

CONDUCT OF MONETARY POLICY

(Pursuant to the Full Employment and Balanced Growth
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HEARINGS
BEFORE THE
COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
NINETY-EIGHTH CONGRESS
FIRST SESSION

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JULY 19, 20, AND 21, 1983
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CONDUCT OF MONETARY POLICY

TUESDAY, JULY 19, 1983

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

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

Present: Representatives St Germain, Gonzalez, Annunzio, Fauntroy, Neal, Patterson, Vento, Patman, Coyne, Roemer, Cooper, Kaptur, Levin, Wylie, Leach, Paul, McCollum, and Roukema.

The CHAIRMAN. The committee will come to order.

I would like to welcome our distinguished witnesses today, and especially Chairman Hawkins, as we begin the first major review of monetary policy under the Humphrey-Hawkins Act. The broad range of witnesses and testimony we hear in the next few days will help us determine if any changes are needed in existing legislation.

Clearly, things have not gone very well for our economy since the Federal Reserve switched to a money target policy in October 1979. There have been two recessions, record unemployment, a depression in our Midwest rustbowl, as West Virginia became the first State since the Great Depression to register unemployment rates about 20 percent, followed closely by Michigan with 17 percent unemployment, and Ohio at 13.7 percent. These tragic ills were caused by record trade deficits, and interest rates high enough to bankrupt merchants, consumers, and home buyers.

In fact, if we look at our economic performance before the 1979 shift in monetary policy and compare it to the postshift period, the damage is clear. Between 1975 and 1979 inflation averaged 7.8 percent, while real output of our Nation's factories grew 4.7 percent a year and we created 3.9 percent more jobs each year. All the while, our exports shot up at a 14.6 percent rate each year.

But the period since we changed our monetary policy presents a very different picture. Between 1979 and 1982, the United States actually lost output and jobs at a rate of one-tenth of 1 percent a year, while prices soared an average of 10 percent. The monetary policy of recession finally clubbed inflation down in 1982 but not before our Nation paid a truly tragic price.

The full cost of recessions can never be measured by numbers alone. No charts or graphs can truly map the human suffering that unemployment, bankruptcy, and failure cause as recessions rip through families and towns without pity. But the numbers do tell us a few things. We know that these years of recession have cost us \$200 billion in lost output and nearly 5 million jobs. If we had

those 5 million jobs now, our unemployment rate would be slashed almost in half.

I hope these hearings will help us inch closer to the real causes of our many disasters in the last few years, and among the causes we hear about daily are the large deficits we now face. In fact, last Tuesday, the New York Times lead editorial was entitled "The Fed Needs More Than Lectures," which said in part,

The Congress and the White House can shout all they want for low interest rates * * * but the current shouts are misdirected. Elected officials should look to their own responsibility for economic management, and above all to those budget deficits that rekindle expectations of more inflation, driving up interest rates and wasting the pain of the last two years.

Well, this is a fine homily, and I suppose it fills up the editorial columns when there is nothing else to write about, but like all cliches it is only partly true. There are three facts that we should all face up to as we begin these hearings: First, no one really knows how much deficit is too big. A few years ago the idea of a \$100 billion deficit would have sent the bond market scurrying for the bomb shelters, and the financial writers into heavy lather, but now a \$100 billion shortfall is looked at as a fine target for 1988 or so. In fact, without all the panic rhetoric the outlook for 1988 might be considerably better since investment, production, and employment would pick up some steam and help shrink those \$200 billion deficits.

For instance, last year just as the Congressional Budget Office began talking about \$200 billion deficits, the Federal Reserve adopted a thoroughly sensible strategy of looking at more than the money supply figures, and let it be known that low interest rates and recovery were the new goals. The bond market and the stock market took off in a bull stampede unlike any we have seen in years.

The talk about \$200 billion deficits didn't bother the markets then, so why now? One thing that has changed in the last year is the Federal Reserve Board's signals about its willingness to foster recovery and low interest rates. Now, there is panic among the financial houses. During last week's FOMC meetings, the bond market virtually shut down. That was no coincidence—they certainly weren't pausing for a few days expecting that Congress would pass new taxes and make huge spending cuts.

The second fact that we all need to keep in mind is that this committee, and many other authorizing committees, have already made massive cuts in their programs. In fact, the House Banking Committee has had to cut billions of dollars from its housing programs for low and moderate income Americans. Our Education and Labor Committee and most other authorizing committees have also made significant cuts in vital programs. It is all very easy to say "cut entitlements, cut entitlements, cut entitlements," but if we exempt social security, which has already been dealt with in the bipartisan compromise earlier this year, and is a contribution-based pension program not an entitlement, then there is only \$300 billion to cut from in nondefense money—and that would wipe out every domestic program from the FBI through the space shuttle to child nutrition. The very unfair and unbelievably expensive Kemp-Roth tax cut of 1981 will be seen in the future as this admin-

istration's most costly mistake. It has cost us any hope of bringing deficits down below the \$100 billion level.

Fact three: There is little chance for any significant deficit reduction in the next 18 months. After all the work that House-Senate conferees, and our committees put into the 1984 budget compromise, this administration refused to accept it. Even though it is clear the Congress will not deprive every poor person of a reasonable diet, a livable room, and meager clothing; the administration continues to say that no other option is acceptable. You can do the addition as well as we can, and it all adds up to stalemate. If Republicans and Democrats, conservatives and liberals on Capitol Hill bring themselves to hammer out a tough budget compromise like we did last month, and the administration simply takes its ball and goes home, there is little we can do about it.

So these hearings must take place with full realization that this committee knows it has a responsibility for fiscal policy. We have made brutally difficult choices, and we will have to make them again. But to use the Federal Reserve Board's favorite phrase, we aren't the only players in the game. Monetary policy makes up a significant part of the other team. There is no single locus of economic decisionmaking that can hold a candle to the power of the Federal Reserve Board, so the board's policies are vital to our future.

These hearings will focus on three main questions: How has the Federal Reserve fared under its monetary policy operating procedures since its switch to money targets in October 1979, or more importantly, how has our Nation fared since this switch? Second, should the Fed continue to rely on monetary aggregates as its primary measure of monetary policy or should there be increased attention paid to other measures of economic performance like nominal GNP, real GNP, inflation and unemployment? Finally, what can the Federal Reserve Board do to increase the understanding of the American people about its conduct of monetary policy. Specifically, should the Fed conduct monetary policy more openly?

I am looking forward to hearing from all of our witnesses. Chairman Hawkins will lead them off this morning.

Mr. Chairman, if you would be kind enough to approach the witness table, we will place your entire statement in the record. And prior to hearing from you, we will call on our distinguished minority leader, ranking minority member on the committee, Mr. Wylie of Ohio.

Mr. WYLIE. Thank you very much, Mr. Chairman, I appreciate the opportunity to make a brief opening statement. I applaud you for having these hearings.

Of course we do have to have them under the Humphrey-Hawkins Act. But the distinguished panel of witnesses here this morning I know will be very helpful in helping us know which direction we should take, or at least giving us some guideposts.

We all agree that monetary policy is at an important decision point, how to insure continued economic recovery without at the same time setting forces in motion that in 2 years or so will again reignite inflation.

As some of you no doubt will tell us—and I agree with that—the problem facing us is not made easier by an enormous budgetary

deficit that is likely to be around even after economic recovery has made further headway. And I agree with the thrust of the Wall Street Journal editorial in that regard, may I say. A scenario could well be envisioned in which full recovery stalls out simply because the demands of the Treasury on the capital markets competing with those of a reviving private sector again drive up interest rates. If this is a reasonable scenario, and I would appreciate the panel's reaction to that statement, then much of the responsibility lies not with the monetary authority but with us here in Congress.

As you know, we will meet tomorrow with Chairman Volcker to receive his testimony about monetary policy under the provisions of the Humphrey-Hawkins Act. Your testimony and your appearance today gives us a unique opportunity to examine together the policy questions the Federal Reserve faces and to prepare for the hearing with its Chairman. For the time and thought that went into your testimony, my colleagues and I are deeply grateful. We are looking forward to your comments with great interest. Welcome again, gentlemen.

The CHAIRMAN. Now, we are very pleased to hear from our distinguished colleague, the coauthor of the Humphrey-Hawkins Act, Congressman Hawkins.

STATEMENT OF HON. AUGUSTUS F. HAWKINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. HAWKINS. May I commend the chairman on a very excellent statement at the beginning of these hearings. For once we hear an individual talking not in economic terms of budget deficits and growth of the money supply, et cetera, to the exclusion of human beings. After all, that is the purpose of economics, to serve human beings, rather than terminologies.

I am pleased to appear before the House Banking Committee, and I will try to read mostly from the statement because I think that will be briefer than adding remarks without reference to the statement.

As you know, the act, which has been known as the Humphrey-Hawkins Act, mandated that 1983 was to be the deadline by which we were to reach the 4-percent unemployment rate and the 3-percent level of inflation. I think it is clear that we have missed those goals, not because we couldn't achieve them but because of deliberate policies that were misdirected.

The Federal Reserve Board's monetary policy was the primary maker of the recession and it is now threatening to serve as the potential breaker of the weak and shaky recovery. Just look at what happened 3 years ago.

When the Fed changed its procedures and began to put the brakes on the money supply at the end of 1979, the economy quickly contracted, and by July 1981, the deepest recession in over 40 years descended on our country. Since the recession began, over 3.5 million American workers have joined the ranks of the officially unemployed. While the unemployment rate has recently been inching downward, the duration of unemployment is getting longer, and for groups such as youth, minorities and women, things are still getting worse.

Stories of the personal suffering of unemployed workers and their families are commonplace in every part of the country; urban, suburban and rural. The effects of unemployment continue to take an enormous toll on the jobless individuals themselves, their children, and their communities. In addition, each 1 percent of unemployment costs the Federal Treasury approximately \$30 billion in lost revenues and transfer payments and is the true cause of the largest ocean of Federal red ink I have ever seen in over 50 years of public life.

Several months ago, when the Fed slightly eased its pincerlike grip on the money supply and allowed interest rates to drop a few percentage points, the current weak rekindling of growth began.

Mr. Chairman, I fear we are faced with a do or die situation here. The Fed's reactions not only divine recession or recovery here in America, but its actions reverberate around the globe. Now, if the Fed goes through with its stated intention of raising the discount rate, countries like Brazil and Mexico could be faced with default, and I select only two for the purpose of illustrating the point. Increased interest rates would detrimentally affect the European market and Japan, and the resultant slower growth rates would create greater problems in the already troublesome trade area.

I strongly believe it is up to those of us in the Congress who have analyzed and evaluated this situation to quickly take strong action to prevent the triggering of another recession, the ninth since 1945.

We, as elected Representatives of the American people, have the responsibility to reassert our policy control over the Federal Reserve Board. It must be remembered that it was the Congress who first created the Fed. It was the President, 30 years ago, who laid the groundwork for the Fed's current position of having no accountability to anybody but its own narrow interests. So, it must be the Congress and the President again who must act to rein in this loose cannon that is shellshocking the American economy and the American people.

Humphrey-Hawkins, as a result of this fear, in 1978 mandated certain actions of the President, the Congress and the Federal Reserve Board. Section 108 of the act, for example, specifically required the Fed to send to the Congress in February and July of each year reports which stated the objectives and plans of the Board of Governors and the Federal Open Market Committee. These reports were to explain the planned ranges of growth of the money and credit aggregates, and the relationship of these figures to the short-term goals for unemployment, inflation and other economic indicators, as set forth in the Economic Report of the President.

Since enactment, the Fed has refused to comply with even these most docile of requirements. In the 5 years since Humphrey-Hawkins required the Fed to spell out how monetary policy affects the achievement of lower unemployment rates, the Fed has never done so.

Faced with such a poor understanding of the requirements of law, and faced with the economic circumstances of the last 5 years, I believe it is time we in the Congress took decisive action to let Mr. Volcker and his cohorts on the Federal Reserve Board know what coordinated economic policy decision making is all about.

First, I recommend strengthening the current language of section 108 of Humphrey-Hawkins. The Fed should be required to set money and credit targets which will enable the achievement of an annual economic growth rate necessary for the immediate reduction of unemployment and the eventual achievement of the interim level of 4 percent unemployment within 5 years, as mandated by law. I think it is widely agreed that a long term growth rate of at least 4.5 to 5 percent is necessary to have an impact on the reduction of unemployment, and I would encourage this committee to clearly spell out in any report language that may accompany legislation or in the provisions of any bill itself, that objective.

The function of the Fed should be to bring the supply of money and credit into line with the private and public needs of the Nation, and with the Humphrey-Hawkins mandate of full resource use. As the last 5 years have shown, the current flexible language has just not been adequate to force the Fed to take this desired course of action. Therefore, Congress must issue such a policy directive to the Fed in specific legislative language, loudly and clearly, and in no uncertain terms.

For instance, the Federal Reserve Board has recently announced plans to raise the discount rate, the interest it charges member financial institutions for reserves. The result of this will be to jack up already high interest rates on everything from commercial loans to home mortgages and car loans. Our beginning recovery will be stopped dead in its tracks.

Their action is being taken unilaterally, without any semblance of accountability to any governmental entity or to the American people. Such action defies all precepts of our Democratic Government. The Fed has no checks and balances as do the congressional, executive and judicial branches of government. What we have here, I am afraid, are a few individuals representing excessively narrow special interests, determining the success or failure of the entire U.S. economy, and for that matter, the rejuvenation or destruction of the world economy.

Therefore, I also propose to amend current law by requiring the Fed to lower the discount rate so that real interest rates can effectively be reduced to their historic level of 2 to 4 percent. In addition to this, I strongly support the reauthorization and strengthening of the Credit Control Act of 1969, which gave the President standby power to institute credit controls "to reduce high levels of unemployment in any sector of the economy or to prevent or control inflation or recession." With the help of this legislation, the Government could take coordinated action to strengthen the recession weary housing, auto, and durable goods industries, for example, and could selectively distribute credit and apply different interest rates for farmers, small businesses, and middle and lower income consumers.

Such action is clearly within the American people's best interest, not to mention the best interest of the economy.

Finally, I hope this committee will take a close look at the composition and length of service for the Federal Reserve Board, and the Open Market Committee. While I don't think Fed Board members should be elected by the public at large, I do think they should at least be accountable to those who are elected Representatives of

the people. I believe a 7-year term for members is long enough, and I also think the chairmanship should be allowed to be changed every 4 years, when presidential elections take place. Also, the Board membership should be widened to include a larger segment of the population. Largely unrepresented now are labor, industry, small business, farmers, consumer groups, and State and local governments.

Mr. Chairman, I thank you for this opportunity to present these views to the committee this morning.

[The prepared statement of Congressman Hawkins follows:]

STATEMENT OF HONORABLE AUGUSTUS F. HAWKINS

BEFORE THE HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

July 19, 1983

Mr. Chairman, I am pleased to appear before the House Banking Committee as you begin oversight hearings on the Federal Reserve Board's actions since the passage of the Full Employment and Balanced Growth Act of 1978.

As you know, Humphrey-Hawkins mandated that 1983 was to be the deadline by which we reached a 4% unemployment rate and 3% level of inflation. It is clear for all to see that we have missed these goals by a long shot and the major culprit has been our own Government and its actions.

The Federal Reserve Board's monetary policy was the primary maker of the recession and it is now threatening to serve as the potential breaker of the weak and shaky recovery. Just look at what happened three years ago.

When the Fed changed its procedures and began to put the brakes on the money supply at the end of 1979, the economy quickly contracted, and by July 1981, the deepest recession in over 40 years descended on our country. Since the recession began, over 3.5 million American workers have joined the ranks of the officially unemployed. While the unemployment rate has recently been inching downward, the duration of unemployment is getting longer, and for groups such as youth, minorities and women, things are still getting worse.

Stories of the personal suffering of unemployed workers and their

families are commonplace in every part of the country; urban, suburban and rural. The effects of unemployment continue to take an enormous toll on the jobless individuals themselves, their children, and their communities. In addition, each 1% of unemployment costs the Federal Treasury approximately \$30 billion dollars in lost revenues and transfer payments and is the true cause of the largest ocean of Federal red ink I have ever seen in over 50 years of public life.

Several months ago, when the Fed slightly eased its pincer-like grip on the money supply and allowed interest rates to drop a few percentage points, the current weak rekindling of growth began.

Mr. Chairman, I fear we are faced with a do or die situation here. The Fed's actions not only divine recession or recovery here in America, but its actions reverberate around the globe. Now, if the Fed goes through with its stated intention of raising the discount rate, countries like Brazil and Mexico could be faced with default. Increased interest rates would detrimentally affect the European market and Japan, and the resultant slower growth rates would create greater problems in the already troublesome trade area.

I strongly believe it is up to those of us in the Congress who have analyzed and evaluated this situation to quickly take strong action to prevent the triggering of another recession.

We, as elected representatives of the American people, have the responsibility to reassert our policy control over the Federal Reserve Board. It must be remembered that it was the Congress who first created the Fed. It was the President, thirty years ago, who laid the groundwork for the Fed's current position of having no accountability to anybody but its own narrow interests. So, it must be the Congress and the President again who must act

to rein in this loose cannon that is shell-shocking the American economy and the American people.

As you may recall, five years ago, when this Congress passed the Full Employment and Balanced Growth Act of 1978, unemployment was at 5.8% and inflation had reached 9.0%. The Congress and the President agreed that in order to simultaneously reduce those unacceptable levels of joblessness and prices, it was necessary for the Government to coordinate its economic policy actions. Humphrey-Hawkins therefore mandated certain actions of the President, the Congress, and the Federal Reserve Board.

Section 108 of the Act specifically required the Fed to send to the Congress, in February and July of each year, reports which stated the objectives and plans of the Board of Governors and the Federal Open Market Committee. These reports were to explain the planned ranges of growth of the money and credit aggregates, and the relationship of these figures to the short term goals for unemployment, inflation and other economic indicators, as set forth in the Economic Report of the President.

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Thank you.

The CHAIRMAN. Well, I want to thank the chairman this morning for his assistance and willingness to put his best foot forward. Obviously, from your statement, we are in agreement on many, many points. Of course that is meaningful because we are going to need your assistance as the weeks go by and as we proceed on this committee.

You mentioned the Credit Control Act. Congressman Annunzio has a little story to tell about what happened in the last Congress on that legislation. I would like to yield to him at this point.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Before I get into the Credit Control Act, like you, I associate myself with your remarks in welcoming Chairman Hawkins, who is also my chairman on the House Administration Committee, to the Banking Committee this morning. I commend him for an excellent statement. He has devoted a lifetime to the solution of the unemployment problems in America. And he has done an outstanding job on the Humphrey-Hawkins bill and is keeping it alive and before the American public.

There are two things about your statement: one, the discount rate. I am happy you mentioned the discount rate. That is something that very few people talk about. We always hear about the prime rate. But actually the discount rate is far more important than the prime rate because the discount rate is the rate that is used by banks to borrow money from the Fed. Based on the percentage of that discount rate is what keeps interest rates high or low.

I also would like to point out, as Chairman St Germain mentioned, that in our subcommittee in the last Congress, we passed legislation to extend the Credit Control Act of 1969 in the subcommittee. And then the legislation, as the procedure is, was brought to the full committee. I had to commend the chairman of our full committee. We passed that in full committee by one vote.

But in order to pass that legislation to extend the Credit Control Act by one vote, it was necessary to hold up the entire committee. And he skillfully managed to do that until we got a quorum, and we did pass the legislation by one vote. And that is what happened in the last Congress.

So far as this Congress is concerned, the chairman has, because of other pending legislation, but he has mentioned to me that when—we hopefully are going to get around to see what type of action we are going to take, and what we are going to do with it. We have, as you know, coming out of this committee, we are watching the Fed, too. We passed legislation to curb the power of the Fed. I would like to find out from them, you know, everybody has an audit. I would like to find out from them what happens to all this money that the banks pay in, reserve money. I would like to find out how they spend their money. They won't tell us, you see.

So, Chairman Hawkins, as a member of this subcommittee and a ranking member, I appreciate your being with us this morning and commend you once again for a very statesmanlike statement on behalf of the unemployed and on behalf of the economy of America. If we follow what you have suggested in your statement, America will be better for it.

The CHAIRMAN. Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman.

I just want to welcome the very distinguished Member from California and thank you very much for your contribution this morning, Congressman Hawkins. Your name has become a household word in this field. We appreciate your taking the time to help us with these hearings.

I have no questions at this time, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Patterson?

Mr. PATTERSON. Mr. Chairman, I want to welcome Chairman Hawkins. I have no questions of him. I read his testimony as well as listened to it carefully, and agree with most of what he says. I think that the Federal Reserve has become too powerful and has done so as a creation of the Congress. I think it is time we take back some of that control, whatever that might be. The Federal Reserve does not seem to be responding to the Humphrey-Hawkins legislation.

I agree with Chairman Hawkins' testimony. However, it is somewhat sad for me to say this because I have generally supported the Federal Reserve. But I think they frankly have had it as far as I am concerned; I do not think their policies are worthy of an institution with the powers we have given them.

The CHAIRMAN. Would the gentleman yield?

Mr. PATTERSON. I would be delighted to yield.

The CHAIRMAN. Are you saying the Federal Reserve indeed did not come about as a result of immaculate conception but rather as a result of actions by the Congress of the United States?

Mr. PATTERSON. I think a prior Banking Committee must have been rolled by the bankers. I have no further comments.

The CHAIRMAN. Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

It is always a pleasure to hear our colleague who has worked so hard on this issue of employment and monetary policy and has tried to bring about a coordinated fiscal and monetary policy in the national economic policy that we pursue. It is regrettable that the high expectations of the Full Employment Act in the late 1940's and revision of that that was so artfully written by the gentleman from California and others has not lived up to the expectations. And I think the Fed has not functioned in good faith with respect to this.

I think that some of the blame can also be laid to the fact that the current administration has not functioned in good faith, and perhaps to some extent, the Congress. But the hope, expectation, and possibility is still there. Indeed as we talk about industrial policy, as we talk about an economic strategy to deal with these things, invariably we come back to some sort of framework that is contained in the Humphrey-Hawkins Act.

I don't say that it doesn't need improvement, that there isn't adjustment that is necessary with regards to the direction we give the Federal Reserve Board. But it does mean that some sort of framework such as this has to be the basis upon which we attack these problems. I feel we must do that if we are going to eventually live up to the expectations of what this economy can be and should be in fulfilling the needs of this country and the world.

So I am pleased with the gentleman's continued interest in this. It would be easy to get frustrated and to walk away. I am glad to see he is with us today to work with us as we address these problems. I thank the gentleman.

Mr. HAWKINS. Thank you.

The CHAIRMAN. Mrs. Roukema?

Mrs. ROUKEMA. Thank you, Mr. Chairman.

I greet my colleague from the Education Labor Committee where we have served together and worked together on some related issues, particularly the job training programs that we have operated on in the past. I appreciate your testimony here today, Mr. Hawkins.

I must suggest that I seem to be doing a lonely vigil here with my colleague, Mr. Wylie, in taking a very opposite point of view from those that have already been expressed with respect to the Federal Reserve Board. I think we share the same purposes and goals. I would suggest, however, that we place too much of a burden on Federal Reserve policy if we do not give equal weight of opinion to the role and responsibility of the Congress in terms of establishing a policy that deals with deficit spending, whether it be the level of spending or the level of taxation, whatever causes those deficits has an equal weight and effect on interest rates, inflation, and monetary policy.

To that extent I think these hearings should fully develop both sides of those issues. But I recognize that you are expressing an opinion that should be expressed and should be given the weight and value of those expressed by the economies of all persuasion.

Thank you.

Mr. HAWKINS. Mrs. Roukema, if I may be allowed to simply express this. I quite agree with you. It was not my intent that the Federal Reserve Board should be singled out as the only culprit. The act in 1978 envisioned a coordination of effort which has not yet been achieved. Some economists have referred to it as a Cadillac on a Model T Ford frame going down a freeway with four individuals trying to drive it: One, the President, trying to steer it; the Congress trying to speed it up by its foot on the gas pedal; another driver, which might easily be the Federal Reserve Board, trying to put its foot on the brake to stop it; and the courts blowing the horn trying to make noise.

So it is the harmony, that was actually mandated in the act; that these entities would work together. Unfortunately, they have not. And I think the Congress has to assume some of the blame. But certainly I think the blame can be spread around among the other entities as well. Certainly the one that is beyond our reach seems to be beyond the reach of the electorate; that is, the people of the country, happens to be the Federal Reserve Board.

We have a recourse to those in Congress who, let us say, caused the recession. The high unemployment, the lack of price stability. There is a way to reach them. But apparently the Federal Reserve Board cannot be reached by anybody. All of us, and officials in high places, criticize the Federal Reserve Board, then quietly and secretly go into places and activities that support the Federal Reserve Board.

So this dual role of publicly saying one thing and privately doing another seems to me has to stop. I think it should stop with the passage of legislation which specifically directs the Fed to do something.

Mrs. ROUKEMA. I agree with you. You have candidly and articulately stated the problem. Let me ask, however, because it causes me some concern, the idea of appointing a Federal Reserve Chairman concurrent with the change in the Presidency. That causes me some concern. Because I would be afraid that it might be politicized in the wrong ways and for the wrong reasons.

Could you just make a further comment?

Mr. HAWKINS. Well, I think it should be politicized to the extent we get responsibility. I don't see why we have to apologize for politicizing an institution in our democratic process. The idea is that the policies of the Chairman of the Board should at least reflect those of the administration. The administration is held accountable. As it is now there is a cat and mouse operation. And I guess the public happens to be the mouse in this operation, in which every one is ducking responsibility.

I think we have to hold the President responsible to a large extent for the policy of the one named as the Chairman of the Board. And I think that in renaming, for example, Mr. Volcker, that there is support for his policies. I don't see how an individual can name someone and then not assume the responsibility of the policies of the person named. We know that Mr. Carter in the first instance named Mr. Volcker, apparently to send a message to Wall Street that he would, through his so-called fiscal austerity, change his policies. And I think that the same is true today.

So I think in a sense you have a President who has to be held accountable for the individual he names. And I think that should be contiguous with the term of the President. I don't see any other way to get that accountability.

Mrs. ROUKEMA. Thank you very much.

The CHAIRMAN. I think what the chairman is saying is that there are those of us in the Catholic persuasion who accept the fact that the Pope has infallibility in his pronouncements but who don't ascribe the same to the Chairman of the Federal Reserve Board and College of Cardinals which in this instance is the Federal Open Market Committee. Would the chairman agree with that?

Mr. HAWKINS. That is true.

The CHAIRMAN. We have to realize that the Fed is a political creature despite the fact that over the years they have attempted to put themselves over and beyond and make themselves a place in the minds of men and women that makes them closer to the Almighty, but in fact they are not. They were created by the Congress in 1913, I believe the year was, the Rome was created by the Congress. The chairman is absolutely correct.

The reason for the administration having its own Chairman of the Fed—and this has been supported by many, many members of this committee with Republican administrations in office—for that is we do think it is only fair that the President have an opportunity to pick his own Federal Reserve Board Chairman.

Mr. Patterson?

Mr. PATTERSON. Thank you, Mr. Chairman.

I certainly want to join my colleagues in complimenting the distinguished chairman, Mr. Hawkins, on his service, not only on this issue but on many others. I think we often see a tendency to blame the Congress for the deficits and everything else that happens in the economy—and to ignore what the Federal Reserve does. Therefore, I am glad you pointed out that there is the addition to the deficit of \$30 billion for every additional 1 percent of unemployment—a phenomenon which is almost mandated by the Federal Reserve policies. Few people talk about the additions to the national debt that result from these abnormally high interest rates that are also a part of the policies of the Federal Reserve. These artificially high interest rates that punish not only our deficit, negating our attempts to balance the budget, but really cause our Nation's manufacturers and producers to be handicapped in their efforts to compete on the world market against the Japanese and others that are not handicapped by similar policies of high interest rates. I think some very serious mistakes have been made by the Fed in its administration of monetary policy in the last few years.

I don't think many people can disagree with this. I know the Congress bears its just share of the responsibility. But the actions of the Fed have caused really untold suffering and harm, not only to America but to the free world. I congratulate the distinguished chairman on his intentions and sincerity of purpose.

The CHAIRMAN. Mr. Coyne?

Mr. COYNE. Thank you, Mr. Chairman.

I would like to welcome Chairman Hawkins here today, also, and thank him for his contribution to these hearings. My question is based on the experience that the chairman has had with the unemployment problem, and on something he pointed out in his statement: That for each 1 percent of unemployment it costs the Treasury in transfer payments and lost revenue \$30 billion. The thing that has always interested me is that with 10 percent unemployment in the country today, the cost to the Nation is a figure in the neighborhood of \$300 billion. As one who has grappled with the unemployment problem, it seems to me if we were to give every unemployed person, all 12 million of them or more in the country today, a \$15,000 check, it would cost the Treasury in the neighborhood of \$180 billion as opposed to the \$300 billion that it costs in lost revenues and transfer payments.

I just wondered what the comments of the chairman would be. Why can't the Congress see the economics that would be helpful if some kind of a program was developed to make full employment a reality? And what prohibits the Congress from doing that?

Mr. HAWKINS. Well, I don't know whether it is courage or lack of integrity or what it is, Mr. Coyne. But it is a very difficult thing to get individuals to see that putting people to work is actually a good investment. The feeling is that to do so would increase the deficit when actually the opposite would be the effect.

The present deficit has arisen during a time when we were deliberately creating unemployment as a means of solving inflation. The fact is that today—we don't have 10 percent unemployment. Actually we have unemployment which is closer to 15 or even above that. The Department of Labor has counted close to 20 million unemployed people. They are not all included in the rates.

What we have now, we have almost a fifth of the total labor force of this country which is unemployed.

To expect that many people to be wasting their efforts, and for us to be wasting our resources; not only are those people not paying taxes and unable to be productive, we are not permitting them to contribute to goods and services. To me this is not commonsense reasoning. However, there is a reason for it. And the reason for it is that some individuals fear that if you have a tight labor market there will be a pressure on wages and we will have to pay somebody a little bit more. And this is in conflict with so-called supply-side economics in which you have to restrict production some times in order to hike up prices.

The only thing they seem to concentrate on is wages. So the fight is not over the number of employed individuals, it is over wages. If we can drive wages down, the feeling is, thereby we save. Unfortunately there are too many individuals and too many so-called economists in high places who recommend this type of approach to the problem. It just is not the answer as I see it. Even if it were economic to do so, I think that it would be immoral for us as a nation to believe that by keeping this many people unemployed in order to achieve price stability, which we haven't been able to do, that this is the solution.

Unfortunately we don't have too many of us who are speaking out in the Congress. I hope that we will begin to address these problems because as we also hinted at the beginning we have had recoveries—eight since 1945. But each recovery leads to another recession. We have had eight recessions as well. We can anticipate a ninth one. Historically that is to be expected if we follow the same pattern, the same policies. Each of the last three have been much more severe than the one before that. And so we end up with a recovery with unemployment about as high as it was during the previous recession.

So, now we are talking about recovery with a so-called official rate of 10 percent unemployment. Now, what will the ninth one be? And what will it mean to the world economy? I think we should give serious thought to what we are actually causing, not only to ourselves, our own economy, but to the economies around the world. And I think this is a serious problem that we have got to face and I think we have got to start out with the Federal Reserve Board because the interest rate situation is out of hand.

Mr. Volcker doesn't mind criticizing us and telling us what we should do. Yet we created the Federal Reserve Board. It is time for us to tell him what they should be doing and leave what we should be doing to ourselves. I hope we can work that out.

Mr. COYNE. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Roemer?

Mr. ROEMER. Thank you, Mr. Chairman.

And I would like to join with my colleague, Mr. Coyne, in thanking Chairman Hawkins for his appearance today and his statement which I just got through reading. I apologize for coming in late, Mr. Hawkins.

A couple of points. First of all, I praise you not because you have a monopoly on the answers, nobody does. I remember working on the Hill years ago with Russell Long, the U.S. Senator from Louisi-

ana and putting together some budget figures of which I was really proud. I had a blackboard and chalk and numbers all over the board, and I did about a 2-hour presentation. When I got through I said, "Do you have any comments, Senator?" His only comments were: "Mighty complex, son, mighty complex."

The issue of unemployment, economic development, where we ought to be as a nation is awfully complex. So my praise for you is not necessarily on your litany of the answers, but on your insistence for raising the question. The question is can we have recovery with 10 percent unemployment? The answer is obviously not. The question is, is 1 out of 10 Americans officially unemployed safe or part of the strategy of either this administration or this Congress? Surely it is not. The question is, is it only 1 out of 10, or are the figures you threw out this morning more accurate? I happen to think they are. It is closer to one out of seven, and increasing in number.

So my praise is not that we are going to agree on how to solve the problem but that we both agree that we must solve the problem in this country, beginning now.

No. 2, I think we would be in error if in the next round of rising interest rates we point a finger only at the Fed. The next round of rising interest rates, which surely is coming, is going to be as much as anybody in this country, our fault. Not the Fed's. Whether it is military spending, a blank check to the generals, which we no longer can afford, whether it is lack of discipline and foresight in entitlement programs, which has gone on too long, part of the problem, at least half in its nature in the deficit, is the lack of action on the part of this Congress. So I just can't sit by and say the Fed is the only problem. It is part of the problem.

The major problem next time around is not going to be Paul Volcker. It is going to be Buddy Roemer, members of this committee and Members of this Congress for not having the foresight or the courage to put some discipline on spending.

Now, this conclusion, I might say that that is not discipline on programs that are there to help people who are without any hope. You don't have to look at social welfare programs or programs that help the very poor in our society, and say that is the reason the budget is out of balance, because frankly that is not the reason the budget is out of balance. There are other programmatic areas, including defense and entitlements, entitlements go \$7 out of every \$10 to middle-class Americans, where we have a problem.

I don't think interest rates will be where they should be until we deal with our budgetary problem. We can criticize Paul Volcker. I have been part of that chorus myself. But next time around it is not going to be Paul Volcker's fault, in my opinion. It is going to be our fault. I thank the chairman for coming. I appreciate his testimony.

Mr. HAWKINS. Well, I would quite agree with the gentleman up to a certain point. But I don't think that we should be here criticizing ourselves too much as being the culprit. After all, there are others we could criticize as well. But to say that the problem has been brought about by excessive expenditures I think is a little shortsighted. The revenues have fallen more than the increase of

expenditures and they have fallen off because of the Tax Act of 1981.

Whether you believe it or not, I have voted for almost as many expenditures in defense as you have, which may be a surprise to you. But if we are going to spend on defense, we should do so on its merit and not think that we can spend on the military without raising the money. But the revenues have fallen off. The entitlements obviously have increased. They always increase during recessions. And so to cut back on entitlements which have risen due to an increase in unemployment caused by policies which were instituted to use unemployment as a means of fighting inflation to me is incorrect. I don't see how we can avoid spending much more money on entitlements if we are satisfied with recession and unemployment as a means of fighting inflation.

We should fight inflation more directly and not in that manner. So I think some of the expenditures are perhaps unwise. But I think they are justified because why should we make innocent individuals suffer for the shortsighted policies of any administration? These policies began during the Carter administration. They began in 1979. So I am not just criticizing this administration. I think the previous administration was wrong. That is one reason why Mr. Carter is no longer President.

But as I indicated, if we were to increase unemployment by 1 percent, we would reduce the deficit by \$30 billion. Now, a 4-percent reduction in unemployment from 10 to 6, which is still too high, would more than balance the budget. And so instead of talking about how we are spending too much, we should be spending more wisely. We should be spending for housing, for example, which would reduce both inflation and unemployment. That would be in line with the Humphrey-Hawkins Act mandate of reducing inflation and employment simultaneously.

Now, by cutting back on expenditures in a field such as housing, for example, we are not saving money. We have never achieved the goal of the Housing Act to provide decent housing and a livable environment for all Americans. Yet we set that goal more than two decades ago. If we would simply achieve that goal, we could appreciably reduce unemployment, reduce the deficit as well. This is the type of expenditure we should be making.

In other words, just to cut back on expenditures may sound all right. But I think we have got to be selective. Cut back on unwise expenditures, where there is waste and so forth. Surely do that. But there are some expenditures we are cutting back on today that are pathetically unwise. Why should we cut back on jobs, for example, on employment and training programs? That to me is very unwise. No other industrialized nation is doing it.

Now, mostly I think I would agree with you, Mr. Roemer. But I think to just generally state that the culprit is too much spending and to blame ourselves, I think that is a very simplistic explanation.

Mr. ROEMER. Thank you, Mr. Chairman.

The CHAIRMAN. Does anyone else have any questions of the distinguished Chairman? I understand he has a committee meeting that he has to chair very shortly.

Mr. PAUL. Mr. Chairman, may I ask one brief question, please?

The CHAIRMAN. Certainly.

Mr. PAUL. Mr. Hawkins, in your written statement you said the Federal Reserve Board has recently announced plans to raise the discount rate. I was curious to know where you got that information because I had not known that. Has that been documented?

Mr. HAWKINS. No; it hasn't. It is just by implication. I hope that they do not do it.

Mr. WYLIE. Mr. Chairman, I didn't ask a question. I wonder if I might make an observation based on the I think valid observations of Mr. Roemer, the gentleman from Louisiana. It seems to me as if you have put too much on monetary policy, if I may respectfully say so, Mr. Chairman, and too little on budget deficits. I think we have rather ignored one of the charges in the Humphrey-Hawkins Act which says that the Congress further declares that it is the purpose of the Full Employment Balanced Growth Act of 1978 to achieve a balanced Federal budget. Have we lost sight of that?

Mr. HAWKINS. No; certainly we think we could have done it. As a matter of fact, we worked out the model for then President Carter whereby in 4½ years he could have done it. But unfortunately he moved in the opposite direction, presumably to become more conservative in order to get reelected. Now, the deficit, we believe came about as a result of the policies which we have used to restrict economic growth. That was due entirely to the fear of inflation. If growth had been maintained even at its historical level, in the neighborhood of 4.5 to 5 percent, we believe that we would have had more revenues, we would have had less entitlements, less of the recessionary costs, and you could have balanced the budget. But we moved in the opposite direction. The economic growth rate has been under 3 percent for the last several years. As a matter of fact, it was zero for a number of years. With that type of an economic growth it is impossible to balance the budget. You just can't do it.

Mr. WYLIE. We thought it was important then, is that what we are saying, but it is not so important now?

Mr. HAWKINS. It is important. I agree certainly with the rest of you that a balanced budget is much to be desired. I disagree sometimes with some who place the emphasis in the wrong place. You are not going to balance the budget by simply reducing expenditures on things that are necessary in the economy. You don't do it at the expense of priority needs. We have needs in housing and transportation, economic development, and other needs. To think we are going to cut out these needs, stop addressing these needs, and balance the budget is just like a family that is going to banish one child to a closet and think that that is going to help balance the budget because the child isn't going to have to be clothed, sent to school or eat. It is just shortsighted.

I think the way to do it is to get economic growth up. That is the first thing. That is the surprising thing Mr. Kemp and I agree on, is supply side economics. That is essential. We do need tax reduction, but we need it on the moderate and low income groups, not on those in the very top level. These are things that can be done. These are things we should be doing.

I think this is a way to balance the budget. But you can continue to cut. I don't know where in the devil we are going to cut. But

even if you start cutting, I don't think even cuts in the military would be necessary if we had economic growth. We could sustain our current level, the level that the President says.

Mr. WYLIE. We agree that fiscal policy is important then?

Mr. HAWKINS. Yes, absolutely.

Mr. WYLIE. Thank you very much, Mr. chairman.

The CHAIRMAN. Any further questions?

Mr. NEAL. May I just make one brief comment?

The CHAIRMAN. Of course.

Mr. NEAL. I would like to commend the chairman and also the gentleman from California, Mr. Hawkins. And I think that if the Federal Reserve System would follow the language in the general policy statement of the Humphrey-Hawkins bill, which says the Board of Governors of the Federal Reserve System and Fed Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates, that if the Fed in fact would do that, that it would have more beneficial impact on our economy than just about anything I can imagine.

That language is a little vague. As I understand it, what it means is that if you look back over the history of our economy, it has grown on average at about 3 percent a year. Commensurate with that would be a rate of money growth of about 3 percent a year. Would that be the way the gentleman would interpret this line?

Mr. HAWKINS. The gentleman is absolutely correct that the language is vague. The language is indeed vague and that is the reason why we are suggesting that we make it a little more specific. We thought that the message would be conveyed by that type of language. But apparently there are individuals who have other objectives and agendas which don't agree with that of the general welfare. For that reason we think it is now necessary to take the gloves off and be a little more stiff.

Mr. NEAL. If you were to quantify the meaning of that language, could you quantify it about as I did?

Mr. HAWKINS. Yes. From 3 to 4 percent above the full inflation rate I think would be close. We would settle for anywhere in that particular range, I think would be about right—would implement that language.

Mr. NEAL. Honestly, that is what I thought. I thought if we could get 3 percent growth in money, we could count on about 3 percent growth in the economy. I believe that is what we would have, and I don't think we would have any inflation, as a matter of fact.

Mr. HAWKINS. We tried to make the language flexible, it was the thought of Senator Humphrey and I, that the results were what we were after. We said, "Look, in 4½ years we want to be in the position of having reduced unemployment on an interim basis to 4 percent and the inflation rate to 3. We don't care how you do it. Do it any way you want to. But that is where we want to be, that is what we want to reach within that period of time.

That is the goal and that is the timetable. We thought by leaving it up to the President and to the Congress and to the Federal Re-

serve Board, they would harmonize their policies and that they would take this responsibility seriously and that we would reach these goals.

Also, in terms of Mr. Wylie's statement, we would reach a balanced budget. But unfortunately they didn't do that. Beginning with President Carter in 1978, after he had signed the bill. In 1979 he deviated completely. Then he began naming a majority to the Federal Reserve Board which were in total conflict with his own philosophy. He seemed to be more interested in what Wall Street thought about his administration. That may be taking a certain amount of liberty, but that is the way it seemed. And so to become conservative, he, deviated. Now those policies have been continued. To say we have new policies now is false, it is a continuation of the policies that began in 1979.

Mr. NEAL. Thank you.

The CHAIRMAN. Are there any further questions?

Mr. FAUNTROY. Mr. Chairman, I should just like to commend the gentleman from California for his leadership over the years on this whole question of full employment and balanced growth, and to thank him for pointing up to us not only the consequences of the tight money policy of the past 4 to 5 years, but for suggesting to us that if we really want to deal with the economic growth needs that we have, that we need to be doing our job better as leaders in the House on the questions of housing expenditures. I want to commend him for doing his job well in terms of suggesting to us the necessary first steps toward dealing with the unemployment question, namely the Community Renewal Employment Act, which I hope will garner the support not only of the members of his committee, but the members of this committee as well when it comes to the Floor of the House.

Thank you.

Mr. HAWKINS. I thank the gentleman.

The CHAIRMAN. Again, we thank you, Mr. Chairman.

Mr. HAWKINS. Thank you. I apologize for the time taken of the committee.

The CHAIRMAN. No, it has been very meaningful, very, very, very helpful.

Now, we will ask our panel to approach the witness table.

Gentlemen, we want to welcome you to our hearings, to express our appreciation for your willingness to assist us. Prof. Donald A. Nichols is chairman of the Department of Economics, University of Wisconsin, and economic adviser to the Governor.

Dr. George W. McKinney is a professor from the University of Virginia.

Robert Barbera is chief economist from E. F. Hutton.

Philip Cagan is a professor from Columbia University.

We will also hear from Mr. Gerald Epstein, professor of Williams College. We will place your statements into the record in their entirety. Initially, we will ask Professor Donald Nichols to be the lead-off witness.

STATEMENT OF PROF. DONALD A. NICHOLS, CHAIRMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF WISCONSIN, AND ECONOMIC ADVISER TO GOVERNOR EARL

Mr. NICHOLS. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, it is a pleasure to appear before you today and give you my opinions about how to create a structure for the oversight of monetary policies.

I have some modest proposals, modest in the sense that they refer to things such as changes in the reporting requirements of the Federal Reserve, and to modest changes in the roles played by the major policymaking institutions, while maintaining the existing organizational structure. That is, I am not proposing that the Federal Reserve be made a wing of the Treasury, or anything like that.

Let me start with a statement of the challenge before us. Then I will get into my list of recommendations.

I think the American economy faces a dual challenge for the 1980's. The first challenge is to return to full employment without inflation. The second is to revitalize its industrial base.

To do this is going to require a high rate of capital formation, and in particular, of business fixed investment. To encourage business fixed investment what we are going to need is low stable real interest rates and we will need some prospect, anyway, of full employment—some prospect of lots of sales and lots of profits out there in front of the businessmen to make it sensible for them to expand their capacity, and to make them, in fact, need to expand their capacity.

To attain an economy in which we have low, stable, real interest rates and a relatively full rate of employment is going to require a close coordination of monetary and fiscal policies over the rest of the decade.

I do not see in place a good institutional structure for that coordination. The current structure comes through the Humphrey-Hawkins Act which amended the Federal Reserve Act, as you know, to require the Federal Reserve to report its policy intentions in terms of the various monetary and credit aggregates.

The Fed is also required to comment on the relation of its intentions to the economic goals of the administration. And that Humphrey-Hawkins Act defines as goals the forecast that is put in the annual Economic Report of the President. It defines that as the goal of the administration for the following year.

The Humphrey-Hawkins Act also requires that the Federal Reserve comment on how its policies are expected to relate to any economic goals the Congress should adopt.

The structure I have just summarized is, I think, too weak.

It is too weak first of all, because the Fed is required only to comment on how its policies relate to those of the administration. I think there should be some requirement that its policy be made to be consistent.

At present they just have to comment on consistency not guarantee it. The act now permits them to say, for example, "Well, the administration's forecast is wrong. They are not going to hit their

economic targets because we are going to tighten up the money supply too much."

They came close to saying something like that a year and a half ago when they expanded their forecast range, so it was 2½ percentage points wide. Their forecast range was widened to include the administration's forecast, but had the Fed's own forecast way at the bottom of it. Essentially, the Fed chose to shoot at a different target from the target the administration was shooting at. That I don't think should be permitted. I think we need all branches of the Government to be at least aiming at the same economic goal.

A second weakness in this structure is that Congress does not now adopt economic goals. If it did, the Fed would already be required to comment upon them. I think that if Congress would start to adopt such goals, it would strengthen the coordination of policy.

Third, I think the list of short-term economic goals listed in the Humphrey-Hawkins Act should be expanded to include something about capital formation or business fixed investment.

Much of the dramatic change in economic policy of 1981 was designed to encourage business fixed investment.

I do think that such an increase is greatly needed. It has not taken place largely because of the recession. We do have tax incentives in place to make investment profitable, but we don't have the level of employment necessary to make that investment profitable.

And we don't have real interest rates at a level that would permit the financing of that investment.

So we put a carrot in the form of tax incentives out in front of business firms to encourage them to invest, but we did not give them the wherewithal in terms of sales, profits and low costs to permit them to expand investment. I would like to have investment be added as one of the economic goals on which the Federal Reserve would be required to comment.

My recommendations, then, for institutional changes follow directly from these weaknesses that I have listed.

First, I think Congress should elevate the status of its economic forecast that accompanies the budget resolution. It should elevate that to the status of a goal. Goal may appear to be an awkward word to use for such a technical economical thing as an economic forecast. We all know forecasts are often wrong, indeed, usually wrong. But the purpose of the goal in this case is to give us a common basis on which to base policy, not an accurate forecast of what is likely to happen.

A common basis is needed just as we need to have a forecast in order to have a budget. Before we can make a budget we need to know what level of unemployment we are talking about, or what level of outlays under social security we are talking about. Similarly, we need a forecast in order to link the monetary and fiscal policies together.

Calling the forecast a goal, will, maybe we could find a better word than "goal," but calling it a goal, elevating the forecast to a goal at least then requires the Federal Reserve to come in and comment on what Congress expects the future to hold.

At least you are asking the Federal Reserve, does it foresee the future the way we see it? Are we looking at the same future when

we make our budget deficit forecast as you are when you make your monetary growth projections?

So the No. 1 suggestion would be to just elevate the status of those economic assumptions to goals.

No. 2, I think the Federal Reserve should be required then to testify to the appropriateness of these forecasts as goals, not just how they link to its own policies, but whether these goals make sense. Are these good targets to have for the coming year? Are they too ambitious in one area or another or not ambitious enough?

Third, once Congress adopts these as goals, I think the Fed should then be asked to pursue them. The Fed should not have its own goals for the economy. If the Congress chooses an outlook it thinks is reasonable, based on lots of opinions, including the opinion of the Federal Reserve, then the Fed has to be part of the policy team that pursues those goals. It cannot run its own course independently and be looking at a different set of goals all by itself.

Fourth, I think the Fed should be required to prepare a whole section of its semiannual reports on capital formation and business fixed investment—the outlook for it, what we need for the long haul, what we are likely to get in the next 2 or 3 years, and what policy changes could be made to increase business investment in the areas that they think it is needed.

Fifth, I would not require that the Fed report its intentions in terms of growth rates of monetary aggregates. We have had much too much turmoil in the link between money and the economy recently to make these monetary aggregates be useful any more. Interest rates, if necessary, could be reported but I wouldn't even require that. I would have the Federal Reserve adopt the goals of Congress for real output. If they want real growth to be 6 percent over the next year or whatever, once we agree on such a target, the Federal Reserve can be permitted the independence to decide what money growth rate is best to pursue that goal.

Finally, of course, the Federal Reserve would retain discretion to deal with short-term unforeseen events. So it would still maintain a lot of independence. Let me just close by giving you a recommendation for current policy.

I think the economy would grow quite sharply right now if we would just let it. We have an unemployment rate near 10 percent, a capacity utilization rate of 74 percent, lower than any other recession. No evidence of shortages can be found, no evidence of bottlenecks in the economy, no evidence of inflation-producing forces. This is the longest and deepest recession, of the postwar period. One would normally expect that recovery from such a recession should be faster than from any other recession, or should be at a faster rate, even though it might take more total time than from lesser recessions. But the rate of growth in the beginning of this recovery should be stronger than from any other recession.

We should not be horrified to see numbers like 6 or 7 or even 8 percent real growth in the next few quarters. I think that should be something we would applaud. I think the Fed should continue to provide credit at current rates of interest without raising them, unless genuine evidence of some shortage or some inflationary problem can be found.

In that event they could come back to you and say it would be risky to finance this recovery any further, and they could show then the change in policy that might be needed. But at present, I would say they should keep interest rates stable and just let this economy recover as it would, I think, if we would just leave it alone.

[The prepared statement of Professor Nichols follows:]

Prepared Statement of

Donald A. Nichols

Improving the Co-ordination of Monetary and Fiscal Policies

This testimony has three parts: (1) A summary of the policy problem now facing the American economy; (2) A set of recommendations for monetary policy and for changing the way Congress oversees the Federal Reserve; and (3) A section of general discussion of some of the issues raised by these recommendations.

I. Summary of the Problem

●The challenges facing the American economy over the next decade can only be met with a high rate of investment. ●The level of investment is influenced importantly by the levels of employment and interest rates and by their stability. ●To keep the economy near full employment with low, stable interest rates would require a closer co-ordination of monetary and fiscal policies than we have had in the past. It would also require a different policy strategy than has been followed in the recent past, particularly by the Federal Reserve. ●A policy to support investment would also be a good policy for recovery in the Midwest, which is the home of much of our heavy investment-goods industries. Many of these industries, which are now depressed, would be profitable and viable in a high-investment world. ●Thus a policy to support investment is needed at the national level, and such a policy would, at the moment, also constitute a sound regional policy.

II. Recommendations

Greater co-ordination of monetary and fiscal policies is needed. At present, the only formal mechanism for co-ordination is provided by some weak language in the Federal Reserve Act (Section 2A) that was amended by the Humphrey-Hawkins Act (Section 108A) in 1978 to read in part:

...The Board of Governors of the Federal Reserve System shall transmit to the Congress... written reports setting forth... the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates... and the relationship of the aforesaid objectives and plans to the short-term goals set forth in the most recent Economic Report of the President... and to any short-term goals approved by the Congress.

This language is too weak to provide a formal basis for the co-ordination of policies because: (1) The Federal Reserve is only required to comment on whether its monetary growth targets are consistent with the Administration's economic goals; it is not required to see that they are; (2) The Congress does not now formally adopt economic goals; it treats the forecasts on which the budget estimates are based as a set of economic assumptions whose purpose is to make the budget estimates realistic; and (3) The list of short-term goals that is required to be set forth in the Economic Report of the President does not include the rate of investment or capital formation, (though a forecast of capital formation is required), nor does it include interest rates or other financial variables that affect capital formation.

The net effect of these weaknesses is that the Federal Reserve now has the power to choose a monetary policy that contributes to high interest rates and low investment, and that causes output growth to be lower than Congress and the President desire. While the Federal Reserve may choose these policies in order to fight inflation, it should be emphasized that an anti-inflationary policy would still be available to the Fed, even with the strengthened language and behavior proposed below, if Congress and the President would also choose as a goal for inflation a 'low enough number. Thus the Federal Reserve would remain able to fight inflation, as at present, if Congress and the Administration wanted

them to. But they would not be able to choose to fight inflation at the expense of other goals if Congress and the Administration ranked these other goals more highly.

Recommendations for institutional change and for policy strategy follow. These are, in turn, followed by a section that discusses these recommendations and that places them in the perspective of the overall economic policy problem.

Recommendations for Institutional Change

If the Humphrey-Hawkins Act is to provide the basis for a more effective coordination of policies, several changes must be made in its language and in the behavior of Congress and the Federal Reserve:

(1) The short-term economic forecast approved by the Congress as a part of the budget resolution, and that provides the assumptions on which the budget estimates are based, should acquire the status of being its short-term economic goals. This is the status now conferred by the Humphrey-Hawkins Act (Section 103A) on the similar economic assumptions that accompany the President's budget message to the Congress.

(2) As the forecasts are being discussed in Congress, and before they are adopted, the Federal Reserve should be required to testify to their appropriateness as short-term economic goals.

(3) Once Congress has adopted its goals, the Federal Reserve should be required to adopt them as its own goals, and to testify as to how it intends to pursue them. This means that the Federal Reserve should not have objectives for the economy that are different from those of the Congress.

(4) The list of goals should be expanded to include the rate of capital formation, and the Federal Reserve should be required to prepare a whole section

of the its semi-annual report on how capital formation is likely to be affected by its intended policies.

(5) The Federal Reserve should not be required to set forth its intended policies in the form of numerical growth rates for specific monetary aggregates unless that is the way it feels it can be most clear in stating its intentions.

(6) The Federal Reserve should retain the right to use some discretion as to how best to respond to unforeseen circumstances that make it impossible to reach all of its short-term goals simultaneously. While Congress may prescribe in advance the general character of the response it would like, unforeseen events generally occur, and when they do, the Federal Reserve would still be left without specific guidance as to how to proceed. In short, it would still have the independence necessary to chose its own actions much of the time.

Recommendations for Current Policy

With the above institutional structure in place Congress should adopt as a major objective the attainment of a high rate of capital formation, and, in particular, of business investment. A high rate of investment would help the American economy meet its major challenges of the 1980s which are 1) to get back to full employment without inflation; and 2) to revitalize its industrial base. Success in these two areas would improve our international competitiveness and provide the basis for steadily increasing standards of living. A high rate of investment would also provide the major ingredient for a recovery of the manufacturing sector in the depressed Midwest. Thus a national policy of high investment happens to be an excellent regional policy at the present time as well as being the policy best-suited to our national needs.

The major elements of a policy strategy to support investment are well known. What is required is the provision of low, stable interest rates and a high rate of employment. Congress should work with the Federal Reserve to see that the policies of both institutions contribute to bringing these conditions about to the greatest extent possible. Only the general nature of such a policy is outlined here.

The basic elements of such a policy are well known.

(1) In general, real interest rates will tend to be lower at a given level of demand the smaller is the federal deficit and the larger are the stocks of money and credit.

(2) Interest rates will be more stable the greater the extent to which the Federal Reserve accommodates short-term fluctuations in the demand for credit.

(3) A high rate of employment and demand can be reached at the present time by permitting the economy to grow using its own strength, and by supporting that strength with injections of money and credit when the economy falters.

The risk to this third element of the strategy, of course, is the potential for an unwanted effect on inflation. Inflationary developments should be monitored carefully as the economy improves so that they are not permitted to grow and sustain themselves. At present, I see no inflationary threat on the horizon and see no reason why a major expansion of money and credit would not finance real increases in production rather than higher prices. As full employment is approached more caution would be required, of course, but with a current unemployment rate of 10% and a current utilization rate of 70% for physical plant, the economy appears to have ample room to grow before inflationary forces are encountered.

While policies supporting a high rate of investment can be easily justified on the national level as necessary (1) to provide the demand necessary to reach full employment, (2) to provide the productive capacity to permit full employment to be reached without encountering inflationary bottlenecks, and (3) to help reduce costs to increase our international competitiveness and our rate of productivity growth, they can also be justified on a regional, or structural, basis.

Our economy has not been near full employment since 1979. The recessions since then have been deep and they have been accompanied by high interest rates and low levels of investment. The Midwest, in particular, has borne the brunt of these recessions because it is the center of our highly cyclical heavy manufacturing industries. Only if investment recovers at the national level will the heavy industries of the Midwest recover. Many social programs have high outlays in the Midwest right now because unemployment rates are so high there. A high-investment policy would help the Midwest recover and would lead to budget savings for these social programs.

The way to encourage a high-investment recovery is to provide the credit necessary to finance that investment. The national economy is badly in need of credit today, having been starved of it for over three years. Only if signs of permanent inflationary developments were to appear would I recommend not supporting the current recovery by providing all the credit the economy can use. I think the risk of inflation is down the road several years and that a strong non-inflationary recovery would take place in the near term if we would only let it happen. Therefore, my single major policy recommendation for the coming year follows.

The Federal Reserve has it in its power to keep interest rates stable as the economy recovers and they should be asked to do so at the present time.

III. Discussion of Related Issues

Problems due to a Lack of Policy Co-ordination in the Past

Taxes on investment were reduced substantially in 1981 in order to encourage investment, yet real business investment has declined since then. The reason for the decline is obvious. A tight monetary policy has caused a major recession. The recession has taken away the wherewithal to invest by keeping pre-tax profits low. It has been so deep and extensive that it has threatened the financial viability of many firms in the short-run, thereby causing them to be more cautious with their investment decisions. By reducing current production, it has taken away the need to expand capacity, even for many firms in growing industries. And the combination of a tight monetary policy with large current and prospective fiscal deficits has kept real interest rates high thereby raising the cost of investing with borrowed money.

Thus the effect of the tax incentives on investment has been more than offset by the overall effect of the monetary-fiscal policy mix. The net effect of these policies has been to reduce pre-tax profits by so much that after-tax profits have fallen despite the tax cuts.

I do not claim that these problems would necessarily have been avoided with stronger institutions for policy coordination. Good policy design is needed along with a good institutional structure. This means we need a good theory on which to base policy and I admit that there has been a notable lack of agreement among economists in recent years over what constitutes good theory, let alone policy. And, indeed, if we could all agree on what constituted good policy we

would probably have it regardless of the institutional structure for policy making. But with a proper co-ordinating we are much less likely than at present to have policies working at cross-purposes in the event there is disagreement over what policies to adopt.

Policy Co-ordination at Present

Formally, monetary and fiscal policies are now co-ordinated through the Congress rather than the Administration, and in the Congress co-ordination is weak because of the separate committee responsibilities for taxing, spending and for the oversight of the Federal Reserve System.

The creation of the Budget Committees in 1974 gave Congress the ability to coordinate its taxing and spending decisions. This has permitted the Congress to participate fully in the fiscal policy process and in the debate over the level of the deficit. But there is no structure at present through which monetary and fiscal policies can be effectively co-ordinated and, therefore, no way for Congress to participate fully in the debate over interest rates, investment and, indeed, overall macroeconomic policy.

But even with the strengthened language I propose, the fact that the forecasts, or goals, are proposed in the Budget Committees while the Federal Reserve's discussion of them is in the Banking Committees means that policy co-ordination will remain fragmented.

Even within the Administration co-ordination of monetary and fiscal policies is absent. Informal discussions do occur between the Chairman of the Board of Governors and the President, and between other members of the Board and high economic officials in the Administration. But these discussions rarely involve a give and take over policy, and there is no way for the

Administration to ask the Federal Reserve to support its goals if the Federal Reserve has different goals.

I do not favor radical reforms that would make the Federal Reserve an arm of the Treasury or that would tightly regulate Federal Reserve behavior by formula. These reforms might lead to greater co-ordination of policy but would upset a delicate institutional balance that now exists between the Congress and the Administration and that exists among the various academic, political and financial factors that now influence monetary policy decisions.

I feel that greater co-ordination is possible through the minor changes in reporting requirements I recommend above and through slightly more specific directives from the Congress to the Federal Reserve. That is, I feel that the existing structure and nature of policy-making organizations should be left alone but that the communication between those organizations as well as the assignment of policy responsibilities to them, could be changed slightly. Even with these changes, coordination will take place largely on a voluntary basis, and will require the good will of all parties.

The Forecast as a Basis for Policy Co-ordination

The element of policy around which it is most promising to co-ordinate decisions is the economic forecast. Granted, we all know how difficult it is to forecast, and, therefore, how unreliable a particular forecast may be as an indicator of what will actually transpire. But just as it is necessary to have an economic forecast before there can be a budget, so there must be a forecast before one can discuss interest rates, money growth, deficits and their co-ordination in a sensible way. The forecast provides a common basis for discussing policies more than it does an exact chart of future events that must transpire.

Congress uses a forecast when it adopts a budget resolution. The forecast is necessary to know what tax receipts are likely to be, as well as what outlays will be for unemployment compensation, interest costs and a whole variety of programs that are influenced by economic activity. The forecast permits outlays to be compared on a common basis as well as to give a realistic estimate of what the outlays for any particular program are apt to be.

At present, the forecast is treated simply as a technical ingredient of the budget estimating process. I believe the status of the forecast could be elevated to provide a common view of the economy around which to organize policy. The Humphrey-Hawkins Act discusses economic goals as well as forecasts. If the short-run forecast, once adopted, could be thought of as an interim economic goal, it would provide a basis for policy co-ordination.

At present, the Federal Reserve is required to testify about the reasonableness of the Administration's forecast. It is required to tell how its actions relate to that forecast. Congress adopts its own forecast with the Budget. The Federal Reserve is not required to comment on it. I suggest that they be required to comment on the appropriateness of the proposed forecast as a goal. And then, rather than having the Fed tell Congress whether its own policies will help Congress reach its goals or not, I suggest that Congress should direct the Fed to design its own policies so as to support the goals Congress has chosen.

At present the Fed reports to the Banking Committees its targets for money growth rates. These targets are justified on the basis of the economy's needs. But the justification is not closely linked to the forecast Congress used when adopting its budget. Yet the Fed has an important influence on the ability of Congress to hit its deficit target, but only rarely does it choose to comment on whether its money growth proposals are likely to lead to deficits smaller or larger than those adopted by Congress in its budget resolution.

Rather than require the Fed to tell Congress what the Fed is going to do, and to require the Fed to come in and testify when it does something different from what it said it would do, Congress should tell the Fed what economic goals are to be pursued. The Fed would still be required to tell congress what money growth rates it intends to pursue as being likely to be consistent with those goals. But when unforeseen events make it necessary for the Fed to print more money than it had intended in order that the economy is to reach its goals -- as has recently been the case -- the Fed should not then be required to apologize for its actions as if they constituted a change in policy.

This example shows us the change in emphasis that would take place when policy is organized around a forecast, and when the forecast is treated as a goal. As long as the economy is kept on the path to the goal, changes in the chosen settings for policy instruments -- such as the money growth rate -- should not be viewed as changes in policy. The policy adopted by the Congress would be to have the Federal Reserve pursue the forecast as a goal, and if the pursuit of that goal required a mid-stream correction in the money growth rate, then that correction should take place and should be considered to be a part of the original policy strategy. Only a change in money growth rates accompanied by a change in the goals would be thought of as a change in policy.

This would be a great improvement over current procedures where the Federal Reserve is required to tell Congress what it intends the money growth rate to be. As long as it hits its money growth target it is now considered to have fulfilled its mission. At present, when unforeseen events cause the economy to lurch, the Fed, with the major burden of its reporting requirements being the money growth targets, might normally be expected to revise its economic forecast

rather than the money growth targets. Under the proposed system, the Fed would normally be expected to revise the money growth targets in order to continue to pursue the economic goals assigned to it by the Congress.

The Independence of The Federal Reserve

Would this proposed structure unduly restrict the independence of the Federal Reserve? I think not. We must remember that the Federal Reserve is not the fourth branch of the government. It is 70 years old in a Republic that is 207 years old. It constitutes but one of many institutional organizations that have been, or could have been, tried by Congress in its pursuit of its Constitutional mission "to coin money and regulate the value thereof."

The modest proposal I have made does not do away with the Federal Reserve, but merely requires it to be a part of the team that makes macroeconomic policy. The Federal Reserve has as important an influence on economic activity as does the Federal Budget. Budget policy and monetary policy must be made in concert if there is to be any overall policy toward interest rates and employment. The Federal Reserve cannot expect to dominate the joint policy process, so it must co-operate with other institutions if true co-ordination is to take place.

Even with the proposed changes, the Federal Reserve would still retain enormous flexibility to change policy as new circumstances would require. While the exact nature of uncertain events cannot be forecast, we know that there will be some, and that our forecasts will be inexact. If, for example, some surprises lead us to believe that real growth might turn out to be less than was forecast while inflation might simultaneously turn out to be greater, there would be no unique change in policy on the part of the Federal Reserve that

would permit both goals to be met simultaneously. If the money growth target was to be raised, real growth would come nearer to its target but inflation would move further away. In this case unless Congress could have specified in advance how the Federal Reserve should react to such a disappointing turn of events, the Federal Reserve would retain the independence to do as it saw fit.

I think this example is typical of the kind of unforeseen events that might occur that would free the Land of the Fed to pursue its own policies even if Congress were to choose specific goals for it to pursue.

In practice, I think that the minor changes I have proposed would leave the Federal Reserve a great deal of independence where independence matters most -- in the regulation of banks -- but would modestly reduce its independence where independence is capable of thwarting the design of a consistent national macroeconomic policy.

The CHAIRMAN. Thank you, Professor Nichols.
Now, we will hear from Dr. Robert Barbera.

STATEMENT OF ROBERT J. BARBERA, CHIEF ECONOMIST, E. F. HUTTON & CO.

Mr. BARBERA. Good morning, Mr. Chairman and members of the committee.

My name is Robert Barbera, and I am the chief economist of E. F. Hutton & Co. I would like to thank you for the opportunity to testify this morning. My remarks, I believe, are even more modest than these of Professor Nichols.

My intention is to focus on the following points:

First, it is clear that the Federal Reserve Board made the right decision last summer when, recognizing the confused nature of various money supply measures, it temporarily relaxed its money targeting policy. The events of 1982 highlight the need for judgment in conducting monetary policy.

Second, judging by their subsequent actions, the financial markets deemed appropriate the Fed's move to a more pragmatic practice. We did not see an upswell of reflation fears. Indeed, as the Fed released its grip on the money supply, interest rates, both short and long-term, declined.

Third, I think one can argue that the Fed today is continuing to practice a more eclectic monetary policy, which I believe is appropriate in the light of the confusion that continues to attend many of the money and credit growth measures. Nonetheless, this policy has left credit market participants, the people who trade bonds on the 10th floor of the building I work in, more in the dark than usual about future Fed action. The Fed could somewhat reduce volatility in the financial marketplace if it provided more guidance as to what it considers an acceptable growth path for the economy.

Fourth and last, changing Fed policy will not provide the ultimate tonic for the stock and bond markets. Again, I concur with the initial comments of many committee members about the need to move away from strict monetary targeting. But the Fed has made that adjustment. Outyear budget deficits, are our fundamental problem today. Fiscal policy, not monetary policy, is at present in need of a major overhaul.

