else being equal, because of the lack of interest rates ceilings, because of the increasing flexibility and fluidity of financial markets, you get a balance of demand and supply in the market that is more fully reflected in interest rates than was the case 10 or 15 years ago when you, in the clearest instance, ran into interest rate ceilings.

That was bad for the economy—I'm not arguing for the old world—but now you've got restraints in a different direction, in nonprice terms, to use the economic jargon. At present an equivalent degree of ease or restraint is entirely reflected in interest rates rather than in administrative restraints, and I think that has some background influence in the general level of interest rates.

Mr. WYLIE. Thank you.

The CHAIRMAN. Mr. Chairman, your humility is absolutely astounding.

You don't think monetary policy has a little bit of effect on interest rates?

Chairman VOLCKER. I do, indeed.

I think the fundamental influence of monetary policy comes through the first of those factors that I mentioned.

The CHAIRMAN. The uncertainty.

Chairman VOLCKER. The combination of inflationary concerns, uncertainty, and all the rest.

The CHAIRMAN. That's why that budget resolution—that certainty—you know, we got to the moon. Back when President Kennedy said, "We're going to go to the Moon," everybody said, "We'll never make it." We made it.

Chairman VOLCKER. I have a great deal of sympathy for that point, Mr. Chairman.

But the question is how do you best approach that problem of giving a sense of continuity of policy and confidence in the outcome over a long period of time. That's what we're talking about.

While I have a great deal of sympathy for that broad purpose, I would question whether this particular approach is the way to do it.

I think that's a useful thing to discuss over a period of time; that is, what kind of broad guidelines and objectives, to use that word in the widest sense, should we have on a continuing basis.

I think, in a sense, that's what Congress said it wanted in the Humphrey-Hawkins Act originally. And that was, in some sense, the impetus for the emphasis on the monetary aggregates.

I take it there's some restiveness about that now which suggests that this matter should be thought through quite carefully. I understand that objective. I sympathize with that objective. It's a question of how to approach it.

The CHAIRMAN. Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Mr. Volcker, I have a number of questions, and I will try to keep them short. Since we only have 5 minutes, I would ask you to try to keep your answers as succinct as possible.

Would you like to be reappointed Chairman of the Federal Reserve Board?

Chairman VOLCKER. I don't think I want to comment on that subject.

Is that a short answer?

Mr. LAFALCE. If reappointed, would you accept?

Chairman VOLCKER. I don't think I want to comment on that one either.

Mr. LAFALCE. We have talked about the "whys" for the high interest rates, high real interest rates. And I realize that the stock market would be hanging on your every word.

But at one time, you suggested that real interest rates were probably a little too high. It's my judgment that they are still too high.

What is your judgment now?

Chairman VOLCKER. I have said, upon a number of occasions, and say again today—there's apparently more impact on the market when it's an unidentified official——[Laughter.]

But I'll be an identified official.

If the inflation outlook is as improved as I think it is—of course, I'm making some assumptions about the future policy in a number of directions—then these nominal interest rates are, indeed, not only high historically, but also relative to what is necessary and desirable to sustain a long, healthy economic recovery.

Mr. LAFALCE. If I may interpret your remarks, I interpret that as a clarion call to the financial institutions of America to bring their interest rates down, that those real interest rates are, indeed, too high now under existing conditions.

Chairman VOLCKER. You say interest rates too high now. We are having an economic recovery, in my judgment at the moment, with the existing level of interest rates. I would not make a case that in the short run the current level of interest rates is incompatible with business recovery.

The comment that I just made is addressed to what seems to me desirable and necessary over a period of time. But I don't make a clarion call to the financial community. I think, in the end, they have to reach their own judgments on these matters, because a recovery is not going to last if they are simply responding to a call from me, clarion or otherwise.

Mr. LAFALCE. Let's go through a couple of suppositions.

Suppose you were chairman of a bank, as opposed to Chairman of the Federal Reserve Board. In your judgment, would the economic conditions that exist today suggest that the interest rates you are charging should be lower than those generally being charged today?

Chairman VOLCKER. Consistent with what I just said, I would certainly be on the hopeful side in that connection. If I saw opportunities where I could further the long-range interests of the institution by being on the leading edge in terms of some of my long commitments, I think consistent with what I just said, I would have to take those.

Mr. LAFALCE. Good. I interpret that as a clarion call. [Laughter.]

Let me pursue that a little bit more, because you talked about being on the leading edge, cutting edge, et cetera.

I don't think that the financial institutions of America have been very innovative lately in responding to the economic needs of America.

And since December 1982, they have virtually been given tremendous increases in assets. I don't think they know what to do with that money right now, and I don't think they are using it very wisely. I don't think they're being innovative enough.

For example, I saw one bank within the past week or two that reduced their rate for an automobile loan from—I think it was 16 percent to 13 percent. And I applauded that, but it made me wonder why they hadn't been reducing it over the past few months from 16 to 15½ to 15 to 14, et cetera. It made me wonder why others across America aren't doing the same.

I notice a local bank here in Washington offering an 11-percent rate, or an 11½-percent rate, on an automobile.

Other banks are offering mortgages—variable-rate mortgages, to be sure—at below 10 percent.

Do you think the financial institutions of America are being as innovative as they should be in responding to the new legislation that is on the books and to the needs of America for economic recovery and their important role in fulfilling that need?

Chairman VOLCKER. Before you put in that phrase, I was inclined to comment that I often think, at this particular stage of things, that financial institutions of America may be a little more innovative than I would like to see sometimes, that there has been very rapid change——

Mr. LAFALCE. You're talking about one thing. I'm talking about something else.

Let's talk about what I'm talking about, helping the consumers, as opposed to branching out in Florida, Texas, what have you.

Chairman VOLCKER. It's a hard judgment to reach; you're really interested in the rate level, I suppose, and how aggressively they're competing through interest rates.

You're quite right in saying they have attracted a great many funds in recent months, particularly through this new money market deposit account, and their liquidity position is substantially improved.

They also paid quite a lot for those funds—particularly in the early days, but even now—relative to the market short-term rates.

Mr. LAFALCE. They're putting it in short-term CD's, sometimes at a negative spread.

Chairman VOLCKER. On the other side of it—and I come back to the first point I made in response to Mr. Wylie—an institution has to look pretty carefully at putting money into a 30-year mortgage. I suspect some of them are doing that; they are really making that a bet on the future. You come back, in part, to the question of confidence to which I referred.

Look at the consumer loan rates. As you well know, some of the finance companies—the captive finance companies of the automobile companies have—indeed, been very aggressive in providing autombile credit at rates as low or lower, relative to market rates, than historical experience would suggest as normal. And that's a big segment of the market.

The CHAIRMAN. Mr. Lundine.

Mr. LUNDINE. Thank you, Mr. Chairman.

Chairman Volcker, I would like to turn our attention to a global subject.

Business executives who are knowledgeable about international trade and finance uniformly, at least in my experience, claim that the U.S. dollar is over-valued, particularly with regard to the yen and the mark.

They firmly believe that foreign governments and central banks manipulate currency to achieve a favorable competitive position. This obviously has serious effects on U.S. competitiveness.

No. 1, do you think that there is an exchange rate problem? And what could you comment regarding the diagnosis of that problem?

And No. 2, if there were such a problem, who has the basic responsibility to address it, the Federal Reserve Board or the Treasury?

Chairman VOLCKER. This is a very large area that you opened up. I think there is something of an exchange rate problem in the broader sense. We have had a lot of instability, very wide movements up and down, of the dollar over the course of the past 10 years. Some of those movements are clearly explicable in terms of what's going on in the economy here or abroad, but the extent of those swings, it seems to me, have been very large and potentially and actually disturbing at times. I would rather see a system that didn't swing so much.

In that sense, I think there is a problem. I don't have the sense that there's manipulation, in terms of attempting to get competitive advantages in the current situation. I think the relevant question is your last one. By implication, what do you do about it, whether it is the Treasury, the Federal Reserve or somebody else? It is one thing for me to say—and it's always easy to say in retrospect—that we have had some big swings that were reversed; maybe it would have been better if we hadn't had such big swings. The question is, what do you do about it? The exchange rate reflects everything going on in the economy here and everything going on in the economies abroad, with a lot of expectations mixed in.

But let's look at some particular factors, as we look ahead. Certainly, interest rates are one factor, and the extent we or others influence interest rates or foreign central banks or governments influence interest rates, that is a factor. There is the underlying inflation trend and what people think about inflation. To the extent the dollar is strengthened because there are improved prospects for American inflation, that basically is a good thing.

But look back on the interest rate factor, the financing factor itself. I think one thing you should be aware of is that to the extent that the Treasury puts a lot of pressure on financial markets through the deficit, to the extent that the Treasury is, in effect, preempting a very large share of domestic savings—and the deficit is going to get financed in the end, somehow—then with the very open financial markets that we have, the pressures on the domestic market will attract money from abroad, to put it overly simply, to finance the Treasury directly or indirectly.

