CONDUCT OF MONETARY POLICY

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

HEARINGS

BEFORE THE

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 17 AND 18, 1985

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Howard Lee, *Staff Director*

CONTENTS

CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 17, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 9:35 a.m., in room 2128, Rayburn House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Chairman Fauntroy; Representatives Neal, Barnard, Hubbard, Roemer, Cooper, Carper, Erdreich, McCollum, Hiler, Leach, and Ridge.

Also present: Representatives LaFalce, Schumer, Wylie, McKinney, Parris, Bereuter, McCandless, and Grotberg.

Chairman FAUNTROY. The subcommittee will come to order.

Today we hold the semiannual hearings on the conduct of monetary policy held pursuant to the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. Our witness today is the Honorable Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve System who will testify on the Federal Reserve's Monetary Policy Report to the Congress.

In our last set of hearings held in February and March of this year, we noted the clouds gathering in the economic horizon. While we were encouraged by the low inflation rate and the rapid rate of economic growth over the previous five quarters, distortions in the economy—including the burgeoning budget deficit, the high unemployment rate, the worsening trade deficit, the strength of the dollar, and the poor performance of heavy industry and agriculture—raised concerns within the subcommittee. At present, the clouds have overshadowed the horizon as economic growth has slowed substantially and unemployment has remained above 7 percent. In addition, the United States has achieved the dubious honor of becoming a net debtor nation for the first time since 1914.

These distortions are both related and unprecedented. The huge budget deficits have resulted in a substantial inflow of foreign funds, strengthening the dollar while worsening the trade deficit and limiting prospects for economic growth in the United States. Interest and trade sensitive sectors, such as heavy industry and agriculture, have been adversely affected by these events while other industries, including services, defense and high tech, have fared relatively well. Since many of these events represent uncharted terrain for economic policy in the United States, we need to address their impact on economic growth and the conduct of monetary policy.

To the Chairman I asked that he address the outlook for the economy in terms of the following questions. How do these distortions affect the current state of the U.S. economy? Are we in a "growth recession?" What are the prospects for growth in heavy industry and agriculture during the coming 18 months? What implications do these distortions hold for the U.S. economy in the long-run as a whole? How are they likely to affect the performance of heavy industry and agriculture? Is the current weakness in these sectors merely a temporary response to the strong dollar, the trade deficits and the high interest rates, or is it indicative of long-run changes in the structure of U.S. industry in response to international competition?

In addition, I requested Chairman Volcker to focus his comments on the impact of these distortions on the conduct of monetary policy. Will they substantially diminish the options of the Federal Reserve in its conduct of monetary policy? What, if anything, will these distortions do to narrow the options available to the Federal Reserve? Do these events explain why, at the end of 6 months, the Federal Reserve exceeded the monetary targets established last year, or does it explain the decision to rebase the M1 target. What is the meaning for the primacy of M1, therefore, as a target for monetary policy.

More to the point, let me simply note that while I fully understand, appreciate and indeed agree with the current easing of the money supply, I am concerned that the rebasing of M1 targets, though intended as a purely technical change, may be misinterpreted by participants in the financial markets. I am concerned that the Fed elected to pursue this course and I hope that Mr. Volcker will elaborate on the circumstances which underlie this decision.

Chairman Volcker, we are honored to have you before the subcommittee. In addition to reaching the goals of the Humphrey-Hawkins Full Employment and Balanced Growth Act, namely those of full employment and stable prices, we must act to address the numerous distortions currently affecting the performance of the U.S. economy. While many of these distortions require legislative and administration action, our assessment of the Federal Reserve's conduct of monetary policy requires that we understand both the response and the parameters of monetary policy.

[The opening statement of Chairman Fauntroy, the letter of invitation to Chairman Volcker, and economic charts follow:]

OPENING STATEMENT OF THE HONORABLE WALTER E. FAUNTROY
CHAIRMAN, SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

at a Hearing

ON THE REPORT ON MONETARY POLICY
OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
MADE PURSUANT
TO THE HUMPHREY-HAWKINS FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

WEDNESDAY, JULY 17, 1985 -- 9:30 A.M.
2128 RAYBURN HOUSE OFFICE BUILDING

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In my letter of invitation to Chairman Volcker, I asked that he address the outlook for the economy in terms of the following questions. How do these distortions affect the current state of the U.S. economy? Are we in a "growth recession?" What are the prospects for growth in heavy industry and agriculture during the coming eighteen months? What implications do these distortions hold for the U.S. economy in the "long-run" as a whole? How are they likely to affect the performance of heavy industry and agriculture? Is the current weakness in these sectors merely a temporary response to the strong dollar, the trade deficits and the high interest rates, or is it indicative of long-run changes in the structure of U.S. industry in response to international competition?

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More to the point, let me simply note that while I fully understand, appreciate and indeed agree with the current easing of the money supply, I am concerned that the rebasing of M1 targets, though intended as a purely technical change, may be misinterpreted by participants in the financial markets. I am concerned that the Fed elected to pursue this course and I hope that Mr. Volcker will elaborate on the circumstances which underlie this decision.

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LETTER OF INVITATION TO CHAIRMAN VOLCKER

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

June 27, 1985

The Honorable Paul A. Volcker
Chairman
The Board of Governors of
the Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D. C. 20551

Dear Paul:

The Subcommittee on Domestic Monetary Policy will hold hearings on the conduct of monetary policy and the Federal Reserve's Monetary Policy Report to Congress made pursuant to the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. I would like for you to testify on the Report and related issues at a hearing to be held on Wednesday, July 17, 1985 at 9:30 A.M. in Room 2128 of the Rayburn House Office Building.

As provided by the Full Employment and Balanced Growth Act of 1978, I would expect your testimony to address the outlook for the economy during the remainder of 1985 and 1986 and the Federal Reserve's objectives for growth of money and credit during this period.

In addition, I would like for your testimony to focus on the distortions in the economy which may contribute to what has been termed a "growth recession." I am particularly interested in your views on the effects of the continued large Federal budget deficits, the continued strength of the dollar in international financial markets, the worsening trade deficit, the implications of our status as a "net debtor" nation," and the decline of employment and investment in heavy industry.

Finally, inasmuch as I am concerned that the options of the Federal Reserve could be substantially diminished with untoward consequences for long term money and credit availability, I would also be interested in your assessment of the impact that these issues may have in narrowing the options of the Federal Reserve in its conduct of monetary policy.

Please plan to testify before the Subcommittee on Wednesday July 17, 1985, at 9:30 A.M. in Room 2128 of the Rayburn House Office Building. Insofar as all Members of the Full Committee are invited to participate in these hearings, please provide the Subcommittee with 150 copies of your own testimony, and 150 copies of the Monetary Policy Report to Congress.

I would like to receive your testimony and the Report no later than 4:30 P.M. on Tuesday, July 16, 1985. In light of the importance which the financial markets place on the information contained in these materials, I would expect that they will be released to the Press at the time of delivery to the offices of the Subcommittee.

If there are any questions concerning this request or your testimony, please contact Howard Lee, Staff Director, at 226-7315.

I look forward to your testimony and thank you for your efforts in support of the hearings on monetary policy.

Sincerely yours,

Walter E. Fauntroy
Chairman
Subcommittee on Domestic Monetary Policy

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

M E M O R A N D U M

TO: Members, Subcommittee on Domestic Monetary Policy
Members, Full Committee on Banking, Finance and Urban Affairs

FR: Walter E. Fauntroy, Chairman
Subcommittee on Domestic Monetary Policy

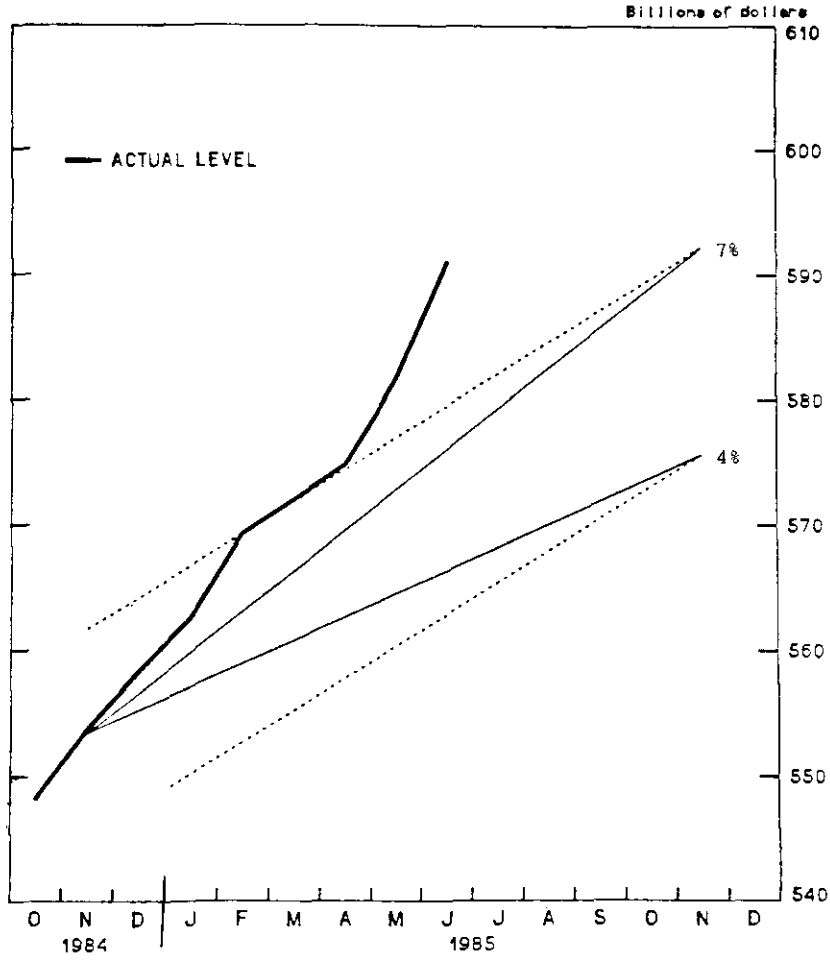
DT: Tuesday, July 16, 1985

RE: Graphic Presentations for Hearings on
the Conduct of Monetary Policy

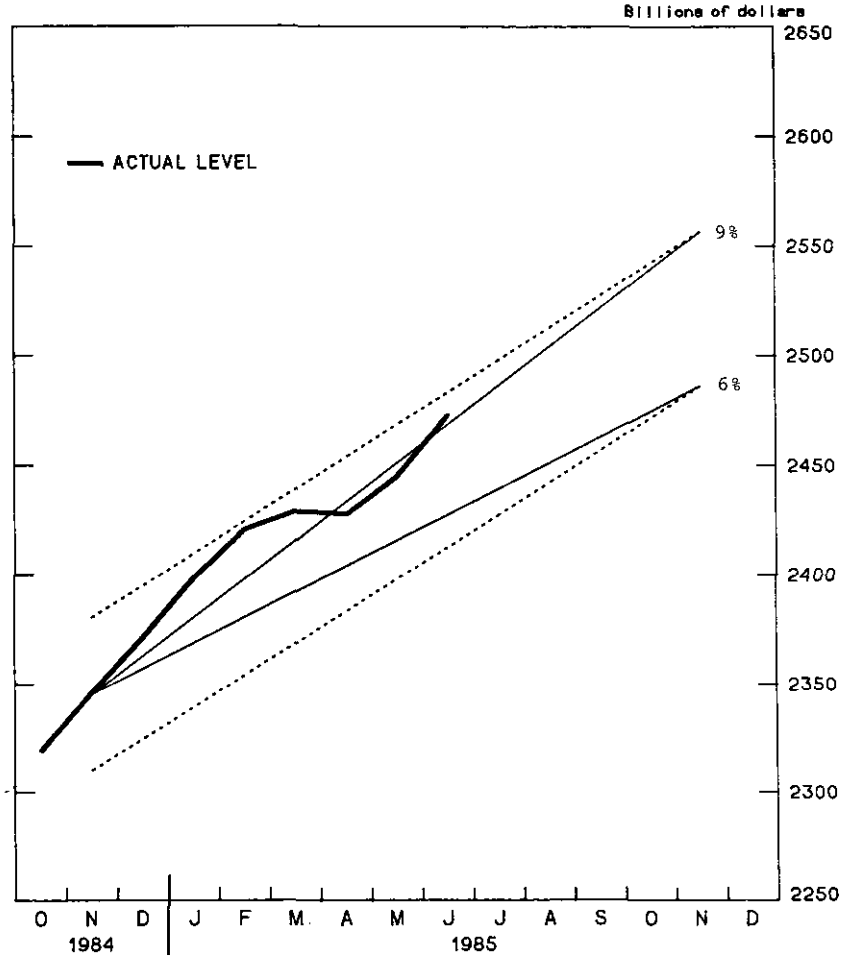
The 17 graphs included contain a presentation of monetary, employment, financial, and economic measures which are constructed to assist Members in reviewing the Federal Reserve's monetary policy report to the Congress for July 1985. The first 4 charts show the target or monitoring ranges for the monetary and credit aggregates. The next 4 charts show various measures of employment and unemployment.

The remaining charts depict the interest paid on the debt, the budget deficit, Treasury interest rates, inflation, economic growth, and the growth of exports and imports.