Again, my first point is that the Fed's decision last summer to relax its grip on the money supply was appropriate.

Clearly, the Fed's October 1979 move to a focus on monetary aggregates in lieu of monitoring the Fed funds rate was a response to the enormous inflationary pressures that had built up throughout the 1970's. The Federal Reserve believed that bold action was necessary and, it began to target money and let credit markets for the most part seek their own level.

The plan, no doubt, was to set money supply targets designed to slow nominal GNP growth and, over time, reduce the inflation within our economy. No one can deny that the approach was effective in reducing inflation. But the simple appeal of this approach, and it was very appealing, particularly to the financial markets, gave way to deep-seated concern by mid-1982.

The question is what happened? Very simply, during 1982 the relationship between money growth in money and growth in nominal GNP was strained beyond recognition.

Again, the Fed's money targets were meant to slow nominal GNP growth, and thereby reduce inflation. In testimony before this committee in late 1981 money supply targets for 1982 were presented.

Implicit in setting such monetary targets were assumptions about the relationship between money growth and nominal GNP growth; that is, the Fed had to assume a certain range for the growth in velocity of money. The Fed assumed the traditional growth rate for the velocity of money—about 3 percent. Putting it another way, the Fed chose a range for money growth based on its best guess about how fast money would circulate through our economy.

As the chart on the next page details, there were dramatic declines in the velocity of money during 1982. No training in economics is necessary to recognize that velocity made a break with the past during 1982.

[The charts referred to may be found in Mr. Barbera's prepared statement.]

The speed at which money moves through our economy has been increasing for decades. The rate of acceleration has varied between 2 and 6 percent, but the velocity has almost always been increasing. For the past several quarters, however, velocity not only slowed its increase, it has actually decreased.

That means that if the Fed had tried to meet its target for M_1 , nominal GNP would have had to collapse dramatically, given that money was moving much more slowly through our economy.

In fact, we could have expected severe economic retrenchment. I think the Fed shelved those monetary targets none too soon.

Today, we have some good explanations for the dramatic slowing of the money circulation rate. We talk of precautionary money balance that increased as the recession deepened, and we talk of revo-

lutions in the banking industry generating new kinds of accounts that greatly blur distinctions among different money measures. For whatever reason, the highly unusual shifts occurred, they demanded adjustment in Fed policy.

The bottom line is that even though a simple rule for administering Fed policy may have great appeal in the abstract, the events leading up to the summer of 1982 prove the importance of judgment in conducting Fed policy.

My second point is that the financial markets welcomed the Fed's decision to temporarily relax its strict adherence to money targets. In my opinion, the markets correctly refused to interpret the Fed's move as giving up the fight against inflation.

The Fed's decision to provide liquidity to the financial system lowered short-term rates, as expected. But many contended that the Fed's significant overshooting of M_1 targets, for 1982—it did not achieve the targets—would cause the financial community to recoil, in anticipation of increases in inflation. And, as a consequence, we would very soon see long rates go up. For committee members familiar with the concept of a yield curve, basically these people expected to see a very steep yield curve; long rates would rise as short rates went down.

That, of course, did not occur. If you turn to the next page, you can see that as the Fed began to provide liquidity over the next 4 or 5 months, long rates moved down as short rates moved down; in fact, the yield on the 30-year long Treasury bond declined from about 13.5 to 10.5 percent as short rates moved down.

So, to recap, I think the Fed correctly adjusted its targeting strategy to accommodate the notable change in the movement of money through our economy, and credit markets rallied in support of this adjustment.

This brings me to my third point, which is simply that volatility in credit markets today could be reduced somewhat if the Fed provided the markets with some guidelines about what it believes is an acceptable growth path for the Nation's economy.

The Chairman, in his opening remarks, noted that the credit markets basically were closed down during the Fed's FOMC meeting on July 12 and 13. I would say that that is an appropriate characterization of the bond markets during that 2-day period. And I think trepidation arose because, since the advent of a more eclectic Fed policy, credit market participants are in the dark about future Fed actions.

As I noted above, the Fed's selection of a money growth target makes assumptions about the advances in prices and economic activity that will attend such money growth. If money expansion is overtargted but the economy does not appear to be responding as anticipated, the Fed will, correctly, adjust its targeting strategy. Overtarget money growth justifies Fed tightening only when it appears that it will stimulate faster than desirable growth in the economy. But the Fed does not provide guidelines on what it considers an acceptable growth path for nominal GNP, and this leaves credit markets in the dark unnecessarily. This additional uncertainty actually keeps interest rates higher than they would otherwise be.

Although strict targeting has fundamental problems, nonetheless, it provides important insight about future Fed policy. These

insights allow borrowers and lenders to function efficiently, an important prerequisite to a healthy pace for business investment.

The initial relaxation of targets did not cause confusion for the credit markets because it was clear that the Fed was fundamentally trying to provide liquidity, bring rates down, and generate a recovery. Once recovery began, however, Fed policy became ambiguous at best. With recovery unfolding, the dominant question became, Is recovery too strong for the Fed? Thus, if you are in the business of trading bonds, you now have to do two calculations.

The first involves your estimate of the extent to which the present and prospective rate of growth will generate reinflation. Then you have to do a second calculation; you must try to anticipate what level of recovery the Fed believes is acceptable. It may be that you believe the economy can accommodate some quarters of 6 or 7 percent real growth in light of 4 years of little growth. But you are not sure the Fed is comfortable with that. If you are not sure the Fed is comfortable with the present level of growth for the economy, then, you will demand a premium to hold a bond.

The CHAIRMAN. Excuse me, but what you are saying is the problem you now have is trying to read the minds of the Fed.

Mr. BARBERA. Well, that has always been a problem.

The CHAIRMAN. But more so now than before, since this change.

Mr. BARBERA. Well, I would say that strict targeting certainly gives a clear signal about what the Fed will be doing. Now, at the same time, we found ourselves in a bind with strict targeting, the dramatic shift in velocity warranted the change in policy. But now credit markets don't have a key, we don't have an insight into how the Fed is interpreting monetary aggregates. That is why some insight into its nominal GNP targets would assist us.

My last point concerns deficits and fiscal policy, not the Fed. I think the call by committee members for future flexibility in Fed policy is appropriate. But that move has been made. I, too, would lament the Fed going back to a strict monetary targeting procedure, but I don't think that that is in the cards. I think that very quickly leaves budget deficits as the problem. I have no doubt that Chairman Volcker will refer to these deficits in many of his response tomorrow.

Deficits do matter—to the credit market and to the recovery. When I said that interest rates moved down for 6 months as the Fed provided liquidity, I think that was a fair characterization. Both short and long rates came down in concert from August to January.

But somewhere around January, the credit market began to feel a little bit nervous, a little bit concerned, as it appeared that recovery was beginning to unfold. I think much of the concern involved the present and prospective deficits. With no recovery, the Treasury's needs could be accommodated by the financial markets. But with the recovery unfolding, the issue of a credit clash emerges. Will private and public credit demands come to loggerheads as private credit needs grow, a certainty with recovery?

With current excess capacity, the present deficit is acceptable. But deficits greater than 5 percent of GNP throughout the decade are simply foolhardy. Business investment will be adversely affected, and businesses involved in international competition will suffer

greatly at the hands of an overvalued dollar. Having worked in Washington, I recognize that some legitimate pleas fall on deaf ears because the politics are wrong for any action.

I guess what I am hearing here is that right now, the politics are not right to do anything perhaps for the next 18 months. That may be the case. I would add, then, that with the resultant high rates that may attend the economy throughout the next 18 months, we may in fact be locking ourselves into a severely lopsided recovery.

Thank you.

[The prepared statement of Mr. Barbera follows:]

Statement of Dr. Robert J. Barbera
Chief Economist, E.F. Hutton & Company, Inc.

THE FINANCIAL MARKETS AND MONETARY POLICY

Good Morning, Mr. Chairman and members of the Committee. My name is Robert Barbera, and I am the Chief Economist of E.F. Hutton & Company. I would like to thank you for the opportunity to testify regarding the five-year review of the monetary policy provisions of the Humphrey Hawkins Act. My intention is to focus on the following points:

First, it is clear that the Federal Reserve Board made the right decision last summer, when, recognizing the confused nature of various money supply measures, it temporarily relaxed its money targeting policy. The events of 1982 highlight the need for judgment in conducting monetary policy.

Second, judging by their subsequent actions, the financial markets deemed appropriate the Fed's move to a more pragmatic practice. We did not see an upswell of reflation fears. Indeed, as the Fed released its grip on the money supply, interest rates, both short-and long-term, declined.

Third, the move to a more eclectic Fed policy, although appropriate in light of the present confusion attending money supply growth, has nonetheless, left credit market participants even more in the dark than usual about future Fed action. The Fed could somewhat reduce volatility in the financial

marketplace if it provided more guidance as to what it considers an acceptable growth path for the economy.

Fourth and last, the ultimate tonic for the stock and bond markets and, in turn, for the emerging recovery would be a significant reduction in out-year budget deficits.

My first point, again, is that the Fed's decision last summer to relax its grip on the money supply was appropriate.

Clearly, the Fed's October 1979 move to a focus on monetary aggregates in lieu of monitoring the Fed funds rate was a response to the enormous inflationary pressures that had built up throughout the 1970s. The Federal Reserve saw that bold action was necessary, and it announced its intention to focus on monetary aggregates and essentially free credit markets to seek their own level.

The Fed began setting money supply targets designed to slow nominal GNP growth and, over time, reduce the inflation within our economy. This approach was effective in reducing inflation. Nonetheless, the simple appeal of this approach gave way by mid-1982 to a deep-seated concern about the depth of worldwide recession. What happened? Very simply, during 1982 the

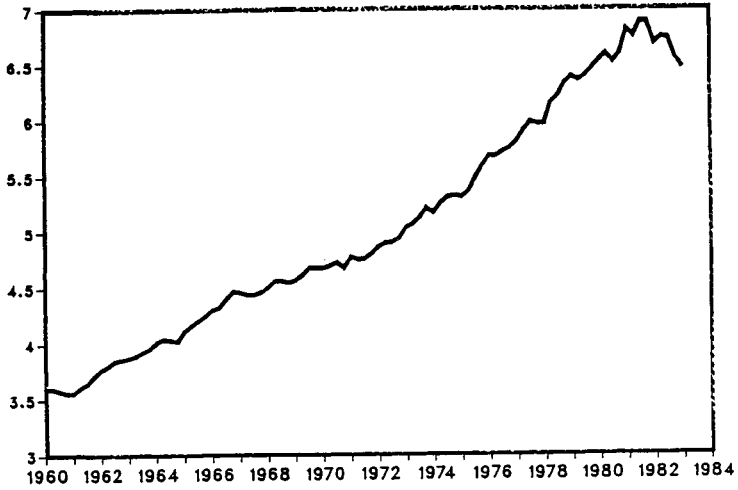
relationship between growth in money and growth in nominal GNP was strained beyond recognition.

Hoping it could continue to slow nominal GNP growth and thereby further reduce inflation, the Fed selected its money supply targets for 1982. Implicit in its setting of such monetary targets were assumptions about the relationship between money growth and nominal GNP growth, i.e., the Fed had to assume a certain range for the growth in velocity of money. Putting it another way, the Fed chose a range for money growth based on its best guess about how fast money would circulate through our economy. Chart 1 reveals that dramatic declines occurred in the velocity of money during 1982. This drastic slowing in money's movement through our economy overshadowed the over-target growth rate of money, and we ended up with a very modest 4.1% advance in nominal GNP. Had the Fed stuck to its strident monetarist approach during the latter half of 1982, severe economic retrenchment was highly likely. I believe the Fed shelved its monetary targets none too soon.

Today, economists have some good explanations for this dramatic shift in money's circulation rate. We talk of precautionary money balances increasing

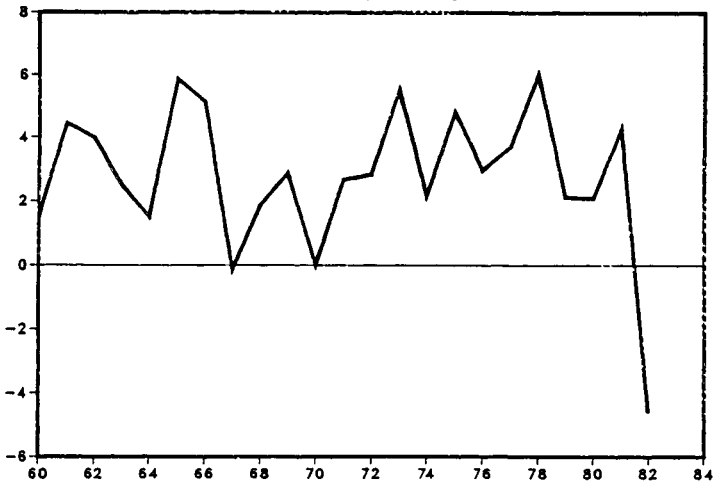
Chart 1

The Velocity Of M1



IV Quarter To IV Quarter Velocity Of Money

Percentage Change



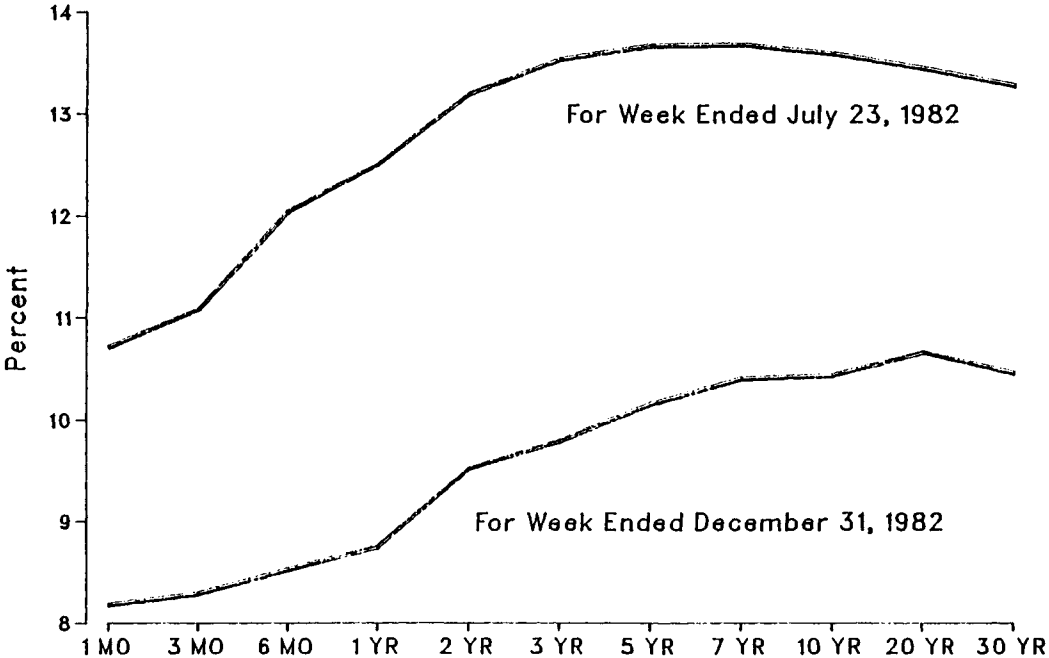
as the recession deepened, and we talk of revolutions in the banking industry generating new kinds of accounts that greatly blur distinctions between different money measures. For whatever reason highly unusual shifts occurred, they demanded adjustment in Fed policy.

The bottom line is that even though a simple rule for administering Fed policy may have great appeal in the abstract, the events leading up to the summer of 1982 prove the importance of judgment in conducting Fed policy.

My second point is that the financial markets welcomed the Fed's decision to temporarily relax its strict adherence to money targets. In my opinion, the markets correctly refused to interpret the Fed's move as giving up the fight against inflation. The Fed's decision to provide liquidity to the financial system lowered short-term rates, as expected. Some, however, contended that in exceeding money targets, the Fed would churn up fears of future inflation and drive the interest costs for long-term borrowers higher. That simply did not occur. Instead, for the next four months, both short- and long-term interest rates declined dramatically. As Chart 2 shows, the cost to the U.S. Treasury of borrowing for 30 years dropped three percentage points, from 13 1/2% to 10 1/2%, just as the cost of borrowing funds for a year dropped from 12 1/2% to just under 9.0%.

CHART 2

Yield Curves



To recap, the Fed correctly adjusted its targetting strategy to accommodate the notable change in the movement of money through our economy, and credit markets rallied in support of this adjustment.

This brings me to my third point which is simply that volatility in credit markets today could be reduced somewhat, if the Fed provided the markets with some guidelines about what it believes is an acceptable growth path for the nation's economy.

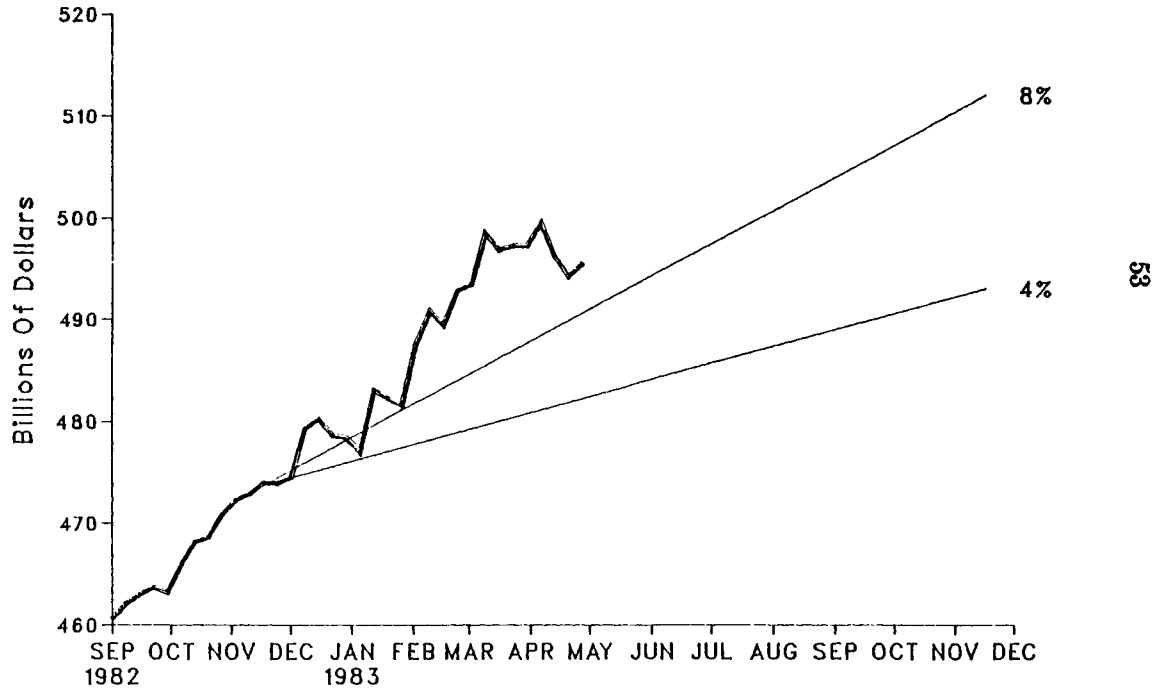
As I noted above, the Fed's selection of a money growth target is based on assumptions about advances in prices and economic activity that will attend such money growth. If money expansion is over-target, but the economy does not appear to be responding as anticipated, the Fed will, correctly, adjust its targetting strategy. Over-target money growth justifies Fed tightening only when it appears that it will result in faster than desirable growth in the economy. But the Fed does not provide guidelines on what an acceptable growth path for nominal GNP is, and this unnecessarily leaves credit markets in the dark. This additional uncertainty actually keeps interest rates higher than they would otherwise be. I believe a quick review of the past three months' activity in the credit markets provides evidence that guidance from the Fed

about acceptable nominal GNP levels could reduce, at least somewhat, volatility in credit markets.

In April, many market participants began to anticipate another easing action by the Fed. March's retail sales, as originally reported in April, were weak, and the failure of auto sales to rebound was of particular concern. [With interest rates appreciably lower, personal income and wealth growing and consumer sentiment surging, economists were somewhat baffled by the missing consumer. But consumer expenditures were not advancing and concern over another stillborn recovery began to grow.] Moreover, in April the money supply (M-1) declined and began to near its upper target range (see Chart 3). Thus a recovery without conviction and slowing M-1 growth were considered ample justification for a discount rate cut. The market anticipated that cut, and interest rates, both short- and long-term, declined. Then, over a two-week period, expectations changed dramatically as a spate of statistics punctured previous perceptions about the state of the economy and the growth in money supply. On May 11, April's retail sales were announced as a dramatic 1.6% higher and March's sales figures were revised upward to a very strong 1.7% improvement from the meager 0.3% advance initially reported. Thus, consumer participation in the recovery was not only

CHART 3

Monetary Aggregate – M1



there, it turned out it had been there for some time. That Friday, the Federal Reserve's industrial production figure was also above expectation, with a strong 2.1% growth rate. And, at 4:15 that Friday afternoon, M-1 was revealed to have risen \$4.2 billion.

The next week topped things off, as M-1 rose \$7 billion. In just two weeks, April's M-1 reduction was gone, and the recovery was taking hold; thus, further Fed easing was not to be expected. Interest rates, both long- and short-term, then backed up. But as weeks passed, and it became clear that recovery was underway, the preeminent question became, "is our present rate of growth too strong?" That is still an essential question. Again, we know that money supply growth has been brisk and that M1 is above target, but we are not sure what that means anymore. We do know that the Fed tempers its reaction to money supply growth based on the pace of recovery. But again, the markets are unsure of the pace that the Fed believes is acceptable. Thus, in addition to judging whether the economy is too strong in terms of its inflation-generating potential, financial market participants must also guess whether it is too strong for the likes of the members of the Federal Open Market Committee. If, in fact, recovery is too robust for the FOMC, a Fed

tightening will be forthcoming. The inability to anticipate such a tightening has led of late to investors demanding a higher risk premium in the marketplace to compensate for this additional uncertainty. Were the Fed to provide some broad guidelines, a sense of what nominal GNP target ranges are appropriate, credit market participants would be better able to anticipate Fed policy.

For the record, I do not think the recovery unfolding is at present rushing us towards reflation. Consequently, I don't believe a Fed-induced slowdown is warranted at this time. After more than four years of very little economic growth and after puncturing an inflationary bubble built up over a decade, the economy can most assuredly withstand some quarters of growth. Thus, I think it is appropriate to allow the recovery here and abroad to continue without dramatic tightening by the Fed. Money supply measures are still very hard to interpret, real interest rates remain very high, excess capacity abounds, both here and abroad, and economic activity is growing from a very depressed base. A healthy recovery without reflation (the goal of almost everyone's monetary policy) does require vigilance against a resurgence in price increases; nonetheless, it is equally unattainable if we refuse to allow recovery to unfold.

Finally, credit market trepidations about Fed policy notwithstanding, it is fiscal posture, not monetary policy, that is in need of a major overhaul. Without significant reductions in out-year deficits, the Fed in the future will find itself in an untenable position as the inevitable growth in private credit demand begins to compete with the ever present needs of the U.S. Treasury and drives interest rates higher.

I recognize that elected representatives have been hearing for decades from conservative quarters that deficits are a problem. Nonetheless, economists of many stripes consider prospects today for out-year deficits unwise. With current excess capacity, the present deficit is acceptable. But deficits greater than 5% of GNP throughout the decade are simply foolhardy. Business investment will be adversely affected, and businesses involved in international competition will suffer greatly at the hands of an overvalued dollar. Having worked in Washington, I recognize that some legitimate pleas fall on deaf ears because the politics are wrong for any action. My present view, from the Street, suggests that, if the politics are wrong for fiscal reform, then a severely lopsided recovery will no doubt ensue.

The CHAIRMAN. That is an unusual conclusion, Dr. Barbera.

I garnered a couple of things from your testimony. I will get to the other gentlemen in half a moment. If someone is wealthy enough to afford the services of the distinguished Dr. Barbera or one of this colleagues, he or she can invest wisely.

But to those millions of Americans who in recent years have attempted to, or have decided to participate in America and its future through the purchase of stocks and bonds, but that cannot afford the services of sophisticated consultants such as yourself, they are really playing russian roulette.

They are really at a disadvantage. So again, this secrecy that pervades and prevails works to the benefit of the wealthy, the sophisticates, and to the detriment of those who are the average investor or average individual who does not have the wherewithal to purchase the talents of brilliant people like yourself.

Mr. BARBERA. I certainly—

The CHAIRMAN. You don't want to handle that one.

Second, you say that nothing will be done for the next 18 months because of the politics of it, and as a result thereof, you see no real, am I—

Mr. BARBERA. No, no. I was saying that—

The CHAIRMAN. Let me finish.

Mr. BARBERA. Certainly.

The CHAIRMAN. Again, I am just trying to understand this. That you see no real hope of reinvestment in our productive capacity because if there were too much demand on the part of industry, the private sector, as opposed to government, to finance deficits, then this would be counterproductive.

Did I read you correctly?

Mr. BARBERA. Let me share with you—

The CHAIRMAN. We would meet interest rates going up again.

Mr. BARBERA. Let me share some of the insights we provide to our clients.

The CHAIRMAN. I hope you are not going to bill us.

Mr. BARBERA. I think at present we suggest that, yes, we have a recovery. It is strong in the present quarter. And will be strong in the next. But it is based in the consumer sector. That is as it should be at this point in a recovery.

However, we are not sanguine about a strong pickup in 1984 in business, fixed investment in those investments in productive endeavors as a consequence of our sense that we will have high real rates.

We would love to be proved wrong about the prospects for significant improvement in the outyear deficit picture, but our best assessment at this juncture is that significant action is not going to be taken through 1984.

As a consequence, with recovery unfolding, and with this sort of enlightened monetary strategy that we think we see going on at the Fed, and with private credit demands growing, we expect to see high real rates.

The CHAIRMAN. I thank you.

We have to get to these other witnesses. You are all very fascinating, those two of you who have testified and those who will testify.

So, we will continue with the fascination. I now ask Professor Cagan of Columbia to address us.

STATEMENT OF PROF. PHILLIP CAGAN, CHAIRMAN, DEPARTMENT OF ECONOMICS, COLUMBIA UNIVERSITY, AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. CAGAN. Thank you, Mr. Chairman.

My statement focuses on the conduct of monetary policy over the next couple of years.

Let me read a condensed version of my introduction to my statement, then I will briefly summarize the rest of it.

The U.S. economy is entering the second stage of an effort to subdue inflation. The first stage cut the inflation rate about in half, from 10 to about 5 percent per year, as I read the figures, which is similar to cuts of half in past cyclical contractions.

In this disinflation the economy underwent a severe recession, of which 1983 is the first year of recovery. The second stage of disinflation is the crucial one of continuing the process while economic activity continues to recover.

This is the stage in which the economy was allowed to overexpand in past episodes, causing inflation to surge and end up higher than before. This decline and discouraging resurgence has occurred three times since the present inflation began in 1965.

Today, we are in the second stage of the fourth attempt to end inflation, and hopefully we shall successfully avoid the mistake of overexpansion that led to the previous failures to end inflation.

Inroads against inflation we have so painfully gained cannot now be taken for granted. They must be protected.

Now, let me comment on three areas of conduct of monetary policy that are coming up now in the next couple of years.

First, the growth of M_1 should be cut back gradually but substantially over the next year. Monetary growth affects the economy over a period of many quarters. If we wait to rein in monetary growth until the economy actually has fully recovered, it will be too late, and we shall be back on square one in the fight against inflation.

It is not too early to start cutting M_1 growth, and we should recognize that we have a good way to go.

In addition to continuing inflation, the economy also suffers from an overvalued dollar, high unemployment, and high real interest rates. These can be partially mitigated by monetary expansion, but we must avoid being drawn into an expansion that reignites inflationary pressures.

The overvalued dollar and high unemployment reflect the disinflationary transition, as do high interest rates, in part. When the process has run its full course, these undesirable consequences will disappear.

If we try to hasten their reversal by monetary expansion, we risk reigniting inflation, after which we shall have to endure them all over again in the next effort to subdue inflation.

I dissent strongly from the view that the Congress or the administration or the Federal Reserve should decide what interest rates

should be, and then the Federal Reserve should determine those interest rates.

I believe that we should let interest rates be determined in the market, and should pursue a monetary policy that is designed to provide smooth growth over the next years.

I don't think we have any way of knowing what a proper interest rate should be that is consistent with that policy.

High real interest rates mainly reflect the large Federal deficit, which absorbs a large fraction of the available supply of loanable funds. The economic effect of the deficit is to reallocate funds to government purposes that could otherwise be used by private borrowers.

The high interest rate is the mechanism by which this reallocation is effected. To attempt to lower interest rates by increased monetary expansion will only change the sectors of the economy that must retrench to finance the Government's deficit, not the fact of reallocation.

Now, it is true that if financial markets adjust rapidly, nominal interest rates may actually increase in the face of monetary expansion. If we tighten up too quickly, though I believe this is unlikely in the short term.

Lower interest rates would, to be sure, lighten the burden of borrowers, particularly foreign countries in debt, at the expense of the return to lenders. It is generally desirable to avoid bankruptcies under these circumstances.

But it is less desirable to run the risk of escalating inflation in order to avoid bankruptcies. That would rule out effective policies to eliminate inflation. While I would not endorse subsidies, it would be far better to shore up insolvent borrowers by direct grants than to support them indirectly by escalating inflation.

While the present cyclical recovery will bring some rise in the inflation rate as previously depressed prices recover, there is no reason why inflation cannot continue to decline after a temporary and moderate rise.

We should not endorse policies which forecast 5-percent inflation indefinitely into the future. We should set zero inflation as the goal, to be achieved in a few years. If our policy is not able to take us from 5 to 0 inflation, it will not easily be able to defend 5-percent inflation against subsequent increases.

The rest of my statement is a discussion of monetary targeting. There is considerable discussion recently of using GNP or total debt or credit as targets. I see nothing wrong with that. But I don't believe that we can avoid using a monetary aggregate also, because the Federal Reserve needs something more current than these longer run targets, which give you a view of what is happening to the economy over a half a year or a year.

We need something closer at hand on a month-by-month basis to see where we are going.

I believe M_1 is still the best target. In my research, and looking at the alternatives, M_1 has been subject to some difficulties. But I believe the other alternatives are even worse.

I also think that some of the distortions that have occurred in M_1 that have been widely discussed are not as serious as made out.

There has been a shift in the demand for M_1 , one which occurred in 1974 and another which I identify at the beginning of 1982.

Both shifts, I think, reflected the inflationary environment. First, there was a tendency to get out of money in 1974. I believe now a return to get back into money in 1982 with a disinflationary process. I don't see evidence of any other shifts, and I think that we can use M_1 as a target.

It may shift in the future, in which case it seems to me that the Federal Reserve, given its studies, could announce that they believe a shift has occurred and change their targets accordingly.

But I believe a published target for M_1 based on what is known at the time would provide the public with an indication of what the Federal Reserve is planning to do, and gives us an opportunity to see the path that will be followed.

The CHAIRMAN. Professor Cagan, if I may interrupt for a moment, hasn't the Federal Reserve itself been coming before us for the past 2 or 3 years with Humphrey-Hawkins telling us about their difficulties with M_1 ?

Mr. CAGAN. Yes, they have. And they have abandoned targeting M_1 , as you know, last year.

The CHAIRMAN. Therefore if you are asking that they return to or place a little more emphasis on M_1 , where do you think they are going to get this knowledge—this accuracy—that they contend that they no longer had?

Mr. CAGAN. Because I believe they will do better that way than the way they are planning to go.

The CHAIRMAN. Would you hold their feet to the fire?

Mr. CAGAN. What they are doing now is targeting on interest rates, which I think is going to lead to even worse problems. They could combine the two. But I believe we ought to have an idea what the M_1 target looks like that they are going to follow. Well, that is the end of my statement, a desire to provide some credibility and an indication of where the Federal Reserve is going, an indication that we will follow a path that inflation won't creep up on us again.

Thank you.

[The prepared statement of Professor Cagan follows:]

Prepared Statement
for House Banking Committee

July 19, 1983

Phillip Cagan
Chairman, Department of Economics, Columbia University
and Visiting Scholar, American Enterprise Institute

MONETARY POLICY

Policy Recommendations:

The U.S. economy is entering the second stage of an effort to subdue inflation. The first stage cut the inflation rate about in half, from 10 to about 5 percent per year, which is similar to cuts of half in past cyclical contractions. The actual rate in early 1980 was higher, and early this year it was lower, but disregarding temporary influences on prices the underlying annual rate of inflation declined between early 1980 and early 1983 from about 10 to 5 percent. In this disinflation the economy underwent a severe recession, of which 1983 is the first year of recovery. The second stage of disinflation is the crucial one of continuing the process while economic activity continues to recover. This is the stage in which the economy was allowed to overexpand in past episodes, causing inflation to surge and end up higher than before. This decline and discouraging resurgence has occurred three times since the present inflation began in 1965. Today we are in the second stage of the fourth attempt to end inflation, and hopefully we shall successfully avoid the mistake of over-expansion that led to the previous failures to end inflation. Inroads

against inflation we have so painfully gained cannot now be taken for granted. They must be protected.

I appear here today to discuss monetary policy in the second stage. Success in ending inflation requires at a minimum that we accept and pursue three objectives:

- o Reduce M1 Growth. The growth of M1 should be cut back gradually but substantially over the next year. Monetary growth affects the economy over a period of many quarters. If we wait to rein in monetary growth until the economy actually has fully recovered, it will be too late, and we shall be back on square one in the fight against inflation. It is not too early to start cutting M1 growth, and we should recognize that we have a good way to go.
 - o Leave Interest Rates to the Market. In addition to continuing inflation, the economy also suffers from an overvalued dollar, high unemployment, and high real interest rates. These can be partially mitigated by monetary expansion, but we must avoid being drawn into an expansion that reignites inflationary pressures. The overvalued dollar and high unemployment reflect the disinflationary transition, as do high interest rates in part. When the process has run its full course, these undesirable consequences will disappear. If we try to hasten their reversal by monetary expansion, we risk reigniting inflation, after which we shall have to endure them all over again in the next effort to subdue inflation.
- High real interest rates mainly reflect the large federal deficit, which absorbs a large fraction of the available supply of loanable funds. The economic effect of the deficit is to reallocate funds

to government purposes that could otherwise be used by private borrowers. The high interest rate is the mechanism by which this reallocation is effected. To attempt to lower interest rates by increased monetary expansion will only change the sectors of the economy that must retrench to finance the government's deficit, not the fact of reallocation. If financial markets adjust rapidly, nominal interest rates may actually increase in the face of monetary expansion, though I believe this is unlikely in the short run.

Lower interest rates would, to be sure, lighten the burden of borrowers, particularly foreign countries in debt, at the expense of the return to lenders. It is generally desirable to avoid bankruptcies under these circumstances, especially large ones. But it is less desirable to run the risk of escalating inflation in order to avoid bankruptcies. That would rule out effective policies to eliminate inflation. While I would not endorse subsidies, it would be far better to shore up insolvent borrowers by direct grants than to support them indirectly by escalating inflation.

- o Continuing Disinflation. While the present cyclical recovery will bring some rise in the inflation rate as previously depressed prices recover, there is no reason why inflation cannot continue to decline after a temporary and moderate rise. We should not endorse policies which forecast 5 percent inflation indefinitely into the future. We should set zero inflation as the goal, to be achieved in a few years. If our policy is not able to take us from 5 to zero inflation, it will not easily be able to defend 5 against subsequent increases.

The Reliability of M1 as a Target

Two arguments are sometimes made why the high growth in M1 is not overly expansionary. One is that other monetary aggregates are not presently showing excessive growth and the other is that interest rates are high, allegedly indicating financial tightness. Neither argument should be accepted.

The monetary aggregates broader than M1 are less distorted, to be sure, by public shifts among the included financial instruments than is a narrower aggregate like M1. Such shifts distort the relationship between M1 and aggregate spending, while a broader aggregate which includes all the affected assets is not distorted by such shifts. But this superiority of the broader aggregates pertains only to shifts among its components from the demand side. Supply-induced changes, particularly by monetary policy, will also produce differences in growth rates of the aggregates. In such cases we expect M1 to reflect the change in supply first and the broader aggregates to respond later. Differences in growth rates among the monetary aggregates can be important in the short run, therefore, and proper interpretation must distinguish between supply and demand influences. This is not always easy and creates uncertainty and the possibility of errors in the conduct of monetary policy. In the face of uncertainty policy should follow the course of the least risk to its long-range goals. I doubt that broader aggregates provide the superior guides for policy.

I have examined the demand for money in my current research and my findings are reported in an appendix to this statement. The conventional equation in the literature for explaining the demand for M1 balances has done fairly well over the years. The equation explains the demand for real M1 balances by relating it to real GNP and interest rates. There appear to

have been two major shifts in the demand equation, however, which are not readily accounted for. The first shift can be dated in 1974 and the second in 1982. These two are almost offsetting: in 1974 II a 2 percent decline in demand and in 1982 I a 1 1/2 percent increase. These shifts appear to reflect changes in inflationary expectations which the demand equation does not capture: a movement out of money in 1974 following the escalation of inflation in 1973, and a movement back in 1982 following the disinflation beginning in 1981.

Predictions of the equation, after allowing for these two shifts, do not show any major discrepancies from the actual balances held thereafter (through 1983 I the latest quarter covered). Consequently, the unusually large decline in monetary velocity in 1983 IV and 1984 I can best be explained, not by a shift in demand for money, but by rapid growth in the supply which has yet to produce an increase in aggregate spending in our presently depressed economy. If the fitted demand equation is accurate apart from the identified shifts, the declines in velocity are a temporary deviation from the equation. The implication is that the recent rapid monetary growth will gradually be translated into higher aggregate spending and nominal GNP, and the decline in velocity will be reversed.

Perhaps some of the new super-NOW accounts introduced in 1983 account for some of the decline in velocity and should be excluded from M1, though they appear largely to be a substitute for regular NOW accounts already included in M1. In any event, it would be implausible and risky to assume that these declines in velocity are permanent and will not be at least partially reversed in coming quarters.

As for the high level of interest rates, it cannot be ascribed to tight money. After M1 growth expanded last August, Treasury bills fell to

7 1/2 percent and have fluctuated around 8 percent, and 5 year Treasury securities have fluctuated around 10 percent. At an inflation rate of 5 percent or less, these are still high real rates. In the current weak economy these rates would ordinarily have continued to decline. Their high level is unusual, which should be attributed to heavy Treasury borrowing and the prospects of higher interest rates in the future. Until the deficits are reduced, it appears that real rates will not go down. As inflation decelerates, however, the inflation premium in nominal rates can decline.

The question remains whether M1 is sufficiently reliable to serve as a specified target for monetary policy. It has been proposed that broader aggregates such as total liquid assets or debt or credit, or even GNP itself, serve as the target for monetary policy. The Federal Reserve has recently returned to a greater reliance on interest rates which it previously abandoned in October 1979.

I do not believe monetary policy can be satisfactorily pursued without paying attention to M1. This traditional aggregate has been subject to distortions in recent years, to be sure, as a result of financial developments which were set in motion by the inflationary environment resulting from monetary overexpansion. But the other monetary aggregates are also subject to distortions and, as I noted previously, they are slow to reflect the supply changes produced by monetary policy. They all show the same decline in velocity as shown by M1 in recent quarters, so it is not obvious that targeting by them would have helped in this case. Yet the broad aggregates may indeed be informative at times, particularly when major shifts among assets are occurring. I investigated these occurrences in a recent study.* But they can be slow to reflect monetary developments,

*Phillip Cagan, "The Choice Among Monetary Aggregates as Guides for Monetary Policy", Journal of Money, Credit and Banking, November 1982.

and monetary policy needs a guide for its month-to-month operation. The base and especially M1 are the best indicators of its operations in the short run. Even if broad aggregates or GNP are used as longer-run targets of policy, monetary policy cannot be conducted without an indication of where it is headed in the short run. Interest rates used to promise this guidance, but as the Federal Reserve itself recognized in 1979, they have proved unreliable, particularly in an inflationary environment.

The Announcement of M1 Targets.

On the presumption that monetary policy will in one way or another have to be guided by M1 growth, what targets should be announced? The Federal Reserve has given notice that M1 is too unreliable to be the basis for announced targets. I believe, however, that announced M1 targets should be reinstated. The economy needs guidance on the path that monetary policy is to follow, and M1 growth is a crucial indicator of policy despite its distortions. When distortions are judged to affect M1, its target growth can be revised, but an announced target based on an assumption of no distortions until they are identified provides a useful guide for policy and a credible indicator to the public of the course they can expect policy to follow.

Appendix

The prediction errors of a standard version of the money demand equation, with alternative definitions of money, are shown in Table 1. The statistical details of fitting the equation to the data are given in Table 2. We may examine the prediction errors for evidence of shifts since 1974 and particularly since 1979. A substantial shift can be seen in 1974 and again in 1982, but no others appear in between those years.

Part I in the tables is based on the standard equation that was widely used through the mid-1970s. In this equation real money balances (using the GNP deflator) are regressed on real GNP, an interest rate pertinent to households (the savings deposit rate) and to businesses (the commercial paper rate), and a lagged value of the dependent variable to allow for partial adjustments in the balances held. All the variables are in logarithms, and a correction is made for serial correlation of the residual error term. Using M1 as then defined, numerous studies found that this equation fit the quarterly data for the mid-1950s to mid-1970s fairly well.^{1/} The standard error of the regression for that period is less than a half percent of real money balances. In the years since this equation was originally used, the definition of M1 has been expanded to include new kinds of checkable deposits (mainly NOW accounts) which pay interest. These revisions of M1 are included here, though they are of no quantitative importance until the late 1970s. The measurement of the two interest rates in the equation have also been redefined here as the differential of these rates over the average rate paid on money balances.

When these fitted demand equations are used to predict real money balances in later quarters, the predicted values minus the actual real

balances are the simulation errors of the equation. The errors of the standard equation began getting large in mid-1970, indicating that actual real money balances were increasing less rapidly than the predicted amounts. When one inspects these errors (not shown), it is clear that a sharp decline in the accuracy of the equation occurs in mid-1974. The date of the shift identified by numerous studies is the first half of 1974, and so the regressions in Part I of the tables were terminated in 1974 II. The simulation errors reach a plateau of around 10-12 percent by 1977 (not shown). The error for two periods after 1979 III is reported in Table 1. For M1 the overprediction continued around 10 percent.

To what extent can these errors be attributed to new financial instruments or arrangements? One development was a change in regulations allowing small businesses and state and municipal agencies to hold savings deposits, previously restricted to individuals. Beginning in mid-1975 a sizable shift occurred from demand to savings deposits by these new holders, estimated to have totaled \$16-1/2 billion by mid-1977. A second development was the significant growth in recent years of overnight repurchase agreements (RP) and overnight Caribbean Eurodollar deposits (ED), which appear to be important substitutes for holding checking deposits. Finally, the rapid buildup of NOW accounts in 1981, which are included in the redefinition of M1, may have reflected an increase in the demand for money balances which the equation is unable to describe. The Federal Reserve published an adjustment of the NOW account data for 1981 to exclude the amount of new NOW accounts that were not replacing other checkable deposits.^{2/} These three developments are allowed for in Table 1 and Table 2 by alternative definitions of money. These alternatives, except for the NOW account adjustment, reduce the simulation

errors of the equation.

Since none of these or other known adjustments of money balances account fully for the large simulation errors after the mid-1970s, it seems likely that the public also developed various arrangements for minimizing money balances in response to high and rising interest rates. The reductions in money demand can be described fairly well by either a lasting reduction all at once in 1974 III or a gradual reduction over a series of years. The former is represented in Part II of Tables 1 and 2 by adding a dummy variable for 1974 III and after, and the latter in Part III by a ratchet interest rate. The ratchet interest rate is a transformation of the market rate on 5-year Treasury securities by which the rate is kept at its highest previous level whenever the market rate is lower. The ratchet rate is intended to approximate the effect of new cash management procedures that, once developed in response to high interest rates, are still effective even after interest rates decline.^{3/} While the shifts in money demand can be described by these additions to the regressions, the explanation given for them in terms of more sophisticated cash management is plausible but unproven. It is plausible on the argument that the sharp escalation of inflation in 1973 acted as a catalyst for the expansion and development of substitutes for noninterest-bearing transactions balances. Parts II and III of the tables allow for these earlier shifts in order to verify whether new shifts occurred after 1979.

Either of these shift adjustments eliminates a large part of the simulation errors. For 1979 IV to 1981 IV the simulation error for M1 averages less than three times the standard error of the equation (1.4 percent with the dummy variable and 1.3 percent with the ratchet variable, versus 0.5 percent standard error of regression fit for both, line 1 of Parts II and III). How-

ever, the acceptability of these adjustments of the equation depends on their success not only in reducing the size of errors but also in leaving the other parameters of the equation largely unchanged (on the presumption that behavior represented by the coefficients was largely unchanged). The regression for M1 with the dummy variable has an unrealistically high coefficient for the lagged dependent variable (Table 1), and differences in the other coefficients (see Table 2), compared with its fit ending in 1974 II. This is also true of the regression with the ratchet variable. The only equation having essentially the same values of all coefficients as its counterpart in Part I is equation 4 of Part II, which includes all the adjustments of the money supply listed. This suggests that, except for a shift in mid-1974, these adjustments of money otherwise provide a demand equation that is the same over the full period up to 1979 III. For this reason it is tentatively to be preferred.

The simulation error for equation 4 in Table 1 includes all NOW accounts on line 4a and the NOW account adjustment (which begins 1981 I) on line 4b. In the first period 1979 IV to 1981 IV the error without the adjustment is smaller. It is smaller for the root mean square as shown in Table 1, and particularly for the mean of unsquared errors not shown there (which is 0.5 compared with 1.4 and which indicates less bias as well as smaller deviations). This strongly suggests that the NOW account adjustment is not needed and that the equation predicts the demand when all NOW accounts are included.^{4/}

The simulation errors for the preferred equation 4a in Table 1 increase substantially for the later period 1982 I to 1983 I. This reflects a decline in real money balances beginning in 1982 I, which is not explained by any of the equations.^{5/} When equation 4a is fitted to the entire period 1955 I to 1983 I, with an additional dummy variable to measure the shift in the final segment, the estimated shift is upward by 1.4 percent.^{6/} The explosive growth

in money in the second half of 1982 and the introduction of super-NOW accounts in 1983 cannot explain such a prior shift beginning in early 1982. This unexplained shift in money demand, called an "increased demand for liquidity" by the Federal Reserve, led to the abandonment of M1 as a target.

The variables in the equation generally account for movements in money demand apart from the 1974 and 1982 shifts. The equation does not, however, account for most of the short-run movements in velocity, in which the growth in money and GNP diverge. Little of the sharp decline in velocity in 1982 IV and 1983 I, for example, can be explained by the variables in the equation. That decline in velocity represents an unusually large response to a recession which can be distinguished from the 1982 shift in money demand.

It will take time to assess the nature of the 1982 shift in money demand and the recent decline in velocity. The issue is whether M1 can be reestablished as a usable target for monetary policy. Although the development of new financial instruments has been stressed as making monetary targeting unreliable, the sharpness of the two major shifts in 1974 and 1982 appear unrelated to new instruments. What the two years have in common is a previous sudden change in the inflation rate: a sharp escalation preceding 1974 and equally sharp reduction preceding 1982. It is plausible that a change in expectations of inflation was involved, which shifted the demand downward (velocity upward) by 2 percent in 1974 and shifted demand upward (velocity downward) 1-1/2 percent in 1982. While the decline in velocity in 1982 IV and 1983 I was to be expected in a severe recession, it was unusually large, which may be attributed at least partly to the unusual spurt in monetary growth coming after August 1982. Whatever the explanation of these unpredicted movements, it is clear that the volatile changes of an inflationary period complicate the conduct of monetary policy.

Table 1
Errors of Money Demand Equations

Money Variable	Standard Error of Regression (percent of M/P)	Reg. Coef. of Lagged Dep. Var.	Simulation Error Root Mean Square (percent of M/P)	
			1979 IV-1981 IV	1982 I-1983 I
I. Period of Regression Fit 1955 I to 1974 II				
1 M1	0.41	0.64	11.8	9.5
2 M1 + savings dep. shift	0.41	0.64	8.8	8.6
3 M1 + RP + ED	0.40	0.64	9.6	5.8
4a M1 + savings dep. shift + RP + ED	0.40	0.64	6.0	2.6
4b M1 + savings dep. shift + RP + ED + NOW adj.	0.40	0.64	6.8	
II. Period of Regression Fit 1955 I to 1979 III with Shift Variable 1974 III and After				
	0.45	0.84	1.4	1.5
	0.44	0.73	2.3	1.8
3	0.45	0.76	1.5	2.8
4a	0.45	0.66	1.3	2.7
4b	0.45	0.66	1.7	0.5
III. Period of Regression Fit 1955 I to 1979 III with Ratchet Interest Rate				
	0.51	0.97	1.3	3.0
	0.50	0.88	3.1	2.7
3	0.54	0.89	1.6	1.9
4a	0.50	0.61	1.2	3.1
4b	0.50	0.61	1.6	1.1

.Source: Equations shown in Table 2.

Note: Errors (predicted minus actual) are derived from dynamic simulations in which the lagged dependent variable and autocorrelation part of the error term are the predicted values from the preceding quarter.

Savings deposit shift (see note to Table 2).

RP + ED is overnight repurchase agreements and overnight Caribbean Eurodollar deposits.

NOW adj. is Federal Reserve estimate for 1981 of amount of new NOW accounts that did not replace other checkable deposits (see John A. Tatom, "Recent Financial Innovations: Have They Distorted the Meaning of M1?" Federal Reserve Bank of St. Louis Review 64, April 1982, pp. 23-35, Table 1). Other variables and form of regression are defined in Table 2.

Table 2
Estimates of Money Demand Equations

Dependent variable in M/P	Constant	$\ln \frac{GNP}{P}$	$\ln(r_{SD} - r_M)$	$\ln(r_{CP} - r_M)$	$\ln \left(\frac{M}{P}\right)_{t-1}$	Dummy shift variable 1974 III and after	Ratchet interest rate	RHO	Standard error of regression	Durbin Watson statistic
I. Period of Fit 1955 I to 1974 II										
1 M1	0.72 (2.9)	0.20 (3.8)	- 0.08 (2.8)	- 0.02 (6.3)	0.64 (6.2)			0.37 (2.5)	.0041	1.85
2 M1 + savings dep. shift	0.72 (2.9)	0.20 (3.8)	- 0.08 (2.8)	- 0.02 (6.3)	0.64 (6.2)			0.37 (2.5)	.0041	1.85
3 M1 + RP + ED	0.64 (3.1)	0.21 (4.3)	- 0.08 (3.2)	- 0.02 (6.9)	0.64 (7.0)			0.26 (1.8)	.0040	1.88
4 M1 + savings dep. shift + RP + ED	0.64 (3.1)	0.21 (4.3)	- 0.08 (3.2)	- 0.02 (6.9)	0.64 (7.0)			0.26 (1.8)	.0040	1.88
II. Period of Fit 1955 I to 1979 III										
1 M1	0.28 (2.5)	0.09 (5.7)	- 0.02 (2.3)	- 0.02 (7.7)	0.84 (23.4)	-0.02 (6.2)		0.15 (1.4)	.0045	1.95
2 M1 + savings dep. shift	0.52 (3.3)	0.15 (5.4)	- 0.05 (3.3)	- 0.02 (8.0)	0.73 (12.5)	-0.02 (5.5)		0.23 (2.1)	.0044	1.96
3 M1 + RP + ED	0.40 (3.6)	0.14 (7.9)	- 0.05 (4.8)	- 0.02 (7.9)	0.76 (20.0)	-0.02 (8.0)		0.06 (0.6)	.0045	1.97
4 M1 + savings dep. shift + RP + ED	0.59 (3.8)	0.21 (6.4)	- 0.08 (4.6)	- 0.02 (8.0)	0.66 (10.3)	-0.02 (6.2)		0.21 (1.8)	.0045	1.96
III. Period of Fit 1955 I to 1979 III										
1 M1	-0.02 (0.2)	0.03 (1.7)	0.02 (2.0)	- 0.02 (5.1)	0.97 (25.6)		-0.01 (1.6)	0.41 (3.7)	.0051	2.01
2 M1 + savings dep. shift	0.24 (1.0)	0.07 (2.2)	0.01 (0.3)	- 0.02 (5.0)	0.88 (11.7)		-0.02 (1.6)	0.49 (3.7)	.0050	2.05
3 M1 + RP + ED	0.19 (0.9)	0.07 (2.7)	0.004 (0.3)	- 0.01 (3.8)	0.89 (14.3)		-0.02 (1.8)	0.47 (3.8)	.0054	2.04
4 M1 + savings dep. shift + RP + ED	0.84 (2.5)	0.20 (3.6)	-0.06 (2.1)	- 0.01 (3.2)	0.61 (5.1)		-0.03 (1.9)	0.68 (5.3)	.0050	2.09

See next page.

Source and Notes: Signs of t statistics have been omitted. Regression fits were by the Cochrane-Orcutt method, where ρ is the coefficient of the lagged error term. All variables are in natural logarithms (\ln). $M1$ is published version as of March 1983, same as Table 2. Savings deposit shift is linear interpolation of following additions to $M1$: \$0.336 billion in June 1975, \$9.453 billion in June 1976, and \$16,405 billion in June 1977 and thereafter (from "A Proposal for Redefining the Monetary Aggregates," Federal Reserve Bulletin, January 1979, pp. 13-42, Table 2). $RP + ED$ is overnight repurchase agreements and Caribbean Eurodollar deposits. GNP is gross national product. P is deflator for GNP. r_{SD} is a weighted average of rates paid on savings deposits in commercial banks and thrift institutions and on money market mutual funds. r_M is a weighted average of rates paid on "other checkable deposits" and, when included, RP and ED (rates kindly supplied by Paul Spindt of Federal Reserve staff). In earlier quarters some rates are approximations. r_{CP} is the 3-month commercial paper rate. Ratchet interest rate is the highest level reached on 5-year Treasury securities up to the current quarter since 1955 I (based on Thomas D. Simpson and Richard D. Porter, "Some Issues Involving the Definition and Interpretation of the Monetary Aggregates," Controlling Monetary Aggregates III, Federal Reserve Bank of Boston, October 1980, pp. 161-234).

Footnotes

- 1/ See Stephen M. Goldfeld, "The Demand for Money Revisited, Brookings Papers on Economic Activity 1973:3, pp. 577-638, and John P. Judd and John L. Scadding, "The Search for a Stable Money Demand Function: A Survey of the Post 1973 Literature," Journal of Economic Literature XX (September 1982), 993-1023.
- 2/ See note to Table 1 on NOW adj.
- 3/ Developed by Thomas D. Simpson and Richard D. Porter ("Some Issues Involving the Definition and Interpretation of the Monetary Aggregates," Controlling Monetary Aggregates III, Federal Reserve Bank of Boston, October 1980, pp. 161-234), who test various complex forms of a ratchet rate.
- 4/ John Tatom (op.cit.) also finds that the NOW account adjustment is not needed, based on an analysis of the currency-deposit ratio.
- 5/ The error for equation 4b in Table 1 is smaller for this period only because its previous overprediction of real money balances is eliminated by the decline in 1982. Its NOW account adjustment does not explain this decline.
- 6/ This regression equation is the following, which includes a dummy for 1980 I to allow for the unusual error produced by the credit controls.

Extension of eq. 4a of Table 1 and Table 2, 1955 I-1983 I
(t statistics without signs in parentheses):

$$\begin{aligned} \ln \frac{M}{P} &= .82 + .25 \frac{GNP}{P} - .10 \ln (r_{sd} - r_m) - .02 \ln (r_{sp} - r_m) \\ &\quad (5.8) \quad (9.7) \quad (7.6) \quad (7.9) \\ &+ .57 \ln \frac{M}{P} - .021 \text{ dummy beginning 1974 III} - .028 \text{ dummy for 1980 I} \\ &\quad (10.7) \quad (8.1) \quad (5.4) \\ &+ .014 \text{ dummy beginning 1982 I.} \\ &\quad (5.0) \\ \text{Std. error} &= .0049 \quad DW = 1.97 \quad \rho = .18 \\ &\quad (1.6) \end{aligned}$$

The CHAIRMAN. Now, we will hear from Professor McKinney.

**STATEMENT OF GEORGE W. MCKINNEY, JR., VIRGINIA BANKERS
PROFESSOR OF BANK MANAGEMENT, McINTIRE SCHOOL OF
COMMERCE, UNIVERSITY OF VIRGINIA**

Mr. MCKINNEY. Thank you, Mr. Chairman.

The experience of the past several years of reporting under the provisions of the Humphrey-Hawkins Act has shown some clear benefits. Periodic formalized reviews of the way the Federal Reserve carries out its awesome responsibilities serve a useful purpose. Yet this experience has also pointed up some major flaws.

First, and most important, the wide publicity that necessarily accompanies the semiannual reviews of Federal Reserve policies has helped foster the impression that the Federal Reserve has far more influence on overall economic activity than is the case. There seems to be a growing tendency to feel that the Fed should be held solely responsible for the performance of the overall economy. This is most unfortunate, because it raises unrealistic hopes on the part of the public and perhaps on the part of the Congress. But it is also tragic in that it diverts attention from the responsibility of the administration and the Congress to follow effective fiscal policies.

The result is that it has been easier for the Government to put together an excessively expansionary fiscal policy, with a highly destabilizing deficit of unparalleled size, while at the same time implying that all would be well with the economy if only the Fed would follow some specified policy, which is generally highly expansionary or highly contractionary depending on the predilections of the critic.

In my prepared testimony I comment in some detail on why the massive deficit in prospect is incompatible with stable economic growth. A deficit that steals two-thirds or maybe three-fourths of the Nation's net savings that could be used for building homes and for productive job-creating investment by business, places the Nation in much the same position as a business concern that has borrowed so much that it is overleveraged. An overleveraged firm makes a lot of money when the going is good. But when something goes sour, profits turn into losses and the firm goes bankrupt. Similarly, an overleveraged nation tends to whip back and forth from prosperity to recession. It can't grow fast for very long, because fast, sustained growth takes capital investments, capital investments require savings, and the Government has already preempted the lion's share of those savings.

I also discuss in my testimony the unfortunate international economic and political repercussions of that deficit. It drives up our interest rates, which draws investment funds from developing nations and slows their growth. More than that: If our interest rates were several percentage points lower, as they would be without the prospects of that deficit, the international monetary and payments mechanism would be under much less strain, and the Mexicos and Brazils would be able to meet their debt servicing requirements. The risk of revolution in some of these debtor nations that are friendly to the United States would be smaller.

Yes, there is a need to review monetary policy on a formal basis. But I would like to suggest there is a need for periodic systematic reviews of the Nation's fiscal policies as well.

A second flaw in the present reporting system is that it has tended to deteriorate into a discussion of techniques as opposed to objectives and accomplishments. Congressional review of what the Federal Reserve does should be result oriented, not process oriented. If this committee were the board of directors of a business corporation, it would be appropriately concerned with the bottom line—what was accomplished. It would discuss with the CEO what he proposed to do, how he would go about it, and would appropriately overrule him if he headed off in the wrong direction. But its evaluation of his performance would not bog down in administrative details; it would focus on broad policy issues, objectives, accomplishments.

Similarly, the Congress should not get itself involved in Federal Reserve operating procedures. The Congress should not waste its valuable time trying to decide what specific targets or guideposts would be best for the Fed to follow. One problem is that no one guidepost is best at all times. At times money is a good target to use—sometimes M_1 , sometimes some other M . At other times, interest rates are a good guide. But the Fed should select those guides to follow from among many, and it should be free to shift from one target to another as circumstances change.

Mandated targets have side effects that are quite counterproductive, more so than if the same targets had been voluntarily selected by the Fed. The problem that makes targeting such a potentially disruptive force lies not with the choice of targets for operating purposes, but with the oversight process and with the public reaction. As long as the Fed is required to target any particular series, the target becomes more important than the end results. The Congress then measures success or failure by the target rather than by the performance of the economy; the public fixes its attention on the performance of the target, which leads to disruptive reactions in money and capital markets any time the series chosen as a target moves up or down, whether or not that movement has any intrinsic significance for the overall economy.

The deficiencies of a mandated target are not confined to the various monetary aggregates. The alternative target most frequently proposed—interest rates—has proved even less satisfactory than money. Of the two, mandated targeting of interest rates is by far the most perilous. No one can know in advance what level of rates will be appropriate a year from now. Attempts to maintain too low rates require excessive, highly inflationary money growth. Vulnerability of elected representatives to short term, narrow political pressures to hold rates at unrealistically low levels is well known. The most likely result from mandated targeting of interest rates—or even mandated reporting on the Fed's interest rate assumptions—would be chronic, virulent inflation.

A third problem may stem, at least indirectly, from the review process. Reviews tend to focus attention on shortrun developments and trends. Thus we are likely to think more in terms of whether targets were hit this month or last month than whether inflation is being contained.

With your permission I will state only my conclusions on several other issues—I am sure under the circumstances that will be satisfactory—and will save supporting arguments until later. First, it has been suggested recently that reserve requirements in the Federal Reserve System should be modified or abolished as being unnecessary. I strongly disagree with that because the shortrun focus on monetary policy has led us to think of reserve requirements in terms of whether they permit the Fed to reach its shortrun monetary targets. That has very little to do with success in containing longrun inflation, which has more to do with whether the appropriate targets were selected and followed.

Second, new policy tools such as selective credit controls are not necessary and are frequently pernicious.

Third, standby credit controls are likely to be misused, as they were in 1980. The standby feature is unnecessary, because Congress could and would act quickly in a genuine emergency.

Fourth, capital ratios may be justified as a means of helping assure soundness of individual institutions. As a credit control device, however, they seem ill-advised.

Fifth, the Federal Reserve and the Congress should focus more on the ultimate objective of nominal GNP, with due attention to the problems of inflation and unemployment. If the Federal Reserve also insists on using some specific intermediate target, or if the Congress insists on one, the most promising is total nonfinancial debt, and the least promising is the narrowly defined M_1 .

Sixth, the Federal Reserve should not reveal its future plans for open market operations. Nor should it announce objectives for GNP, inflation, and unemployment.

Seventh, Congress should guard against recent proposals to require closer coordination of monetary and fiscal policy. Such mandated coordination would in fact subordinate monetary policy to fiscal policy, and would impact a greater inflationary bias to the economy.

Eighth, and last, proposals to alter the present representation formula on the Board and the Federal Open Market Committee would encourage factionalism and would dilute the salutary sense of national purpose that has distinguished the Federal Reserve over the years.

If you want me to comment further on these issues during the question period, I shall be pleased to do so. Thank you.

[The prepared statement of Professor McKinney follows:]

Prepared Statement by Dr. George W. McKinney, Jr.
Virginia Bankers Professor of Bank Management
McIntire School of Commerce, University of Virginia
before the U. S. House of Representatives
Committee on Banking, Finance and Urban Affairs
July 19, 1983

Mr. Chairman, members of the Committee. I am George McKinney, Virginia Bankers Professor of Bank Management at the McIntire School of Commerce, the University of Virginia.

Thank you for this opportunity to comment on current and prospective Federal Reserve monetary policy, and on the ground rules under which the Federal Reserve operates. Monetary policy is of even greater than usual importance, since with the right macroeconomic policy choices today our nation could move into an extended period of prosperity comparable to that of the 1960s, with strong real growth, high employment, low inflation, and low interest rates. Unfortunately, the chances for achieving the optimum combination of policies that would permit the attainment of that result are very small. Not because of any deficiency in Federal Reserve policies or actions which, although not perfect, seem to have been about as good as could have been expected under the circumstances; but because of the enormous strains imposed on the economy by the current and prospective government deficit. The deficit places special limits on the extent to which the Federal Reserve can contribute to a stable and prosperous economy.

Under more normal circumstances, ours is a very resilient economy. There is a wide range of monetary policies that could be followed without getting the economy into trouble. If Fed policy were to prove to be too easy, there would be time and leeway for corrective tightening before the resulting expansion got out of hand. Or, if policy were too tight, that fact would be come evident in time to take off-setting expansionary action.

But today it's a different story. The Federal deficit has taken away much of that room for maneuvering. The heavy government borrowing requirements eat up most of the nation's savings. Since the government's demands for funds are relatively fixed, any variations in private demands for credit are focussed on a comparatively small part of the total savings flow. In the normal course of the business cycle, those private demands for credit vary considerably. If these large changes in private credit demands could bid for the total supply of credit, markets could be cleared with reasonably small swings in interest rates. But when most of the nation's savings are preempted by government, the very large changes in private credit demands are necessarily focussed on that comparatively small residual supply of savings that remains after the government demands are satisfied. Therefore credit markets tighten much more quickly and more severely when private credit demands increase, and ease faster when demand slackens.

The recent upward movement in interest rates hints that this problem may be closer at hand than many of us had expected. Individuals who want to buy homes have to pay up for their mortgage money in competition with government. Mortgage rates are already moving up, and every percentage point boost in those rates means that another \$4,000 of income is needed to qualify for the typical mortgage loan. So would-be home owners are once again finding themselves priced out of the market for homes. Businesses that want to carry inventories and to build new plant and equipment will find that they have to pay up for borrowed money in competition with government. At some point, government competition for resources that could be used for homes and for job-creating investment will choke off the current recovery.

In fact, the prospects for massive budget deficits for the indefinite future guarantee that our nation will have an unsatisfactory economic performance over longer periods of time. Because of the enormous amounts the government must borrow, our nation is somewhat in the position of the firm that has borrowed so much that it is over-leveraged. An over-leveraged business has wild swings in earnings, and it runs the risk of bankruptcy whenever its earnings decline to the point that it can't service its heavy debt burden. An over-leveraged nation has wild swings in national output and all of the associated economic measures: production, employment, inflation, and interest rates. And, while our nation can't very well go bankrupt, it does run the risk of severe financial disruption of one sort or another. Such a financial trauma is not in store for 1983, and probably not for 1984. But the odds of avoiding major financial difficulties if that deficit is allowed to stand are exceedingly slim.

And there's not much the Federal Reserve can do about it. It could create more money, as many are recommending today, but that's no answer. It cannot create real savings. It can't do anything about the fact that the real resources that are purchased through deficit financing are no longer available for home building and for the business investment that would create the lasting jobs needed by the nation's unemployed.

The best we can hope for is that the government's diversion of savings away from business investment will only slow economic growth over the next years. Certainly it will do that, for without savings there is no growth of capital. And without capital growth we will be hard put to find growth of the economy. But the most likely outcome is that the strong countervailing pressures between the private economy's need for funds for economic expansion, and the government's demands for the same funds to finance its spending programs (whatever they may be) will cause an exceedingly volatile economy. We are most likely to see brief periods of rapid, euphoric growth, choked off by economic reality as the funds and the resources to support the expansion simply aren't there. It's quite likely that we will see at least a year, possibly two, of good real growth. But without capital investment there's no place for the private economy to go. Sustained recovery is unlikely; rapid growth over a protracted period is a virtual impossibility.

There are specific implications for Federal Reserve policy. First, it must be very careful not to go overboard, either by following policies that are too expansionary (and that is the greatest current potential danger) or by following overly restrictive policies. Moderation is much more important than it would be if a rational fiscal policy were being followed. Second, flexibility is essential. The potential for surprises--quick, unexpected changes in the economic outlook--is much higher than usual. Therefore the Fed will need to be ready to change course to adjust to the new realities. This would be a very bad time to lock policies rigidly into preselected narrow target ranges for monetary aggregates, interest rates, or any other intermediate policy objective. No one--in the System or out of it--knows now what rate of money growth would be optimal over the next year. No one knows what level of interest rates would be most appropriate. Since the very best judgments will be modified to reflect changing realities during the course of the next year, it is essential that the Fed preserve enough freedom of action to make changes--quite possibly very substantial changes--in whatever intermediate targets it selects.