That capital inflow tends to keep the dollar higher than it otherwise would be. You have a basic response to too much weight and pressure put on our own domestic savings capacity. If we exceed our capacity to save domestically, then the natural reaction would be to draw in funds from abroad. That is just not true of the United States—it happens to be true of the United States now—but it is the lesson of history in a great many countries. If you run an excessive internal deficit, it tends to push you into external deficit; the financing comes in from abroad, and you get into debt in a heavy way. We don't, I think, have to worry at the moment about the extent to which we are indebted abroad. What we see is the exchange rate impact of that; it tends to drive up the exchange rate.

As I look ahead, and if you are concerned about the dollar becoming overvalued in some sense, I think you have to consider the interrelationship of that with general financial policies domestically, and particularly with the budgetary problems.

Mr. LUNDINE. Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Chairman Volcker, I would like to follow up on the discussion about the general purpose of these hearings. You used the word useful, you find them useful, but I find them at times very frustrating.

Chairman VOLCKER. Those aren't mutually incompatible sometimes, I find.

Mr. PAUL. I feel like they are frustrating because they never seem to achieve very much. I think, at times, it is somewhat of a charade that we go through, not so much that it is deliberate, but it is sort of inevitable because of what exists today in this country with regard to money. For instance, just the other day, Governor Wallich was quoted as saying, "I think a great deal of uncertainty surrounds the money supply numbers. The nature of money is changing." I find that very intriguing, because I think that is the number one problem in the nature of money. As a matter of fact, I think the charade and hostility and the propaganda and the politicizing is going to continue absolutely until we solve that problem of defining money. For instance, this past year, we got the report that M_1 was to increase between 2.5 percent and 5 percent. We missed it a little bit. It went up 8.5 percent. It's not too bad an error—70 percent.

Now a businessman can't quite get away with that, but I guess if we can create credit now, it doesn't matter too much. This year we estimate 4 to 8 percent, but if we miss it by the same amount, we are going to have about 12 percent, but we are already closer to 14 percent. This is the source of my frustration, that we do a lot of talking and planning, but to me it is sometimes just a big charade.

What is so wrong with talking about a monetary system where we can address the fundamentals? What is the nature of money? What is the definition of money? As long as the leaders, the managers of the money system say the nature of money is undefinable, it's forever changing, why can't we talk about defining the monetary unit as a weight of some commodity? Why can't we talk about a stable unit of account? Why can't we think about letting the market create credit rather than a planning board?

We know that planning doesn't work in Russia, where they plan their farming. Why do we think we are so brilliant, that we can plan money, and that the market is unable to do it? It seems that we have to get to these fundamentals. For instance, I see a contradiction in the economic indicators. If money supply goes up, if I am correct, I think this is a positive sign for economic indicators. And yet today, the markets don't interpret a money supply increase that way. Last week, if the supply of money had gone up $5 billion, the market this week would have been different. It went down $100 million. So the market reacted in a positive way, because it anticipates what you are going to do and respond to it. I think this is a remnant from the true monetary standard, that when credit is created in a growing economy it is created by the marketplace, and this is a very positive thing. But under today's circumstances, I think it is ironic that we still list a money supply increase as a positive indicator.

Is the time right? Don't you think we should get back to some fundamentals in trying to define money once again?

Chairman VOLCKER. I certainly think we ought to discuss this issue. You put it in the context of planning, of growth in the money supply against an alternative of some kind of commodity standard. I suppose I would say, just semantically, that is a different kind of plan. It's still a plan; the question is what works best over a period of time, and that is a very legitimate question to raise.

Basically we follow the money supply because, at this stage, I would say the relationships are not completely indefinable; the basis of the approach in any way implies some relationships that can be relied upon out of past history. But in the end, you have to decide whether that is a better way to approach it than going to a commodity standard or to, let's say, a GNP targeting standard, as may be implied by some of these other resolutions, or to some mixed standard. That does seem to me to be the issue.

You ask is it worth discussing? I certainly think it is much better to discuss it and debate these issues, because they are very fundamental issues, than to stick one particular version on a budget resolution. That was my only point.

Mr. PAUL. I think the time is right, because I don't see how anybody can defend the current system we have, with the chaos that exists. So, I welcome the opportunity that we followthrough and have more discussion on these lines.

Thank you. My time has expired.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Chairman Volcker, you implied in your statements with respect to the issue over whether or not the Federal Reserve Board or the

Federal Open Market Committee ought to set out various other types of objectives, that there was an intention to comply with Humphrey-Hawkins. I think you are well aware that I and others on this committee have been concerned about the method with which we comply with that.

Frankly, I think that you should. I think there is a tendency here to drop the defenses, to shore up things, and to say that we want our independence, and that is sacrosanct. And therefore, that is the major objection to accepting any type of change. But the fact of the matter is that in 1982, you found it necessary to substantially depart from the monetary aggregate system that you instituted in October 1979, one that I disagreed with and others have disagreed with since then.

In any case, we, therefore, think it is appropriate to look at more specific aspects in the context of what you do. Surely, you do look at unemployment. Surely, you do look at these other factors. The real question is, what would the fiscal policy of this country look like, if the Congress only dealt with what we spend and what we take in in revenue and not, for instance, say that we have any goals with regards to unemployment, any goals with regards to GNP or economic growth. And that, basically, is what you have submitted and what you persist to claim is the only role you want to have.

In other words, we would like to see, and it is inherent in the Humphrey-Hawkins Act, is the assumption that there is going to be a coordination between fiscal and monetary policy. But what we have on one side of the monetary policy, it seems to us, is a reluctant participant or participants that says we are only going to say what M_1, M_2, and M_3 is. We don't know what the hell that means exactly, but that is what we are going to deal with.

We used to always think that we were one leg behind. We were dealing with the interest rates, with Burns and Miller, but we find we are not only one or two, but we are three steps departed from what the sense of reality is.

What we would like to do is start stating these objectives specifically. Believe me, I am sure that Reagan and Co., Carter and Co., and also of us are embarrassed when we set a deficit at zero that ends up being $60 billion or a deficit at $100 billion that ends up being $200 billion. It is damned embarrassing, both politically and otherwise.

You should be able to share a little bit in that embarrassment with us, in the sense that you do impact upon unemployment and upon what the state of the economy is.

We're saying, "Let's start setting those specifics now." It doesn't deal with independence. I guess some of us have a different posture with regard to your independence, as well, but we would at least like to say, since what you have been using in terms of monetary aggregates is imperfect, at least in the sense that you have departed from it, let's look at a wider range of things where you can specifically talk about these, and maybe as objectives specifically report to us. Then I think if we have this type of interfacing and this type of cooperation in terms of Humphrey-Hawkins, we would be more in the spirit of what it actually is supposed to do.

Chairman VOLCKER. I understand your concerns, and why it looks, from that perspective, plausible to set down these objectives. Certainly, we look at unemployment, we look at growth rates, we look at what is happening to inflation when we make our policy. I can only respond to you along the lines that I have already indicated. Frankly, I think we are all groping with precisely what is meant by this resolution.

I would repeat my concern that the process may be the substance at some point, and that either now or later the process of setting down something that is called an objective rather than an assumption or a forecast may lead to false impressions——

Mr. VENTO. If there is any misunderstanding, Mr. Chairman, it doesn't start with me. I think I understand what an unemployment rate is as an objective. I understand that gross national product is as an objective. I understand that an inflation rate is as an objective. I think that to suggest that there is somehow some confusion here is really begging the question. I think that is what you are doing is begging the question. I understand that you don't want to do it. That's what I understand. You are coming through very clear to me. It comes through very clear as to what you do and don't want to do. And I don't think denigrating that is really the answer, Mr. Chairman.

Chairman VOLCKER. I don't think denigrating that is the answer. The only satisfactory answer I know is that we approach the question of what is an appropriate way of formulating monetary policy and expressing our objectives over a period of time. If you put the objective 5 years ahead, I have no trouble in saying our objective should be reasonable price stability, full employment, good growth. But is that a helpful operational approach?

Mr. VENTO. Mr. Chairman, my time has expired.

The CHAIRMAN. Thank you.

The Chair would like to note the presence of the distinguished gentleman from Connecticut, but he is not being called on at this point. I just want everybody to know that he is here. [Laughter.]

Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman, for again being with us. Are you suggesting over the next few months we could go through a lot of discussions in this committee and other related committees on how to meet these objectives we are all talking about, saying there was an opportunity in the budget resolution to participate in that and that we ought to be doing that?

Chairman VOLCKER. If you want to, let's say, amend the Humphrey-Hawkins Act and deal with this question of the monetary aggregates, yes, I would like to participate in discussions with the committee as to the best way to approach that.

Mr. LOWRY. Thank you.

Page 3, you refer to the needed discipline required, no more in any area than the Federal budgetary process.

That's primarily referring to the deficit?

Chairman VOLCKER. Yes.

Mr. LOWRY. What is the effect in 1985, 1986, of a $200 billion deficit?