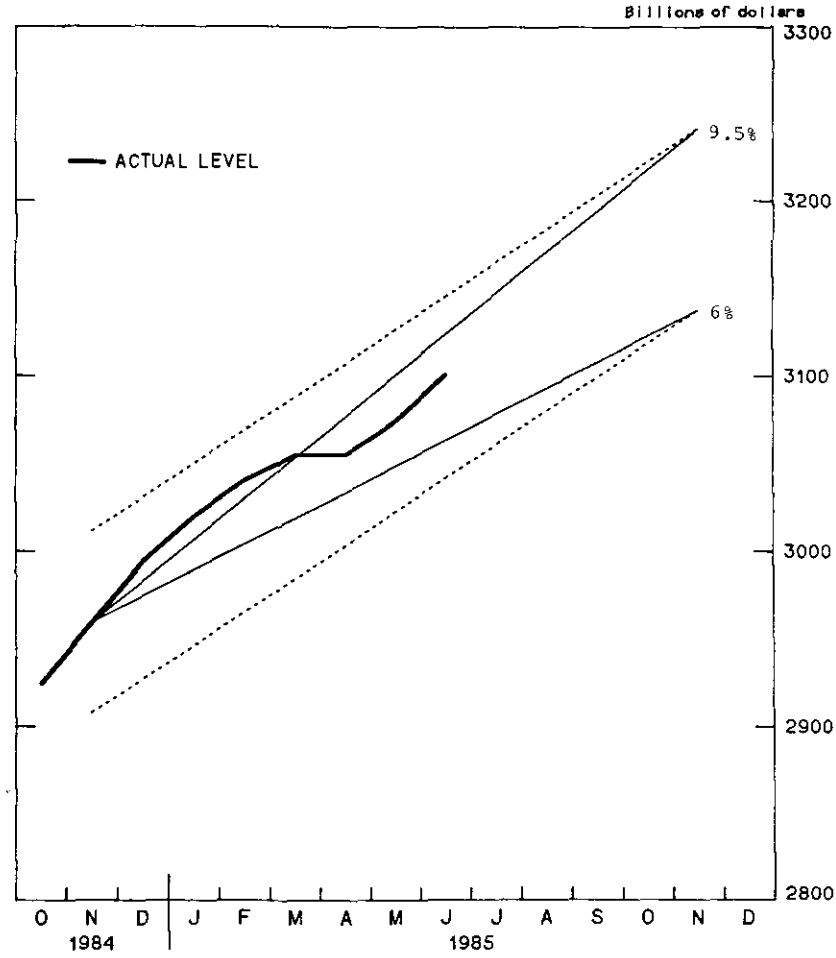
M1 Target Ranges and Actual



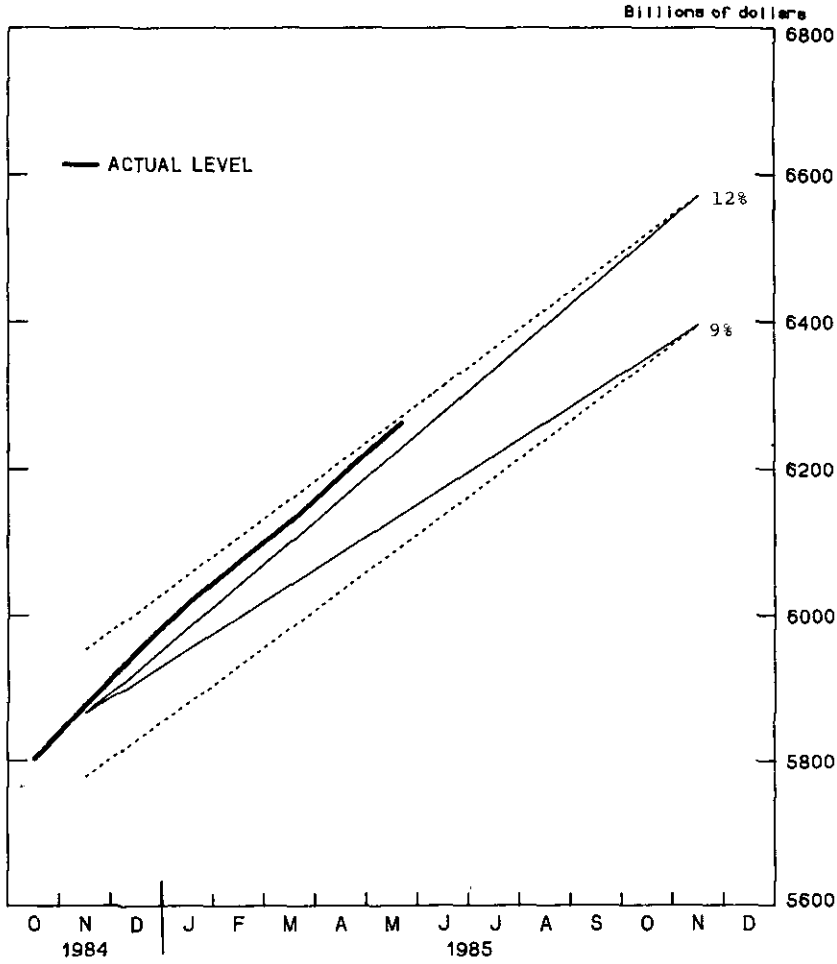
M2 Target Ranges and Actual

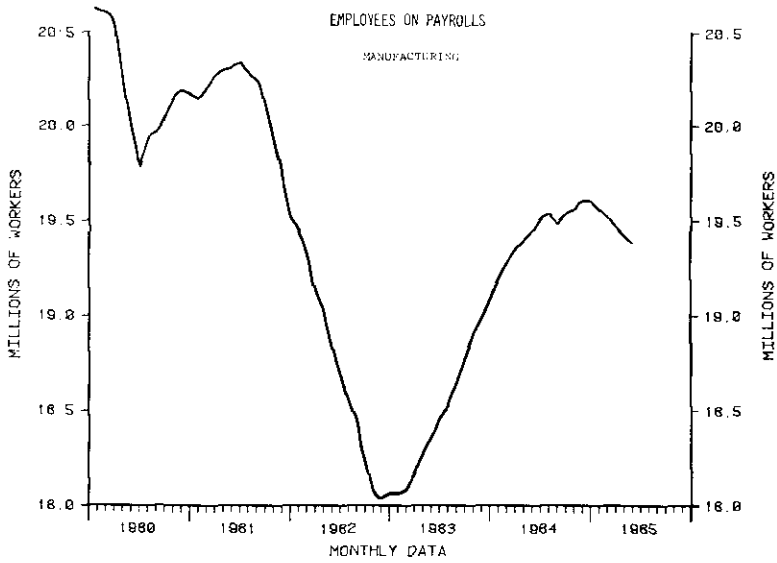


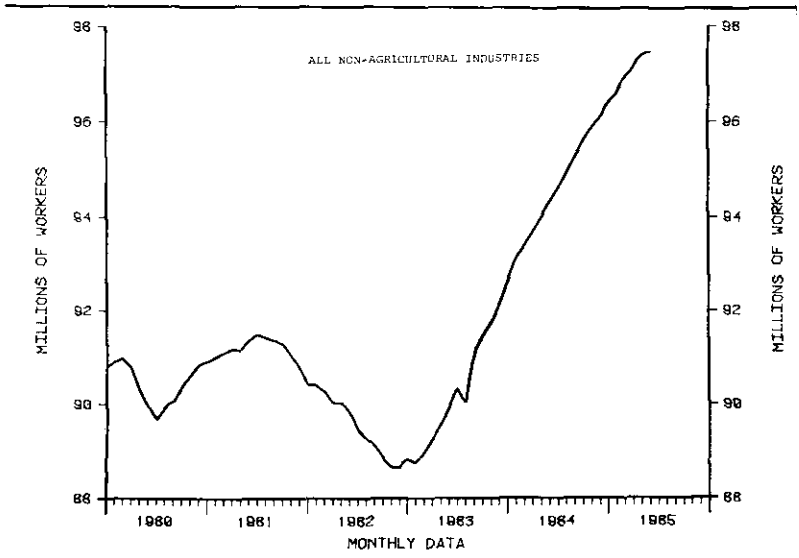
M3 Target Ranges and Actual

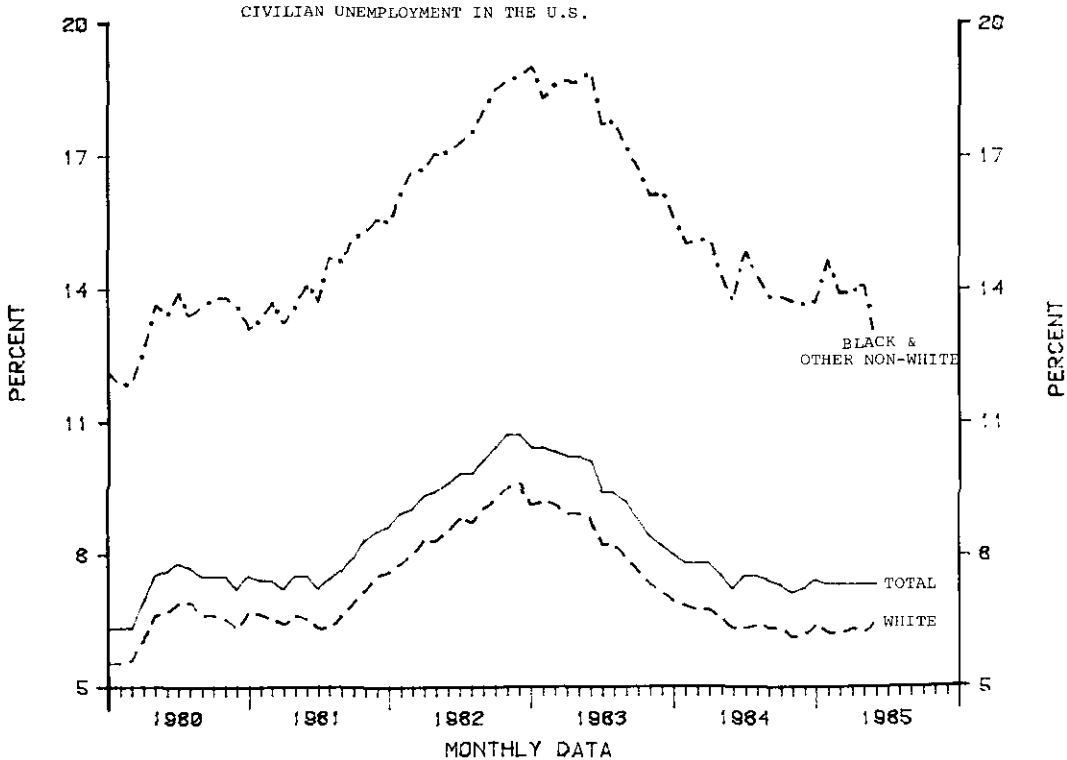


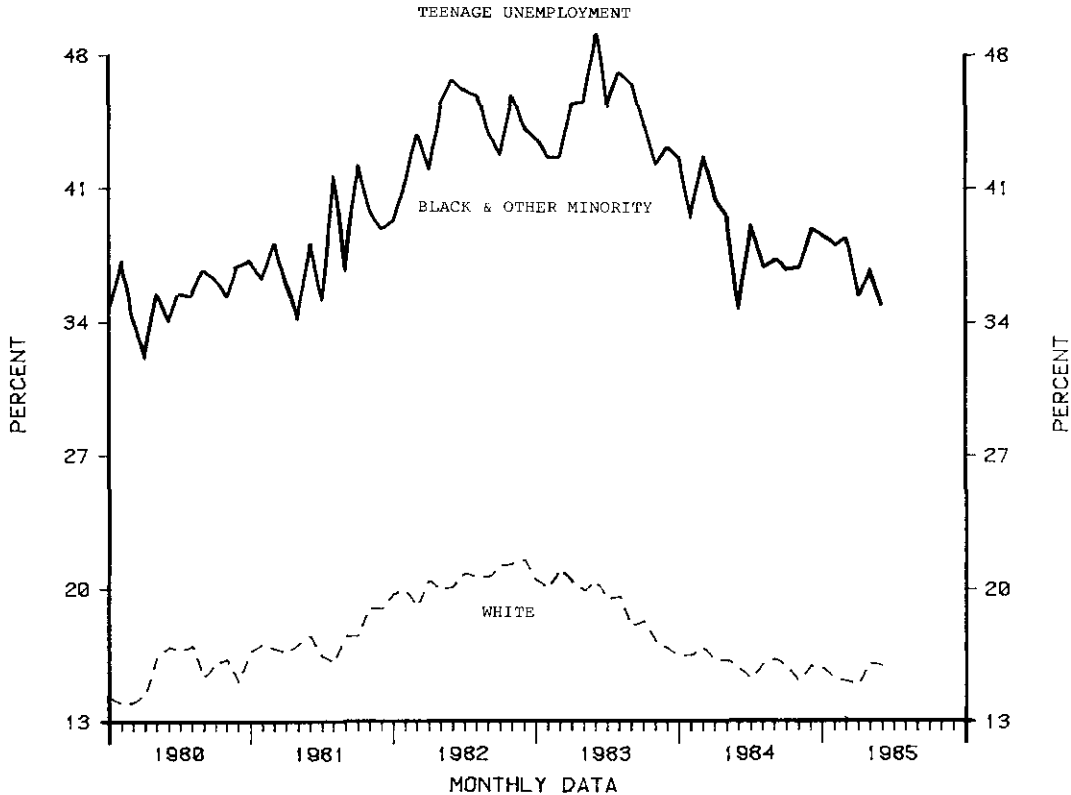
Debt Monitoring Ranges and Actual

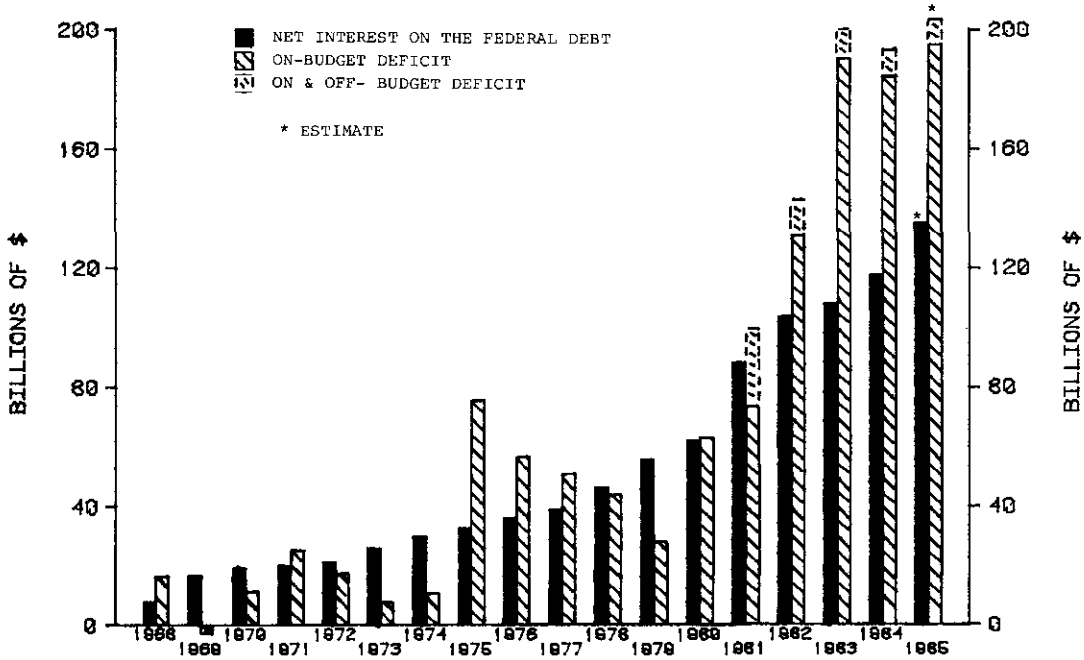


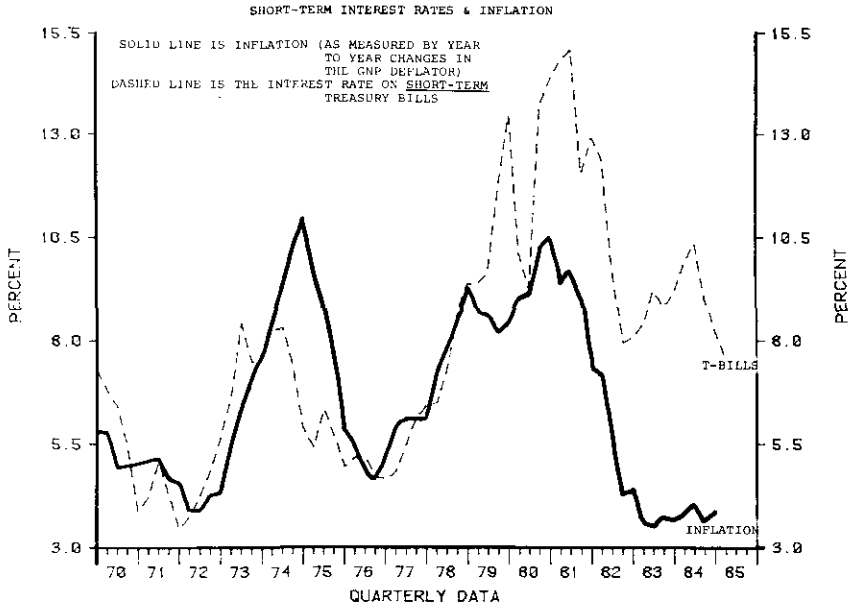


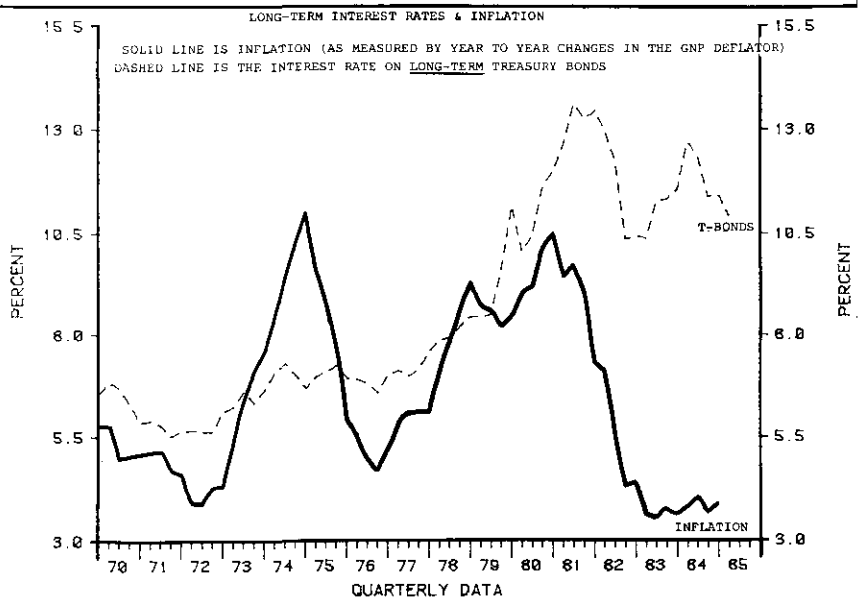


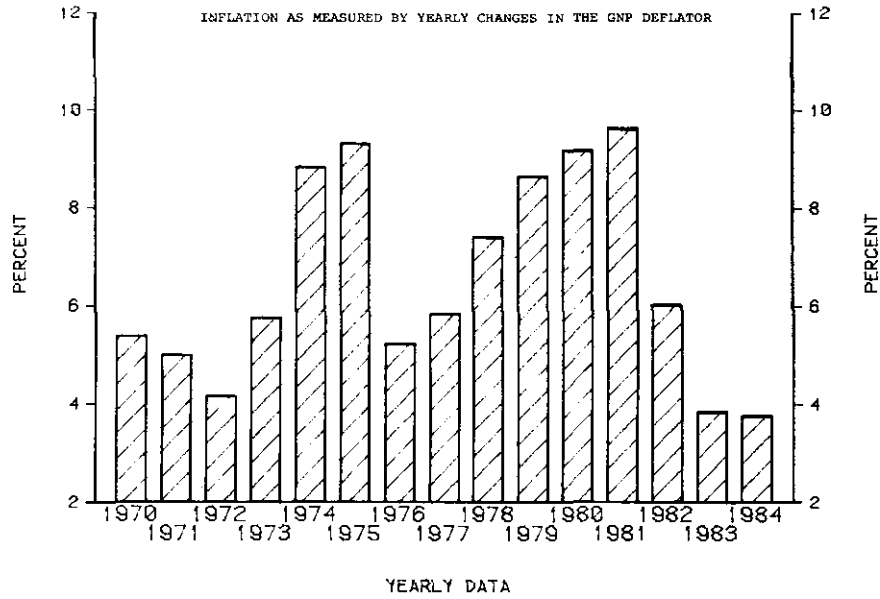


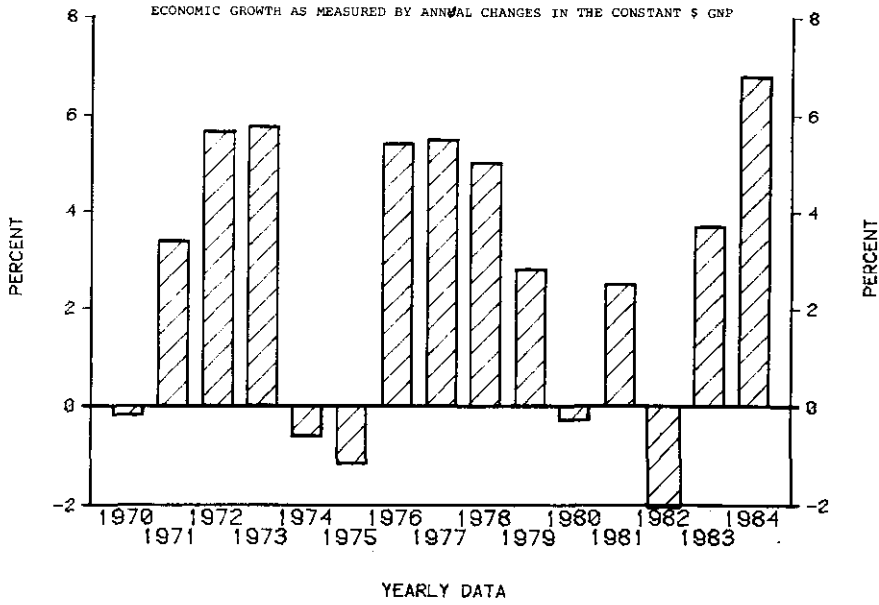


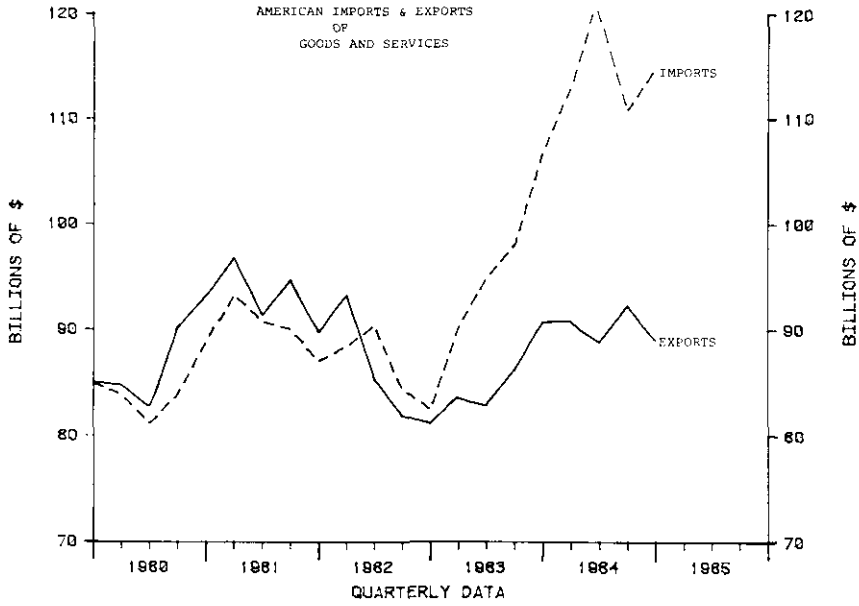


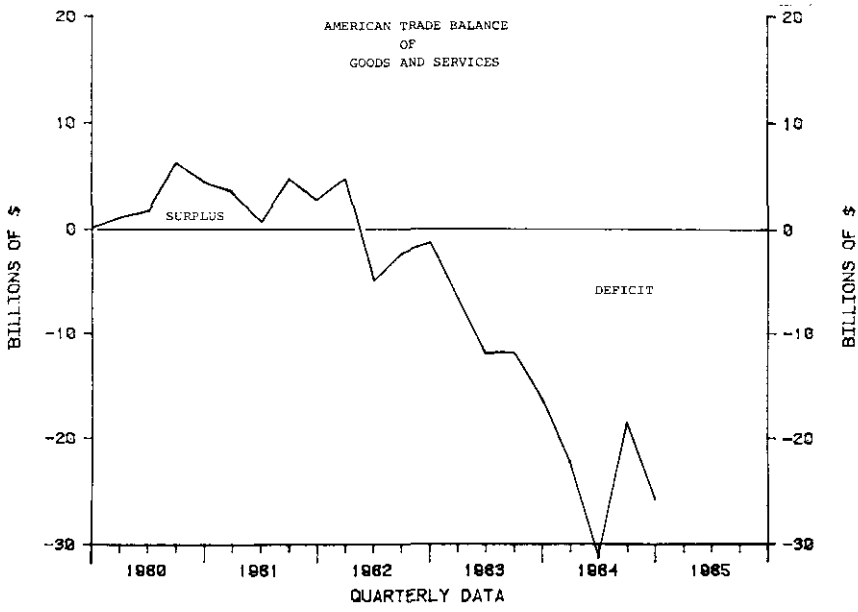


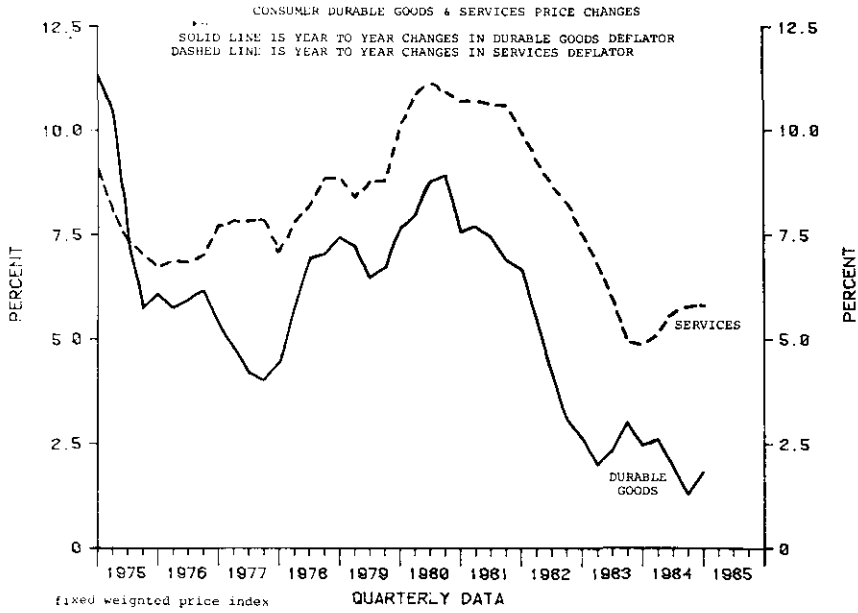


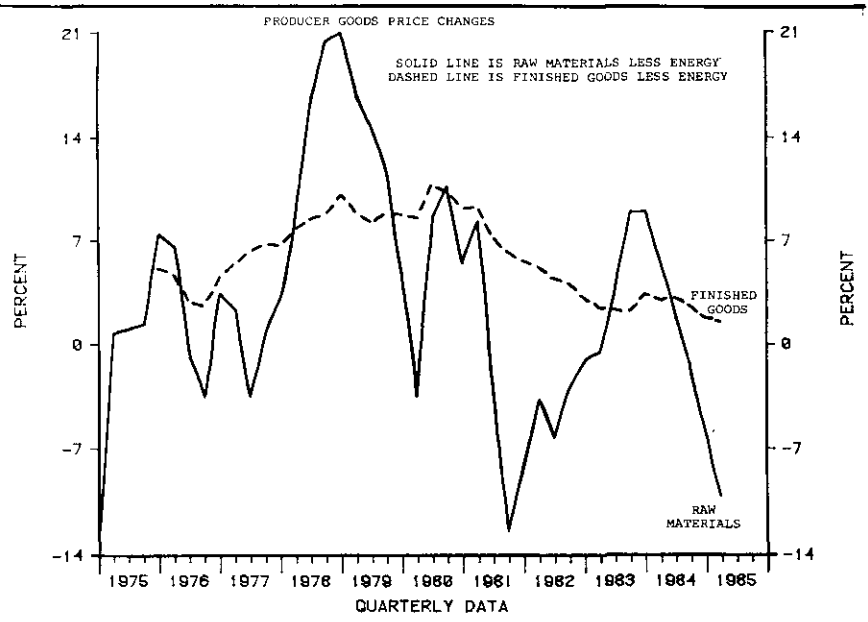












Chairman FAUNTROY. Before yielding to the Chairman for his presentation, let me yield to the distinguished ranking minority member of the subcommittee, the gentleman from Florida, Mr. McCollum.

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

I would like to take this opportunity to welcome Mr. Volcker to the semiannual hearing on the conduct of monetary policy.

Mr. Chairman, we on this committee, as evidenced by last week's hearings on government securities dealers, can hardly wait for our chance to gain insight into what the thinking is of the Chairman and the other members of the Open Market Committee. The goal of monetary policy in my view is to provide sufficient liquidity for the maximum amount of non-inflationary growth possible in our economy. This growth should be sufficient to accommodate the new entrants into the work force, and should provide for reduction of domestic unemployment to the full noninflationary rate.

This growth should also provide for a real growth in personal income so that all Americans enjoy a better, fuller life. I understand that sometimes monetary policy must accommodate other short-term economic situations such as liquidity crunches due to bank failures. Therefore, we depend on the expertise of members of the Open Market Committee to make these decisions.

The problem which is faced by members of the committee and others is that the monetary policy does not function in a vacuum. The performance of the economy depends on many factors, but primarily is dependent on monetary and fiscal policy.

As much as my monetarist friends would like to sever this relationship, it appears that monetary policy and fiscal policy are inextricably linked. What concerns me is the recent failure of the House and Senate budget conferees to come to grips with meaningful cuts in the budget deficit.

Earlier this year, Chairman Volcker testified before us that the Fed's economic projections and the credit market participants were anticipating a minumum of $50 billion in deficit reductions. Now it appears that we are looking at a compromise of only $40 billion in cuts and very few, if any, of the changes that would lead to meaningful cuts in the out years.

I am very interested in the Chairman's views on the effect that the new budget numbers will have on the Fed's conduct of monetary policy and economic conditions that will prevail under this scenario. Our economy is truly international in nature. We have recently experienced an extremely large trade deficit due primarily to the high value of the dollar. This situation has affected the American economy from the corn fields of Iowa to the assembly lines of Detroit to the computer manufacturers of Silicon Valley.

In recent weeks, we have seen what I hope is a reversal of the value of the dollar. I am interested in Chairman Volcker's analysis of the situation and how the Fed views the present exchange rate movement.

I am also interested in the timing that a decline in the value of the dollar and an increase in domestic manufacturing activity that has been predicted to follow this decline. I am concerned about the impact of the declining dollar on our ability to finance the Federal debt and the possibility of crowding out of U.S. borrowers, both

commercial and consumer, as foreign investors abandon their dollar-denominated holdings.

The recent rapid growth of M1 above the targets has raised questions about M1. With the increase in M1 we would expect to see the rate of economic activity increase at a greater pace than we experienced recently. This leads me to wonder if there is not validity to the argument there has been a fundamental change in the savings participation of U.S. citizens and corporations.

It has been brought to my attention that the NOW account section of M1 increased faster than the other segments of M1. This would lead, since the turnover rate for NOW accounts are lower, to a sharp decline in the velocity we have seen. Are our citizens using NOW accounts more as savings accounts, thus discrediting targets for M1? We experienced an increase in business savings of 3 percent over the savings rate of 1983. Is this a permanent change in business behavior or is it just a result of depreciation rules that we are now operating under?

These are all questions that I hope will be investigated during the course of the hearings.

I am eager to hear the testimony of the Chairman, Mr. Volcker, and to ask questions and to hear questions of my colleagues. I believe we as a country are lucky to have a Chairman of the Federal Reserve that is as well respected worldwide and is as articulate as you are, Mr. Volcker, and I welcome you.

Chairman FAUNTROY. I thank the gentleman for his remarks.

Are there opening comments that the members on the majority side would choose? Are there opening comments by members of the minority side? Hearing none, Mr. Volcker, we are again very pleased to have you appear before our subcommittee, and we look forward with great anticipation to your statement. We have it in its entirety, you may proceed in whatever manner you so choose.

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

Mr. VOLCKER. Thank you. Mr. Chairman, Mr. McCollum, you both raised a good many relevant questions, most of which I at least touch upon in my statement, so I will proceed by reading it, if that is acceptable.