International Considerations

International economic circumstances also demand both moderation and flexibility on the part of our nation's central bank. The unfortunate policy mix our nation is following--with a highly expansionary fiscal policy that necessitates a restrictive

monetary policy--has contributed importantly to the pervasive and deep-seated financial problems around the world. The insidious impact of our Federal deficit extends beyond our own nation. Interest rates pay very little attention to national borders, so our high interest rates draw investment funds from other nations, drive up their interest rates, kill off their new investment in productive businesses, and slow their growth rates. We're preempting a substantial share of the funds that could be used for expansion in the developing nations of the world, simply because of our bad policy mix.

The Federal Reserve is unavoidably interested in the international implications of the budget deficit, since that policy mix also endangers the world financial structure and risks collapse of the international credit and monetary mechanism. If our deficit does drive international interest rates so high that it aborts the nascent world recovery and causes a collapse of the world financial structure and payments mechanism, the Federal Reserve will have an enormous financial mess to clean up here at home. If interest rates in the United States were several percentage points lower, as they would be without that massive Federal deficit, the Mexico and Brazils wouldn't be overpowered with debt service charges they can't afford to pay.

Political implications, too, are interesting but not encouraging. Russia, whose international policies are not particularly inhibited by such mundane considerations as money market conditions, stands to benefit enormously from our policies that unnecessarily weaken our debtors and build resentment against us. If debtor nations permit draconian reductions in their domestic standards of living in order to meet their international debt payments, the climate will become significantly more favorable for revolution. Successful overthrow of governments friendly to the United States is considerably more likely.

These risks are a pretty steep price to pay for an imbalance in our macroeconomic policies. Yet it's a price we may have to pay if we continue to throw the entire burden of economic stabilization on the Federal Reserve.

There's an additional reason for the Federal Reserve to be concerned over the international impact of our policies--the feedback to our own economy. Our budget deficit was a major factor in boosting the price of the dollar (and everything we sell abroad) by 40%, and in cutting the price of competing imports by 40%. The resulting drastic decline in our net sales abroad accounted for one-third to one-half of the recent recession. It knocked \$100 billion off our net export sales, and cost one and a half million jobs. It's not a temporary thing, either. Our foreign competitors are getting dug in in many cases. The longer we continue our Federal deficit, thereby forcing interest rates to hold at high levels, the more U. S. export business we will be destroying for the long haul.

These international considerations do not imply a need for different Federal Reserve policies. But they do underscore the same basic conclusions that are reached in examining the domestic economy: the need for moderation, for avoidance of overly tight or overly easy policies; and the urgent need to preserve flexibility so the Fed can adjust to developments that are not now expected.

Changes in Federal Reserve procedures, organization, policy tools

On the occasion of the fifth anniversary of the Humphrey Hawkins Act, many proposals are being made to change the Federal Reserve's authority, structure, powers, procedures. My immediate reaction is "if it ain't broke, don't fix it."

This is particularly true with respect to the oft-proposed requirement that closer coordination of monetary and fiscal policy should be mandated. The quasi-independence of the Federal Reserve serves a highly useful purpose, in that it makes it possible for the nation to have a monetary policy with a longer-term orientation. As long as the Federal Reserve has some meaningful level of freedom of action, the Congress is under less pressure to respond to short-term political blandishments of constituents that would result in excessive expansion of nominal GNP. Any attempt to force coordination of monetary and fiscal policy would likely reduce the degree of Federal Reserve independence and subordinate monetary policy to fiscal policy. Since fiscal policy tends to be chronically inflationary, such a shift would impart a greater inflationary bias to the economy.

A good case can be made for leaving immediate responsibility for one major facet of macroeconomic policy in the hands of a group of professionals charged with a specific economic policy function, as opposed to concentrating all macroeconomic policy in the hands of an Administration that might be more interested in short-term political advantage to the possible detriment of the national economy.

That is not to say that there is no place for oversight of the Federal Reserve by the Congress; that seems highly appropriate. But it should be an arms-length oversight; great care should be taken to limit it to consideration of broad objectives and the extent to which those broad objectives have been pursued.

Another proposal that surfaces from time to time is the addition of the Secretary of the Treasury to the Federal Reserve Board or to otherwise tie him into the policy-making process. In judgment, the Congress should guard assiduously against Administration dominance of the Federal Reserve, and specifically against domination by the Treasury Department, because of obvious conflicts of interest between the collection of taxes and the management of the money supply.

At one time the Secretary of the Treasury did serve as a member of the Board, but the Congress wisely chose to sever that linkage. This nation benefits greatly from the wisdom of the founding fathers who foresaw the advantages of separation of powers among various bodies. The constitution reserves to the Congress the power to create and manage money, which it does through the institution of the Federal Reserve System. To hand over the money-creating function and its regulation to the Executive Branch would subvert the intent of the constitution and would weaken the checks and balances that are a key feature of our political democracy and economic free-market focus.

Proposals are also being renewed to alter the current makeup of the Board of Governors to require formal or informal representation from various special-interest groups. This strikes me as a particularly dangerous train of thought. Throughout the history of the Federal Reserve, the members of the Board of Governors and of the Federal Open Market Committee have looked on themselves as representing the public. They have felt that they are responsible to the nation as a whole, not to special-interest constituencies. That attitude must continue to prevail if we are to have an effective central bank.

It would be a mistake to alter the present representation formula, for that would unduly focus attention of the question of special-interest representation. It is unlikely that the image of high public purpose could be maintained if new legislation were to specify representation of special-interest groups. To delineate formal or informal spaces for specific sectors of the economy would encourage factionalism and would dilute the salutary sense of national purpose that has distinguished the Federal Reserve over the years.

A newer proposal has been to do away with reserve requirements. This reflects a short-term orientation, and a lack of understanding of how Federal Reserve policy works over a longer time horizon. Considerable study might profitably be given to the need for expanding the coverage of reserve requirements (not increasing the size of the required reserve ratio) to cover all institutions that issue liabilities with some particular level of liquidity. But without some effective level of reserve requirements the Federal Reserve would be ill-equipped to deal with a strongly inflationary environment.

Without reserve requirements, a monetary expansion creates its own reserve base as deposits created by one bank become reserves for the bank in which the newly created funds are re-deposited. True, institutional factors prevent any one institution or class of institutions from expanding disproportionately. But they do not limit the total expansion of credit. That was one of the major problems in the years before the Federal Reserve came into existence: unrestrained credit expansion led to periodic exuberant economic expansions, inevitably followed by panics and depressions.

Some assume that the Federal Reserve could always conduct open market sales of securities and mop up enough liquidity to contain any credit expansion. But this argument is relevant only in a short-run context. The Federal Reserve would quickly run out of government securities to sell, if it tried to counter a strong credit expansion without reserve requirements to leverage its open market sales. Without reserve requirements, the Federal Reserve is really not much different from an equal-sized commercial bank. Total assets of the whole Federal Reserve System are about twice the size of the largest commercial bank. In a head-on confrontation with the entire banking system, the Fed could only offset 18 months of normal growth for bank credit, even if it disposed of all of its assets and went out of business. If inflation subsequently caused credit growth to speed up, the most the Federal Reserve could do would be only a drop in the bucket.

Reserve requirements have not been discussed in a proper context in much recent literature, because the authors have been concerned with measuring the effect of open market operations on short-term rates of money supply growth. In that context, reserve requirements are irrelevant. But the national interest lies in the prevention of inflation over periods of many years. In that context, reserve requirements are essential.

The inevitable proposals for selective control of credit are being brought up again. I suggest that new tools are unnecessary, and are frequently pernicious. The tools the Federal Reserve now possesses are adequate to permit it to accomplish what can be accomplished through monetary policy. Selective controls over credit are generally counterproductive--witness the 1980 application of selective controls that clearly intensified the recession, if they did not cause it.

There are reasons other than the control of credit that might justify control of capital ratios. Indeed, consideration should be given to capital requirements that would limit unwise exposure of all financial institutions (not just banks), although the practical application of meaningful limits would be difficult. Any limitations of capital ratios, though, should be linked to the soundness of the individual institutions, and should not be used to control the cyclical or secular expansion of total credit in the economy. Total growth of credit can be best limited through conventional means.

It is frequently argued that credit controls should be available on a standby basis for use in a major national emergency such as an all-out war. Yet the 1980 experience demonstrates that standby legislation tends to be used in other than emergency conditions, with less than salutary results. In the case of a genuine

emergency, the Congress could and would pass enabling legislation quickly. Thus advance passage of standby legislation seems ill-advised.

Changes in Targets and Targeting

The futile search for the one magic button to control the economy continues. Over the past decade, that one magic button has been the money supply. While money is undeniably a very important factor, it is not the only one. Exclusive or excessive reliance on this one policy guide, particularly in Congressional oversight of the Federal Reserve's actions, is a serious mistake.

There are many problems with money (or with any other exclusive intermediate policy target). For one thing, the definition of money won't hold still. Money today consists of many things not contemplated a century ago, a decade ago, or even a year ago.

A money growth target set in 1860 would not have included checking accounts, for they were not a significant factor then. Thus a seemingly reasonable money growth target would have led to a vastly excessive money growth as demand deposits expanded rapidly over the next few decades. More recently, money market deposit accounts grew \$350 billion in the first four months after their authorization in late 1982; continued deregulation of interest rates on savings accounts is further blurring the distinction between what does and what does not qualify as money. The Federal Reserve is still trying to decide what share of particular kinds of accounts should be called money and what share should be called something else.

It seems absurd to focus on any target that must be arbitrarily defined and which is subject to such fantastically wide swings in its components. This is not a unique example; the introduction of nationwide NOW accounts in 1981 created similar distortions, as did the spread of cash-management techniques. The current revolution in the financial services industry is sure to bring on further distorting changes of significance that will further lessen the usefulness of money targeting.

Yet the alternative target most frequently proposed--interest rates--has also proved unsatisfactory. Their de facto use as intermediate targets during much of the decade of the 1970s gave a distinctly inflationary bias to the economy. Pegged rates after World War II were a major factor in that inflation. Thus history tells us that neither interest rates nor money is a satisfactory intermediate target under all circumstances.

Yet, of the two, mandated targeting of interest rates is by far the most perilous. No one can know in advance what level of rates will be appropriate a year hence. Attempts to maintain too low a rate require excessive, highly inflationary money growth. Vulnerability of elected representatives to political pressures to hold rates at artificially low levels is well known. Thus the combination of elected officials requiring the Fed to report on targeted interest rates would likely lead to chronic, virulent inflation.

Still, there is considerable interest in having the Congress impose these or other specific targeting procedures. This seems to me to tie the Fed's hands without any particular gain. In my judgment, the Federal Reserve should be free to target the money supply, interest rates, or any other variable, from time to time as an exclusive intermediate target if, in its judgment at the time, that is the most helpful policy guide. But it should be free to change those target variables whenever, in its discretion, other targets seem to be more helpful.

The problem that makes targeting a potentially disruptive force lies not with the choice of targets for operating purposes, but with the oversight process and with the public reaction. As long as the Federal Reserve is required to target any variable, the target becomes more important than the end results. The Congress measures success or failure by the target rather than by the performance of the economy; the public fixes its attention on the performance of the target, which leads to disruptive reactions in money and capital markets whenever there is some change in the targeted series, whether or not that change has any intrinsic significance for the overall economy.

The only target the Congress should concern itself with is overall economic performance. That is best measured by nominal GNP, with due consideration being given to inflation, unemployment, and real growth. The Federal Reserve cannot determine but can only influence nominal GNP growth, and it cannot dictate the way in which any nominal growth is divided between inflation and real growth. The Federal Reserve and the Congress should discuss the need for nominal GNP growth given the current environment for inflation and for unemployment. Then the Federal Reserve should be held responsible for contributing to the attainment of that desired rate of growth of nominal GNP. But full recognition should be given to the many factors--notably including fiscal policies--that make it impossible for the Federal Reserve, by itself, to bring about any particular growth rate.

One more comment on targets. As a broad generalization, the broader the definition of money the less it is subject to erratic influences and therefore the better its potential as a proxy for economic performance. The best candidate for an intermediate target seems to be total nonfinancial debt. However, it is conceptually impossible to have any one series that simultaneously has a stable relationship to GNP, to inflation, and to unemployment, unless one can postulate a stable relationship among those three series themselves. Since the three do not move together in anything approaching a stable manner, the search for anything that is closely related to all three is foredoomed to failure. Recent proposals to require such simultaneous targeting would inevitably lead to erroneous policy prescriptions.

Communicating Federal Reserve Policy

From time to time it is suggested that the Fed should tip its hand as to its future plans for open market operations. However, financial markets are extremely complicated and very volatile. If the central bank is to influence these markets constructively, it must have the flexibility to react to short-term changes in market conditions. Any external requirements that limit its flexibility necessarily reduce its effectiveness. The only conceivable advantage to requiring announcement of intentions is to open up opportunities for risk-free arbitrage on the part of large participants in money markets. I can see no public benefit from such requirements.

It has been proposed, too, that the Federal Reserve should publish money supply data less frequently, since markets react to their publication even though the data are volatile and unreliable. However, the culprit is not the frequency of publication of money supply data; the culprit is the Federal Reserve's reliance on money supply data. As long as Federal Reserve policy in fact responds to short-run changes in the money supply (and particularly if the Fed is required to respond to short-run changes in the money supply), the markets will react to perceived changes in the money supply. Any change in the frequency or form of release might change the timing of the reaction to its release, but it would not change the substance.

Thank you for giving me this opportunity to comment on Federal Reserve policy and on the circumstances surrounding its formulation and implementation.

The CHAIRMAN. Thank you, Professor. When the five of you go home I hope you all have an opportunity to get copies of each other's statements to take back with you, and then just place yourself up here, having read your colleague's statements. You say to yourself, well, now, where do we go and how do we go and what do we do? That is a problem we face. I think you will recognize it when you have read your statements.

Mr. MCKINNEY. May I suggest, sir, that the disagreements among specialists in the field, each of us of whom know a good bit about the subject matter, demonstrate that your committee would be well advised to deal in the general policy levels and talk about what the Federal Reserve is doing and leave it to the Fed to fight about how they do it.

The CHAIRMAN. That is one conclusion. Another conclusion is that the inaccuracy and complexity of the science with which you are involved, I am in no way being critical, I appreciate the sincerity, the ability and many years that all of you put into your studies. All I am saying is that here you are specialists in your fields, and we have to make decisions, perhaps that decision that you have just stated, Professor McKinney. But remember, it is not easy for us to reach that conclusion with such facility, because there are a great many pressures on us demanding, so to speak, that action be taken, or that, in the case of what you just stated, no action be taken.

The CHAIRMAN. Professor Epstein?

STATEMENT OF PROF. GERALD EPSTEIN, THE GRADUATE FACULTY, NEW SCHOOL FOR SOCIAL RESEARCH, THE CENTER FOR DEMOCRATIC ALTERNATIVES AND THE CENTER FOR POPULAR ECONOMICS

Mr. EPSTEIN. Mr. Chairman, members of the committee, I thank you for inviting me to meet with you today concerning the Humphrey-Hawkins Act. I will read a shortened version of my testimony.

Soon after the passage of the Humphrey-Hawkins Act, in 1978, the unemployment rate began to rise. It rose for 3 consecutive years, the longest period of increase in the postwar period. Over that time, we also witnessed 4 years of virtual economic stagnation, the longest bout since World War II. Monetary policy is not wholly responsible for this debacle. But it must shoulder a good share of the blame.

These hearings are being held to ask where monetary policy has gone wrong and what can be done about it. Many economists will answer that the Fed has used the wrong targets or tools of monetary policy and that it should be changed. My view is different. I submit that to analyze and correct the problem of the Fed we need to answer two central questions: Who controls monetary policy? And, who should control it? My answer is that the Fed's policies are too strongly influenced by the needs of the commercial banking sector of the United States, and too little influenced by the rest of us. The solution is that Congress should take more control over monetary policy.

The CHAIRMAN. Excuse me. Could I interrupt you?

Mr. EPSTEIN. Sure.

The CHAIRMAN. That the Fed is too strongly influenced by the needs of the commercial banking industry of the United States.

Mr. EPSTEIN. That is what I am going to argue in my testimony.

The CHAIRMAN. On that point, when we conducted the FINE study among the conclusions we reached was to take from the Federal Reserve the regulatory functions over commercial banks. The reason being that it would be better placed in perhaps one agency or two agencies, depending on whether you wanted to have the thrifts under one agency and the commercials under other regulatory, because as a result of this combination of duties that the Fed has, particularly having the regulatory, and it is obvious to me having been chairman of the subcommittee for many years, chairman of the full committee as well, in talking with many members of the Federal Reserve Board over the years, it is obvious to me that your statement is very correct.

They have to recognize, look at and evaluate their actions as they apply to the commercial banking system of this country. And I think too many times undue emphasis is placed on that rather than the needs of the 200-and-some-odd million citizens of the United States of America.

Mr. EPSTEIN. I think that is absolutely right, Mr. Chairman. The problem is that it can affect monetary policy as well.

The CHAIRMAN. Absolutely. I am sorry to have interrupted, but I just couldn't resist the fact that we have indeed studied this and came to that conclusion in the past. You may proceed.

Mr. EPSTEIN. As I said, the solution is that Congress should have more control over monetary policy.

Now, congressional control of monetary policy is often seen as a radical idea. The rationale for an independent Fed is familiar. If it weren't for the Fed, Congress would be swamped by irresistible demands for easy money which would lead to our inflationary ruin.

The argument recalls the story of Ulysses and the sirens in Homer's *Odyssey*. Ulysses' ship was to pass by an island populated by beautiful sirens whose beckoning was alluring but deadly. To protect himself from their calls, Ulysses begged his shipmates to tie him to the ship's mast. ". . . you must bind me hard and fast," he cried, "so that I cannot stir from the spot where you will stand me . . . and if I beg you to release me, you must tighten and add to my bonds." Otherwise, unable to resist their sounds from shore, Ulysses would have jumped ship to his certain death. By asking his mates to bind him to the mast, he would keep himself from doing what he otherwise would want to do, for his own good.

And so it is with the Fed. We need the independent Fed to protect ourselves from ourselves. We need the Fed to tie Congress hands.

But do we? Without binding ourselves to the mast of Federal Reserve independence, would we really be destroyed by the siren song of easy money? Perhaps. But a careful look at history suggests that mast binding can be even more dangerous.

The behavior of the Fed during the Great Depression of the 1930's is especially instructive here. As my colleague Thomas Ferguson and I demonstrate in a recent paper, the Federal Reserve used its independence to resist pleas from the Treasury Secretary

and Congress to help turn around the economic disaster that was occurring all around them. The Federal Reserve sat idly by while the economy collapsed around it.

There are many reasons why the Fed stopped but, as we show, one of the most important ones was that member banks opposed further expansion. The bankers feared that if interest rates fell much more, their earnings, and perhaps their solvency, would be threatened. Partly in response to the banker's opposition, the Fed ended its brief attempt to reflate the economy.

By tying ourselves to the mast in the 1930's, we almost sunk the ship.

One might think that the Great Depression is a special case. After all, anyone can make mistakes. Moreover, reforms taken after the debacle corrected structural defects which were responsible for the system's paralysis, or so it might appear.

Yet, one needn't stop at the 1930's for evidence of the detrimental effect of Federal Reserve independence from elected officials. After the reassertion of its independence in 1951, the Fed promptly helped orchestrate two recessions in 10 years. In the Kennedy-Johnson years, fiscal policy had to do an end run around the Federal Reserve to institute the boom of the middle 1960's. And the painful experience of the current recession is well known.

What is the problem? Why has Federal Reserve independence been so devastating? The answer is that the claim that the Fed should be independent is really a veil. A better description of the Federal Reserve is that it is relatively independent of the elected representatives in Government, but at the same time, it is highly dependent on one major sector of American business: The commercial banking sector. So while the Fed should be making policy in the interests of the public at large, at the same time it has the incompatible task of advancing the interests of a specific industry.

The Fed's ties to the financial sector are manifold. The revolving door of Federal Reserve staff and directors is well known, and, as supporters contend, reasonable: The business of monetary policy is technically complex. Firsthand experience is certainly valuable. In addition, it is important to recall that the Fed's original purpose is to enhance the stability of the financial sector. So it should come as no surprise that the Fed must be concerned with the financial sector's welfare.

But there are other, more subtle connections which not only create a common mind set between central and commercial bankers, but tie the two together in even stronger ways. These connections give the commercial banks great incentive to gain influence in the central bank, and give the Fed great need to elicit the banks' cooperation. In conducting monetary policy, for example, the Fed works through commercial banks, so it needs their cooperation in following regulations. And the Fed needs banks' support in its fights with Congress and the administration. On the other side, as the chairman pointed out, the Fed regulates banks and therefore has large effects on them. Banks, therefore, have a great incentive to gain influence within the Federal Reserve, and try to do so. Mutual back scratching becomes virtually irresistible.

These close, and indeed, intimate relationships between the Federal Reserve and the commercial banks, have one very important

implication: The Fed is likely to see the world through "finance" colored glasses.

In this regard, the Federal Reserve is similar to other regulatory agencies which must be concerned with the health of the industries they regulate. But because of its central importance in macroeconomic policy, the independence of the Fed from democratic political control combined with the influence on the Fed of the commercial banking sector can be devastating for the welfare of the majority of the people in the United States. In the current period, for example, this combination means that the Fed is conducting a policy that affects millions of U.S. citizens while they have very little control over its policies. But more than that, the Fed is conducting that policy with a bias toward one sector of American business.

Evidence in support of that bias is striking. The table below shows the trend of unemployment, nonfinancial business profits, the real rate of interest, and the rate of return on equity of commercial banks.

Since 1979, the unemployment rate has gone up—and it is 10 percent currently—and the rate of profit of nonfinancial corporations has declined by 30 percent. The rate of profit enjoyed by bankers has increased by over 30 percent relative to the previous 20 years.

It can be argued that the Fed is not responsible for any of these phenomena. And, indeed, it would be ludicrous to suggest that the only determinant of these major economic trends has been the behavior of the Federal Reserve. However, a glance at the behavior of real interest rates which tripled between the two periods, makes it difficult to absolve the Federal Reserve from blame.

One might argue that the recent and prospective behavior of the Fed has been necessary to correct the inflationary excess of the 1970's. The economy has been faced, one might say, with major structural problems and something had to be done.

I agree. But, and this is a crucial point, the existence of this form of Federal Reserve independence does not solve these structural problems. It only exacerbates them. The problem is that the independent Fed is an institution which, because of its power can get things done. It becomes too easy, therefore, for elected officials to abdicate responsibility to the Federal Reserve, rather than face the most difficult and painful process of democratically and directly confronting the serious problems we face. The result is that the policies implemented to solve these problems are biased toward one sector of the economy and destructive for the rest. Monetary policy is not only undemocratic, it is inefficient to boot.

The Fed blames the Congress for deficits but before blaming Congress, Congress should have the power to effect all the tools which affects the deficits. This includes monetary policy. So what is the solution? Let me join the chorus proclaiming that none is easy. The economic problems we face are major and no monetary policy, however accommodating, is going to solve them by itself. But that is the point. We need a whole set of coordinated policies, and without more congressional control, we are unlikely to get it.

How can Congress get more control? There are basically two ways. One is by playing a more direct role in monetary policymak-

ing itself. A second is having more say in appointing the Open Market Committee. I support both of these, but making progress on either would be significant.

With regard to direct control, for example, just as Congress votes on a budget each year, it could also vote on a set of monetary targets proposed by the administration with consultation of the Fed. That way the two tools of macro policy would be coordinated each year and on similar political footing.

Second, the appointments process should be changed. The terms of the members of the Fed should be shortened and make coterminus with the Presidential election cycle. In addition, the appointment of the Chair of the Federal Reserve should be subject to a vote of the House and Senate. The press routinely describes Paul Volcker as the second most powerful man in the Nation. His power will increase still as the international debt problem becomes worse and he plays a pivotal role in managing it. In a democracy, can the electorate have so little way over one of its most powerful leaders?

Finally, at a minimum, the seats on the Open Market Committee held by the regional Reserve bank presidents should be eliminated. These are simply the most blatant symbols of banker influence over the Federal Reserve which has now taken more subtle forms.

Before I conclude, let me emphasize one point. I am not claiming that the Fed or the banks are perfidious or evil. The problem we face is a structural one. Monetary policy is not the proper weapon to cure our ills. But until Congress gets more control over it, it is the weapon that will be used.

In terms of our fable, to understand the nature of the Federal Reserve, Ulysses and the Sirens must be turned on its head. Congress is Ulysses which the siren Federal Reserve is trying to lure away from the helm of economic policy. Here it is interesting to recall what made the sirens so irresistible. They promised Ulysses perfect knowledge of all things past, present, and future. He rejected their offer. Congress must do the same. Until it does, and agrees to tie itself to the mast of decision, the Fed will continue to woo Congress with its siren song. And, if it succeeds, all but the banks will pay.

Thank you.

[The prepared statement of Professor Epstein follows:]

Statement on Monetary Policy

Testimony Prepared for the House Committee on Banking, Finance,
and Urban Affairs

by

Gerald Epstein

Mr. Chairman, members of the Committee. I thank you for inviting me to meet with you today concerning the Humphrey-Hawkins Act.

Soon after the passage of the Humphrey-Hawkins Act, in 1978, the unemployment rate began to rise. It rose for three consecutive years, the longest period of increase in the post-war period. Over that time, we also witnessed four years of virtual economic stagnation, the longest bout since World War II. Monetary policy is not wholly responsible for this debacle. But it must shoulder a good share of the blame.

These hearings are being held to ask where monetary policy has gone wrong and what can be done about it. Many economists will answer that the Fed has used the wrong targets or tools of monetary policy and that it should change them. My view is different. I submit that to analyze and correct the problem of the Fed we need to answer two central questions: Who controls monetary policy? and, Who should control it? My answer is that the Fed's policies are too strongly influenced by the needs of the commercial banking sector of the U.S., and too little influenced by the rest of us. The solution is that Congress should take more control over monetary policy.

Congressional control of monetary policy is often seen as a radical idea. After all, the Fed was established to be relatively independent of elected officials both in the administration and on the hill. The rationale for an independent Fed is familiar. If it weren't for the Fed Congress would be swamped by irresistible demands for easy money which would lead to our inflationary ruin.

The argument recalls the story of Ulysses and the sirens in Homer's Odyssey. Ulysses' ship was to pass by an island populated by beautiful sirens whose beckoning was alluring but deadly. To protect himself from their calls, Ulysses begged his boat-mates to tie him to the ship's mast. "...you must bind me hard and fast," he cried, "so that I cannot stir from the spot where you will stand me...and if I beg you to release me, you must tighten and add to my bonds." Otherwise, unable to resist their sounds from shore, Ulysses would have jumped ship to his certain death. By asking his mates to bind him to the mast, he would keep himself from doing what he otherwise would want to do, for his own good.

And so it is with the Fed. We need the independent Fed to protect ourselves from ourselves. We need the Fed to tie Congress' hands.

But do we? Without binding ourselves to the mast of Federal Reserve independence, would we really be destroyed by the siren song of easy money? Perhaps. But a careful look at history suggests that mast binding can be even more dangerous.

The behavior of the Fed during the Great Depression of the 1930s is especially instructive here. As my colleague Thomas Ferguson and I demonstrate in a recent paper, the Federal Reserve used its independence to resist pleas from the Treasury Secretary and Congress to help turn around the economic disaster that was occurring all around them. [1] The Federal Reserve sat idly by while the economy collapsed around it, with the Gross National Production falling by half in four years.

Debate rages over whether the Federal Reserve caused the Great Depression. But there seems little doubt that, at least in the early stages, the Fed could have done much more to ameliorate its effects. But the Fed did almost nothing from October 1929 to January 1932. For a brief time in 1932, the Fed used expansionary open market operations, but it stopped after only six months.

There are many reasons why the Fed stopped but, as we show, one of the most important ones was that member banks opposed further expansion. The bankers feared that if interest rates fell much more, their earnings, and perhaps their solvency, would be threatened. Partly in response to the bankers' opposition, the Fed ended its brief attempt to reflate the economy.

By tying ourselves to the mast in the 1930s, we almost sunk the ship.

One might think that the Great Depression is a special case. After all, anyone can make mistakes. Moreover, reforms taken after the debacle corrected structural defects which were responsible for the system's paralysis, or so it might appear.

Yet, one needn't stop at the 1930s for evidence of the detrimental effect of Federal Reserve independence from elected officials. After the reassertion of its independence in 1951, the Fed promptly helped orchestrate two recessions in ten years. In the Kennedy-Johnson years, fiscal policy had to do an end run around the Federal Reserve to institute the boom of the middle 1960s. And the painful experience of the current recession is well known.

What is the problem? Why has Federal Reserve independence been so devastating? The answer is that the claim that the Fed should be independent is really a veil. A better description of the Federal Reserve is that it is

relatively independent of the elected representatives in government, but at the same time, it is highly dependent on one major sector of American Business: the Commercial Banking Sector. So while the Fed should be making policy in the interests of the public at large, at the same time it has the incompatible task of advancing the interests of a specific industry.

The Fed's ties to the financial sector are manifold. The revolving door of Federal Reserve staff and directors is well known, and, as supporters contend, reasonable: the business of monetary policy is technically complex. First hand experience is certainly valuable. In addition, it is important to recall that the Fed's original purpose is to enhance the stability of the financial sector. So it should come as no surprise that the Fed must be concerned with the financial sector's welfare.

But there are other, more subtle connections which, not only create a common mind set between central and commercial bankers, but tie the two together in even stronger ways. These connections give the commercial banks great incentive to gain influence in the central bank, and give the Fed great need to elicit the banks' cooperation. In conducting monetary policy, for example, the Fed works through commercial banks, so it needs their cooperation in following regulations. And the Fed needs bank's support in its fights with Congress and the Administration. On the other side, the Fed regulates banks and therefore has large effects on them. Banks, therefore, have a great incentive to gain influence within the Federal Reserve, and try to do so. Mutual back scratching becomes virtually irresistible.

These close, and indeed, intimate relationships between the Federal Reserve and the commercial banks, have one very important implication: The Fed is

likely to see the world through "finance" colored glasses. This affects the Fed more or less depending on a variety of factors, but the tendency is always there.

In this regard, the Federal Reserve is similar to other regulatory agencies which must be concerned with the health of the industries they regulate. But because of its central importance in macroeconomic policy, the independence of the Fed from democratic political control combined with the influence on the Fed of the commercial banking sector can be devastating for the welfare of the majority of the people in the United States. In the current period, for example, this combination means that the Fed is conducting a policy that affects millions of U.S. citizens (to say nothing of millions of others in the World) while they have very little control over its policies. But more than that, the Fed is conducting that policy with a bias towards one sector of American business.

Evidence in support of that bias is striking. The table below shows the trend of unemployment, non-financial business profits, the real rate of interest, and the rate of return on equity of commercial banks.

UNEMPLOYMENT, NON-FINANCIAL PROFITS, "REAL" INTEREST RATE,
AND BANK PROFITS

	Unemployment[a]	Before Tax Profit For Non-Financial Corporate Sector (percent) [b]	"Real" Rate of Interest (percent) [c]	Net Return on Bank Equity (percent) [d]
1960-1978	5.4	15.9	1.3	10.4
1979-1982	7.5	10.7	4.3	13.2

- [a] Average unemployment rate for all civilian workers. Economic Report of the President, 1983, Table B-33, p. 201.
- [b] Average before tax rate of return on depreciable assets for non-financial corporations, Economic Report of the President, 1983, Table B-88, p.263.
- [c] Prime Commercial Paper, 4-6, months minus % rate of change of the GDP implicit price deflator, averaged. Economic Report of the President, Tables B-67, p.240 and B-5, p.169. This is one measure of the ex-post real rate. Many other measures are possible, but are unlikely to show major differences.
- [d] Federal Reserve Bulletin, various issues. Numbers for all years not strictly comparable because of definition changes.

Since 1979, the unemployment rate has gone up (and it is 10% currently) and the rate of profit of non-financial corporations has declined by 30%. The rate of profit enjoyed by bankers has increased by over 30% relative to the previous twenty years.

One of the major ways in which tight money harms non-financial corporations is through its effects of their ability to compete abroad. Tight money raises the foreign exchange value of the dollar which, while having salutary effects on the inflation rate, also worsens U.S. foreign competitiveness, one of Congress's main worries. Since early 1982, U.S. firms have been at a 20% disadvantage relative to their competitive standing in the 1970's as measured by wholesale prices and by nearly 30% as measured by unit labor costs. [2] Much of this deterioration is due to the major appreciation of the foreign exchange value of the dollar that has occurred since 1979.

It can be argued that the Fed is not responsible for any of these phenomena. And, indeed, it would be ludicrous to suggest that the only determinant of these major economic trends has been the behavior of the Federal Reserve. However, a glance at the behavior of real interest rates which tripled between the two periods, makes it difficult to absolve the Federal Reserve from blame for the current economic quagmire.

It might seem odd to be arguing that the Fed has been too tight-fisted when, since September, monetary growth has been rapid and an economic expansion has begun. But, far from contradicting my view, the timing of the monetary expansion strongly confirms it. It is highly likely that the Fed loosened up when it did mainly because of its concerns about the Third World indebtedness to commercial banks. It made the right choice. But, again, it

was the financial imperative that called the shots. The recovery is only a fortunate by-product.

As for the economic expansion itself, we are getting mixed signals about its prospects. Industrial production statistics are promising, but there are other signs that three years of tight monetary policy have not solved the basic problems facing the U. S. economy. The rate of growth of real GNP for the first two quarters of this year is only 4.6%, half the average for post-war recoveries. Productivity growth during the first quarter was only 4.8% compared with an average of 9% growth for the first quarter of other recoveries.

So, the recovery is fragile, even if the Fed supports it. But there are signs that the Fed is tightening up again. If it does, chances for a healthy expansion become even worse.

One might argue that the recent and prospective behavior of the Fed has been necessary to correct the inflationary excess of the 1970's. The economy has been faced, one might say, with major structural problems and something had to be done.

I agree. But, and this is a crucial point, the existence of this form of Federal Reserve independence does not solve these structural problems. It only exacerbates them. The problem is that the independent Fed is an institution which, because of its power can get things done. It becomes too easy, therefore, for elected officials to abdicate responsibility to the Federal Reserve, rather than face the more difficult and painful process of democratically and directly confronting the serious economic problems we face. The result is that the policies implemented to solve these problems are biased toward one sector of the economy and destructive for the rest. Monetary policy is not only undemocratic, it is inefficient to boot.

What is the solution? Let me join the chorus proclaiming that none is easy. The economic problems we face are major and no monetary policy, however accommodating, is going to solve them by itself. But that is the point. We need a whole set of coordinated policies, and without more congressional control, we are unlikely to get it.

Why am I arguing for more congressional control, rather than more control by the Executive? I support more influence by the administration as well. But the Executive Branch already has power over the Fed, especially through the appointments process. For example, by being able to reappoint Paul Volcker, the Reagan administration must now take some responsibility for his actions. But, in comparison, Congress is out in the cold.

How can Congress get more control? There are basically two ways. One is by playing a more direct role in monetary policy making itself. A second is having more say in appointing the Open Market Committee. I support both of these, but making progress on either would be significant.

With regard to direct control, for example, just as congress votes on a budget each year, it could also vote on a set of monetary targets proposed by the administration with consultation of the Fed. That way the two tools of macro policy would be coordinated each year and on similar political footing. One could imagine numerous other, less comprehensive changes as well, but this one gives the flavor of the kind of control I am proposing.

Second, the appointments process should be changed. The terms of the members of the Fed should be shortened and made coterminus with the Presidential election cycle. In addition, the appointment of the Chair of the Federal Reserve

should be subject to a vote of the House and Senate. The press routinely describes Paul Volcker as the second most powerful man in the nation. His power will increase as the international debt problem becomes worse and he plays a pivotal role in managing it. In a democracy, can the electorate have so little say over one of its most powerful leaders?

Finally, at a minimum, the seats on the Open Market Committee held by the Regional Reserve Bank Presidents should be eliminated. These are simply the most blatant symbols of banker influence over the Federal Reserve which has now taken more subtle forms.

Before I conclude, let me emphasize one point. I'm not claiming that the Fed or the banks are perfidious or evil. The problem we face is a structural one. Monetary policy is not the proper weapon to cure our ills. But until Congress gets more control over it, it is the weapon that will be used.

In terms of our fable, to understand the nature of the Federal Reserve, Ulysses and the Sirens must be turned on its head. Congress is Ulysses which the siren Federal Reserve is trying to lure away from the helm of economic policy. Here it is interesting to recall what made the sirens so irresistible. They promised Ulysses perfect knowledge of all things past, present, and future. He rejected their offer. Congress must do the same. Until it does, and agrees to tie itself to the mast of decision, the Fed will continue to woo Congress with its siren song. And, if it succeeds, all but the banks will pay.

I would like to thank Samuel Bowles, Francine Deutsch, John Garret, Manuel Pastor, Tom Riddell, Morton Schapiro, Juliet Schor, and Thomas Weisskopf for helpful discussions.

[1] Gerald Epstein and Thomas Ferguson, "Monetary Policy, Loan Liquidation and Industrial Conflict: The Federal Reserve and the Great Contraction," presented at the Southern Economic Association Meetings, November, 1982.

[2] See IMF, International Financial Statistics, world production tables, relative wholesale prices and relative unit labor costs. See, also, Morgan Guaranty Trust, World Financial Markets, May 1983.

The CHAIRMAN. Thank you, Professor Epstein, and all of you. Just wonder what Paul Volcker's reaction would be tomorrow morning if I were to introduce him as the siren. As Mr. Wylie says, not only have they us bound to the past—there is no doubt the Fed has, I don't think anyone can deny the fact that the Fed has had great influence over the Congress over the years. Suffice it to look at their success in lobbying over the years. It has been, probably after the postal employees, probably the best lobbying group in the Nation when you consider the vast difference in numbers. Certainly it is an amazing factor. I am going to ask some questions.

If we run short of time I am going to submit additional questions in writing, but I would say so that my other colleagues can ask questions, I must say that your testimony, the testimony from each and every one of you has been most fascinating. And more importantly, I think that what we have to continue to try to do here is to elicit information and enlightenment from people like yourselves as well as from the Federal Reserve when it testifies in such a manner that the general public can more readily understand what is being said. I have noted a trend in this direction recently. We are going to ask more and more of you and your colleagues when you come to testify in the manner that you have testified this morning, so that the average individual who might not be an economist can understand the complexities of all the M_1 , et cetera, can more readily get a grasp on what you are saying and what your recommendations are.

Do you have questions?

Mr. GONZALEZ. Mr. Chairman, thank you very much. I just wanted to explain my absence. I had committed myself to some constituents and also attended a press conference that some colleagues had invited me to. And the subject was one in which the Federal Reserve and Chairman Volcker have considerable interest.

The CHAIRMAN. Impeaching the—

Mr. GONZALEZ. No; that is mine. I have the impeachment resolution. I don't want to put that on these other fellows. They had a different reason. And that was the IMF bill. But I want to tell the witnesses who have come a long distance in some instances to be here that I have read the testimony, and that I regret very much not being here to listen to the detailed presentation.

The CHAIRMAN. Well, I will tell you what. I realize that you had heavy responsibilities elsewhere. I wish that you would not have attended the press conference on the IMF. But under the circumstances, no, I am just kidding you. I understand on that. But by the same token I must say that the testimony has been very, very well presented, excellent.

Mr. Fauntroy?

Mr. FAUNTROY. Thank you, Mr. Chairman.

I had a number of questions that were detailed by Mr. Epstein's direct categorical and declarative sentences and paragraphs which move me to request of the other witnesses of the panel their assessment of the specific identification of the problem and any solutions.

The CHAIRMAN. You have 5 minutes, you realize that.

Mr. FAUNTROY. Could I hear from anyone who has strong feelings one way or the other about it.

Mr. MCKINNEY. As a nonbanker I have some strong feelings. And I spent 23 years as a commercial banker and 12 working with the Federal Reserve. I have been on both sides of this thing.

Mr. FAUNTROY. He is saying you are on the same side.

Mr. MCKINNEY. All right. But from the point of view of somebody who has worked that long in a commercial bank, if you can persuade the Fed to do something you want it to do you have really accomplished something. Bankers are most unhappy about the fact that the Federal Reserve System is unique among the supervisory agencies in that it feels it has no statutory responsibility for its apparent natural constituency. My impression joins that of the banking system, that this is the case. I think the gentleman is wrong.

The CHAIRMAN. Will the gentleman yield?

Mr. FAUNTROY. I yield to the chairman.

The CHAIRMAN. Thank you for yielding.

You see, I have been observing the Fed from this vantage point for many years as well as listening to the commercial banking industry and their complaints about the Fed. But the fact remains, I can liken it to—we are using comparisons here and illustrations—the parent who says to his child, “You must be home at 10 o’clock this evening,” or, “If you take the automobile, you must not go over 50 miles an hour.”

The Fed indeed is the parent that watches over the banks, the children, who oftentimes tend to stray. But, indeed, the fact of the matter is still that the Fed’s concentration is on the commercial banking industry and its best interests, whether the commercial banking industry agrees or not. More so there I regret to say that for the best interests of the American people oftentimes.

Mr. MCKINNEY. I would think that the Fed is interested in the well-being of the banking system only to the extent that it is in the best interests of the American people. That is the orientation that I understood when I worked there.

The CHAIRMAN. Well, we could go on for hours, just by my understanding of it. I have heard complaints, as I say, from all the major bankers in this Nation about the Fed.

Mr. Fauntroy, I thank you.

Mr. FAUNTROY. I may have asked the wrong question, Mr. Chairman. Mr. Barbera.

Mr. BARBERA. Let me comment on that without addressing it directly. I agree, the Fed is concerned about the banking industry, but they do have more fundamental concerns in terms of what is going on in the economy. I would just like to cite one example.

We talked, both Professor Cagan and myself, about the incredible difficulty we have all had in interpreting M_1 in light of the changes in the velocity of M_1 . It so happens that last year the banking industry was very, very strongly in favor of money market demand accounts, Super NOW accounts, different kinds of accounts that would allow them to compete with money market funds—

The CHAIRMAN. Only after the money market funds established them.

Mr. BARBERA. That is right. But when those accounts were voted on, Paul Volcker voted no, he was very adamantly against Super NOW accounts, and he said simply because, although it would be advantageous for the banks, it would hinder his ability and the

ability of the people at the Fed to interpret M_1 , and therefore perform the more fundamental duties of the Federal Reserve in terms of employment and growth.

Mr. FAUNTROY. And he was overruled.

Mr. BARBERA. Yes, he was.

Mr. FAUNTROY. Yes. Several of you have advocated that the Fed's objectives be specified in terms of economic factors, rather than monetary aggregates. Among those economic factors could be nominal GNP growth or real growth or inflation. Which of those do you think should be the focus of the Fed—those of you who have advocated alternatives?

Mr. MCKINNEY. OK; the one that—the Fed can only influence the total amount of spending. There is no way that the Fed can determine how much of that spending goes into inflation and how much goes into real growth. Therefore, the only realistic ultimate objective is nominal gross national product. The Federal Reserve should obviously be really concerned about unemployment, which is real growth in effect, and inflation, so that it should bear these things in mind when it sets or shoots at a nominal GNP target.

Mr. NICHOLS. I would favor real growth as the target. I agree that the Fed can do nothing about the division of nominal GNP into prices and output. But we can get a reasonable reading of what the historical trend in inflation has been and use that as a simple projection.

There are these underlying inflation forces that roll along. That is what makes inflation so hard to stop. Frankly, that is what makes it hard to start as well. You have got to have several years of bad policy because you can get a good inflation roaring. I think we can take inflation from the past, project it into the future, and assume the rest of any money that is printed would go into real growth. And the minor shocks that happen year to year—some year you have a bad corn harvest, some years a good one, so the price goes up one year and down another—they dominate the month-to-month changes in the inflation rate—but don't have a large, substantial long-run effect.

I think there is a lot to be said for a real growth target. From the perspective of a year, I think they should be able to hit the target that they choose pretty closely.

The CHAIRMAN. Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman.

I, like the chairman, have found this panel discussion this morning to be very, very fascinating, indeed. It certainly is thought provoking.

At the same time, I must admit to some confusion. I found your testimony, Professor Epstein, somewhat disconcerting, may I say.

But, Dr. Barbera, in your statement—you submitted this for the record but didn't mention it in your remarks—on page 9, you say, it is fiscal policy, not monetary policy, that is in need of a major overhaul.

I understand from you, Professor Epstein, that you would say that it is monetary policy and not fiscal policy that is in need of a major overhaul?

Mr. EPSTEIN. That is right. The reason why—

Mr. WYLIE. So we have a major difference among the distinguished scholars right here on the panel.

Mr. EPSTEIN. In order to get an overhaul in fiscal policy, Congress has to have control over monetary policy. That is my basic view. If Congress is going to bear the political costs of cutting the deficit, it also ought to have the power to make sure that by cutting the deficit they will get the monetary effects they want.

Mr. WYLIE. What would you have Congress do? Would you have us set monetary aggregates?

Mr. EPSTEIN. I would support my colleague, Professor Nichols, that Congress ought to set real GNP targets and ought to set a budget and instruct the Federal Reserve to use a monetary policy that is consistent with that real GNP target.

Mr. WYLIE. How about M_1 ? Should we have M_1 targets?

Mr. EPSTEIN. That is up to the Federal Reserve. These are technical issues.

Mr. WYLIE. How about interest rates? Should we set interest rates?

Mr. EPSTEIN. Well, in general I support the view that the Federal Reserve has to keep its eye on a lot of balls at once. It has to look at interest rates; it has to look at credit; it has to look at various ends in order to reach the real GNP target. The real GNP ought to be the ultimate target.

Mr. WYLIE. Do you think Congress has done a good job on fiscal policy?

Mr. EPSTEIN. I think one reason why Congress might not be doing as good a job on fiscal policy as it could is because it doesn't have the power over monetary policy. If it had power over monetary policy, it would be forced to do a good job on fiscal policy, and it would get the benefits from doing it.

Mr. WYLIE. I think we have done a poor job on fiscal policy, and I think we would do a worse job if we had the complicated role of establishing monetary policy.

Mr. EPSTEIN. It is an illusion. The reason it seems you have done poorly on fiscal policy is you haven't had the control over monetary policy, as well.

Mr. WYLIE. Do you agree with that, Dr. Barbera?

Mr. BARBERA. No. In a word, no. However, I do agree some coordination is absolutely essential. I think, though, that there are budget problems that go beyond the issue of coordination. And I think I would harken back to last year when the Congress did agree to some tax increases which I think were appropriate, and did reduce the deficit somewhat. As I remember, there was a sense of Congress or sense of the Senate that was directed to the Fed which basically said we feel we have taken a step; we have improved our house, somewhat; we would like some assistance on your end. And that assistance was rather rapidly forthcoming.

Now, whether you want to institutionalize that, I think, is a second question. But I think a fundamental point that I was making is that right now the Fed has been accommodating, and I think what we need is assistance on the fiscal side.

Mr. WYLIE. Professor Epstein, do you think the financial climate has improved since mid-1982?

Mr. EPSTEIN. Well, monetary policy has become more expansionary and the financial climate has improved.

Mr. WYLIE. Inflation rate is down; interest rates are down.

Mr. EPSTEIN. Unemployment is very high. But the financial climate has improved. But one reason why the monetary authority became expansionary in September was not because of its concern about unemployment or production; it became expansionary when it did because of its concern about Third World debt and the commercial banks.

Again, the major focus of its policy was the financial sector. The effect on the unemployment rate and economic expansion was only a fortunate but not necessary by-product of that.

Mr. WYLIE. You don't think that the Federal Reserve System has made any contribution to economic recovery at all, then?

Mr. EPSTEIN. As I said, it has, but it has been a by-product of its main concern, which has been its concern with the Third World debt problem and effects on the commercial banks.

The CHAIRMAN. If I may, Dr. Barbera was a little confused. It is the House, in its budget resolution, that went to the Senate, that issued directions to the Fed, in conference with the Senate, that was eliminated. However, as a consequence, the Fed, in its lobbying effort with the Senate saying stand fast, don't go along, then the Fed reacted and took actions. That was sort of a quid pro quo, the little things you gentlemen sometimes are not aware of that occur here in Congress that—

Mr. BARBERA. That is the current resolution. I was speaking of the one last August and the resolution at that time which did precipitate the loosening by the Fed.

Mr. WYLIE. I have no further questions, Mr. Chairman.

The CHAIRMAN. Mr. Patman?

Mr. PATMAN. Dr. Barbera, in your experience on Wall Street in high economic circles, do you find that those who have the benefit of the advice that you give and others of your level give know pretty much what the Fed is doing shortly after it does it, or not?

Mr. BARBERA. I guess some of my testimony was addressing the fact that it is difficult now that the aggregate targets are admitted to be difficult to interpret, and the Fed has to make judgments—

Mr. PATMAN. It has made it difficult for you. But in the main, prior to the recent change in the Fed's supposed targets or ways of considering things, you could pretty well tell what was going to happen—

Mr. BARBERA. No. I think that is an overstatement. I wouldn't say we could tell. I would say we had a better sense of the Fed's decisions.

Mr. PATMAN. Could you anticipate whether rates of interest would go higher or lower?

Mr. BARBERA. That is the business we are all in, but it is a very difficult business. As you know, consensus is rare in terms of the direction, short-term direction of rates.

Mr. PATMAN. Do you think the Feds should have realized that its monetary policies were too tight when interest rates got up around 20 percent? Or do you think they were at that point?

Mr. BARBERA. Well, I think that they made—as I said, they made the appropriate decision to forego the M_1 targets. And I guess one could argue in retrospect, they were late in making that decision.

Mr. PATMAN. You are thinking about in August of 1982, aren't you?

Mr. BARBERA. Yes. I am saying some months before they could have made that decision.

Mr. PATMAN. I was thinking about January of 1981. What about that?

Mr. BARBERA. Well, I think we did continue to have a situation where monetary restraint continued to yield inflation reduction. There is—as I think all individuals who have testified have noted or lamented, there is a trade-off—although not a simple trade-off—between growth and inflation. A recession in that light may be necessary when the populace-at-large decides that it no longer will accept, at any cost, a particular level of inflation.

I would harken back for a moment. In 1979, I participated in hearings wherein Alfred Kahn was testifying; as the head of COWPS—the Council on Wage and Price Stability—he was painfully explaining that his efforts had had little impact on inflation. He positively noted, however, that we then had low unemployment, that the employment ratio was the highest it had been post-World War II; and that we had created millions of jobs during that period.

He basically listed the very positive aspects of a strongly growing economy. And he was uniformly lambasted by the Senate Banking Committee because he dared to compare job creation with the, then, No. 1 problem in America—inflation. Whether or not it was right in terms of an economic trade-off, it seems that inflation was deemed politically to be the No. 1 problem; and the recession, I think, was simply the solution.

Mr. PATMAN. I am sorry I don't have time to ask some of the other witnesses for their responses.

The CHAIRMAN. Thank you.

Mr. Roemer?

Mr. ROEMER. Thank you, Mr. Chairman. Because of the time, I will be brief.

I would like to focus on Professor Epstein's—

The CHAIRMAN. Would you go for 3 minutes, and our colleague for 3?

Mr. ROEMER. Yes. It is hard to talk Southern in 3 minutes, but I will try, Mr. Chairman.

Professor, I appreciate your statement. I am not smart enough to know whether I agree or disagree. So let me pursue it for just a second.

In a colloquy with the chairman of our full committee, there seemed to be a dilemma in regard to Federal independence. One view was that the Fed was too tightly interwoven in its relationship with commercial banks and needed independence. The other was that the Fed was too independent from Congress.

Is that a dilemma? Is your view of the Fed's relationship to Congress precluding cutting off the ties with commercial banks, or does your view include both eliminating the ties with the commercial banks and coming under the umbrella of Congress?

Mr. EPSTEIN. Both are necessary. The Congress has to get control over the Federal Reserve. That is the main point. If it does, that will break off or reduce the ties between the Federal Reserve and the commercial banks. So that first you need congressional control, and the second will come along with it.

Mr. ROEMER. I see.

Finally, you are not bothered, it seems, either by the history of congressional ineptitude when it comes to fiscal management, or the need in history for some independence of the Fed. Neither of those historical facts is before you. You think they are overcome by the fact that we need a closer coordination between monetary and fiscal policy, and that that must come from the Congress.

Am I overstating the case?

Mr. EPSTEIN. What I am trying to say is that there is kind of an optical illusion. If the Congress knew that it had to be responsible both for fiscal policy and monetary policy, it would do the two together in a responsible way. The way it is now with the independent Fed, Congress, because it is very difficult to be fiscally responsible, can just let the Fed do it. Congress needs to do both.

Mr. ROEMER. I thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Roemer.

Now our clean-up hitter for 3 minutes, Mr. Hiler.

Mr. HILER. I thank the gentleman and probably won't take 3 minutes. I don't really have a question; maybe two or three quick comments.

Professor Epstein, I find that I agree with some of your statements that you make. But, in general, I can't agree with your overall testimony. I don't have the faith that you have in Congress ability to suddenly straighten out our fiscal house if we are given more or less total control over monetary policy.

But I do agree with a point I think you made, and I think you made it forcefully, that the deficit problems we face today are not entirely due to fiscal policy but, in fact, much of the deficit we face is as a result of the very severe recession that many would say was a direct result of the very restrictive monetary policy or monetary policy that was restrictive far beyond the timing when it should have been restrictive.

Dr. Barbera, I guess I just question the fact, going back to last August when the Fed decided to loosen the monetary supply—I frankly don't think that the tax act we passed last year has resulted in higher revenues. I think the Fed actually started to loosen up the money supply when it appeared that the international system was about ready to go down the tubes. And I think that there was perceived at that time a dire necessity to get away from this dancing on the pinheads of M₁'s and get to a more realistic monetary policy that recognized that real growth and employment and all these things entered in.

With that, Mr. Chairman, I know we have a vote on. Since you and I are the only ones here, I will yield back to you.

The CHAIRMAN. Fine. I thank the gentleman.

Really, I would like, as we all would, to go on with you. Unfortunately, when we set the hearing we weren't aware we would have the type of session we are having today, which really requires our

presence. It is on a very delicate but very important topic—you know, how do you weigh the equities.

But, again, I want to thank you most sincerely for your assistance. We will be submitting some questions in writing for you so that you can further elaborate and educate us. If you will be cooperative, we would be most grateful. Thank you, one and all.

The committee will be in recess until tomorrow morning at 10 a.m.

[Whereupon, at 12:40 p.m., the committee recessed, to reconvene at 10 a.m. the following day, Wednesday, July 20, 1983.]

CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 20, 1983

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

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

Present: Representatives St Germain, Minish, Annunzio, Mitchell, Fauntroy, Neal, LaFalce, Vento, Schumer, Patman, Coyne, Roemer, Lehman, Morrison, Cooper, Kaptur, Erdreich, Levin, Carper, Torres, McKinney, Leach, Paul, Bethune, Shumway, Parris, McCollum, Wortley, Roukema, Lowery, Dreier, and Bartlett.

The CHAIRMAN. The committee will come to order.

I certainly want to welcome Chairman Volcker to the fifth year of our monetary policy reviews on the Humphrey-Hawkins, and our 10th semiannual attempt to make the Federal Reserve Board provide the American people with sufficient information about its policies.

I might also note that it is the first anniversary of my having gone cold turkey on cigarettes and cigars, and hence, my presentation to the chairman of the cigar that was presented to me.

Now, in preparation for this hearing, I have been reviewing our history of congressional oversight both before Humphrey-Hawkins and since its passage. Since the early 1960's, at least this committee, our counterpart in the Senate and the Joint Economic Committee have all tried to pry important information from various Federal Reserve chairmen.

In fact, I ran across many statements I made in this period which directly parallel statements I made to you as recently as April of this year.

In July 1975, I said to your predecessor, Dr. Burns:

It seems to me that we are playing a lot of semantics here this morning. You mentioned that staff makes projections with which members may agree or disagree and that staff disagrees among themselves tomorrow or the day after. We all recognize that fact.

The Fed does, however, reach policy decisions on monetary policy. Therefore, I cannot believe that each and every one of you have not, after looking at projections by the staff, reached a conclusion as to what effect policy decisions will have on GNP, on inflation and on unemployment.

What is wrong with letting the American people know what the goals are? I think that the American people should be informed as to the goals and the aims and the hopes of the Fed when it sets policy. It occurs to me that the sophisticates on Wall Street, based on history, can make a determination and a sophisticated guesstimate

as to what the policy decisions have been. Why not share this with the rest of the people?

Now, this is 1983, and, Mr. Chairman, I can say exactly the same thing this morning. Nothing has changed in the last 8 years to let a little light in on what the Fed is doing down the street from the White House.

The pattern throughout these years has been the same. The Federal Reserve fights every proposed reform and every possible tear in its veil of secrecy. The press and financial pundits are lined up to tell of the dangers if policy is compromised, and to tell us the world will crumble if any change is made in current practice.

This opposition is mounted full force until the last second—just before congressional legislation is on its way to you—and then the Federal Reserve switches tactics, and we are flooded with information about the minutiae of monetary policy. All the time, those sacred scrolls of Federal Reserve Board economic intentions are protected from sight.

The congressional resolution of 1975 and the Humphrey-Hawkins Act requirements themselves are classic illustrations of this process. Since 1979, Congress has been suffused with several different monetary targets and reams of explanations about why those targets are each of dubious value.

Even in your first report to Congress under Humphrey-Hawkins, delivered in February 1979, the fledgling aggregates were already suspect.

The Federal Reserve told the American people that year:

The unexplained flatness of M_1 in recent months introduced another uncertainty in the FOMC's deliberations regarding the monetary growth ranges. At this stage, it is impossible to tell whether the weakness of M_1 relative to what would have been expected on the basis of historical relationships among money, income and interest rates is a transitory phenomenon or one that is likely to persist for some time.

In the meantime, M_1 may continue to be a somewhat ambiguous indicator of monetary policy, and it will be especially important to monitor the behavior of other financial variables.

Then in February of 1983, you, the Federal Reserve, told the American people about the difficulties in setting M_1 targets for the year. I quote:

In setting guidelines for monetary growth * * * the Federal Open Market Committee recognized that the relationship between growth ranges and ultimate economic objectives had deviated substantially from past patterns during 1982 * * * The atypical behavior of velocity last year will likely prove to be at least in part temporary * * * All of these factors contributed to the complexity of setting target ranges for 1983, and the committee recognized that an unusual degree of judgment would be necessary in interpreting the growth of money and credit in coming months.

Now comes the July 1983 report, and today you repeat the mournful refrain:

The decision to establish a new base for monitoring M_1 reflected a judgment that the rapid growth over the past several quarters should be treated as a onetime phenomenon, neither to be retracted or long extended.

I don't think many of us would disagree that judgment and a broader economic focus is necessary for effective monetary policy. In fact, I believe that more attention to economic variables is just the tonic we need to navigate the course between recession and virulent inflation.

My only question is, what good does it do the American people to be told about monetary targets that are always subject to special conditions which render them almost useless? How many one-time phenomena can M_1 be subjected to?

I think it would be best for all Americans if you would just let us know where you believe your policies will take the economy, and then we can judge your performance by criteria that we all understand.

This committee does not want to hear another year of reasons why the monetary aggregates are not perfect gears for controlling the economy. I have been convinced of that for years.

We heard Chairman Miller tell us in 1979, and I quote:

Once you get past this year, we will be looking at M_1 figures progressively comparable to past year figures.

Let us not play that game again.

Instead, I would like your answers to the following questions.

First, if it were not for the danger of international financial collapse in the wake of high U.S. interest rates, would you move to induce high rates at this time—that is, do you believe our 7-month boomlet needs to be slowed down?

Second, when do you believe unemployment will drop below 7 percent given current fiscal policies, and the monetary policies you plan to follow in the near future?

Third, do you think anything productive comes of the financial and interest rate nervousness connected with the traditional Federal Reserve secrecy, such as the virtual halt in the bond market that occurred last week during your FOMC meetings? If not, is there anything you would suggest that could ease that nervousness?

Four, you have often said that monetary policy cannot bear the full burden for keeping inflation down. Obviously, your predecessors as Chairman have agreed with that analysis. Do you agree with former Chairman Miller, who told this committee in the first Humphrey-Hawkins hearing that—

To enhance the possibility of simultaneously achieving low unemployment and price stability, it may be necessary to augment monetary and fiscal policies with carefully focused programs to facilitate job placement and to provide skill training?

You have also placed the blame for much of our current problem on large Federal budget deficits. While it is all very well to say “cut spending,” just where do you think it should be cut? Or do you think it doesn't matter where it is cut?

Our constituents certainly believe it matters.

Those are the type of questions, Chairman Volcker, that I think are important to this Nation. I hope you will apply yourself to answering them with the diligence we have come to expect from you in your past relations with this committee.

At this time, I would like to recognize Mr. McKinney, who has a statement to introduce on behalf of Mr. Wylie, our ranking minority member.

Mr. MCKINNEY. Thank you, Mr. Chairman.

Congressman Wylie had to Chair the Joint Economic Committee today. He apologizes for being late.

I ask unanimous consent that his opening statement be included in the record at this point.

The CHAIRMAN. Without objection, so ordered.
[The opening statement of Mr. Wylie follows:]

OPENING STATEMENT OF HON. CHALMERS P. WYLIE
HEARING ON THE CONDUCT OF MONETARY POLICY

July 20, 1983

Chairman Volcker, on behalf of the Republicans on the Banking Committee, I welcome you to these important oversight hearings on the conduct of monetary policy. You are joining us at a time when monetary policy has approached an equally important decision point, as I think you will agree. The key question, it seems to me, is how to ensure continued economic recovery without at the same time setting in motion forces which may again reignite inflation at some point down the road.

You no doubt will tell us that the problem facing the Federal Reserve, and indeed all of us, is made more difficult by an enormous budgetary deficit that is likely to persist even after economic recovery has made further headway. In fact, this year's budget resolution expressly recognized the burdens that sizable budget deficits place on the conduct of monetary policy. A scenario could well be imagined in which full recovery stalls out simply because the demands of the Treasury on the capital markets again drive up interest rates because of competition with the needs of a reviving private sector. If this is a reasonable view of the future -- and I would appreciate your reaction -- then much of the responsibility for the successful achievement of a sustained, noninflationary recovery lies as much with us here in Congress as it lies with our Nation's monetary authority.

Chairman Volcker, you have just been paid the ultimate compliment for a job well done when President Reagan reappointed you to the leadership of the Federal Reserve System. No doubt, our colleagues in the other body will vote your confirmation this week. My colleagues and I join in congratulating you and wishing you the very best of success, particularly -- as Senator Proxmire described last week -- because yours is a difficult and at times thankless job. Welcome again, Chairman Volcker. We are eager to hear your testimony.

Mr. MCKINNEY. I would like to welcome Chairman Volcker.

I think it was about 3 months ago that I sent my letter to the President of the United States urging him to reappoint the Chairman. I think he has done an excellent job and am confident he will continue to do so.

I, unlike some, would be literally terrified to see the body politic enter into the way he runs the Fed.

I remember asking the question, I think it was just 2 years ago, as to what he would do if we turned coward, or the administration turned coward, and started to push the economy into spiraling heights. His answer was that someone has to stay as a sea anchor. I compliment him on his job of being a sea anchor for the Nation.

I think the rest of the Nation is dreadfully concerned about the fact that this resurging economy may be eclipsed by interest rates, and I know we are waiting to hear what he has to say about it.

I will be asking him questions specifically about the International Monetary Fund and our relationship with it and the rest of the world.

Again, welcome Mr. Chairman.

The CHAIRMAN. At this time, the Chair would recognize the distinguished chairman of the Subcommittee on Domestic and Monetary Policy, Mr. Fauntroy.

Mr. FAUNTROY. Thank you, Mr. Chairman.

I do not have any comments to make at this time, except that I do want to commend you for providing our members the opportunity to reevaluate the monetary policy targets and the policies of the Federal Reserve in their semiannual report to the Congress.

I think it is fair to say that you have taken the lead in bringing the issue before the full committee both through your work on the Budget Committee and through your letter to more than 300 economists soliciting their views on targets and other monetary policy issues. The remainder of the hearings which are scheduled with 10 very good witnesses will, I think, provide us with a very valuable understanding of what the Fed has done and how we might provide better guidance to the Fed for what we want them to accomplish.

I look forward as well to hearing from Chairman Volcker. I welcome him to the committee, and I extend to him my congratulations for his reappointment and offer my best wishes in the job that he has, which is a most difficult one.

The CHAIRMAN. Chairman Volcker, I reiterate that which I wrote to you upon your reappointment, and that is that God bless you. Thank God you accepted. We have disagreed agreeably in the past and probably will in the future, but we are very grateful for your decision to continue to serve the Nation.

At this time the stage is yours. We will place your entire statement in the record as well as the agenda, and you may now proceed.

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

Mr. VOLCKER. I realize I have a rather long statement. I don't know whether it falls in the category of excessive minutiae or in-

complete information, Mr. Chairman, but we try to draw the appropriate line. I won't read the whole statement.

You already addressed already four or five questions which I deal with in the statement. You asked a few more questions today anyway, some which I deal with indirectly, and which perhaps we can get into later. Let me I take the time to summarize part of the statement.

I do welcome this opportunity to discuss again Federal Reserve policy with the Banking Committee. You have before you the mid-year monetary policy report and, as usual, I will simply expand upon some aspects of that report or deal with some other questions that have been raised.

Let me emphasize that we meet at a time when economic activity is plainly advancing at a rate of speed significantly faster than we, the administration, the Congress and most other observers thought likely at the start of the year.

Over the past 6 or 7 months of expansion, our economic activity has risen about as fast as in the average postwar recovery. The unemployment rate has dropped nearly a percentage point from its peak.

The very sizable gain in the gross national product during the second quarter has, in substantial part, reflected a cessation of inventory liquidation and perhaps small accumulation by businesses. That is not unusual in the early stages of expansion, and it doesn't necessarily suggest continuing gains at the same rate of speed. But it is also evident that domestic final sales and incomes are now increasing fairly rapidly, that the midyear tax cut is releasing further purchasing power, and that consumer and business confidence has improved. Consequently, strong forward momentum is carried into the third quarter and potentially beyond.

The expansion so far has been accompanied by remarkably good price performance. Finished producer prices were essentially unchanged over the first half of 1983, and consumer prices were up at a rate of only 3 percent.

Perhaps more significant for the future, the rate of nominal wage increase—at about a 4-percent annual rate—is now at its lowest level since the mid-1960's, and average real wages as in 1982 are rising. That pattern has been assisted by sizable productivity gains.

In all these respects, we are clearly doing better. Yet, even as the economy has expanded and the inflation rate has remained good, widespread forebodings remain evident for the future. Those concerns are understandable and justified so long as the major policy issues—issues that I emphasized in my testimony to you earlier in the year—remain unresolved.

Indeed, the very speed and vigor of the recovery in its early stages has increased the urgency of facing up to these problems.

I have repeatedly expressed the view that we have come much of the way toward setting the stage for a long, sustained period of recovery, characterized by greater growth of productivity and real incomes and by much greater price stability. Responsible and prudent monetary policies must be one important element in making that vision a reality, but it would be an illusion to think that monetary policy alone can do the job.

Before turning to monetary policy in detail, my statement covers some other important aspects of the economic environment.

You would not be surprised, Mr. Chairman, that I emphasize the budgetary situation, the fact that unless Congress implements measures contemplated in the recent budget resolution—which is a matter of great debate and difficulty itself—unless further actions are taken, deficits are going to remain close to \$200 billion, and they are going to absorb a very large fraction of our savings potential as the economy expands.

That raises the question of whether that budget outlook is consistent with the kind of economy we want, particularly the case with respect to such heavy users of credit as housing and business investment.

The question I raise is, how many people are going to be squeezed out in the process of financing that deficit unless action is taken? I emphasize that with the economy increasing more rapidly than anticipated—which, in itself, is a good thing—dealing with the budget is more pointed and more urgent. I do think that is the greatest hazard that we can discern now to future progress.