Chairman VOLCKER. I think the effect, along the lines that I suggested to Mr. Lundine, will be to put pressure on our capacity to save; if that means higher interest rates than you would otherwise have, it means more pressure on the dollar, than you would otherwise have.

The most favorable kind of conclusion you can arrive at is that it's bad for investment, bad for housing. But there may be offsetting benefits if benefits is the right word—in terms of consumption, because the deficit itself would tend to keep up income.

My concern is that the net impact will be even worse than that. Because of this continuing pressure on the financial markets, you may get some disturbances, anticipations, that would give you an even worse economic performance than the weakness of investment and housing relative to consumption alone would suggest.

Mr. LOWRY. We've had many economists testify before us that they really foresee the problem of a deficit in those years as greater than a deficit in 1983 and 1984.

Do you concur in that?

Chairman VOLCKER. In general terms, yes, partly for a relatively simple reason. A large share of the current deficit in 1983 reflects the immediate business situation, the recession, the unemployment.

When you look at the budgetary outlook in 1985, 1986, I, at least, am implicitly or explicitly assuming that we are going to have a period of recovery from now until then, that unemployment will be lower, that we will then be looking at what has come to be called a structural deficit.

Financing that deficit when the economy is growing and people other than the Government want to raise a lot of money poses a much greater problem than it does in the middle of a recession when other credit demands are low.

It's those outyears that are more troublesome than the inyears.

Mr. LOWRY. So, a budget approach that gave us a $30 billion lower deficit in 1985 and $40 billion lower deficit in 1986 would be preferable as far as the extent of the pressures on the financial marketplace?

Chairman VOLCKER. Those numbers that you use are not very big relative to the size of the projected deficit. It's in the right direction obviously.

Mr. LOWRY. So, you would like numbers larger?

Chairman VOLCKER. Yes, considerably larger.

Mr. LOWRY. In that same page of your statement, you say you take encouragement from the successful effort to reach a compromise in social security legislation.

Is that primarily, again, because of the handling, at least for the time being, of the social security deficit?

Chairman VOLCKER. I was referring in that sentence to handling the social security just within the framework of the social security program; in dealing with that shortfall we also improve, to some extent—not very greatly, but to some extent—the overall budgetary picture.

Yes, I think it's fair to say I was encouraged in the limited sense that we were dealing with a problem within the social security system. But in dealing with that problem, to some degree, we help the overall budgetary problem.

Mr. LOWRY. I assume that's what you meant.

Of course—and I thought we did the right thing on that. I think the President and the rest of Congress did the right thing on that.

Of course, the vast majority of the handling of that problem was incurred from increased taxes, not from reduced benefits.

Chairman VOLCKER. I should not comment officially, but there is a lot of room for debate about how it was done in terms of revenues versus expenditures. In that sentence, I'm looking at the bottom line.

Mr. LOWRY. My time is up. But I think the obvious point of my question is looking for increased revenues insofar as the rest of the deficit in the outyears might be the painful but preferable choice also, looking at the effects in the future.

Chairman VOLCKER. We have discussed the deficit. I guess I am forced to add—I've said this many times—that purely from the economic standpoint, yes, the deficit is terribly important. But from the standpoint of the overall functioning of the economy, the more that can be done on the spending side, the better off you are.

Mr. LOWRY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

Chairman Volcker, you have categorized these hearings as useful, and other of my colleagues have categorized them as frustrating. And I have frequently called them analogous to kissing your sister—it's a pleasant but obligatory act that is not terribly satisfying.

The CHAIRMAN. Do you have a sister?

Mr. PARRIS. I do. [Laughter.]

I have no great desire to perpetuate the rhetorical minuet here, Mr. Chairman. So, I have a very simple question for you.

I, like many other Americans, have held my nose and paid my taxes this week and made my deposit to my IRA, and I got 9.45 percent compounded daily. This is going to require a very modest forecast on your part.

When I do this again next year, will I get more or less? [Laughter.]

Chairman VOLCKER. Consistent with the comment I made earlier to Mr. LaFalce—you're giving me a whole year—I would hope the probabilities are on the side of less. I know you may be interested in a higher rate in your IRA, but if things develop on the inflation front as I hope and expect, and since I think the interest rates are extraordinarily high now, I would think, in the space of a year, they might be lower.

Mr. PARRIS. On that—and I don't mean to be facetious about it, Mr. Chairman, but I will ask one serious question.

The short-term rates on Treasury securities, as you are well aware, have risen from 8.1 to 8.4.

And my question is: Is there a fundamental reason why these rates have risen? And is this a beginning of an upward trend in rates? And should we be concerned about an increase of this size?

Chairman VOLCKER. I suppose you can always be concerned about any change. But a relatively small upward movement in rates—I don't know just what period you're thinking of, but there has been some upward movement in short-term rates over some recent weeks—is not, in itself, of a character or to an extent that, it seems to me, arouses great concern.

I don't know just what period you are thinking of, but I think that that period may have been accompanied by an actual decline in long-term rates.

Mr. PARRIS. I had reference to short-term rates.

Chairman VOLCKER. I know.

But I mentioned the long-term rates because, in evaluating the total interest rate picture, that's certainly an important component. Long-term rates haven't acted just the way the short-term rates have acted in these past months or so.

Mr. PARRIS. It would not then be the first indication that we are, in fact, exceeding the capacity of the domestic financing market?

Chairman VOLCKER. In some sense, we're exceeding it now. We have been exceeding it all along. We are drawing on capital abroad. The exchange rate is high.

We are, even in the midst of a recession, pressing our capacity to provide credit, not as much as we were a year ago, but that is still a factor.

Mr. PARRIS. The only real answer to that, then, is to keep on the fiscal pressure?

Chairman VOLCKER. I think that is correct.

Mr. PARRIS. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

Once again, I add my thanks to you, Mr. Chairman, for staying.

I have a practical question, which I will then follow up with some others. This is a question that numerous constituents have asked me in the last month.

Mr. Chairman, if you were a first-time home buyer, would you chose a fixed- or a variable-rate mortgage?

Chairman VOLCKER. I'm not going to get into that one.

Mr. SCHUMER. Come on. Millions of Americans are waiting.

Chairman VOLCKER. Look, I had to face that precise question within my own family, and I took the only wise course—telling them that's their decision. [Laughter.]

Mr. SCHUMER. So, that's what I ought to tell all my constitutents who are asking me?

Chairman VOLCKER. It depends upon their individual circumstances and all the rest.

Mr. SCHUMER. To rephrase the question, do you think mortgage rates will go down or stabilize over the long-term period?

Chairman VOLCKER. I'm not going to make interest rate forecasts. I will make an analytic point—I'll make it again—that if the inflation outlook is as good as I think it is, then you can discount these recent figures a bit. But if the basic trend is downwards, as confidence grows in that, I think the outlook for interest rates is in the downward direction.

A huge qualification I have to put in that analysis is what happens to the budget.

Mr. SCHUMER. My second question relates to banking deregulation.

There has been a lot of talk about deregulation of money and the new money market accounts that the banks have. And that makes it more difficult and may even obliterate the line between checking and savings, and it makes your job more difficult.

How much do you think—I have not heard too much talk about the general deregulation of money as pushing interest rates up so that they will never really come down. There's no more zero percent money sitting in our banks. There's becoming less and less 5¼ percent money.

And aren't we, by deregulating left and right, creating higher interest rates, interest rates that will never decline to the rates that used to prevail, and thus creating a major change in our economy?

Chairman VOLCKER. I think you overstate it. But I made the thrust of your point earlier that I think, in the kind of financial climate we have now—taking the average of good years, bad years, years with pressure on markets, restraining years, nonrestraining years—that when you're in a phase of restraint, more of that will be reflected in higher interest rates than under the old financial environment. On the average, that will probably produce higher interest rates.

You say interest rates never can come down. No, I don't believe that.

And there are many other——

Mr. SCHUMER. But the days of, say, mortgages at 5 percent or 6 percent are over for good, wouldn't you agree with that, no matter what happens?

Chairman VOLCKER. I like to look way into the future, and I hope those days aren't gone forever. Those days of 5-percent mortgage rates followed a long period in the economy when people didn't worry about price stability. Of course, they had a long depression, which is not a good way to get there. But they had become used to and accustomed to low interest rates.

If you have confidence in a stable financial environment over a long period of time, those types of interest rates would be quite normal.

It's going to be very hard to get back to that climate, because everybody has lived through the late 1960's and the late 1970's.

Mr. SCHUMER. Isn't it also true that banks' cost of money has also increased, regardless of the climate? And once you deregulate, you're never going to go back there no matter how much confidence people have?

Chairman VOLCKER. Again, there is something to that point.

But if you say you never can get back to a 5-percent mortgage rate, I don't believe that.

Mr. SCHUMER. It's most unlikely.

Chairman VOLCKER. If of the economy, particularly the price level were stable long enough, if there were enough confidence in that being maintained, we could get back there. If you ran into a year or two where policies were quite restrictive, there wasn't enough money, enough savings to go around, yes, you would get a higher interest rate during that period of time in this new financial climate than you would have gotten 15 years ago, for the reasons you suggest.