I welcome the opportunity to review with you monetary policy in the context of recent and prospective economic and financial developments. The economic setting and the decisions of the Federal Open Market Committee with respect to the target ranges for the monetary and credit aggregates are set out in the semiannual Humphrey-Hawkins Report. As usual, I would like to amplify and develop some aspects of those decisions in my testimony.

THE ECONOMIC AND FINANCIAL ENVIRONMENT

The pattern of slower, and more lopsided, growth in domestic output that developed during the latter part of 1984 became even more pronounced during the first half of 1985. Manufacturing activity overall has been essentially flat following exceptionally large gains earlier in the expansion period. The farming and mining sectors have remained under strong economic and financial pressure.

But consumption—supported directly and indirectly by large increases in personal and Federal debt—has continued to rise fairly strongly. Construction activity has also expanded, responding in part to lower interest rates. Despite recent losses of manufacturing jobs, employment growth in services and trade has been strong enough to keep the overall unemployment rate essentially unchanged at about 7¼ percent.

The contrast between marked sluggishness in the goods-producing sector of the economy and rising domestic consumption and demand is reflected in continuing strong growth in merchandise imports. Those imports in real terms are up by about 60 percent in 3 years; in manufactured goods alone the increase has been even more rapid. Overall, imports have now reached a level equivalent to 21 percent of the value of domestic production of goods. In contrast, exports have stagnated, and now account for only about 14 percent of goods output.

I can put the same point another way. Domestic final sales—to consumers, to businesses, and to governments—appear to have been expanding at a relatively brisk rate of more than 4 percent so far this year. Domestic output of goods and services has not nearly kept pace, rising at a rate of around 1½ percent or perhaps less. That is partly because inventory accumulation has slowed. But it is mostly because more of the domestic demand is being satisfied by growing imports.

That was true earlier in the expansion period as well. But we have felt it more as growth in demand has slowed to a more sustainable rate. Another potentially disquieting development has been the apparent failure of productivity to maintain the strong gains achieved earlier in the expansion period. The implication is that the underlying trend may not have increased as much as hoped from the poor record of the 1970's.

Against those cross-currents in the economy this year, the Federal Reserve, in conducting its open market operations, has not appreciably changed the degree of pressure on bank reserve positions, which had already been substantially eased by the end of 1984. In May, the discount rate was reduced from 8 to 7½ percent. That action was consistent with the general tendency of market interest rates to decline further over the period, extending the rather sharp reductions during the Autumn and early last winter. Both the discount and short-term market interest rates in May and June reached the lowest levels since 1978.

The relatively accommodative approach in the provision of reserves has been designed to provide support for the sustained growth of economic activity against a background of relatively well contained inflationary and cost pressures. Indeed, sensitive agricultural and industrial prices—including prices of crude petroleum—have been declining appreciably, and prices at the wholesale level have been almost flat. It is somewhat reassuring that the trend in wage and salary increases has, overall, remained at the sharply reduced pace established at the start of the recovery period, although the slowdown in productivity has been reflected in higher unit labor costs and some pressures on profit margins. Clearly, even if reduced, some momentum of inflation has persisted in the economy as a whole, and expectations remain sensitive. But so far this year,

price increases have been concentrated largely in the service sectors.

Meanwhile, the broader measures of monetary growth—M2 and M3—have remained generally within the target ranges established early in the year. However, currency and checkable deposits, measured by M1, have increased much more rapidly than envisaged.

[See the attached charts on pages 32-34.]

Until May, growth in that aggregate remained in an area reasonably close to the upper band of the target range. Given that the more rapid growth during that period followed some months of subdued expansion, the outcome through April was reasonably in line with FOMC intentions and expectations. More recently, in May and June, a new surge in M1 carried that aggregate much further above the targeted range.

At the same time, total nonfinancial debt [see attached chart on page 35] has continued to expand substantially more rapidly than the GNP, propelled particularly by the Federal deficit and consumer credit. As much as 1 percent of that debt expansion can be traced to a continuing—and, from a structural point of view, disquieting—substitution of debt for equity as a result of mergers and other financial reorganization. More generally, these developments also point up the apparent dependency of economic growth, under circumstances existing this year, on a relatively high level of debt and money creation.

Unduly prolonged, those developments would not provide a satisfactory financial underpinning for sustaining growth in a context of greater price and financial stability. For the time being, however, taking account of current and likely economic developments, the downward pressures on commodity prices, and the high level of the dollar that has prevailed in the foreign exchange markets, the growth in M1 and debt has not in itself justified a more restrictive approach toward the provision of reserves to the banking system.