We are financing that budget in part, directly or indirectly, by a massive inflow of foreign capital; the counterpart of that is a weak trade position. I don't think any of us want to see that persist. There is no way we can draw upon capital from abroad without running a current account deficit, and you see that in our weakening trade position.

In the international area, which is the second problem area I cite, you know of our pressing debt problems in much of the developing world, particularly in Latin America. I think that is a threat not only to the world financial system but to financial stability in the United States. Those strains have been managed. There are signs of progress in some areas, particularly in Mexico. Brazil took important steps last week, but it is clear that the problems will be with us for some time.

I just want to emphasize, particularly on this occasion, that the IMF plays an absolutely crucial and central role in managing this process.

The CHAIRMAN. Chairman Volcker, I think that that which you have just stated is very important and I am going to take advantage of my chairmanship here to have a little colloquy with you.

I think it is important that the American people hear the other side of the story as far as the IMF is concerned. There have been some very, I think, irresponsible statements made about increased participation in IMF.

As a matter of fact, we have heard some commercials being run that might be labeled, in quotes, "cheap shots." I think it is important that the American people hear from you as Chairman of the Federal Reserve Board.

Do you buy the cheap shot? What is your reaction to that little statement that reads, "Don't bail out the big banks that have been aiding and lending to Communist countries?"

I would like your reaction to that.

Mr. VOLCKER. I don't think this is a process of bailing out the big banks. I have not heard those particular commercials, but I have heard those comments.

As part of this process, as you know, Mr. Chairman, the bank creditors themselves are typically called upon specifically by the IMF as part of an adjustment program to provide additional credit to permit those adjustment programs in the borrowing countries to be successful.

Most of them need some additional transitional financing while they are getting their own houses in order. The IMF can provide a margin of that financing, but the bulk of that financing has come, and is going to have to continue to come, from the existing creditors.

The banks are called upon and, indeed, have been participating in the general effort to restore stability in this area; that does not seem to me to fit the definition of a bailout.

Obviously, if this situation is effectively managed, it will not work to the disadvantage of the bank, but more importantly, it won't work to the disadvantage of the United States.

If it is not worked out, you are going to see repercussions on our own financial markets and our own prospects for recovery.

The CHAIRMAN. Chairman Volcker, would you define briefly what you mean by repercussions? I think it is important. It is a generality, but give us a few examples of what could happen if we did not.

For instance, Mr. LaFalce just handed me a note that says, "Ask the Chairman what would happen to interest rates if we fail to agree to this increased participation in IMF."

Mr. VOLCKER. I think the effect would be to increase interest rates in the U.S. market, but let me just describe the mechanism by which I see that happening.

American banks have over 100 billion dollars' worth of credits to developing countries. Banks around the world have more than twice that much.

The CHAIRMAN. I think it is important that we emphasize that it is not just American banks; it is banks internationally.

Mr. VOLCKER. This is an international problem, and large foreign banks in industrial countries have more loans to these countries than the American banks do, but it is a large amount in both instances.

If there were widespread fear—or worse, the actuality of failure to service these debts—you would have an impact on the capital of these banks, not just in the United States but elsewhere in the world, and that cannot be measured. It would depend upon how widespread it was; it could be substantial.

I simply raise the question that if you have a very substantial impact on the capital of the banking system in the United States and elsewhere, are those banks going to have the ability to do the domestic lending in the United States quite specifically? You can ask the same thing about other countries that are necessary to support economic expansion.

The CHAIRMAN. Mortgages on homes all the way to lending to provide jobs for Americans.

Mr. VOLCKER. I think it will affect all of that, and, in a sense, you don't have to wait for the defaults and the bad loans; the fear of that possibility is bound to have a psychological effect on the market.

The CHAIRMAN. If I may interrupt again, just as the fear that the Fed might tighten up on the money supply has an effect on the markets and on interest rates.

Mr. VOLCKER. I would think the other kind of a fear is considerably more pernicious.

The CHAIRMAN. Well, this is an example of what would happen internationally.

Mr. VOLCKER. It is not just the interest rate impact. You have concerned lenders; the availability of credit may not be the same; it will not be the same particularly to borrowers who are on the margin.

This is not just an American effort, as you know, Mr. Chairman. If we do not approve the IMF, the United States, virtually alone, would be standing out among all the countries of the western world saying, "We don't agree with this approach and we are willing to take that other risk." I think it is almost more than a risk; it is predictable, just a question of degree. You would be sending a signal around the world, I think, that the United States is out of step on this point and is willing to take risks that seem inappropriate to the rest of the world. It is not just a U.S. problem.

The CHAIRMAN. One last item. A few seconds ago, before I interrupted you, you mentioned the importance of foreign capital coming into this country, but also the importance about balance of trade and our exports. If the IMF participation were not to be increased, would that not have a tremendous adverse impact in that area as well?

Mr. VOLCKER. It would certainly have an adverse impact on world trade and our exports, because the borrowing countries that the IMF is working with are going through most difficult times.

Most of them are, in fact, having to restrain imports now, but they are having to restrain imports with a margin of IMF financing, with a margin of bank financing.

If you project a situation where that collapsed, then the strains on those countries would only be redoubled. It would directly affect our export position as well as those of other countries and, through that avenue, affect the growth in our economy. That is quite correct.

Mr. ANNUNZIO. Will the chairman yield?

Chairman Volcker, in answer to the chairman of the full committee, you said that if we don't grant the IMF loan, interest rates will go up.

Now, can you assure us that if we do grant the loan, that interest rates will come down?

Mr. VOLCKER. No. Obviously there are other factors at work in the marketplace, and that is the subject of much of the rest of my testimony, directly or by implication, but I am not going to argue the IMF legislation is the only factor in the interest rate outlook.

The CHAIRMAN. I apologize, but I think that was important because of the fact that you had not testified on IMF for a long period of time.

Mr. VOLCKER. I appreciate the questions.

I do touch in my statement on wage price trends and the importance that they remain moderate in the period ahead. Those trends have been favorable, as I emphasize.

The question is whether they will remain favorable as the economy expands, as profit improves, as employment goes up. I think it is terribly important that we do not revert to the pattern of the 1970's, but that temptation may exist in an improving economy.

I think it is important that we maintain open and competitive markets—which has an international dimension—and that as the economy improves, we do look again at all those things we do at home to maintain rather artificial supports for prices and costs in some industries.

Those are continuing problems, but they have become much more important, and it is more feasible to do something about them in the context of an expanding economy.

Against that setting, my statement goes on to discuss in some detail monetary policy. It does so, of course, against the background that interest rates did drop sharply in the second half of 1982.

Certainly growth in credit and money has been adequate to support growth in economic activity, because economic activity has been, in fact, growing, and growing more rapidly than we and others anticipated at the beginning of the year.

There have been abnormal movements and shifts in the relationship of some of the monetary aggregates to economic activity. You asked whether velocity patterns established earlier in the postwar period might be changing cyclically.

We put less emphasis on M_1 in policy implementation, but for a while, M_2 was also distorted, particularly by the introduction of the money market deposit account. We believe that that particular source of distortion now is essentially behind us, but all during this period, judgments as to banking reserve conditions have been conditioned by available evidence about trends in economic and financial conditions, prices, exchange rates, and other factors.

As the economy has been growing and picking up speed, the broader monetary and credit aggregates have moved consistently within the ranges set in February, and prices were relatively stable. Sensitive commodity prices did rise for a while, but they have been fairly stable for a couple of months.

We have had a very strong dollar in the foreign exchange markets. We have these international financial strains; they did not point in the direction of restraint.

For some time a broadly accommodative approach with respect to banking reserves appeared appropriate despite much higher growth in M_1 , alone among the targeted aggregates, than anticipated.

In the latter part of the second quarter, against the background of growing momentum in economic activity, monetary and credit growth showed some tendency to increase more rapidly. M_1 growth did remain particularly high—higher, if sustained, than seemed consistent with long-term progress against inflation and sustained orderly recovery.

In these circumstances, the Federal Open Market Committee, beginning in late May, has taken a slightly less accommodative posture toward the provision of bank reserves through open market operations, leading to increases in borrowings at the discount window.

Whether viewed from a domestic or international perspective, limited, timely and potentially reversible measures, now, when the economy is expanding strongly, are clearly preferable to the risk of permitting a situation to develop that would require much more abrupt and forceful action later to deal with new inflationary pressures and a long—sustained pattern of excessive monetary and credit growth. These steps have been accompanied by increases ranging from about three quarters to 1 percent or more in both long- and short-term market interest rates.

Apart from any monetary policy actions, these limited changes, particularly in the intermediate and longer term areas of the market, appear also to have been influenced by larger private and government credit demands currently as well as by expectations generated by stronger economic and monetary growth and the budget deficit outlook.

Over the more distant future, balanced and sustained economic growth with strong housing and business investment would appear more likely to require lower rather than higher interest rates. That outcome, however, can be assured only if the progress against inflation can be consolidated and extended.

Considering all these factors, the Open Market Committee basically concluded that the prospects for sustained growth and for lower interest rates over time would be enhanced rather than diminished by modest and timely action to restrain excessive growth in money and liquidity given its inflationary potential.

I must emphasize again that the best assurance we could have that monetary policy can, in fact, do its part by avoiding excessive monetary growth within a framework of a growing economy and reducing interest rates lies not in the tools of central banking alone, but in timely fiscal action.

Looking ahead, the committee decided the growth ranges established earlier in the year for M_2 and M_3 during 1983 are still appropriate. The most recent data, while showing somewhat larger increases in June, are still within the range for M_2 , and about at the upper end of the range for M_3 .

As anticipated, the massive shifting of funds into M_2 as the result of the introduction of money market deposit accounts, and to a more limited extent, into super NOW accounts, has abated and we assume, as I said, that they will not be a source of major distortion looking ahead.

The committee also decided to continue the associated ranges for growth in total domestic nonfinancial credit of $8\frac{1}{2}$ to $11\frac{1}{2}$ percent; 1983 is the first time the committee set a range for such a broad crediting aggregate. It is not given the same weight as the broader monetary aggregates, at least until we gain experience.

We are aware that, consistent with the established range, growth in credit during 1983 could exceed nominal GNP, although a long-term trend is for practically no change in the ratio of credit to income. Somewhat faster growth in credit is consistent with experience so far this year, and may be related to the relatively rapid expansion in Federal debt.

Looking ahead to 1984, we contemplate a reduction of one-half percent in all three of those ranges, M_2 , M_3 , nonfinancial domestic credit. That small reduction appears appropriate and desirable

taking account of the need to sustain real growth while containing inflation.

Those targets appear fully consistent in light of experience with the economic projections of the Open Market Committee as well as those of the administration and those underlying the budget resolution. The targets are, of course, subject to review around year end.

One question that arises is whether the somewhat more rapid growth in credit and nominal GNP will or should desirably continue consistently with progress toward price stability and toward a more conservative pattern of private finance than characteristic of the years of inflation. Again, the pressures on aggregate expansion stemming from the budgetary situation are a source of concern.

Decisions concerning appropriate targets for M_1 were more difficult. In an appendix to this statement I discuss some of the questions you raise about M_1 , its velocity, and meaningfulness. I think we can say that the velocity relationship has varied significantly from usual cyclical patterns recently—first, in dropping back more sharply during the recession, and second, in failing to snap back as quickly during the recovery. While a number of more temporary factors have contributed significantly, it appears to be related to the fact that a major portion of the narrow money supply now pays interest. The spread between the return available to individuals from holding M_1 money and market rates has narrowed substantially, more than the decline in market rates itself implies. Put another way, NOW accounts where the growth has been most rapid, are not only transaction balances, but now have a savings or liquid asset component. For a time at least, uncertainty about the financial and economic outlook and less fear about inflation may also have bolstered the desire to hold money.

At the same time, growth in M_1 —running well above our targets for 9 months—has not been confined to NOW accounts alone. Moreover, there are signs that the period of velocity decline may be ending. In looking ahead, with the economy expanding and with ample time for individuals and others to have adjusted to the rapid decline in interest rates last year, we must be alert to the possibility of a rebound in velocity along more usual cyclical patterns even though the longer term trend may be changing.

Taking all this into account, the committee felt that the appropriate approach would be to reassess future growth from the base of the second quarter of 1983, looking toward growth close to, or below, nominal GNP. Specifically, the range is set at 5 to 9 percent for the remainder of this year, and at 1 percent lower—4 to 8 percent—for 1984.

Thus, the committee, in light of recent developments, looks toward substantially slower, but not a reversal of M_1 growth, in the future. Velocity is expected to increase, although not necessarily to the extent common in earlier recoveries.

The range specified is relatively wide, but, depending on future evidence with respect to velocity, either the upper or lower portion of the range could be appropriate. As this implies, M_1 will be monitored closely but will not be given full weight until a closer judgment can be made about its velocity characteristics for the future.

We are, of course, aware of the proposals to pay interest on demand deposits which could, if enacted, influence velocity trends

further over time, but that does not appear to be a near term prospect.

These targets are designed to be consistent with continuing growth in economic activity and reduced unemployment in a framework of sustained progress against inflation. Indeed, they are designed, insofar as monetary policy can, to contribute to these goals. The targets by themselves do not necessarily imply either further interest rate pressures or the reverse in the period ahead.

Much will depend on other factors; in particular, progress on the budget and continued success in dealing with inflation should be powerful factors reducing the historically high level of interest rates over time to the benefit of our private economy and the world at large.

The next section of my statement, Mr. Chairman, deals with questions that you specifically raised about setting objectives for a variety of economic variables, nominal GNP, real GNP, inflation, unemployment and the like.

As you know and as you have before you, we now do report ranges for assumptions, projections, or forecasts. This time and last time we have provided "inside range," so to speak, where the assumptions have clustered.

I would say there is a sense in which those projections reflect the view as to what outcome should be both feasible and acceptable given other policies and factors in the economy. Otherwise, monetary policies would presumably be changed.

But I also point out that like any other forecast, these are imperfect, and actual experience has sometimes been outside the forecast range.

I do believe there are strong reasons why it would be unwise to cite objectives for nominal or real GNP rather than projections or assumptions in these reports. The next few pages of my testimony explain why, even though I recognize there is a certain surface appeal to say "this is the objective."

An "objective" might appear to assist debate, but I do think it contributes to a sense that monetary policy is more powerful than it is, and that the emphasis would be on short-term forecasts or objectives that we cannot really control.

We would be encouraged to do much more fine tuning, to focus on the short run, to an extent that would be unhealthy. So much of our policymaking depends upon a judgment as to what the lagged effects are of any policy decision over a considerable period of time, how it fits in with a longer range strategy, and not precisely what the GNP is over the next 6 months or year.

I detail these concerns over several pages in my statement, but I think it boils down to the fact that if we look back, we paid a very high price for thinking we could buy a little more growth with a little more inflation in the past; we ended up with a lot more inflation and less growth.

I fear that a sense that the Federal Reserve could fine tune the economy in the short run, as may be implied by an objective-setting process of the sort that you discuss, would only increase the difficulties, rather than improve policy.

I might say in that connection, the Open Market Committee is a committee. It has 12 members. Getting them all to agree upon a

specific objective would, at best, be an artificial policy or artificial approach. You can add up individual convictions and divide by 12, I suppose, but whether that is a meaningful exercise.

I would urge you to consider that the kind of information, the kind of assumptions and projections we now provide do give the Banking Committee, I think, the basis for what you are after. We had some discussion about this late last year and I think that was the conclusion at that time.

You raise some questions about the international monetary system, which I deal with rather briefly. I think I could summarize by saying we cannot coordinate, in an explicit sense, in terms of common interest rates or common monetary targets when considerations are so different in different countries at this time.

I would like to see coordination. We all aim at sustainable, non-inflationary growth, and I think it is very important that the monetary authorities—indeed, economic policymakers in general—remain in close touch with their foreign counterparts so we know what their reactions and concerns will be about our actions, what they are thinking about, and what their concerns are.

I do not believe it is practical, right now, to move toward a much more structured international system with fixed exchange rates, but consideration of that possibility might well be on my agenda for the future.

Let me just conclude, Mr. Chairman, by saying we are making more progress toward our economic objectives over the past 6 months, than we anticipated. But it is also true, partly because economic growth has increased, that the need to deal promptly and effectively with the obstacles to sustained growth and stability have become more pressing. I think those obstacles are well known to all of you.

There is little disagreement conceptually. What has been difficult is the strong consensus about the specifics—how, in a practical way, to deal with them.

There should not be any assumption that monetary policy can substitute for budgetary discipline, open and competitive markets, inadequate savings or for structural financial weaknesses. I think the world economy today offers ample illustration of the dangers of procrastination and delay in the face of political impacts.

I hope that the problems will subside by themselves, only to be faced in crisis circumstances, with the need for some stronger action in an atmosphere of shattered confidence. That great intangible of confidence, once lost, can only be rebuilt laboriously, step by step.

Here in the United States we have with great effort already gone a long way toward rebuilding the foundation for growth and stability. We are not today in crisis.

The American economy, for all its difficulties, still stands as a beacon of strength and hope for all the world. But we know something of the risks and difficulties that could turn that outlook sour.

I also know that the actions necessary to make division of stability and sustained growth a reality are within our grasp, and I believe we have come too far with too much effort to fail to carry through now.

Thank you, Mr. Chairman.

[Chairman Volcker's prepared statement on behalf of the Board of Governors of the Federal Reserve System and the "Midyear Monetary Policy Report to the Congress" prepared in accordance with the Humphrey-Hawkins Act follows:]

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

I welcome this opportunity to discuss Federal Reserve monetary policy with the Banking Committee in the context of current and prospective economic conditions and other policies at home and abroad. You have before you the Midyear Monetary Policy Report to the Congress prepared in accordance with the Humphrey-Hawkins Act. This morning, I will highlight or expand upon some aspects of that Report and deal with certain further questions raised by your Chairman.

We meet at a time when economic activity is plainly advancing at a rate of speed significantly faster than we, the Administration, the Congress, and most other observers thought likely at the start of the year. Over the past six or seven months of expansion, output has risen about as fast as in the average postwar recovery, more than 1 million more people are employed, and the unemployment rate has dropped by nearly a percentage point from its peak.

The very sizable gain in the Gross National Product during the second quarter in substantial part reflected a cessation of inventory liquidation -- and perhaps small accumulations -- by business. That is not unusual in the early stages of expansion, and does not necessarily suggest continuing gains at the same rate of speed. But it is also evident that domestic final sales and incomes are now increasing fairly rapidly, that the midyear tax cut has released further purchasing power, and that consumer and business confidence has improved. Consequently, strong forward momentum has carried into the third quarter, and potentially beyond.

The expansion so far has been accompanied by remarkably good price performance. Finished producer prices were essentially unchanged over the first half of 1983, and consumer prices were up at a rate of only 3 percent through May and by about 3-1/2 percent over the last twelve months. Perhaps more significant for the future, the rate of nominal wage increase -- at about a 4 percent annual rate -- is now at its lowest level since the mid-1960's, while average real wages, as in 1982, are rising. That pattern has been assisted by sizable productivity gains.

In all these respects, we are clearly "doing better." Yet, even as the economy has expanded and the inflation record has remained good, widespread forebodings remain evident for the future. Those concerns are understandable and justified so long as some major policy issues -- issues that I emphasized in my testimony to you earlier in the year -- remain unresolved. Indeed, the very speed and vigor of the recovery in its early stages has increased the urgency of facing up to those problems.

I have repeatedly expressed the view that we have come much of the way toward setting the stage for a long-sustained period of recovery, characterized by greater growth in productivity and real incomes and by much greater price stability. Responsible and prudent monetary policies must be one important element in making that vision a reality. But it would be an illusion to think that monetary policy alone can do the job, and before turning to monetary policy in detail, I want to touch again upon some crucially important aspects of the environment in which monetary policy must be conducted.

The Budgetary Situation

I am aware of the enormous effort in the Congress over recent months to shape a responsible budgetary resolution -- indeed to preserve an orderly budgetary process. But the concrete results of that effort to date appear ambiguous at best, measured against the challenge of reducing the growing structural deficits embedded in the current budgetary outlook.

The current fiscal year is likely to see a budget deficit -- not counting Treasury or other market financing of off-budget credit programs -- of some \$200 billion, or about 6-1/2 percent of the GNP. Forecasts of future years necessarily entail judgments about Congressional action yet to be taken as well as economic factors. Should Congress fail to implement the expenditure restraints as well as the revenue increases contemplated in the recent Budget Resolution -- and doubt has been expressed on that point within the Congress itself -- deficits appear likely to remain close to \$200 billion for several years, even taking account of economic growth at the higher rates now projected. The hard fact remains that, as economic growth generates income and revenues to reduce the "cyclical" element in the deficit, the "underlying" or "structural" position of the budget will deteriorate without greater effort to reduce spending or increase revenues from that incorporated in existing programs. We would be left with the prospect that Federal financing would absorb through and beyond the mid-1980's a portion of our savings potential without precedent during a period of economic growth.

That outlook raises a fundamental question about the consistency of the budget outlook with the kind of economy we want. That is particularly the case with respect to such heavy users of credit as housing and business investment. To put the issue pointedly, the government will be financed, but others will be squeezed out in the process.

While that threat has been widely recognized, there has also been a comfortable assumption that the problem would not become urgent until 1985 or beyond. That might be true in the context of a rather slowly growing economy. But the speed of the current economic advance certainly brings the day of reckoning in financial markets earlier. In the second quarter, total non-federal credit demands were already increasing substantially, even though business demands were essentially unchanged at a relatively low level. Potential credit market pressures have been ameliorated by a growing inflow of foreign capital, but a net capital inflow can be maintained only at the expense of a deep trade deficit. Banks have been sizable buyers of government securities during the early stages of recovery while business demands for credit have been relatively slack. But there has also been some tendency for overall measures of money, liquidity, and credit to rise recently at rates that, if long sustained, would be inconsistent with continuing or even consolidating progress toward price stability.

All of this, to my mind, points up the urgency of further action to reduce the budgetary deficit to make room for the credit needed to support growth in the private economy. Left unattended, the situation remains the most important single hazard to the sustained and balanced recovery we want.

The International Dimension

The pressures on our capacity to finance both rising private credit demands and a huge budgetary deficit have, as I just noted, been one factor inducing a growing net capital inflow. One short-term consequence is lower domestic interest rates than might otherwise be necessary, and maintenance of extraordinary strength of the dollar at a time of rising trade and current account deficits. But the sustainability of those trends can be questioned. The picture of the largest and strongest economy in the world relying, in a capital-short world, on large inflows of funds to finance, directly or indirectly, internal budget deficits is not an inviting one for the future. The implication would be a persistently weak trade position, instability in the international financial system and exchange rates, and lack of balance in our recovery.

More immediately, the pressing debt problems of much of the developing world -- centered in, but not confined to, Latin America -- remain a clear threat to financial stability. In the period since we last discussed these issues, the strains have been successfully contained, but by no means resolved. To be sure, there are clear signs of progress with necessary economic adjustment in some instances -- notably in Mexico. Within the past week, Brazil -- which, along with Mexico, is the largest debtor -- has taken forceful and encouraging domestic actions that should provide a base for renewed IMF support and for added private financing. But "normalcy" has plainly not returned.

Confidence and market-oriented financing patterns cannot be fully restored without sustained growth among the industrialized countries, so that the debtors can earn their way with greater exports. Lower interest rates will be important as well. But that process will take time. Meanwhile, failure to provide the IMF -- which is the international institution at the center of the adjustment and financing process -- with adequate resources to do its job would deal a devastating blow to the extraordinary cooperative effort that has been marshaled to manage the situation, with potentially severe consequences for the U. S. financial system as well as the developing world. Early action by the House on the Administration's request in this matter is thus one key element in a program to sustain recovery.

Wage-Price Trends

I touched earlier on the relatively favorable wage-price-productivity trends of the past year. We are now approaching a new test -- whether those trends can be extended into and through a period of recovery. Today, orders are rising, businesses are hiring, layoffs are sharply diminished, and profits are improving. After the inflationary experience of the 1970's, the temptation could arise to revert to what some might consider "normal" behavior -- to anticipate inflation, to return to wage increases characteristic of the earlier decade, to fatten profit margins as fast as possible by raising prices

in a stronger market rather than relying on volume increases. But pressed collectively, the irony would be that such behavior, by inciting doubts about the inflationary outlook and affecting interest rates, would impair prospects for continued growth in real wages, in profits, and in employment.

We and other industrialized countries have had little success in dealing with that threat through so-called "incomes policies." But government policy can make a powerful contribution toward moderation through two avenues: first, by making evident in its fiscal and monetary management that inflationary pressures will continue to be contained, and second, by insisting upon open, competitive markets.

In that respect, open markets internationally serve our continuing basic interest in spurring efficiency and competition. Virtually every country has made compromises with protectionism during the period of recession. With growth underway, it is time not only to halt but to reverse that trend to help sustain expansion and the gains against inflation.

Moreover, as the economy grows stronger, I hope we will seriously turn more of our attention to the many purely domestic inhibitions to competition, and to reducing the artificial supports for prices and costs in some industries. All too often, they work at cross purposes to the needs of the economy as a whole.

Monetary Policy in 1983 and Beyond

This setting of gratifying immediate progress, yet evident looming threats, has provided the environment for decisions with respect to monetary policy. As you are well aware, interest rates dropped sharply during the second half of 1982 as the recession continued, and, with inflation subsiding, reserve pressures on the banking system were relaxed. Growth in money and credit has been, quite plainly, adequate to support growth in economic activity -- indeed more growth in the first half of 1983 than had been generally anticipated.

During much of the period after mid-1982, institutional change, as well as adjustments by liquid asset holders to the sharp drop in interest rates, to declining inflation, and to the uncertainties of the recession, appeared to be affecting one or another of the monetary aggregates. In particular, the behavior of M1 in relation to economic activity and the nominal GNP has raised questions about whether the patterns in velocity established earlier in the postwar period might be changing, cyclically or on a trend basis. For that reason, less emphasis has been placed on that aggregate in policy implementation. For a time, the enthusiastic reception of the public to -- and aggressive marketing by depository institutions of -- the new ceiling-free Money Market Deposit Accounts plainly affected growth in M2. Consequently, the target base for 1983 for that aggregate was set at the February and March average, rather than the fourth quarter of 1982, to avoid most of those distortions.

More broadly, given the questions about interpreting some of the monetary and credit aggregates, judgments as to the appropriate degree of pressure on bank reserve positions have been conditioned by available evidence about trends in economic and financial conditions, prices (including sensitive commodity prices), exchange rates, and other factors.

Through most of the first half of the year, as the economy picked up speed, the broader monetary and credit aggregates moved consistently with the ranges set in February. At the same time, trends in overall price indices were relatively favorable, and sensitive commodity prices, after an increase from cyclically depressed levels early in the year, appeared to be leveling off in the second quarter. The continuing exceptional strength of the dollar in foreign exchange markets and the international financial strains did not point in the direction of restraint. In all these circumstances, a broadly accommodative approach with respect to bank reserves appeared appropriate, despite much higher growth in M1 -- alone among the targeted aggregates -- than anticipated.

In the latter part of the second quarter, against the background of growing momentum in economic activity, monetary and credit growth showed some tendency to increase more

rapidly, and M1 growth remained particularly high -- higher, if sustained, than seemed consistent with long-term progress against inflation and sustained orderly recovery. In these circumstances, the Federal Open Market Committee, beginning in late May, has taken a slightly less accommodative posture toward the provision of bank reserves through open market operations, leading to some increase in borrowings at the discount window. Whether viewed from a domestic or international perspective, limited, timely and potentially reversible measures now, when the economy is expanding strongly, are clearly preferable to the risks of permitting a situation to develop that would require much more abrupt and forceful action later to deal with new inflationary pressures and a long-sustained pattern of excessive monetary and credit growth.

These steps have been accompanied by increases, ranging from 3/4 to 1 percent or more, in both long- and short-term market interest rates. Apart from any monetary policy actions, these limited changes -- particularly in the intermediate and longer-term areas of the market -- appear also to have been influenced by larger private and government credit demands currently, as well as by expectations generated by stronger economic and monetary growth and the budgetary deficit.

Over the more distant future, balanced and sustained economic growth -- with strong housing and business investment --

would appear more likely to require lower rather than higher interest rates. That outcome, however, can be assured only if the progress against inflation can be consolidated and extended. In considering all these factors, the FOMC basically concluded that the prospects for sustained growth and for lower interest rates over time would be enhanced, rather than diminished, by modest and timely action to restrain excessive growth in money and liquidity, given its inflationary potential. But I must emphasize again that the best assurance we could have that monetary policy can in fact do its part by avoiding excessive monetary growth within a framework of a growing economy and reduced interest rates over time lies not in the tools of central banking alone, but in timely fiscal action.

Looking ahead, the Committee decided that the growth ranges established early in the year for M2 and M3 during 1983 (7-10 percent and 6½-9½ percent, respectively) are still appropriate. The most recent data, while showing somewhat larger increases in June, are still within (M2), or about at to the upper end (M3), of those ranges. (Charts and tables attached.)

As anticipated, the massive shifting of funds into M2 as a result of the introduction of Money Market Deposit Accounts, and to a more limited extent into Super NOW Accounts, has abated. We assume these new accounts, and the further deregulation of time deposit interest rates scheduled for October 1, will have little impact on growth trends in the period ahead. Given the reasonably favorable trend of prices, the ranges should be consistent with more real growth than thought probable at the start of the year.

The Committee also decided to continue the associated ranges for growth in total domestic non-financial credit of $8\frac{1}{2}$ to $11\frac{1}{2}$ percent. As you know, 1983 is the first time the Committee has set a range for a broad credit aggregate, and it is not given the same weight as the broader monetary aggregates, at least while we gain experience. We are aware that, consistent with the established range, growth in credit during 1983 could exceed nominal GNP, although the long-term trend is for practically no change in the ratio of credit to income (i.e., "credit velocity" is relatively flat). Somewhat faster growth in credit is consistent with experience so far this year, and may be related to the relatively rapid expansion in Federal debt.

For 1984, the Committee tentatively looks toward a reduction of $1/2$ percent in each of those ranges, for M2, M3, and nonfinancial domestic credit. That small reduction appears appropriate and desirable, taking account of the need to sustain real growth while containing inflation. Those targets appear fully consistent, in the light of experience, with the economic projections of the Committee (as well as those of the Administration and those underlying the Budget Resolution).

The targets are, of course, subject to review around year end. One question that arises is whether the somewhat more rapid growth in credit than nominal GNP will, or should desirably, continue, consistent with progress toward price stability and toward a more conservative pattern of private finance than characteristic of the years of inflation. Again, the pressures on aggregate debt expansion stemming from the budgetary situation are a source of concern.

Decisions concerning appropriate targets for M1 were more difficult. As discussed further in an Appendix to this statement, the velocity of M1, whether measured as a contemporaneous or lagged relationship, has varied significantly from usual cyclical patterns, dropping more sharply and longer during the recession and failing to "snap back" as quickly. While a number of more temporary factors may have contributed, a significant part of the reason appears to be related to the fact that a major portion of the narrow "money supply" now pays interest, and the "spread" between the return available to individuals from holding M1 "money" and market rates has narrowed substantially, more than the decline in market rates itself implies. Put another way, NOW accounts, where the growth has been most rapid, are not only transaction balances, but now have a "savings" or "liquid asset" component. For a time at least, uncertainty about the financial and economic outlook, and less fear about inflation, may also have bolstered the desire to hold money.

Growth in M1 -- in running well above our targets for nine months -- has not, however, been confined to NOW accounts alone. Moreover, there are signs that the period of velocity decline may be ending. In looking ahead, with the economy expanding and with ample time for individuals and others to have adjusted to the rapid decline in interest rates last year, we must be alert to the possibility of a rebound in velocity along usual cyclical patterns, even though the longer-term trend may be changing.

In monitoring M1, the Committee felt that an appropriate approach would be to assess future growth from a base of the second quarter of 1983, looking toward growth close to, or below, nominal GNP. Specifically, the range was set at 5 to 9 percent for the remainder of this year, and at 1 percent lower -- 4-8 percent -- for 1984. Thus, the Committee, in the light of recent developments looks toward substantially slower, but not a reversal, of M1 growth in the future. Velocity is expected to increase, although not necessarily to the extent common in earlier recoveries.

The range specified is relatively wide, but depending on further evidence with respect to velocity, either the upper or lower portion of the range could be appropriate. As this implies, M1 will be monitored closely but will not be given full weight until a closer judgment can be made about its velocity characteristics for the future. We are, of course, aware that proposals to pay interest on demand deposits could, if enacted, influence velocity trends further over time.

These targets are designed to be consistent with continuing growth in economic activity and reduced unemployment in a framework of sustained progress against inflation -- and indeed are designed, insofar as monetary policy can, to contribute to those goals. The targets, by themselves, do not necessarily imply either further interest rate pressures or the reverse in the period ahead -- much will depend on other factors. In particular, progress in the budget and continued success in dealing with inflation should be powerful factors reducing the historically high level of interest rates over time, to the benefit of our private economy and the world at large.

"Targeting" Other Economic Variables

The Chairman of the Committee has asked for my views on the Federal Reserve's setting and announcing "objectives" for a variety of economic variables. As you know, the FOMC already reports its "projections" or "forecasts" for GNP, inflation, and unemployment. These projections are included with the materials I am reporting to the Committee today, as they have been at earlier hearings. I believe the practice of reporting the full range and the "central tendency" of FOMC members' expectations about the economy may be useful in reflecting the general direction of our thinking, as well as suggesting the range of possible outcomes for economic performance in the 12 or 18 months ahead, given our monetary policy decisions and fiscal and other developments over those periods.

There is a sense in which those projections reflect a view as to what outcome should be both feasible and acceptable -- given other policies and factors in the economy; otherwise monetary policy targets would presumably be changed. But I would point out that, like any other forecast, they are imperfect, and actual experience has sometimes been outside the forecast ranges.

Moreover, I believe there are strong reasons why it would be unwise to cite "objectives" for nominal or real GNP rather than "projections" or "assumptions" in these Reports.

The surface appeal of such a proposal is understandable. If a chosen path for GNP over a 6 to 18 month period could be achieved by monetary policy, specific objectives might appear to assist in debating and setting the appropriate course for monetary policy.

Unfortunately, the premise of that approach is not valid -- certainly not in the relatively short-run. The Federal Reserve alone cannot achieve within close limits a particular GNP objective -- real or nominal -- it or anyone else would choose. The fact of the matter is monetary policy is not the only force determining aggregate production and income. Large swings in the spending attitudes and behavior of businesses and consumers can affect overall income levels. Fiscal policy plays an important role in determining economic activity. Within the last decade, we also have seen the effects of supply-side shocks, such as from oil price increases, on aggregate levels of activity and prices. In the last six months, even without such shocks, the economy has deviated substantially from most forecasts, and from what might have been set as an objective for the year.

The response might well be "so what" -- it's still better to have something to "shoot at." But encouraging manipulation of the tools of monetary policy to achieve a specified short-run numerical goal could be counterproductive to the longer-term effort. Indeed, we do want a clear idea of what to "shoot at" over time -- sustained, non-inflationary growth. But the channels of influence from our actions -- the purchase or sale of securities in the market or a change in the discount rate -- to final spending totals are complex and indirect, and operate with lags, extending over years. The attempt to "fine tune" over, say, a six-month or yearly period, toward a numerically specific, but necessarily arbitrary, short-term objective could well defeat the longer-term purpose.

Equally dangerous would be any implicit assumption, in specifying an "objective" for GNP, that monetary policy is so powerful it could be relied upon to achieve that objective whatever else happens with respect to fiscal policy or otherwise. Such an impression would be no service to the Congress or to the public at large; at worst, it would work against the hard choices necessary on the budget and other matters, and ultimately undermine confidence in monetary policy itself.

Some of the difficulties could, in principle, be met by specifying numerical "objectives" over a longer period of time. But, experience strongly suggests that the focus will inevitably, in a charged political atmosphere, turn to the short-run. The ability of the monetary authorities to take a considered longer view -- which, after all, is a major part of the justification for a central bank insulated from partisan and passing political pressures -- would be threatened. Indeed, in the end, the pressures might be intense to set the short-run "objectives" directly in the political process, with some doubt that that result would give appropriate weight to the longer-run consequences of current policy decisions.

I would remind you that we have paid a high price for permitting inflation to accelerate and become embedded in our thinking and behavior, partly because we often thought we could "buy" a little more growth at the expense of a little inflation. The consequences only became apparent over time, and we do not want to repeat that mistake.

Put another way, decisions on monetary policy should take account of a variety of incoming information on GNP or its components, and give weight to the lagged implications of its actions beyond a short-term forecast horizon. This simply can't be incorporated into annual numerical objectives.

As a practical matter, I would despair of the ability of any Federal Reserve Chairman to obtain a meaningful agreement on a single numerical "objective" among 12 strong-willed members of the FOMC in the short run -- meaningful in the sense of being taken as the anchor for immediate policy decisions. Submerging differences in the outlook in a statistical average would, I fear, be substantially less meaningful than the present approach.

As you know, we adopted this year the approach of indicating the "central tendency" of Committee thinking as well as the full range of opinion. These "estimates" provide, it seems to me, a focus for debate and discussion about policy that, in the end, should be superior to an artificial process of "objective" setting that may obscure, rather than enlighten, the real dilemmas and choices.

Your questions, Mr. Chairman, went on to raise the issue of international coordination of monetary policy and whether or not to stabilize exchange rates multilaterally. I can deal with these important issues here only in a most summary way.

Coordination, in the broad sense of working together toward more price stability and sustained growth, is plainly desirable -- indeed it must be the foundation of greater exchange rate and international financial stability in the common interest. But stated so broadly, it is clearly a goal for economic policy as a whole, not just monetary policy.

The appropriate level of interest rates or monetary growth in any country are dependent in part on the posture of other policy instruments and economic conditions specific to that country. For that reason, explicit coordination, interpreted as trying to achieve a common level of, for instance, interest rates or money growth, may be neither practical nor desirable in specific circumstances. What does seem to me desirable -- and essential -- is that monetary (and other) policies here and abroad be conducted with full awareness of the policy posture, and possible reactions, of others, and the international consequences. In present circumstances, we work toward that objective by informal consultations in a variety of forums with our leading trade and financial partners, recently on some occasions with the presence of the Managing Director of the IMF.

As this may imply, I believe a greater degree of exchange market stability is clearly desirable, in the interest of our own economy, but that must rest on the foundation of internal stability. In recent years, in my judgment, the priority has clearly had to lie with measures to achieve that necessary internal stability. In specific situations, particular

actions may appear to conflict with the desirability of exchange rate stability; that possibility is increased when the "mix" of fiscal and monetary policy is far from optimal, as I discussed earlier in my statement. Such "conflicts" should diminish as internal stability is more firmly established.

The idea of a more structured international system of exchange rates to enforce greater stability in the international monetary and trading system raises issues far beyond those I can deal with here. I do not believe it would be practical to move toward such a system at the present time, but neither would I dismiss such a possibility over time should we and others maintain progress toward the necessary domestic prerequisites.

Concluding Remarks

In important ways, even more progress toward our continuing economic objectives has been made during the past six months than we anticipated. But it is also true -- partly because economic growth has increased -- that the need to deal, promptly and effectively, with the obstacles to sustained growth and stability have become more pressing. Those obstacles are well known to all of you. There is, indeed, little disagreement, conceptually, about their nature.

What has been lacking is a strong consensus about the specifics of how, in a practical way, to deal with them. There should be no assumption that monetary policy, however conducted,

can itself substitute for budgetary discipline, for open and competitive markets, for inadequate savings, or for structural financial weaknesses.

The world economy offers ample illustration of the dangers of procrastination and delay in the face of political impasse, and in the hope that problems will subside by themselves -- only to be faced, in crisis circumstances, with the need for still stronger action in an atmosphere of shattered confidence. That great intangible of confidence, once lost, can only be rebuilt laboriously, step by step.

Here in the United States we have, with great effort, already gone a long way toward rebuilding the foundation for growth and stability. We are not today in crisis. The American economy -- for all its difficulties -- still stands as a beacon of strength and hope for all the world.

We know something of the risks and difficulties that could turn the outlook sour. But I also know that the actions necessary to make the vision of stability and sustained growth a reality are within our grasp. We have come too far, with too much effort, to fail to carry through now.

* * * * *

APPENDIX

Questions have been raised about the practicality of identifying a particular concept of money that has a stable relationship to broader economic objectives, such as economic activity, prices, and employment, and about the related issue of whether the recent "breakdown" in velocity behavior relative to historical norms is temporary or longer-lasting. Both these questions bear directly on the role of monetary aggregates in the formulation and implementation of monetary policy.

No single concept or definition of money or credit aggregates can reasonably be expected always to provide reliable signals about economic performance, or about the course of monetary policy and its relation to the nation's basic economic objectives of sustainable economic growth, high employment, and stable prices. One reason is that market innovations and regulatory changes can alter the significance of the various aggregates at different times. Usually, however, such changes take place gradually without basically altering relationships over the shorter-term. On occasion, their impact may be more sizable and abrupt, both in terms of influence on measured monetary aggregates and their relation to over-all economic performance. Definitions of the monetary aggregates can be, and have been, adapted to significant institutional changes, although all definitions of "money" necessarily involve at the margin a degree of arbitrariness. The various money and near-money assets often serve a variety of functions for their holders that cannot be precisely distinguished statistically.

Even in the absence of institutional changes in financial markets, changes in the public's desires to hold liquidity as compared with "normal" past patterns can, through impacts on velocity, alter growth

rates in the aggregates that may be consistent with broader economic developments. These shifts in liquidity preference historically have occurred during periods characterized by unusual economic uncertainties associated with such developments as protracted economic weakness, fears of inflation, or instability in the financial system.

Consequently, the use of monetary and credit aggregates as guides for policy and in interpreting likely economic developments requires continuing judgment about the impact of emerging institutional developments and changing public preferences for money and credit demands, particularly when the economic or financial environment has changed drastically. In that context, the value of the aggregates for policy depends not so much on the "stability" of their relationships to other economic variables, but on the predictability of these relationships, taking into account structural shifts that are known to be in process. Monetary targeting is based on the presumption that structural changes will not be so rapid or so unpredictable as to undermine the usefulness of the aggregates as annual targets, although over time they may need to be adapted to ongoing behavioral changes.

For the past decade or so a series of institutional changes have affected the meaning and interpretation of the several monetary aggregates. Around the mid-1970s, various instruments and techniques began to be developed in financial markets that enabled depositors to economize on holdings of cash and to earn interest on highly liquid balances that to some extent substituted for cash. This new financial technology, abetted by legislative and regulatory changes that permitted depository institutions to compete more effectively, changed the shape of financial markets. The Federal Reserve adapted its definitions of monetary aggregates to the emerging institutional structure.

The narrowest definition of money--M1--was designed to measure transaction balances, and thus could be expected to bear a closer, more predictable relation to aggregate spending than the broader measures, which were affected as well by attitudes toward saving and wealth. The measure of M1 was redefined a few years ago in light of institutional changes to encompass transaction-type balances held in forms other than demand deposits. In particular, interest-bearing savings accounts subject to a regulatory ceiling rate but with checkable features (such as regular NOW accounts) were included in the measure, and later such accounts that could pay a market rate were also added (super-NOW accounts). However, these accounts served broader purposes for their holders than simply facilitating transactions. They also were an attractive repository for longer-term savings. Thus, interpretation of M1 was affected, and made less certain, especially over the past year or more, by its changing character; and the weight placed on this aggregate in policy implementation was necessarily altered during such periods of transition.

Over the last several quarters, the income velocity of M1 has fallen considerably and been much weaker than experience over comparable stages of post-war business cycles would have suggested, whether velocity is measured contemporaneously as the relationship of GNP to money in the current quarter or is measured on a lagged basis as the relationship of GNP to money one or two quarters earlier. This occurred as the share of NOW accounts in the aggregate expanded, as financial markets adjusted to lower rates of inflation, and as economic uncertainties were heightened during the recent period of economic contraction. The unusually large and sustained drop in M1 velocity may in the circumstances in large part

reflect an enhanced demand for M1 that arose from the decline in inflation and the related sharp fall in market interest rates during the second half of 1982. The availability of interest-bearing NOW accounts may have made depositors even more willing to hold funds in M1-type accounts as market interest rates declined. In addition, M1 was probably boosted by heightened savings and precautionary demands. These savings demands originally manifested themselves in the contractionary phase of the current economic cycle, but apparently have to a degree continued into the expansion phase.

The "breakdown" in the pattern of the velocity of M1, in the sense of its unusual behavior during the current economic cycle, may well be abating. Its income velocity declined much less in the second quarter of this year than it had over the previous five quarters--which may suggest that velocity is beginning to move back toward a more familiar and predictable pattern of behavior. Of course, the radical change in composition of M1 over the past two and a half years--with interest-bearing NOW accounts (some subject to ceiling rates and some at market rates) presently representing about one-third of the deposits included in M1, a share that will probably grow--suggests that the pattern of M1 velocity, even after a transition period, may come to vary from what it had been in the past.

While the relatively short experience with an M1 measure that includes a prominent savings component (NOW accounts) tends to heighten uncertainty when predicting velocity behavior, it is by no means clear that our understanding of emerging velocity trends will be so limited as to preclude reasonable estimates of the outlook for velocity. Efforts to re-estimate money demand equations in light of recent institutional developments have helped explain a considerable part of recent velocity movements, and can be expected to be of assistance in projecting velocity.

Institutional changes have also affected the broader aggregates-- M2 and M3--and they have been redefined as necessary to incorporate new instruments, such as money market funds, repurchase agreements, Eurodollars, and money market deposit accounts. With the definitional coverage of broad money measures enlarged, they encompass a very wide spectrum of liquid assets, so that these measures would tend to be less distorted than M1 by financial innovations and shifts of funds among various liquidity instruments. Very large shifts of funds, as were associated with the introduction of MMDAs, could distort particular money measures for a relatively short time, as was the case particularly for M2 in early 1983.

While the velocity of M2 departed from historical norms during the past several quarters, it did so to a lesser degree than M1. During the recent downturn M2 velocity declined only somewhat more than it had in past cyclical contractions on average. Thus far in the recovery phase of the cycle, the velocity of M2 has turned upward on average (after rough allowance for the distorting influence of shifts associated with the introduction of MMDAs) within the range of experience of previous cyclical expansions.

With regard to credit, institutional developments, the process of deregulation, and the emergence of innovative financing techniques in bond and other markets have contributed to reducing the special significance of bank credit as the cutting edge of changes in credit availability. As a result, more weight has been placed on a broad measure of total credit--in particular, the aggregate debt of domestic nonfinancial sectors--for helping to track credit needs as related to the overall economy and to guide monetary policy in that respect.

In brief, several money and credit measures taken as a group, together with an updating of definitions and measurement techniques as needed, can serve, and have served, as a useful guide for monetary policy, and in the light of a long sweep of history cannot be ignored. While it is true individual aggregates from time to time may be distorted by special developments and may not readily track the performance of the economy, the presumption remains of a longer-term stability and predictability in relationships.

Longer-run Ranges for Monetary and Credit Aggregates
Set by FOMC, 1983 and Tentative 1984
(Per cent increase, Q4 to Q4 unless otherwise noted)

	<u>Target Ranges</u>	
	<u>1983</u>	<u>1984</u>
M2	7 to 10 ¹ / ₂	6-1/2 to 9-1/2
M3	6-1/2 to 9-1/2	6 to 9
	<u>Monitoring Ranges</u>	
	<u>1983</u>	<u>1984</u>
M1	5 to 9 ² / ₂	4 to 8
Total credit ³	8-1/2 to 11-1/2	8 to 11

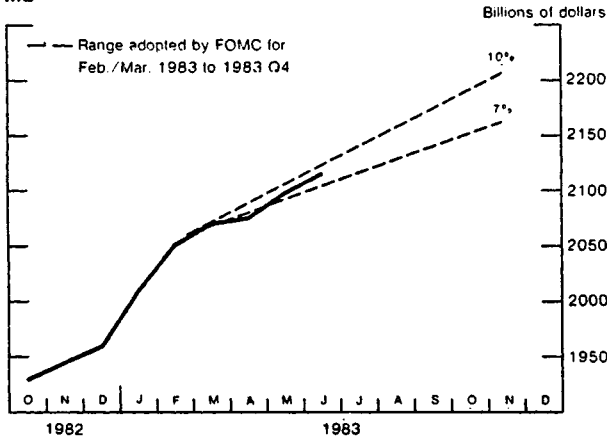
1. February-March 1983 average taken as base.
2. Q2 1983 taken as base.
3. Represents growth in domestic nonfinancial sector debt between yearends.

Economic Projections for 1983 and 1984

	<u>FOMC Members</u>		<u>Admini-</u>
	<u>Range</u>	<u>Central Tendency</u>	<u>stration</u>
----- 1983 -----			
Percent change, fourth quarter to fourth quarter:			
Nominal GNP	9-1/4 to 10-3/4	9-3/4 to 10	10.4
Real GNP	4-3/4 to 6	5 to 5-3/4	5.5
Implicit deflator for GNP	4 to 5-1/4	4-1/4 to 4-3/4	4.6
Average level in the fourth quarter, percent:			
Unemployment rate	9 to 9-3/4	About 9-1/2	9.6
----- 1984 -----			
Percent change, fourth quarter to fourth quarter:			
Nominal GNP	7 to 10-1/4	9 to 10	9.7
Real GNP	3 to 5	4 to 4-1/2	4.5
Implicit deflator for GNP	3-3/4 to 6-1/2	4-1/4 to 5	5.0
Average level in the fourth quarter, percent:			
Unemployment rate	8-1/4 to 9-1/4	8-1/4 to 8-3/4	8.6

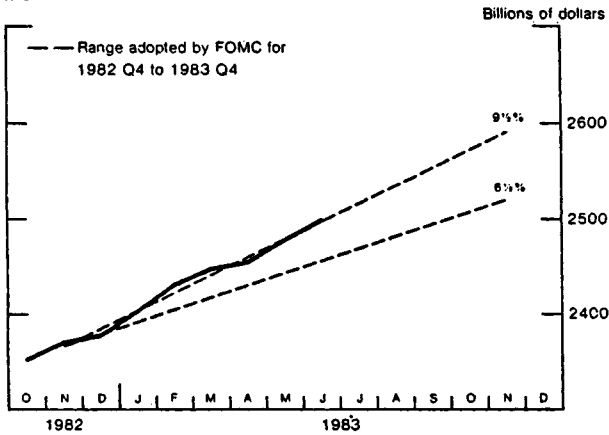
Ranges and Actual Money Growth

M2



Rates of Growth (annual rate)	
Feb./Mar. 1983 to 1983 Q2	8.2 percent
Feb./Mar. 1983 to June 1983	9.1 percent

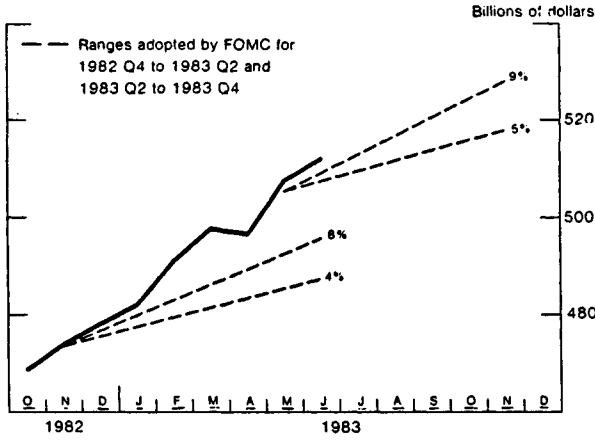
M3



Rates of Growth (annual rate)	
1982 Q4 to 1983 Q2	9.3 percent
1982 Q4 to June 1983	9.6 percent

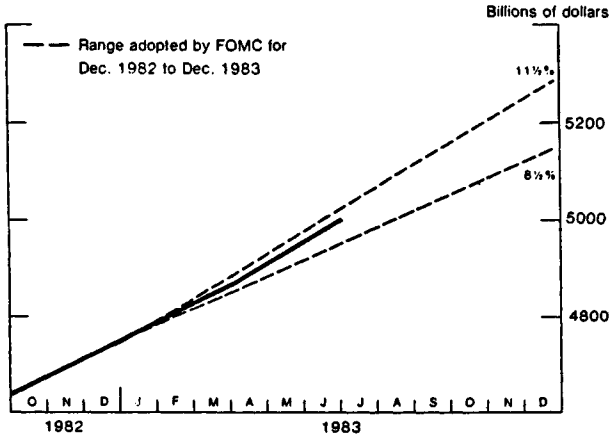
Ranges and Actual Money and Credit Growth

M1 .



Rates of Growth (annual rate)	
1982 Q4 to 1983 Q2	13.4 percent
1982 Q4 to June 1983	13.9 percent

Total Domestic Nonfinancial Sector Debt



Rate of Growth (annual rate)	
Dec. 1982 to June 1983	10.6 percent

For use at 10 a.m., E.D.T.
July 20, 1983

Board of Governors of the Federal Reserve System



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

July 20, 1983



Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 1983

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

Section 1: The Outlook for the Economy

When the year began, an economic expansion was under way, but it was widely expected that the recovery, at least in its initial phases, would be significantly less rapid than the average postwar cyclical upswing. The economic recessions of the early 1980s and more moderate than anticipated inflation had exposed serious financial strains both at home and abroad--strains that in part grew out of practices that developed during years of inflation. Consumer confidence was still at a low ebb, and a high degree of caution was apparent in the business community. Interest rates, despite having declined substantially, were still at levels that appeared likely to inhibit strong growth of activity in interest-sensitive sectors, and a weak demand for U.S. exports was expected to damp the pace of economic expansion.

By the second quarter, however, the recovery had gained vigor, and was following in most respects a typical cyclical pattern. Advances in residential construction were exceptionally large during the first half, and there were sustained increases in consumer spending, particularly for durable goods. Businesses continued to liquidate inventories at a rapid pace through the first quarter, but then apparently began rebuilding stocks in the second quarter as final demands strengthened. Employment gains became substantial as the recovery gathered speed, and the unemployment rate in June--while still high historically--was three-quarters of a percent below the earlier peak.

Given the momentum of the recovery--and the added stimulus of another reduction in personal taxes at midyear--there is a strong likelihood that real GNP will continue growing at a healthy pace through the second half of 1983. Gains in employment have generated sizable increases in income,

which in turn are laying the groundwork for further advances in consumer spending. And, business spending on equipment appears to be turning up. The cumulative forces of economic expansion thus appear to be well established.

Real GNP growth in the second half as a whole may not match the rapid second-quarter pace, which partly reflected the sharp swing in inventory positions. In addition, given the level of housing starts reached in the second quarter, and with mortgage interest rates no longer falling, outlays for residential construction seem unlikely to continue rising at the extraordinary pace of early 1983. Business spending for structures may still be sluggish in the second half, particularly with office space in ample supply in most cities. The foreign sector, too, will be exerting a restraining influence on growth of output in the United States, owing to a strong dollar, relatively slow growth in the other industrial nations, and financial difficulties besetting many developing countries.

Employment is likely to continue expanding as the recovery in output progresses, with gradual declines in the unemployment rate. However, if past experience is any guide, the strengthening economy will itself prompt more job-seekers to enter the labor force, thereby reinforcing the inertia of the unemployment rate. Consequently, unemployment will remain high, relative to the earlier postwar period, for some time.

The near-term outlook for inflation continues to be reasonably favorable. Wage pressures have moderated further into 1983; productivity is improving; and the continued strength of the dollar is limiting increases in the prices of imported goods. A partial rebound in energy prices during the early spring, following the pronounced weakness earlier in the year,

already appeared to be abating by midyear. A spurt in some food prices resulting from bad weather does not appear to be cumulating into a major price advance. Given these considerations, as well as the favorable first-half price performance, the chances appear excellent that inflation rates for 1983 as a whole will be as low as, or even lower than, those of 1982.

At the same time that the general trend of price increase is still slowing, there are indications that some of the cyclical influences that helped reduce inflation during the recession have waned. With demands for goods and services strengthening, price discounting is diminishing; and the downward pressures on prices and wages in some markets will lessen as orders and labor demand rise. Such developments are to some extent inevitable. What is of critical importance is that these cyclical influences not impair more lasting progress toward reduction in the underlying rate of inflation, as reflected in the interactions of wages, productivity, and costs.

Recently, the concerns on that score have been heightened somewhat by several factors. Preliminary indications are that growth in nominal GNP approached 11 percent in the second quarter. That high rate of spending growth is a welcome development insofar as it has come about in the context of accelerated real output growth and moderating prices. However, growth in some measures of money and credit also have been relatively large recently, and growth in nominal spending at the present rate over a sustained period would suggest renewed inflationary pressures.

The vigor of the private economy at midyear also has underscored the potential problems associated with federal budget deficits that will

remain massive in the years ahead, unless there are decisive actions to reduce expenditures or--absent such action--to increase revenues. Prospects for interest rates are related to a number of factors, including importantly the actual and perceived trend in inflation. In 1982, when the economy was mired in recession and the inflation rate was falling, record-large government deficits were consistent with declining interest rates. However, should public credit demands remain at or near record highs while private credit demands are expanding rapidly in response to rising business activity, the outlook for interest rates would clearly be affected.

The difficulties of controlling federal deficits are evident in the legislative developments of recent months, during which there have been extensive and laborious efforts to arrive at a workable budget resolution. These difficulties notwithstanding, unless there is further progress in reducing deficits, the risk of strains in credit markets intensifying is apparent, impairing the prospects for a balanced economic recovery.

FOMC Members' Economic Projections

Members of the Federal Open Market Committee believe that the current economic recovery will be well maintained over the remainder of 1983 and on through 1984. The central tendency of forecasts of the FOMC members show this year's growth in real GNP falling in a range of between 5 and 5-3/4 percent--a significantly stronger rate of growth than in the projections previously submitted to Congress in the Monetary Policy Report of last February. Real growth in 1984 is expected to be about one percent slower than in 1983, and the unemployment rate is projected to trend lower through the end of next year.

Most FOMC members expect this year's increase in the GNP implicit price deflator to range between 4-1/4 percent and 4-3/4 percent--about the same as last year's increase and in line with the projections of the February Monetary Policy Report. There is less consensus about the inflation outlook for 1984, with some concerned that inflation is likely to accelerate. However, most FOMC members feel that, with appropriate policies, prices overall are likely to rise in the same range as, or only a shade more rapidly than, in

Economic Projections for 1983 and 1984

	FOMC Members		Admini- stration
	Range	Central Tendency	
----- 1983 -----			
Percent change, fourth quarter to fourth quarter:			
Nominal GNP	9-1/4 to 10-3/4	9-3/4 to 10	10.4
Real GNP	4-3/4 to 6	5 to 5-3/4	5.5
Implicit deflator for GNP	4 to 5-1/4	4-1/4 to 4-3/4	4.6
Average level in the fourth quarter, percent:			
Unemployment rate	9 to 9-3/4	About 9-1/2	
----- 1984 -----			
Percent change, fourth quarter to fourth quarter:			
Nominal GNP	7 to 10-1/4	9 to 10	9.7
Real GNP	3 to 5	4 to 4-1/2	4.5
Implicit deflator for GNP	3-3/4 to 6-1/2	4-1/4 to 5	5.0
Average level in the fourth quarter, percent:			
Unemployment rate	8-1/4 to 9-1/4	8-1/4 to 8-3/4	8.6

1983. The cyclical strengthening of demand associated with the recovery is one factor in this inflation projection, but price developments next year will also reflect a number of special factors, such as policies to reduce farm product supplies and raise farm incomes, cost pressures from increased payroll taxes, and the possibility of some weakening in the foreign exchange value of the dollar.

The central tendency projections of the FOMC members, for prices as well as for real GNP and unemployment, are closely in line with the economic assumptions prepared by the Administration for its mid-session review of the budget.

While most FOMC members are relatively optimistic about the prospects for maintaining economic growth and containing inflation over the next year and a half, they also are mindful of potential difficulties that could disrupt the outlook and cause the nation's economic performance to be less favorable than is now expected. There is, as already noted, the prospect that federal budget deficits will remain extremely large into the indefinite future; as the private recovery lengthens, the dangers associated with those deficits are likely to increase, posing a threat to both the inflation outlook and the sustainability of a balanced expansion.

There also are some broader risks, not specifically related to the budget, that some of the progress against inflation could be reversed as the private economy strengthens. The persistence of inflationary expectations is evident both in recent surveys of private opinion and in the behavior of financial markets, in which borrowers remain willing to pay high nominal rates of return on long-term debt instruments. As the recovery progresses, wage

and price developments will need to be monitored with great care to make sure that these still-present expectations of inflation are not undergirding a new round of acceleration in actual wage and price increases.

More generally, the United States has become much more integrated into the world economy than it was a decade ago, and our economic fortunes have become closely linked with those of other nations. Because of those close linkages, the economic difficulties of many foreign nations, particularly the serious financial problems still plaguing many developing countries, could affect this nation's economic performance in the period ahead.

To some extent, these risks in the economic outlook can be moderated by appropriate policies. For example, the risk of a further deterioration in the economic prospects facing the developing nations can be lessened if lenders, borrowers, national authorities, and international organizations maintain the high degree of cooperation that has become evident in the past year. Prompt action by the United States to bolster the resources of the International Monetary Fund and of the multilateral development banks is an essential element in managing successfully a difficult adjustment process.

This country's budgetary problems also are manageable, provided the Congress and the Administration take action. The Federal Reserve, for its part, remains committed to monetary policies that will provide enough money and credit to support economic growth in a context of containing inflation; without reductions in future fiscal deficits, the goal of maintaining a balanced recovery while at the same time holding down inflation could prove elusive.

Section 2: The Federal Reserve's Objectives for Growth of Money and Credit

The Committee reviewed its target ranges for 1983 and established tentative ranges for 1984 in light of its basic objectives of encouraging sustained economic recovery while continuing to make progress toward stability in the average level of prices. In setting these ranges, the Committee recognized that the relationships among the money and credit aggregates and economic activity in the period ahead are subject to considerable uncertainty; consequently, it was emphasized that, in implementing policy, the significance to be attached to movements in the various aggregates would depend on evidence about the strength of economic recovery, the outlook for prices and inflationary expectations, and emerging conditions in domestic and international financial markets.

With respect to the ranges for the broader monetary aggregates--M2 and M3--the Committee reaffirmed the 1983 ranges of 7 to 10 percent and 6-1/2 to 9-1/2 percent, respectively, that had been established earlier in the year. The tentative ranges for next year set for these aggregates were reduced one-half percentage point to 6-1/2 to 9-1/2 percent and 6 to 9 percent, respectively, as measured in both cases from the fourth quarter of 1983 to the fourth quarter of 1984.

It was expected, in setting these tentative ranges, that shifts into money market deposit accounts (MMDAs) would not significantly distort growth in the broader aggregates, particularly M2, in contrast to the experience in the early part of this year. (A discussion of this and other monetary developments earlier this year can be found in Section 4.) However, it was also

recognized that the greater flexibility in liability management for banks and thrift institutions resulting from the availability of MMDAs, together with the recent decision of the Depository Institutions Deregulation Committee to eliminate ceiling rates on time deposits ¹/ by October 1 of this year, would be a factor encouraging somewhat more rapid growth in M2 relative to M3, as banks and thrifts may rely relatively less on large CDs and other money market liabilities in funding credit expansion. With greater growth in real (and nominal) GNP than anticipated earlier--but in the context of moderating inflation--actual growth in M2 and M3 may reasonably be higher in the ranges than thought likely earlier.

The FOMC also agreed that principal weight would continue to be placed on the broader monetary aggregates in the implementation of monetary policy, in view of the continuing uncertainties that attach to the behavior and trend of M1 over time. As discussed in Section 4, an unusual, sizable decline in the velocity of M1 has been experienced over the past several quarters, likely reflecting in part the fact that interest-bearing NOW accounts have become an important component of M1. These accounts, which have both savings and transactions characteristics, appear to have increased the response of M1 demand to changes in market interest rates, which may explain a good part of the acceleration of M1 growth beginning last summer. Also, particularly in the course of 1982, demand for M1 may have been increased because savers sought to hold funds in highly liquid forms in light of various economic and financial uncertainties.

Recent evidence suggests that the decline in the velocity of M1 may be abating. The income velocity of M1 evidently declined only modestly in the

1. Except for accounts less than \$2,500 maturing in 31 days or less.

second quarter of this year. With the upward impact on M1 demand of earlier interest rate declines having faded, and given the sizable build-up in liquid balances that has taken place, it seems probable that some pick-up in the velocity of M1 will develop over the quarters ahead, in closer conformance with cyclical and secular patterns of earlier years.

Whether any rise in velocity would be as strong as in earlier decades of the post-World II period remains uncertain. Experience to date with a measure of M1 that reflects to a greater extent the savings propensities of the public, as well as transactions demands, has been relatively limited, which makes it difficult to assess its behavior under varying economic circumstances. Moreover, it is not clear how responsive M1 demand will be to market interest rates over the period ahead if Super NOW accounts, which yield a market return to holders, become a more important element in the aggregate. (If the authority to pay interest on transactions balances were extended beyond currently eligible accounts, this too would affect M1 behavior, presumably in the short run increasing the demand for the aggregate, but no specific allowance has been made for that possibility.)

Taking account of these various uncertainties, for the purpose of monitoring M1 behavior, the Committee established a growth range of 5 to 9 percent (annual rate) for the period from the second quarter to the fourth quarter of this year. The decision to establish a new base for monitoring M1 reflected a judgment that the rapid growth over the past several quarters should be treated as a one-time phenomenon, neither to be retraced or long extended. A monitoring range of 4 to 8 percent was tentatively established for the period from the fourth quarter of 1983 to the fourth quarter of 1984.

These ranges anticipate no further decline in the velocity of M1 during a period of relatively strong growth in economic activity and allow for the likelihood of some rebound in velocity. M1 growth would be expected to move lower in these ranges as and if velocity strengthens.

The Committee reaffirmed the range of 8-1/2 to 11-1/2 percent used for monitoring the behavior of domestic nonfinancial sector debt in 1983. That range was reduced to 8 to 11 percent for 1984. The federal government next year is expected to continue absorbing an unusually large share of overall credit supplies. The Committee's range would encompass the possibility of growth of total debt in excess of likely GNP growth (and the long-term trend of credit in relation to GNP) in light of the analysis of various factors bearing on credit growth. Nevertheless, the prospect of intensifying conflict between sustained large government requirements and growing private sector credit demands is a serious concern.

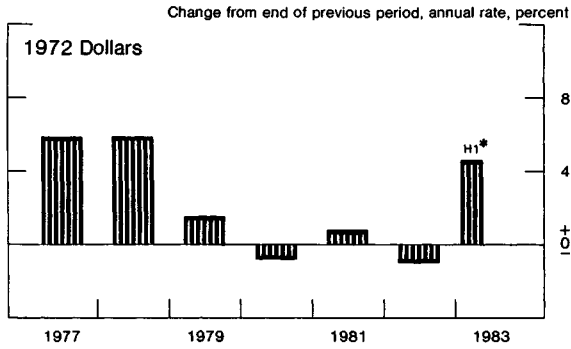
Section 3: The Performance of the Economy in the First Half of 1983

The economic expansion that began at the end of 1982 gathered momentum over the first half of 1983. After increasing moderately in the first quarter, real gross national product registered a strong advance in the second quarter, as production and employment rose in a broad range of industries. An apparent completion of the recession-induced inventory liquidation accounted for much of the second-quarter growth; but domestic final sales also strengthened considerably, and forward-looking indicators point to further output gains in the months ahead.