Mr. SCHUMER. Right.

My final question, just phrased another way.

Do you think that the Federal Reserve, the administration, the Congress give enough thought to the long-term consequences of financial deregulation in terms of their effects on the overall economy, as opposed to the effects on the individual financial institutions?

Chairman VOLCKER. I think, so far, not enough.

This committee and the Senate committee are to have legislation in front of you that will be the occasion for trying to think through the longer term consequences. I think that should be done. You are going to have one of those rare occasions to do it, where I think the issues will be put on the table in front of you and you will be able to make a judgment.

There are so many things going on in the financial world now that I think it is urgent that the Congress sit down and decide; the traditional, legal, customary, framework is eroding very fast.

Let me give you two instances of it. The Secretary of the Treasury commented on both of them recently.

We have some sweeping legislation proposed in some States. Some of the States say, "You can have enormously sweeping powers if you're a State bank so long as you don't operate in my State. You can operate every place else."

I think that obviously raises some questions about who is going to control the evolution of the banking system. It's one of those events forcing us to come to grips with the issues.

The other one is these loopholes—if that's the right word—that people have found in combining banks with institutions that most people thought were separated from banks historically. Some actions are being taken to close off that loophole—not to prejudge the issue, but to permit enough time for the Congress to consider the direction they want to go in an orderly way. And I think it's important that loopholes be closed off for that reason.

Mr. SCHUMER. Thank you.

My time has expired.

The CHAIRMAN. Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Mr. Volcker, you have been quoted in the past as hoping that the inflation rate of this country could be stabilized in the range of 2½ to 3 percent in the next decade. There are some financial analysts who believe that if that could be done the interest rates on the prime in this country would be somewhere around 8½ to 8¾ percent. There are those who are more optimistic than perhaps you yourself would be, based on your comments and answers to the last question, if we did stabilize the inflation rate.

What I would like to know is, assuming the favorables of stability and the inflation rate of the 2½ to 3-percent range and assuming within the next decade the interest rates fall to 8½ to 8¾ percent or better, what would be the outlook for the money supply? Where will we be?

Chairman VOLCKER. Let me make a preliminary observation. I don't think I have ever said 2½ to 3 percent, that kind of narrow range. I think we should aim for general price stability over a period of time.

The question is where the money supply would rise relative to the economy at a low or nonexistent inflation rate on a kind of trend basis.

I am not going to give you a certain answer to that question for two reasons. If we look at the past 25 years or so, using M_1 the relationship between the money supply and nominal GNP has shown a quite clear trend; smaller growth in the money supply than in the nominal GNP. Velocity was rising at, let's say, 3 percent a year on the average.

I suspect, myself, that in a stable economic climate of the kind that you project, in a lower and stable interest rate economy, I am not sure that that upward trend in velocity, downward trend in the money supply relative to GNP, would persist as a normal situation.

I think that is even more true if we pay interest on the money supply, in effect. We didn't use to do that, and there was a great incentive, particularly when interest rates were high, to keep as little money in the bank as possible. Those incentives are different when you are paying interest on money.

For those reasons, as a first approximation, not knowing with certainty—you can look at the evidence as it develops over a period of time—you would think that the money supply would rise much more in line with the nominal GNP, let's say, over time.

But on top of that a lot of financial innovations that blur the very distinction between a checking account and a savings account or a time deposit and you throw in another factor that would have to be evaluated if——

Mr. McCOLLUM. Mr. Chairman, let's assume for a moment, if the money, the velocity, which has been declining, returns to more normal levels, how would that affect the monetary supply and monetary policy?

Chairman VOLCKER. We would presumably take that into account. I am sure we would try to take it into account, with the procedures we use now, estimating and setting forth our monetary targets relative to the continuing objectives of stability and growth and all the rest.

But it would affect the level at which those targets were set.

Mr. McCOLLUM. Mr. Chairman, one last question. Last week, the Comptroller of the Currency announced a moratorium on the chartering of so-called nonbank banks until January 1, 1984. I assume you support that moratorium.

I would like you to comment on that and also comment on whether or not the creation of such nonbanks has impinged on the conduct of monetary policy, or if it is continued or allowed to resume, will it impinge on the conduct of monetary policy?

Chairman VOLCKER. I don't think anything that has happened so far impinges on the conduct of monetary policy, but I certainly think that was a step, a limited step, in the direction I was just talking about with Mr. Schumer. We are setting precedents here. We are getting institutions in place that may or may not be consistent with the evolution of the financial system you would like to see.

I very much support a standstill on this kind of innovation for a limited period of time, so that Congress can debate the issue of which way you want the financial system to go.

Now, I could imagine an evolution, even at the rate of speed things are moving. We are not there yet, but you can imagine a rate of evolution that resulted in a quite different definition of money, if we can define it at all, along the lines of apparently Governor Wallich's comment. I don't think we are there yet, but you can imagine an evolution that created problems of that sort.

You can imagine an evolution that changed the institutional structure enough so that it would affect—not the objectives of monetary policy—but the way you conduct it.

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

The CHAIRMAN. Mr. Patman.

Mr. PATMAN. Thank you.

Chairman Volcker, on or after October 1979, when changes were made in monetary targets and actions were taken to achieve those targets, did you know significantly higher rates of interest would result?

Chairman VOLCKER. In 1979?

Mr. PATMAN. 1979 and thereafter.

Chairman VOLCKER. I think we said explicitly, when we made the announcement, that we would expect a lot more fluctuations in interest rates, and implied in that statement the possibility that they would be higher for a while.

I did not, just in the interest of full disclosure, think that interest rates were going to be as high as they were for as long as they were.

Mr. PATMAN. You expected them to be higher, didn't you?

Chairman VOLCKER. I thought they could be. If I would have had to have guessed, I would have thought that in the short run they would rise.

Mr. PATMAN. How about rates of unemployment? Would they rise? Did you anticipate that?

Chairman VOLCKER. I am trying to put myself back in that particular setting.

Mr. PATMAN. You don't have to go all the way to October 1979, just anywhere in the recent history.

Chairman VOLCKER. Let me answer your question this way. I thought, in the process of moving down from a high and accelerating rate of inflation, we would go through a period of disturbed economic conditions, that the risk of a recession would be high; I think I stated that in public at the time.

Mr. PATMAN. So you expected higher interest rates and unemployment to result and perhaps higher bankruptcy rates, too, is that not true?

Chairman VOLCKER. Apart from the correlation between bankruptcy rates and financial pressures and recession, I didn't have any particular expectation about bankruptcy rates.

Let me say, I expected this pain in the context of moving to an economy that over time would be stronger, healthier, with more employment and more stability in the long run. That is the only reason you do this.

Mr. PATMAN. Did you calculate the enormous cost that resulted from these higher interest rates?

Chairman VOLCKER. I didn't expect interest rates to be as high for as long as they were.

Mr. PATMAN. All right. Now that they have occurred, have you calculated the results of those high interest rates? Do you know how much damage they have done to this economy, to this country?

Chairman VOLCKER. I don't know how you calculate that.

Mr. PATMAN. Calculate it on the basis of business bankruptcies. Have you been concerned about that?

Chairman VOLCKER. Yes, but business bankruptices are not the only factor to look at.

Mr. PATMAN. Of course. What damage has occurred? Can you enumerate some of the instances?

Chairman VOLCKER. There has been a lot of pain in the economy, a lot of short-term damage.

Mr. PATMAN. I am not talking about pain. I am talking about real damage that has been done to this country.

Chairman VOLCKER. Compared to what? That is the question.

In my view, the greatest damage, the most lasting damage to this economy would have been caused by a failure to face up to the inflationary problem.

If you don't believe that, we have a disagreement.

Mr. PATMAN. What I would like you to do, though, is calculate the results so you really could make the comparison, not just say, well, something else would have resulted.

Chairman VOLCKER. I would not only have to calculate what has happened recently; I would have to make some calculations of what will happen over the next 5 or 10 years to make that comparison.

Mr. PATMAN. There is a great concern in this Nation that higher interest rates may prevent an economic recovery in this country.

If the Federal Reserve institutes policies which are likely to result in higher interest rates, should not the President be apprised of that, made aware of that?

Chairman VOLCKER. I think the President should be aware of all the continuing problems.

Mr. PATMAN. Will you notify him, then, when that occurs?

Chairman VOLCKER. I am not sure what the premise of your question was. That interest rates are going to go up or down——

Mr. PATMAN. At least tell the President if you are going to institute a policy that will result in higher interest rates.

Chairman VOLCKER. I simply don't see it in the same way that you see it, Mr. Patman. You say that we might institute policies that result in higher interest rates.

I say there are a lot of other factors in addition to our policies that affect interest rates, and the end result in the market shouldn't be singlemindedly traced to what we do.

Mr. PATMAN. But when you make a change in policy, do you not know the results that are likely to occur on interest rates just as one factor?

Chairman VOLCKER. With less precision than you may think.