After increasing sharply from already high levels in the early weeks of the year, the dollar more recently has fallen back against the currencies of other leading industrial countries, dropping abruptly over the past week or so to about the average levels of last summer. At these exchange rates—still about 60 percent above the relatively depressed levels of 1979 and 1980—prospects for stemming the deterioration in our trade accounts, much less achieving a turnabout, remain uncertain. Much depends upon the rate of growth in other countries that provide the principal markets for our exports and are the source of our imports. In any event, the potential effects of interest rates and decisions with respect to monetary policy on exchange rates and the external sector of the economy have necessarily been a significant ingredient in FOMC deliberations.

THE OUTLOOK FOR THE ECONOMY

Members of the FOMC generally have projected a pickup in economic activity over the second half of 1985 and sustained growth through 1986. In those circumstances, while employment gains should remain substantial, unemployment would be expected to drop only a little if at all. The overall rate of price increase would be expected to remain close to the recent pattern, assuming dollar

exchange rates do not vary widely from recent levels. (See table I on page 30 for the numerical projections.)

Obviously, neither the anticipated stickiness of the unemployment rate nor the projected inflation rate is entirely satisfactory, and a substantial range of uncertainty must be associated with any economic projections at this time. As I emphasized earlier, there are sharp differences in the performance of different sectors of the economy. Demand for and employment in services, where most upward price pressures have been concentrated, continue to expand rather strongly. Most sectors more immediately sensitive to interest rates and monetary conditions—including construction and automobile sales—have also been performing relatively well. Other sectors exposed to strong international competition are sluggish, and agriculture remains under strong financial pressure.

THE BROAD POLICY CHALLENGE

The cross-currents, dislocations, and uncertainties in the present situation point up one uncomfortable but inescapable fact. We are dealing with a situation marked by gross imbalances that can neither be sustained indefinitely nor dealt with successfully by monetary policy alone, however conducted.

—We are borrowing, as a Nation, far more than we are willing to save internally.

—We are buying abroad much more than we are able to sell.

—We reconcile borrowing more than we save and buying more than we sell by piling up debts abroad in amounts unparalleled in our history.

—Our key trading partners, directly or indirectly, have been relying on our markets to support their growth, and even so most of them remain mired in historically high levels of unemployment.

—Meanwhile, our high levels of consumption and employment are not being matched by the expansion in the industrial base we will need as we restore external balance and service our growing external debt.

—And, after 2½ years of economic expansion, too many borrowers at home and abroad remain under strain or over-extended.

At their core, these major imbalances and disequilibria may lie outside the reach of monetary policy—or in some instances, U.S. policy generally. But they necessarily condition the environment in which the Federal Reserve acts, along with all the current evidence about monetary growth, economic conditions, and prices.

In all our decisions, whether with respect to monetary or regulatory policies, we would like to work in a direction consistent with reducing the imbalances, or at the least to avoid aggravating them. That sounds obvious and straight-forward. The difficulty is that, as things now stand, some policy actions that might seem, on their face to contribute toward easing one problem could aggravate others. Nor can we afford to apply a mere poultice at one point of strain in the hope of temporary relief at the expense of undermining basic objectives.

Our monetary policy actions need to be conducted with a clear vision of the continuing longer-term goals—a financial environ-

ment in which we as a Nation can enhance prospects for sustained growth in a framework of greater stability. To succeed fully in that effort, monetary policy will need to be complemented by action elsewhere.

THE 1985 AND 1986 TARGET RANGES

As I indicated earlier, the recent surge in M1 in May and June has carried that monetary aggregate well above the target range set in February. M2 and M3, while also rising rather sharply in June, have remained generally within, or close to, their targeted ranges. Against the background of a high dollar, the sluggishness of manufacturing output, and relatively well contained price pressures, quick and strong action to curtail the recent burst in M1 growth has not been appropriate. The potential implications of the relatively strong growth in M1 since late last year nonetheless had to be considered carefully in developing our target ranges and policy approach.

You may recall that somewhat similar high growth rates in M1 developed during the second half of 1982 and during the first half of 1983. At that time, important regulatory changes involving new accounts and affecting the payment of interest on checking accounts had taken place. Pervasive uncertainty during the latter stages of the recession appeared to affect desires to hold cash. Both circumstances made interpretation of the monetary data particuarly difficult, and M1 was deemphasized. Those circumstances are not present today, at least not in the same degree.

However, one common factor, and an important factor, was at work during both periods. The rapid growth in M1 in 1982 and 1983 and this year followed sizable interest rate declines, with a lagged response evident for some months. Analysis strongly suggests that, as market interest rates decline, individuals and businesses are inclined to build up cash balances because they sacrifice less interest income in doing so. The possibility today of earning interest on checking accounts—and the fact that these interest rates change more sluggishly than market or market-oriented rates—probably increases that tendency.

Moreover, as I have suggested in earlier testimony, the payment of interest on checking accounts may over time encourage more holdings of M1 relative to other assets, or relative to economic activity, than was the case earlier. Partly for that reason, the upward trend in M1 "velocity"—the ratio of GNP to M1—characteristic of the earlier postwar period may be changing.

That trend was, of course, established during a period when inflation and interest rates were trending upward. In contrast, over the past 3½ years, velocity has moved irregularly lower, with the declines concentrated in periods of declining interest rates.

The earlier 1982-83 period of rapid growth in M1 was correctly judged not to presage a resurgence of inflationary pressures, contrary to some expectations. I would emphasize in that connection, however, that M1 growth was moderated substantially after mid-1983, and velocity rose during the period of strong economic expansion, as anticipated.

We simply do not have enough experience with the new institutional framework surrounding M1 (which will be further changed next year under existing law) to specify with any precision what new trend in velocity may be emerging or the precise nature of the relationship between fluctuations in interest rates and the money supply. Moreover, while the surge in M1, and the related drop in velocity, can be traced at least in substantial part to the interest rate declines of the past year, the permanence of the change in velocity will be dependent on inflationary expectations and interest rates remaining subdued. For those reasons, the committee has continued to take the view that, in the implementation of policy, developments with respect to M1 be judged against the background of the other aggregates and evidence about the behavior of the economy, prices, and financial markets, domestic and international.

None of the analysis contradicts the basic thrust of a proposition that we have emphasized many times—that excessive growth of money, sustained over time, will foster inflation. Certainly the burst in May and June cannot be explained by trend or interest rate factors. But, it is also true that monthly data are notoriously volatile, and sharp increases unrelated to more fundamental factors are typically moderated or partly reversed in following months.

In all these circumstances, the FOMC, in its meeting last week decided to "rebase" the M1 target at the second quarter average and to widen the range for the rest of the year to 3 to 8 percent at an annual rate. That decision implies some adjustment in the base of the M1 target range is appropriate to take account both of some change in trend velocity and a return of interest rates closer to levels historically normal.

We are, of course, conscious that, because of strong June growth, M1 currently is high relative to the rebased range, and the committee contemplates that M1 will return within its range only gradually as the year progresses. Consistent with the conviction that marked slowing in the rate of M1 growth is appropriate over time, the committee tentatively set the target range at 4 to 7 percent for next year—a decision that will be reassessed on the basis of the further evidence available at that time. Meanwhile, the lower part of the range set for the remainder of this year reflects the willingness of the FOMC, in appropriate surrounding circumstances, to tolerate substantially slower M1 growth for a time should the recent bulge in effect wash out.

No changes were made in the target ranges for M2 and M3 and the associated monitoring range for debt this year. As was the case at the beginning of 1985, the committee would find growth in the upper part of these ranges acceptable. The changes tentatively agreed for 1986 are small, limited to a ½-percent reduction in the upper limit for M3 and a 1-percent reduction in the monitoring range for debt.

These target ranges are felt to be fully consistent with sustained growth in the economy so long as inflationary pressures are contained. I should note again, however, that members of the FOMC are concerned about the persistent debt creation well in excess of the growth of the economy and historical experience, and therefore look toward some moderation in that growth next year, as reflected

in the monitoring range set out. (The new growth ranges are set out in table II on page 31.)

The uncertainties surrounding M1, and to a lesser extent the other aggregates, in themselves imply the need for a considerable degree of judgment rather than precise rules in the current conduct of monetary policy—a need that, in my thinking, is reinforced by the strong cross-currents and imbalances in the economy and financial markets. That may not be an ideal situation for either the central bank or those exercising oversight—certainly the forces that give rise to it are not happy. But it is the world in which, for the time being, we find ourselves.

COMPLEMENTARY POLICIES

The massive trade deficit that has rapidly developed over the period of economic expansion is the most obvious and concrete reflection of underlying economic imbalances. The trade deficit, in an immediate sense, has been primarily related both to the strength of the dollar in the exchange markets and to relatively slow growth elsewhere in the world. In effect, much of the world has been dependent, directly or indirectly, on expanding demand in the United States to support its own growth. Put another way, growth in domestic demand in Japan, Canada, and Europe has been less than the growth in their GNP, the converse of our situation. And, even with surging exports to this market, output been increasing too slowly to cut into high rates of unemployment in Europe and elsewhere. As a consequence, the demand of others for our products has been relatively weak.

The strong competition from abroad has, in an immediate sense, had benefits as well as costs for this country. It has been a powerful force restraining prices in the industrial sector and in encouraging productivity improvement. The related net capital inflow has eased pressures on our interest rates and capital markets. We have been able to readily satisfy the higher levels of consumption driven in part by the budget deficit.

But those benefits cannot last. Sooner or later our external accounts will have to come much closer toward balance. Indeed, as our debts increase, we will have to earn even more in our trade to help pay the interest.

In the meantime, the flood of imports, and the perceptions of unfairness which accompany it, foster destructive protectionist forces. The domestic investment we will ultimately need is discouraged while our companies shift more of their planned expansion overseas. And the larger the external deficits and the longer they are prolonged, the more severe the subsequent adjustments in the exchange rate and in our economy are apt to be. We will have paid dearly indeed for any short-term benefits.

These considerations have tempered the conduct of monetary policy for some time. Specifically, our decisions with respect to providing reserves and reducing the discount rate have been influenced to some extent by a desire to curb excessive and ultimately unsustainable strength in the foreign exchange value of the dollar. But we have also had to recognize the clear limitations and risks in such an approach.

The possibility at some point that sentiment toward the dollar could change adversely, with sharp repercussions in the exchange rate in a downward direction, poses the greatest potential threat to the progress we have made against inflation. Those risks would be compounded by excessive monetary and liquidity creation.

As I have said to this committee before, there is little doubt that the dollar could be driven lower by bad monetary policy—a policy that poses a clear inflationary threat of its own and undermines confidence. But such a policy could hardly be in our overall interest—it would, in fact, be destructive of all that has been achieved.

The hard fact remains that so long as we run massive budgetary deficits, we will remain dependent on unprecedented capital inflows to help finance, directly or indirectly, that deficit. The net capital inflows will be mirrored in a trade deficit—they are Siamese twins.

As things now stand, if our trade deficit narrowed sharply, both the budget deficit and investment needs would have to be financed internally, with new pressures on interest rates and a squeeze on other sectors of the economy—some of which are now doing relatively well, such as housing, and some, such as farmers and thrift institutions, already under strong financial pressure. The implications for our trading partners and for the heavily indebted developing countries would be severe as well.

There has to be a way out of the impasse—a way that would maintain and even enhance confidence in our own economy and prospects for stability, a way that would not simply shift the pressures from one sector of the economy to another, and a way consistent with the economic growth of other countries. But that way cannot be found by U.S. monetary policy alone.

What we can do is reduce our dependence on foreign capital, and the rising imports to meet our domestic demands, by curtailing the budget deficits that importantly drive the process. In that sense, the choice is before you—in the decisions you will make in the budgetary deliberations that have been so prolonged.

The needed adjustments would be eased as well if other industrialized countries became less dependent on stimulus from the United States for growth in their own economies.

I am a central banker. I can well appreciate and sympathize with the priority that those countries have attached to budgetary restraint and particularly to the need to restore a sense of price stability in their own economies. They have had a large measure of success in those efforts in the face of depreciation of their currencies vis-a-vis the dollar, which has made the process more difficult. The pull of capital into the United States, and the reduced outflow from the United States, has also had effects on their own financial markets and interest rates, and thus on the possibilities for home grown expansion. But as those adverse factors diminish in force, or even begin to be reversed, opportunities surely exist for fostering more expanison at home, in their own interest as well as that of a better balanced world economy.

All of the industrialized countries, working with the International Monetary Fund, the World Bank and by other means, need to continue to support the efforts of much of the developing world to restore the financial and economic foundations for growth in their

countries. That process, under the pressure of the debt crisis, has been underway for some years. By its nature, the fundamental adjustments required pose challenging questions of economic and political management. There is a certain irony in observing the enormous difficulties in our own political process in achieving—so far without success—deficit reductions equivalent to 1 to 2 percent of our GNP while much poorer countries with much greater demands upon them are cutting their deficits by much larger relative amounts.

That effort—along with others—is justified only by its necessity to their own economic health. It is hardly surprising that progress has been uneven, that from time to time setbacks are encountered, and that impatience and frustration surface politically. But I know of no realistic shortcuts or substitutes for the effort to place their own economies on a sounder footing any more than we can ultimately escape our own responsibilities to put our budget in order.

What is so encouraging is that the strong effort that has been made in most of the indebted countries is yielding some tangible results. A measure of growth has been restored in Latin America as a whole. With interest rates lower and many debts restructured, debt burdens are gradually but measurably being reduced.

For the most part, the heavily indebted countries are still a long way from regaining easy access to commercial credit markets. Extraordinary cooperative efforts by the IMF, the World Bank and commercial banks will continue to be required for a time to make sure external financing obligations are structured in a way that matches ability to pay. As always, the ultimate success of all those efforts—most of all those by the borrowers themselves—will depend upon orderly growth, reasonable interest rates, and access to markets in the rest of the world, which will be determined by our actions and those of our trading partners.

CONCLUSION

We have had a relatively strong economic expansion in the United States over the past 2½ years as a whole. At the same time, the rate of inflation has remained at the lowest level in more than 15 years. That combination should be a source of great satisfaction. But 2½ years is not, in itself, terribly significant in the economic life of the Nation. What will count is whether we can build on that progress, and extend it over a long time ahead.

The inherent strength of our economy and the momentum of our expansion have carried us a long way. We have done a lot to lead the world to recovery. The longer-term opportunities are still there for the taking. But we also do not need to look far to see signs of strain, imbalance, and danger.

In these circumstances, monetary policy has accommodated a sizable increase in monetary and credit growth, and interest rates have dropped appreciably even though they are still relatively high in real terms. In that way, economic growth has been supported at a time when the dollar has been particularly strong and inflationary pressures, at least in contrast to the 1970's and early 1980's, quiescent. But there are obvious limitations to the process of mone-

tary expansion without threatening the necessary progress toward stability upon which so much rests.

Plainly, there are implications for other policies as well.

The widely shared sense that other nations should do more to open markets, to deal with the structural rigidities in their economic systems, to encourage growth—to get their own houses in order—is certainly right. We can legitimately cajole, and urge, and bargain to those ends.

But there can also be no doubt that it all will come much easier as the United States does its part. Monetary policy must be part of that effort. But we also do need to come to grips with the budget deficit. We do need to avoid a witch's brew of protectionism.

The success of the world economy—and of our fortunes within it—is in large measure dependent on us. That is the inescapable consequence of size and leadership.

Thank you, Mr. Chairman.

[The tables and charts referred to in Chairman Volcker's statement follow:]

Table I

Economic Projections for 1985 and 1986*

	FOMC Members and other FRB Presidents	
	Range	Central Tendency
1985		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	6-1/4 to 7-3/4	6-1/2 to 7
Real GNP	2-1/4 to 3-1/4	2-3/4 to 3
Implicit deflator for GNP	3-1/2 to 4-1/4	3-3/4 to 4
Average level in the fourth quarter, percent:		
Unemployment rate	6-3/4 to 7-1/4	7 to 7-1/4
1986		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	5-1/2 to 8-1/2	7 to 7-1/2
Real GNP	2 to 4	2-1/2 to 3-1/4
Implicit deflator for GNP	3 to 5-1/2	3-3/4 to 4-3/4
Average level in the fourth quarter, percent:		
Unemployment rate	6-3/4 to 7-1/2	6-3/4 to 7-1/4

*The Administration has yet to publish its mid-session budget review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

Table II

Long-run Growth Ranges for the Aggregates
(Percent increase, QIV to QIV unless otherwise noted)

	Adopted in February for 1985	Adopted July 1985	
		1985	Tentative for 1986
M1	4 to 7	3 to 8 1/	4 to 7
M2	6 to 9	6 to 9	6 to 9
M3	6 to 9-1/2	6 to 9-1/2	6 to 9
Domestic Non-financial debt	9 to 12	9 to 12	8 to 11

1/ Annual rate of increase over the period from QII 1985 to QIV 1985.