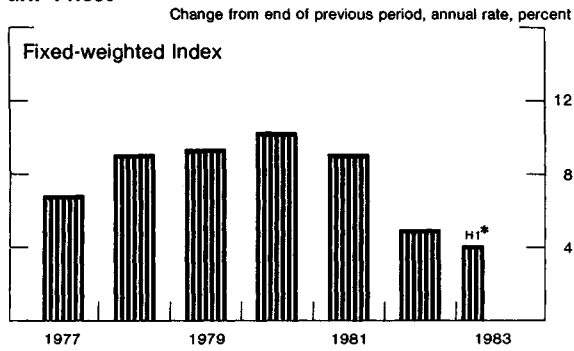
To be sure, a number of serious economic problems remain. The economic recovery is far from complete. At midyear, 10 percent of the civilian labor force was still unemployed. Many companies continue to face major adjustments in an effort to stay competitive in their industries here and abroad. Some domestic energy producers remain in financial difficulty, as do many producers in the agricultural sector. The nation's external sector continues to be a weak link in the recovery, as exports are being limited by a strong dollar, the sluggishness of a number of other industrialized economies and the severe adjustment problems of much of Latin America; the international indebtedness and related economic difficulties of a number of developing countries remain a matter of particular concern.

This country's period of moderating inflation lengthened in the first half of 1983. In 1982, many price measures recorded the smallest increases in a decade, and price developments so far this year have been even more favorable. Transitory elements clearly have played a part in

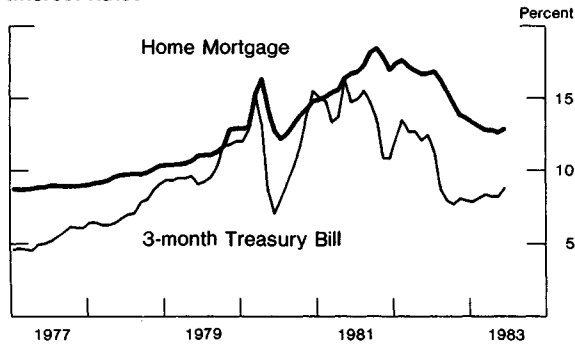
Real GNP



GNP Prices



Interest Rates



* Data for 1983 H1 are based partly on advance projections from the Commerce Department.

this improving price performance, but there also continue to be indications of more lasting progress. In particular, productivity has been improving and increases in compensation continue to moderate, so that the interactions between costs and prices, which imparted a stubborn momentum to inflation through the 1970s, are still working to reduce the underlying or trend rate of inflation.

However, even though prices have slowed dramatically, concerns persist that inflation will reaccelerate as the recovery progresses. To a considerable extent, these concerns arise from the experience of past business cycles and from an expectation that the federal government's budget deficits will remain massive in the years ahead, making more difficult the sustained application of a noninflationary monetary policy. Because of such concerns about the future, as well as the present high level of actual government borrowing, short- and long-term interest rates in the first half of 1983 continued to be quite high, relative both to historical experience and to the current pace of inflation.

As had been true during the recession, government debt rose very rapidly in the first half of 1983; in addition, household borrowing picked up as the expansion accelerated. Even though the growth in business borrowing remained relatively low, total debt outstanding in the domestic nonfinancial sectors grew at an annual rate of about 10-1/2 percent--a faster pace than in 1982. Debt grew faster in the second quarter than in the first.

Money holdings also increased rapidly in the first half of 1983, as a strengthening of private spending bolstered the demand for transactions balances and as lower interest rates led many individuals and businesses to

hold a larger portion of their financial assets in the form of money balances. In addition, money growth also was affected by portfolio shifts arising from the progressive liberalization of deposit rate regulations; these shifts were especially important in boosting growth of the broader monetary aggregates early in the year.

Interest rates

Short-term interest rates had fallen sharply in the second half of 1982, when the recession was deepening; and by the end of last year, rates were only about half the peak levels of 1981. Yields then fluctuated in a relatively narrow range through most of the first half of 1983, before moving a little higher around midyear as the recovery strengthened. At midyear, short-term yields were generally 50 to 125 basis points above their December levels; the Federal Reserve discount rate remained unchanged over the first half of the year.

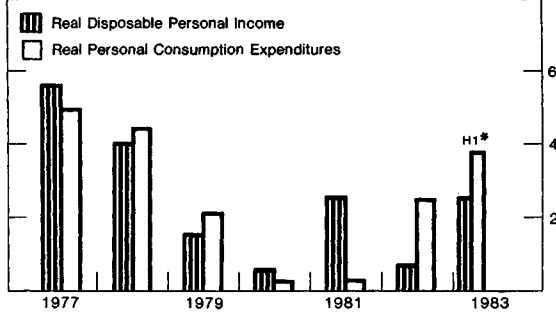
Long-term rates eased further into early 1983, extending the decline that began in mid-1982. The further reduction in long-term yields resulted from beliefs that the recovery might be relatively weak, thereby limiting private credit needs and, at the same time, enhancing the prospects for a continued moderation of price inflation. In the second quarter, however, long-term rates turned up slightly as economic activity strengthened further and as market participants began to focus more directly on the potential effects of heavy federal borrowing and the implications of continued rapid money growth.

Consumer Spending

Much of the vigor of the current expansion has arisen from increases in income and spending in the household sector. Throughout the recession,

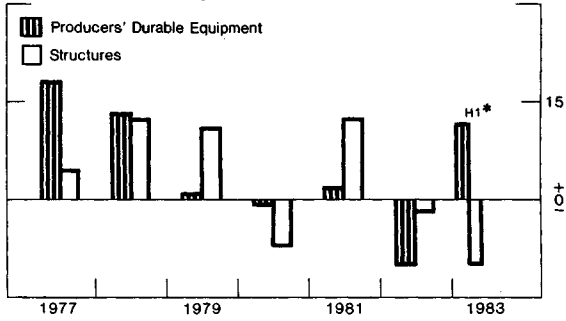
Real Income and Consumption

Change from end of previous period, annual rate, percent



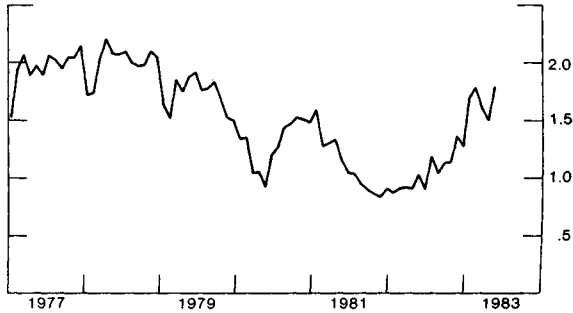
Real Business Fixed Investment

Change from end of previous period, annual rate, percent



Total Private Housing Starts

Annual rate, millions of units



* Data for 1983 H1 are based partly on advance projections from the Commerce Department.

the nominal disposable incomes of consumers had been unusually well maintained by a combination of countercyclical transfer payments, rising interest income, and reductions in tax rates. A rapid decline in inflation enhanced the purchasing power of these nominal income gains, and by the end of 1982, real disposable personal income was about 2 percent above its prerecession level of mid-1981.

Households have strengthened their balance sheets considerably in recent years by acquiring large amounts of liquid assets and holding down the accumulation of new indebtedness. In addition, a sharp, sustained rise in stock prices added considerably to household wealth after mid-1982. Thus, when aggregate wage and salary income began rising with the upturn in activity, consumers were well positioned to boost spending on goods and services.

After a period of sluggish growth through most of 1982, consumer spending improved toward the end of last year and strengthened further in the first half of 1983. Second-quarter spending, in particular, was quite vigorous, as purchases of autos and other big-ticket items increased markedly. Sales of domestic autos were at an annual rate of about 6-3/4 million units in the second quarter, the best quarterly sales pace since mid-1981; sales of foreign models were maintained at a rate of about 2-1/4 million units.

With income growth accelerating, economic prospects brightening, and interest rates lower than in 1982, consumers became more willing to take on new debt in the first half of 1983. In addition, lenders showed a greater interest in making consumer loans, partly--in the case of depository institutions--as an outlet for investing the large inflows to new accounts. Thus, after rising only 4 percent in 1982, installment debt rose at more than a

7 percent annual rate in the first quarter, and still faster growth appears to have occurred in the second quarter.

Business Spending

Economic conditions in the business sector also have improved. Reduced interest rates, the elimination of unwanted inventories, and an expanding economy have relieved some of the financial strains brought on by the recession and, at the same time, have created a better climate for investment spending. Business cash flows improved in the first half, as profit margins widened considerably. Buoyed by rising investor confidence, stock prices rose to new highs, enabling businesses to rely heavily on equity financing while limiting the growth in indebtedness. In addition, encouraged by bond yields that were well below earlier peaks, firms strengthened their balance sheets by shifting their borrowing toward longer-term maturities. These general trends notwithstanding, many firms that were weakened by the recession continued to face financial difficulties in the first half of 1983, and the number of business bankruptcies--though declining--remained high.

Business investment spending, which fell nearly 8 percent in real terms during the recession, turned up in the first half of 1983, as real outlays for equipment rose in both the first and second quarters. In contrast to equipment, spending for structures fell appreciably during the first half of 1983, led by reduced outlays for commercial and industrial buildings. With office and industrial vacancy rates now quite high, it may be some time before the expanding economy begins to generate a sustained increase in outlays for these types of facilities.

Businesses had liquidated inventories at a rapid pace during the recession in an effort to bring stocks more in line with the recession-reduced sales levels, and the momentum of that liquidation carried into early 1983. More recently, with final sales continuing to rise, businesses appear to have begun a cautious rebuilding of stocks. In the second quarter, a move from sizable inventory liquidation to an apparent small accumulation of stocks provided a strong impetus for increased production, resulting in a rise in second-quarter GNP much larger than the advance in final sales.

Residential construction

Responding to lower interest rates, activity in the housing sector rose sharply in late 1982 and increased further in the first half of this year. At the end of last year, mortgage rates were about 5 percentage points below the peak rates reached in the fall of 1981, and they continued to trend gradually lower before firming in the past two months. Mortgage credit flows increased strongly in the first half--especially at thrift institutions, whose fund availability was enhanced by the advent of new deposit instruments.

In response to the drop in financing costs, as well as demographic influences, home sales turned up in 1982 and rose rapidly through the first half of 1983. By the second quarter of 1983, sales were up nearly a third from the final quarter of 1982; both new and existing homes shared in the sales gains. With the inventory of unsold new homes quite low, rising sales have supported a strong advance in new construction activity. Continuing the uptrend evident in 1982, starts of new single-family homes in the first five months of 1983 rose to a level about three-fourths above a year earlier--a sharper rebound than many analysts had expected in light of prevailing

mortgage rates. Starts of multifamily units also have been quite strong so far in 1983, partly reflecting enhanced profitability in the markets for rental property. Low levels of housing construction over the past few years clearly left a sizable pent-up demand that has provided strong support for new construction activity.

Government sector

Federal spending declined moderately during the first half of 1983, but the drop resulted mainly from transitory factors, particularly a reduced rate of accumulation of farm inventories by the Commodity Credit Corporation (CCC). Abstracting from these inventory swings, federal expenditures were still trending up in the first half. Excluding outlays of the CCC, federal purchases of goods and services, in current dollars, appear to have increased at an annual rate of more than 10 percent from the fourth quarter of 1982 to the second quarter of this year.

The federal budget deficit was extremely large in the first half of 1983. Because of changes in tax laws and, until recently, slow growth in taxable incomes, receipts have increased only moderately from the levels of two years ago. During this same period, spending has increased considerably, owing to increased defense purchases, recession-induced transfer payments, and, on average, relatively high payments to support farm incomes. As a result, the combined federal deficit (unified plus off-budget) accumulated to about \$95 billion over the first half of 1983, three times the level of a year earlier. During the first half, direct federal borrowing (which does not include federally guaranteed loans or the debt of sponsored credit agencies) absorbed more than two-fifths of all funds raised in credit markets by the domestic nonfinancial sectors.

Real state and local government purchases edged lower in the first half of 1983, extending the gradual decline evident over the preceding two years. Real outlays for employee compensation and new construction spending were held down by the budget concerns still apparent among many states and localities. As in 1982, a number of governmental units raised taxes to relieve pressing financial difficulties. By midyear, however, some of the budgetary strains began to ease, as rising economic activity expanded the state and local tax base, boosting the sector's overall operating budget back into surplus.

Borrowing by state and local governments also increased rapidly, though part of the rise probably reflected a rush to market debt instruments in advance of a new requirement that securities be issued in registered, rather than bearer, form; the requirement deadline took effect on July 1, after having been postponed from January 1. In addition, tax-exempt borrowers took advantage of lower interest rates to refund or pre-refund bond issues that were sold when borrowing costs had been higher.

The International Sector

As in 1982, net exports continued to exert a negative influence on U.S. economic activity in early 1983; slow growth in foreign industrial economies and a strong dollar have both constrained export sales. At the same time, the vigorous expansion in the U.S. domestic economy pushed imports higher, so that the trade account showed an increasing deficit over the first half of the year.

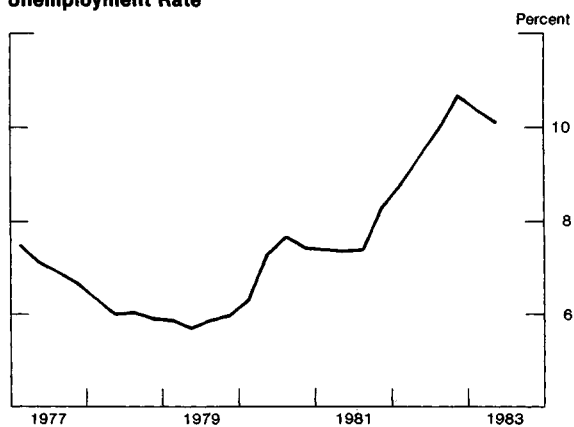
An additional element limiting prospects for U.S. exports is the serious external financing problems facing a number of developing countries, including some that are major trading partners of the United States. Among

these nations, reduced trade volume and depressed commodity prices have limited export earnings and--in the face of high world interest rates--made debt repayment difficult. So far, these repayment problems have been contained through an extraordinary degree of cooperation among borrowers, private creditors, national authorities, and international organizations; in many instances, existing debts have been restructured, new funds have been raised, and the borrowing nations are implementing programs to restore internal financial stability, to increase their debt-servicing capacity, and to convince international lenders of their creditworthiness. Nevertheless, the process of adjustment is still far from complete.

Labor markets

Labor markets began to strengthen around the turn of the year, and by June, payroll employment had increased 1.1 million from its December trough, regaining more than one-third of the losses sustained during the recession. Job gains have been widespread over the past six months, with especially large advances in services and manufacturing. In manufacturing, employment increases during the past six months have retraced nearly a fifth of the 2 million jobs lost during the 1981-82 recession. Employment growth in the services industry, which had slowed during the recession, appears to be showing renewed vigor as the expansion has taken hold.

The total number of unemployed workers declined by almost a million during the first half of 1983, and the civilian unemployment rate fell to 10 percent, three-fourths of a percentage point below the postwar peak reached last December. Layoffs had begun easing late last year, and with labor demands strengthening through the first half, many firms have started

Nonfarm Payroll Employment**Unemployment Rate**

rehiring. Despite these gains, jobless rates at midyear remained far above the levels of late 1979, before the two back-to-back recessions that added greatly to labor market slack in the early 1980s.

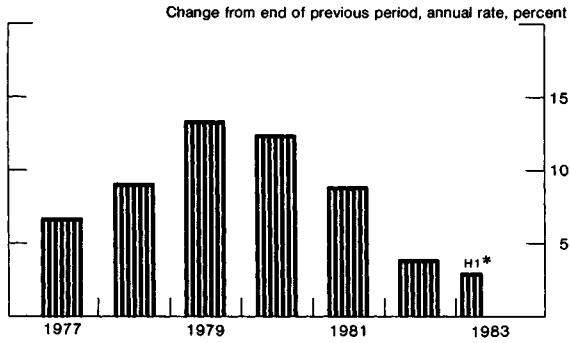
Wages and Labor Costs

The falloff of labor demand during the recession, along with the general unwinding of inflation, led to a sharp slowing in the rate of wages and labor cost increases, and that slowdown has continued into the first half of 1983. From the fourth quarter of last year to the second quarter of 1983, the average hourly earnings of production workers rose at about a 4-1/4 percent annual rate, the slowest rate of nominal wage increase since the mid-1960s. But, because the rise in consumer prices has slowed even faster, the slower nominal wage gain has been consistent with increases in real purchasing power.

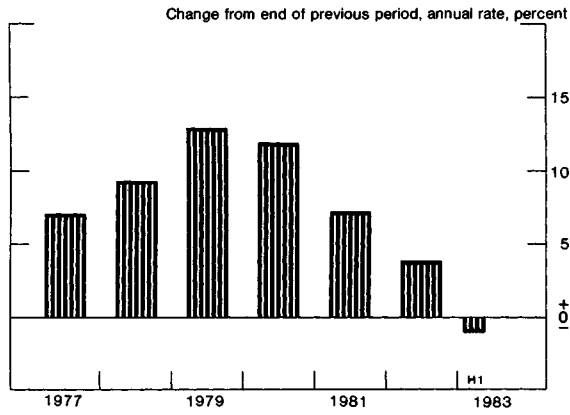
The slowing of nominal wage increases has been broad-based, affecting nearly all major industrial and occupational groups. With inflation easing, workers in general are feeling less pressure to catch up with past inflation or to try to stay ahead of anticipated future inflation. In addition, in industries particularly hard hit by recession, as well as by heightened domestic or foreign competition, workers have agreed to contract adjustments calling for wage freezes or outright wage reductions.

Unit labor costs also moderated further in the first half of 1983, as strong productivity gains reinforced the impact of smaller wage increases. In the nonfarm business sector, labor costs rose at only a 1-1/4 percent rate in the first quarter, and evidently the second quarter advance also was quite moderate.

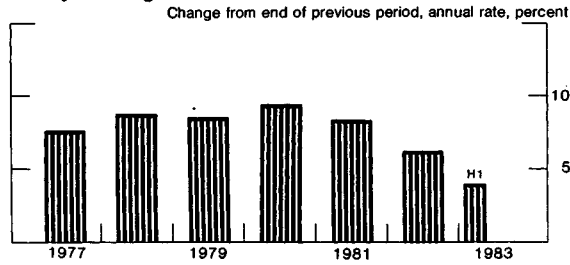
Consumer Prices



Producer Prices



Hourly Earnings Index



*Price changes for 1983 H1 are based on data for the December to May period.

The sizable productivity gains of recent quarters have been an especially encouraging development because they may reflect not only the customary cyclical patterns of an economic expansion, but also some improvement in the trend rate of productivity growth. Work rules in many establishments are being revised to enhance efficiency, and qualitative reports from the business sector point to strong efforts to trim costs and improve market competitiveness.

Price developments

Price developments continued to be favorable in the first half of 1983. The consumer price index rose at an annual rate of only 3 percent from December to May, and over the first half, the producer price index for finished goods actually declined. An acceleration of prices from the first to the second quarters resulted mainly from swings in energy prices that appear to be temporary and from the transitory effects of adverse weather on the prices of some foods. The prices of raw industrial materials rebounded from depressed levels early in the year, but have leveled off in recent months. In other markets, including those for both consumer goods and capital equipment, price inflation in the second quarter still seemed to be trending lower.

Price increases during the past year have been the smallest since the early 1970s, and the period of moderating inflation has now extended over 2-1/2 years. Still, the recent period of slower price increases has by no means erased the memories of accelerating inflation during the previous two decades. The recent deceleration in prices occurred during a business recession, and there remains a deep-seated skepticism about whether the gains against inflation can be maintained as the period of economic expansion is extended. The task of economic policy is to overcome that skepticism by preserving the gains already won against inflation while sustaining the economic expansion that took hold in the first half of 1983.

Section 4: The Growth of Money and Credit in the First Half of 1983

The 1983 ranges for the monetary and credit aggregates announced in February were chosen by the Federal Open Market Committee with the objective of providing sufficient liquidity to support economic recovery while continuing to encourage progress toward price stability. In setting those guidelines, the Committee recognized that the relationship between growth of the monetary aggregates and economic activity had deviated from usual historical relationships during 1982, and looking ahead, account had to be taken of the possibility that past patterns might be shifting in some respects.

Specifically, during 1982, monetary growth had been quite rapid relative to income; the velocities of both M1 and M2 had registered exceptionally large declines over the year. Although these declines in velocity were thought likely to be in part temporary--M1 velocity in particular commonly has increased appreciably in the early stages of a recovery--it also was felt that the experience of 1982 might well be indicative of a more basic shift in the underlying demands for money. Institutional changes have led to the increased availability of transactions accounts that bear interest, which would be likely to increase the public's willingness to hold M1-type accounts. These accounts are used partly as repositories for savings, as well as to support transactions, and this tendency was expected to be reinforced by the introduction of Super NOW accounts.

The Committee also recognized that the introduction of new deposit instruments had affected, and would continue to affect, the behavior of the broader aggregates. A very substantial inflow of funds into money market

deposit accounts (MMDAs) from market instruments had greatly inflated growth of M2 at the end of 1982 and in the early weeks of 1983. It was anticipated that further flows into these accounts, and to a lesser extent into Super NOW accounts, would continue to affect the aggregates for some time, although the impact could not be determined with a high degree of accuracy.

In implementing policy, Committee members agreed that, for the time being, primary emphasis would be placed on the broader aggregates. It was expected that distortions resulting from the initial adjustment to new deposit instruments would lessen. The behavior of M1 would be monitored, with any increase in the emphasis placed on that aggregate dependent on evidence that its velocity behavior was assuming a more predictable pattern. Debt expansion, although not targeted directly, would be reviewed in assessing the behavior of the monetary aggregates and the stance of monetary policy. The Committee emphasized that, given the above uncertainties, policy implementation in 1983 would require a greater degree of judgment, involving crucially the evaluation of the relationship of monetary growth to movements in income and prices, until such time as the aggregates returned to more predictable behavior.

The specific target ranges announced in February were: for M2, an annual rate of 7 to 10 percent for the period from February-March of 1983 to the fourth quarter of 1983; and for M3, 6-1/2 to 9-1/2 percent for the period from the fourth quarter of 1982 to the fourth quarter of 1983. Also for the latter period, a tentative range was established for M1 of 4 to 8 percent, with the width of this range reflecting the relative uncertainty about the behavior of this aggregate. An associated range of growth for total domestic nonfinancial sector debt was estimated to be 8-1/2 to 11-1/2 percent, December

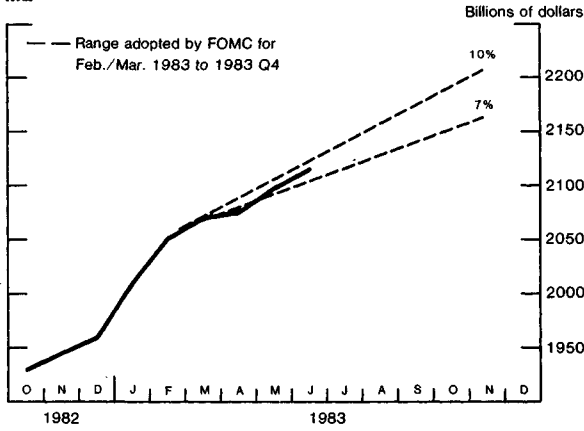
to December, while bank credit growth was expected to be between 6 and 9 percent for the year.

Growth in M2 and M3 appears to be broadly consistent with the target ranges adopted in February. M2 expanded at a 9 percent annual rate from the February-March base period through June, a little above the mid-point of its range. M3 growth was somewhat stronger and, at 9-1/2 percent from the fourth quarter of 1982 through June, was at the upper end of its target growth path. In contrast, M1 continued to surge, with growth averaging 14 percent at an annual rate from the fourth quarter of last year.

In setting the annual target range for M2, the Committee selected the February-March base period to reduce the distortions resulting from the massive inflows to MMDAs following the introduction of these accounts in December. Moreover, the range of 7 to 10 percent was one percentage point higher than that set for 1982, to allow for some residual shifting from outside M2 into these accounts through the remainder of the year. There is growing evidence that the stock adjustment to MMDAs is abating; inflows to these new instruments slowed from around \$17 billion per week in February to an average of about \$1 billion weekly in June. Thus, it appears that the distorting effects of these instruments have, as expected, become relatively minor as time has progressed. The interest rates offered on these deposits--in absolute level and relative to other short-term rates--have fallen considerably from the extraordinary yields posted immediately following the introduction of this account. Since March, the average rates on MMDAs have been below rates available on virtually all market instruments, although they remain somewhat above the returns on money market mutual funds.

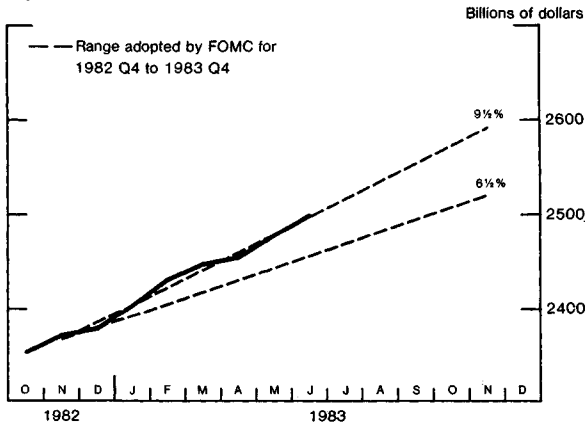
Ranges and Actual Money Growth

M2



Rates of Growth (annual rate)	
Feb./Mar. 1983 to 1983 Q2	8.2 percent
Feb./Mar. 1983 to June 1983	9.1 percent

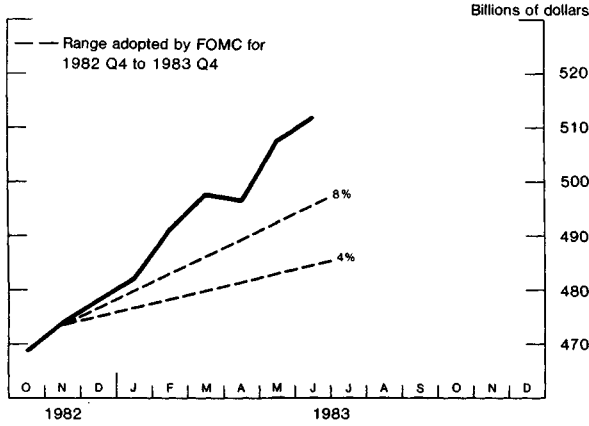
M3



Rates of Growth (annual rate)	
1982 Q4 to 1983 Q2	9.3 percent
1982 Q4 to June 1983	9.6 percent

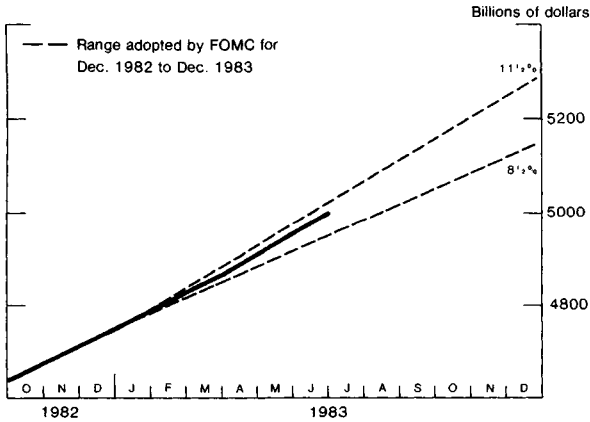
Ranges and Actual Money and Credit Growth

M1



Rates of Growth (annual rate)	
1982 Q4 to 1983 Q2	13.4 percent
1982 Q4 to June 1983	13.9 percent

Total Domestic Nonfinancial Sector Debt



Rate of Growth (annual rate)	
Dec. 1982 to June 1983	10.6 percent

The recent behavior of other components of M2 also appears to reflect the waning of the public's initial adjustment to the availability of MMDAs. Runoffs of small denomination time deposits and M2-type money market funds, which were substantial during the first quarter, have slowed considerably, and in fact small time deposits registered a slight increase in June. Savings deposits, which likewise had declined by record amounts earlier in the year, increased at a moderate rate in May and June.

For M3, the range selected of 6 to 9 percent was identical to that for 1982. It was believed that M3 would be less affected by the new accounts because some of the funds flowing into them would come directly from large deposits and, in any case, many depositories have the option of reducing their issuance of large CDs in response to greater inflows to MMDAs or other core deposits. However, the extent to which this would occur would depend in part on changes in the public's perceptions of the desirability of insured deposit accounts relative to open market instruments and the willingness of depositories to make use of their new deposit authority to increase the extent of their financial intermediation. In the event, large CDs in the aggregate declined sharply in the months following the introduction of the new accounts, but have tended to pick up recently as inflows to MMDAs have slowed.

Besides running off large CDs, commercial banks responded to the influx of MMDA funds by increasing their holdings of liquid assets, principally Treasury securities; commercial bank holdings of Treasury securities expanded at an annual rate of more than 50 percent during the first half of the year. Small banks in particular, which rely less on managed liabilities than do large banks, invested heavily in these assets. Savings and loan

associations appear to have relied largely on asset adjustments to MMDA inflows. These institutions showed a sharp acceleration in their holdings of cash and investment securities over the first quarter of 1983, and only moderate declines in large time deposits. In the second quarter, with slower inflows to the new accounts and an apparent pickup in mortgage lending, issuance of large time deposits by S&Ls registered a sizable increase.

The impacts on M1 of portfolio shifts into the new accounts are difficult to assess, but would appear to have been largely offsetting. Funds shifted into Super NOWs from outside M1 likely were about equal in magnitude to the outflow of funds from M1 into MMDAs. Nevertheless, M1 has been growing at a rate well above the 4 to 8 percent range that was set in February and much faster relative to nominal GNP than has been normal during periods of economic recovery, when velocity has tended to rise at above average rates. In fact, the income velocity of M1 continued to decline during the first half of the year, although the second-quarter decline was modest.

The decreases in M1 velocity may reflect in substantial part the changing nature of M1. With interest-bearing regular NOW accounts and Super NOWs making up a growing share of M1, this aggregate is becoming increasingly influenced by components that bear interest and thereby may attract "savings" as well as transactions balances. Indeed, there is evidence that the introduction of nationwide NOW accounts at the beginning of 1981 has made M1 more responsive to fluctuations in market rates. With market rates registering large declines in the latter half of 1982, the opportunity cost of holding NOW accounts--which carry a ceiling rate of 5-1/4 percent--fell sharply.

As money demand usually responds to falling rates with a lag, this would help explain the strong growth of M1 in the latter half of 1982 and early 1983. More recently, however, some of the strength likely reflected growing transactions needs accompanying the pickup in economic activity. Given the limited experience with NOW and Super NOW accounts, uncertainty surrounding M1 behavior remains substantial, but account needs to be taken of the possibility that more normal cyclical patterns may be returning.

Full data are not yet available for the second quarter, but preliminary indications are that the aggregate debt of domestic nonfinancial sectors grew over the first half at a rate somewhat above the mid-point of the 8-1/2 to 11-1/2 percent range projected by the FOMC, with a marked increase in the second quarter. This aggregate was swollen by federal borrowing, which has accounted for more than 40 percent of total credit flowing to domestic nonfinancial sectors since December. As indicated in the accompanying table, growth in federal debt has been very rapid in recent quarters, averaging in excess of 20 percent at an annual rate over the last four quarters. Residential mortgage financing and consumer credit have picked up since last year, reflecting the strengthening of these sectors. Business borrowing has remained moderate due to reduced needs for external financing and has been concentrated mainly in longer maturity debt; short- and intermediate-term business borrowing has been weak since the fourth quarter of last year. Borrowings by state and local governments were strong during the first half, as noted earlier, partly reflecting heavy issuance of tax-exempt bonds in advance of the July 1 registration date and borrowing for future refunding of higher cost debt.

Domestic Nonfinancial Sector Debt
(Annual rates of growth, in percent)¹

	Total	U.S. Government	Households	Nonfinancial business	State and Local govt.
Annually²					
1979	12.1	6.0	15.1	13.5	7.4
1980	9.9	11.9	8.7	10.1	9.3
1981	9.9	11.8	8.2	11.3	7.0
1982	9.5	19.4	5.6	7.4	13.4
Quarterly³					
1982					
3 rd quarter	10.2	24.5	4.9	8.1	9.2
4 th quarter	9.8	24.5	5.9	3.7	18.2
1983					
1 st quarter	9.6	19.1	7.4	5.3	13.5
2 nd quarter ^P	11.4	23.0	8.5	5.4	19.1

p--preliminary

1. Based on end of period data.

2. December to December.

3. End-of-quarter to end-of-quarter.

Commercial bank credit, boosted by heavy acquisitions of Treasury securities, has expanded at a 10-1/2 percent annual rate since December. Reflecting the general weakness in business demand for short-term credit, business loans at commercial banks were about flat over the first half, while bank mortgage and consumer lending has picked up. Some of the build-up of Treasury securities could be a temporary response to strong inflows to MMDAs, held as a hedge against possible withdrawals as rates on MMDAs remain below market yields. On the other hand, since some investors evidently shifted funds to insured MMDA accounts from open market instruments, the increase in investment holdings could mark a permanent increase in overall intermediation by commercial banks, thereby raising bank credit above its normal range. Indeed, as thrift institutions likewise have become more competitive with the introduction of MMDAs, the share of total credit extended by all depository institutions rose appreciably over the first half of this year; about 40 percent of domestic nonfinancial credit was extended by depositories during the first half, compared with an average of less than 30 percent from 1980 through 1982. During the first half, commercial bank acquisitions of Treasury securities helped to absorb the massive increase in Treasury financing, but, as private demands for credit pick up in response to rising business activity, such an absorption of Treasury debt may be more difficult within the context of non-inflationary growth of the monetary aggregates.

The CHAIRMAN. Thank you, Chairman Volcker.

Now, you have said that the Federal Reserve should not be required to target economic growth because you were not the only ones to affect growth. Using monetary policy to hit yearly targets will damage your longer term effort.

Now, two questions based on that statement.

First, were your dramatic restrictions in monetary growth followed by dramatic increases in monetary growth during the last 3 years part of the longrun effort or were they more reactions to problems of the day that arose on various occasions?

Second, we heard from many witnesses yesterday who were quite impressive that the Congress should set economic growth goals explicitly and that the Fed should then adjust its monetary policy to hit those goals. Now, you have said that you are worried that no Federal Reserve Chairman could ever convince FOMC members, those 12 independent minded individuals, to agree on targets.

Now, parenthetically, if I were to subscribe to that, I would have a problem as an attorney with the justice system of this country agreeing on whether someone was guilty or not guilty over the years or how much damages should be assessed against individuals and certain civil liability cases. But anyway, since you have said you are worried about those people not agreeing, would the fact that Congress 535 voices help you move the FOMC to agreement? Do you think the Congress ought to set growth targets in an effort to coordinate monetary and fiscal policy in a more productive way? In other words, give the 535 independent Members of Congress an opportunity to take a stab at it?

Mr. VOLCKER. You asked me two questions. Let me take them up in order. I think our particular policy decisions in recent years have certainly been taken in the framework of a long-term effort.

The CHAIRMAN. There were no reactions?

Mr. VOLCKER. I would add that obviously particular actions at particular times are affected by what is going on at that particular time. I think the answer is both; that they are clearly taking place in a framework of a long-term effort to reestablish the conditions for stability and growth and that the tactics of particular actions at particular times clearly take account of what is going on at those particular times.

I am afraid on your second question, consistent with my general view, I would have to say that I do not think that having an up or down vote in the Congress among your 535 Members on what the nominal GNP next year should be or what the real GNP should be or what the inflation rate should be next year would be constructive in the economic policy process. I think it would be a rather artificial process, frankly.

I think these goal settings are partly a decision of policy, but, when you look at it for the next year or 6 months they are partly a very technical decision, too, as to what is possible and feasible and what needs to be balanced off, one thing against another, in a context of considerable uncertainty.

The CHAIRMAN. Could I then rephrase a tiny part of the question or go to one that I enunciated to you in my opening statement and that would be, as you say, you cannot predict you must have some hope, some aspiration in certain areas.

Mr. VOLCKER. Sure.

The CHAIRMAN. So might I ask you, if you had any idea whatsoever as to when unemployment might drop below 7 percent given current fiscal policies and the monetary policies you plan to follow in the future?

Mr. VOLCKER. I haven't got a specific projection going out far enough. We gave you a projection, as you know, and the committee consensus has it down to about 8½ percent at the end of 1984. That is about 1 percent lower than we would anticipate at the end of this year. If that rate of decline continued, it would take another 18 months to get down to 7 percent.

The CHAIRMAN. Lastly, with respect to the reduction in the deficit, you know everybody says to Congress, "Reduce that deficit," and we would like to but it seems to me that we have slashed domestic programs intolerably and now where do we go from here? Where or how do we effectuate further relations unless it is done by decreasing unemployment which would save us, I think it is \$30 billion a year for each percentage point in unemployment?

Mr. VOLCKER. Reduction of unemployment obviously would have an impact on the budgetary deficit of a cyclical kind. Our problem remains one that the underlying budget deficit, that portion that isn't going to be improved by economic growth, is not only large but in the absence of action will get larger, and that is the real source of concern.

When you ask me how to go about dealing with it I think you are really getting beyond questions that I can reasonably help you with. I well realize that those are questions that affect particular sectors of the economy, particular people, particular programs, and Congress has to make those decisions.

I have said before, and I would say again, that from an economic standpoint, the performance of the overall private economy, the more that can be done on the spending side the better, but if you can't deal with the deficit adequately by restraint on the spending side, then I think you have got to face up to the job of looking at the revenue side of the budget.

The CHAIRMAN. My time has expired but I might say to you, Chairman Volcker, that over the years the Fed has become more and more participatory and has had less and less reluctance to tell the Congress how it should do what and when it should do it, et cetera. So I hope that as time goes by you will feel as though you can be more forthcoming. We may not agree with you, but by the same token, we would like for you to take a stab at it every now and then.

Mr. VOLCKER. It is a question of whether, without any particular expertise in those matters and without any mandate—unless you want to give us one—those are issues that we should really involve ourselves in, because they are not monetary policy questions.

The CHAIRMAN. Well, you know obviously a lot of us don't have the expertise that maybe we should have in the area that you are dealing in and yet we are not reluctant to jump in. So we want you to join us.

Mr. VOLCKER. You well know that monetary policy is a constitutional responsibility of the Congress, so you are entitled to have a

comment or two about it, even though I don't think it is unwise that you delegated that responsibility.

The CHAIRMAN. It is always a fascinating experience.

I have stated to the committee that what we have done is blocked out the arrival of the members as we have done in the past with these hearings that are so well participated in and so if some of the members aren't called upon in order understand that it is because we have gone to 15-minute segments.

At this point I call on Mr. Minish.

Mr. MINISH. Thank you very much. I might say, Mr. Chairman, that when he didn't answer your question all he is doing is practicing the independence of the Fed. When he asked you how to get the debt down I said you are just practicing the independence of the Fed.

Mr. VOLCKER. That is correct—and a certain amount of Federal Reserve restraint on the specifics.

Mr. MINISH. The Chairman talked about the reduction in the unemployment rate and it has been said that for every 1 percent of unemployment, Treasury receives in revenue anywhere from \$27 million to \$1 billion and of course the social security trust fund receives about \$4.2 billion or some figure close to that. So, in effect, if the unemployment does come down 1½ or 2 percent, it means that the \$200 billion deficit could very well be roughly \$140 billion or \$150 billion.

How does that stack up with your figures?

Mr. VOLCKER. I think the figure is in the neighborhood of \$25 billion, maybe a little more, for a reduction of 1 percent in the unemployment rate, as a reasonable rule of thumb. That assumes, obviously, that the unemployment rate is going down because of growth in income and employment and so forth.

Mr. MINISH. Mr. Chairman, some of the problem loans that some of the banks made to countries which resulted in a request for an increase in the IMF were based on the theory that these particular countries that received the loans, their economy would expand. And, of course, some of them or most of them in the OPEC area had to reduce the price of oil which resulted in a squeeze on the lending institutions. Is that a fair statement?

Mr. VOLCKER. Yes; but I also think some of these lending practices were explicitly based upon an assumption that inflation would continue, that interest rates would remain very low in negative and real terms, the pattern in the 1970's that people become used to. And yes, there was an assumption of growth and there was an assumption of inflation as well, I believe.

Mr. MINISH. But during the time that these loans were made in the early part, the banks were doing very well. Now that they have a problem—and I believe in the free enterprise system, when they are making this big money, it is free enterprise, but when they are not making too much money, they want to socialize it.

Mr. VOLCKER. I would not suggest that the process is being socialized now. It is outside the normal process. It is not a market process for many of these countries when you have IMF programs and official participation in credits. You have a process among the banks themselves that isn't the ordinary competitive process, I agree with that. Just to take your reference to the IMF legislation,

we are dealing with an institution that was created in 1945; while they did not specifically have developing countries in mind quite so strongly then, the general kind of financial situation that we face was a contingency that was envisaged in general terms all along in the creation of the IMF.

The growth in the IMF through the years has not been larger than the growth in the world economy, the world international financial markets, the world banking system.

Viewed in that particular perspective, this increase in IMF quotas is in line with the policy that has extended over 30 years in terms of the desirability of having an international institution of that sort available to deal with situations of precisely this kind.

Mr. MINISH. Well, while it has been in effect for 30-plus years, the facts are that the crunch has come now because of the problem loans.

Mr. VOLCKER. The biggest crunch that it has faced has come now. It has not had, by today's standards, many crunches in the past, but there have been problems from time to time.

Mr. MINISH. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Chairman, let's get one thing straight. While you were talking to Mr. Minish, this occurred to me. The increased participation, that 8.5 billion in increased participation is a guarantee to the IMF that the money will be there for the International Monetary Fund if necessary, is that not correct?

Mr. VOLCKER. That is correct.

The CHAIRMAN. Is any of that money going to the banks?

Mr. VOLCKER. No.

The CHAIRMAN. It is going to the debtor countries, those countries that owe the money.

Mr. VOLCKER. Precisely.

The CHAIRMAN. It is comparable to the legislation that we have attempted to pass here on occasion to help people pay their debts when they are unemployed for a long period of time.

Mr. VOLCKER. That is right. It is a margin of additional funds available to the borrowing countries; the IMF record of repayment, I think, has been perfect to date.

The CHAIRMAN. Mr. McKinney.

Mr. MCKINNEY. Mr. Chairman, my entire line of questioning was going to be on the IMF but the committee chairman has already covered that. I just think to review it for people who were not here I should mention that you suggested that failure to fund the IMF would increase unemployment. You suggested it would probably cause higher interest rates and you suggested that a smaller supply of capital would probably be available for domestic use if in fact we did not finance it, is that correct?

Mr. VOLCKER. Yes; and of course the chain of reasoning is that I think it would be a very great risk, that failure to fund the IMF could give rise to the inability to manage this situation. In a series of defaults, those consequences would follow.

Mr. MCKINNEY. On a more parochial level, I find myself somewhat confused but I find my constituents a great deal more confused about one subject. In Washington both on radio and on television and in the newspapers in New York City which serve my

district, there has been a dramatic increase in the last 3 months in banks begging you to borrow money.

This morning, just driving six blocks to the cleaners and then to work, I heard two ads urging me to come in and borrow money to buy a ring or buy a piece of jewelry or for any other purpose.

I think my constituents have a right to question why it is that if, in fact, banks are absolutely buried in cash which they appear to be at the moment, judging from what they are spending on advertising, interest rates are on the rise. Banks are advertising like crazy, "Borrow for your trip, borrow for a ring, borrow for this and that." They aren't urging loans for nice commonsense things that might get the economy going like an automobile or a washer or dryer or a house.

My constituents are saying, "If in fact banks have so much money and if, in fact, supply and demand is the order of the economic system, why, are interest rates inching up?"

Mr. VOLCKER. I may find it difficult to answer that question. Your preliminary remarks suggested to me that we might have been a little too easy. All I can answer, I guess, is that the situation may not be quite what meets the eye. They are eager to make some loans at interest rates they think are high enough to give them a return that is satisfactory. I think interest rates have been inching up, reflecting, basically, an overall balance of supply and demand in the market that is pushed in that direction.

When one takes into account, in addition to all the types of loans that you mentioned, three quarters of a billion dollars a day or so that the Treasury is taking out of the market, demands for credit have been increasing. There was a noticeable increase in total credit demands during the second quarter, and I think that is not irrelevant in looking at this interest rate picture.

I might say credit demands increased appreciably during the second quarter, even though business credit demands did not. Businesses have been in a period of relatively low credit usage because they have been liquidating inventories and their profits are improving. As the economic recovery continues, you would expect that in time they could come back in the market in bigger volume, and that is part of the problem: how that additional demand will be managed unless, the Government deficit is declining during that period.

Mr. MCKINNEY. When I came to Congress I was forced to resign from the board of a small bank. Sometimes we had money sloshing all around us. We advertised a great deal to have people come in and take it out so we could make more money on it. But when we didn't have the availability of much money, when we didn't have a lot of money to loan, we just cut down on advertising campaigns. When we had a lot of money we found out that we made a lot less from it.

Mr. VOLCKER. Let me give you this particular perspective. There is no question that a good many banks have more money in the sense that their liabilities are going up. They have a lot of money-market deposit accounts among other things. They have also acquired, during this period, a fair amount of Government securities. And I don't doubt that many banks, in looking at their portfolios, would prefer to make more loans at higher interest rates than they make on Government securities.

Nevertheless, the Government securities have to be financed and that has an impact on the market.

Mr. MCKINNEY. Well, I guess everything that I learned shows that economics as taught to me doesn't work anymore anyway.

Congratulations on your reappointment. Stay for the full term.

The CHAIRMAN. Now to one of the more demure and silent members of the committee, Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman. I am not acquainted with the word "silent."

Chairman Volcker, I have heard you speak on numerous occasions about the causes of inflation and of course inflation is a great impediment to a full employment policy. Time and time again I have heard you say that the way to stop inflation is to reduce Government spending. I would suggest that if you believe that increased Government spending is the major cause of inflation, that the Federal Reserve System and its Chairman does not practice what Paul Volcker preaches. George Bush discovered voodoo economics, but Paul Volcker has now come up with you do economics. He tells everybody else "You do your job to control Government spending," but he and the Federal Reserve System spend at a record setting pace.

I wonder if you realize, Mr. Chairman, that the 1982 expenditures of the Federal Reserve System were 148 percent greater than the System expended in 1979, the year you became Chairman of the Fed? In fact, you are the first Chairman in the Federal Reserve Board history to preside over an agency whose expenditures topped the \$1 billion mark. Humphrey Bogart uttered the famous words, "Play It Again, Sam." Perhaps the Fed's motto to set the record-spending pattern of the agency should be, "Spend it again, Paul."

I realize that some of the increases in Fed spending have been brought about by the very inflation that you are trying to fight but that does not justify the two-fisted spending going on at the Federal Reserve System.

In 1982, you spent nearly \$500 million on salaries and other personal expenses. You spent over \$14 million in travel, a large, large increase over the previous year. And your increase comes at a time when we have deregulated the airline industry and air fares have been reduced. One of the interesting categories of your expenditures is that you spent over \$10 million on an item called "other" which also increased over 1981.

You know, Mr. Chairman, I have been through this before with other Chairmen on the auditing bill and I wonder whether your agency is still buying the 20,000 ping pong balls that the Dallas Federal Reserve Bank purchased some years ago. I wonder if the Federal Reserve banks are still throwing the lavish parties charging all that booze and hor d'oeuvres and all other types of personal expenses to the Federal Reserve System, including babysitting services.

Now, my question is this: How can you tell the Congress of the United States to cut Government spending when you are the most expensive Federal Reserve Board Chairman in the history of the agency?

Mr. VOLCKER. I think you have gone back in history a bit for some of this too long before my tenure. Our expenses have not

gone up 148 percent during my tenure. I haven't got the figures right in front of me, but it is true that we——

Mr. ANNUNZIO. You can supply any of the figures you want for the record.

Mr. VOLCKER. I would be glad to supply them. I think you will find them going up more slowly than general Government expenditures. We did spend over \$1 billion on the most recent budget. About half of that is spent for priced services, where we get a return, and it is balanced by direct charges to the banks or the savings and loan associations that use the services. The rest of it is in connection with our monetary policy, supervisory and normal central banking functions. Our employment has actually been decreasing a bit on a trend basis in recent years. And I think you will find that we spend those funds with every degree of prudence and efficiency that we can manage and we take our responsibilities very seriously in that respect.

I think you will find that our productivity record over the years is good. We had a bulge in expenditures for a couple of years following the passage of the Monetary Control Act, when we moved from account relationships with member banks only to some multiple of that number of financial institutions who had direct connections with the Federal Reserve; that did create an increase in expenditures extending over a period of somewhat more than a year that was at a faster rate than I would contemplate or tolerate on a trend basis.

Mr. ANNUNZIO. Mr. Chairman, I have looked at your sheet. I would appreciate your answering for the record, but I want to know and I mentioned the \$1 billion; that is the bottom line after all fees have been paid.

Mr. VOLCKER. That is the gross expenditure, Mr. Annunzio. That is before revenues. The gross expenditures are \$1,074 million or something like that.

Mr. ANNUNZIO. You are spending \$1 billion after?

Mr. VOLCKER. We spend \$1 billion plus gross.

Mr. ANNUNZIO. My time has expired.

[Chairman Volcker subsequently submitted the following information for inclusion in the record of the hearing:]

Federal Reserve System expenditures in 1982 totalled \$1.1 billion, a 39.6 percent increase from 1979, or 11.8 percent on an average annual basis. This rate of increase is considerably less than the 148 percent figure cited by Mr. Annunzio during the hearing and is less than the 48.4 percent rate of growth in federal government outlays during this same period. The \$1.1 billion figure represents total expenses before reimbursements from the U.S. Treasury and revenue earned from priced services are deducted. In 1982, the System received \$76 million from the U.S. Treasury and earned \$422 million on priced services, close to half of total System expenses.

Approximately \$500 million of Reserve Bank expenses in 1982 was for salaries and other personnel expenses, and average salary per capita was \$20,202. A total of \$14 million was spent on travel—an increase over 1981 of only 4.3 percent. The 1982 "other" expense figure appears to refer to the category "other building expenses". This category of expense captures payments to outside firms for contract housecleaning, maintenance of elevators, vault doors and locks, and repair to our buildings; it increased only 4.6 percent from 1981 to 1982.

The expenditure pattern during the 1979 to 1982 period has been extraordinary for the Federal Reserve banks as they have had to adjust to new relationships with depository institutions and adjust operations to the pricing of services. The Monetary Control Act resulted in 4,500 new account relationships—a 73 percent increase in only two years. Up until 1980, Reserve Bank employment had been decreasing at

an annual rate of close to 3 percent from 1974, and unit costs had been declining approximately 2 percent per year. Following passage of the Monetary Control Act, total employment increased slightly and productivity fell off as volume of priced services declined faster than Reserve Banks were able to adjust staffing levels. In 1982 and projected for 1983 we again see declines in employment and improved productivity as Reserve Banks have made the adjustments brought about by the Monetary Control Act.

The CHAIRMAN. Mr. Mitchell.

Mr. MITCHELL. Thank you. Mr. Chairman, I will not address any questions to you about the unemployment. I found that to be fruitless in the past and it is my very distinct impression that this administration and indeed a part of this Congress does not intend to do anything about reducing unemployment through fiscal spending. It is going to be dependent entirely upon the private sector to reduce unemployment and that is not likely to occur. So I think any questions that I might put to you about your use of monetary policy and its use to reduce unemployment would be absolutely fruitless, and therefore I shall not do so.

What was the money supply, using whatever combinations you want, M_1 , M_2 , M_3 , what were the money supplies on a given recent date?

Mr. VOLCKER. You want a figure?

Mr. MITCHELL. Yes, please.

Mr. VOLCKER. June 29, the M_1 figure for the week ending June 29 was \$508.3 billion.

Mr. MITCHELL. Will you translate that to a percentage for me, please?

Mr. VOLCKER. Percentage of what?

Mr. MITCHELL. Does that reflect an 11-percent growth above your average grant, or what?

Mr. VOLCKER. That is the absolute figure. It grew 13.8 percent from the fourth quarter of last year to the average for the month of June.

Mr. MITCHELL. 13.8 percent. Now, in your testimony, you indicated that all other things being considered, you would like to reduce that money growth by one-half percent for next year?

Mr. VOLCKER. To half that rate or less, yes.

Mr. MITCHELL. One-half the rate, not one-half percent, but one-half that rate. You would cut it down to 6.5?

Mr. VOLCKER. The range we cited for next year was 4 to 8; for the remainder of this year, 5 to 9.

Mr. MITCHELL. Somewhere in between your range for next year then?

Mr. VOLCKER. Right.

Mr. MITCHELL. Now, in prior testimony you indicated that you wanted to achieve a gradual reduction. Would you define what you mean by a gradual reduction? I am raising the question because that seems to me to be a rather precipitous reduction to cut it in half.

Mr. VOLCKER. We had a precipitous increase in recent months. What we are looking toward in terms of the future is a restoration of more normal—I don't necessarily say normal, but more normal relationships—between money and growth in the economy. We have had an exceptionally rapid growth in M_1 relative to the growth in economic activity for more than a year, for six quarters.

We think that that will change in the future.

Mr. MITCHELL. That is really not responding to what I want. I guess what I am trying to ask you is, in your opinion, is a reduction of one-half in 1 year a precipitous reduction or is that gradual?

Mr. VOLCKER. I would not call that gradual.

Mr. MITCHELL. Well, then, it is precipitous.

Mr. VOLCKER. It is something in between the two, I suppose. Let's not call it gradual.

Mr. MITCHELL. My point is, it seems to me that the Fed is putting itself in an enormous dilemma. If you do a precipitous reduction—and I call that precipitous chopping in half in 1 year—then it seems to me that you start recessionary trends immediately beginning in 1984.

Mr. VOLCKER. I think perhaps we are focusing too much on M_1 . If you look at M_2 or M_3 , bank credit, I think anything that we are proposing you would put in the category of gradual. I think that particular target for M_1 reflects an assumption, which will be monitored, that we will have what you might call a precipitous change in velocity. But if you look at the array of these targets, there is clearly nothing precipitous in what we are proposing.

Mr. MITCHELL. Well, with reference to velocity in your testimony, you indicated that that velocity rate was going to be abated. That is your anticipation?

Mr. VOLCKER. Our anticipation, our best guess looking at M_1 at the moment, is that velocity is likely to be restored, not necessarily fully, but to a more normal cyclical pattern.

We have not had that problem of going off track in terms of velocity with the other aggregates to the same degree; and the basic targets that we are setting forth for M_2 and M_3 are unchanged for this year.

We are roughly within those targets. We are not changing the targets, and we are reducing them by only one-half of 1 percent next year.

Mr. MITCHELL. In terms of just M_1 again, and you can't discount that as being meaningless in the equation.

Mr. VOLCKER. I am not saying meaningless. It is in a somewhat subsidiary position, if I may put it that way.

Mr. MITCHELL. In terms of that—and may I have time to finish my question? In terms of just M_1 , I am willing to make a flat prediction right now to this committee, you cut that in half in 1 year and a recessionary trend is going to start which is going to begin to reflect itself in 1985. There is no way—that is the history of the Fed. There is no way you can avoid it and I think it is a serious, serious mistake. This comes from a Member of Congress who does not understand all the esoteric information about the Federal Reserve System but I can read history and I have seen all the way back for 30 years, or 20 years, or however long you have been in existence, whenever the Fed has dropped its supply that fast, inevitably, 2 years later or 3 years later, the recessionary trends start.

Mr. VOLCKER. If I may just respond briefly, Mr. Mitchell, I think you are putting more emphasis on M_1 than I would want to. I don't think that would be the case with the M_2 , M_3 credit numbers which were maintained in the ranges that we are projecting.

Mr. MITCHELL. I don't have the time but I really would like to talk to you about this because M_1 has a drag effect on M_2 and M_3 , obviously. Let's talk about it. My time is up.

The CHAIRMAN. Mr. Chairman, we have to go to another member.

Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman. Ever since I have been attending these hearings and Mr. Volcker has come to report, I think each time he has mentioned the budget deficit. He has been consistent and always claimed that there has been a problem to the Fed because of the huge deficits. But there is something that he says today that confuses me a bit because, as I understand it, if we have a big deficit or present a big deficit to the Fed, this causes a problem because there tends to be pressure on the markets. They either have to monetize that debt or there is a squeezing out and a tendency to push interest rates up.

It is rather remarkable that if the Fed goes into the market and borrows \$8.4 billion in order to turn this money over to the IMF, it doesn't have the same effect. As a matter of fact, the chairman takes the position that if we don't do it, we are going to raise interest rates. So I think it is a rather interesting phenomenon that sometimes pressure in the market is good and sometimes it is bad. One time it will raise interest rates and another time it might keep them level or even lower them.

Just in some defense of those of us who have a great deal of resistance to the IMF, and we have done a fair amount of talking this morning about it, the bankers themselves have done some advertising and lobbying. The big bankers have had an interest in them. If they have received no benefit from this lobbying, it is rather interesting to note that they will spend a lot of money for these benevolent reasons. When I talk to the little guy on the streets, he is quite concerned about it and he doesn't like the idea that there will be further funding of the IMF.

I also know that those in the Treasury have admitted that this is really just a small amount of the total they need for funding, and in the very next year they will need further funding, so this is not the end of the problem. It is just a token effort to try to take care of a paper money system that is collapsing.

I think it is a wrong argument—and you might answer to me on this if you choose to—that it is going to create jobs. That is, I think, just erroneous. This money goes to countries that are indebted, but they do not use it for specific programs. This funding is different. We cannot lump this aid together with the development banks or World Bank or Eximbank, even though I don't endorse those; every time you create a job through that funding, you have to steal a job from somebody else. Nevertheless the IMF funding, to me, is quite different than the funding through development banks and export-import banks. So I think it is wrong to say that we create jobs with this.

I have a specific question, though, having to do with our interest rates and discount rates. Yesterday our colleague, Mr. Hawkins, was here and he was concerned about interest rates, as all of us are. His proposal is to establish the discount rate at 3 to 4 percent and all will be well.

The discount rate now is 8½ percent. The deficits quite frankly are going to continue. I see deficits may be going down a little bit because of the economy picking up but we are locked in. We cannot expect Congress really to cut spending. So the deficits will remain and you will face that problem of continued borrowing.

My question is this—if the deficits continue at \$200 billion and you continue to get the political pressure, which is pretty heated now because it comes from people in the leadership position who write and say don't raise interest rates. Now, if your instructions or if you set out for this goal of low-interest rates with a \$200 billion deficit and you use all the tools at hand such as massive monetary expansion, if needed, perhaps just setting the discount rate at 3 to 4 percent, tell us what is wrong with that approach. What happens if you set the discount rate tomorrow at 3 to 4 percent and use all the monetary tools to seek out and try to achieve, say, a 7-percent prime interest rate? What happens to the economy?

Mr. VOLCKER. With all the other assumptions you made about the deficit and so forth?

Mr. PAUL. Yes; deficits remain high.

Mr. VOLCKER. I think it is clear that you would have a lot of inflation and ultimately much higher interest rates.

Mr. PAUL. For what reason? Evidently, some Congressmen don't accept that argument because they say if they could just have the discount rate at 3 to 4 percent, it is going to solve our problem. Who benefits from the discount rate being 3 to 4 percent?

Mr. VOLCKER. If the discount rate were 3 or 4 percent in today's market under all the other assumptions you make and we were to permit banks to borrow—and I assume you are assuming that—there would be an enormous amount of borrowing, an enormous expansion in bank reserves.

There would be an explosion in the money supply under those conditions, and you would have a very rapid increase in inflationary expectations soon to be followed under those particular conditions by inflation itself.

I don't think you would have any interest under those conditions in buying 30-year mortgages or long-term corporate bonds because people would be running to protect themselves from the collapse of the currency.

Mr. PAUL. Has there been any increase in borrowing at the discount window since 8½ is below the market?

Have you seen any surge in borrowing?

Mr. VOLCKER. There has been an increase in borrowings at the discount window over the past 6 weeks to 2 months, which were induced in part by the fact that we have been somewhat less liberal in providing reserves through the open market; that is a natural reflection of a slight increase in pressures on bank reserve positions.

Mr. PAUL. My time has expired.

Mr. VOLCKER. If I may just say for the record, I suppose it is absolutely clear from what I have said before that I don't agree with your analysis of the IMF situation in a number of dimensions. I would just reiterate my earlier comments. The direct potential impact of borrowing in the U.S. market to fund the IMF which is

implicit in the action; we don't deny that is a minor impact compared to the other risks that you would be running.

It is not clear in the short run, through the international mechanism, that it would really add to the pressures on our markets. But to the extent that it did, it is the tail of the dog, and not the dog.

Mr. PAUL. But does the market know the difference between borrowing for the IMF versus the deficit? The market can't distinguish that.

Mr. VOLCKER. In terms of giving rise to Treasury financing, the question is what the recipient of that money does with it. To the extent that it reduces bank loan demands, you have an offset.

In the first instance, it is all Treasury borrowing. That is correct.

The CHAIRMAN. Mr. Fauntroy.

Mr. FAUNTROY. Thank you.

Mr. Volcker, 20 years ago this August, three-quarters of a million people gathered here in Washington. This became a historic march on Washington for jobs and freedom. You may recall that Martin Luther King gave that magnificent "I have a dream" speech. The black unemployment rate at that time was 10.8 percent. In the Nation generally it was 5.7 percent, which was above the target for the Humphrey-Hawkins measure.

As you know, right now, 20 years later, as we prepare to celebrate the 20th anniversary of that march, we expect tens of thousands of people of good will around the country to be here again—marching for jobs. Right now, millions of people of all ages and races, particularly young black people, are looking for jobs, without success. The unemployment rate in the black community is 20 percent against 10.8 percent 20 years ago, and yet here we have the Fed worried, according to most recent reports of the open market committee meeting, that M_1 is growing too fast, and thus that a moderate amount of tightening is appropriate to slow down M_1 growth.

Let me ask you a question which I have asked Preston Martin, who testified before my subcommittee last month. Is the Fed concerned that the pace of recovery is too fast—that a 6- or 7- or 8-percent rate of growth in real GNP for the rest of 1983 is too much? Are you tightening monetary policy now because economic growth is too fast, because you want to have a more moderate economic recovery with real growth in the first year of 4 to 5 percent instead of the more normal 6- to 7-percent growth rate during the first year of recovery?

What are the costs of this growth in terms of prolonged unemployment and failed businesses and higher deficits and continued suffering and deprivation on the part of the people who are going to be marching here next month to say "we want jobs?"

Mr. VOLCKER. Let me say, the growth in GNP in the second quarter, which I suspect may be higher than the preliminary projections, in itself is not a source of concern. Extending that ahead in the immediate future is not in itself a source of concern. But, as this process goes on, you have to look at more than the total growth and ask yourself, constantly, whether developments are consistent with sustaining growth over time and making long-term progress on that unemployment problem as well as progress, let's say, for the rest of 1983.

I think that is what the whole purpose and intent of this process must be. Can we sustain this process over a period of time? We would look not simply at the growth rate.

The more growth you get, in some sense, in the short run, the better, but is it being accompanied by developments that could be difficult or damaging over time in terms of keeping the process going?

The actions that we have taken recently are not large, but I tried to explain why we think they are desirable in terms of maintaining the expansion over a period of time and, indeed, moderating interest rates over a period of time.

That is the judgment we have to make.

Mr. FAUNTROY. So that the unemployed today who have little prospect of being reemployed—perhaps that have fled the country—should be patient and not look to participating in the recovery that we have been hearing is underway?

Mr. VOLCKER. Patience is necessary, but I certainly hope that they will participate in the recovery and participate over a long period of time and get a job and keep it or have other jobs available to them over a period of time.

You referred back to the economic developments in the 1960's. That was a glorious period in many respects.

We had a long period, in the first half of the sixties, of not terribly rapid growth by the standards of last quarter, but it was long sustained.

It took place in an atmosphere of price stability. It took place in an atmosphere of relatively low and steady interest rates. That is the kind of environment that we would like to recreate.

By the end of that decade, while the unemployment rate remained low, it also seemed reasonably clear that some things were developing in the economy that were not consistent with maintaining that beautiful pattern we had in the early part of the sixties. As the seventies progressed, imbalances, difficulties, inflation developed. I view the current period as a very difficult, painful period of trying to restore the base for the kind of economy we had in the 1960's or during much of the 1960's.

Mr. FAUNTROY. Mr. Chairman, my time has expired, but I would like unanimous consent to submit several questions to Mr. Volcker.

The CHAIRMAN. At this point, I would ask unanimous consent that all members have the opportunity, those who are present and those who are not, to submit questions to Chairman Volcker.

[Under the unanimous-consent agreement, Congressman Fauntroy submitted the following correspondence with Chairman Volcker for inclusion in the record:]

WALTER E. FAUNTROY, D.C. CHAIRMAN
 STEPHEN L. NEAL, N.C.
 DONALD BARNARD, JR., GA.
 CARROLL HUBBARD, JR., KY.
 BILL PATMAN, TEX.
 BUDDY ROEMER, LA.
 BRUCE A. MORRISON, CONN.
 JIM COOPER, TENN.
 THOMAS R. CARPER, DEL.

GEORGE HANSEN, IDAHO
 RON PAUL, TEX.
 BILL MACCOLLUM, FLA.
 BILL LOONEY, CALIF.
 JOHN HILER, IND.

U.S. HOUSE OF REPRESENTATIVES
 SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
 OF THE
 COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
 NINETY-EIGHTH CONGRESS
 WASHINGTON, D.C. 20515

July 25, 1983

The Honorable Paul A. Volcker
 Chairman
 Board of Governors
 Federal Reserve System
 20th and Constitution Avenue, N.W.
 Washington, D. C. 20551

Dear Paul:

In accordance with the unanimous consent agreement of the Committee on Banking, Finance and Urban Affairs, I would like to tender to you the following questions:

First, I have a question about the central tendencies of the FOMC's 1984 forecasts. The FOMC is projecting real GNP growth with a central tendency of 4 to 4-1/2 and inflation of 4-1/4 to 5. However, when these are added up to get nominal GNP, the results are 8-1/4 to 9-1/2, compared with the stated central tendency of 9 to 10. Indeed, a 10% nominal GNP growth rate cannot be attained given the central tendency of forecasts for inflation and real growth. What is the explanation for this discrepancy?

Second, how do the central tendencies of FOMC forecasts for real growth compare with real growth during the first and second years of real growth in past recoveries?

Third, what is the status of these forecasts? Are these growth, inflation, and unemployment rates the conditions which the FOMC would like to see, and which it will be trying to bring about through its policies? Or are these the conditions which the FOMC is afraid will happen, despite its best efforts to foster faster growth and lower inflation, because of other factors, such as large deficits and weak international conditions?

I look forward to your responses to these questions.

Sincerely yours,



Walter E. Fauntroy
 Chairman



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

August 2, 1983

PAUL A. VOLCKER
CHAIRMAN

The Honorable Walter E. Fautroy
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Walter:

Your two recent letters raised a number of questions about monetary policy particularly as it relates to expectations or forecasts of growth in GNP and of related variables.

You noted a seeming discrepancy in that the central tendency of FOMC members' forecasts for nominal GNP in 1984 could not be obtained by adding the central tendency of forecasts for real GNP and prices. Basically, the reason for this is that the mixes of nominal and real GNP and prices that were projected by the individual members of the Committee can vary enough one from the other that they lead to central tendencies for each of these variables that at the limit appear to be mutually inconsistent, as was the case in some degree for 1984. In addition, as you know, the growth rates of real GNP and prices will, because of the mathematics involved, always differ by a small amount from the growth rates for nominal GNP (the discrepancy being given by the product of growth rates in real GNP and prices).

You also asked how the central tendency forecasts for real growth in 1983 and 1984 compare with real growth during the first and second years of past recoveries. As compared with the average of five previous postwar recoveries in the 1954-1975 period--eliminating the exceptionally rapid recovery period beginning in 1949 and the limited recovery of 1980--the central tendencies show growth somewhat lower in the first year of the current recovery, and a shade higher in the second year. These real growth rates, and accompanying projections for unemployment and prices, should be interpreted as representing the FOMC's view as to the most likely pattern of economic developments, given the monetary and credit targets for 1983 and 1984 and the overall economic environment including fiscal policy and conditions in domestic and international financial markets. An even better economic performance, should it evolve, consistent with sustainment over time of economic growth and progress toward reasonable price stability would of course be both desirable and acceptable.