Mr. PATMAN. Regardless of that. But do you not know what interest rates will occur—higher interest rates or lower interest rates are likely to occur?

Chairman VOLCKER. Do we not know, Know with a capital K—the answer to that is no.

Mr. PATMAN. You don't know what is going to happen; it comes as a surprise to you as a result?

Chairman VOLCKER. Sometimes it does, and sometimes it doesn't.

Mr. PATMAN. You have a projection, do you not, at the time you take your action as to whether or not interest rates will go higher or lower as a result of your action?

Chairman VOLCKER. We do not have a mathematical projection. I am sure everybody sitting at the table has some feeling about which is more likely, to happen.

Mr. PATMAN. So you are saying it comes as a surprise to you and other members of the Board when interest rates go higher or lower whenever you take an action on the Federal Reserve policy, monetary policy?

Chairman VOLCKER. Occasionally it does. Go back to 1979, because I remember that quite clearly. I thought there was some risk—if that is the way to put it—when we introduced a new operating technique, that the immediate effect on the market would be higher short-term rates.

I also had at least a hope, more than a hope, that the net effect of that policy would be, in a short period of time, to produce lower interest rates. That was a misjudgment in the light of history, but it happened to be my judgment at the time.

Mr. PATMAN. And have you calculated the cost on that in any respect?

Chairman VOLCKER. You raised that question before. We haven't calculated it in a numerical sense. I would simply repeat that we make these judgments on the basis of what we hope and expect will be the least cost to the economy over a period of time.

Mr. PATMAN. But you do care?

Chairman VOLCKER. Care? It is our job to care.

Mr. PATMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Roemer.

Mr. ROEMER. Thank you, Mr. Chairman. I would like to compliment Mr. Volcker for his appearance and testimony today. He is a master, either by birth or by practice, at these hearings, and I mean that complimentary.

Your testimony is worthy of some study. Let me follow up on what my colleague from Texas has, I think admirably, been trying to do and phrase it a different way.

In your written testimony and in your answers to questions today, you have shown a great deal of reluctance—not a closed mind, but a great deal of reluctance to set different types of objectives for Fed policy.

Specifically, you seem to show preference for continuation of the monetary aggregate objectives rather than—let me call—less esoteric objectives; for example, interest rate levels.

Is it, in fact, true that your reluctance is based on a fear or concern that the Fed, through its monetary policy, will not in the future be able to do exactly what Mr. Patman said that you did in the period in and around 1981, where, because of your fear of inflation and what it was doing to this economy, you deliberately had a policy that raised rates to abnormally high levels as the only method to control inflation?

Is that your fear or your concern about different objectives?

Chairman VOLCKER. That isn't quite the way we saw it at the time. As I was trying to convey to Mr. Patman, I did not—to speak for myself—think it was inherent in the policies that we adopted then that interest rates would remain at abnormally high levels for any really significant period of time.

In fact, you may recall—to trace out the history a little bit—rates went up immediately after our action and I think stabilized for some weeks and months; then they went up and had a real spike early in 1980; then they came down very rapidly during the spring and summer of 1980. It looked, at that point, mistakenly, as though that interest rate episode was short, but over.

Mr. ROEMER. But, Mr. Chairman, to be fair about it now, in 1980 we had some credit controls applied which brought the rates down. When they were relieved preelection, the rates went back up right after the election. Now, I think that is a fact.

Chairman VOLCKER. The rates went up well before the election.

Mr. ROEMER. You used the word spike, and we had a monumental spike?

Chairman VOLCKER. In early 1980.

Mr. ROEMER. Yes, then again in late 1980 and early 1981 through 1981?

Chairman VOLCKER. That is correct.

Mr. ROEMER. Is it not true that there were conversations in the Fed that laid it on the table, that said in order to fight inflation, in order to deal with the problem in this country, that interest rates had to go up, that, as Mr. Patman tried to get from you—let me try another way—that you had to raise interest rates to fight inflation?

Is that true?

Chairman VOLCKER. Some people might have seen it that way, but I think those conversations went on within the Federal Reserve in a slightly different way.

We said we have to deal with inflation, that it is going to take monetary restraint to deal with inflation. There weren't any other tools that we had or anyone else was applying at that time. We knew that would for a period of time, depending on how the economy was acting, and imply certainly the risk of higher, and perhaps substantially higher, rates of interest.

That's as far as I think it's fair to go. Nobody was saying it was desirable to have a higher rate of interest, or that we had an interest rate target—I certainly wasn't.

We accepted the need to restrain growth in the money supply and growth in credit in the interest of getting inflation down. Indeed, our feeling was that you would never get interest rates down permanently unless you dealt with the inflation problem, and that involved the probability of some instability in interest rates in the short run. The instability itself, I suppose, implied the risk of relatively high rates for some period of time.

The CHAIRMAN. Will the gentleman yield to the chairman?

Mr. ROEMER. I'd be happy to.

The CHAIRMAN. Let me try to rephrase it. I realize that no one at the Fed would want to say that it was desirable that interest rates go up, but in order to deal with inflation, you had to take certain action.

Chairman VOLCKER. Right.

The CHAIRMAN. Was it not, though not desirable—I'm trying to rephrase this. Though not desirable, rather obvious that the consequence of your actions would be an increase in the interest rates, though undesirable?

Chairman VOLCKER. You say, obvious. All things become more obvious in retrospect than they were in prospect.

The CHAIRMAN. Let's strike the word obvious. Let us say it was a probability that as a consequence—interest rates would——

Chairman VOLCKER. I'm not really trying to be difficult, but I think this conversation does not reflect the way it looks to a policymaker at any particular point in time.

You've already got an interest rate. You've already got a money supply. You are taking some marginal action. There is usually room for some debate about whether the particular action you are taking at that particular time is going to have a pronounced effect on interest rates in either direction.

Look where we're sitting today; listen to the conversation that goes on in the press and elsewhere.

There are those that would say action, forceful action, to reduce the rate of growth in the money supply will quite soon bring lower interest rates. That is a point of view which is expressed quite frequently in the financial press every day. Then there are those who say any action to restrain the growth in the money supply is going to bring higher interest rates and have a severe effect on the business expansion.

I cite that because these contrasting wishes/hopes/analyses are prevalent any time you take this kind of action. I'm perfectly willing to say that in the process of restraining the money supply we recognize that it might come about that interest rates will go higher and be maintained at a higher level for a considerable period of time. But I think it is just wrong to suggest that we sat there and said, "We think right now, a 16- or 18-percent interest rate is what is called for in terms of the inflationary situation."

It is just not the way the problem was formulated.

Mr. ROEMER. Mr. Chairman, my time has expired. Could I ask the chairman's permission for 1 minute.

The CHAIRMAN. You get an extra minute.

Mr. ROEMER. Thank you, Mr. Chairman.

Thank you, Mr. Volcker, for your answer.

Let me conclude by summarizing my view of your testimony thus far. Correct me where I am in error. I will make five quick points.

One, the Fed's goal is lower interest rates, but you are unwilling for a variety of reasons to set a target. Two, in fact, you believe that the real rate of interest is if anything, too high at the moment.

Three, although monetary policy is important in interest rates, the key to those rates over the next few years is fiscal policy.

Four, the deficit in the out years is much too high. And five, a deficit reduction is necessary. Spending controls are preferable to tax increases. But a combination is probably required.

Chairman VOLCKER. I think I said all those things.

Mr. ROEMER. Thank you, Mr. Chairman.

Chairman VOLCKER. I didn't really respond to Mr. Roemer's initial question. I might just make one comment about that, if you would permit me, Mr. Chairman.

You asked are we concerned. Was the initial thrust of your question are we concerned about an interest rate target because it would inhibit our ability to raise interest rates?

To rephrase a bit, of that, are we concerned that an interest rate target would lead to pressures or directives to set a particular interest rate that might be inappropriate in our judgment?

Yes, that would be a concern.

The CHAIRMAN. Mrs. Roukema. The gentlelady from New Jersey.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

At this late hour, I don't think there are many questions that can be left to be stated. But I for one, Mr. Chairman, would like to commend you for your statements today.

I would like to have had a little more—a little greater signal of confidence regarding the interest rate question.

Certainly you have indicated confidence in a downward trend. But my people, both consumers as well as investors, are withholding making long-term commitments because of the uncertainty of interest rates.

If you would like to make any further statement on that, I would appreciate it, but I think you've said everything that can be said.

The CHAIRMAN. I think that's probably right.

Mrs. ROUKEMA. I would, however, like to underscore and hear any further comments you would like to make on the issue of the structural deficit.

I have recently returned from my district, and I found the single most troublesome item on the minds of the people in my district is that structural deficit.

And that is the reason for their nervousness about the future.

And then I would like to ask one more question, and that is there have been suggestions that you were reluctant to respond to the committee's request for a report consistent with the congressional resolution, because of fears that it might be a step toward undermining or compromising the independence of the Fed.

Would you comment on that?

Chairman VOLCKER. On the first question about the deficit, I don't think I can add much, except that I think the instinct of your constituents is right, that this is a major concern.