Chart 1

M1 Growth Ranges and Actual

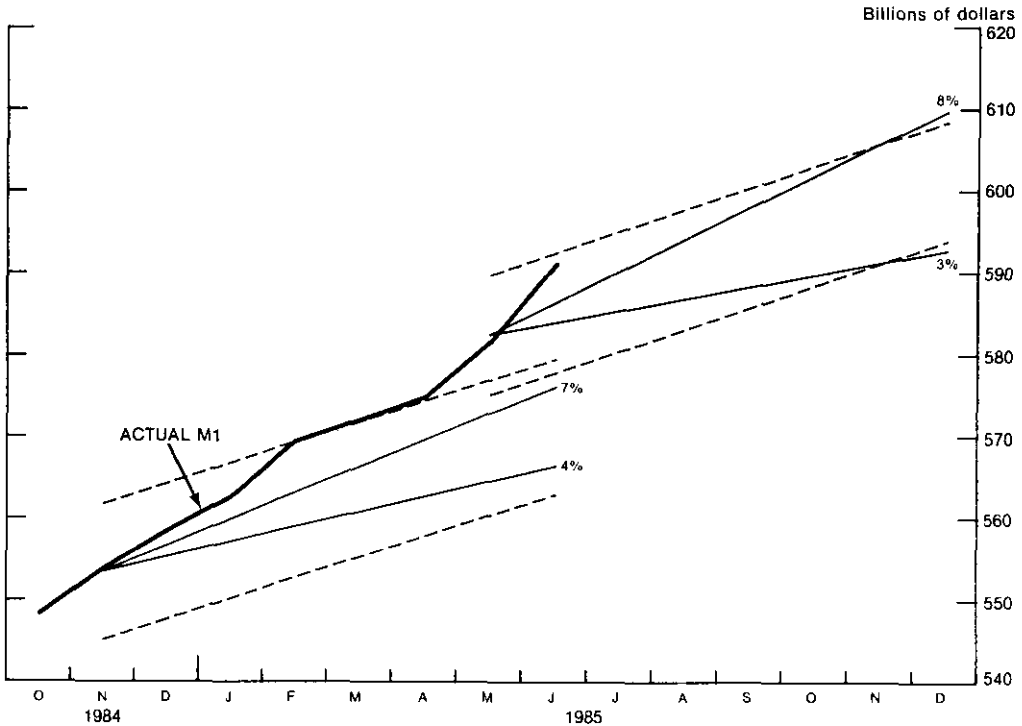


Chart 2

M2 Growth Range and Actual

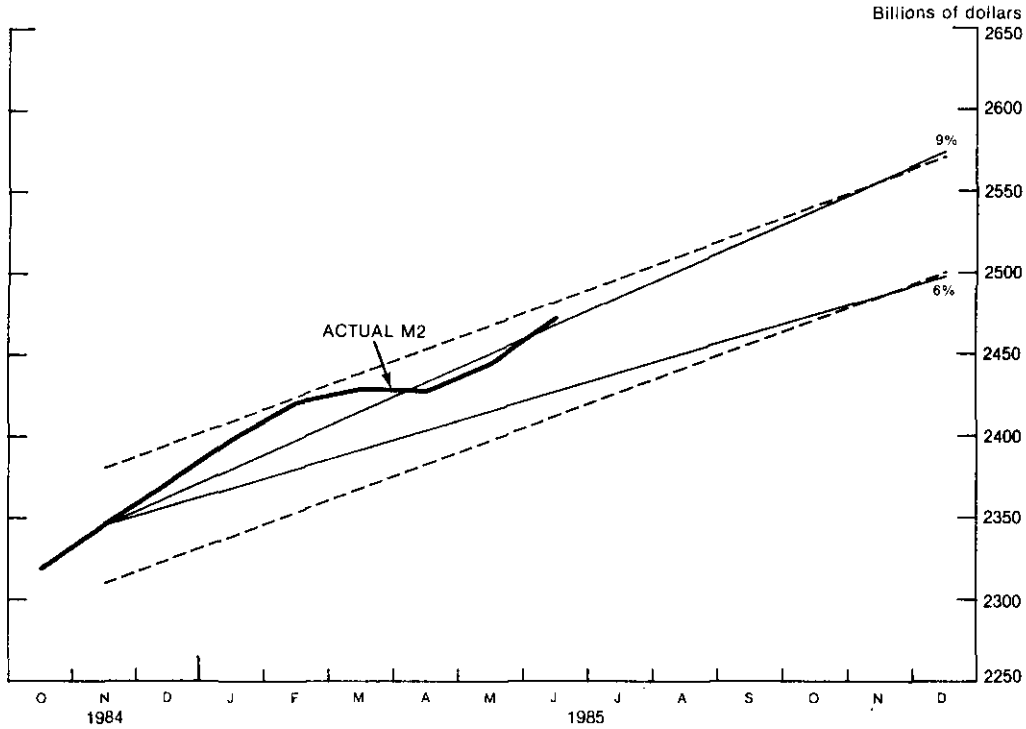


Chart 3

M3 Growth Range and Actual

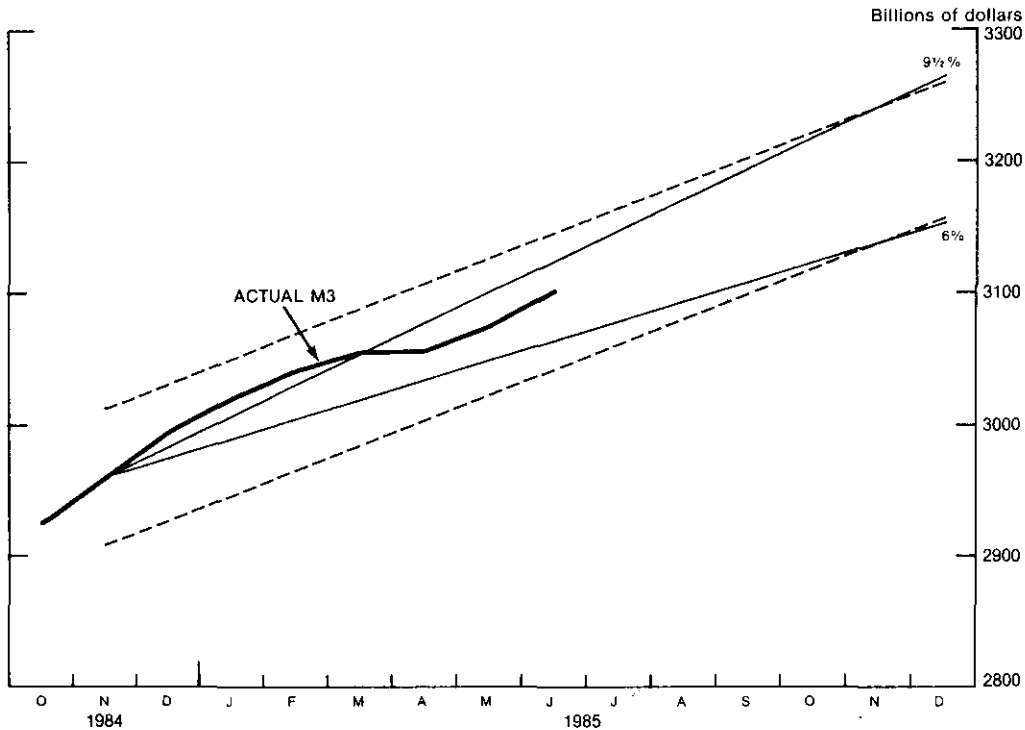
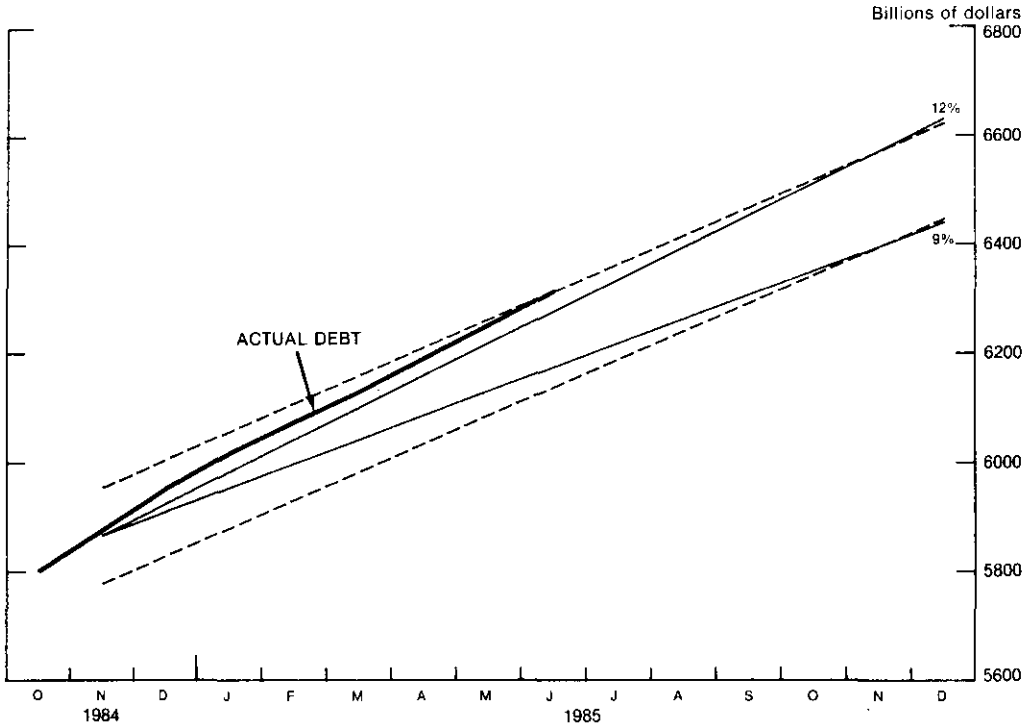


Chart 4

Debt Growth Range and Actual



Chairman FAUNTROY. I thank you, Mr. Chairman, for the clear, blunt, frank and straightforward statement, and I certainly commend you for reading it in its entirety. It was well worth the clarity with which it was presented.

We will now proceed with questions of the witness under the 5-minute rule.

Mr. Chairman, I have become enamored of late of a three-word history of the United States: farmer, worker, clerk. Do you think we are in the midst of a major transition from an industrial to a service-oriented society? If that is the case, what do we need to do to adequately make that transition without extreme pain, particularly for the least among us in this country?

You have pointed out, and we know, that our economic situation is one in which we have a split personality in the economy. The major industries and manufacturing sectors have experienced a decline. There has been certainly strong growth in the service area, but certainly not enough to absorb the more than 100,000 jobs that, by some estimates, have been lost in the last 6 months in the manufacturing sector.

You indicate that monetary policy obviously alone cannot solve this problem. You raise some questions as to whether U.S. policy generally—fiscal or monetary—can effectively address this problem. Would you take a stab at suggesting how we get through this "third" phase of American history?

Mr. VOLCKER. Let me put it in a little longer term perspective, as your question implies. In terms of employment particularly, we have been making a transition from a manufacturing economy to a service economy for a long time. That has been a steady trend over the postwar period, and you would now have manufacturing employment down to 20 percent, or maybe a little less, of the number of workers.

It was not very many years ago, maybe 15 years ago, that that was 30 percent, so it has been part of a rather persistent downward trend. That trend is not matched in terms of the output figure. The value of manufacturing output has been much better sustained relative to the economy. You get more productivity in manufacturing areas.

So you have had a decline in employment consistent with a fairly well-sustained fraction of the GNP in manufacturing, when you measure it in final goods prices. You have to allow for that increase in productivity, which is not entirely bad, to say the least.

What has been happening recently is, superimposed upon that trend toward relatively less manufacturing and relatively less manufacturing employment in particular, you have a special wrenching, which is reflected in this very large increase in our trade balance.

We are now importing, as I said in my statement, an amount equivalent to 21 percent of our manufacturing output. We are only exporting 14 percent. So you have 7 percent of it coming net from abroad. A few years ago, the difference was zero.

It is that extra 7 percent that seems to me an extraordinary acceleration of the trend, if you will. That does create some problems, because we are going to have to go backward on that, in my opinion.

We are going to have to, someday, come much closer to balance in our trade accounts, and we are going to have to pick up, in effect, that 7 percent that we are now drawing from abroad. That may come against a general trend toward declining manufacturing employment, but still it is going too fast now and implies a disequilibrium and a wrench back in the other direction. If it is not handled right, it will have inflationary implications.

What you do about it, I think, are two things. There is not much monetary policy could do; we can pump up the economy, but that would only aggravate those imbalances and accelerate inflation. You can deal with the budget deficit with its insatiable requirements for financing, part of which is coming from abroad, directly or indirectly, and feeds this trade imbalance and accelerates the process that you are concerned about.

And we can also—we, in the larger sense of the world—look for more growth abroad that would assist our exports and probably decrease the incentives to export to the United States from those countries.

There is a lot of room to grow abroad, because they have a high level of unemployment. Some of that relative pressure on our manufacturing industry reflects the fact that the level of economic activity abroad is low.

Chairman FAUNTROY. Mr. Chairman, what was the vote in the last Open Market Committee meeting for rebasing the monetary aggregate? Were there dissenting views, and if so, what were they?

Mr. VOLCKER. We had a limited number of dissents on the various decisions we had to make. In terms of the 1985 targets, there was only one dissent. Just to anticipate your question, there were a couple of dissents from the 1986 targets, and those dissents went in different directions, I think, in their implications.

Chairman FAUNTROY. Please explain the general direction in which they went. What reasons were given?

Mr. VOLCKER. As to the dissent this year, I am not sure exactly. I will see when the dissent is written whether it was a problem with the rebasing itself or whether they thought the target was too high. I don't know.

There was some concern that next year the targets may be too low, but the dissents were, as I indicated, a small minority.

Chairman FAUNTROY. What about the central tendencies expressed in the report—were there any dissents?

Mr. VOLCKER. What we do in the report, Mr. Chairman, is give you the full range of everybody's projection. The central tendency gives you some feeling for where the cluster was.

You do not dissent; you just give a projection, and everybody's projection is reflected in the ranges of those set forth on page 9 in the Humphrey-Hawkins Report.

Chairman FAUNTROY. In making your decision to rebase the M1 target range for the remainder of 1985, what consideration did you give to the possible misunderstanding by the financial markets as to your intentions to continue to fight against inflation?

Mr. VOLCKER. I suppose we give some attention to that. It is my responsibility to try to explain this so that misunderstanding

does not arise. But that does not provide perfect assurance, I have discovered.

I think that there was a feeling that, as it worked during the first half of the year, and given the growth in M1 that we have had, against all those factors, the old target implied a policy that we were not prepared to follow, I suppose, and seemed inappropriate under the circumstances.

If this was the case, and I think there was general agreement on that point, then you are left with precisely how to present most accurately your intentions for the future. And I think the feeling was—certainly my feeling was—that it gives a fairer picture of how we look at the future to rebase with a lower target range than to give a new number for the whole year, which may imply to some people that we are off on a course of expansion that we do not intend.

Chairman FAUNTROY. Do you consider the FOMC decision to rebase a reaffirmation that the monetary aggregates continue to be primary in conducting monetary policy?

Mr. VOLCKER. Certainly we operate in the framework in which setting forth these aggregates—and of course it is required by law—is a primary point of departure in judging policy, and that continues.

Chairman FAUNTROY. Did you believe that was better than continuing to allow the M1 aggregate to grow outside its target range?

Mr. VOLCKER. No, I think we feel that the kind of discipline provided by these targets remains useful. Of course, that does not mean that we do not feel it necessary to exercise some judgment in changing them if we find the evidence requires that. We did not change most of them this time, but we did change the M1 target because we thought that was necessary upon analysis of the performance of M1 against the background of what is going on in the economy. These are the points of departure which we assess against other factors, as we have emphasized repeatedly.

Chairman FAUNTROY. Thank you, Chairman Volcker.

Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

This morning's Wall Street Journal has an article and the lead line is "Most interest rates fell yesterday and many analysts expect further declines soon."

In your statement to us this morning, you have indicated that in May the lowering of the discount rate, at least the Open Market Committee action in May, followed the lowering of interest rates generally in the economy and that general trend seems to be still downward.

In the near term and under the existing conditions you described in your statement today, if the interest rate trend continues in the marketplace to be generally down, may we assume that it is likely that the Open Market Committee will again lower the discount rate at some point?

Mr. VOLCKER. It is the Federal Reserve Board that changes the discount rate. But you started that question with an assumption, and I do not think I am going to answer that kind of hypothetical question. I am not going to project interest rates.

Mr. MCCOLLUM. Do you believe interest rates are trending down?

Mr. VOLCKER. I think that all depends upon what happens in the economy in coming weeks and months.

Mr. MCCOLLUM. Well, may I ask you a follow-up question relative to what is in your statement already.

You have stated that the Federal Reserve made a lowering of the discount rates presumptively following the general trend in the economy of the interest rates in the marketplace downward. What other factors did you consider or was that the primary factor at the time?