Sincerely,

A handwritten signature in cursive script that reads "Paul".

The CHAIRMAN. Now we will call on the distinguished member, Mr. LaFalce.

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

Right now we are going through a bit of a crisis and that is whether or not the IMF bill that is tentatively scheduled for a vote tomorrow will pass or not.

Chairman Volcker, if there is a vote on the IMF bill tomorrow as tentatively scheduled and if the vote tomorrow is negative; that is, if we do not pass the IMF quota increase tomorrow, what do you think will be the national, domestic, and international impact?

Mr. VOLCKER. I think it would work directly against the concerns expressed by Mr. Fauntroy, for instance, in getting this expansion going and getting interest rates down and improving employment.

In a more immediate sense, I believe it would be a very discouraging signal not just to the IMF itself, but to all the other people around the world—not just in the United States who are working to manage and contain the international debt situation.

Mr. LAFALCE. Could you quantify that in terms of worldwide economic growth coming out of the recession, domestic and international interest rates, et cetera, if not in numerical terms, at least with some appropriate adjectives?

Mr. VOLCKER. Yes. I can't do it in numerical terms; I tried to use some appropriate adjectives earlier.

I think the risks are very substantial. I think the direction of impact is clear. How serious is it? I think you would be taking an enormous risk of undermining the efforts that have been taking place to consolidate these debts, to create a new base for growth in those countries, to stabilize the international financial system. If that got ripped apart and really went through Latin America, let's say, you would have a major problem on your hands.

Mr. LAFALCE. Thank you very much. I think that you have shown good leadership on the issue of the IMF, not only today, but over the past 6 months to a year, easily since last August, if not before.

I think that contrasts markedly with the lack of leadership, though, that has been shown by President Reagan not only last August 1982, but up until today.

He has not forthrightly gone to the American people explaining the need for the increase in the IMF quota.

He had the opportunity this past Saturday when I am advised he was urged to speak on radio about the necessity of the IMF increase, but perhaps he got confused between IMF and INF and MX. These initials are difficult to comprehend.

Perhaps we should have called it IMX, rather than IMF, and we could have gotten a combination statement on the import of both military might and economic might in order to make America strong.

But, so be it.

Mr. VOLCKER. If I may just interject, Mr. LaFalce, I think the President and the administration are fully behind and active in the support of this effort.

Mr. LAFALCE. The administration and the President are fully behind. Whether they are active enough and whether they have

shown appropriate leadership is something I suppose that reasonable men can disagree on.

I have staked out my position. If the President can go before the American public on the issue of Gramm-Latta, if he can go before the American public on the issue of tax cuts and social security and the issue of Central America, he has an obligation, it seems to me, to go before the American public on something that is less understood, more complex and something which over the past 20 years he has created a climate against.

He, in large part, has created a climate among the American public which is not only not sympathetic to international financial institutions, but opposed to them. So I think there is an obligation for him to do at least what he has done on other issues; go to the American public.

To return to the issues within your jurisdiction. I understand your reluctance to have the Federal Reserve set and announce objectives for a variety of economic variables because the tools at the disposal of the Fed are monetary policy tools and you need a wide array of macroeconomic and microeconomic tools in order to accomplish certain of these objectives.

But would you favor, Chairman Volcker, the concept of an accord, an accord at least between the executive branch and the Congress and perhaps the Federal Reserve Board, also, either as a strong consultant to the accord or as an actual participant to the accord.

Would you favor an accord in which you are involved in some way along with the executive branch and the legislative branch in which we plan objectives for GNP growth, inflation, unemployment and come to an agreement regarding what type of deficit we would have, what type of fiscal policy and monetary policy would appropriately mesh in order to reach these more targeted objectives?

Mr. VOLCKER. I think some of my basic concerns about objectives in the short run would apply to the legislature or the administration, too.

I don't think that it has been the habit to cite the forecast or the projections that have to be made as "objectives."

I think it would be counterproductive, to the extent it led to short-term tinkering or finetuning or the kind of will-o'-the-wisp effort to meet a figure which assumes undue importance just because it happens to be written down at the beginning of the year and called an objective.

Mr. LAFALCE. You are not opposed to the concept of objectives, are you?

Mr. VOLCKER. I was about to say, we have in the Humphrey-Hawkins Act quantified objectives over a 5-year period, I believe.

My sense is that that becomes something of a pro forma exercise because of the uncertainties in the outlook. I am certainly not opposed to having objectives, whether or not spelled out statistically, over a period of time.

Obviously, our objective, it seems to me, is quite plain. We want as much price stability as we can get and we want it in the context of a growing, fully employed economy.

To state it at that level of generality does not solve many problems either, but that objective is clear enough.

The CHAIRMAN. Mr. Bethune.

Mr. BETHUNE. Welcome, Mr. Chairman.

You were in a discussion with Mr. LaFalce and said there would be a substantial risk if we did not pass the IMF measure and, of course, none of us like to take risks.

We always want to avoid whatever risks we can. As I was thinking about that, I wondered about the talk that we hear constantly in connection with interest rates about the risk premium.

What is meant by that?

Mr. VOLCKER. It depends upon the context in which it is used. It has been used frequently, recently, I think, with respect to the risk premium against inflation reasserting itself and the caution attached to long-term lending because of a concern that an interest rate that may look good today may not look good 3, 4, 5 years from now, if inflation takes hold again.

There are obviously other risk premiums.

Mr. BETHUNE. So, in other words, a lender in order to protect himself against inflation will charge a risk premium so that he won't suffer a loss and can continue to make some sort of profit.

So I take it from that that profit then is relevant as well as supply and demand and other factors. Profit is relevant to the interest rate charges that are being made.

Mr. VOLCKER. Profit certainly motivates the market in the direct sense. Expectations are important.

Mr. BETHUNE. It is relevant and related to risk then as well?

Mr. VOLCKER. Yes.

Mr. BETHUNE. The thing that bothers me about most of what I have heard today is that you have said that if we don't bail out the banks and do the IMF, that interest rates would go up.

I take it that because they would take a bath and would have to suffer some loss and not make their profit, that interest rates would go up.

That would be one of the factors involved. But, on the other hand, if we should bail them out and thus alleviate some of the risk and take them off the hook, interest rates would not go down.

Now, that troubles me because the proposition here is that, I take it, some of those banks, Citibank, and Chase Manhattan have made some substantial profits.

I understand they charge fees and some rates are as high as 20 percent in the last couple of years. Did they pocket those, do you know?

Mr. VOLCKER. We are just looking at the impact of this particular action and isolating it. I think there has been a general expectation, as best that I can judge it, that this legislation will pass, that the total situation will be contained. The market is operating on that assumption.

In carrying out that assumption, I would not anticipate a great impact on the market or any impact at all. If that assumption is shattered, that is where the risk lies.

If I may just amplify one other point, you say I mentioned risk. I certainly did. Sometimes you have to take risks; but you ought to balance risks against rewards, and I guess I see the risk as substantial in this one, and I don't see the reward on the other side.

Mr. BETHUNE. I think you are missing my point here. If, in fact, we go back and eliminate the risk that they said they had which permitted them to charge rates as high as 20 percent, you may get to keep the profit that they pocketed as a result of that.

Mr. VOLCKER. I understand your problem, but you are not eliminating the risk entirely. I don't mean to suggest that.

I think you have taken a step to avert a risk to the whole system. You have not eliminated all the risk for particular countries.

Some countries will be successful and some won't, but you would have worked against what might be called a systemic risk, a risk to the total system.

You can handle problems in individual countries. When that problem is very generalized, it is much more difficult to handle.

The banks should have some risks with respect to individual countries. They did the lending and they ought to be able to stand up to those risks. But when you have a risk that goes right across the system—

Mr. BETHUNE. Not in this instance?

Mr. VOLCKER. Yes; even in this instance they have risks with particular countries.

Mr. BETHUNE. Well, to the extent that we can relate the amount that we are alleviating and protecting the banks against the loss that we are protecting them against, should not they have to kick back in the profits that they stuck in their pocket over the last 2 years?

Mr. VOLCKER. I think there is a concern, which I certainly recognize, a problem with respect to the amount charged for some of these loans, and that some account should be taken of the degree of public support that is provided in specific instances.

That is a very difficult problem and an area for negotiation country by country. Many of these banks would argue, from their point of view, that whatever the IMF does in any one of these particular situations, a substantial amount of risk still attaches, in some cases at least, to making these loans, and they are providing most of the money; to a degree that is, of course, true.

Mr. BETHUNE. My time is expired.

Thank you.

The CHAIRMAN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

Once again, it is a pleasure to listen to the Chairman of the Federal Reserve.

I have an initial question. Given all the reports in the papers that you were offered jobs that would pay over \$1 million, why did you subject yourself to this all over again?

Mr. VOLCKER. Sometimes I wonder, Mr. Schumer.

Mr. SCHUMER. My next question is on the comments that appear on page 3 of the report of the Federal Open Market Committee, where it was stated that at the present rate of GNP growth and nominal spending, 11 percent for the second quarter, that there would be a real inflationary risk.

Given that, and given your answers to Mr. Fauntroy and Chairman St Germain, are we not really between a rock and a hard place? Doesn't this report say to the American people that if we

grow fast enough to make a real dent in unemployment we are going to trigger inflation all over again?

It seems there is almost no way out looking at your report and your statements because I think most of the American people find the prediction that we will have 8.5-percent unemployment by the end of 1984 and below 7 percent by July 1986, to be unacceptable.

Mr. VOLCKER. Even if it continued to grow at the same rate.

Mr. SCHUMER. Even if it grows at this rather large rate which risks inflationary dangers. It is an ugly and almost damning predicament.

Mr. VOLCKER. I think you are raising, in a general way, an aspect of the problem we face. But if you tell me there is no way out of that box, I don't agree with that.

Our policy is aimed at avoiding it to the extent that we can.

You say we are in a box; I think we are in a box in a narrower sense. The faster the economy grows, the quicker the day will come when we will have a very sharp conflict in the markets between a prolonged large budgetary deficit and the credit demands that the rapidly growing economy will generate.

That is one aspect of it, but it is obviously amenable to a policy decision. You can deal with that very straightforwardly. You know what the problem is and the remedy to it.

Mr. SCHUMER. Well, what is the remedy other than the fiscal side?

Mr. VOLCKER. Cut the budget. There is no remedy to that other than the fiscal side.

Mr. SCHUMER. Do you think that the 1981 Reagan tax program was a mistake in retrospect?

Mr. VOLCKER. It is hard to rake over all the old coals.

Mr. SCHUMER. It is certainly the greatest contributor to this deficit, greater than any spending increases or cuts far and away.

Mr. VOLCKER. I think I took the position then, before this committee and elsewhere that I was concerned about that tax cut and particularly about extending it over so long a period of time and about adding many things to it—which happened in the congressional process—without an equally rigorous commitment to the expenditure controls that I thought that kind of tax reduction implied.

I suppose what has happened does not make me change my mind in that respect.

Mr. SCHUMER. It is kind of frustrating for those of us on this side of the table. We talk about fiscal constraint and you say, well, reducing spending is more important than raising taxes.

But the long and short of it is Congress is deadlocked on reducing spending. There is neither a majority for cutting defense spending nor for cutting social spending.

So I think it behooves people like yourself to start saying, well, we either should undo part of the Reagan tax cut or—and maybe not now, but maybe 6 months from now, or 1 year from now—or come up with some other kind of what is euphemistically called a "revenue enhancement."

Mr. VOLCKER. I agree with that. I said that again this morning. From a purely economic standpoint, you should do it on the ex-

penditure side, but you have many other considerations, national security, personal security, and so forth.

But if you end up deadlocked on the expenditure side, you have to turn to the revenue side.

Mr. SCHUMER. Let me switch to the IMF, which is an issue you and I have discussed at some length, and follow up on Mr. Bethune's question.

Certainly I am aware of the risks of not approving the IMF quota increase. But in my assessment there are two other risks, and in my final question I would like you to address these.

No. 1 is this: Let's say the IMF appropriation passes and 6 months to 1 year from now, because the austerity imposed on borrowing countries is too severe, that a major debtor repudiates. That, I think, would put the system at greater risk than not passing this bill, and leads to my second question, which has two parts: While the IMF negotiates the specific terms of austerity programs with Third World countries, it does not set interest rates.

Nor does it set fees. That is done by the large banks.

Part 1, are those interest rates and fees too high, and part 2, if they were lowered, would that not decrease the likelihood of the repudiation that we all are talking about?

Mr. VOLCKER. I don't want to suggest that the risk of repudiation, particularly under those conditions, is as high as you may suggest. But there is no question that lower interest rates would ease the problem to a degree and create a more favorable atmosphere, perhaps, in countries that are undergoing austerity programs.

Mr. SCHUMER. Might amendments that would be added to the IMF bill to do that be salutary?

Mr. VOLCKER. I did not deal with the other side of the question. You have got to get a quasi-market or market mechanism working that produces the money, and those two conditions have to be balanced off.

Mr. SCHUMER. Thank you.

The CHAIRMAN. Mr. Patman.

Mr. PATMAN. Thank you, Mr. Chairman.

Chairman Volcker, I appreciate the statement you have made in response to the mandate under the Humphrey-Hawkins bill. Can you tell me if you have pledged to yourself or to the President that you will not repeat any of the mistakes that the Fed has made on monetary policy since your initial appointment to the Fed in 1979?

Mr. VOLCKER. I wouldn't repeat any mistakes that I am aware of.

Mr. PATMAN. Are you aware of any?

Mr. VOLCKER. Someone would always play the record a little differently, I suppose, but I am not sure I am prepared for a mea culpa here.

Mr. PATMAN. Has monetary policy caused the recession we are in?

Mr. VOLCKER. I think what has caused not just a recession, but a period of some time of poor economic performance, is a whole series of events that built up over a number of years, many of which can be summed up in the accelerating inflationary mentality and the fact that we had during the 1970's—

Mr. PATMAN. Have the decisions of the Fed with respect to monetary policy contributed to the recession in any way?

Mr. VOLCKER. I think the decisions of the Federal Reserve affect the timing. They affect the short-run business outlook. I have indicated many times that if we did not face up to the inflation problem, ultimately we would have had a worse problem in the economy.

Mr. PATMAN. Many people in the country feel that the Fed flung the Nation into a recession to control inflation. Is that incorrect?

Mr. VOLCKER. We certainly had restrictive measures to control inflation, under the conviction that was necessary for the long-term health of the economy; that affected business activity in the short run; yes.

Mr. PATMAN. Hopefully in the short run. You can't say for sure that it would have been just in the short run; can you?

Mr. VOLCKER. I can't say for sure because we are still in the short run, but that is my conviction.

Mr. PATMAN. The recession we are in is not necessarily one that we are going to get out of in the near future, is that true?

Mr. VOLCKER. We are getting out of it, I would say. In the technical sense, the recession is behind us, but we still have a lot of unemployment and we have a lot of excess capacity.

Mr. PATMAN. You mentioned the importance of confidence. Can the small businessmen in this Nation, as well as others, be assured that the Fed will not impose artificially high interest rates on the economy that will result in the recession coming back on us in greater measure than it has been?

Mr. VOLCKER. We are not going to impose what I would think of as artificially high interest rates.

Mr. PATMAN. Would you say you never have?

Mr. VOLCKER. Artificially high? No.

Mr. PATMAN. In other words, your actions with respect to money supply don't cause interest rates to go up higher than they otherwise would be?

Is that what you are saying?

Mr. VOLCKER. Our actions with respect to the money supply have impacts on interest rates both in the short and longer run.

Mr. PATMAN. In either of those cases, short run or longer run, do they cause them to go up?

Mr. VOLCKER. It might have an influence in the short run if you take a more restrictive action in the short run; yes. It could be favorable in the long run.

Mr. PATMAN. I am not saying "might." In fact, don't the actions of the Fed definitely cause interest rates to go up in some cases?

Mr. VOLCKER. In some cases; yes.

Mr. PATMAN. Long term and short term?

Mr. VOLCKER. In some cases; yes. But in some cases they would have the opposite effect.

Mr. PATMAN. When the Fed's actions that cause the rates to go up are taken, do those tend to cause the country to go into a recession or something of that nature?

Mr. VOLCKER. Not necessarily. I would say any actions we have taken recently, for instance, are designed to help maintain a sustained recovery.

Mr. PATMAN. I had not heard about your offers of \$1 million a year, Mr. Volcker. Where did those come from?

Mr. VOLCKER. I read about them in the papers.

Mr. PATMAN. I don't know if we could pay you \$1 million in this country, but if we could pay you enough to avoid the kind of recession we have been through or any contribution that the Fed made to that recession \$1 million would be very, very cheap because there have been estimates of \$200 billion that we have suffered in lack of income and economic impact adversely in this Nation because of the actions of the Fed and certainly the recession.

Would you say those estimates are low or high?

Mr. VOLCKER. The estimates run very high in terms of the costs in lost output from the economic performance of recent years. I am going to separate myself a bit from attributing all that to the Federal Reserve.

Mr. PATMAN. But you will acknowledge a major role in whatever is happening, would you not?

Mr. VOLCKER. I would hope that the net effect of the actions over a period of time would be a plus in terms of production and employment, but enough time has not passed yet for me to prove that point to you—if anyone ever could.

Mr. PATMAN. I would just be happy to know that your hope would be realized, but there, again, I would like to have more confidence.

Mr. VOLCKER. I hope it will be realized, too, but I can only say, again, that the thrust of your questioning attributes a degree of omnipotence to the Federal Reserve that the facts may not justify.

Mr. PATMAN. Maybe not omnipotence, but certainly power which I think you certainly have.

Thank you.

The CHAIRMAN. Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

The CHAIRMAN. The Chair would announce that the three bells for a live reported quorum call. The Chair feels that this hearing is rather important.

The Chair will continue the hearing. Mr. Parris can question and he can come back and Mr. Roemer will be next.

You can sort of gage your time.

The questions will be Mr. Parris and then we will go back to Mr. Roemer, and Mr. Morrison.

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

Mr. Volcker, let me add my voice to those who have extended their congratulations to you for your reappointment. I would hope that your successful confirmation will be forthcoming in the near future.

I had what I hope is not an overly technical question, but for my personal elucidation, Mr. Chairman, you said to us last year in one of your appearances before this committee that M_1 should be deemphasized because of the expected distortions in the measurement of the money supply and that M_2 is the money measure to watch.

On page 12 of your statement today you say, in part, that in 1984 the committee looks toward a reduction of one-half percent in each of the ranges for M_2 , M_3 , and that "a small reduction appears ap-

propriate and desirable taking into account a need to sustain real growth while containing inflation.”

Now, taking into consideration the velocity trends in money market, as I understand it, M_2 has declined six out of the last six quarters. My real question, to you Mr. Chairman, to you is what you alluded to in your other brief summary comments that the M_2 may be modestly distorted or the velocity affected in some way by the money market deposit accounts.

Mr. VOLCKER. You had a big distortion, but for a limited period of time; we think it is over.

Mr. PARRIS. It has in some way corrected itself for future measurements?

Mr. VOLCKER. We believe so; yes.

Mr. PARRIS. What I am really trying to get at, Mr. Chairman, is to what do you attribute the decline in the money loss and do you continue to believe that some of the changes that have been in the more reliable figure, the M_2 figure, have been induced by institutional changes or lower interest rates or more ample money supply?

To what do you attribute that adjustment?

Mr. VOLCKER. An analysis of M_1 suggests that, in contrast to 3 or 4 years ago, about a quarter of the total is NOW accounts; some margin of those NOW accounts are super NOW, upon which there is no interest rate ceiling, but on all of them you can pay interest at $5\frac{1}{4}$ percent.

The fact that you can get interest now by holding what is, in effect, a demand deposit leads us to believe—and some analysis supports this—that people want to hold more money in that form than they did when they got zero interest at any given level of interest rates in the marketplace.

Of course, interest rates declined rapidly last year and the difference between what you could earn on a NOW account and what you could earn in the market narrowed substantially as the bill rate went from, let's say, 15 percent or thereabouts, at the peak, to, 7 to 8 percent.

If you were making zero on a demand deposit, that was still quite an incentive to hold a Treasury bill, let's say, but that changes when you were making $5\frac{1}{4}$ percent on a NOW account.

We think that was part of what was going on and affects the cyclical characteristics and may offend the trend over a period of time.

I am not at all sure you can explain the whole thing from that single change, important as it is. I think that that is enough to account, potentially, for some change in trend.

Last year we were in recession. There was a great deal of uncertainty, nervousness. You were in a period of rapid economic change.

We have some record in the past that when things are changing very rapidly, the desire to hold cash in any form may change. When people are nervous and uncertain, they want to hold more cash.

I think something of that sort may have been going on last year, as well. You may have a mixture of some things that affect the

trend, affect the regular cyclical patterns, and some things that may have been once and for all.

Our judgment is, in looking ahead, that we have to consider the strong possibility that while the trend may be changing somewhat, the fluctuations around the trend in relation to interest rates or the business cycle may be more normal. It is normal at this time in the business cycle for velocity to be increasing, not decreasing.

The latest figures that we have don't show an increase in velocity, but they show a much slower rate of decrease. The pattern is consistent, again, with a more normal pattern—maybe not “normal,” but it appears that it may be moving in that direction.

Mr. PARRIS. If money supply affected your commercial activity, you would still monitor M_2 as compared to M_1 ?

Mr. VOLCKER. Yes. We are putting more weight now on the broader aggregates, as the testimony indicates. But if M_1 is rising too fast, we can't ignore it.

Mr. PARRIS. Thank you.

The CHAIRMAN. Mr. Roemer?

Mr. ROEMER. Thank you, Mr. Chairman.

Let me add my congratulations, Mr. Volcker, for your reappointment. Quickly, on the IMF question, you have stated the case today for making the increase in our quota. In testimony before this committee some months back, vis-a-vis this question, the bankers who have a vested interest in such a move testified that in terms of what we should do to prevent this from happening again, they hope we didn't increase regulations on the bank in their international loans.

Do you think that that is a positive step, that is that we give the increase in the quota and do nothing either in terms of public disclosure, reserve requirements or other regulatory habits and regulations on the banks themselves?

Mr. VOLCKER. No. I think we tried to learn from this experience. We have taken steps and are continuing to take steps in that direction. Of course, they are quite in line with provisions that are in the Senate bill and in the House bill. There are provisions in the House bill that go further than I would want to go.

Mr. ROEMER. Well, because time is short, I won't belabor the point, but it might behoove your ultimate goal in the IMF settlement if some statements from you and/or your office could register to the American public the need for regulation to prevent this from happening again.

Mr. VOLCKER. We have such statements. You are quite right. I don't think there has been anything in the press quite recently about them, but the actions have been taken.

Mr. ROEMER. No. 2, I am uncomfortable listening to your talk about the need for perhaps slightly higher interest rates concerned about anticipatory inflation at a time when wage settlement increases are down, industrial capacity is near an alltime low. Oil and gas stability, let's call it energy stability, seems reasonable for the next 2 or 3 years and agricultural price stability seems reasonable for the next 2 or 3 years. At the same time when inflation expectations should be down, given the facts, real interest rates are at or near an alltime high.

Given that background, how can the Fed say we need even a slightly higher interest rate environment now. It seems to me a better case could be made for a slightly lower interest rate environment.

Mr. VOLCKER. Obviously, the issue is debated. The considerations that you raise are quite reasonable. I don't think it makes anybody terribly comfortable to take these decisions in either direction. Based upon the kind of analogies that I reflect in my statement, we can see some signs that a stitch in time may save nine. We are dealing, in a context of very considerable economic expansionary strengths, so I don't think you need to fear any short-term repercussions on the economy. We have to keep an eye on what is best in the long run and, as I indicated in the statement, if we are successful on the inflation side and maintain the kind of pattern that you are suggesting, and that I hope for and really expect myself, in time those interest rates should be coming down.

Mr. ROEMER. I hope you are right. Let me conclude because time is short, and I am sorry to rush you.

We had a statement before the committee from Dr. Gerald Epstein who represents the new School for Social Research and the Center for Democratic Alternatives that the Fed was, in effect, too dependent on the commercial banks and too independent from the Congress in its monetary policy. He went through a number of arguments saying that the Fed should cut its ties with commercial banks and should reduce its independence from Congress.

He pointed out, for example, in his testimony that if you compare the period 1960 through 1978, about 20 years, with the years since 1978, unemployment is up by almost 40 percent in that period. Before-tax profit for nonfinancial corporate sector is down by 30 percent. Real rates of interest are up by 300 percent and net return on bank equity is up 35 percent.

His conclusion was that the American public had a vested interest in monetary policy and interest rates, but both monetary policy and interest rate policy as set by the Fed was geared to the commercial banks whose profits are up and not to American people whose expectations are down.

Do you think his conclusions are accurate?

Mr. VOLCKER. No. I suppose I would ask what happened in the previous 20 years when the opposite must have been the case? It is the same Federal Reserve.

Mr. ROEMER. Maybe his criticism shouldn't have been against the institution but against you, personally, but he didn't state it that way.

Mr. VOLCKER. That would be more logical, I suppose. We should not be an instrument of the commercial banks. I do not believe we are, and I don't know what more I can say.

Mr. ROEMER. Well, I am concluding, Mr. Chairman, by pointing out in Dr. Epstein's testimony he showed us, for example, that the terms of the members of the Fed should be short and made co-terminous with the Presidential election cycle.

In addition, the appointment of the chair of the Federal Reserve System should be subject to a vote of the House and Senate and finally the season open market committee held by regional reserve bank presidents should be eliminated. These are simply the most

blatant symbols of banker influence over the Federal Reserve which now has taken more subtle forms.

I thank you, Mr. Chairman.

The CHAIRMAN. And Mr. Morrison.

Mr. MORRISON. Thank you, Mr. Chairman.

I would like to start, Chairman Volcker, by returning for a moment to the IMF question. When you testified before the committee earlier this year we discussed some of the causes of the crisis. As we try to solve the immediate problem which I think most of us want to do, putting sufficient reserves out there to renegotiate these loans, we ought to take cognizance of how we got to where we are now.

And I think that the committee, in struggling with this in the House when it comes to a vote is going to be looking at the questions of how we got into the situation we are now in.

I think the gentleman from New York, Mr. Schumer, touched on some of that, the question of whether the continued high interest rates and the large profits that the banks made in the good times is part of the problem with these loans and doesn't justify some attempt by the United States in extending its additional credits to move the system toward longer terms and lower interest rates so that the packages that these countries must accept will be more acceptable politically for the countries internally and in terms of the world economic situation that results.

I would like you to comment a little more fully than you had an opportunity to do on Mr. Schumer's question and on mine. Would it not be in the interest of all of us if we could move the system toward somewhat lower interest rates and longer maturities on some of these outstanding loans to try to make a reconstruction process more helpful?

Mr. VOLCKER. I think the general answer to that question is yes, and I think to the extent financial influence has been brought to bear, it has been in that direction. But that doesn't give me a precise statistical answer, I suppose.

Again, we come back to the problem of getting the participation of a large number of lenders, and that interest rate negotiation, in the end, is their negotiation. But, yes, to the extent that it can be done for longer terms and lower interest rates, it helps deal with the situation.

Mr. MORRISON. Don't they also, themselves, have to face up to the fact that if there is an increased risk of renunciation of these loans or greater defaults that the outstanding credits that they have out there are likely to be defaulted on? So they are not really free or totally as free to proceed.

Mr. VOLCKER. That is correct. That is why they are in there in the first place, I suppose. It is a matter of degree. Different lenders will see their position in a somewhat different light, which is a major complication in this situation. I think to the extent we can, we should move in that direction.

Mr. MORRISON. Let me move to the domestic scene for a moment. Would you agree that interest rates, both short term and long term, are at very high rates in real terms?

Mr. VOLCKER. Yes; as I appraise real interest rates. Again, for real interest rates, particularly long term, you have to look toward

the future and what people are expecting. There are surveys made on this score. The last one I saw said the financial people expected the inflation rate over a period of 5 or 10 years to be, I think, between 6 and 7 percent.

In my judgment, that is far too high. But if that is really what they think, that is the measurement that should be used in terms of judging where the real interest rate is.

Mr. MORRISON. Do you have any concern that the structural changes in the financial marketplace and the cost of money to those who ultimately lend is a contributing factor to this new, really historically, unprecedented level of real interest rates, both short term and long term?

Mr. VOLCKER. I think, to some extent, yes, in the sense that in this relatively deregulated system the only restraint on the borrower is the interest rate. Mr. McKinney was talking about the banks freely offering loans for all sorts of things because they could charge an interest rate, and I suspect that, relative to a more tightly regulated system with more credit rationing, in effect—I am not arguing that it is a better system—relative to that system, you probably tend to get somewhat higher interest rates, particularly when there is any pressure on the market now.

Mr. MORRISON. Do you think that a period of lower, long-term interest rates can be realized rapidly with a continuation of our tendency toward fixed rates as opposed to variable rates, and how would you assess the differences between moving to a more variable rate oriented approach to try to get long-term rates down?

In other words, what is the extent to which a fear of repetition of the high rates of inflation we experienced in the 1970's is resulting in artificially high interest rates?

Mr. VOLCKER. We have had a tendency in recent years, given the fluctuations in interest rates and uncertainties, toward variable rate instruments. From the standpoint of a financial institution, particularly a thrift institution dependent upon short-term money and making long-term commitments, that is obviously a prudent financial practice.

I think that is also a symptom of decay, if you will, in what I think of as a well-functioning financial system that could provide long-term money freely at low rates.

In the past 6 months, there has been a considerable tendency for the fixed-rate, long-term markets to reassert themselves. Leaving aside the particular problem of the depository institutions, I think that is a sign of some degree of emerging confidence or willingness to make that kind of a commitment—and a healthy symptom, a desirable symptom.

You asked how quickly rates go down; I think they are inhibited—talking about these long-term fixed rate markets in particular—by the lingering concerns and skepticism on the inflation side, and that is the clearest area in which it is, I believe, demonstrable. You can't expect large, prolonged, sustained declines in long-term rates without confidence about the inflation outlook.

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

The CHAIRMAN. Mr. McCollum.

Mr. MCCOLLUM. Thank you very much.

Mr. Chairman, you testified at Senate hearings that the M's are less relevant for technical and other reasons than sensitive price indicators. I would like to know which price indicators are you looking at and, specifically, what indicators are you looking at that would cause you to tighten the money supply and interest rates?

Mr. VOLCKER. I don't know that I said less relevant. I said sensitive price indicators are something we ought to look at and an important ingredient in our judgment. We had a runup, take the averages, of maybe 20 percent earlier in the recovery period, and it was pretty fast during a brief period of time, but not entirely unexpected in the sense that those prices had been artificially depressed during the recession period. Clearly you weren't going to have recovery without some recovery in sensitive commodity prices.

In the past couple of months, they have been pretty level and somewhat reassuring, I think.

Mr. McCOLLUM. So, there is no specific price indicator that would cause you to want to put this pressure on the last couple of months. Earlier there were?

Mr. VOLCKER. Yes; but even those I would discount heavily.

Mr. McCOLLUM. Well, then, is it just the M's that you are looking at that would cause you to recommend the tightening of the credit in the short term by the Fed.

Mr. VOLCKER. If the M's grow—and liquidity—that's the most important single factor looked at broadly.

Mr. McCOLLUM. Doesn't it primarily have to be M_1 ?

Mr. VOLCKER. M_1 is certainly a factor, given the fact that we don't give that the same emphasis we did before. We also know that M_1 has been rising at 13 percent so far this year. It was rising rapidly in the latter part of last year. It has been rising for an extended period and, yes, definitely that introduces a real note of caution.

Mr. McCOLLUM. The reason I am concerned about it, I heard you say many times M_1 is something you have a hard time getting a grip on these days. While it is true that there has been a 6-month growth rate in M_1 between 10 to 14 percent since last November, the growth rate of M_3 has slowed from 12 to 9 percent.

I don't see how you can judge the basis of what you have been doing on M_1 with that kind of a change in M_3 .

Mr. VOLCKER. What time period were you looking at?

Mr. McCOLLUM. Since November.

Mr. VOLCKER. You may have had a high rate in November for a while. But M_3 is just about at the top of our growth range and has been rising a little more rapidly in the last couple of months.

Mr. McCOLLUM. But it has actually come down. In the same period that M_1 has gone up, it has come down.

Mr. VOLCKER. It may have come down from November, but that must have been a high month. As I say, it is at the top end of our target. It is somewhat of a cautionary signal.

Mr. McCOLLUM. I understand that. Let me ask this just in the same vein. You have said the price indicators have not been that relevant in terms of the recent times, although they would be relevant, but that the activity hasn't made a play on this. Why should we be so concerned about M_1 when the price of gold and other sen-

sitive commodities have been stable and the dollar has been rising against the Deutsche mark and the yen?

Mr. VOLCKER. Because M_1 has risen by enough that, even with deemphasis, it is a factor that goes into that side of the equation. To put the answer a different way, many of the factors that you are mentioning are reasons why the actions that we have taken have not been draconian, to say the least. They have all been factors that suggested a more moderate reaction than otherwise would have been the case.

Mr. McCOLLUM. Well, what bothers me, and I will make this the last question. M_1 is such a turbulent measure of the economy today. By your own admission in the past and all the other testimony we have had here and in Switzerland, which I know is maybe not a good country to use as an example, I have a statistic that shows that M_1 has grown 26 percent annual rate between 1981 and 1982. M_1 in Switzerland grew at 18 percent from the fourth quarter of 1977 to the fourth quarter of 1979 without acceleration of inflation over there appreciably. I just question M_1 a great deal and apparently that is the primary reason why, of all of the indicators that you have been looking at, you have seen fit to make the little tightening you have done.

Mr. VOLCKER. It is not the only indicator. The tightening move has been very limited, as I indicated. Let me just make an observation. I don't know that it will clear anything up, but there has been a fairly rapid increase in M_1 equivalent measures in most of the foreign countries during this period, and it raises questions as to whether there is a common kind of phenomenon going on in many other countries as well as the United States.

Mr. McCOLLUM. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Erdreich.

Mr. ERDREICH. Thank you, Mr. Chairman.

Chairman Volcker, something that puzzles me, about 2 weeks ago we started seeing accounts in the newspaper and media that there were going to be meetings of the Fed to discuss the possible elevating or tightening of credit to elevate interest rates. That was brought up a few days later by the President being quoted as saying that he felt interest rates shouldn't go up.

Then your testimony last week, as I understood it at the Senate side, you revealed that back in May the meetings had already taken place, if I understand your testimony, and what I see in your testimony here today, that produced those higher interest rates.

It just puzzles me that these things surface when actually the decision was made some month-and-a-half ago if I read your testimony correctly. Was there any communication between you and the President were about this tightening back in May? Was it really a revelation that came last week or was it something that had already been communicated?

Mr. VOLCKER. We met and discussed the situation on a number of occasions since May, but it is true that the first step toward a very slight restraint action was taken in May. I think the fact that we were taking slight restraining actions couldn't have been an entire surprise to the administration, as it was not to the market.

Mr. ERDREICH. So when again, last week, the President is quoted as saying that he believes the interest rate should not rise, what you are saying is that there already had been communications and awareness of this tightening going on over the last 6 weeks?

Mr. VOLCKER. In very moderate dimensions.

Mr. ERDREICH. It produced what, about a 1-percent rise in interest rates?

Mr. VOLCKER. Let me comment. It has been a factor, certainly, in short-term money markets. I think there are other things going on during this period that affected the general increase in interest rates, which has been three-quarters of 1 percent, or something in that neighborhood.

Mr. ERDREICH. Well, without that action by the Fed, do you believe you would have had that rise?

Mr. VOLCKER. I believe we would have had some rise.

Mr. ERDREICH. But not that level?

Mr. VOLCKER. Certainly not in a very short-term market probably, but we might have had even more in the long-term market because there might have been concern that the Federal Reserve was letting things get out of hand; but in the short-term market I think our actions had a direct influence. Whether the long-term reaction would have been greater or less, I just don't know.

Mr. ERDREICH. If the economy continues to grow or to recover as your estimate indicates, do you anticipate additional steps such as what was taken in May?

Mr. VOLCKER. Not necessarily. I think the interest rate outlook turns a great deal over the time period of those projections and forecasts on what happens to the budgetary situation. It obviously depends upon the speed of the business advance. But if you were asking me whether we can manage an economic recovery of the general proportions that are forecast with a good mix of fiscal and monetary policies without a rise in interest rates or even with a decline in interest rates, I think that is possible and, again, if we are successful in the inflation side, probable.

Mr. ERDREICH. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Carper?

Mr. VOLCKER. If I may just add, I think any modest tightening we have done recently is designed partly to enhance the prospect that we can manage this recovery without abrupt increases in interest rates and maximize the chances of reduction.

Mr. CARPER. Thank you, Mr. Chairman.

Mr. Chairman, my constituents in Delaware would be disappointed with me if I didn't say that they were pleased with your reappointment and wish you continued success.

Last year before the Senate, you provided some constructive criticism on the IMF bill that is before the House of Representatives. You pointed out how we might improve on that legislation.

Would you care to review those comments with us today?

Mr. VOLCKER. Yes. This article in the press last week surprised me a bit because it goes back to a letter I had written a couple of months ago, and to some discussion with Congressman Neal at that time. It is a matter of concern to us that basically the administration would have no authority to participate with other countries in an SDR increase without coming back to the Congress.

I feel that the arrangements surrounding the SDR have been carefully circumscribed and controlled by various voting devices and otherwise to make sure that the increase is not excessive. But there are times when prompt action is necessary and desirable, as present law provides within limitations. The administration should have that flexibility, and it is important to the SDR and the International Monetary Fund.

Now the present restrictions in law could be narrowed or circumscribed, and that is what I had discussed with Congressman Neal. I think he had some sympathy with that approach. I don't want to suggest with any definitiveness what position he may take in the future. I think the point is, can we do something to put reasonable constraints around it, but leave a necessary degree of flexibility? There are constraints now and it is a question of degree.

Mr. CARPER. Second, the budget resolution that has been adopted by the House and the Senate calls for approximately \$75 billion in revenue increases over the next several years—roughly \$12 billion next year, \$15 billion the following year, and close to \$50 billion in 1986.

I would welcome your comments on the possible negative impact that those revenue increases might have on the economic recovery, particularly in fiscal years 1984 and 1985, as compared to the negative impact of not further reducing budget deficits.

Mr. VOLCKER. If you have to resort to tax increases, the impact of reducing the deficit would far outweigh the negative impact of the tax increase itself; it is essential and more than constructive to begin getting that deficit down more rapidly. If that takes a tax increase, I think the balance is clearly on the side of the tax increase.

I suppose those figures are in the resolution. I read, as we all do, a lot of commentary that the prospect of that being enacted is very limited, and my reservation would be on the side of whether, given the spending totals in there and if we are fixed with those spending totals, it is enough soon enough.

Mr. CARPER. Finally, I recently read that the value of the dollar compared to other currencies has appreciated by about 50 percent over the last 3 years on average.

Mr. VOLCKER. Fifty percent, no. The dollar has been very strong. I don't know as it has appreciated much over the last year, but it has certainly remained very strong. It has appreciated certainly 20 or 30 percent over a period of several years, but not 50 percent.

Mr. CARPER. What steps have to be taken by us in Congress to help reverse that cycle, to reverse that trend, and begin to depreciate somewhat the dollar?

Mr. VOLCKER. I sound like a broken record, but one factor in that is the very heavy demands placed upon our capital market.

Mr. CARPER. The budget resolution that has been adopted in the House and the Senate indicates that if we actually pass the revenue increases, if we actually hold the line on spending—

Mr. VOLCKER. I still have a question whether you are making enough progress soon enough, but it is certainly going in that direction. Just looking at the interest rate situation and the dollar situation, it would help.

Mr. CARPER. Again, thank you for your appearance and testimony today.

The CHAIRMAN. Mr. Neal?

Mr. NEAL. Thank you, Mr. Chairman.

Mr. VOLCKER. Mr. Neal is here. I was quoting him, and I thought you weren't here.

Mr. NEAL. Let me say I agree with you. I was a little surprised to see that story, also. We talked about that, as you indicated, a couple of months ago. The reason we put that restraint in the bill was because the creation of SDR by the IMF can have the exact same impact on our credit markets as a quota increase, and we just wanted there to be some restraint. I am sure we can come to some agreement in line with what you were just suggesting.

Of more immediate importance, it seems to me, is the passage of the IMF bill, and I just think that maybe you could express, and your expression would carry more weight than probably anything I could say, what might happen if the House were to bring this bill up and vote on it and it be rejected.

It would seem to me that that would have very negative impact not only on the financial condition of this country but of the world. Would you comment on that, please?

Mr. VOLCKER. I agree with you, and we have gone over this on a number of occasions—I think before you came into the room this morning. But the initial impact is psychological in the sense that this cooperative effort involving many people in this country and abroad to manage this situation would be undercut. That is quite evident and the risks of that effort failing would, therefore, be greatly increased.

The risk is, ultimately, that the situation would deteriorate into a series of defaults that I think would be bound to feed back in our own domestic credit markets and the capacity and the willingness of our banking system to finance recovery here. It is going to have impacts both on the availability of credit and interest rates, and that risk is a significant one.

Mr. NEAL. Well, I quite agree with you. I want to tell you publicly here about a little political problem that we have with the bill. It is our understanding that only about 60 Republican Members have indicated that they might vote for it, and even that count is pretty soft. The fact is that it is going to be difficult to ask Democrat Members who want to be responsible in this area to take the lead if there cannot be Republican support.

The President is asking support for the IMF, as has every President from Franklin Roosevelt through Ronald Reagan. Every Congress has known that it is in our best interest to participate fully in the IMF and yet at this point we find ourselves with not very many Republican votes for this bill.

And I just think that it would be a disaster if we brought the bill up and failed to pass it, and I would hope that we wouldn't bring it up until we have a solid commitment from at least 100 Republican Members in Congress.

Mr. VOLCKER. I can't make the point right now because there doesn't seem to be any here.

Mr. NEAL. Not right now, but if you find ways to do it, I certainly hope you will do it, Mr. Chairman, because this is no minor issue.

Mr. VOLCKER. I understand.

Mr. NEAL. Just on one other subject, if I can. I don't find it too terribly surprising that those people with resources to commit for the long term are thinking that we might have a recurrence of inflation. We are proceeding with a tremendously stimulative fiscal policy. We have had a rather stimulative monetary policy over the last several months. Oil prices are down. We have had some good luck in the short term. It should be no surprise that the economy is perking right along.

But, if you look at the long term, I am not aware, of any time in history when the Fed did not ultimately monetize the debt. Am I wrong about that? Is my sense of history wrong? I hope that it wouldn't happen again.

Mr. VOLCKER. I don't know quite what you mean by monetizing the debt, but we certainly cannot afford a period of the kind of increases in liquidity and the money supply that would regenerate inflationary pressures. I think you have expressed very well the counterpoint to Mr. McCollum's question; I don't know if you were here.

Mr. NEAL. Yes, I was here.

Mr. MCCOLLUM. He was citing all the evidence that the current inflationary picture is rather quiescent.

Mr. NEAL. I wouldn't want to bet on that.

Mr. VOLCKER. And you have just expressed the other side of it. We are aware of both sides and have to make the decision, and we made for the moment the decision that we made.

Mr. NEAL. What about on the historical question? Has there been a sustained period when there were big deficits that the Fed didn't move to accommodate that?

Mr. VOLCKER. We have never had a deficit problem quite of this sort, to my knowledge. The Federal Reserve certainly accommodated deficits in the World War II period and they were monetized, in any definition of the word, to a considerable extent. The budget was in reasonably good shape, certainly by today's standards, through the 1950's.

Mr. NEAL. That is what I am thinking of. During the Vietnam war period, we did something very much like we are doing now.

Mr. VOLCKER. In retrospect, you have to say whether or not you call it monetizing the debt. I don't remember, in a technical sense, how much debt the banks were buying during that period. You wish, in retrospect, that more restraint had been maintained on the growth of money and credit from the mid-1960's for some period thereafter.

Mr. NEAL. But it wasn't.

Mr. VOLCKER. But it wasn't. And, of course, the same problem arises during that period that we have now. In any short-term context—going back a little bit to projecting economic objectives in the short run—I think the way policymakers and others, undoubtedly urged by the Congress, looked at it at that time was that inflation was only beginning. It was not all that much. They said, "Let's not take a risk of too much restraint because maybe economic growth

this year will be a little larger if we don't." And then the next year, of course, the same decision is made; you put those decisions together and you end up with a problem over time, and that is what we would like to avoid.

Mr. NEAL. Public pressure for low interest rates will certainly continue, and I just don't see how, in an expanding economy, when the needs of the Government collide with those of the private sector, and the public is asking for low interest rates, you are going to accomplish it.

Mr. VOLCKER. There is a sense in which we have been monetizing debt for the last 6 months. Business credit demands have been low. Government is borrowing a lot of money, and there has been quite an increase in bank holdings of Treasury securities. Under the circumstances, perhaps that is understandable, but to the extent that it is accompanied by too rapid growth in liquidity and money over a period of time, it is a source of concern. That is one way of looking at the budgetary situation.

Who is going to buy those Treasury securities, if the banks don't, when the business credit demands increase? If you have difficulty selling them, that means pressure on the market. They are going to be sold all right, but they are going to be sold by putting pressure on the market.

Is that good for housing? No. Is that good for business investment? No. But can it be dealt with by monetary policy? No.

Mr. NEAL. I think you are right.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

I might rhetorically say I think it depends really on what the Government uses that money for. If it uses it for tax expenditures, that doesn't result in a productive type of investment. I think, then, the answer is no. So I mean ultimately I think that you are really begging the question. The assumption, I don't think, is anything to apologize for in terms of the Federal Reserve Board accommodating and making the economy work, monetizing the debt, or whatever the adjectives you could add to it.

Mr. VOLCKER. If the Government was really spending \$200 billion for productive investment, you would have to look at it somewhat differently. I don't think the Government is.

Mr. VENTO. I tend to agree and say "amen" to that in terms of where things have gone in recent years. But in any case, let me get back to the focus of the report that you made today.

I want to also congratulate you on your reappointment, and I hope that things go better in this term for you than what I believe they have in the past term.

One of the disagreements that we have had is over the monetary aggregate issue which started in October of 1979 and had been pursued pretty vigorously through the middle of last year, a 3-year period, Mr. Chairman. It seems to me the things that you have said with regard to monetary aggregates especially with regard to M_1 , paying close attention to the discussion between you and Mr. Mitchell, indicate a great deal of uncertainty about those monetary aggregates.

But yet we seem ready now to run back and try to jump within the lines, so to speak. We have never been very successful in stay-

ing within those lines. Is this a message to Congress that we are going to have less accommodation? I applaud the accommodation that occurred last year. I think it ought to continue. I want to be put on the list of supporters asking for accommodation of the Federal Reserve Board of what the policies of the National Government are with respect to the economy. Is that the message that you are giving us?

Mr. VOLCKER. The message is one of degree. Do I hear some concern about the monetary aggregates or even M_1 ? Yes. By historical standards, if it were rising at 7 percent, let's say, it would be high and it is higher than we would have intended some years ago. If there is enough uncertainty about it, that wouldn't bother me particularly. When it is 12 or 13, I have to question it.

Mr. VENTO. My concern is that you seem so sensitive to these monetary aggregates.

Mr. VOLCKER. That is not very sensitive—the difference between 7 and 13—

Mr. VENTO. Well, that is what you are utilizing and yet not looking at some of the other things like real interest rates and the inflation rate. You could always make a pretty good case, especially today, for tight monetary policies—highest deficit in history, trade deficits, defense spending at unprecedented level.

But you could make the case for other things, like real interest rates, cuts in social security benefits this year, the value of the dollar on the international market. I think that this is what the problem gets to be.

Mr. VOLCKER. All I can say is I have raised some of these considerations. Mr. McCollum raised some of the considerations. I agree there are many encouraging signs and the inflation picture to date has been favorable. We have to balance that against these other warning signals for the future. The committee has to sit down and weigh all these things and reach some judgment, and we have certainly put into that balance the indications that liquidity and money may be rising faster than is sustainable or good for sustained growth over time.

Mr. VENTO. Well, I think the concern that I have, and most people have, is the real interest rate, the difference between inflation and the actual rate being charged, and that would seem to me to give you so much insulation and so much early warning that you would have so much running room in between there. I don't understand how—

Mr. VOLCKER. Let me put it this way, Mr. Vento. We may have had a discussion very much like this some months ago. I know I did in the Senate, about the feeling that real interest rates are so high that we ought to be looking at real interest rates as crudely defined because the economy could not grow. It could not reach the projections that we then presented because the interest rates were too high.

Since then, economic growth has been much faster than we expected and interest rates aren't any lower.

At the moment—and I am not saying this is good for the long run—I say again my suspicion is these interest rates have to come lower to have a sustained, balanced, recovery over a period of time.

But at the moment, the economy is having a reasonably vigorous expansion at the current level of interest rates.

Mr. VENTO. But my time has expired, but at the moment, I think we are also talking about a restrictive versus accommodative, and I think that is the key here that we want to maintain that accommodative posture especially with this running room.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Vento.

Mr. Chairman, one of our members who was here all morning had to leave because he had a meeting, but he asked me to propose a question to you, which I shall do, and I would ask you to answer for the record as you will be doing with other questions that will be submitted.

And the question from Mr. Levin of Michigan is: If there is no action on the fiscal side to reduce the projected deficit, when, in your opinion, is the crisis likely to occur? If you would answer that for the record.

[The information follows:]

Chairman Volcker subsequently furnished the following in response to a question posed by Congressman Levin:

I don't want to talk in terms of "crises" and I certainly can't pinpoint a crisis date, but I think we can make certain points about the growing risks implied by unabated budget deficits. Even now the call of the Federal Government on the markets adds to interest rate pressures. But we have been able also to say, in the midst of recession, that it has provided purchasing power.

Now, with the economy growing rapidly (particularly consumption), demands for mortgage and consumer credit are picking up. The dangers of a "squeeze" and stronger interest rate pressures will increase--perhaps strongly--when business credit demands also rise sharply. That day will come closer the more rapid the expansion. With a continuing strong expansion, the problems could be apparent toward the end of this year and in 1984--potentially jeopardizing the orderly progress of the economy.

Continued progress against inflation could be one potentially strong counterweight. But what would remain true is abnormally high real interest rates, with the risks described.

The CHAIRMAN. I would say to the members that the Chairman had asked to be allowed to leave at quarter of one, and we have gone beyond that, but I would say to the Chairman that the reason for that having occurred is the fact that I think it is important to note the emphasis placed on these hearings by the members of this committee. We have had exceptional attendance and participation.

I think the hearing has been a very productive one and a very meaningful one, and I am hoping that the colloquies with the various members, particularly on the IMF which I think is the most very crucial issue of the day, will be utilized by the media because the American people have to know that there are two sides of that IMF question, and it is good to hear the Chairman of the Federal Reserve Board express his opinion as to the importance of the adoption of that legislation and to put to rest some of the spurious and ridiculous arguments that have been made in opposition to that legislation.

Mr. VOLCKER. I appreciate the importance of these hearings in general. But I think it is particularly timely in respect to the IMF. To the extent that members still have questions—and I know that they do—let me repeat again that the IMF is not a new institution. It has been consistently supported by administrations of every political dimension and stripe for the entire postwar history.

It is in the midst, now, of dealing with a situation that is more difficult, a situation in which its presence and strength is more necessary than ever before in its history, and I think it is terribly important to our own economic welfare, our own recovery, our own level of interest rates that that legislation be passed.

The CHAIRMAN. Chairman Volcker, as I stated earlier, there are other members who have additional questions they would like to propound, and I am sure you would be happy to reply in writing for the record.

Mr. VOLCKER. I would be happy to do so.

The CHAIRMAN. Thank you, Chairman Volcker.

[Whereupon, at 1 p.m., the committee was adjourned to reconvene on July 21, 1983.]

[The following additional written questions were submitted to Chairman Volcker by Congressman Vento, and appears with Chairman Volcker's responses:]

Question #1. It is generally agreed that in August, 1982, the Federal Reserve shifted to a more accommodating monetary policy. (A move which I, incidentally, applaud.) As a result of our tight money policies of recent years, have we learned something new about the value and accuracy of using monetary aggregates as the primary measurement and criteria for the performance of the economy? If this has led us to a re-evaluation of the value of monetary aggregates as a simultaneous tool and measure of monetary policy, was this the primary cause of the shift in policy in August, 1982? If not, what was the primary cause for the August, 1982, change in policy?

The behavior of the various monetary aggregates and interest rates since the late summer of 1982 reflected both policy adaptations to shifts in the public's preferences for money and the behavior of the economy. The substantial drop of interest rates in the second half of 1982 reflected Federal Reserve easing of pressure on depository institutions reserves to help sustain money growth, the further weakening of the economy and private credit demands, and reduced inflationary expectations resulting from the sustained improvement in price performance. In the process M2 and M3 grew around the upper limits of their longer-run target ranges.

M1 growth, however, accelerated sharply and was well above its longer-run range in late 1982 and into the early part of 1983. The Federal Reserve was more accommodative to overshoots in M1 growth than it had been earlier. It had become evident that the public's demand for assets in M1, particularly for NOW accounts which paid a ceiling interest rate, had increased sharply--with the result that the velocity of M1 declined in the second half of 1982 by much more than it usually had in a cyclical contraction. In part this decline, which continued into the first quarter of 1983, reflected the special circumstance of a large movement of funds into NOW accounts--which perform both a savings and transactions function and have come to be an increasing share of M1--as the cost of holding

these highly liquid balances dropped sharply with the decline in market interest rates. More recently the velocity of M1 appears to be rising, though by less than in earlier cyclical expansions.

The atypical behavior of M1 velocity caused in part by the increased importance of NOW accounts, together with uncertain affects on M1 associated with the maturity of All Savers Certificates in the fall of 1982 and early 1983, led the Federal Reserve to place less emphasis on M1 as a policy guide than it had previously. The broader aggregates were given more emphasis, though it was recognized that these too would be distorted, at least for a time early this year, by the availability of new deposit instruments.

It seems to me that these experiences simply underscore a basic premise that has always been a key element in our approach, which is that a certain flexibility in achieving and evaluating monetary targets is needed in light of changing financial practices and institutional arrangements. Incoming data on money growth will always have to be interpreted in relation to information about a variety of economic and financial indicators. Even so, experience over long periods in a variety of circumstances has shown that, interpreted with care, monetary aggregates can be and normally are valuable guides to monetary policy formulation and implementation.

Question #2. In light of some current economic conditions, supporters of a tight money policy can make a very strong case. For example, the current federal fiscal policy is extremely expansive and the federal deficit in nominal dollar terms, in terms of percentage of G.N.P. and in terms of percentage of total savings, is extremely large. In addition, there seems to be little likelihood that reductions in federal spending or increases in federal revenue will reduce the deficit. These circumstances appear to me to be precisely the type of conditions which prompt many people (and indeed the Federal Reserve in years past) to call for a tightened money supply.

On the other hand, for the past several months, forces have acted, during a time of an accommodating Federal Reserve Board policy, to restrict the availability of credit. In spite of low inflation, real interest rates remain high enough to restrict the availability of credit to such a degree that it is not realistic to fear a new round of inflation by a rapidly expanding economy fueled with easily affordable credit. It seems to me that the effect of the market forces (higher priced credit) has been essentially the same as the effect of a tightened monetary policy (scarce supply of money, leading to higher priced credit). While the effect has been the same, the method of obtaining this result is very different.

If these market forces continue to result in high real interest rates, do you foresee a need to move away from the Federal Reserve's more accommodating monetary policy in the near future?

The overriding objective of our monetary policy is to promote a period of sustained noninflationary growth in the economy. In choosing monetary and credit growth ranges to promote this end, one of the important factors we have taken into account is the expansive stance of fiscal policy and the likelihood that the federal deficit would remain extremely large. As you note, these deficits--actual and prospective--have served to keep real interest rates at unusually high levels, but these rates apparently have not interfered with a substantial rebound in economic activity this year.

We believe our ranges for money growth are appropriate for attaining the objectives we all share for the economy. In recent months--with the economy rebounding strongly--we have moved in a measured way to a slightly

less accommodative reserve supplying posture to assure control of money growth over the longer run. This move had the effect of producing a firming in money markets in the short run, but by promoting greater confidence we would adhere to a noninflationary course, we believe these actions have helped to reduce the risk of a greater tightening in credit market conditions down the road.

The moderate rise in interest rates over recent months has reflected as well the massive borrowing needs of government, and concerns that these are beginning to compete with expanding private credit demands in a growing economy. A more accommodative monetary policy would not prevent such a conflict for a limited volume of savings, but would only promote an imbalanced recovery and future inflation and recession. A reduction in budget deficits is the key to reducing these high real rates and ensuring a balanced, sustainable expansion in economic activity.

Question #3. I have been concerned about the fact that interest rates seem to be staying at historically high levels relative to the inflation rate. (I think most economists will agree that interest rates have traditionally been approximately 3-1/2 percent above the inflation rate.) This has been true for many months now, and it seems that this irregularity is even more important now that we have begun to come out of the recession.

In the exercise of your monetary policy tools to control the money supply, to what extent are you limited by the fact that some profitable corporations, and individuals, are, in effect, only paying half of the market rate of interest on their borrowings after deducting interest expenses from their taxes?

Would you comment on whether interest rates have in part remained so high above the inflation rate because of this tax treatment?

If a substantial segment of business is sufficiently profitable to be paying a net interest rate below the rate at which their investments are inflating, does this create a distortion in the economy?

I do not view the tax treatment of interest payments as an important limitation on monetary policy, but it to some extent does influence the allocation of financial and real resources--depending on which firms or individuals are receiving favorable tax treatment on their borrowing relative to the tax treatment on their earnings, which is in turn affected by such issues as whether their earnings are in the form of current income or capital gains or the impact of using available depreciation and inventory accounting methods. While, in practice, the influence is difficult to measure, the level of real interest rates (before taxes) in the market appears to be higher than they otherwise would be, in a period of general inflation, because of various properties of the tax laws. While the basic characteristics of the tax treatment of interest have been in place for many years, the impact is different, and potentially greater, during a period of high actual or expected inflation. However, at the present time, high "real" rates in large part reflect pressures generated by current and expected unusually large federal deficits.

Question #4. Chairman Volcker, the fundamental purpose of the Humphrey-Hawkins Act is to require that in setting national economic policy, equal consideration should be given to several economic factors, such as unemployment, inflation and interest rates. However, I don't think that it can be disputed that your recent policy has concentrated on reducing inflation at the expense of the highest real interest rates and unemployment rates in memory.

For instance, in your report, you project unemployment rates in 1983 at 9-1/2 percent and about 8-1/2 percent in 1984. What if we changed the Humphrey-Hawkins Act to require you to place the greatest emphasis on unemployment?

What changes in policy would you pursue if you were required, as your primary responsibility, to achieve a 6-1/2 percent to 7 percent unemployment rate to the end of 1984?

If we were to give primary emphasis to reducing the unemployment rate to the 6-1/2 to 7 percent area by the end of 1984, we would have to increase money growth even more rapidly. But such a policy emphasis would be not only short-range but also short-sighted. The kind of aggregate demand stimulus needed to achieve such an unemployment rate by the end of 1984 if indeed that were at all possible, would give tremendous impetus to inflation and sow the seeds of future economic disruption. A longer-range focus on achieving sustainable economic expansion in the context of moderating inflation provides the best hope for achieving durable progress on the employment front.

CONDUCT OF MONETARY POLICY

THURSDAY, JULY 21, 1983

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

The committee met, pursuant to call, at 10:15 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Frank, Patman, Roemer, Cooper, Kaptur, Levin, Carper, Wylie, Lowery, Hiler, Ridge, and Bartlett.

The CHAIRMAN. The committee will come to order.

I would like to welcome our witnesses to the final day of hearings in this committee's review of monetary policy under Humphrey-Hawkins.

Our first day we heard very informative testimony by business and academic economists. Yesterday, Chairman Volcker demonstrated once again that the handwringing Cassandras of renewed inflation were crying in vain. His blunt statement that monetary policy would not be tightened was just the tonic to boost both bond and stock markets into a major rally of relief that tight money and renewed recession were not the Fed's prescription of choice. Today will certainly be as interesting as the previous hearings.

We will be listening to Dr. Andrew Brimmer, a former Governor of the Federal Reserve System and now Chairman of the Monetary Policy Forum; Gordon Pye, chief economist of Irving Trust Company of New York; Professor Benjamin Friedman, a neighbor from Harvard University; and Professor Sam Bowles of the University of Massachusetts at Amherst.

Professor Bowles will arrive slightly later, and we will interrupt the questioning, if it has begun, to allow him to make a brief statement.

Gentlemen, again we welcome you. It is good to see you again, Dr. Brimmer.

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

The CHAIRMAN. I hate to say this, but we were here together when you were at the Fed.

Mr. BRIMMER. We were.

The CHAIRMAN. We are going to put your entire statement in the record. So why don't we ask you to be the leadoff witness this morning.

STATEMENT OF ANDREW BRIMMER, PRESIDENT, BRIMMER & CO., AND CHAIRMAN, MONETARY POLICY FORUM

Mr. BRIMMER. Good. Thank you very much, Mr. Chairman.

As you have already indicated, Mr. Chairman, I am appearing today in my role as chairman of the Monetary Policy Forum, which was recently established.

As my statement describes in some detail, this voluntary organization of financial analysts and businessmen was started with the aim of providing objective and dispassionate analysis and research on the formulation and conduct of monetary policy, with special emphasis on the effects of policy on the real sectors of the economy.

In anticipation of my appearance before this committee, I asked the members of the forum to respond to three basic questions concerning the conduct of monetary policy at this juncture.

The first question was the following: Should the Federal Reserve act now to bring the growth rate of the money supply, M_1 , down to the previously set target range of 48 percent? If yes, why? If no, why not?

I should say, Mr. Chairman, that that telegram went out to members of the forum about 10 days or 2 weeks ago.

The second question was, should the discount rate be raised now? If yes, why and by how much? If no, why not?

The third question was, at this stage of the economic recovery, what should be the objectives of monetary policy?

We have now heard from virtually all of the members of the forum and I can summarize very quickly the responses to the questions.

In general, the members of the forum believe, and I share these views, that the accommodative monetary policy purviewed by the Federal Reserve of the last year has been appropriate. The degree of restraint on banking reserves being exerted by the central banks is about right and it should not be increased further.

The prevailing configuration of interest rates is consistent with the transition of the American economy from recovery to sustained expansion without rekindling inflationary pressures. However, the persistence of large Federal budget deficits is casting a shadow over the money and financial markets, which threatens to exert substantial upward pressure on long-term interest rates.

Such an outcome would arrest the expansion of output and leave the economy with considerable unused capacity and excessively high levels of unemployment.

You will recall, Mr. Chairman, that in the summer of 1982, partly because of the severe recession, the Federal Reserve did adopt an appropriate policy of accommodation. The growth of money and credit responded, and the level of interest rates declined substantially. That was, of course, a reversal of the earlier policy, which was essentially a monetarist approach to the conduct of monetary policy.

That particular approach had a mixed result. It helped to check the worst bout of inflation we have had in peacetime but it also left a residual which was the worst recession we have had since the end of World War II.

Therefore, the shift to an accommodative policy last year was appropriate and the Federal Reserve committed itself to conduct monetary policy in a way to achieve expansion and sustained growth without inflation. We think that was appropriate.

Now, the members of the forum responded to the question with respect to the monetary aggregate in a variety of ways, but in general, the conclusion reached by the members of the forum is that M_1 , as traditionally defined, as one member said, is "meaningless because of the definitional problems." And for a variety of other reasons, reflecting innovations in a banking system and the change in the public demands for more money, it would be unwise to gear the conduct of monetary policy substantially to M_1 .

The members of the forum also thought it would be extremely unwise for the Federal Reserve to seek to reduce the growth rates of the money supply, M_1 , back to the range of 4 to 8 percent. It turns out, of course, that, while we had no way of knowing that, that the Federal Reserve apparently concluded also that the older base and the older targets were inappropriate. And, as we were told by Chairman Volcker yesterday, the new base is the average for the second quarter of 1983 and that target growth range is 5 to 9 percent for the balance of this year, and a new range of 4 to 8 percent would be established for 1984.

In our opinion, that was a wise decision and it should provide substantial liquidity for the economy over the rest of this year. We would support the Federal Reserve in that condition.

With respect to the discount rate, all members of the forum concluded that it would be unwise and unnecessary to raise the discount rate at this time. On the other hand, I personally do recognize that the discount rate, which is so far out of line with the cost of money to the banking system, which is typified by the Federal funds right now, that that discount rate of $8\frac{1}{2}$ percent does represent a sizable subsidy to the borrowing banks. That is a subsidy of public money to the member institutions. In my judgment, it is unjustified.

But nevertheless, if the discount were to be raised at this time, it would represent a wrong signal. Consequently, we think that the Federal Reserve has some ways through moral suasion, if necessary, to assure that borrowing does not become excessive.

The CHAIRMAN. Excuse me. I am going to interrupt you here for a second.

Mr. BRIMMER. Yes, Mr. Chairman.

The CHAIRMAN. When you say that an increase in the discount rate, despite the fact that you and your colleagues as well as many others feel that it is, indeed, a subsidy to those banks that are utilizing it at this point in time, and that was addressed yesterday in the hearing, it would convey a wrong signal.

Now, are we not at a point where if Chairman Volcker should give up cigars, for instance, would that convey a wrong signal? Aren't the markets at a point where they attribute too much to too little, the insignificant minutia?

Mr. BRIMMER. I agree wholeheartedly with your last conclusion, Mr. Chairman. Too many observers are giving too much weight to symbols.

The CHAIRMAN. Do you think that perhaps what has happened is that because of the veil of secrecy that prevails at the Fed, that a school or a religion has come into being and that religion is second-guessing or trying to first-guess the Fed, what the Fed is doing or will be doing by looking at certain actions they take that are patent and obvious and, from that, attempting to analyze what they are saying and doing and thinking in their secret meetings?

Mr. BRIMMER. Well, Mr. Chairman, it is more than that. It is not only a religion but a whole industry now is flourishing consisting of persons who devote a good bit of their time, banks and other institutions, brokerage firms, trying to anticipate what the Federal Reserve will do and act accordingly.

I agree with your judgment that that emphasis is overdone, but nevertheless it is done.

The CHAIRMAN. But what it demonstrates is that the secrecy that prevails, and we won't go through all the arguments for or against it, but the fact of the matter is that it is a two-edged sword because it does produce adverse results such as this, that the Fed is in a position where they feel, as you stated, I think, quite accurately, that were they to increase that discount rate at this point, it would convey a signal that would be detrimental. So therefore, the other side of the two-edged sword.

Mr. BRIMMER. Precisely, precisely.

The CHAIRMAN. Thank you.

Mr. BRIMMER. Thank you, Mr. Chairman.

Now, the final question we asked was, as I said, what should be the appropriate goals of monetary policy at this time?

Here, the members of the forum were unanimous. They believe, and I share this view, that the proper objective of monetary policy at this stage of the recovery should be to support continued expansion and the positioning of the economy on the path of sustained expansion and the creation of new jobs without rekindling inflation.

Now, the members of the forum who share these broad objectives also emphasize and stress a number of specific tasks. These are described in some detail in my statement. But basically, our several members believe that the recovery is getting under way.

It is already under way, but some of our members believe that it is a fragile recovery, that it is not broadly based and that a great deal needs to be done to assure that the growth in activity spreads through the basic remaining elements of the economy, such as increases in real spending on plant and equipment and improvements in the foreign trade balance, both of which continue to be very weak.

They also believe that it is important that we sustain growth to reduce what by our standards is an extremely high level of unemployment, with unemployment rates among minority groups and so on being still at historically high levels.

Finally, we believe that it is absolutely important for the other side of stabilization policy to be addressed, and that is the role of fiscal policy.

We believe that fundamentally, from now on the focus of public policy must be on fiscal policy. Monetary policy alone should not be

asked to carry the sole burden of restoring this nation to the path of price stability, growth, and expanded employment.