I have had some psychological concern of my own, which I hope is totally unwarranted, that the mere fact that people have a sense that the economy is recovering now and that interest rates are much lower than they were a year ago—even though very high—will lead to a comfortable assumption that this problem isn't all that urgent.

The real problem still sits out there in the coming years, and it becomes more urgent as the economy recovers. It's just nothing we can deal with through monetary policy.

I was glad the question of the exchange rates arose, because that's illustrative of the side effects.

The question of how this resolution may bear upon Federal Reserve independence, let me say, on the face of it, I don't think it does. But part of my concern is with a resolution like that coming up literally overnight, so far as we know. I found in what probing we did that great attachment was given to the word objective as opposed to assumption.

I try to begin thinking through where that may lead. Perhaps I am unduly sensitive to some of these things. On the face of it, the proposal is quite comprehensible and plausible, but I would feel more comfortable if I knew where other people thought it might lead over a period of time.

Mrs. ROUKEMA. Thank you. I would share your concern about that, and I would also like to note for you some unsolicited comments, which are, a number of my people would hope that Mr. Volcker would stay on as Fed Chairman.

Chairman VOLCKER. Thank you very much.

The CHAIRMAN. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman. I have three short questions.

Mr. Volcker, you said you like to look at things in retrospect, rather than prospectively. And seeing as how we've had about a 7-percent decline in inflation since January 1981, I'm curious as to what portion of that drop you attribute to the policies of the Fed versus other factors, such as the softening of oil markets, harvests, and so forth.

Would you comment on that, please?

Chairman VOLCKER. I can't give you an answer. Take the oil prices, which in some sense are a separable factor and have had a measurable favorable effect on the price level recently. Even that is not entirely removed from what is going on in the U.S. economy, from what monetary policy has been over a period of time.

On the up side, many people commented—and I think there is something to this—that the degree and speed with which oil prices rose was related to the general inflationary climate, the general credit market climate during the 1970's. Similarly, I think you would not have had this oil price decline, in my judgment, if the inflation rate were continuing in the United States at double-digit levels in the past couple of years. In that case, we would be sitting here today talking about how much oil prices were going up, not down.

It's very hard to separate out these factors. I think one thing we have to be conscious of is that prices are doing as well as they are doing now because we are in the midst of a recession.

We're not going to have a successful continuing anti-inflation program in the midst of recession. There is no tolerable tradeoff there.

So we have to shape policies that are going to keep the inflation down, as the recovery proceeds, because we don't win until we combine the progress on inflation with a better economic situation.

Ms. KAPTUR. It must be very difficult. You must get very frustrated in trying to decide what extent your policies contribute to declining inflation, then.

Since you don't seem to attribute any of that success, if one defines——

Chairman VOLCKER. I think it adds something to——

Ms. KAPTUR. Do you think you are 25-percent responsible?

Chairman VOLCKER. I'm not going to quantify it. If I resist too much precision in laying out the business forecast, I better not have too much precision in attributing what goes on in this world economy to one instrument of policy.

I obviously think monetary policy has something to do with it, but how you distinguish the effects of monetary policy on the current improvement in inflation from the more temporary effects of recession and a low level of economic activity is the source of my difficulty.

Ms. KAPTUR. So we may have made a major mistake in adopting the policies at the Fed. We have no way of knowing, really.

Chairman VOLCKER. If the future develops the way I would hope and expect it to develop, if we can look back from the mid-1980's or a little beyond on continuing strong recovery—with the unemployment rate progressively lower, productivity higher, and the inflation rate remaining low—at that point, I think you could say that monetary policy gets most of the credit. I don't see anything else particularly helping in that direction.

Ms. KAPTUR. My second question was which factors do you look at when you think about recovery, and I guess you just stated the three that you're going to look for when you try to decide whether or not we are truly on the road to recovery: Unemployment, productivity, and the inflation rate.

Chairman VOLCKER. Those are some of the end results, although productivity does enter into the prospect. Right now, I think we are seeing a few things fairly evidently.

We are seeing a big housing recovery, more than I think the housing experts expected. We are seeing, I sense, some inventory turnaround, and that has provided impetus to production. We are seeing more gradual increases in consumption. We are seeing further decline in business investment and in exports. You've got a tax cut coming along, which should help consumption. But we won't have a well-balanced recovery, the kind you would like to see for it's own sake, and the kind you would like to see in terms of its sustainability, until we see the investment side of the economy begin turning around as well.

Ms. KAPTUR. Those are the four areas, then?

Chairman VOLCKER. I had four or five, I guess. Inventories, housing, investment, exports, and consumption. That gives me five.

Ms. KAPTUR. Thank you very much.

Chairman VOLCKER. Only three of the five are moving in a favorable direction at this point.

Ms. KAPTUR. Thank you.

The CHAIRMAN. Mr. Cooper wanted to say hello to you. No questions?

Mr. COOPER. No questions.

The CHAIRMAN. Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman. I would also like to say hello to you, Mr. Chairman Volcker. I do have a few questions, though.

Earlier in the testimony you were asked, I think, a couple of reasons why you felt real interest rates were staying so high. I believe in response to that question you outlined three primary reasons.

The first of those was the uncertainties of future inflationary expectations——

Chairman VOLCKER. Right.

Mr. CARPER. Second, you mentioned the Treasury's borrowing demands, about three-quarters of a billion dollars a day. Then you mentioned a third factor as well.

I didn't follow that third factor through to the end. Would you recap that for me?

Chairman VOLCKER. In a general sort of way, when we are operating a financial system—which I should emphasize most people think is a better financial system in terms of its flexibility, competitiveness and all the rest—but when you remove a lot of the inhibitions, the restraints that we had in the 1950's and 1960's—which at times restrained economic activity—you create a situation where the restraints don't disappear, but rather come out in a different form; they come out in terms of interest rates.

I think I can illustrate what I have in mind by giving you a more concrete historical example. In 1969, the economy began getting a little overheated, interest rates began rising from what had been a rather low level. We still had interest rate ceilings on financial institutions.

As soon as market rates began piercing those ceilings, institutions—savings and loans, and to some extent banks—could no longer raise money freely in the market, so they cut off their lending—they cut off their mortgage lending, in particular—because they couldn't raise money in the market. We had what was called a credit crunch. That meant some people couldn't get money.

The economy turned down a bit. The pressures on the market were relieved and interest rates went down again, but they had never gotten very high.

In today's environment, if you go through a similar period there aren't any interest rate ceilings. Banks and savings and loans don't have to ration credit; what they do is charge a higher interest rate. Because the market rates are going up, they say, "I'll charge a little higher rate."

The borrowing continues, and the market rates get ratcheted up a little more. I'm exaggerating now, I'm talking in extremes, but instead of cutting off the flow of credit, the effect is higher interest rates.

Eventually that discourages the borrower. We learned it didn't discourage him very fast, and we ended up with a higher level of interest rates over a period of time.

That is a byproduct, if you will, of changes in the financial system that were widely supported intellectually and politically by the institutions involved. It has had some very real benefits, but it has produced a different kind of financial environment.

Mr. CARPER. In moving to address these three concerns, these three factors that are effectly maintaining high real interest rates, I think we both have some ideas on what we can do on the first score, that is, our removing some of the uncertainties of future inflation.

Two, I think we the Congress and I think you certainly and the administration have some ideas about what we might do about the second component, that is, reducing our deficits, reducing the Treasury's demand for credit.

What do we do about the third factor?

Chairman VOLCKER. I'm not sure what we should do because there are benefits in this new environment. A powerful motivating force in changing those old rules and regulations was the fact that people so intensely disliked what they called "credit crunches."

We don't have credit crunches anymore; we have very high interest rate levels, upon occasion, instead.

I don't want to put all the weight on this factor; I gave it less weight than the other factors. But I think there is something to that analysis.

Mr. CARPER. Thank you. One other question as well, sir.

Have you any idea of what the aggregate savings are in the country this year? What is it expected to be?

Chairman VOLCKER. I'm going by memory. Something like 7 percent of the GNP on a net basis would be close.

Mr. CARPER. Does that exceed the Treasury's borrowing demands?

Chairman VOLCKER. Yes, but not by very much. The Treasury borrowing demands are going to be about 6 percent of the GNP; you're very close.

Treasury demands relative to the savings capacity—I'm talking about domestic savings capacity—cyclically get high in a recession, but this is exceptionally high.

Again, the heart of the problem is that in the past we thought that Treasury proportion of net savings absorption would go way down during a period of recovery. As things stand at the moment, the prospects of that going down very much are not very good—I'm talking about before any congressional action. As things now stand, before any action by the Congress on the deficit, those ratios are going to remain very high.

I am being given some figures that show the deficit as a percent of savings.

Net domestic non-Federal savings for 1982: 7.1 percent of GNP. My memory wasn't so bad.

Mr. CARPER. My time has expired, sir. I would just like to thank you for your presence and for your testimony here today.