Mr. VOLCKER. We did it in the context of declining interest rates in the market. I think reducing the discount rate, at least in the short-term horizon, has the effect of facilitating, or not being a drag on, further declines in interest rates, if that is where the market wanted to go.

It was done against a background, as we indicated at the time, of relatively sluggish economic performance, no signs of upward pressures on prices beyond the trend that has been established, and a strong dollar. Those three factors, at least, were important parts of the environment in which that decision was made. We would always look to that kind of factor in the environment in deciding whether or not we wanted to reduce the discount rate in response to market rates or otherwise.

Mr. MCCOLLUM. In this particular case, you did respond to the decline in market rates.

Mr. VOLCKER. Against that particular background we certainly did, yes.

Mr. MCCOLLUM. And while you don't want to project a trend, you would agree that interest rates have generally continued to trend downward to this point in time?

Mr. VOLCKER. In the last couple of weeks I do not think they have done much. Whether that interrupts a trend, I do not know. Only time will tell.

Mr. MCCOLLUM. Clearly they went down yesterday.

Mr. VOLCKER. They went down yesterday. I think that is correct.

Mr. MCCOLLUM. OK.

I want to go off that and get to another question to ask about your projections in the report itself on real GNP.

I understand that the presidents of the Federal Reserve Board are projecting now for the fourth quarter to, fourth quarter GNP growth for 1985 to be in the range of 2.25 to 3.25 percent growth, and the central tendency is 2.75 to 3 percent. That is what I read from the report.

Mr. VOLCKER. That is correct.

Mr. MCCOLLUM. We had a very flat, obviously flat first quarter in economic growth, and we don't know what the second quarter is but it doesn't seem to be a greatly improved growth.

Does this mean or should I interpret from this that the FOMC members and Reserve Board presidents are anticipating that we are going to have a significant growth in GNP in the second half, in the range of 5 to 6 percent in order to be able to reach the 2.75 or 3 percent for the year.

Mr. VOLCKER. I do not think it has to be that much. You are correct, it must anticipate a more rapid growth in the second half

than in the first half, but I think in the area of 4-plus percent rather than 5 to 6 percent.

Mr. McCollum. But you have to get there to get the average?

Mr. Volcker. That is correct.

Mr. McCollum. It appears to me as a practical matter, Mr. Volcker, that the Open Market Committee is presently ignoring that in setting policy, because M1 is distorted and that is distorted relative to other factors. You may not have said it precisely that way and I know you have given yourself leaway to talk about it this morning, but it seems to me distortion in M1 is a function of the greater savings by Americans, both businessmen and individuals, that in return has resulted in a less turnover of dollars and lower velocity, which is what we talk about technically at that point.

If the trend—I hate to use the word trend in light of my last line of questions, but that is what we are looking at here in oversight—if the trend in greater savings and lower velocity continues for the significant period of time down the road here this year and next year, do you anticipate that the Open Market Committee, the Federal Reserve, will consider changes in the basic structure or components of M1 or possibly recommend simply doing away with it as a judgment factor altogether in policymaking?

Mr. Volcker. Let me distinguish between a couple of points. I do not observe an increase in the savings rate for the economy as a whole. We have had some cyclical increase because of increased business savings, but the basic trend, using that word as opposed to cycle of total savings, seems to me pretty much unchanged. But what is at issue here is whether a bigger fraction of those savings are being put in this form of money, particularly NOW accounts and Super NOW accounts. We think that might be happening to some extent, and that would change the trend in M1 velocity over a period of time; it is at least one factor that would change it.

I personally am inclined to think it works in that direction, and that it is a factor that says the upward trend in velocity that was characteristic of most of the postwar period will now be—for that reason alone anyway—less, and that would have some implications for these targets as we set them from year to year.

I don't think that factor—the change in the longer-run trend of velocity growth—is in itself large enough to necessitate a really drastic change in the targets. It certainly does not explain what happended to M1 velocity in the first half of this year, which was too big a movement to be explained by changes in long-run trends. However, it is quite a reasonable hypothesis, if I can use that word, that the trend of nominal GNP relative to M1, the historic upward trend in velocity, might be reduced. That trend can be characterized in different ways. For many years it averaged something more than 3 percent per annum, but if you adjust that figure to make allowance for the effects of the upward trend in interest rates on people's desired holdings of money, the underlying trend might have been 2 percent or so. In a world of reasonably stable interest rates, low inflation, and fewer regulatory constraints on deposit rates, you might take that 2 percent down toward 1 percent or maybe even less. It is that order of magnitude of difference we are dealing with in regard to the long-run trend of velocity.

Mr. McCollum. Very significant change.

Chairman Fauntroy. The time of the gentleman has expired.

Mr. McCollum. Thank you. I appreciate it.

Chairman Fauntroy. I want now to yield to the distinguished Representative from the Fifth Congressional District of North Carolina, the former chairman of this Subcommittee on Domestic Monetary Policy and now chairman of our Subcommittee on International Finance Trade and Monetary Policies, Steve Neal.

Mr. Neal. Thank you, Mr. Chairman.

Chairman Volcker, I want to start my remarks by expressing a great respect and gratitude to the chairman. I say gratitude because it is clear to me and I think most economists, as I read about their views, that it has been your policies over at the Fed starting in late 1979 that have brought down the rate of inflation rather dramatically, and not Reaganomics.

I think it is important that we remember that, too, because I have a feeling the way things are going that we are going to face inflationary problems again, and the answer shouldn't be to build up another huge layer of debt and so on like we have done under the current program.

Having said that, let me say I see what appears to me to be a problem with what is going on at the Fed now, and that is that during several periods over the last couple of years, M1 growth has far exceeded the target ranges which you have set and we in the Congress have essentially agreed to.

I am not aware of any other time in history when that kind of money growth hasn't been followed by higher inflation. A number of economists are saying that we are setting the stage for higher inflation in the future, and not only is that, it seems to me, a real danger, but I am thinking of another situation where the dollar might continue to fall in value relative to other currencies, which would then have the effect of increasing prices in our economy, increasing interest rates, because not as much money would be available in the economy, and it would seem to me by having already far exceeded your own money growth targets, that your options would be severely limited.

You might assume that under such a circumstance that the Fed would pump in some more money to sort of take up the slack for a short period of time, but I think that would be difficult for you at that time, and might only exacerbate the problem.

Now, I have to say I hope that that doesn't occur, and I hope that the dollar declines in an orderly fashion and so on, but I don't think we can count on that. That is not a sure thing by any means.

There are two concerns that I have. Let me wrap up with that. One is that it seems to me we have had very excessive money growth recently. You are under a lot of pressure, I know, to increase it even more. And let me ask the question: What would you do if the dollar declines? Isn't it a problem?

Doesn't the fact that money growth has been in excess of target ranges, rather dramatically sometimes, limit your options in the case of a rapid decline in the value of the dollar?

Mr. Volcker. I am not sure that it limits our options in the case of a rapid decline in the value of the dollar. I think whether or not

it is a problem depends upon the degree to which our judgment and analysis of what caused it is correct.

As you pointed out, there was a rapid increase from mid-1982 to mid-1983 that gave rise to considerable concern by some people. It might have inflationary implications. Now, 3 years later, I think it is pretty well agreed that that burst in M1 growth did not have inflationary implications, and that judgment at the time that it would not turned out to be correct.

It does not prove what will be correct in the current instance. We will wait and see, but we see some plausible reasons to think that this recent burst has some of the same characteristics of that earlier burst. When one looks at the background of what is going on currently—and this certainly is not a complete answer—we ask what is different from what happened or what we thought might happen at the beginning of the year.

One thing is that M1 is higher than we thought it would be at the beginning of the year. But, we have also had almost steady declines in commodity prices over that period, oil prices are at the least soft and probably declining. We have wage rates going up actually a little slower this year than last year; we have manufacturing goods prices pretty steady, and we have slow economic growth. That is not exactly inflationary.

Just look at that in and of itself, so I think we have had a lot of factors working against inflation, happily, and I don't interpret bursts in M1 growth at this stage—and let us hope I am correct—as being inflationary against that background. I agree with you as a matter of judgment, unduly prolonged it would be. I certainly recognize the risk that you cite of what happens if the dollar goes down and goes down a lot and precipitously. That almost mechanically, after some point at least, has inflationary implications. It also has implications for improving our trade position and for a more rapidly growing economy, and I certainly don't see the implications of that situation as ones where we would be more liberal on the money supplying side. But we don't want to compound that risk by creating too much money now. I would agree with that, and that is a matter of judgment.

You asked what you can do to deal with that. You cannot deal with all those risks by monetary policies alone, and that is a principal risk that points to the urgency of dealing with the budgetary problem.

Chairman FAUNTROY. The time of the gentleman has expired. Mr. Hiler.

Mr. HILER I thank the Chairman.

Mr. Volcker, Chairman Volcker, at various times in the last several years the average public or financial analyst or anyone who cared to take the time to observe could have watched M1, could have watched maybe inflation figures, could have watched capacity utilization, could have watched the tone of labor agreements, a variety of things, to get an indication of maybe what the Fed might be looking at to determine the course of monetary policies.

I would ask you today, when I leave here at 11 o'clock or 12 noon or 1 o'clock, whenever this hearing is over, what should I watch to get some type of indication as to what the Fed is looking at over the next several months?

Mr. VOLCKER. The only honest answer I can give you, Mr. Hiler, is all of the above. You use monetary figures, debt figures to provide a kind of framework for approaching policies. If they were all going in one direction, it gives you a good starting point.

I spent a lot of time this morning, and I am sure we will spend a lot more time, appraising what appears to be a rather different kind of performance in M1, to which there is necessarily a certain amount of uncertainty attached. So we look at M1 more cautiously and try to make allowances for those uncertainties, and if these are our starting point, then we look at all those other factors you mentioned.

What other indications we have are the tenor and trend of inflationary forces, the direction of the economy, the level of the dollar, and its affect on our trade position and on economic distortions.

Mr. HILER What indicators might I be able to look at tomorrow that would indicate that there would be a tightening in policies? Is there any indicator today in the bag of indicators that you look at that you would point to tightening policies, or are they all pointing to maintaining a loose policy?

Mr. VOLCKER. No, you have a high level of M1 to start with. Just look at that by itself. That would say, I suppose, a tight policy, so that is one on that side.

Mr. HILER Which today we have discounted.

Mr. VOLCKER. We have discounted it, yes, not eliminated it. But you asked what indicator one would look at, and that is one you would look at. I don't know what to say about the dollar now, because it has been declining pretty sharply in the last week or so, so you might begin at some stage to put that in the other category.

Mr. HILER Would you say there is a trend there?

Mr. VOLCKER. I would not want to project using data from only the last week into a trend. It would be a rather sharp trend, but you know, that depends upon which way it is going, whether you would look at that as a matter of concern on the tightening side. Then you appraise as best you can but do not put full weight on it, because these things are not always certain. I am not putting full weight on any of these things you look at—the direction of economic activity and what other evidence you have about the degree of present pressures or dangers.

Mr. HILER Thank you.

Mr. VOLCKER. I only speak for myself. There are 12 members of the FOMC. I often read in that newspaper that policy is run by last quarter's GNP figure. I do not think that is a very good indicator of policy. There is nothing you can do about the last quarter.

Mr. HILER Hopefully we can sometimes use the last quarter to indicate whether we ought to try to obtain a better next quarter.

Mr. VOLCKER. There might be something going on in the events of the last quarter that give you some clue as to what might go on in the future—that is what you are really interested in.

Mr. HILER I think you mentioned in your testimony or maybe it was in the report—my time has expired so this will be my last question—that really we have somewhat of a dichotomy on the price side. We have falling prices, or at least stable prices in many

of the manufactured goods and commodities, and yet we have rising prices in the service sector.

Mr. VOLCKER. Correct.

Mr. HILER Do you see those rising prices in the service sector as a cause to be alarmed about?

Mr. VOLCKER. I certainly think just on the surface, that they help keep the overall inflation rate moving along at too high a level, and they keep inflationary expectations alive. I think there is some evidence that the underlying factors in the service area are working a bit towards a slower rate of increase in prices over time, and I think that will be the case if the goods sector of the economy remains pretty flat in terms of price change. We want to be sure, to the extent we can, that service prices go in that direction rather than seeing the sectors of the economy that are not inflating appreciably now begin to ratchet up to what is going on in the service area.

That is one way of viewing the policy problem, I suppose. It is very important that you can not change service prices very rapidly, but that they continue to move in a less inflationary direction, and they have been doing that very slowly.

Chairman FAUNTROY. The time of the gentleman has expired. The distinguished gentleman from Georgia, Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Chairman, in your statement I discern that we or you pretty well could explain the increase in M1 in previous cycles of increase, but I did not really see any full explanation, maybe I misread it, as to why we were having such a tremendous increase in M1 now, except that we were having it.

The question comes to my mind, on page 27 you say in your statement that "we do not need to look far to see the signs of strain, imbalance and danger."

Don't you feel like that there is general public unrest or lack of confidence by not only the business community but individuals as to what is going on as far as the budget, trade imbalance, imports, to such a degree that the public is just sort of waiting to see what is going to happen?

Mr. VOLCKER. Let me not forget the comment you made first, because I do not fully agree with it. I think we do have a good sense of what is going on in M1, up until May and June anyway. We can not yet explain the bulge in May and June, but that is a brief period of time.

Be that as it may, I think I sense something of what you are saying about the size of the trade deficit, the size of the budgetary problem, and the fact that the manufacturing sector has been under some pressure all of which give rise to some feeling of increased uncertainty. However, you do not see that reflected very much in these regular surveys that are made of consumer attitudes. The indexes of consumer sentiment are not quite as high as they were in terms of confidence, but they are pretty high, and I think the last one actually showed a small increase—maybe not significant, but they have not declined. They have not shown any great erosion in consumer confidence in terms of buying plans or the outlook for the economy—the things that are usually surveyed.

I am still left with the same feeling you are, that there is some sense of concern and uncertainty about some of these other factors, and I think it is legitimate. If that sense of concern and uncertainty could coalesce in action in a couple of directions, in Congress and elsewhere, I think we would all be better off.

Mr. BARNARD. In that regard, of course, much of the blame does associate itself with what we are not doing right now, and that is reducing Federal spending and trying to bring the budget under control, and as we discuss the budget even today, and we see the indecision that still prevails in the committees, we notice that there are a lot of recommendations coming other than from the White House for a consideration of tax increases, feeling that we have probably done as much as we can do without penalizing some segments of the public severely in reducing Federal spending.

In your opinion, if a tax increase came about through a consumption type tax, what harm do you think that would do to the economy?

Mr. VOLCKER. As I have already said as a preface to that that if Congress can not make sufficient savings in the budget—sufficient reductions in the deficit purely on the spending side, which would be best for the economy—then you must turn to revenues. If you did that by a consumption tax, I think in the long run that would be a desirable way to do it. The trouble with some consumption taxes is that in the very short run they can have an impact on the Consumer Price Index. That is not real inflation in the sense that I would think of it conceptually, but since it appears in the Consumer Price Index, people read it as inflation. That is a drawback, but otherwise I think the basic economics of it says if you are going to go for increased revenues you go in that direction.

Mr. BARNARD. And you are saying though that the impact on inflation—couldn't that be somewhat controlled?

Mr. VOLCKER. I hope it is controlled by good monetary and other policies, but it depends upon the type of consumption tax. If you had a tax on income it would not have this kind of effect, but if you are thinking of some kind of a sales tax or a value added tax—which I wonder whether you could do in the short run; I am talking structurally now rather than what might be practical in terms of this year's decision—I do not know how you would avoid that tax being passed through very largely in the first instance, to the Consumer Price Index.

Mr. BARNARD. Mr. Volcker expired my time.

Chairman FAUNTROY. The time of the gentleman has expired. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

In reading your statement, Mr. Volcker, it appears that you have a rather extraordinary mix of good and bad news. The good news is the economy has been doing rather well for the last 2½ years, and the developing countries are adequately managing the debt situation.

The bad news is that it is based on American consumer borrowing, both public and private debt. What is left is the picture of a country living for the present, and also a country where there is a great deal of unevenness in the economy, as you have pointed out.

As a representative of an area that is probably as negatively impacted by recent fiscal and monetary policies as any, I would simply like to express concern over the combination of a rather tight monetary policy and a loose fiscal policy. An eased monetary policy has implications for fairness as well as for the economy at large, and that a little bit of inflation and a reduction in the value of the dollar may well be the greatest way to avoid protectionist efforts from a congressional perspective, and that this ought to be a serious concern of the Federal Reserve Board.

In that regard, I, as one, am rather pleased with your latest move in terms of easing monetary targets, and think that a little too much consistency, as many people pointed out, is the hobgoblin of little minds, but I do have a fear that it is too late for some parts of American society.

Of course, right now in the farm belt, we are facing some problems that could only be described as wretched. As we look at our credit system, most particularly the $80 billion farm credit system, does the Federal Reserve Board have the mandate to move as aggressively to see that the farm credit system doesn't collapse as it did in the case of the Continental Bank?