As I said, Mr. Chairman, I would be delighted if you would put this entire statement in the record.

The CHAIRMAN. Without objection, we shall do that with your statement as well as that of your colleagues this morning. We are certainly not disappointed in your statement. It is very meaningful and helpful, and we look forward to asking you questions.

Mr. BRIMMER. Thank you.

[The prepared statement of Mr. Brimmer on behalf of the Monetary Policy Forum follows:]

MONETARY POLICY AND THE AMERICAN ECONOMY
Translating Recovery Into Expansion

By

Andrew F. Brimmer*

Mr. Chairman and Members of the Committee, I was delighted to receive the invitation to present my views on the appropriate course for Federal Reserve monetary policy. I appear at these Hearings in my capacity as Chairman of the Monetary Policy Forum. In part of my testimony, I will summarize the comments and appraisals of monetary policy by Forum members.

The central point in my testimony can be stated succinctly: at this stage of the economic recovery, the Federal Reserve should continue to pursue an accommodative monetary policy. If such a policy were to be replaced by much greater restraint on the growth of money and credit, the pace of economic expansion would be slowed considerably, and the presently high level of unemployment would decline very little.

* Dr. Brimmer is President, Brimmer and Company, Inc., a Washington, D.C.-based economic and financial consulting firm. He is also Chairman of the Monetary Policy Forum. He is a Former Member of the Board of Governors of the Federal Reserve System.

Monetary Policy Forum

The Monetary Policy Forum was established to provide a systematic and objective examination of Federal Reserve monetary policies. The Forum's membership is composed mainly of economists, business and financial analysts, and participants in financial markets. Through research, analysis, discussions and publications, the Forum will seek to increase public understanding of the nature and economic effects of Federal Reserve policies designed to influence the availability of money and credit and the level and structure of interest rates. The inter-relations between monetary and fiscal policies - and their joint impact on economic activity - will also be examined by the Forum.

Monetary policy in this country is formulated and implemented by the Federal Reserve System (and especially by the seven members of the Board of Governors and the twelve-member Federal Open Market Committee). These key decision-makers do maintain contact with participants in the private sector of the economy - particularly with banks and other financial institutions. However, they do not have a continuing opportunity to benefit from the assessment of the impact of monetary policy by business leaders, economists, and financial analysts meeting in a common setting. The Forum was established to fill this void.

The Forum is non-partisan, and its membership spans a wide range of political views as well as different approaches to economic analysis. Therefore, members cannot be classified neatly either as

"monetarists" or as "anti-monetarists." However, they do believe that "money matters" - at least to some degree - with respect to its impact on output, employment, and prices. But they do not believe that control of the narrowly defined money supply (M1) should be the dominant objective of Federal Reserve Policy.

In carrying out its program, the Forum will give particular attention to the inter-relations among financial variables - such as changes in the money supply, credit availability, and interest rates - and the level of economic activity. The Forum already has underway a periodic Survey of its members to obtain their forecasts and assessments regarding financial and economic developments. The Survey results will be presented in the Forum Report, which will be published monthly. Through a "Forum Papers" series, the findings and conclusions of conferences, discussions, and studies (some of which will be specially commissioned) will be published. From time to time, the Forum will hold Discussion Sessions and Conferences in which a variety of issues relating to monetary and fiscal policies will be explored.

Appraisal of Monetary Policy

In anticipation of my appearance at these Hearings, I canvassed members of the Monetary Policy Forum to obtain their assessment of the way in which the Federal Reserve is presently conducting monetary policy. As a basis for the evaluation, three questions were posed:

- (1) Should the Federal Reserve act now to bring the growth of the money supply (M1) down to the previously set target range of 4 to 8 per cent? If yes, why? If no, why not?

- (2) Should the discount rate be raised now? If yes, why and by how much? If no, why not?
- (3) At this stage of the economic recovery, what should be the objectives of monetary policy?

The responses to these questions indicate a broadly based consensus: the accommodative monetary policy pursued by the Federal Reserve over the last year has been appropriate. The degree of restraint on bank reserves being exerted by the central bank is about right, and it should not be increased further. The prevailing configuration of interest rates is consistent with the transition of the American economy from recovery to sustained expansion without rekindling inflationary pressures. However, the persistence of large Federal budget deficits is casting a shadow over money and financial markets which threatens to exert substantial upward pressure on long-term interest rates. Such an outcome would arrest the expansion of output and leave the economy with considerable unused capacity and excessively high levels of unemployment.

Strategic Objectives of Monetary Policy

It will be recalled that, in the summer of 1982, as the severity of the recession became more apparent, the Federal Reserve adopted a much more accommodative monetary policy. Bank reserves were supplied generously at a time when the overall demand for funds was subsiding. The net results were a significant increase in credit availability and a marked decline in interest rates.

Prior to last October, the Federal Reserve's policy was based on an essentially monetarist approach. Primary emphasis was placed on influencing the growth of bank reserves and the monetary aggregates

(particularly M1) while the control of interest rates received less weight in policy decisions. The main objectives of monetary policy were the eradication of inflation and the creation of conditions for sustained economic growth.

The results of the monetarist approach were quite mixed: it contributed substantially to checking the worse bout of peace-time inflation this nation has seen. But, at the same time, it also helped to throw the economy into the worse recession since the end of World War II.

In an effort to end the recession (and also partly because of tensions in the international capital markets), the Federal Reserve adopted a more accommodative policy in October, 1982. In response to the change, money and credit expanded at a rapid rate. In fact, by the spring of this year, one measure of the money supply (M1) was growing at a rate far in excess of the range set by the Federal Reserve. This led to strong suggestions (both within and outside the Federal Reserve) that efforts be made to curb the growth of the narrow money supply.

Behavior of the Monetary Aggregate

In my opinion - and in the opinion of most members of the Forum - it would have been extremely unwise for the Federal Reserve to act to restrain the growth of M1 to the 4 to 8 per cent range from the fourth quarter of 1982 to the same period this year. That target was announced by the Federal Open Market Committee (FOMC) last January. At that time, however, the Federal Reserve also stated that - partly because of the introduction of several new

types of deposit accounts, other banking innovations, and a sharp decline in velocity - the narrow money supply (M1) had been greatly distorted and was no longer a reasonable proxy for the behavior of nominal gross national product (GNP). Consequently, the FOMC would give little weight to M1 in formulating and implementing monetary policy.

As the situation unfolded, M1 expanded at a rate greatly in excess of the Federal Reserve's target range. For example, through mid-July this year, M1 rose by 14 per cent at a seasonally adjusted annual rate (SAAR). This very strong, above-target growth rate (despite the FOMC's de-emphasis of M1) generated renewed fears of rekindling inflation and fostered considerable uncertainty over the likely course of monetary policy. It led many participants in money and capital markets to anticipate an early shift to a much more restrictive policy which would produce a sharp boost in interest rates. At the same time, some observers criticized the Federal Reserve for permitting the above-target growth of M1 and demanded that steps be taken to restrain it.

But, as already mentioned a large majority of the Forum members believe that such a move would have been unnecessary as well as undesirable. One member stated:

Target growth rates for M1 are meaningless because of definitional problems. Emphasis on the aggregates should be on broader items, and one should look at the "Adjusted Bank Credit Proxy." If a target range needs to be established for M1, use the 4 to 8 per cent, but apply it to the old M1A (currency plus demand deposits subject to check).

Another view held:

Even though M1 velocity appears to be returning to trend (versus its sharp decline since mid-1982), the savings character of NOW and Super-NOW accounts still makes it difficult to say what the "proper" growth rate for M1 really is. A better procedure would be to set the reserve path based on a target for some broader aggregate - preferably M2 - whose behavior relative to the economy has been more stable.

Still another response held:

The Federal Reserve should not try to bring money supply growth back into the target range that it set earlier this year. [The narrow money supply] (M1) is obviously distorted by institutional changes, and its growth rate cannot be related to economic performance in any meaningful way. Apart from that, even if it were not distorted in this way, policy should not be tightened because of M1 developments when other, more direct evidence on the economy tells us we should encourage expansion. That is where we are today.

On the other hand, three members of the Forum thought the growth of M1 should be moderated. To quote two of them:

Although there are many who say that M1 is not very meaningful, the response of the economy says that it is... The Federal Reserve should move to bring it into the 4 to 8 per cent range over the next four-to-five months because the economy is about to take off into a much faster rate of expansion.... The M's have been more meaningful than the doubters have given credit. The test of monetary policy is how the economy responds to it, and the economy has been responsive.

Another advocate of restraint said:

In recent months, M1 has increasingly become a good proxy measure once again for the nominal value of transactions in the U.S. economy. The new depository instruments, the Super-NOWs and the MMDAs, which previously had been

distorting M1 and M2, have settled down. With M1 a better proxy for nominal GNP now than earlier this year, its bulge in the second quarter reflected a greater-than-desired rise in the economy relative to implicit Federal Reserve goals, suggesting the need for some slowing in the second half. Some attempt now to reduce the rate of growth in M1 would make less necessary a tightening of monetary policy later this year that perhaps might have to be even more pronounced to slow the economy and ease monetary growth. A modest dose of restriction or less accommodation now will help to hold the initial stage of the expansion at a more sustainable pace, with a posture on the part of the central bank of slower growth early postponing the time when a new reacceleration of inflation could pose new problems for the economy.

But, as I stated above, most members of the Forum thought any attempt to wipe out the earlier bulge in M1 would be unwise. As matters developed, the FOMC holds the same view. At its meeting on July 11-12, the Committee decided to let by-gones be by-gones. Instead, it set the second quarter level of M1 as a new base and to target its growth in the range of 5 to 9 per cent for the balance of this year. A range of 4 to 8 per cent was set for 1984. In my opinion, this was the correct decision.

Management of the Discount Rate

An increase in the Federal Reserve discount rate (currently at $8\frac{1}{2}$ per cent) was opposed by all - except one - of the Forum members who responded to the question. The reasons advanced were diverse, but the following citations are illustrative:

The discount rate should not now be raised for at least four reasons. First, borrowings from the Fed, other than extended borrowing, are not excessive. Second, the spread between the Federal funds rate and the discount rate is not

excessive. Third, the fast (7+ per cent SAAR) rate of real GNP growth in the second quarter will not be sustained, as the new housing pace slackens, and the already lofty level of real interest rates restrains inventory and fixed investment. Fourth, the implications of higher interest rates and a stronger dollar for a world economy where trade is languishing and the LDC debt burden is staggering must be clear to all....

Another member said:

The discount rate should not be raised now. Even should the Federal Reserve wish to tighten further, it can do so by raising its borrowings target. Historically, the central bank has not raised the discount rate until the funds rate has been 100 basis points or more above the discount rate. Assuming that the FOMC has now set a borrowings target consistent with funds in the 9-9½ per cent range, [it] could make an additional one or two ¼-point tightenings before it would need to consider a rise in the discount rate.

A third Forum member stated:

The reason for not raising the discount rate immediately to 9 per cent is that it would signal too aggressive a move toward tightening than is warranted at the present time. Already, the rises of interest rates over the past two months have been associated with essentially no change in M1 in the past six weeks. With growth in the economy likely to slow over the third and fourth quarters, M1 growth should also ease.... The discount rate hike would strengthen the dollar more, possibly creating continuing difficulties for recovery in the rest-of-the-world and potentially aggravating the debt problems of third world countries. If U.S. economic growth and the performance of M1 do not taper off in the summer, then a more aggressive promotion of higher interest rates might be in order.

Appropriate Goals of Monetary Policy

The members of the Forum were unanimous with respect to the proper objectives of monetary policy at this stage of the recovery: the over-riding tasks should be the support of continued recovery and the positioning of the economy on the path of sustained expansion and the creation of new jobs - without rekindling inflation. But, behind these broad objectives, particular members appraised the situation differently and stressed a number of specific tasks. For instance, two members emphasized the limited scope and fragility of the recovery so far:

[Policy] should all be based on stark economic realities that are not essentially mitigated by the current recovery. These include 11 million unemployed not including many who do not appear in the official statistics. We also have excessively large idle capacity in many industries, for example steel. This situation reflects poor profitability. Both large unused capacity and unsatisfactory profits have dampened industry's desire and ability to invest in new plant and equipment. Thus American industry faces further loss of competitive strength in world markets. The stark realities are not confined to a poorly performing domestic economy. [We must also consider] LDC financial problems - explosives that could be ignited with little provocation. Nor can the influence of American interest rates on currency valuations be overlooked. If the recovery falters, the U.S. trade deficit will be the immediate cause. To keep the United States on the road to recovery and to provide a climate that will enable other countries to follow parallel paths, every effort should be made to promote business activity. The situation I have briefly described and the prospects of little further stimulus to business recovery in 1983 until now represent a real peril to the economy's further improvement. Activity has been promoted by the record Federal deficit

which will probably narrow, by the surge in housing that may be reaching a plateau, and by the shift from inventory liquidation to accumulation - a shift that can be made only one in each cycle. Business' nonresidential capital investment would under typical circumstances come to the rescue, but it is showing little signs of doing so.

And:

Despite what appears to be the wide scope of the economic recovery, [I am] concerned that the recovery is in fact somewhat fragile at this time. [I] do not feel that the current economic growth could be sustained if interest rates rise another 1 to 1½ points.... In addition, international economic recovery is at best very fragile - and not sustainable if our interest rates rise and our recovery slows.

Another member observed:

Federal Reserve objectives should be to foster an economic recovery that makes up for the sub-par growth which our economy has experienced since 1979. While such an approach might stimulate a modest rise in inflationary pressures, the point to recognize is that non-monetary procedures may have to be looked at to avoid the resurgence of inflation.

Still another member stated:

There is far greater risk that the recovery will lose momentum rather than the economy becoming overheated. If interest rates were to move up another 1 or 2 percentage points, real growth by the first part of 1984 will be back to 2 or 3 per cent, which is unacceptably low. Therefore, monetary policy is currently tighter than it should be.

The importance of avoiding a sharp rebound in interest rates was identified as follows:

The current objective of monetary policy should be to support continued market growth and improved employment in those interest sensitive industrial activities that had

suffered the most during the preceding high interest rate period. That would entail avoidance of a resurgence of high interest rates, so that the entire economy could enjoy continued, relatively stable growth.

The challenge to monetary policy and economic recovery posed by large Federal budget deficits also was stressed:

Monetary policy should have as its objective accommodating the transition of the business cycle from recovery to expansion. A year from now, if the Congress and the Administration in the interim have failed to agree on measures that will slash prospective budget deficits, then the Fed will have no other course open to it other than to tighten the credit and money screws.

The twin objectives of promoting economic growth while avoiding the rekindling of inflation were emphasized by two members:

The Federal Reserve should be attempting to find a level of interest rates that is consistent with sustained but moderate growth in the economy, in order to contain inflation but at the same time reduce the unemployment rate. I would suggest that the System aim for a real GNP growth rate somewhere around 4-5 per cent, and that it couch this objective in terms of a permissible rate of growth for one of the broader monetary aggregates, preferably M2.

In my view, monetary policy objectives now should be to foster growth (consistent with fostering recovery but broader) and further progress toward price stability... Only in extreme situations is there any escape from the need to focus primarily on long-term multiple goals. Historically, policy makers have breached that principle more often than not. From what I know of the Federal Reserve authorities' actions of the recent past, I would not criticize their policies.

Finally, one member made the following comprehensive assessment of the tasks confronting the Federal Reserve:

Monetary policy should aim for the following goals at the present time. First, to encourage a sustained recovery in the U.S. economy and abroad so that progress will continue to be made in restoring real economic growth, employment, and economic health to those sectors, industries, and countries so devastated in the downturns of 1979 to 1982. Failure to do so risks the possibility of yet another recession and potential collapse in the U.S. and rest-of-the-world economies. Second, at the same time, the central bank needs to provide some restraint, given the heavy dose of fiscal stimulus and large amount of deficit financing that is occurring. A fully accommodative or aggressively easier monetary policy, along with the \$30 billion fiscal stimulus of the personal income tax cuts, large federal budget deficits and lagged stimulative effects from the reductions in business taxation and prior personal income tax cuts, could well set off too rapid an economic expansion. The way out for the central bank is to "lean against the wind," permitting gently higher interest rates that do not interrupt growth in the economy during the early stages of expansion. In this way, a resurgence of demand-pull inflation might be postponed and monetary and fiscal policies could be designed to attempt a long period of sustained economic growth and increasing employment at relatively low rates of inflation.

Concluding Observations

In summary, my personal appraisal of monetary policy - which is generally shared by members of the Forum - can be repeated: The accommodative monetary policy pursued by the Federal Reserve over the last year has been appropriate. The degree of restraint on bank reserves being exerted by the central bank is about right, and it should not be increased further. The prevailing configuration of interest rates is consistent with the transition of the American economy from recovery to sustained expansion without

rekindling inflationary pressures. However, the persistence of large Federal budget deficits is casting a shadow over money and financial markets which threatens to exert substantial upward pressure on long-term interest rates. Such an outcome would arrest the expansion of output and leave the economy with considerable unused capacity and excessively high levels of unemployment.

Therefore, the fundamental focus of public policy must be on fiscal policy. Monetary policy alone should not be asked to carry the sole burden of restoring this nation to the path of price stability, growth and expanding employment.

The CHAIRMAN. Now we will ask Dr. Gordon Pye, chief economist of the Irving Trust Co. of New York.

STATEMENT OF GORDON B. PYE, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, IRVING TRUST CO. OF NEW YORK

Mr. PYE. My name is Gordon Pye, senior vice president of the Irving Trust Co. I am pleased to appear before you today and provide my views on monetary policy under the Humphrey-Hawkins Act.

I would like to stress two major points. First, the economic difficulties of the last 5 years have not been the result of monetary policy but the result of the severe inflationary spiral with which that monetary policy has had to deal.

Second, the Federal Reserve should continue to target the money and credit aggregates. But judgment based on other economic indicators should be used in determining how forcefully and rapidly to correct for deviations from these targets.

Although I don't propose major changes, I have shared with you considerable frustration over our nation's economic performance under the Humphrey-Hawkins Act. We have had high unemployment, high interest rates, and until recently, high inflation.

Yet in the conduct of monetary policy, attention has seemed to focus not on our economic performance but on some arcane monetary aggregates, which even economists have difficulty defining.

I am sure you have joined with me in lamenting: Can't we forget about the aggregates and concentrate on the things that really matter—inflation, employment, and real income? Why doesn't the Federal Reserve target something more meaningful?

Yet, before we jump in and start changing the system, we have to ask, is it really the way we have been conducting monetary policy that is at fault?

We must remember that an inflationary spiral had become well entrenched in our economy long before Humphrey-Hawkins was ever enacted. Going back 10 years before, inflation had been ratcheting ever upward in each business cycle. And this inflationary

cycle was further exacerbated by the second oil price shock at about the time Humphrey-Hawkins was passed.

By 1979, inflation was well up into double digits and the value of the dollar was at an all-time low on foreign exchange markets. U.S. economic prestige in the world was at a low watermark. Inflation was named as the No. 1 problem in all the opinion surveys.

We had little choice but to bring this inflation spiral to a halt by forcefully curbing money and credit growth. This has now been done. The inflation ratchet has been broken.

Recent inflation experience has been the best in over 10 years and clearly better than at the previous cyclical low following the 1974-75 recession. Our strong dollar is the envy of the world even as they complain about it. And most countries are looking to our strong economic recovery to lead the world back to economic health again. U.S. economic prestige is clearly on the rise.

To be sure, everything is not yet rosy. Unemployment remains distressingly high. It is, of course, extremely unfair whenever anyone loses a job through no fault of their own, and many jobs have been lost. But it is also extremely unfair to see someone's life-time savings cruelly wasted by inflation as was happening to so many only a short while ago.

We had no choice but to slow money and credit growth. Therefore, I believe it is unfair to blame the way we have been conducting monetary policy for the economic problems we have had.

My reading of the history of the past 5 years is not that these problems are the result of monetary policy. Rather, these problems are the result of the extreme inflationary spiral with which that monetary policy had to deal.

There is another important lesson to be learned from monetary policy over the past 5 years. This is that monetary policy must not be based on the rigid adherence to any fixed mechanical rule. The Federal Reserve should continue to set targets for growth in the money and credit aggregates.

However, and this is a very important caveat, it should use judgment in deciding how forcefully and rapidly an attempt should be made to correct the deviations from these targets. This judgment should be based on various indicators of inflation, unemployment, and economic activity.

These judgments, of course, must be periodically defended along with the targets before this committee, as is wisely mandated under the Humphrey-Hawkins Act.

Back in 1979, when inflation was the No. 1 problem, we needed to quickly take strong measures to bring it under control. We needed to set stringent targets for money growth and to reach those targets aggressively. Now with other problems paramount, less stringent targets have been set.

And even though M_1 has been well above its target for some time, only gradual action is being taken to bring it into line, or, in fact, as we found out yesterday, targets have been revised to make it not out of line.

Nevertheless, the existence of the target serves to remind us that, unless M_1 otherwise comes back into target, action will have to be taken eventually if we are to continue the progress we have made on inflation. The recent emphasis on the broader aggregates

that do remain within their targets is a clear example of the use of good judgment in monetary policy and not blind adherence to rigid mechanical rules.

Nevertheless, some critics allege that the problem with monetary policy has been that it has not been rigid enough in meeting monetary targets. They argue that money growth has been allowed to fluctuate too much, and that it is this volatility which has pushed up interest rates.

The fact is that interest rates would likely have been even higher and more volatile if money growth had been more stable. The reason is that the Fed has influence over money supply but not money demand, and money demand can fluctuate significantly from week to week or month to month.

The rate of interest is the price which equates the demand for money to its supply. If the Fed had held the supply of money relatively fixed in the face of these changes in demand, the rate of interest would have moved up and down in response to these demand fluctuations.

By partially accommodating these demand changes with changes in supply, interest rate volatility was reduced. But this necessarily meant some volatility in money growth.

Other critics argue that it would be better for the Fed to target real interest rates instead of money. This sounds simple, but once you get down to the nitty-gritty of actually trying to implement such a target, the problems rapidly multiply.

For instance, what interest rate is to be used and should it be a long term one or short term? What inflation rate should be used?

We are right back with the same definitional problems that we have with the money supply. More fundamentally, we probably know even less about the relation between various levels of real interest rates to aggregate measures of economic activity than we do for the money supply, and we have no experience in using such targets.

Moreover, the relationship which exists between real interest rates and economic activity is certainly subject to the same sort of shifts from time to time as is the case with the relationship for money.

In conclusion, I would like to reiterate my main points.

First, the economic difficulties of the last 5 years have not been the result of monetary policy but the result of the severe inflationary spiral with which that monetary policy has had to deal.

Second, the Federal Reserve should continue to target the money and credit aggregates. But judgment based on other economic indicators should be used in determining how forcefully and rapidly to correct for deviations from these targets.

These targets and judgments should, of course, continue to be defended before this committee as required by the Humphrey-Hawkins Act.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Pye follows:]

MONETARY POLICY UNDER HUMPHREY-HAWKINS*

Gordon B. Pye

My name is Gordon B. Pye and I am a Senior Vice President of the Irving Trust Company in New York and have charge of the economics division at the bank. I am very pleased to appear before you today and to provide my views on monetary policy under the Humphrey-Hawkins Act.

I would like to stress two major points. First, the economic difficulties of the last five years have not been the result of monetary policy but the result of the severe inflationary spiral with which that monetary policy has had to deal. Second, the Federal Reserve should continue to target the money and credit aggregates. But judgment based on other economic indicators should be used in determining how forcefully and rapidly to correct for deviations from these targets.

Although I don't propose major changes, I have shared with you considerable frustration over our nation's economic performance under the Humphrey-Hawkins Act. We have had high unemployment, high interest rates, and until recently high inflation. Yet in the conduct of monetary policy attention has seemed to focus not on our economic performance but on some arcane monetary aggregates which even economists have difficulty defining. I'm sure you have joined with me in lamenting: Can't we forget about the aggregates and concentrate on the things that really matter--inflation, employment and real income? Why doesn't the Federal Reserve target something more meaningful?

*Testimony to the House Banking, Finance and Urban Affairs Committee on July 21, 1983 for hearings reviewing monetary policy under the Humphrey-Hawkins Act.

Yet before we jump in and start changing the system, we have to ask is it really the way we have been conducting monetary policy that is at fault? We must remember that an inflationary spiral had become well entrenched in our economy long before Humphrey-Hawkins was ever enacted. Going back 10 years before, inflation had been ratcheting ever upward in each business cycle. And this inflationary cycle was further exacerbated by the second oil price shock at about the time Humphrey-Hawkins was passed. By 1979 inflation was well up into double digits and the value of the dollar was at an all-time low on foreign exchange markets. U.S. economic prestige in the world was at a low watermark. Inflation was named as the number one problem in all the opinion surveys.

We had little choice but to bring this inflation spiral to a halt by forcefully curbing money and credit growth. This has now been done. The inflation ratchet has been broken. Recent inflation experience has been the best in over 10 years and clearly better than at the previous cyclical low following the 1974-75 recession. Our strong dollar is the envy of the world even as they complain about it. And most countries are looking to our strong economic recovery to lead the world back to economic health again. U.S. economic prestige is clearly on the rise.

To be sure, everything is not yet rosy. Unemployment remains distressingly high. It is, of course, extremely unfair whenever anyone loses a job through no fault of their own, and many jobs have been lost. But it is also extremely

unfair to see someone's lifetime savings cruelly wasted by inflation as was happening to so many only a short while ago.

We had no choice but to slow money and credit growth. Therefore, I believe it is unfair to blame the way we have been conducting monetary policy for the economic problems we have had. My reading of the history of the past five years is not that these problems are the result of monetary policy. Rather these problems are the result of the extreme inflationary spiral with which that monetary policy had to deal.

There is another important lesson to be learned from monetary policy over the past five years. This is that monetary policy must not be based on the rigid adherence to any fixed mechanical rule. The Federal Reserve should continue to set targets for growth in the money and credit aggregates. However, and this is a very important caveat, it should use judgment in deciding how forcefully and rapidly an attempt should be made to correct for deviations from these targets. This judgment should be based on various indicators of inflation, unemployment and economic activity. These judgments, of course, must be periodically defended along with the targets before this Committee, as is wisely mandated under the Humphrey-Hawkins Act.

Back in 1979 when inflation was the number one problem, we needed to quickly take strong measures to bring it under control. We needed to set stringent targets for money growth and to reach those targets aggressively. Now with

other problems paramount, less stringent targets have been set. And even though M1 has been well above its target for some time, only gradual action is being taken to bring it into line. Nevertheless, the existence of the target serves to remind us that, unless M1 otherwise comes back into target, action will have to be taken eventually if we are to continue the progress we have made on inflation. The recent emphasis on the broader aggregates that do remain within their targets is a clear example of the use of good judgment in monetary policy and not blind adherence to rigid mechanical rules.

Nevertheless, some critics allege that the problem with monetary policy has been that it has not been rigid enough in meeting monetary targets. They argue that money growth has been allowed to fluctuate too much, and that it is this volatility which has pushed up interest rates. The fact is that interest rates would likely have been even higher and more volatile if money growth had been more stable. The reason is that the Fed has influence over money supply but not money demand, and money demand can fluctuate significantly from week to week or month to month. The rate of interest is the price which equates the demand for money to its supply. If the Fed had held the supply of money relatively fixed in the face of these changes in demand, the rate of interest would have moved up and down in response to these demand fluctuations. By partially accommodating these demand changes with changes in supply, interest rate volatility was reduced. But this necessarily meant some volatility in money growth.

Other critics argue that it would be better for the Fed to target real interest rates instead of money. This sounds simple, but once you get down to the nitty-gritty of actually trying to implement such a target, the problems rapidly multiply. For instance, what interest rate is to be used and should it be a long-term one or short-term? What inflation rate should be used? We're right back with the same definitional problems that we have with the money supply. More fundamentally, we probably know even less about the relation between various levels of real interest rates to aggregate measures of economic activity than we do for the money supply, and we have no experience in using such targets. Moreover, the relationship which exists between real interest rates and economic activity is certainly subject to the same sort of shifts from time to time as is the case with the relationship for money.

In conclusion I would like to reiterate my main points:

The economic difficulties of the last five years have not been the result of monetary policy but the result of the severe inflationary spiral with which that monetary policy has had to deal.

The Federal Reserve should continue to target the money and credit aggregates. But judgment based on other economic indicators should be used in determining how forcefully and rapidly to correct for deviations from these targets. These targets and judgments should, of course, continue to be defended before this Committee as required by the Humphrey-Hawkins Act.

The CHAIRMAN. Now we will hear from Professor Freidman. We will put your entire statement in the record and you may proceed.

STATEMENT OF BENJAMIN FRIEDMAN, PROFESSOR, HARVARD UNIVERSITY

Mr. FRIEDMAN. Thank you, Mr. Chairman. I am very pleased to be able to share my views on monetary policy with you and the members of this distinguished committee. I will try to summarize my remarks very briefly.

I believe that U.S. monetary policy is now at a critical juncture in two separate respects. The first of these is that we must now chart a monetary policy to meet the needs of the current business recovery without leading to a renewal of price inflation. This is not a small task, and I think even the most casual inspection of the post-World War II record of business recoveries in the United States suggests that, if we can manage to have a sustainable noninflationary recovery, it will be an enormous accomplishment.

The second, and more fundamental, sense in which I believe that monetary policy in our nation is now at a critical juncture is that it is time to rethink the conceptual basis on which the Federal Reserve System plans and implements its policy. Quite simply stated, the problem is that the rigid and mechanistic focus on the monetary aggregates which we have pursued for the past 4 years has now become an anachronism. Market forces have simply overwhelmed this approach to monetary policy making, but deciding what to put in its place is not an easy task.

I will speak to both of these questions, and then conclude by saying something about the process of oversight of monetary policy in which this committee has played such an important role during the 5 years of the Humphrey-Hawkins legislation.

First, the specific stance of monetary policy: Each time since World War II that the United States has had a recovery from a business recession, we have always allowed that recovery to proceed either too rapidly or too far to maintain price stability. The overriding consideration now is to make sure that the citizens who have made enormous sacrifices in the interest of getting inflation under control, sacrifices that were not of their own choosing but imposed upon them by forces over which they had no control—should not be left asking what those sacrifices were all about in the first place. We must therefore pursue a monetary policy that will prevent the current recovery from becoming simply a renewal of inflation.

That would be a difficult task in any case, but it is made all the more complicated by the fact that fiscal policy today is so out of line with the needs of a noninflationary recovery. I realize that the purpose of this hearing is to talk about monetary policy, and I will do so, Mr. Chairman, but anyone who pretends to talk about monetary policy today without taking into account the extraordinary difficulties imposed by our current fiscal policy is simply missing the point.

Fiscal policy in the United States today is more expansionary than at any time in our country's peacetime experience. Fiscal

policy is propelling our economy forward far more rapidly than monetary policy is retarding it. Moreover, it appears likely that, as the recovery gains momentum, fiscal policy will simply become all the more expansionary.

Each of us in this room can probably think of a number of initiatives that would change this fiscal policy situation. It appears unlikely, however, that any of these initiatives will come about in the near future.

Hence, the appropriate question to ask is not simply what is the right monetary policy in some abstract situation, but rather what is the right monetary policy in the specific context of a fiscal policy that is more expansionary than any we have ever known. I think the best answer, Mr. Chairman, is to continue the course of monetary policy that the Federal Reserve has pursued in the first half of this year.

Let me be specific: I would attach little if any importance to the rapid rate of growth of the narrow M_1 money stock in the first half of this year. The massive shifts in deposit flows that are occurring in our markets, as a result of changes in financial instruments and patterns of intermediation, have—at least for the time being—rendered the M_1 money stock. By contrast M_2 and M_3 money stocks, as well as the credit aggregate that the Federal Reserve is targeting now, are growing about in line with the Federal Reserve's targets. I believe that these targets are consistent with the needs of a noninflationary recovery. Hence, I would encourage the continuation of the moderate expansion of broad money and credit that the Federal Reserve has already been pursuing.

What about interest rates? Interest rates are of substantial importance in this context, not just for monetary policy per se but also because interest rates are what the average individual sees as the cutting edge as monetary policy. Interest rates are now rising. Moreover, interest rates in comparison with inflation are higher by some margin than we have typically known in the past.

It is quite likely that, if we continue to pursue a responsible monetary policy, and if fiscal policy remains unchanged, interest rates, will have to rise further. Why? Because monetary policy, if it is to avoid an increase in price inflation, should accommodate the business recovery but should not accommodate the outsized needs for credit imposed by our current expansionary fiscal policy. As the recovery gains momentum, a middle-aged recovery, and as fiscal policy—

The CHAIRMAN. Excuse me. Do you mind if I interrupt a moment?

Mr. FRIEDMAN. I would be delighted, Mr. Chairman.

The CHAIRMAN. Well, Mr. Pye, a few moments ago, stated that we have got to remember that monetary policy can control supply but not demand.

Mr. FRIEDMAN. Yes, sir.

The CHAIRMAN. In line with that, you just stated that monetary policy can control the supply, but a fiscal policy remains as it is. That is the demand over which it has no control, is that what you are saying?

Mr. FRIEDMAN. That is exactly right, Mr. Chairman.

The CHAIRMAN. So both of you are on the same wave length and going down the same highway then?

Mr. FRIEDMAN. That is correct, Mr. Chairman.

Mr. PATMAN. Mr. Chairman, may I ask a question, too?

The CHAIRMAN. Well, a fellow named Patman told me that years ago that the chairman of the full committee could do that on occasion, but if we allow all the members, it would be chaotic.

Mr. PATMAN. Well, at that juncture I was wondering if we could perhaps make the point that the Fed was rationing supply via the price of money.

The CHAIRMAN. I would ask you to defer your question until after the gentleman has concluded.

Mr. PATMAN. Thank you.

Mr. FRIEDMAN. Let me be specific. The answer to your question, Mr. Chairman, was, yes, I was making the same point that Dr. Pye had made before me. I was going to go on, however, to draw an implication for the pattern of interest rates. Just as you said, if the Federal Reserve is maintaining an even supply of money and credit, while at the same time the combination of the business recovery and the outsized Federal fiscal policy is creating ever-larger demands for credit, sooner or later those demands are going to run into the halter provided by the Federal Reserve. The way that the market will handle this problem is through higher interest rates.

I think it is important, as we think about monetary policy during the course of the business expansion, to realize exactly what those higher interest rates are. They will not represent an independent tightening of monetary policy. Instead, they will represent the grinding of an even monetary policy against the demands created by the recovery and by the fiscal policy.

I want now to turn briefly to the issue of the fundamental framework within which the Federal Reserve System formulates and then implements monetary policy. I would also like to say something about the role that this committee and the Senate Banking Committee play in the oversight of monetary policy by the Congress.

As I stated at the outset, I believe that the narrow mechanistic approach to monetary policy that was tried in the past few years is, quite simply, an historical anachronism. There is no basis for it today in the workings of the American financial markets.

What then should we put in its place? A monetary policy framework that is both broader and also more flexible is essential. I therefore take as a favorable sign the Federal Reserve's including a new credit aggregate in this year's set of guidelines for monetary policy, and I hope that the Federal Reserve now is in fact placing at least some significant emphasis on that credit guideline. The advantage of a credit guideline is that it enables monetary policy to draw on both the liability as well as the asset side of the public's balance sheet in relative monetary policy actions to the behavior of the economy.

The adoption of a credit guideline, however, is not enough. It would be just as big a mistake to think that a mechanistic approach to a money-and-credit framework would work any more than a mechanistic approach to a money-only framework. The Federal Reserve must be flexible, must look at interest rates as well as

money and credit, and at the same time must consider what is happening in the nonfinancial economy. For example, last summer's decision to ease monetary policy was a correct one not just because of what was happening in the financial markets but because, at that time, the recession was deepening and showed no signs of turning around. I believe that looking at the nonfinancial economy was what led the Federal Reserve to that decision, and I think it was a correct decision.

Any such more flexible—and, therefore, more judgmental—approach to monetary policymaking of course creates difficulties for those in the financial markets who would like to monitor monetary policy, but that should be of little concern to policymakers. Similarly, but more importantly to this committee, which must exercise its constitutional responsibility to oversee the monetary policy process, it would be very convenient if there existed some simple summary measure—like a money stock or a stock of credit—that we could monitor just as we monitor a patient's temperature or a company's profits. But no doctor would want to do a diagnosis on the basis of a temperature, and no businessman would want to make a business plan on the basis of the bottom line only.

The implication for this committee is that congressional oversight of monetary policy must accept a more flexible and more judgmental approach to monetary policymaking, and must not constrain monetary policy to follow rigid mechanical rules which are simply outmoded. Monetary policy flexibility makes the task of this committee all the harder, but it does not in any way alleviate the importance of congressional oversight in a democratic republic. It means that this committee must enter into the judgment that goes into a judgmental monetary policy, and must attempt to understand the reasoning behind whatever flexible policy the Federal Reserve pursues. Any such policy may involve wise or unwise judgment, and wise or unwise flexibility. Nevertheless, assessing policy on broad and flexible grounds is the correct way both to make policy and also to oversee it.

Thank you very much, Mr. Chairman, for the opportunity to present my views to you and the members of the committee.

[The prepared statement of Mr. Friedman follows:]

July 21, 1983

TESTIMONY BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVESCOMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Benjamin M. Friedman

Professor of Economics
Harvard University

Mr. Chairman:

I am grateful for the opportunity to present my views to this committee as it not only evaluates the current stance of U.S. monetary policy but also reviews the five-year experience of monetary policy and Congressional oversight of it under the current Humphrey-Hawkins legislation.

Monetary policy in the United States is now at a critical juncture in two respects. At the most immediate level, the Federal Reserve System must now chart an appropriate monetary policy to meet the needs of the business recovery that has only just begun. The essential objective of that policy must be to achieve a sustainable, non-inflationary recovery to full employment of the economy's vast resources. Even the most casual inspection of the record of the U.S. economy's recessions and recoveries since World War II readily indicates that doing so will be no small accomplishment.

In addition, and more fundamentally, it is necessary today to re-think the basic conceptual framework within which the Federal Reserve designs and implements monetary policy. The narrow and mechanistic focus on the monetary aggregates that has so dominated U.S. monetary policymaking in recent years has become an anachronism, rendered obsolete by swiftly moving and widely ranging changes in the economy's financial markets. What should fill the resulting vacuum in the monetary policy process, however, is far from clear.

Principal Objectives for Current Monetary Policy

The overriding goal of U.S. monetary policy since 1979 has been to slow the economy's rate of price inflation, and the policy actions taken have been largely successful from this perspective. The nation's basic underlying inflation rate has declined sharply, from nearly 10% per annum two years ago to only about half that today. At the same time, this slowing of inflation has been extremely expensive — expensive in terms of lost jobs, foregone output, sacrificed incomes and profits, and, perhaps most damaging from the standpoint of the economy's longer-term prospects for gains in productivity and competitiveness, a decline in productive capital formation. Unfortunately, the increasingly popular claim that a pre-announced and sustained policy of slowing inflation via slower money growth would carry only minimal cost for the real economy has, quite simply, proved incorrect. If anything, the more traditional, and more pessimistic, assessments of the real cost of slowing inflation have proved remarkably accurate.

The immediate challenge confronting U.S. monetary policy today is to enable the economy to achieve a sustained, non-inflationary business recovery in the wake of the double-recession experience of the early 1980s. This task is not a small one. To be sure, the enormous underutilization of labor and capital resources in the U.S. economy today will make it somewhat easier, at least at first. So too will the current stability of the international price of oil (if it lasts), as well as the continuing strength of the dollar in the international exchange markets. Nevertheless, the goal of achieving a lasting and non-inflationary recovery presents a major challenge. Never before during the post World War II era has the U.S. economy managed this feat. In the past, recoveries from business recessions have, for one set of causes or another, always brought renewed inflation within a matter of several

years. Experience has amply shown both how to have an inflationary recovery and how to have no recovery at all. It has not shown how to have a recovery that continues, that brings the economy to a full utilization of its resources, and that preserves price stability.

Two important but often forgotten principles bear crucially on the choice of a correct monetary policy today. The first is that monetary policy affects nonfinancial economic activity only after some substantial time lag, perhaps a half-year or even less in some areas of business, but substantially longer in others. Monetary policy actions taken today and implemented over the remainder of this year will have their first significant effects on the nonfinancial economy sometime in 1984. In choosing an appropriate stance for monetary policy today, therefore, it is essential to place that choice in the context of the economy of 1984, not 1983. By next year the business recovery that is now so new will have moved into its second year. By that time unemployment of the labor force will be down, and utilization of plant capacity will be up, in comparison with today. All indications now suggest that business activity is already advancing vigorously, and that it is likely to continue to do so through the remainder of this year and into the next.

The second important but often overlooked principle is that monetary policy is not all that matters. In particular, fiscal policy exerts a powerful influence on the direction and pace of nonfinancial economic activity. This point is especially important today because the current stance of U.S. fiscal policy is unprecedentedly expansionary. It is no longer correct to argue, as it was only a year or two ago, that all or most of the Federal Government's budget deficit is due to the shortfall of revenues and excess of spending brought about automatically by a weak economy. Instead, the major part of today's deficit is due to a fundamental imbalance between the

government's revenues and expenditures, an imbalance that would remain even if the economy were already at full employment. In the absence of significant initiatives that are not now in sight, this imbalance will not merely persist but worsen in the years immediately ahead.

Because the relevance of fiscal policy to the choice of an appropriate monetary policy is so great today, it may help to be explicit here. In recent months there has been an extraordinary amount of confusion about the economic effects of federal budget deficits, and some observers have even suggested that the deficit itself can "abort" the business recovery before the economy reaches full employment. Such suggestions reflect a fundamental misunderstanding of how government deficits, and the higher interest rates that typically accompany them, come about.

It is true, of course, that a more expansionary fiscal policy makes interest rates higher if monetary policy is not accommodative. It is also true that the resulting high interest rates exert a negative impact on interest-sensitive spending, including business investment, homebuilding and purchases of consumer durables. These negative effects are not the end of the story, however. When the government runs a larger deficit, it does so because it is spending more itself, or because it is making larger transfer payments, or because it is collecting less taxes. Any or all of these actions increase demand in the economy, either directly in the case of the government's own spending or indirectly in the case of the spending of transfer recipients and taxpayers. The overall effect on the economy's total demand is the net of the negative impact on interest-sensitive spending and the positive impact of the actions that immediately account for the deficit. Although there are some conditions under which the negative effects on spending due to higher interest rates would outweigh the positive effects that are

more obviously tied to the government's spending and taxing, it is highly unlikely that those conditions even roughly describe the U.S. economy. Large budget deficits caused by an active fiscal policy that is increasing government spending and/or reducing taxes will raise the overall level of economic activity, at least as long as there is room left to raise it. Budget deficits, in and of themselves, will not cut short the recovery.

Budget deficits do importantly affect the choice of an appropriate monetary policy, however, especially when the principal objective of that policy is to promote a non-inflationary recovery. Expansionary fiscal policy is expansionary, and today fiscal policy is propelling the U.S. economy forward even more vigorously than monetary policy is retarding it. If monetary policy were to accommodate this expansionary fiscal policy — that is, if monetary policy were to stand aside while fiscal policy continued to thrust the economy ever more rapidly forward — then the business recovery that has already achieved a pace typical of prior post-war recoveries would in all probability gain even further momentum. Because even the average post-war recovery has brought a re-acceleration of price inflation, however, such an outcome would only leave the average citizen wondering what his or her sacrifices in the fight against inflation had been all about in the first place.

Monetary policy should not fully accommodate this fiscal expansion. Instead, monetary policy should maintain an even course, in part resisting the economic momentum that fiscal policy would otherwise generate. The resulting clash between monetary and fiscal policies will, of course, have undesirable aspects, including a continued depressing effect on the economy's rate of capital formation. Nevertheless, for monetary policy to do otherwise while fiscal policy continues to be so at variance with the requirements of

a sound recovery would only invite a renewal of inflation and thereby vitiate the sole victory that the anti-inflationary policies of the last few years have won at such enormous cost.

Implications for Money, Credit and Interest Rates

In terms of the specific guidelines for the growth of money and credit by which the Federal Reserve System primarily formulates policy, and reports to the Congress on its plans and progress, recent developments are approximately in line with the requirements of such an appropriate policy.

The extraordinarily rapid growth of the narrow M1 money stock during the first six months of this year probably does not correspond to more fundamental economic forces, and hence probably does not present cause for serious alarm. Not surprisingly, the introduction of the latest generation of new consumer-type deposit instruments has effected yet a new wave of shifts in the public's portfolio behavior, apparently including its preferences for holding narrowly defined money balances. In comparison with an M1 money stock totaling just over \$500 billion, and a broader M2 money stock of just over \$2 trillion, the new money market deposit accounts (which are included in M2 but not M1) have already attracted more than \$350 billion in only six months since banks first offered them. The new "super-NOW" accounts (included in both M1 and M2) have also performed well, though hardly so dramatically. In an environment dominated by such massive changes in asset holding arrangements, narrowly defined aggregates of institutionally intermediated deposits are likely to give misleading signals at best.

By contrast, the broader monetary aggregates continue to grow roughly in line with the Federal Reserve's 1983 targets — targets that are probably about right for the needs of a non-inflationary recovery. As of June, the M2 money stock was within the growth range indicated in the Federal Reserve's

February report to the Congress. The even broader M3 money stock was approximately within the targeted range for the first half of this year, running over by only \$1 billion out of nearly \$2.5 trillion.

In addition, the new credit aggregate, for which the Federal Reserve announced an expected range for the first time in its February report, has also been growing about in line with those expectations. Published Federal Reserve data for the January-March period show a growth of 9.6% per annum in total domestic credit, just below the midpoint of the 8 1/2 - 11 1/2 % expected range. Although the Federal Reserve does not yet publish aggregate credit data on a monthly basis, and has not yet published a second-quarter figure, it is straightforward enough to construct the relevant aggregate (at least approximately) from readily available monthly data. Doing so indicates that during the April-June period total domestic credit expanded by about 10 1/2 - 11 % per annum, again well within the expected range indicated in February. This range too is probably about right for the credit needs of an economy that is to recover without an undue threat to price stability.

On balance, therefore, the course set by monetary policy during the first half of 1983 has represented an appropriate mix, accommodating the business recovery but not the excessive pressures potentially associated with fiscal policy. In large part because of fiscal policy, however, this monetary policy when measured in the conventional terms of interest rates — and especially by the relationship between interest rates and price inflation — has been extraordinarily tight. Despite sharp declines from the near-record levels prevailing just a year ago, U.S. short-term interest rates remain unprecedentedly high in relation to the economy's ongoing rate of price inflation. Long-term interest rates are probably high in real terms as well, although such an inference is always dubious in that it must rest

on some assumption about market participants' expectations of price inflation over the time horizon appropriate for evaluating multi-year fixed-income securities. With the inflation rate now low and likely to remain so at least temporarily, however, today's high level of real yields for short maturities is unambiguous. For some months now, most short-term debt instruments have borne yields in the range of 8-9%, in comparison to an ongoing annual inflation rate of about 4% per annum. The resulting 4-5% real yields not only far exceed the U.S. post-war average of 1%, but even exceed the maximum real yields experienced in the United States at any time during this period until 1979. Indeed, at this stage of the business cycle short-term real yields would more typically be negative.

The only plausible explanation for such high real interest rates on short-term instruments is continuing tight monetary policy. The policy of moderate growth of money and credit that has been in place since the beginning of this year is tight not by any absolute standard but in comparison with the potential demands for money and credit in an economy dominated by an unprecedentedly expansionary fiscal policy. As long as the recovery continues at its current pace, and as long as fiscal policy continues in its current extraordinarily expansionary stance, the even monetary policy that the Federal Reserve is now implementing will continue to be tight as measured by interest rates.

Further, there is every reason to believe that, as the economy continues to recover, monetary policy as measured by interest rates will appear progressively tighter if fiscal policy remains unchanged. The force of fiscal policy, generating credit demands on its own and spurring private economic activity which in turn creates private credit demands, will increasingly strain against the halter of Federal Reserve restrictions on credit growth.

As this friction mounts, higher interest rates will probably result. It is essential to understand, however, that these higher interest rates do not and will not, in and of themselves, represent an independent tightening of monetary policy. Together with their unfortunate effects on the nation's capital formation rate, they will instead reflect what happens when a non-inflationary monetary policy must do its job in the context of an excessively expansionary fiscal policy.

Designing and Overseeing Monetary Policy

With varying dedication since the early 1970s, U.S. monetary policy has hinged on targeted growth rates for specific monetary aggregates. In October, 1979, the Federal Reserve System rededicated itself to this central focus on the monetary aggregates, and made control of those aggregates the primary basis underlying its policy. The reasoning motivating the initial adoption of monetary aggregate targets is by now thoroughly well known. During periods of rapid and volatile price inflation, the nominal interest rates that had served as the chief focus of monetary policy in earlier years became a progressively less valid guide. In addition, the relationship of money growth on the one hand to either price inflation or growth of nominal income on the other appeared to many to be stable and reliable.

By now it is also well known that the developments of the past few years have largely destroyed the rationale supporting this approach to monetary policymaking. Financial innovations have changed patterns of deposit holding and financial intermediation in ways that are stubbornly resistant to the definition of any new narrow aggregate to serve as a single policy fulcrum. At the same time, the standard relationships connecting price inflation and nominal income growth to any of the familiar monetary aggregates have all but collapsed. Under its new policy regime, the Federal Reserve successfully

slowed the growth rate of the M1 money stock from 8.2% in 1978 to 7.4% in 1979, then 7.3% in 1980 and finally 5.0% in 1981, before allowing a renewed acceleration last year. Can anyone seriously pretend to explain the remarkable experience of the U.S. economy during the past four years in terms of this mild monetary deceleration? By contrast, the M2 money stock has shown no deceleration whatsoever during this period. Its growth increased from the same 8.2% rate in 1978 to 8.4% in 1979, then 9.2% in 1980 and 9.5% in 1981, and finally 9.8% last year. Does anyone seriously claim that this steady acceleration of M2 money growth explains any major aspects of the U.S. economy's performance during this otherwise turbulent period?

Just a year ago the Federal Reserve confronted the sharpest dilemma it had had to face since commencing its rededication to the monetary aggregates strategy in late 1979. As of July, 1982, the 1981-82 business recession was a year old, and despite strong money growth early in the year economic activity was only sinking further. Nevertheless, monetary growth, which had been somewhat in excess of the upper end of the targeted range since the beginning of the year, suddenly began to accelerate rapidly. Under these circumstances the Federal Reserve wisely chose to ignore that money growth, and allow interest rates to decline, in the second half of the year.

That policy decision was a correct one, and without it there would probably have been no economic recovery. A continued squeeze on the financial markets sufficient to have depressed the growth of the money stock to within the previously targeted range would only have so choked off economic activity as to drag out further what was by many measures the longest and most severe recession of the post-war era. It is also worth pointing out that financial market participants hardly reacted to the resulting surge of money growth as if they believed that it merely foretold a renewed bout of price inflation.

Despite the warnings of both public officials and many private observers to the effect that any increase in money growth would only lead to higher interest rates because it would create fears of renewed inflation, interest rates tumbled rapidly and stock prices immediately began what has developed into the strongest market rally in a generation. The claim that an otherwise correct policy action would be vitiated by financial market paranoia proved dramatically wrong.

A narrow focus on the monetary aggregates as a basis for U.S. monetary policy is clearly an anachronism by now, but what then is the appropriate framework for the conduct of policy today? It is evident that policy must adopt a more broadly based approach. In this context the Federal Reserve's apparent willingness this year to place at least some weight on a credit aggregate guideline, thereby basing its policy stance on both the asset and the liability sides of the economy's balance sheet, is highly welcome.

Ample evidence shows that total domestic credit, measured by the total outstanding indebtedness of all U.S. borrowers other than financial institutions, bears just as stable a relationship to nonfinancial economic activity as does any of the more familiar monetary aggregates. In addition, the available evidence also shows that this relationship is not simply that of a mirror reflecting what has already happened in the real economy. Credit movements today provide advance signals of what is likely to happen to economic activity some time in the near future. For that reason credit growth is a useful signal for monetary policy, along with money growth. If credit is expanding unusually rapidly, the typical indication is that, unless monetary policy changes, before long so too will the economy. Conversely, an unusually sluggish credit expansion indicates that, if policy does not change, before long the economy too is likely to weaken.

A two-target strategy based on both money and credit is therefore a useful improvement over the money-only strategy that has dominated Federal Reserve policymaking since 1979. It is, of course, too early to tell whether the Federal Reserve is in practice placing any significant emphasis on its new credit measure, but its inclusion of a credit guideline in its February report to the Congress is a helpful sign. Because it appears that today credit growth (like M2 growth) is within the range specified in that report, there is no cause yet to ask whether the Federal Reserve is willing to take the measures that would be warranted by a marked deviation of credit expansion either above or below that range.

Although the addition of a credit aggregate to the Federal Reserve's policy framework is welcome, the experience of the past several years has decidedly shown the inadequacy of any rigid, mechanistic approach to monetary policymaking. In an era of rapid financial innovation, involving not only the introduction of new financial instruments but also the wholesale rearrangement of financial institutions, it is implausible to expect any simple measure — be it either a monetary or a credit aggregate, or some combination of the two — to provide a wholly reliable guide to the conduct of monetary policy. A money-and-credit strategy is better in this regard than a money-only strategy, but it would be just as dangerous to place blind faith in the former as in the latter.

There is no substitute today for an even more broadly based, and even less mechanistic, approach to monetary policymaking. In addition to monitoring carefully the implications of money and credit growth, in designing an appropriate policy the Federal Reserve must also take explicit account of interest rate movements and any other available signs of the direct effects that its actions are producing in the financial markets. There is no other

way to judge adequately the impact that these actions are having and will have on nonfinancial economic activity. Last year's marked easing of monetary policy was warranted not just because of any narrow indication of what was happening in the financial markets but because the recession in the nonfinancial economy was already severe and was offering no sign of an end. It would be fortunate, of course, if there were some single, readily observable measure (or even a small set of such measures) on which the Federal Reserve could confidently focus to the exclusion of all other sources of either financial or nonfinancial information. It would be convenient if there were some simple device that would allow the Federal Reserve to place monetary policy on automatic pilot. Unfortunately, and inconveniently, the complex working of the modern economy provides no such all-powerful tool. Diversity and judgment are unavoidable.

The broadly based and flexible operating strategies that are appropriate for monetary policy in this environment will no doubt be less than satisfying to some who still seek some convenient single yardstick by which to measure policy. It is always handy to know exactly the patient's pulse count or the company's profits. Nevertheless, just as a pulse count does not complete a diagnosis, and a bottom line is no substitute for a footnoted balance sheet, so too in today's economy no single measure can provide all that policymakers need to know. The greater complexity of a more broadly based monetary policy, including an important role for policymakers' judgment, only mirrors the enormous complexity of the monetary policy process itself in the U.S. economy's highly developed and rapidly evolving financial markets.

A more flexible and more broadly based monetary policy framework also makes more cumbersome the valuable process of Congressional oversight of monetary policy, in which this committee has played such a leading and

useful role in recent years. When monetary policy decisions and actions rest on a broader base than one or two readily observable aggregate measures, Congressional evaluation of that policy must also be more broadly based. When in addition monetary policy decisions and actions depend on difficult-to-specify and impossible-to-quantify judgments, Congressional evaluation must also attempt to enter into just those judgments. The resulting process of Congressional oversight is less straightforward, just as the monetary policy decision-making process is less straightforward. Nevertheless, the Congress retains its Constitutional responsibility for the oversight of monetary policy regardless of how complex that task may be, and it is essential to the health of a democratic republic that committees like this one continue to execute that responsibility.

Mr. Chairman, thank you for the opportunity to present my views to the committee.

The CHAIRMAN. I want to thank all three witnesses and at this point I would like to ask you, Dr. Friedman, you say that at the next immediate level the Federal Reserve System must now chart an appropriate monetary policy to meet the needs of the business recovery that is only just begun.

Have you felt a sense of disappointment or frustration, as have many of us, at the fact that business recovery has just begun?

In view of the ambitions, the hopes and desires—and I don't say this critically—have the proponents of the 1981 tax cuts that were supposed to stimulate business investment, have you felt a sense of frustration that it has not happened sooner and do you know why it took so long for this to begin to occur, this investment by industrial America in itself?

Mr. FRIEDMAN. Mr. Chairman, I think I differ somewhat from your characterization. I believe that the increase in investment which the 1981 tax cut was supposed to differ has not yet begun to occur.

The CHAIRMAN. You are more specific than I. I am trying to feel that it has begun.

Mr. FRIEDMAN. I do not believe that that is the case. I think what we are seeing is exactly what the 1981 tax cut was not supposed to deliver, namely, a consumer-led expansion of the economy. What we have today is not, and I think will not be, an investment-led growth. It is a consumption-led growth. It is fueled, in part, by the expansionary fiscal policy that I mentioned a moment ago.

The notion that the 1981 tax bill would importantly stimulate business investment, on balance, was not correct at the time and

will not prove correct now. To be sure, the 1981 tax bill contains several significant measures that are likely to stimulate business investment; but the effect of these specific measures is being offset, and will be offset in the future, by the rest of the tax bill which delivers enormous Federal deficits that are likely to continue to grow in the future.

The deficits that we are now facing will lead not merely lead to high interest rates, as I mentioned in my earlier remarks, but also, through those high interest rates, to less capital formation rather than more. For this reason I think that we have not yet seen the promised increase in business investment, and we are not going to see it.

The CHAIRMAN. Until our fiscal policies change?

Mr. FRIEDMAN. Yes, sir. If we adopt a more appropriate fiscal policy, which ceases draining the great majority of the private economy's net saving, then that net saving will be available to fuel investment not only in business capital but also in residential capital which is important as well. Under current policies, however, the Federal deficit will absorb the overwhelming majority of the net saving that the private economy generates. There will be little if anything left to fund net business investment or, for that matter, net investment in anything else.

The CHAIRMAN. I want to stay within my 5 minutes, but I also understand that all three views I heard you testify to agreed that the importance of M_1 no longer exists because of the inaccuracies and the difficulties in determining or arriving at an accurate M_1 at this point in time; is that correct?

Mr. PYE. I don't think that M_1 should be used as the guide to policy as it has in the past in this current period, where we know that the growth in NOW accounts partly reflects savings rather than transactional balances, and by M_1 , we are trying to measure transaction balances.

The CHAIRMAN. Dr. Brimmer, we had a witness testify here on Tuesday, and in essence he stated—and I think you were around when I conducted the FINE study?

Mr. BRIMMER. I was, Mr. Chairman.

The CHAIRMAN. And those former governors of the Fed—I wish I could remember his name, the very distinguished former governor of the Fed who testified that the regulatory powers of the Fed over the financial institutions should be taken away, that they don't belong in the Fed.

Can you help me out on that?

Mr. BRIMMER. Well, I could speculate. The chances are that was either Gov. George Mitchell or Gov. Sherman Mason.

The CHAIRMAN. It was George Mitchell, right.

Now, you have been a member of the Fed. This witness on Tuesday testified that, indeed, that should occur because the Fed attaches too much importance or too much significance in its actions to the welfare and well-being of the banking institutions of this country, particularly the commercial banks.

What is your reaction to that thought that was propounded to us?

Mr. BRIMMER. I would not agree with it, Mr. Chairman. I do make a distinction between the monetary responsibilities of the Federal Reserve.

The CHAIRMAN. Excuse me. Let me add to that.

There was another witness who said he spent a lot of time in the Fed and with the commercial banking industry, and he is now a distinguished professor, and he too disagreed. So I should make that point as well.

Mr. BRIMMER. Well, thank you, Mr. Chairman. You made several points.

The first one with respect to too much time of the Federal Reserve being devoted to commercial banks, I would not agree to that. I do believe the Federal Reserve's primary responsibility ought to be its monetary functions concerned with the cost availability of credit.

But with respect to the banking system, after all, despite the proliferation of other types of financial institutions, the commercial banking system, that system concerned with the acceptance and management of deposits and extension of loans, especially commercial loans, that is still a banking function and it is crucial to the conduct of the overall central bank's responsibility for the stability of the financial system and soundness of the financial system.

I remember we used to debate whether the Federal Reserve could carry out that responsibility without examining banks, for example. Let the controller do that. That could be done, but I think on balance, the responsibility of the central banks are better carried out if it has some supervisory responsibilities.

Now, I would not argue for the continuation of the duplication we have now. It still exists, although the supervisors do try to allocate responsibility.

I would not strip the Federal Reserve of concern for the financial system from capital conditions and simply restrict the Federal Reserve to a boardroom with some computers concerned with the money supply, which seemed to be implicit in whatever is being said.

Now, with respect to the question of whether the Federal Reserve is too tender with commercial banks, that is concerned with their welfare, and so on, I do not agree with that.

The CHAIRMAN. Nor do the commercial bankers feel that way. By the same token, this member did not say that.

On occasion I have to differ with you, Dr. Brimmer, because I met with, as you know, many chairmen of the Fed over the years. We have had private discussions and we have discussed their concerns. They may not realize it, but their concerns have been on behalf of those commercial banks, the large ones.

Again, I say the chairmen of the Board and the presidents of those institutions come in that same office of mine and yell like mad about how rudely and cruelly they are being treated by the Fed.

Mr. BRIMMER. I understand.

The CHAIRMAN. My time has expired.

Mr. Patman.

Mr. PATMAN. Mr. Chairman, I am interested in these hearings. I think they are very important or could be very important, but I

know that you three gentlemen have been listening to what Paul Volcker said yesterday and reading all about it.

Do you think that you agree among yourselves about what he said and what his declaration or the intentions of the Fed are or were?

Mr. PYE. I did not have any major disagreements with what he had to say.

Mr. PATMAN. Well, let me go back a little bit on all these Humphrey-Hawkins hearings and all the declarations of the Fed in the last few years.

Have you felt you knew reasonably confidently what it was going to do?

Mr. PYE. Well, I think that the situation he has had to deal with has changed over that period of time, and that he very appropriately has changed his approach to the situation in light of economic circumstances.

Mr. PATMAN. Do you ever feel sometimes that they are working on monetary policy down there at the Federal Reserve and putting it in place and perhaps causing a recession, or at least fostering one, and when the Congress meets up here, we pass things like health insurance for unemployed workers and extended unemployment benefits because of the recession?

Do you think they sit down there and talk to themselves and say, "Wonder why they are doing that," or does it come as a surprise to them entirely?

In the coordination of fiscal and monetary policy, don't you think we have got to be realistic in thinking about the results of certain monetary policies and what the reaction of Congress will be in response to those?

If a recession is caused by those monetary policies, that Congress is going to react in some way that tries to make the effects less harmful or less painful?

Mr. PYE. Well, I am sure the Federal Reserve did not set out to have some of the unfavorable effects that we have had in the economy recently.

Mr. PATMAN. Well, the fact that we have a recession now is the main reason we have low inflation, is it not?

Mr. PYE. Well, I think the fact that we have slowed down significantly money and credit growth is why we have lower inflation.

Now, that might have had certain side effects which are unfavorable.

Mr. PATMAN. Let me ask you if it surprises you that we find ourselves in a recession, given the slowdown in the money growth that the Fed put into effect. Did it surprise you that we had a recession?

Mr. PYE. Well, it did not surprise me that the economy slowed down in response to a slowdown in money and credit growth, no.

Exactly what the response would be, I don't think anyone could have said before the fact.

Mr. PATMAN. You were not surprised that we went into a recession when money growth was slowed down the way it was, were you?

Mr. PYE. Well, as I say, I don't think anyone would know exactly what the effect would be of the slowdown in money growth.

One would certainly anticipate that the real economy would slow down in response to a slowdown in money growth along with the slowdown in the rate of growth in prices. But exactly what the mix would be would be very difficult to estimate.

Mr. PATMAN. Where do you distinguish between a slowdown in the economy and a recession?

Are you saying that those two are synonymous by chance?

Mr. PYE. Well, no. For instance, I would be looking for some slowdown probably in the rate of recovery this winter, but I don't look for a recession because I certainly would not look for economic activity to begin declining again. I think that has got a very low chance, but there is certainly a very good chance that we would see a slower rate of growth, say, this winter than we are seeing right now.

Mr. PATMAN. Well, do you think the Fed was surprised when a recession was brought on or came about or took place following their tightening up on money the way they did?

Mr. PYE. Well, I can't speak for that.

Mr. PATMAN. Do you think a reasonable economist sitting in the position that the Federal Reserve is in would be surprised, given the circumstances that we went into, by a severe recession or a slowdown?

Mr. PYE. I am sure they were surprised by it being as severe as it was. I don't think there is any question in my mind about that.

Now, exactly what they might have been expecting, as I say, I can't say. I am really quite confident in my own mind that they did not expect anything as severe as what materialized.

Mr. PATMAN. Mr. Brimmer, and then Professor Friedman, please, a short one for each of you.

Mr. BRIMMER. Yes, Mr. Patman, I read the policy record for virtually every one of the Open Market Committee meetings, and if you go back and look through, say, 1981, with the modest recovery from the 1981 recession and from the summer of 1981, as the Federal Reserve began to exert more and more pressure on banking reserves and interest rates began to rise, the staff of the Federal Open Market Committee began to tell the committee that they expected the reduction in availability of credit in the face of continued strong demand for it to result in a slowdown, and eventually an actual decline in the growth of output.

Mr. PATMAN. Excuse me. I have to ask you how you know what the staff was telling the Federal Open Market Committee at that point?

Mr. BRIMMER. It is summarized in the minutes of the Open Market Committee, which is released about 30 days after each meeting.

Mr. PATMAN. It is available to us as well as it is to you and everyone else?

Mr. BRIMMER. Oh, yes.

While the staff was reasonably clear in their anticipations, the members of the committee expressed different views with respect to the likely outcome, but there was no mystery.

On the record, they fully seemed to have anticipated that there would be a reduction not only in the rate of growth of output and actual decline in output; it seemed that they did not anticipate that

it would be as deep or as prolonged. But it did seem that they made a choice.

They had to make a judgment between the extent to which they should run the risk of contributing to a slowdown and eventual decline in real output as opposed to not making a contribution to the moderation of inflation.

My own personal judgment, Mr. Patman, is that you cannot attribute the substantial moderation in the underlying and actual rate of inflation we have experienced over the last year or so simply to the slowdown in money. Part of it reflects this enormous increase in excess capacity. In my own business, I see a good number of companies who simply cannot post and achieve high prices. Demand has just been too weak.

So as to excess capacity, the weak final demand, which has had a lot to do with moderation in inflation and, of course, the substantial easing in the energy situation we had, put so much pressure on prices.

The CHAIRMAN. Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman.

Professor Friedman, you were talking about, in response to the chairman's questions, about the Economic Recovery Tax Act of 1981 really not achieving what many thought that it would; in fact, maybe going in the opposition direction.

I am curious. Let's say that it is 1983 now, or 1984. Many people would like to see taxes raised. I am curious as to, if you felt that a revenue adjustment was needed, that we needed to raise taxes?

Mr. FRIEDMAN. Yes, sir, I do.

Mr. HILER. How many dollars of taxes do you think we need to raise, let's say, as a percentage of the gross national product, and in what way would you like to raise those?

Mr. FRIEDMAN. Congressman, as you know, the Federal deficit is running currently in the neighborhood of 6 percentage points of the GNP. That is very distressing, in that the economy's net saving is only 7 percent of the GNP. I believe it is essential to reduce the deficit to no more than, say, 2 percentage points of the GNP.

My own preference would be to meet that 4-percentage point gap one-half by revenue measures and one-half by spending reductions. As to the specific type of revenue measures, I would prefer to emphasize revenues that are likely to retard consumption spending and avoid revenue measures that are likely to retard investment spending. I would also hope to avoid revenue measures that are likely to provide disincentives to saving.