Also echoing the comments of my colleague from New Jersey, the gentle lady from New Jersey, I think we have some in Delaware as well.

Chairman VOLCKER. Thank you.

The CHAIRMAN. Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman. One thing that has been mentioned only once today, but it would seem to me to play an integral role in your targeting and setting of your M's. Velocity has not done what anyone expected velocity would do here the last several years.

Is there any reason to assume that we are going to be able to predict velocity any better in the next year to 2 years than we have in the last year to 2 years?

Chairman VOLCKER. I think it's fair to say that after seeing these big changes in velocity for the last 18 months—I wouldn't put it at a much longer period than that—that one is bound to be a little more tentative in making a judgment about what the next 18 months may bring. Our working assumption is that you would expect a cyclical movement back to a higher rate of velocity after these historically large declines in velocity.

It's a question of degree. Certainly that is the reason we put less weight on the M_1 number for the past 6 months; I think there is a greater feeling of uncertainty about making that estimate than we would have had a couple of years ago.

Mr. HILER. Is there any way that we coincidentally know what's happening in velocity, or does our knowledge of it lag by a significant time period?

Chairman VOLCKER. We can make a pretty good estimate about what is happening to velocity, currently. It is an estimate, it's not a precise figure, but it gives some idea of what's happening currently.

I suppose the nature of the problem is, in part, that the relevance of today's velocity figure—the absolute current velocity figure—may be limited, because what is going on in the economy today, to the extent that it's influenced by monetary policy, may reflect what happened to the money supply 3 months ago or 6 months ago.

You have to look at it partly in that context. Whatever way you look at it—whether you take contemporary velocity, whether you take velocity with lags—we have had very unusual declines in velocity.

Mr. HILER. The oil price situation with prices having fallen as dramatically as they have is going to have a negative impact on the deficit, certainly in the short term, because of the decline in windfall profit tax.

So on the one hand we have what someone would interpret as good economic news, that oil prices are falling, as ending up being bad news for the deficit.

It has been mentioned quite a few times today that it's that deficit and the fear that that deficit could lead to future inflation, that has the financial institutions a little bit skittish on lowering interest rates.

How do we in a complex economy, how can we point to the deficit figures, whether it's this year, next year, or the year after, and say that that is the reason: that unless we get the outyear deficits down—and many would say the outyear deficits are greatly exaggerated, but unless we get those deficits down, we're going to have higher interest rates while some of the things that contribute to those deficits would have to be interpreted as good economic news.

Chairman VOLCKER. The direct impact of the decline in oil prices on the budget is negative; it's not huge, but compared to the deficit we have, it's negative. Many people have pointed out that progress on inflation itself can have a negative impact on the budget for a year or two.

You ask how you can convince people to take the very difficult actions that are necessary.

The only thing I can answer is to cite again some of the figures that we were just discussing on the size of the deficit relative to our savings capacity. I think you should be skeptical about any particular deficit figure. Nobody is so good that he can project the actual deficit 3 or 4 years ahead or even, very narrowly, what you might think of as the full employment deficit or the structural deficit.

But you don't have to be very precise with these estimates to know that you have got a very big problem now. All the budgetary analysts, inside or outside government, converge on that point.

They might differ by $50 billion or so out in 1987. That sounds like a big number, but when you're talking about an estimate of a structural deficit that may be $200 billion, whether it turns out to be $250 or $150 in 1988 isn't as relevant as the fact that you're in the general ball park of $150 to $250. That requires a major action, not all of which is going to be made this year anyway.

You can hardly go wrong by taking a big bite out of it. It's got to be in the right direction and, through expectational and other effects, it is going to be favorable on the interest rate and business picture in the short run.

Mr. HILER. My time has expired.

The CHAIRMAN. Mr. Bartlett.

Mr. BARTLETT. Thank you, Mr. Chairman. Mr. Chairman, in response to several questions and in your direct testimony, you're telling us what I think we all know but perhaps Congress refuses to acknowledge, and that is that the results of the quite-large deficits coupled with vast increases in spending policies of the budget that at least passed this House is bad for the economy, and you stated it in answer to one question, would be bad for housing and bad for investment.

I wonder if you could describe with more specificity, or perhaps quantify if not at least characterize, the economic results in the years 1985 or 1986 as to how bad for the economy we are facing if this Congress doesn't reverse itself, and if this Congress leaves in effect the large increases in spending coupled with large deficits and increases in taxes.

Chairman VOLCKER. If you are an optimist—and I emphasize if you are a real optimist—the results of the deficits that are in prospect unless meaningful budget action is taken will be high exchange rates, poor exports, significantly higher level of interest rates, a real depressing effect on housing and on business investment. The economy as a whole will continue to grow or to limp ahead because it's going to have a lot of consumption, which is in part related to the deficit itself; I think that's the good news.

It's not a terribly satisfactory economic picture. It's not a picture of a high productivity, high-growth economy sustained over a period of time.

This may be what an econometric equation shows. But econometric equations don't show institutional strains on the financial market; they don't show the risks we're running in terms of the domestic or the international credit situation from prolonged high interest rates and pressures on financial markets; they don't show fully the damage that may be done in protectionist pressures that arise out of a continually high level of the dollar and a depressed trade picture.

Realistically, nobody can forecast any of those things with accuracy, but realistically you have to assume that things may not go as smoothly as a simple econometric equation shows. That isn't a very pretty picture.

Mr. BARTLETT. Would you conclude then that there is some likelihood that unless Congress reverses course on the budget picture, the budget in terms of increasing spending and increasing the deficits and increasing taxes—would you conclude there would be some likelihood of a return to a recessionary economy in 1985, 1986, high unemployment, high interest rates?

Chairman VOLCKER. If you don't take significant steps to get the deficit outlook under control, I think it's quite clear you take many more risks of curtailment, of an early, premature ending of the recovery. I think those risks increase. I can't quantify them, but what seems to be perfectly clear is that those risks are on that side.

It is something you have got to take into account. I'm not talking about a remote contingency, I'm talking about things that are all too real, if you assume nothing is done about the deficit.

Mr. BARTLETT. A very significant likelihood?

Chairman VOLCKER. I don't think you can project what contingencies might arise, but I think you can assume that it puts adverse pressures in several different possible directions.

Mr. BARTLETT. One quick question on one of the institutional subjects that we have dealt with all day on the other side of it. That is, what suggestions would you have, if any, for institutional changes to result in more coordination and dialog between Congress and the Federal Reserve on the coordination of monetary and fiscal policies?

Are there institutional changes that you would advocate?

Chairman VOLCKER. For some years you have done the thing which seems to me perhaps most important—and I know it is a frustrating process—but you do get us up here before this committee, before the Senate committee, before other committees, relatively frequently. I'm not sure that there's any magical substitute, that there's any mechanical substitute for testimony of this sort, in which you are free to probe in whatever direction you like and to demand as good an answer as we can give you—as inadequate as you may find that at times.

I think it's partly a question of communication, but partly other issues are involved. As we touched upon earlier, is it in the interests of confidence, continuity, and many other good things such as understanding to examine the broad guidelines given to the Federal Reserve?

We have four or five competing ideas in that area. They all have their difficulties, and maybe we haven't arrived at a millenium in the competing ideas. It's worth some thought.

We put emphasis on the money supply, not simply because of the Humphrey-Hawkins Act—although it is indeed required by the Humphrey-Hawkins Act—but also because that is a method of communicating in substance, and it is a discipline imposed upon the monetary policy makers.

We have got to justify our policy in terms of what is going on in the money supply, and that is rooted in a conviction that we and the Congress shared; that over reasonable periods of time, the relationship between the money supply and inflation and the nominal GNP is crucial.

Mr. BARTLETT. Thank you, Mr. Chairman.

The CHAIRMAN. And now the moment you have been waiting for, Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman. I came in late, and I want the record to show—just for the record to show why I say "TJFT," just got back from Texas, and I don't think I would abuse anybody by prolonging this. I will submit maybe a couple of questions for the record. I just did come in from Texas, the "Lone Shark State," in coming up here to hear all the folks that are nationalizing the lone shark and, in fact, giving them a Federal marshal's commission. So it is very interesting. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Wortley.

Mr. WORTLEY. Thank you, Mr. Chairman.

Chairman Volcker, as deregulation of financial institutions progresses and they open up more lucrative business opportunities, do you think that we are going to have ample funds available for consumer loans, mortgages, and small businesses? Isn't deregulation likely to increase the interest rates?

Chairman VOLCKER. As I said, the financial system is one of the things I think you want to consider and reexamine. I am not sure if I ranked the three areas that you mentioned. I don't feel any great concern about the availability of consumer credit.

Mr. WORTLEY. The consumer rate is high now.

Chairman VOLCKER. Relatively, but it has been coming down. And there are many more sources of consumer credit today than there were a few years ago. I think there is basically a bit more competition in that area than there was some years ago. The small business question revolves in part around whether there are going to be opportunities for small financial institutions to flourish in the new environment, because small financial institutions tend to be more oriented toward serving the needs of smaller customers and of the small businessman, in many cases. I am sure all my banking friends will write to me and tell me that the big banks do that too; and indeed, many of them do. I think it is a question that you would want to consider as part of this whole investigation.