Mr. VOLCKER. We have been looking at the farm credit system. I do not think it is going to collapse, it has some very substantial strengths. I do not anticipate it is going to require any Federal Reserve assistance. If all those judgments turned out to be wrong, I think ultimately we have certain authorities that could be used.

Mr. LEACH. Can you specify what those might be?

Mr. VOLCKER. I am thinking primarily of the authority we have in the discount window, both specifically and more generally in terms of emergency provisions in the Federal Reserve Act.

Mr. LEACH. So that you are prepared to look at that in a serious way?

Mr. VOLCKER. We would look at it if the circumstances dictated that. I do not want to suggest that it is easy.

If you give me the opportunity to intrude upon your time, I do not agree with your thought that a little bit of inflation might be a good thing. The trouble with a little bit of inflation is it leads to more, and we already have too much.

Mr. LEACH. That could be the case, except in contrast with the alternatives, and if the alternatives are a non-manufacturing base in the United States, a nonfarming base in the United States, a nonmining base in the United States, then perhaps a little bit of inflation is more attractive.

I have no more questions, Mr. Chairman.

Chairman FAUNTROY. Thank you. The distinguished gentleman from Kentucky, Mr. Hubbard.

Mr. HUBBARD. Thank you very much, Mr. Chairman, and to you, Chairman Volcker, we thank you for appearing before our subcommittee and for your presentation today.

As we know, this year one of the few laws that have been enacted was when Congress passed and the President signed into law the repeal of the contemporaneous recordkeeping requirements that we imposed upon business people in the tax bill last year and the regulations that were written by the Internal Revenue Service and went into effect this January, but a majority of the Members

of Congress cosponsored legislation both in the Senate side and the House side to make sure that was repealed.

I mention that because Congress acted quickly when the people were upset and uptight about something they didn't like. I think most of us in this room agree that the Federal deficits are just as serious as you have mentioned in your statement.

You have said "the hard fact remains that so long as we run massive budgetary deficits, we will remain dependent on unprecedented capital in flows to help finance directly or indirectly that deficit."

You are familiar with my district, and I was honored a couple of years ago when you appeared in the gymnasium at Mayfield, KY, my hometown, to talk to about 2500 people. You will recall that very few people that night were uptight about the deficit.

They were concerned about interest rates, whether Social Security could last, and mad about foreign aid. But just in today's paper we see headlines that read "Impasse with Senate Endangers Congressional Efforts to Reduce the Deficit."

Last week we passed in the House by voice vote a foreign aid authorization bill which will cost $12.6 billion if that is approved in the appropriations process. Yesterday we voted by voice vote in the House for $15.3 billion of spending for energy and water funds, and that is only $217 million below last year's level.

If you were speaking again in my hometown, trying to convince those folks I represent that the deficit is really serious, what could you tell them that would make them as uptight about the deficit as they were about these IRS regulations which require businessmen to log their mileage?

We acted on that, because the people were mad, but the people are not mad about the deficits, and you have said today, Mr. Chairman, "We have a relatively strong economic expansion in the United States over the past 2½ years as a whole. The rate of inflation has remained at the lowest level in more than 15 years. That combination should be a source of great satisfaction."

One major reason our President was reelected, carrying 49 States, most of us in Congress were reelected, is because people thought the economy was in good shape. What do we say to our folks back home to convince them that this deficit is dangerous?

Mr. VOLCKER. I remember very well that visit. It took place in the middle of the recession, as I recall, at a time when interest rates were pretty high. I had a sense that they were concerned about inflation and where this country was going, and I am sure that concern still exists. I just find it a little surprising that the people in Mayfield, KY, would not be concerned about the budget deficit.

Mr. HUBBARD. They are. But they don't want their Social Security benefits cut, and they don't want to lose other benefits.

Mr. VOLCKER. That is the classic problem. Unlike the IRS recordkeeping of expenses, this hurts somebody in its specifics. I think it has to be put to them as a reasonable sharing of burdens. They have to understand the importance of this in terms of maintaining that economic performance, that economic growth, and that price performance, that is the cause of some satisfaction; it has to be explained to them. I hope that is not an impossible job, because I

think they have a lot of good common sense and horse sense out there, and that is not an impossible thing for them to understand.

When we are living on this much borrowed money, we are also living on this much borrowed time; and if they are reasonably satisfied with economic circumstances, they must do something to enhance the prospects that that continues.

Mr. HUBBARD. Last, I want to say the people of this country do respect you. The members of this subcommittee and the Members of Congress respect you. We do listen to you as to your comments. Your statements reflect many changes on Wall Street and across the country, even things you say today. I would hope that you can strongly appeal to the American people that this deficit is extremely dangerous, because as yet surely you realize, in watching Congress, the message has not been brought to us as clearly as it should be because we continue to pass foreign aid authorization bills, energy and water appropriation bills.

There is an impact now in the Budget Conference Committee, and the people I hear from are not writing about the deficit; they are writing about personal problems.

Mr. VOLCKER. I see this deficit somewhat like a bully in a schoolyard; he grabs some money from half the kids and gives them bloody noses, and pays off the other half. Sometimes people say, well, you, the Federal Reserve, go around with some band-aids and take care of all the bloody noses. But some day that bully is going to run out of the money to pay off half the kids and we are going to run out of band-aids. And you cannot run home to mother. So, we had better go after the bully.

Chairman FAUNTROY. That is a very graphic analysis of what we need to do.

The distinguished gentleman from California, Mr. Dreier.

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

Although not a member of this subcommittee, I appreciate the opportunity to participate today.

Mr. Chairman, other than the reduction in interest rate differentials, to what do you attribute the fact that the dollar has been weakening? Based on what you said, that might not be a trend that started last week, but it certainly is a shift in direction from what we have seen over the past several years.

Mr. VOLCKER. I am afraid my analysis may be no more authoritative than all the reasons that might have been given earlier for why it was so exceptionally strong in the face of some developments that you would think ordinarily might move in another direction. But interest rates have been lower for some time in absolute terms, relative to those prevailing in other countries.

I think the market is affected by what its interpretation is of the economic outlook, and therefore the interest rate outlook. How much of that is entering into this recent movement, I do not know.

I think there has been some feeling in the background for a long time that the dollar is very high, and that some time it might go lower. And I think that accounts for the suddenness of some of these movements. But, as I said, that feeling has been there for a long time.

You sought an answer to the question why it affects the market now, and it did not earlier.

Mr. DREIER. Assuming that there is a continuing decline, at what point do you believe that it will have an impact on our tremendous trade deficit problem?

Mr. VOLCKER. My feeling has been that, with the rise in the dollar in the past year, on top of an already strong dollar, the profit margins for many foreign exporters have gotten very large. There probably could be some decline in the dollar without much effect on either import prices—that is the favorable side—or the unfavorable side, without much effect on incentives to export to the United States. So I would not expect, in the magnitude that we have been operating in, much effect either on inflation or on the trade balance. But a less robust dollar obviously goes in the direction of working against further increases in the trade deficit.

Mr. DREIER. Just one more question before we have to go for our vote. You mentioned the fact that a number of nations have been able to reduce their debt at a much more substantial rate than we have.

Mr. VOLCKER. Their internal debt, yes.

Mr. DREIER. Right.

What kinds of steps do you believe that we could take, modeled after those things other nations have done?

Mr. VOLCKER. They have no magic formulas. They face up to the same old questions of reducing expenditures and increasing taxes, with one difference that is not relevant to our experience. Many of them have state-owned enterprises where they have been subsidizing the prices, and thus can make a big impact on their budgetary situation. It is not easy, but they can raise the prices and avoid giving such large subsidies to state-owned enterprises. That has been a major way that they have gone about their budgetary problem, which is not open to us. But they have just the same slogging problems on the expenditure and tax side that we do.

Mr. DREIER. Over the next 18 months, what do you see as the weakest spots in our economy?

Mr. VOLCKER. The weak area of our economy seems to me to be the goods-producing side. In agriculture, we continue to experience financial problems. You do not get into reduced output, but there are pressures on the manufacturing side. I am not projecting any decline in manufacturing activity, but that is the area where the pressures are. There are also even more pressures in mining, but that is a relatively small sector.

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

Chairman FAUNTROY. Thank you.

I would like to inquire into an area that Mr. Neal, as chairman of the Subcommittee on International Finance, Trade and Monetary Policy has also addressed in his work. In view of the debilitating effects of the enormous outstanding debt of developing nations to U.S. banks, should the United States continue to insist on strict austerity programs for borrowers, enabling them to make good on their loans? Would it be better in terms of both economic stability in the financial markets and political stability in those countries to seek some long-term restructuring of the debt to equity, developing a secondary market, or capping interest rates? I seem to recall that both Vice Chairman Preston Martin and Dr. Kissinger have made some suggestions along these lines.

Mr. VOLCKER. I think you have to work within the area of what is possible and practical. These countries, by and large, now need or will need some new money. You have to ask who is going to provide that money. I think it is in their interests, and I think they have conceived it to be in their interests, to service their debts, looking toward getting new money now or getting new money later and establishing and maintaining their creditworthiness.

There has been a lot of restructuring. There has been some narrowing of interest rate spreads where there has been improvement in their performance. I see no conflict between so-called austerity for these countries and getting themselves in a restructured position, and I will interpret restructuring somewhat differently than you did—that supports their growth and economic health over a period of time.

The budgetary austerity may be necessary for a period. You are talking about austerity in some of these cases relative to a budget deficit of 10 percent of the GNP, or 15 percent of the GNP, or 20 percent of the GNP. They are not going to prosper in those circumstances. They have to go through a period, in my judgment, of getting their fiscal house in order. But they also have to do other things that put their economies on a firmer, growth-oriented trend, and those things come with as much difficulty or even greater difficulty sometimes than reducing the budgetary deficit, which is simple in concept, but not in carrying out.

I think it is important that these countries open up their economies. And when I say open up, I do not mean just externally—I think that is important, too. But they should have more competitive markets internally, so they have a stronger, more dynamic private sector, less stifling controls over their economies. Those are the fundamental things that have to be done, I think, to support the growth that they certainly need. They certainly need also a favorable external economic environment, both in terms of economic growth and interest rates.

Chairman FAUNTROY. Thank you.

Mr. VOLCKER. You can talk about all kinds of ways of restructuring the debt. One question that arises is: Are you going to appropriate the money? Are the banks going to volunteer great amounts on their own score? If the money does not come from the banks and it does not come from the U.S. Congress, where is it going to come from?

Chairman FAUNTROY. I will to continue that line of questioning as we proceed through the hearings. We have been joined now by the distinguished representative from Louisiana, Mr. Roemer.

Mr. ROEMER. Mr. Volcker, I want to thank you for coming, and do more than my perfunctory courtesy to witnesses. In honesty, as part of the etiquette of this institution, we tell them with some sincerity that we appreciate them being here. But I want to go further and tell you that I appreciate the job that you are doing. I know it is difficult, and I think you have done a heck of a job under difficult circumstances.

I would like to divide my questions into two parts, if I could; first, as relates to your role as our central banker.

In reading your report this morning, or your presentation, there is some uncertainty in my mind, as I think there is in the report,

over the usefulness of M1. Would that be a fair way to characterize it? And are we replacing the uncertainty of M1 with other measurements that you have not stated here, or aggregate measures that you are using?

This is a technical question, but I would like a straightforward answer.

Mr. VOLCKER. I would state it somewhat differently. I think M1 is a useful measure, something that has to be watched. But there is an exceptional amount of uncertainty surrounding its recent performance. We are in a period where I think it has to be looked at with some caution, but I do not want to throw out M1, or take as strong a measure as your statement suggested. But we are certainly in a period of uncertainty. Are we replacing it with another kind of mechanical rule? I think the answer to that is no.

Mr. ROEMER. Are you looking for a replacement?

Mr. VOLCKER. Conceptually I would like to have one. But I do not know what it is.

Mr. ROEMER. Would I be unfair if I say that M1 has limited usefulness at present? You would love to find a replacement; you just don't know where to look?

Mr. VOLCKER. Its usefulness is more limited than I would like. But I do not know where to find the replacement.

Mr. ROEMER. All right.

Second, on the central banker's role—and that is the value of our dollar—I think we would fairly say that it is overvalued and that, in reading your report this morning, I find that you find problems with that overvaluation. I also sense, in reading your report, that you find problems if it were to be more in line with value. In other words, I read in your report that it is bad that the dollar is up, it is bad if the dollar is down, and it is bad with the dollar right where it is.

Would you like to see—would your institution like to see, if it can see at all, the dollar up, down, or unchanged?

Mr. VOLCKER. I cannot answer that question unless you specify some other things. If the dollar went down in the context of significant progress with respect to the budgetary deficit—which in itself deals with some of the real and expectational inflationary effects and more directly reduces the demands on the capital markets, in the face of a potentially reduced supply of capital from abroad—within limits that could be a reasonable and healthy thing. I would hate to see the dollar go down because of lack of confidence in the United States, when we have to finance our huge budget deficits, because you are just going to squeeze some other sector of the economy if that happens.

Mr. ROEMER. I always have to translate what you say into my north Louisiana language. And it is difficult. That is my problem—not yours.

But, do I hear you saying that you would like the dollar to fall, but for the right reason?

Mr. VOLCKER. I would rather see it fall in the context of the right reasons than fall for the wrong reasons; that is for sure.

Mr. ROEMER. I am pressing you; not successfully, I might add—but does that mean you would accept the dollar where it is, over-

valued, with all the effects on this economy, if the choice were to fall for a lack of confidence?

Mr. VOLCKER. If I have no choice, yes.

Mr. ROEMER. Thank you.

Mr. VOLCKER. I consider falling for lack of confidence the equivalent of no choice.

Mr. ROEMER. Finally, in terms of economic, not central banker judgments—and you are allowed to make these judgments, Mr. Volcker, as an American citizen, and are well-qualified to do so—I don't see a budget resolution—one person's view; I hope I am wrong—I don't see a budget resolution, particularly if the test of resolution is significant deficit reduction.

If my assumption is true, what do you foresee over the next year until the next budget cycle is reached? What advice would you give to those of us looking for courage, for example, and leadership, on the question of deficit reduction? Now, be specific for me.

What cost are we going to have politically back home if we don't get up off our rear-ends, cut military, cut social, raise corporate minimum taxes, and lower the deficit, cut COLA's, all the rest? I am just going to spell it out. If we don't do that, what political costs do my colleagues and myself face?

Mr VOLCKER. I think I have to give you a range of results, embodying the good economic news and the bad economic news. And, I do not know; nobody knows or could predict the timing of these things or the reaction to them.

The good news would be that we would continue with more of what we have had. The dollar would remain high—this is the good news story—because there is some continuing confidence in monetary policy though not fiscal policy. This would help to contain pressures on prices, but certain sectors of the economy would remain under pressure; there would be continuing pressures of imports on the goods producing sector of the economy. As imports continue in excess of exports, debt piles up abroad and that debt will have to be serviced or repaid. But the adjustments that are entailed will still be in the future. However, the future will have become more difficult because in the meantime we will be getting less of the productive investment at home that we will need to yield the productive capacity to meet—when the net inflow of foreign capital abates—both our domestic needs and the obligations built up by borrowing from abroad.

Your constituents have been living through that situation, but they have not seen the bad news. The bad news is that, for whatever reason, including the adverse reaction of manufacturing to the good news scenario, the economy as a whole is not ebullient and confidence in the dollar erodes. Or the dollar may drop because failure to take fiscal action reduces confidence in our capacity to manage our affairs. The dollar goes off—goes off enough so that it has inflationary repercussions. The drop in the dollar may potentially help the manufacturing sector of the economy, but you are going to run into interest rate problems in the market. You could have a greater inflationary threat evident to your constituents at the time, and a great deal more concern and perhaps actuality about pressures in the financial markets as the Federal budget also continues to demand a large share of the Nation's saving while the

net inflow of foreign saving may be dropping off. That will shift the pressures in the economy to other sectors, and it will do it in the midst of a lot of uncertainty and discomfort.

Mr. Barnard referred to a feeling of uncertainty before. If you think there is a feeling of uncertainty now, in those circumstances, I think you would see it maximized.

Mr. ROEMER. My time has expired. I thank you for your answer.

I just say, that is the problem. That is why we won't solve the budget, Mr. Volcker. I mean, every man here has to answer the question of what does it do to my people, and your answer is, in the long run, it hurts them and damages them badly. But, whether that is next week, next month, next year or a decade from now, nobody knows.

Mr. VOLCKER. I understand your problem very well, and I sympathize with it. But I guess I have to feel somehow the political system has to be able to anticipate a problem.

Mr. ROEMER. I agree. I share your thoughts.

I would say that your comments on the protectionism in your statement are excellent. Read the Washington Post of the last 2 days on the shipbuilding industry where we are building fewer, hiring less Americans, and it is costing us more.

Mr. VOLCKER. I should have mentioned, even the most favorable scenario I can see only builds protectionist pressures. I would suspect by next year, if nothing is done, it is going to build to the point where they break out. People may be happy about that; the constituent may think it is going to help them in the first instance. But I do not think it will take them very many months to find out that was a bad idea.