I can give a few examples, if you like. Specifically, I think that reversing the most recent across-the-board 10-percent cut in taxes, which we have all enjoyed starting last July 1, would be a very constructive measure—as opposed to eliminating targeted tax incentives for saving or targeted tax encouragements to investment. I see little merit, at this stage in our economic development, in across-the-board tax cuts that simply fuel consumption spending. Hence the very first thing I would do would be to reverse the part of the tax bill that only just came into effect.

Mr. HILER. Let me interject at that point.

When the tax bill was passed, we had an immediate cut in the top tax rate from 70 to 50 percent. Would you think that should be reversed at all?

Mr. FRIEDMAN. No, sir.

Mr. HILER. You only think that we should stop the tax break for the low- and middle-income people and not the upper-income folks?

Mr. FRIEDMAN. No, sir. The tax breaks that are across-the-board, on all kinds of income, and therefore available to support consumption spending, are what should be emphasized. The specific aspect of the 1981 tax bill that you were referring to, the Rostenkowski proposal that reduced the tax rate from 70 to 50, was a good idea because that 70 percent tax rate only applied to income earned from saving in the first place.

Mr. HILER. So the savings that somebody in the 75-percent tax bracket earns are not as important than somebody might generate at the 70-percent level. And so that individual who is at the 25-percent level should maintain his 25 percent tax on savings but the person who is at the 70-percent should have his dropped to 50 percent?

Mr. FRIEDMAN. I believe that everyone's saving is important, Congressman. I also believe that the 70-percent rate was too high in comparison with the needs of the country to generate saving. I would like to see a more consumption-oriented and less income-oriented tax system, as a whole—one that would reduce the taxes on everyone's saving.

To cite another example, the IRA provisions in the 1981 tax act were a good idea, because they moved at least partly in this direction. They make a \$2,000 saving provision tax exempt, not just for large income earners but for everyone. That is the kind of measure that encourages everyone to save.

Mr. HILER. So the basic problem with the across-the-board approach is not so much that tax rates were reduced for some kinds of dollars that people have in their back pocket, but that it was reduced for all dollars that somebody puts in their back pocket, savings dollars as well as consumption dollars.

So would you be in favor of a flat tax concept or a consumption tax, with the significant drop in tax rates on income, with an increase in natural sales tax or some type of consumption tax?

Mr. FRIEDMAN. I would like to distinguish between a flat tax and a consumption tax. Any step we can take to move our tax system away from an income concept toward a consumption concept would be a very healthy thing to do. That need not be a wholesale revolution of the tax code. There are many incremental changes of that nature, like the ones we have just been discussing.

I am not in favor of most of the specific flat tax proposals. Progressivity is an important part of our tax system, not because of any economic principle but because of principles of equity and fairness.

It is important to point out that a consumption tax can be progressive, just as an income tax can. We can have a flat tax on income, or a progressive tax on income. We can have a flat tax on consumption, or a progressive tax on consumption. I would hope that, if we entertain more proposals to move away from income

taxes toward consumption taxes, we don't make that a reason to move away from a fair amount of progressivity in the tax code.

Mr. HILER. Thank you.

The CHAIRMAN. Thank you, Mr. Hiler.

Gentlemen, No. 1, I note the arrival of Professor Bowles.

But I am going to have to apologetically ask you to note the departure of myself and our ranking minority member, Mr. Wylie. We have a meeting that has just been called, to which we must take ourselves. When the Secretary of the Treasury and the Speaker call you, like good troopers, we march to their tune.

So we are going to ask Professor Bowles in a moment—we will put your entire testimony in the record, and then we will ask you to address the members.

Mr. Frank, a fellow resident of the Commonwealth of Massachusetts, will take over the Chair on my behalf.

Once you have completed your testimony, we will then continue the question and answer period.

Mr. Wylie and I may or may not be able to get back, but on behalf of other members who are at other meetings as well, we would like the opportunity to submit written questions to you gentlemen and ask you if you would be kind enough and gracious enough to respond to them for the record.

With that, I am going to hand the gavel over to my distinguished colleague, Mr. Frank, and he can take over the meeting at this point.

Mr. FRANK [presiding]. Professor Bowles, we will proceed with your testimony and then we will continue with the questioning.

STATEMENT OF SAMUEL BOWLES, PROFESSOR, UNIVERSITY OF MASSACHUSETTS, AMHERST, MASS.

Mr. BOWLES. I am disappointed to see the chairman leave, not because I am unhappy to find you in the Chair, Mr. Frank, but because I noted in the New York Times on Tuesday that he gave a cigar to Paul Volcker. Knowing some of the opinions of this committee about the Fed I thought if your Chair gave a cigar to Paul Volcker maybe he would give me two.

Mr. FRANK. I have been waiting for 2½ years and I have never received one from him, although his assistant, Mr. Nelson, is usually good for a touch. I will send you to him later.

Mr. BOWLES. What I want to do is report on a series of research studies that I have conducted over the past 3 years along with David Gordon, who is chairman of the economics department at the New School for Social Research, and Tom Weisskopf, who is professor of economics at the University of Michigan.

To get right to the point, a major finding in our research, and the one I would like to focus on here today is that monetary restraint over the past few years has had a by and large deleterious effect on the economy.

The main effect I would like to focus on is the effect on wages. I can summarize what I will say in the following way.

The key to a sound economic recovery in this economy, or indeed in almost any economy, is an increase in productivity. This is true both for the simple reason that productivity measures the capacity

of the economy to provide goods and services, but it is also true because productivity is the key to combating inflation.

The second, and the more interesting part, perhaps, is that low or declining real wages has a negative effects on productivity and, in general, has negative effects throughout the economy.

We conclude that monetary policy, or indeed any other social or economic policies which have the effect of lower real wages is counterproductive both in terms of economic growth in general and in terms of combating inflation in the long run.

What I am putting forth here could be called a wage-led growth strategy.

The idea of wage-led growth, of course, is an old one. It has been around for at least as long as people have been reading Keynes.

The idea that higher wages are good for the economy rather than bad for the economy therefore is nothing new to this committee. However, the reasons I would put forward in support of a wage-led growth strategy are not particularly Keynesian, they really relate at least as much to the supply side of the economy as to the demand side.

The underlying idea behind a supply side and demand side wage-led growth policy is that the current economy, indeed, the economy in the recent past in the United States, is not a zero-sum game.

The idea of a zero-sum society is that if you have more of A you must have less of B. This is thought to be common sense. It is taught in all economic textbooks. It is wrong.

It is wrong simply because in an economy in which you have a vast amount of underutilized and misutilized resources, you can obviously have more of both A and B. So the idea of tradeoffs, for example, that one must reduce consumption in order to have more investment, is true only if the economy is operating at full capacity and operating efficiently at full capacity.

We come to the conclusion in our book, "Beyond the Waste Land," that the United States is not a zero-sum society. It is a society in which it is possible to have what is said to be impossible by some economists: a free lunch.

It is possible to have a free lunch when you have 10 or 11 million people out of work. Basically, the recipe for the free lunch is to more fully and more effectively utilize the resources that you have. It seems to me that this should be the prime objective of economic policy in this country, and it is particularly fitting that I should be able to say that in a hearing about the Humphrey-Hawkins bill.

Let me mention briefly what I find to be mistaken about the idea that the monetary restraint has beneficial effects on the long-term economic growth of the country.

Monetary restraint is often advocated as the basis of an unsaid argument. Everyone knows it. People talk about it. I have not seen many people talk about it publicly, although some are candid enough to. It is basically that the effect of monetary restraint will be to increase the levels of unemployment, which will have the effect, after some time, of lowering the rate of growth of money wages and real wages.

The effect of this, it is hoped by some, will be to raise the profit rate and thereby to raise the rate of investment in the long run, thereby stimulating growth.

More obviously, it is thought that controlling the rate of wage increase will also help to control inflation because inflation is, to some extent, based on a wage push.

I regard those arguments as fundamentally wrong in today's economy. They are not incorrect for all time. I certainly can imagine situations in which that scenario would be correct.

Other countries at particular times, even this country in the past, have in many respects corresponded to that model. But the U.S. economy does not now correspond to that model. And the attempt to make economic policy on the basis of that model is fundamentally flawed and is inflicting unnecessary suffering on vast numbers of people.

I should say that I don't know, nor do I think it particularly important, whether or not the idea that lowering wages through unemployment is an explicit objective of the Fed or whether it is simply one of those things which is thought to be a happy byproduct, from the standpoint of the business community or those people who employ labor. I am not much interested in figuring out what the various motivations involved were.

Whatever the motivations, I think it is fairly clear that the effect of 4 years of monetary restraint has been a period of zero growth in real wages. Moreover the high levels of unemployment are surely implicated in that rather disastrous performance.

The error in this notion of low wage growth, or low wages as a strategy for growth, is, first, not to focus sufficient attention on the problem of productivity and to fail to make that the central issue in economic policy making.

More importantly, perhaps, is the second error in this view, namely, that it presumes that wages are determined by productivity. Again, that is a conventional viewpoint. It ignores and overlooks the extent to which productivity might also be affected by wages. I will shortly argue that an increase in wages can affect an increase in productivity under certain conditions, conditions which in the U.S. economy now exist.

I don't think I need to argue why productivity growth is central to the economy. What I would like to focus upon instead is three reasons why I believe that at the present time, increased real wages would have the effect of stimulating productivity and therefore stimulating growth.

On the basis simply of looking at comparative international evidence, one might accept the conclusion right off. That is, you have a number of countries which have pursued high wage strategies over the long haul, that is, since the end of the Second World War, and have done very, very well. These countries are examples of what I would call a wage-led growth strategy. They include many of the northern European countries, which until the recent rise of the dollar, had considerably higher wages in manufacturing than the United States.

Of course, it could be said, and I think with some reason that you cannot use such comparative evidence to argue for a wage-led growth strategy for the simple reason that it may well have been that it was good economic performance that led to high wages and not the other way around.

Well, I want to argue that, in fact, it was high wages which led to strong economic performance and that we don't have to wait for the resumption of good economic performance to have higher wages. Rather, we should use higher wages as a part of a growth strategy.

There are three basic reasons why I think this is a reasonable strategy.

The first one has to do fairly directly with the productivity problem. It is widely understood by businessmen and also by others who work on the productivity problem, not so much by economists sometimes, that productivity is not simply a matter of technology, machinery and equipment, but a matter of how much people put into their jobs; how much care and effort they put into their work.

Basically the argument that I put forward is that to the extent that workers, employees—

Mr. FRANK. You can continue and ignore that buzzer. We will have to go up in a little while.

Mr. BOWLES. To the extent that the people who do the work have a significant amount of influence on how hard they work and how well they work, and I believe that that is a significant factor in productivity, obviously wages have or may have a major effect on productivity.

It is very simple. High wages are the carrot of worker motivation. Supervision and unemployment are the stick.

The carrot and stick work together. That is, a high-wage economy with a lot of unemployment and with close on the job supervision is one in which it does not pay not to put in a good day's work.

Now, what has happened since 1979 in this country, is that the carrot side of this country has been set aside, and the stick side of the strategy has taken over. You have increasing levels of unemployment and actually declining real wages. On the face of it, we can't say whether more stick and less carrot would work or not. But we know very well from the productivity figures of the past 3 or 4 years that indeed it has not worked.

The stick by itself is a very costly and, so far, ineffective means of restoring productivity growth.

The second basis of wage-stimulated productivity increases concerns not so much the level of wages, but rather the inequality of wages. We have an economy which has tremendous inequalities between different segments of the labor force, often the result of discrimination against women and against black people and against the others.

An economy that has large low wage segments is an economy that has a large segment of low-productivity firms. The reason is that the availability of low-wage labor makes it possible to have low-productivity firms. Obviously, no firm will purposely be low productivity, but an economy which has pockets of substantial numbers of low-wage workers is one in which low productivity firms can survive.

The elimination of low-wage labor simply through the rapid increases in the lowest of the wage segments would eliminate low-productivity firms. It has been done elsewhere with tremendously good effects.

I would argue, on this basis that simply increasing wages from the bottom up in conjunction with aggressive pursuit of full employment is the best industrial policy we could have in this country. It would simply eliminate any firm which could not design jobs in which workers produce \$7, \$8, \$9 an hour's worth of output. And that, to me, would make tremendously good sense.

It would also speak to the concerns of social justice, which must also be on the minds of the members of the committee.

Lastly, I will come to a familiar point: wages can stimulate productivity when you have a productivity problem which is to a significant extent the result of low levels of investment and capacity utilization. Increases in wages through stimulating consumer demand can reduce the level of idle capacity and thereby stimulate investment. Both increased investment and less idle capacity will stimulate productivity.

Of course, one might argue that higher wages might reduce investment if it had the effect of lowering the profit rate. It could. But, as you know, the profit rate is determined by the ratio of wages to productivity as well as by capacity utilization.

It seems quite likely, and, in fact, has occurred over a period in the United States in the 1960's, that increasing real wages can be associated with quite rapidly declining real unit labor costs so that there is no need to anticipate that increasing wages will increase unit labor costs and lower the profit rate.

Further, an increase in wages will stimulate consumer demand, thus increase levels of capacity utilization, thereby raise the profit rate, and both directly and indirectly stimulate investment therefore.

I have not focused on how a policy of high wages may be implemented. I have attempted in this brief testimony to ask the committee to think about a different way of stimulating growth, different from that being carried out by the Fed, more consistent, I believe, with economic reason at the present time.

However, among the kinds of policy measures which would be necessary, I certainly would include measures to increase the equality of wages through the elimination of low-wage labor, raising minimum wages, aggressive implementation of fair employment practices, the elimination of sexual and racial discrimination, active and aggressive interpretation of equal pay for comparable worth, and things of this type.

Second, it would involve measures to foster the rapid increase in real wages across the board. This probably would require removing some of the impediments to trade union organizing, such as the passage of the failed 1978 labor law reform legislation and other measures.

It would probably also involve reorienting antiinflation policy at the Fed and in the U.S. Government at the present time.

Inflation is often seen as the result of too much money chasing too few goods. But why not focus on the too few goods' side of the problem rather than the too much money? Why not combat inflation by accelerating the growth rate, accelerating the rate of productivity increase?

That seems to me to be top priority, to turn priorities around and focus on the growth problem rather than the monetary aggregates.

Now, all of these policy initiatives would require full employment. All three of these policies will be economically and politically impossible except in an environment of full employment.

In sum, a rational economic policy today calls for aggressive pursuit of full employment as well as the particular measures which I mentioned.

Thank you very much.

[The prepared statement of Professor Bowles entitled "Wage-Led Growth: An Alternative to Zero Sum Economic Policy Failures" follows:]

WAGE-LED GROWTH: AN ALTERNATIVE TO ZERO SUM ECONOMIC
POLICY FAILURES*

by

Samuel Bowles**

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, AND FRIENDS:

I would like to discuss with you some of the results of a recently completed three year research project on economic policy conducted jointly with Professors David Gordon of the New School for Social Research in New York and Thomas Weisskopf of the University of Michigan in Ann Arbor.¹ Among the conclusions of our research which I will present, one is of particular importance: rapid and stable long term growth in the U.S. economy cannot be stimulated by economic and social policies which result in real wage reductions and in the persistence of a low wage sector of the economy. This is not to say that high wages can never be a problem or that they are not now a problem in particular industries, but rather that they are not now a problem in the U.S. economy as a whole, and that at least a part of the unfortunate economic situation we now find ourselves in may be traced to those policies which have, by design or inadvertance, resulted in a decade of no growth in real wages.

The conclusion -- that high wages can stimulate growth and low wages retard it -- will be familiar enough to a generation schooled in Keynesian economics, but the underlying logic is quite un-Keynesian, as it hinges at

* Testimony presented to the U.S. Congress House of Representatives Committee on Banking, July 21st, 1983.

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¹ Published last month in Beyond the Waste Land: A Democratic Alternative to Economic Decline, (Doubleday) and in "Hearts and Minds: A Social Model of Productivity Growth in the U.S. Economy, 1948-1979," forthcoming, Brookings Papers on Economic Activity.

least as much on what have come to be called supply side as demand side problems.

The key to a wage-led growth strategy is the positive effect of wages on productivity and the central importance of restimulating productivity growth in any viable economic strategy. The crucial analytical proposition underlying the wage-led growth strategy is that the U.S. economy today is a slack economy not a zero sum economy. Increases in investment do not require decreases in consumption. The textbook world of inevitable trade offs is a poor description of our society, in which free lunches are indeed possible if we find the right recipe. More practically, the wage led growth strategy rejects the idea that prosperity down the road requires belt tightening by workers so as to redistribute income towards the wealthy and the corporations.

Before explaining in detail why Gordon, Weisskopf and I believe the low wage strategy for economic growth to be counter productive, it might be well to insist that the level and rates of growth of real wages are quite integrally related to monetary policy in general, and to the policy of the Federal Reserve system in particular.

I take it that while the explicit logic of the restrictive monetary policy inaugurated in 1979 was to break the inflationary spiral, one of its implicit logics has been to control the rate of growth of wages by putting more bite into the threat of unemployment, and thus helping to give employers the upper hand at the bargaining table. Whether an objective of Fed policy or merely a byproduct, the growth of money wages has indeed slowed dramatically as the rate of unemployment has risen, registering an unprecedented decline in wage settlements for the first year of major multi-year collective bargaining agreements concluded in the first quarter of this year.² Real hourly compensation has

² According to the U.S. Bureau of Labor Statistics, reported in New York Times, June 12, 1983.

has declined at an average annual rate of 1.4 percent since 1978, the year before Paul Volcker took the reins at the Fed, after growing at an average annual rate of 2.3 percent over the 1948-1978 period (and 0.6 percent from 1973 to 1978).³ Real hourly compensation in 1982 stood at almost exactly the level it had attained ten years earlier; real after tax hourly wages stood well below their 1972 level.

The economy as a whole was unmoved by these unusual developments. Though loudly applauded by business, the most sustained period of real wage decline since the immediate post World War II period was followed with a one year lag by the longest period of stagnant real output since the Great Depression. The three years of continuously rising average annual unemployment rates following 1979 also sets a post Depression record. Fixed investment (in real terms) plummeted. Moreover, as my co-authors and I suggest in the brief article appended to this testimony, the recovery currently underweigh is by almost any reasonable standard the weakest of the 6 post war expansions prior to the 1980s.

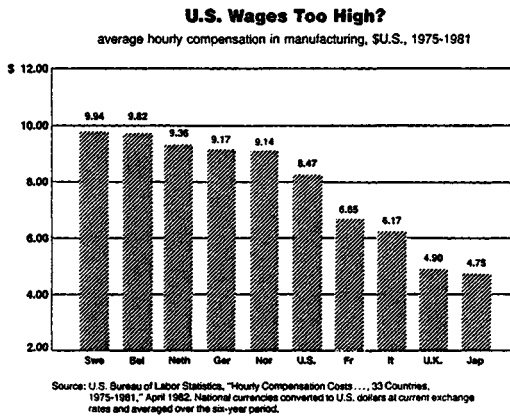
The underlying structural weakness which accounts for much of this disappointing economic performance is the (also record setting) four year stagnation in the level of productivity since 1978. A second problem, which has depressed investment (and thus contributed indirectly to the productivity debacle), is the low level of utilization of existing productive equipment. Both problems, as we shall see, have been exasperated

³ These figures and those concerning wages, productivity and unit labor costs below refer to the non-farm business sector of the economy and are calculated from data in the Economic Report of the President, 1983. The real after tax hourly wages series from S. Bowles, D. Gordon, and T.E. Weisskopf, "A Continuous Series on Real Spendable Hourly Earnings," Technical Note, Economics Institute of the Center for Democratic Alternatives, 1983.

by the decline in real wages.

The idea that lower wages are part of the solution rather than part of the problem finds little support in either historical or contemporary comparisons.

- o By comparison with many advanced industrial economies, U.S. workers are not paid high wages (see figure). Moreover, in the process of overtaking the U.S. in terms of wages during the post World War II era, the now high wage economies outperformed the U.S. in terms of investment ratios and rates of economic growth as well.
- o If we divide the recent history of the U.S. economy into an early period (1948-1966) of rising profits, rising investment, stable prices and rapid growth, and a later period of cumulating economic difficulty, we note that real hourly compensation rose at an average annual rate of 2.9 during the early period and at 0.8 during the latter.



By themselves, of course, these data hardly demonstrate the viability of the wage-led strategy, for it could well be that successful economic performance leads to higher wages rather than the other way around. Moreover, the relationship between economic performance and high wages need not be either/or: it may plausibly be argued that the two are mutually supporting aspects of the growth process. To unravel these connections we must understand the causal relationships between wages and productivity.

A school of economic thought quite prevalent in the U.S. asserts that wages are determined by labor productivity. While it is arithmetically true that productivity sets a limit on wages, the conventional wisdom cannot be sustained in any stronger sense, for there are important causal connections in the other direction; namely, ways in which wages determine productivity. I will touch on three.

First, high wages contribute to productivity because they constitute the carrot of worker motivation. As both workers and employers know and as economists sometimes forget, productivity is powerfully influenced by the quality of work and amount of effort a worker puts into a job; and both the amount and the quality of effort are determined at least as much by the worker as by the employer. High wages are one strategy to elicit high quality work effort; another is closer supervision. In the context of widespread unemployment, high wages and close supervision constitute the stick of worker motivation as well as the carrot, for under these circumstances the worker has a lot to lose by not putting in a decent day's work. Indeed, some commentators have openly hailed high levels of unemployment as a means to restore workplace discipline.

Over the last decade, and particularly since 1979, the carrot strategy has been dropped in favor of the stick. The shift has been costly in terms of the growing numbers of employees engaged in supervision rather than production (one manager or supervisor for every six non-supervisory workers in 1980). More costly still has been the growth of unemployment.

Moreover, the stick did not work, or at least it has not worked yet: after four years of no productivity growth, the rate of productivity increase in the first quarter of the current expansion was roughly one half of that achieved in the six pre-1980s expansions.

A wage-led growth strategy would reverse this costly and apparently counterproductive reliance on the stick.

Second, high wages contribute to productivity growth by forcing employers to modernize or go out of business. My point here is very simple: the main problem in the U.S. economy today is not low productivity workers but low productivity jobs. Low productivity jobs exist and proliferate because the abundance of low wage workers -- often the subjects of discrimination and other limitations on economic opportunity -- makes low productivity jobs profitable for employers. By shifting workers from low productivity to high productivity jobs, a high wage strategy coupled with a full employment program would dramatically increase productivity in the economy as a whole, even if it had no effects on productivity in each sector of the economy. Gordon, Weisskopf and I estimate that the productivity gains from such a strategy would repay the labor restraining and increased capital costs involved many fold.

Higher wages stimulate productivity in a third way as well: higher wages, and particularly rising wages, would contribute to consumer demand,

and thus under current conditions, to investment. In a slack economy in which high levels of idle capacity and slow growth of total demand constitute the primary obstacles to expanded investment, an increase in consumer demand will stimulate investment. It would be wishful thinking to believe that higher levels of investment will solve the productivity problem (its onset during the years 1966-1973 coincided with an investment boom); but a revival of investment now would certainly contribute to its solution.

The substantial decline in fixed investment from 1979 to 1982 (down 10 percent in real terms) was a response not only to rising borrowing costs, but also to the mounting level of idle productive capacity, itself the result of the virtual halt in the growth of per capita personal disposable income and personal consumption expenditures. The considerable decline in the before tax rate of return on depreciable assets of non-financial corporations over these years was undoubtedly one of the major developments curbing investment, as it surely depressed the expected profit rate on new investments: something like three quarters of this decline can be explained by the increase in idle capacity.

While it is quite certain that an increase in real wages will stimulate consumption demand, one may object that it may fail to expand aggregate demand if the wage increases lower the expected rate of profit on new investments and therefore result in further decline in investment. But we have just seen that the level of capacity utilization is a major determinant of the profit rate, and wage increases could be expected to improve capacity utilization levels through their effect on the growth of consumer demand.

The other major relevant determinant of expected profits and hence of fixed investment is the relationship between unit labor costs and producer

prices, or what we term real unit labor costs. If wage increases and the reduction of wage inequality boost productivity they could well lower real unit labor costs. (This is exactly what happened between 1960 and 1965 when real wages rose by 13 percent and real unit labor costs fell by 4 percent.)

The productivity-enhancing possibilities of the wage-led growth strategy cast doubt on two additional possible objections: that higher wages will reduce savings and hence raise borrowing costs, and that higher wages will place U.S. producers at a disadvantage in worldwide competition.

The total amount of savings in an economy depends on the size of the total product and the fraction of it which is saved. Assuming that workers tend to save less of their income than the recipients of property income, the fraction of total income saved will go up if productivity gains outpace wage increases. Even if productivity gains fell short of wage increases, total savings might increase via the positive effect of higher wages on consumer demand and hence on total output.

The international competition argument against the wage led strategy is equally dubious. According to the U.S. Bureau of Labor Statistics, over the period 1981-1982 hourly compensation in U.S. manufacturing fell (relative to its major trading partners) by 1.0 percent.⁴ Unfortunately for the U.S. competitive position, relative U.S. productivity in manufacturing fell considerably faster, by 2.5 percent. The result was a deterioration of the U.S. trade position even in the presence of relatively lower wages. Worse still,

⁴ U.S. Bureau of Labor Statistics, "International Comparison of Manufacturing Productivity and Labor Cost Trends: Preliminary Measures for 1982." U.S. DL 83-248, May 26, 1983.

the disadvantage brought about by the increase in U.S. relative unit labor costs (1.5 percent) was dwarfed by the negative effects of the appreciation of the dollar, fostered by high U.S. interest rates. The increased value of the dollar eroded the U.S. competitive position by 11.9 percent. Considering the 1980-1982 period as a whole, the 2.2 percent decline in relative U.S. wage rates was almost entirely offset by a deterioration in relative U.S. productivity. (During the same two year period the appreciation of the dollar alone accounted for a 25.1 percent deterioration in the U.S. competitive position.)

The evidence of these years thus gives little support to the tight money and wage restraint strategy for a more competitive economy. (Members of this committee might be interested to know that according to the same Bureau of Labor Statistics study, among the major economies, the country which manufacturing productivity grew fastest last year, outstripping its nearest competitor by a factor of two, was the only one which did not follow a monetarist course -- France.)

I have focused here on the macroeconomic logic of a wage-led growth alternative rather than on its obvious advantages from the standpoint of social justice, economic security and the alleviation of personal suffering. Nor have I dwelt on the policy measures which might implement a wage-led growth strategy; if the desirability and macroeconomic rationality of higher real wages and the elimination of low wage employment is accepted, the members of this committee would not be at a loss to propose measures which would move the U.S. economy in this direction. Among those included in the 24 point program in Beyond the Waste Land are:

- o wage equalization through increased minimum wages, rigorous enforcement of anti-discrimination legislation, and broad application of the principle of equal pay for comparable worth.
- o wage increases through promoting full employment and passage of the 1978 Labor Law Reform legislation.
- o shifting the emphasis in controlling inflation from monetary restraint to promoting productivity growth, and dealing with the short term adjustment or transition problems through a system of flexible tax-based price controls.

These segments of our overall program do not by themselves constitute an adequate response to the continuing weakness of the U.S. economy. But we believe they are a necessary part of any program worthy of the humane and democratic hopes of a society that is not ready to accept another decade of economic stagnation.

Mr. FRANK. Thank you, Mr. Bowles.

We will proceed with the questioning now with Mr. Roemer.

Mr. ROEMER. Thank you, Mr. Chairman.

I appreciate your statement, Professor Bowles.

I would like to ask the other members of the panel to focus on the critical part of the professor's opening statement; that is, that an increase in real wages can lead to positive things in the economy, specifically, an increase in productivity and growth and ultimately full employment.

He arrived at a conclusion with which I personally agree, and I think we all do. I wonder about his method of getting there.

Do you buy his critical argument that it is an increase in return for the laborers that makes the difference in productivity, ultimately growth, and full employment?

Mr. BRIMMER. Well, I would volunteer to comment since I can do so very briefly.

I heard Professor Bowles say at the outset that an increase in real wages is essentially tantamount to improvement in real incomes, and I would not disagree with that.

I have a great deal of difficulty, however, traveling the analytical route which he traveled to come back around this circle to substantiate that point.

Certainly, as long as I have the floor, I would say that in the 8½ years I spent as a member of the Federal Reserve Board, I never heard nor certainly did not feel myself that the strategy of monetary policy was to depress the level of real wages. I would have to take strong exception to that.

Mr. ROEMER. Maybe Professor Bowles would want to comment on that, but let me deal with you just a second, Dr. Brimmer, if I could.

Are you saying that you disagree with the contention at the heart of his presentation that we can lead and influence this cycle beginning with an increase in real wages, that that is the way to

do it? That obviously commands the attention of the worker and ultimately gets the productivity level of the worker up.

It seems I have heard that somewhere in the free enterprise litany that we often hear that incentives do get response. What about the incentives of better wages for the most critical part of our society, the human resource portion?

Do you disagree with that? That is the heart of his presentation.

Mr. BRIMMER. I would suggest that the improvement in real wages should be the outcome, one of the results of the complex of decisionmaking which starts not with the decision of the worker but with the decision of those who make decisions to employ resources and combine them and increase output.

In other words, the demand for labor derived from the demand for output and that starts with the decisionmakers in the firm. So I meant what I said.

The analytical approach is fundamentally different and I doubt, and I am surprised, Mr. Congressman, that you would think that what you heard was an exposition of the workings of the free market.

Mr. ROEMER. Professor Friedman.

Mr. FRIEDMAN. Congressman, like you and like Dr. Brimmer I believe that incentives matter. I also believe that the prospect of higher real wages is an important aspect of getting workers to apply more effort and to be more productive.

But I disagree with the idea that an opening strategy of raising real wages in a significant way, before the productivity is in hand to support those higher real wages, is a constructive way to go about generating real growth. If we pursue some strategy which involves using nonmarket forces to raise real wages significantly above the level that businesses are at the time prepared to pay, before additional productivity is in hand to fund those real wages, there are several outcomes that would occur, none of which would be very palatable. One would be an immediate surge of inflation. A second would be an absolute collapse of any kind of physical capital formation. A third would be some kind of imposition of a wage price control mechanism. I believe this is what Dr. Brimmer had in mind in saying that this did not sound much like a free enterprise solution.

In sum, yes, I agree that incentives matter. Yes, I agree that the prospect of higher real wages has a great deal to do with higher productivity. No, I do not agree with a strategy that opens with a significant increase in real wages.

Mr. ROEMER. Maybe if I could, and I know my time is running out, Mr. Chairman, maybe—obviously, Professor Bowles, like all of us in this room, will have to study your remarks over time more analytically myself.

But it rings a note in my mind of a study recently published of excellence in business. I forget the title of the book.

I have carried it around with me for a couple of months trying to get through it. Wherein the successful businesses in America were judged by this team to be a success because they took the precious commodity within the business, human resources and placed a value on that resource, treated them as human beings, involved

them in decisionmaking, rewarded them, and provided incentives for a job well done.

So maybe listening to you, Professor Friedman, Professor Bowles is right on on focusing on the human resource, right on in talking about incentives. Maybe it ought not be a national policy.

Maybe if you and I were to start a business tomorrow, the way to succeed would be to pay our workers time-and-a-half what the competition is paying and we might outproduce the marketplace.

Mr. FRANK. The gentleman's time has expired.

Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman.

I would like to ask Mr. Friedman. You earlier talked a little bit about what is happening in the marketplace right now.

You really did not use the term recovery, although a lot of the newspapers do. What do you, when you talk to your colleagues, what do you call what is happening now in the marketplace?

Mr. FRIEDMAN. I call it a business recovery. For the record, I serve on the Business Cycle Dating Committee of the National Bureau of Economic Research. Our committee met several weeks ago, and expressed an opinion that the current business cycle recovery began in November. I was present at that meeting, and I voted for that conclusion. I believe that we are now more than a half-year into a business cycle recovery.

Ms. KAPTUR. And when you look at different factors, for example, you talked about investment and what is not happening in investment. If we could take off some factors like investments, exports, housing, unemployment, inflation, and productivity and you might want to add one or two more, would you very quickly grade those for me or give me some sense of it?

I would like to know what is contributing to this recovery. Housing starts just went down due to interest rates. Then I have a couple of other brief questions.

Investment really is not occurring to the extent you think it could for the recovery. So you don't attribute the recovery due to investment?

Mr. FRIEDMAN. No, ma'am, I do not. Business investment is continuing to fall, not rise.

The mainstay of this recovery has two big components and one small one. The biggest, of course, is the increase in consumer spending, and in part it is being fueled by the tax cuts. The second biggest component is the increase in Federal defense spending, although at least to date it is as much in prospect as in hand. The third is a boost—which, following your point, I believe will be short-lived—in residential construction. As a result of the dramatic easing of monetary policy a year ago, residential construction has been increasing rapidly in recent months. It is a significant part of the recovery today. I believe, however, that if we continue along a path of an even monetary policy, and if fiscal policy does not change, then we will have higher interest rates both in real and nominal terms. Within some period of time, therefore, housing investment will once again become a drag on the economy rather than an addition.

Business fixed investment, as I said before, will also continue to be weak, as I have already explained.

The remaining part of the economy to comment on is the net export sector. There, once again as a result of this same clash between monetary policy and fiscal policy, we are crowding out our foreign sector—by which I mean not only firms that export to foreign purchasers but also firms that compete in the United States against imports made by foreign producers.

The fiscal-monetary policy clash is now crowding out several recognizable sectors of the economy, including not only business investment and residential investment through high interest rates, but also the foreign sector through the high exchange rate. It will continue to do so.

Ms. KAPTUR. Could I just ask one other thing? Over what period of time would you hope to reduce the deficit as a percentage of GNP?

You talked about the 4-percent differential between 2 and 6 percent. Over what period of time, if you could rule the world, 1986?

Mr. FRIEDMAN. I would like to move rapidly, Congresswoman. I do not believe that we now need as large a fiscal stimulus as we have. By the 1984 fiscal year, it will already be the case that something like 70 percent of the Federal deficit will not be due any longer to the shortfall of revenues and bulge of expenditures that go along with a weak economy, but will be due to this fundamental imbalance between what the revenues would be and what the expenditures would be at full employment.

Beginning as early as next year—but, if not next year, then in fiscal year 1985, and thereafter moving as rapidly as we can—I think that, for the health of our economy, we ought to be moving toward a radically different fiscal policy.

Ms. KAPTUR. Do I have any time remaining, Mr. Chairman?

Mr. FRANK. Go ahead.

Ms. KAPTUR. One additional thing. When you talked about reversing the 10-percent tax cut, very specifically, name me one or two consumption taxes that you think would be particularly useful.

Mr. FRIEDMAN. I would prefer to think about moving toward a consumption tax by incremental measures, and I will suggest a few of them.

One is to index the base for the capital gains tax. Studies repeatedly show that more than 100 percent of the capital gains that we tax in the United States actually represents capital losses after inflation. That is to say, a person buys a stock at \$100, the stock goes to \$110 at the same time that inflation is reducing the real value of that stock from \$100 to \$95, and we tax the result as if the person had made a gain.

Second, I believe that \$2,000 is too low for the amount of saving on a tax-exempt basis that the average citizen ought to be able to do through the IRA legislation. That revenue is a good idea. But, for a broad range of citizens, doing more than \$2,000 is quite a possible thing. The Government ought to encourage that.

A third idea would be to increase the non-IRA exemptions on interest and dividend income. We have used specific measures for the utility industry. I see no reason why utilities should be the only industries that ought to receive this advantage.

Mr. FRANK. We are running out of time.

Mr. FRIEDMAN. I will stop at those few examples then.

Mr. FRANK. Thank you.

Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

I would like to welcome the panelists today and thank you for your testimony. It is particularly good to see you again, Dr. Brimmer.

Mr. BRIMMER. Thank you very much.

Mr. CARPER. I would like to start out by raising a couple of questions on your testimony, if I could, sir.

On the first page of your testimony, sir, you say:

The central point in my testimony can be stated succinctly at this stage of the recovery. The Federal Reserve should continue to pursue an accommodative monetary policy.

Later in your testimony, on page 13, you state that the Fed has followed an accommodative monetary policy for the last year. Specifically looking at the targets that have been set for M_1 , M_2 , and M_3 , and the credit guidelines. How accommodative do you see those to be?

Mr. BRIMMER. First, with respect to the monetary aggregates, let me turn to the attachment to Chairman Volcker's testimony which I thought described it rather well.

If you look at the growth target and actual performance, the broad monetary aggregate, M_2 , it is right on course and I think that target range is somewhere between 7 and 10 percent annual rate of growth is appropriate and I think they are achieving it.

The same is true with respect to M_3 . There the actual growth has been just about at the high end of the target they had set.

What troubled me earlier was the presumption in the Federal Reserve of target for M_1 that they could achieve 4 to 8 percent growth rate and still remain accommodative by which I mean supply bank reserves at a rate sufficient to assure that the banking industries are in real assets investments along with the growth at a rate reflecting the credit demands of the economy.

That target was too low. If they had persisted in using the fourth quarter 1982 base and tried to achieve the growth target of 48 percent, that would have been not simply inappropriate.

I think it would have been a disaster. If they had really reduced the growth rate of bank reserves sufficiently over the remaining 6 months of this year in order to achieve that target, I think, the recovery would have been aborted sometimes over the next year and we would have stood a real chance of slipping back into a recession.

Given the fact that the Federal Reserve essentially has, as I said in my testimony, decided to let bygones be bygones, and accept the growth in M_1 that has taken place through the second quarter of this year as given and then to suggest a growth rate of 5 to 9 percent of that through the end of this year, it would be acceptable.

I think that was a wise decision.

Mr. CARPER. Thank you.

Dr. Friedman, in your comments you talked a little bit about the Fed's adoption of credit guidelines. Chairman Volcker talked a bit about that yesterday.

I think it is the first time that the Fed has set those along with targets for the monetary aggregates. How significant is the adoption of credit guidelines?

Why is it important?

Why did not we do it before if it is important now?

Mr. FRIEDMAN. Whether it is significant or not depends upon whether the Federal Reserve places emphasis on it. The only honest answer, Congressman, is that we don't know yet because we have not yet had enough experience with it.

I believe that the adoption of a credit guideline is potentially of substantial significance, and I will briefly say why. As I explained in my remarks earlier, I believe that a narrow focus on the monetary aggregates has simply become an anachronism. There may have been a time in the past when the monetary aggregates were sufficiently closely related to aspects of macroeconomic activity that we care about that a narrow focus on them would have been appropriate. That may or may not have been true in the past, depending upon one's reading of 10-year-old evidence. The evidence today is overwhelming, however, in showing that that situation, if it ever did prevail, does not any longer.

We need something more than the monetary aggregates. This is not to say that there is no useful information at all contained in the monetary aggregates. It is just that it is not enough. We need something else.

I found in my work that a credit aggregate seemed to exhibit a very close relationship with economic activity in the United States. Moreover, the credit aggregate is not just another way of adding up the public's assets. It is a wholly different idea, crossing over to the liability side of the economy's balance sheet. If we try figure out how far away some distant object is, it is helpful to have two points from which to triangulate. Looking at the monetary aggregates and then at something from the other side of the economy's balance sheet is useful in the same sense. As someone who advocated a credit aggregate for some time, I am now pleased to see that it is adopted.

I also think it is important to be very clear that this is not a panacea. It is a good idea, but it is not the end of the story. It would be just as foolish to set up some mechanical money-and-credit automatic pilot as it would have been to have a mechanical money-only automatic pilot. I would prefer to think of the credit guideline as one step in a general broadening of the base, and move toward flexibility in our monetary policy.

Mr. CARPER. Thank you. I think my time has expired, again. Thank you very much for your testimony.

Mr. FRANK. Mr. Levin.

Mr. LEVIN. Thank you. A theme that I don't think all of you adopted, but most of you do, is that if there is no basic change in fiscal policy that our present course will turn downward and perhaps in a rather dramatic sense.

Dr. Friedman, you came close to it and then backed off as to when that might occur, but I think it is important in order to understand the potential urgency or severity of this issue for Congress to get advice as to when the crush might come if there is no basic change on the fiscal side.

So, if I might ask you to hazard a guess.

Mr. FRIEDMAN. May I just make sure I understand the question, Congressman?

I don't believe that fiscal policy, if uncorrected, will cause the economy to turn down. If anything, it is the other way around.

I believe that fiscal policy is unduly expansionary, as we look ahead to an economy that will be in its second, and then third and then fourth year of a recovery. What will happen is that, through some combination of high interest rates and high exchange rates, specific pieces of the economy will be crowded out. Also, unless monetary policy is extraordinarily rigid, there will be a risk of renewed price inflation.

I don't see——

Mr. LEVIN. Which would lead to a fall in housing starts, which would lead to perhaps reduced auto sales because interest rates are too high and, therefore, a downward trend in the economy or however you want to describe it.

Let's call it serious trouble. How much time do we have? Do you think before that phenomenon would occur?

Mr. FRIEDMAN. If we think that the fiscal year 1985 budget is the earliest budget on which there is a real prospect of making significant progress, I would say that, by the time frame incorporated in the Government's 1985 fiscal year, we will be seeing these pressures emerge in our economy in sufficient force that we would have wished we had done something about it.

Mr. LEVIN. Would anybody else like to comment on that?

Mr. BRIMMER. I will comment, Mr. Levin. I would not want to put a calendar date on when the adverse effects of the deficit would be registered, but I would suggest to you that they are being registered already.

One of the adverse consequences of investors' perception of the large and persistent deficit into the future is an unwillingness to make commitments for the assumption of long-term obligations, debt and so on, so that real interest rates, that is, the difference between the trend rate of inflation and expected rate of inflation and the nominal rate so that the real interest rate today is in the neighborhood of 5, 6, 7 percent, no matter what series you want to use and that is imposing a very high hurdle over which our investment decisions cannot jump.

So that the high rates are dampening the demand for investment and outlays for plant and equipment and I suggest that that will lead to a moderation in growth long before you see a collapse of any particular sectors.

Now, I don't think you have any time at all. I understand the difficulties that this body and the Congress in general would face in trying to keep with raising higher revenue and moderating expenditures between now, say, and the first Tuesday in 1984.

I recognize that, but the task is still there. The shadow of the deficit is already very long and very dark, and I think there is no way to escape the adverse consequences.

Mr. LEVIN. Very long and very dark.

Dr. Friedman, would you agree with that?

Mr. FRIEDMAN. I agree that some of the problems that we are seeing today are already problems that would be significantly less-

ened without so great a deficit. An example is the pressure on our foreign markets. It is very clear that even today the exchange rate is exerting enormous pressure on companies in the foreign and foreign-competitive sector of the economy. It is also clear that the exchange rate would not be where it is were it not for the deficit.

But it is also important to note that the fiscal policy situation has been changing very rapidly. In the 1981 fiscal year, more than all of the deficit was the shortfall of revenues and bulge of expenditures due to the weak economy. The budget was in surplus in 1981 on a high employment basis. Last fiscal year 80 percent of the deficit was due to the weak economy, and only 20 percent was on a high employment basis. This year will turn out to be about half and half, and it is only in this coming year, the 1984 fiscal year, that will get up to a significant majority, probably around 70 percent, of the deficit being this active component.

We should not think that it would have been a good idea to have been deficit trimming last year, or even this, just as the economy was at its bottom. The deficit then was not an active deficit, but was a passive deficit associated with a weak economy.

Mr. LEVIN. Thank you.

I think Mr. Pye had a comment and then my time would have elapsed by a few minutes.

Mr. PYE. My thoughts are not that different from what you have been hearing, but I think there is this gradation. Last year you could actually say the deficit was good and that the economy would have been weaker without the deficit than it was.

Now we have moved into a phase where the deficit is bad, but it is certainly not going to cause any collapse. It is bad in the sense that people are channeling savings into Government certificates rather than into capital formation, which would do something to help productivity growth.

When the deficit becomes most intolerable, I would say, is when we get up close to full capacity because then it begins adding directly to inflation, dollar for dollar, because the economy can't produce anymore to cover the increased spending demands of the Government, and so those extra dollars that are chasing a limited number of goods all go into price increases.

So I think in that case the deficit becomes intolerable.

Mr. LEVIN. Let me just finish by saying that I think the three of you send very different messages.

Mr. BOWLES. I would like to increase the amount of differences, very briefly. I have less concern about the size of the deficit than my colleagues here.

The problem of the deficit is thought to be that it will lead to higher costs of borrowing for businesses who intend to invest. The essential argument there is that the reason why corporations are not investing is because of high borrowing costs.

I don't think that is the primary reason why corporations are not investing. I think that the essential obstacle to investment today is the rate of growth of demand, and idle capacity.

I think we all agree that businesses invest when they expect the profit rate to exceed by a considerable margin the cost of borrowing. But what determines the profit rate?

The profit rate is determined by a number of things which I mentioned in my testimony. A critical determinant of the profit rate is the level of capacity utilization. Moreover, no one is going to build new capacity when you have very high levels of capacity disutilization unless there is very rapid technical change.

So a lot of the discussions that I hear about the deficit raising borrowing costs and, therefore discouraging investment, seem to me misplaced.

It is based on a theory of what determines investment which I believe is simply empirically false or at best irrelevant to the United States today.

[In regard to the question above of Congressman Levin, the following additional information was submitted for the record by Professor Bowles:]

CONCERNING BUDGET DEFICITS

Recent studies of investment behavior (by Peter Clark of Stanford University and by economists at the Organization for Economic Cooperation and Development) suggest very strongly that the main determinant of investment is the rate of growth of demand rather than the cost of borrowing.

What this implies is that attempts to balance the budget at the present time may reduce rather than increase investment because they will necessitate cutbacks in expenditures or increases in taxation and consequently a decline in the rate of growth of demand. The beneficial attempts of reducing the upward pressure on the interest rate may simply be swamped by the negative effects of the dampening of total demand.

There are times, of course, when a large government deficit will have the effect of reducing investment. But this will only occur when the economy is operating at fairly high levels of capacity utilization and full employment. I do not think that anyone believes that the United States economy is currently in that situation.

Mr. FRANK. The gentleman's time is expired, but I will want to pick up a little bit on the deficit in my own questioning.

You alluded, Mr. Bowles, to one other aspect and that is the disproportionately high value of the dollar, particularly compared to the yen, but also elsewhere. I wanted to ask you that because of your reference to the wages of American workers.

I think we are in the process of making American workers crazy and that is not a good thing to do. The chairman and the ranking minority member are now at a meeting with the speaker and the secretary of the Treasury to schedule the bills to vote for the funds with the IMF to help the large banks and the resulting problem.

We voted a program for the Caribbean Basin. The President went on television and said "give me \$600 million for Central America."

That is insignificant. But in identical instances, when we talk about programs that might respond to some of the needs of the American workers who have been hit by the recession, it all gets reversed.

Banks made what were good loans at the time they were made. The recession is worse than we think it is going to be and so the borrowers become temporarily illiquid.

The question then is should the U.S. Government advance funds to help those temporarily illiquid borrowers over the crunch. The answer is, yes, if they are Argentina, Brazil, Chile, and Yugoslavia; no, if they are people who live in Toledo and Akron and Cincinnati.

Six million dollars is an insignificant amount when it is for Central America, but when it is for a program that might help American workers who might otherwise lose their homes because they can't make mortgage payments because they have been unemployed, virtually the same sum becomes a budget buster.

I think we have a series of crises here. I have seen more antiforeign feeling among the average American in this last year than I have seen in 15 or 20 years of watching. It affects immigration policy.

It affects international development and lending, trade policy. I think what we are doing is engendering among American workers a degree of resentment of foreigners and resistance to national policies which may very well be in our interests by what we are doing and one important piece of this does seem to be the excessive value of the dollar.

It was nice to have a strong dollar and it is nice to be able to travel cheap in other countries and hold down the inflation rate somewhat, but it does seem to me by this reliance on high interest rates and what it has done to the dollar we are paying a social price that people are not paying attention to and it is going to kick back.

I would like comments on that. I think we have a very serious crisis coming. I think all of us who serve this Congress have seen a reaction on the part of American workers to a set of policies which are hurting them and people say, gee, you should be for free trade.

Don't be protectionist and don't be restrictive, but simultaneously to pursue a policy which prices American goods out of the market, really, you can talk all you want about people not being protectionist, but if you give them that kind of an overweighted dollar which prices their goods out of the market, you are going to have very serious problems.

I would be very interested in anybody's comments on that.

Mr. Bowles?

Mr. BOWLES. I share your concern about that. I agree with the underlying ideas—I have seen them change very rapidly, too.

The first job I had was an assistant to a member of the U.S. Senate who was in favor of the 1958 Reciprocal Trade Agreements Act and wanted to mobilize support at home. He sent out telegrams to the UAW who then asked members to write in about how important it was to have an open world economy. The UAW could be counted on in the fifties to support free world trade.

They were in favor of that act in 1958. They and other unions supported free trade because workers in this country made an implicit deal at the end of the war which was essentially they were going to support free trade on the understanding that they were not going to be put out of work in large numbers.

There was an implicit understanding which was that we are going to have a full employment economy and one open to the rest of the world.

A lot of people who started off in the late forties opposing free trade turned around because they believed that full employment was, in fact, going to be the objective of the U.S. Government.

I think when you find the xenophobia and antiforeign attitudes and among some American workers today, it is because they feel they have been sold out.

They feel basically the international economy is now coming back to haunt them.

Now, I happen to think that they exaggerate that. It seems to me a very small part of the unemployment in the United States today can be attributed to foreign trade. It seems to me by far the larger amount has to do with the domestic effects of the monetary policies followed by the present administration and, indeed, to some extent the policies of the previous administrations.

If you add up, the foreign sector is not really the basic problem. It is the whole U.S. economy and the amount of fiscal or monetary restraint under which it has been operating for a very long period of time.

Mr. FRIEDMAN. Congressman, in my earlier remarks I have already agreed with what you said about the importance of the international exchange rate.

I would like to say something very briefly about your comment about the resistance of the administration to taking measures, many of them proposed by the Congress, which would have alleviated—or, if passed now, would alleviate—the burden placed on people who have lost their jobs. This also touches on a point raised by Congressman Patman earlier on.

It is important that people understand that the policies that brought inflation down are the same policies that gave us the recession. That is how we got the inflation down, and it makes no sense for anyone—the Federal Reserve, or the administration, or, for that matter, the Congress—to take the credit for getting inflation down and not simultaneously take the blame for causing the recession.

What that means, I think, is that workers who lose their jobs, as part of a national effort to reduce inflation, are doing a form of public service. They are not losing out by accident.

The policy has been to get inflation down. Maybe that is a good policy, and maybe it is not. But if we are going to have a policy to reduce inflation, we may as well be honest about how it works, and realize that people lose their jobs as a part of that policy. Somebody who does a national service ought to be compensated for it.

Mr. FRANK. Thank you. I am afraid my time has expired.

We are going to return now to Mr. Patman because Mr. Bowles was not here when he questioned and we will just throw it open to Mr. Patman to take another round.

Mr. PATMAN. Mr. Brimmer, is it true or did you say that the banks received a subsidy or the borrowers received a subsidy when they get money from the discount window?

Mr. BRIMMER. I said the potential for subsidy is there when they can borrow from the Federal Reserve through the discount window at a rate below what they would pay to borrow excess reserves from other banks as it is reflected in the Federal funds market.

Mr. PATMAN. Do you acknowledge that there have been subsidies granted to certain borrowers when the discount rate was below the market rate?

Mr. BRIMMER. That that subsidy is there at all times and it has been substantial from time to time.

Mr. PATMAN. You are speaking as a former member of the Federal Reserve Board, too, is that true?

Mr. BRIMMER. That is correct.

Mr. PATMAN. Now, is there any effort by the Fed to allocate that subsidy among banks or is it a matter of first come, first serve? What is it?

Mr. BRIMMER. Well, you see the subsidy is there not because the Federal Reserve says we will supply this subsidy, but because the interest rate differential exists.

So any bank who walks up and decides to borrow from the Federal Reserve as opposed to borrowing in the market gets the benefit of the subsidy.

Mr. PATMAN. Why would they borrow in the market if they could borrow at the Fed at that discount?

Mr. BRIMMER. I have always been puzzled by that and I concluded that, first of all, remember that the typical member bank in the Federal Reserve does not borrow at all from anybody. The typical, especially the smaller ones, have excess reserves.

But among those banks which do borrow, they borrow first from other banks through the Federal funds market and only reluctantly do they come to the discount window to borrow at all and those tend not to be the large banks, but the middle-sized banks.

Mr. PATMAN. Well, if they can borrow at a cheaper rate at the discount window, why don't they do that instead of borrowing from other banks?

Mr. BRIMMER. Because I don't think their decision is motivated entirely by the differential cost because of posture, attitudes. The typical banker to whom I have spoken over the years is embarrassed to go to the Federal Reserve to borrow.

Remember, when a member bank borrows, the first time there is probably no question at all. The vice president in charge of the discount function will say, yes.

Remember, he is borrowing at the margin to maintain the required reserves.

Mr. PATMAN. Let me ask you, are the big eastern banks the ones that do this borrowing in the main?

Mr. BRIMMER. No. The reverse is true. Small- and middle-sized banks.

Mr. PATMAN. This is something that really takes a little more education than you have time to give me, so let me move on to something else.

I appreciate your response; except for one other question that I would like to ask.

Is there a public record available that shows which banks are borrowing?

Mr. BRIMMER. No; only the volume of borrowing, the total amount of loans outstanding on the books of the reserve banks at any time, but not the amounts to individual banks.

Mr. PATMAN. Why should not that be a matter of public record?

Mr. BRIMMER. I can think of no good reason why it should not be. From time to time under so-called distressed or emergency borrowing, the Federal Reserve does identify who borrowed such as the

Franklin National and so on, but in general this has simply been treated as a matter between the banker and its customer.

Mr. PATMAN. Thank you.

I am concerned about our getting to the cost of this recent recession and, Professor Friedman, you mentioned that there are those who would ask what were all those sacrifices and were they necessary and I think a lot of us are asking those questions.

What has been the cost of the recession that we have just gone through and that we are just recovering from?

Mr. FRIEDMAN. I think that the costs have been enormous, Congressman. I mentioned this in my written statement, though not in my oral remarks.

The sad fact is that very traditional estimates of the cost of reducing inflation have proved remarkably correct. In recent years many economists have been advancing novel and analytically appealing ideas suggesting that it would be costless to reduce inflation through a preannounced and systematic reduction in the money growth. Unfortunately, those ideas have quite simply proved wrong. More traditional estimates, indicating that reducing inflation would be very costly, have been more correct. These costs are also very widespread through the economy.

It is jobs. It is incomes. It is profits; this has been the worst recession in postwar history in terms of falling profits. It is capital formation. It is job training as well as jobs that provide income across-the-board.

This has been a very expensive effort.

Mr. PATMAN. I would like to know if you or the other members could give me an estimate as to the costs quantified in, say, \$200 billion, which is a figure I have heard mentioned.

You hear the figure of \$30 billion being the impact on the deficit by one percentage point in unemployment.

Mr. FRIEDMAN. Yes; I will try that.

I worked through that calculation recently and concluded that the cost estimate that used to be fairly popular some years ago was fairly accurate, of 3 percentage points of unemployment maintained over the course of a year—or 1 percentage point of unemployment maintained for 3 years—was what it took to get inflation down by 1 point.

We have reduced the basic underlying inflation rate in the economy by something like 5 percentage points—from, say, 10 to 5. Before the episode is over, that will have cost us 15 of these so-called point-years of unemployment.

A point-year of unemployment in turn translates into something between 2 and 3 percentage points of the national output. So, 15 times 2½ gets us to the neighborhood of, four-tenths of a year's GNP—spread out over several years, of course—with the GNP now above \$3 trillion. Four-tenths of that means that this has been a \$1 trillion program to reduce inflation.

Mr. PATMAN. \$1 trillion has been the cost?

Mr. FRIEDMAN. I believe that is a good rough estimate, Congressman.

Mr. PATMAN. Just one further question on a different subject. Do you advocate switching the target that the Federal Reserve follows from whatever it is following to gross national product?

Mr. FRIEDMAN. No, sir, I do not.

Mr. PATMAN. Thank you.

Mr. FRANK. Mr. Roemer, one more question.

Mr. ROEMER. Yes, one question, Mr. Chairman.

Each of you has implied, at least to my ears, that there needs to be some coordination between monetary and fiscal policy. So my question has to do with the Fed and its relationship to the Congress; historically we have structured some independence between the Fed and the Congress.

We had testimony Tuesday of this week before this full committee. Dr. Epstein and others suggested that that independence was dysfunctional for coordination.

That, in fact, the Fed was too dependent on the commercial banks and Dr. Epstein gave a series of graphs and figures to show that, somewhat convincingly, I might add, and that the Fed was too independent of the Congress.

In fact, Congress—and I will read you one paragraph and ask for your comment. This is Dr. Epstein.

He said:

The problem is that the independent Fed is an institution which because of its power can get things done. It becomes too easy, therefore, for elected officials to abdicate responsibility to the Federal Reserve rather than face the more difficult and painful process of democratically and directly confronting the serious economic problems we face.

He concluded with the series of recommendations to erase the independent relationship. Specifically that the chairman of the Fed be appointed by the President, but have that matter be voted on by the House and the Senate.

That certain other changes in the Fed be made to erase the lines of independence and put squarely on the Congress the requirement for coordinating fiscal and monetary policy.

Could you quickly tell me, A, do you think that is a good idea? If so, why?

If not, why not? Mr. Pye.

Mr. PYE. I think it is not a good idea. I think the Federal Reserve and everyone else fully realizes that Congress is the ultimate authority, but I think the independence has served a very useful function and I think the checks and balances that exist through the fact that the Congress remains the ultimate authority has served to temper what the Federal Reserve might have liked to do in the past.

So I see that checks and balance system, that together as having served us well really, and I would not like to see that changed.

Mr. ROEMER. Professor Bowles.

Mr. BOWLES. I agree with the recommendations, at least to the extent that I heard what you said from Epstein.

At least I propose such things, perhaps even stronger than Epstein's proposal, namely, that the Board of Directors should be elected by Congress for 4 years to coincide with the Presidential term.

Mr. ROEMER. He made that recommendation, also.

Mr. BOWLES. I see no reason for this asymmetry between fiscal and monetary policy. If the right to tax is something which is closely guarded as an important aspect of a democratic society, it seems

to me that the right to inflict untold economic hardships on business and labor in this country through the use of monetary restraint should be similarly accountable to the public.

More practically, looking back at the last 4 years, I think that a board of governors elected by the U.S. Congress, whatever mistakes it would have made, would not have made mistakes of the magnitude and with the persistence that the Fed has made in the past 4 years.

Mr. ROEMER. Thank you.

I am short of time. Professor Friedman.

Mr. FRIEDMAN. I believe that the Federal Reserve is already quite clearly a creature of the Congress. Congress has the ability to exert as much direction over monetary policy now as it could conceivably want. I see no advantage to be had by the Congress actually having day-to-day involvement.

There are already these annual oversight hearings, which I think are appropriate and useful. To the extent that the Congress does not like what the Federal Reserve says it is going to do, a simple act of Congress would be sufficient to direct the Federal Reserve to do anything Congress wants. All think that is as it should be. The fact that Congress has not chosen to exercise the authority that it already clearly has in this area must indicate either that this is something that the Congress wants to stay out of, or that different constituencies within the Congress would very much like to do something about it can't agree on what they want to do.

Mr. ROEMER. Well, Dr. Epstein would make the point, I am sure, if he were here. He made it Tuesday, that politicians would like to take credit but they avoid the blame.

The problem with the independence, as currently structured, is that it is perceived independence and the round of high interest rates of the last year and a half are Paul Volcker's fault, not the U.S. Congress.

You and I know that it is much more complex than that.

The Congress does have certain authority which it refuses to exercise, but his point was the public perception now is that the Fed is, in fact, independent.

They are to blame and not the fiscal policies of the Congress.

Mr. FRIEDMAN. Scapegoats have served useful functions since Biblical times.

Mr. FRANK. Excuse me. We don't have time for the Bible. I am sorry.

Mr. ROEMER. Mr. Brimmer, my time is long gone.

Mr. BRIMMER. Professor Stein has prepared this committee with a complete misstatement of the situation. It is not a question of independence of Congress.

The Federal Reserve is independent of the executive branch of the Government, and that is because the Congress—

Mr. ROEMER. It is. It is independent of the executive branch by the Constitution, and this body has chosen to keep it that way.

Mr. BRIMMER. It is article 1, section 8 of the Constitution that gives to the Congress the right to coin money and determine the value thereof. This Congress has tried at least four times to implement that provision of the Constitution, with the first bank of the United States in 1791. It went to second bank in 1816, and went to

the National Banking Act in the 1860's, and finally, with the Federal Reserve Act in 1913.

In each instance, the Congress chose not to delegate its own responsibility to the executive branch, but to maintain it itself.

In 1935—

Mr. FRANK. I am afraid we are running out of time.

Mr. BRIMMER. Well, I would just say, finally, Mr. Chairman, that you have the responsibility. You have never given it to the executive branch. You have kept it.

You have the oversight over the Federal Reserve and that is why we are in these hearings.

Mr. ROEMER. Thank you, Mr. Brimmer.

Mr. FRANK. Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

If I could turn to a few of the comments that Professor Bowles has made. In looking at the increases that have taken place in a couple of our smoke-stack industries, for example, steel and autos, my understanding is that their wages are on balance about 100 percent above the average wages earned in other manufacturing sectors. Auto workers' wages I think, are close to 100 percent in excess of average wages paid to other components of the manufacturing economy.

Those are pretty good wages, yet those are some of the sectors where we have had the most problems with productivity and really competing in a worldwide market.

Is that consistent with the comments that you have made?

Mr. BOWLES. I think it is true that if you look at international competition, there are industries in the United States in which high wages have been a problem. I think the two you mention are among them.

I think I would reiterate that even in steel and auto, the job loss in those sectors is not primarily attributable to international competition or high wages, but rather to the slow growth of domestic demand.

I have not studied the rates of productivity growth in steel and auto industry by industry, so I can't respond to whether or not productivity has been relatively better or worse in auto and steel.

I did once look at the auto data and it does not look like you have a very rapid decline in productivity there, out of line with that of the rest of the economy. I did not look at steel. It seems to me also that what you have in auto and steel is a question of recent lack of modernizing investment, which has, I think, probably been the decisive feature in those industries. By recent, I mean over a period of 10 years.

But I think that probably to understand those two industries, you would be better off asking an economist from either the UAW or steelworkers or from employers in the industries.

Mr. CARPER. Mr. Pye, I have one last question on a slightly different subject. You are familiar, I suspect, with the compromise budget resolution which was adopted by the House and the Senate last month.

I would like you to give me an assessment or critique, if you will, of the progress that is implicit in those budget resolutions to be made in reducing budget deficits from about \$210 billion this year

to \$170 billion next year to about \$150 billion and then to \$120 to \$130 billion in fiscal 1986.

Does that progress, which is a combination of revenue increases and spending restraints, is that sufficient, in your judgment?

Mr. PYE. Well, I think it is certainly not desirable progress. I think I would like to see the deficit dropping faster than that, and I think in that compromise resolution, to me, at least, there is a distressingly small amount of cutting of spending going on—I think really a failure not to really bite the bullet on the spending issue.

It is not really only the deficits that one might say are out of control. They are at 6 percent of GNP, which is a record in this country, other than World War II. But Government spending as a percentage of GNP is at 25 percent, and that is also a record, other than World War II.

So I think we have a real problem with respect to getting Government spending down as well as getting the deficit down, so that I would certainly second what was said here, I think, by Professor Friedman. We need a real package of spending cuts with the tax increases.

I did not really see very much of that in the budget compromise resolution.

Mr. CARPER. The budget resolution calls for tax increases of \$12 billion in 1984 and in 1985, by about \$15 billion.

Do you think those increases are of a sufficient magnitude to threaten the economic recovery?

Mr. PYE. Well, I couldn't think that would cause us to go back into recession or anything of that sort, so they don't disturb me from that point of view.

But they do disturb me from the point of view of wanting to see this package of spending cuts and revenue increases together and really some real effort to get spending under control, particularly in some of the entitlement programs.

Mr. CARPER. Thank you, sir.

Mr. FRANK. Mr. Levin.

Mr. LEVIN. Thank you.

The hour is late. Let me just react to your estimate, Professor Friedman, about \$1 trillion. I think we were all struck, if not startled, by it. Not for the purpose of finger-pointing, but to learn from hindsight, let me just ask you, maybe you could elaborate either for the record or just through private communications.

Let me start with you, Professor Friedman, because you gave the estimate.

Looking back, was there an alternative?

Mr. FRIEDMAN. Yes, sir, I believe there were two alternatives. One would have been to decide that inflation was not a sufficient problem to be worth bearing the cost, and to continue on as we were. Then we would not have had the tightening of both monetary and fiscal policy that gave us the two recessions in a row that have brought inflation down.

A second alternative would have been to impose wage and price controls. I believe that the problems associated with that solution are well known.

The third available course is what we did, namely, decide that inflation was a serious enough problem to make it worth a large price to reduce it, and then to proceed as we did.

I think those were the three main choices in hand and we could have picked any one of the three. We chose to pay the cost to get inflation down.

Mr. LEVIN. In hindsight, which of the three, in your judgment, was preferable?

Mr. FRIEDMAN. That is a very difficult thing to say, Congressman. I honestly don't know what I would have done had I been in the position of Congress and the administration. I am sensitive both to the problems caused by inflation as well as to these enormous costs which we have been pricing out in dollar terms, but the real aspects of which of course go well beyond dollar magnitudes.

The only honest answer is that I don't know exactly what I would have done in that place.

[In regard to the question of Congressman Levin, the following information was submitted for the record by Professor Bowles:]

CONCERNING ALTERNATIVES FACED BY POLICYMAKERS

While one might wish that the menu of options had been considerably broader than that suggested by Professor Friedman, I think that the list of three which he proposes does fairly accurately reflect the viable options open to policy-makers in, say 1979 or 1980.

In contrast to Professor Friedman, however, it seems to me that the choice among the three alternatives (at least in retrospect) should have been fairly obvious. Doing nothing about inflation was clearly not a viable alternative. The policy of monetary restraint which was adopted cost the American people, according to Professor Friedman, about one trillion dollars. According to my calculations, while it substantially reduced the rate of inflation, it did not break the inflationary spiral in the sense of shifting the price-unemployment relationship in a favorable direction. It simply had the effect of moving along the same old highly unfavorable tradeoff line to a tradeoff with exceptionally high unemployment and relatively low (by recent standards) rates of inflation. With a one trillion price tag on this set of policies, the arguments for some system of price control look quite appealing; indeed, it seems to me that no reasonable estimate of the obvious costs of a system of price control, whether it be in terms of bureaucratic rigidity in prices, allocative inefficiencies, or simply the use of labor to administer these controls, no reasonable estimates of these costs would be likely to come close to matching the trillion dollar anti-inflation policy initiated by the Federal Reserve System in 1979. Moreover, a considerable amount of the disruption of personal lives, human suffering, and worse occasioned by the high levels of unemployment and declining real wages could have been avoided had the Federal Government chose to attempt to control prices directly rather than by using the unemployed as the shock troops of the war against inflation.

I would not favor, however, a system of direct price controls of the type which we had during World War II. It seems to me that a system of tax-based price control incentives can be devised. A number of proposals have been circulated. My co-authors and I in *Beyond the Wasteland* outline one such tax-based price control system in which the taxes raised from the tax penalties against excessive price increases would be used for investment subsidies in bottleneck sectors of the economy, thus inducing greater flexibility, and facilitating a smoother and more rapid reallocation of resources when necessary.

I would ask the opponents of price controls, which appear to be most members of the Economics profession, unfortunately, to come up with an estimate of the likely costs of a system of price controls and see how it compares with the exceptionally costly recent four year period of economic stagnation, which is apparently the best that those that rule out price controls as a matter of principle can come up with as an anti-inflation measure.

Mr. LEVIN. Well, maybe we should close. It is late.
Thank you, Mr. Chairman.

Mr. FRANK. Thank you, gentlemen. We appreciate your spending these hours with us.

The hearing is adjourned.

[Whereupon, at 12:45 p.m., the committee adjourned.]