The area that has been questioned the most is the mortgage area. In some basic sense, it is probably true—and we have seen this in a variety of institutional settings—that if you have a really tight money market, it is the home buyer who tends to get squeezed. He used to get rationed out under the old system. The institutions would just say, "I am sorry, we have no mortgage money today." Today they say, "I've got mortgage money at a very high interest rate." The homeowner may be the first one to say, "Thanks, but no thanks. That's too high for me." It is, and has been, a continuing broad issue of public policy as to how much official support should be given to that market, either cyclically or over time.

One development in that area which may help, which many people think is very promising, is this variable rate mortgage idea. Many consumers resist it. It is new; they are not familiar with it; they are often frightened of it. But it also may have some advantages in enabling mortgage credit to compete better for money in a more open financial system.

Mr. WORTLEY. You indicated that maybe smaller banks would take care of the small business, but isn't the trend going to be toward fewer banks, more concentration of power in larger banks?

Chairman VOLCKER. I think there is no question that the trend will be toward some consolidation and concentration. It is a question of how far. Of course, the bigger banks—some of them, at least—can actively lend to small business as well, but I think the tendency will be in the direction of fewer units. Of course, we have an enormous number of commercial banks, 14,000.

Mr. WORTLEY. But it still hasn't done much to lower the interest rates, the competition.

Chairman VOLCKER. No, but I think the market is quite competitive. Other factors are affecting the interest rates, and I think we have talked about those quite a lot today.

Mr. WORTLEY. When you came up with your economic projections, Gross National Product, inflation, unemployment, for 1983, presented them to Congress in February, you were pretty much in line with the Congressional Budget Office and the administration. Two months have gone by since then.

Have any of your projections changed since that time?

Chairman VOLCKER. We haven't conducted any new poll or canvas of the committee members. I would guess—and I don't think there is any great significance in this, but just judging from comments that I have heard committee members make in other contexts—that it is more likely that some of them might have moved the numbers up for real growth and probably down a little bit for inflation from 2 months ago. But I would also be surprised if the changes were at all radical.

Mr. WORTLEY. You're still bullish on the economy?

Chairman VOLCKER. Moderately so. We have a rather moderate recovery projected. You give me a chance to say again what I do believe looking at a longer term perspective. I think we do have a great opportunity, in this recovery that is starting, for a long, extended, durable, sustained recovery, consistent with much more price stability than we have seen for a long time. We have got a few little things that must be taken care of to make that vision a reality. I do think we were in a no-win situation for a while, by the end of the 1970's. We have gone through a very difficult period. The reward will be if it has produced a win situation for the next decade, and I hope that it has.

Mr. WORTLEY. Thank you, Mr. Chairman. I hope we will see more of you in the ensuing months and years.

Chairman VOLCKER. Thank you.

The CHAIRMAN. He's not convinced whether or not he agrees with you on that. Mr. Bethune.

Mr. BETHUNE. Thank you, Mr. Chairman.

You said a moment ago, that this was the moment that the Chairman had been waiting for. This is the moment the Chairman has been waiting, I am sure, since I am the last questioner.

On March 23, as a member of the Budget Committee, Mr. Chairman, I offered an amendment to delete the monetary policy language, which worked itself into the budget resolution.

Chairman VOLCKER. I recall that day.

Mr. BETHUNE. I made a long speech at the time saying why I did. I can shorten it by saying, I think monetary policy is an arcane subject. I am not sure that I know what you are doing. Worse still, I am not sure that you know what you are doing. One thing that I am sure about and what prompted me to offer the amendment is that, as a rule, Members of Congress don't know beans about monetary policy, and if people think that you have screwed up monetary policies, they should just wait until the Congress gets its hands on the subject, because I am absolutely convinced that we would so disrupt the credit markets that they would never recover from it.

I believe in all seriousness—what I just said was serious too, but what I believe in more seriously is that I really believe that there is a trend here in the Congress to gain more control over monetary policy. It manifests itself in many ways. The language in the Budget Resolution is one way. The heated political rhetoric is another way. I think there is a way that is not well understood that is also underfoot, and you and I have discussed it on occasion, and that is the growing Federal lending programs. Now over $600 billion of Federal credit assistance is out there in one description or another.

I believe that confounds your ability to establish monetary policy, and so my question is this: If this trend to increase the great amount of Federal credit assistance program continues on and on, and we go from $600 billion outstanding to $800 billion outstanding, more and more encroachment into that area by the Congress, something that is neither fiscal nor credit policy, it is sort of a hybrid of the two, whereby this Congress establishes the availability of credit and allocates the credit to various industries and even goes so far as to establish the price of that credit on occasion, what is left for you to do?

If we go on with that to the extent that we actually one day allocate all the credit and establish a price, what is left for you to do?

Chairman VOLCKER. When you are at that stage, nothing, except to supervise the banking system and see that they follow all the rules that you lay down for them, I guess. At that extreme, we have a quite different economy, we have a quite different financial system, and I hope we don't get there.

More generally, on your point, I think it is fair to say that the more the Government—by credit programs or otherwise—gets into the credit allocation business, and whether a particular program is good or bad, the more we squeeze our actions on a limited section of the economy. We are charged, with the general responsibility for trying to stabilize the economy, with taking certain actions that affect the credit markets. The more you allocate, the more those actions get squeezed on a more limited sector of the market with adverse, destabilizing implications for the sector that is left free, so to speak. That ultimately would be destructive. It is a matter of degree, and I don't think that we have lost our power or squeezed the forces of monetary policy on too limited a sector now.

But as you go more in that direction, that's what happens. You push the whole policy variable, or response, off on a more and more limited sector that gets put through the wringer, so to speak, or, on the other hand, goes way up when the pressures are off; you end up with more instability.

Mr. BETHUNE. You can see what's happening here, as the pressure to hold down spending increases, the creative applicants for assistance from the Federal Government simply move over to the lending.

Chairman VOLCKER. That's been true, of course, for years, and it may be aggravated by the current situation. I don't know any way of handling that, other than by coming back and self-consciously looking at a credit budget, as well.

Mr. BETHUNE. The point I want to make is that you and others spend an awful lot of time worrying about Congress trying to encroach on the control of monetary policy, and what I am suggesting is that I don't think near enough attention has been given to the encroachment which results from Federal lending. And unless we get that under control, you might discover that you have been guarding the wrong gate, that you've done an excellent job of fending off the amendments and resolutions, like the language in the budget resolution, while Congress has been very busy on the lending front, sopping up your jurisdiction and your discretion in that area.

The CHAIRMAN. Mr. Chairman, I couldn't help note your observation about credit allocation in your colloquy with Mr. Bethune, and something popped into my mind. As you know, we are going to be considering or having further hearings next week on the International Monetary Fund legislation to increase our participation. You know, credit allocation; every now and then, raises its ugly head; it is an inevitability. Unless I am mistaken, even the Federal Reserve Board just recently participated in credit allocation, did it not, saying to some of our lending institutions, "Yes, you should continue your loans to Mexico, Brazil, et cetera"?

Chairman VOLCKER. I wouldn't describe it that way, but I can understand why you describe it that way.

The CHAIRMAN. The bottom line, Mr. Chairman, you know we allocated credit for housing for many, many years, and every now and then——

Chairman VOLCKER. You allocate credit, in some sense—as I think was clear in our conversation—every time you have a credit program. You make those decisions, and you should make those decisions.

The CHAIRMAN. But the point is, every now and then, Mr. Chairman, we face a situation where we don't have much of an alternative but to, indeed, allocate some credit.

Chairman VOLCKER. I agree with that. Certainly, these Federal programs do that, and I don't think I have ever stated that you should have no Federal credit programs. But I simply observed that if you begin allocating a very large percentage of all the available credit through those programs, there isn't much left over for the rest of the market; and you are going to get more instability in those sectors of the market.

The CHAIRMAN. To be continued in further hearings on IMF.

Chairman VOLCKER. Very good.

The CHAIRMAN. Mr. Chairman, we want to really thank you. And I personally, on behalf——

Chairman VOLCKER. I began to get worried when you lifted a larger gavel than I thought you had. [Laughter.]

The CHAIRMAN. It's grown from the beginning of the hearing this morning, but we verily, in truth, want to thank you for your cooperation, as well as that of the faceless mystics in getting the testimony up to us on time, because that way my committee members were very, very pleased and happy. It saved us a great deal of time. We had a lot of time for questioning, and I think it's been productive. I think you feel likewise.

Chairman VOLCKER. I think it was; I agree with that, Mr. Chairman.

The CHAIRMAN. As you noticed, some members here had to leave because of the tremendous participation. Therefore, they will probably have some written questions for you, and I am sure you will have no problem with responding to same.

Chairman VOLCKER. Faceless or not, we will respond to the best of our ability.

The CHAIRMAN. The committee stands adjourned.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

O