Mr. ROEMER. I agree. Thanks.

Chairman FAUNTROY. The time of the gentleman has expired.

We have been joined by the distinguished ranking member of the full Banking, Finance and Urban Affairs Committee, and the distinguished gentleman from Ohio, Mr. Wylie.

Mr. WYLIE. Thank you very much Mr. Chairman, for your warm welcome.

I want to join in welcoming the Chairman of the Federal Reserve at this hearing on monetary policy this morning, and I would agree that we are at a critical juncture as the Federal Reserve tries to set its course for the remainder of the current year.

As you mentioned, there have been some significant changes in the economy since last February, when you were here. We had an inkling that first quarter growth of the economy would be weak, but we did not know at the time how disappointing it might turn out to be. Neither did we know how much of the total domestic demand would be met by foreign suppliers, and thus add to the lopsided imbalance in our foreign trade.

Given the economic outlook, which appears more than normally shrouded in uncertainty with the fiscal policy that remains controversial, as several members of this panel have already suggested, it is going to make it more difficult for you to insure against noninflationary growth.

But, in arriving at your monetary targets for 1986, Mr. Chairman, what assumptions have you made with respect to fiscal policy?

Mr. VOLCKER. We have generally been making the assumption that something on the order of magnitude, or a little less, of the package that emerged from the Senate—I think it really is a different package than emerged from the House—quantitatively something approaching $50 billion, would be a little optimistic at this point.

Mr. WYLIE. Still optimistic that Congress will come up with a budget deficit reduction package of around $50 billion, and you are sticking to that?

Mr. VOLCKER. That is correct.

Mr. WYLIE. All right.

Well, I hope that your optimism bears fruit, and I am not so sure that I am as optimistic today as I was last week, along with the gentleman from Louisiana.

You mentioned, also, about the decline of the dollar. How would that be reflected in our exports if the dollar continues to decline?

I will tell you where I am coming from on this. You are right that there is a growing mood for protectionism all across the country, and it is based in the Midwest area where I come from. For instance, there are bills in now which would restrict the importing of automobiles, television sets, footwear, textiles, bicycles and lumber, just to mention a few. What impact does that have on the economy?

Mr. VOLCKER. The protectionist pressure?

Mr. WYLIE. Well, no. The fact that there are these imports coming into the country. Last year—and that was a good question—there was a trade deficit, a merchandise trade deficit, of $108 billion.

Mr. VOLCKER. It will be a lot more this year.

Mr. WYLIE. It will be more this year. Now, do you factor that in?

Mr. VOLCKER. Yes. That, in itself, is the reason that manufacturing, the goods-producing side of the economy, has been as sluggish as it has been—it has been that increase in imports. It is not the demand; demand is quite healthy. It is not as high as it was—in terms of rate of increase—in 1983 or the early part of 1984. But, domestic final demands have been growing 4 percent or more, which is certainly a pretty good rate of speed to be sustained. It is not appearing in production, precisely because of those imports that you are referring to.

Mr. WYLIE. What suggestion would you have for us to thwart fears that the imbalance in trade is causing a really harmful impact on our economy, and that we ought to do something about it vis-a-vis protectionism?

Mr. VOLCKER. You say it has a harmful impact on the economy. The direct impact on the manufacturing industry is harmful. But the related fact is that that surge in imports and increase in the trade deficit is the opposite side of the coin of a big net capital inflow, which is very helpful to the economy, and it is going to be helpful and necessary so long as this country has such a big budget deficit. You cannot talk about getting rid of the trade deficit without getting rid of the capital in-flow. You may love to get rid of the trade deficit, but you are not going to love to get rid of the capital inflow, so long as the demands on our capital markets are so big.

Of course, the area you can do something about is the Federal budget deficit. Now, that is awfully hard to explain to a fellow in Ohio who is worried about his manufacturing job and sees the imports.

Mr. WYLIE. It certainly is.

Mr. VOLCKER. But I do not think it is going to help that situation if you say, "Okay, we have too many imports; we will take the most direct measure we can take, a protectionist measure." I think you are going to find that whatever help it may be to a particular manufacturer, a particular worker at a particular time, it is not going to help the overall trade situation. You will get retaliation; you will get more price pressures. If nothing else happens and you put on some protectionism—you will probably get a still higher dollar. I do not think it is likely that nothing else would happen. You would get foreign retaliation.

Mr. WYLIE. I think my time has expired. But I would like to ask one more question in the form of a summary of your testimony.

Would you say that the Federal Reserve has done all it can to encourage lower interest rates and help reduce the value of the dollar? In doing so, the Fed has accepted a considerable amount of risk of reviving inflation domestically and causing serious problems for Third World debtor countries, and it is now up to Congress to do the rest by bringing down the Federal deficit.

Mr. VOLCKER. I think we feel we have done all we can within the limitation of not disturbing the basically favorable inflation outlook, which is central to our whole approach.

Mr. WYLIE. Then, in the process, we would adopt policies which would provide for home-grown expansion, if you please, and that would help us as far as——

Mr. VOLCKER. We have a home-grown expansion. It is flowing abroad. The foreign countries need home-grown expansion.

Mr. WYLIE. I accept that.

Mr. VOLCKER. We are fertilizing the rest of the world.

Mr. WYLIE. I accept that caveat, sir.

Thank you very much, Mr. Chairman.

Chairman FAUNTROY. Thank you, Mr. Chairman. The distinguished gentleman from Tennessee, Mr. Cooper, has yielded to the distinguished gentleman from Alabama, Mr. Erdreich.

Mr. ERDREICH. I appreciate the gentleman from Tennessee for yielding for a moment. I am curious, 6 months ago, Mr. Chairman, when we had our last hearings, your growth expectations were a little better than what you are looking at or telling us here now.

Mr. VOLCKER. Correct.

Mr. ERDREICH. We are looking at 2.75 or 3 percent growth ranges as your current projection. I heard one of your Board members talk about this using a term I don't like, a growth recession, and I would be curious, do you characterize where we are now as a quote "growth recession"?

Mr. VOLCKER. No, I do not use that phrase generally, but I would not characterize it as a growth recession in any event.

Mr. ERDREICH. Are you satisfied with the level of growth at 2 or 3 percent? What bothers me is we are still apparently stuck in a rut on unemployment. Your figures I think show a little better than 7 percent, possibly 7 percent. Do you see any opportunity in

the next 6 or 12 months to improve on unemployment so more folks are working?

Mr. VOLCKER. These are a range of projections. We have been wrong in some respects before and we could be wrong again. If you are asking me whether there is any opportunity to do better on growth and employment, I certainly think there is.

Mr. ERDREICH. I mean any optimism that it will be better?

Mr. VOLCKER. I would think the chances are as good, they could be better, but they could be worse. This is the center of the range. I think we will do better on the inflation side than these projections. The Federal Open Market Committee has overestimated the inflation rate for 4 consecutive years in these projections. I hope this is another one.

Mr. ERDREICH. Thank you, Mr. Chairman. Thank you for yielding.

Chairman FAUNTROY. The gentleman from Tennessee, Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

Mr. Volcker, would it be fair to say that if Congress had taken action say 2 or 3 months ago and each House voted for a $50 or so billion worth of real deficit reduction and it passed and was approved and all of that, it would have been at least possible in recent actions of the Fed to change your basics somewhat, it would not have been necessary? That would have been a sufficient boost to the market or spur to growth that perhaps your action wouldn't have been called for?

Mr. VOLCKER. I think if budgetary action had been taken 2 or 3 months ago it would not have affected monetary figures in that time span very much. We still would have been faced with the same basic facts. I suspect we would have arrived at roughly the same conclusion.

I think the difference would be—and this is a very important difference—the odds on achieving a slower, seemingly more sustainable rate of monetary growth without interest rates going up again or, indeed, consistent with a further decline in interest rates. We would be much better off in that respect if that budgetary action had been more clearly taken, in my judgment.

Mr. COOPER. That is exactly what worries me. It seems to me and I appreciate very much your willingness and your ability to do it, but it seems that the Fed has for months if not for years now been bending over backwards to accommodate Congress in its delay and unwillingness to face up to the deficit problem. I appreciate your willingness to bend over backwards, but my big fear is I guess in the sense of the better job you do with all your skill and ability, the harder the landing might be when that day of reckoning comes, and the worse the ultimate impact could be, and that to me is my big concern.

Mr. VOLCKER. I share that worry though perhaps in a little different way. I think the more wrenching the adjustment will have to be, the longer the delay.

Mr. COOPER. You don't worry sometimes that your very skills and persuasiveness and so on in the long run——

Mr. VOLCKER. I worry about a lot of things.

Mr. COOPER. But not those.

One last question. You mentioned earlier the several strains, imbalances and dangers on the horizon. Would you include in that the recomposition of the Federal Reserve Board due to personnel changes on that Board?

Mr. VOLCKER. I do not put that, in my mind, at great risk. I feel we will get people of good sense and competence.

Mr. COOPER. Thank you, Mr. Chairman.

Chairman FAUNTROY. Thank you. I yield to the distinguished gentleman from Minnesota, Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

It is a pleasure to see the Chairman present today to visit about monetary policy and to note that there is a greater degree of pragmatism in recent months with regards to the monetary policy approach.

As the Chairman might suspect, I am not completely satisfied with the degree of pragmatism but whatever little bit——

Mr. VOLCKER. It is a bad word with some people.

Mr. VENTO. But, I think that this flexibility is, Mr. Chairman, desirable and in fact, absolutely necessary in this environment.

The fact is, that the problem concerning our balance of trade I think is the most critical one in terms of what is happening with the so-called bloated dollar and our inability to deal with that. I agree but I don't share the pessimism that my other colleagues do with respect to budget reductions.

In fact, I think it is clear there is going to be about a $24 billion reduction in terms of what the projected Reagan spending was in terms of outlay for military spending.

So I don't think we should give that up. If we throw our hands up and let it slide, it would be a disaster. Some other changes, while I may not like them, I think that they are possible to attain. So I hope we don't walk away from it.

I think there have been victories on the part of the White House and victories on the part of Congress in terms of social security and other things. But I hope we don't walk away from it. The area I see lacking—and I see the Treasury Secretary in recent months has been talking more about the currency imbalances, the bloated dollar—and we have had an interventionist attitude on the part of the Fed dealing with Third World debt.

I think it has probably been necessary. We have had a dealing with certain commodity problems, certain banks within our country, and I am wondering what is on the agenda in the months ahead in terms of the issue of currency.

I notice that the French Prime Minister's conference that he had wished obviously is not in the cards. I think it is becoming abundantly clear that we have to provide some agreement with our major trading partners in terms of currency. But looking at the problem with Canada, for example, nobody is going to buy any grain in this country as long as it is being sold at 20 percent less some where else. The fact of the matter is, our agricultural exports are scheduled to be something like $80 billion this year and we are going to import into this country in oats and grain, and so forth, $40 billion worth of various commodities, Mr. Chairman.

I am wondering what is on the agenda in terms of dealing with this problem?

Mr. VOLCKER. In terms of international discussions, nothing is on the agenda at this point except a carry through on a study that was just completed. There was a study in the Group of Ten over the course, I guess, of a couple years to reexamine and reach some conclusions, at least in a preliminary way, on the international monetary system. I think that report said a number of useful things, but it did not take any striking new initiatives on the exchange rate system. It talked about a need for prudent policies in individual countries and expressed the hope that the exchange rates would be more stable. That report will still be discussed in various other international bodies in the course of the next year. But it does not start with new departures.

I do think there has been some convergence in some respects in international policies, at least in international results. Inflation rates are about as close together internationally as I can remember them. But there are wide differences in the level of unemployment.

My own feeling, which I have expressed on a number of occasions, is that if the exchange markets remain as volatile as they have been, viewed either in the short-term context or a somewhat longer-term context, after we have made a little more progress toward convergence of national policies with inflation remaining contained, not only here but elsewhere, if we still continue to get this volatility in exchange rates, we better take another look at it.

Mr. VENTO. I don't think we can tolerate a $150 billion trade imbalance, Mr. Chairman, and I am disappointed—the fact of the matter is that Treasury, in terms of their actions and guaranteeing and other activities, have in fact reinforced the value of the dollar last year and only recently we have had these changed attitudes, or at least recognition of the problem.

Why can't we have agreements like the French have with the Germans? Why can't we have such an agreement with the Japanese? We are going to, I think, in the direction of passing protectionist legislation; that is really the only alternative we are faced with, Mr. Chairman.

Mr. VOLCKER. I think you have to recognize that with the agreements that the European countries have among themselves, they give up a lot of independence of their own monetary policies, and to some degree, fiscal policies. That is a legitimate issue. To what degree should independence be given up? How much do you really have anyway? The point I would make is, even in this system, we have an illusionary amount of freedom. I recognize all your problems about the dollar. But if we could snap our fingers and put the dollar at the level you would like from the point of view of the trade situation, you will transfer pressures someplace else, all things being equal.

We cannot finance ourselves as things now stand.

Mr. VENTO. I think it is a matter of choices, Mr. Chairman. I don't think the burden ought to be all on the manufacturing, or farmers of this country.

Mr. VOLCKER. I agree.

Mr. VENTO. I think it is quite a burden. We are talking about $150 billion balance of trade problems, that is very significant.

Mr. VOLCKER. There is no question, the burden should not all be on those sectors of the economy. But we are not gaining much if we

do something to transfer it from those sectors to other sectors, then you will come back or others will come back and say, why should the burdens all be on housing? Why should they all be on investment? To get a balanced approach we are going to have to do something more fundamental than fiddling with the dollar.

Mr. VENTO. Mr. Chairman, we are out of balance in terms of my time.

Chairman FAUNTROY. Thank you; your time has expired.

Mr. Chairman, under the current international monetary system, could you envision any circumstances under which the United States would devalue the dollar to promote growth in the domestic economy?

Mr. VOLCKER. Are you asking if we would deliberately undertake actions to depress the dollar?

Chairman FAUNTROY. Can you envision any circumstances in which you might do that?

Mr. VOLCKER. It would be very difficult for me to envisage those circumstances. I am not interested in pushing the dollar down artificially through bad policies. I know the way you can do that—you can do it by undertaking a bad monetary policy. But we are not about to do that.

Chairman FAUNTROY. You have suggested that the time has come for Japan and Europe to help push the world economy as we have in the last 3 or 4 years. Are our present difficulties and economic distortions a function of the inability or unwillingness of these nations to stimulate their own economies?

Mr. VOLCKER. I do not think there is any question that the size of our trade imbalance is partly a reflection of the fact that there is 10 percent or so unemployment in Europe, and that Japanese growth, to a significant extent, has been predicated on export-led growth rather than domestic-led growth.

I think more vigorous growth of domestic demand in those countries would have a very significant effect on our trade position and balance in the world economy. I think that will come more easily. We are possibly seeing signs of it now, in a context of less downward pressure on foreign currencies, the converse of the strength of the dollar. As these currencies depreciated, they felt a certain inflationary pressure. They were very concerned, and rightly so, about restoring a sense of price stability. They had to do that fighting a depreciation of their own currencies against the dollar.

In terms of expansion of their economies, they have also been faced with this pull of capital out of the country. So I would think a change in the exchange rate situation may provide a more favorable climate for their expansion. If capital were not drawn so strongly toward the United States, it would, I think, lead to more expansion in Europe and Japan.

[U.S. Merchandise Trade with foreign G-10 countries prepared by the Federal Reserve Board follows:]

U.S. Merchandise Trade with Foreign G-10 Countries
(billions of dollars)

	1979	1980	1981	1982	1983	1984	1985 5 months
U.S. Exports to:							
Belgium	5.2	6.7	5.8	5.2	5.0	5.3	2.0
Canada	33.1	35.4	39.6	33.7	38.2	46.5	20.4
France	5.6	7.5	7.3	7.1	6.0	6.0	2.7
Germany	8.5	11.0	10.3	9.3	8.7	9.1	4.0
Italy	4.3	5.5	5.4	4.6	4.4	3.9	2.2
Japan	17.6	20.8	21.8	21.0	21.9	23.6	9.8
Netherlands	6.9	8.7	8.6	8.6	7.8	7.6	3.1
Sweden	1.5	1.8	1.8	1.7	1.6	1.5	0.7
Switzerland	3.7	3.8	3.0	2.7	3.0	2.6	1.1
United Kingdom	10.6	12.7	12.4	10.6	10.6	12.2	5.3
Sum	97.0	113.9	116.0	104.5	107.2	118.3	51.3
U.S. Imports from:							
Belgium	1.7	1.9	2.3	2.4	2.4	3.1	1.4
Canada	38.0	41.5	46.4	46.5	52.1	66.5	29.0
France	4.8	5.3	5.9	5.5	6.0	8.1	4.0
Germany	11.0	11.7	11.4	12.0	12.7	17.0	8.4
Italy	4.9	4.3	5.2	5.3	5.5	7.9	3.8
Japan	26.2	30.7	37.6	37.7	41.2	57.1	28.1
Netherlands	1.9	1.9	2.4	2.5	3.0	4.1	1.7
Sweden	1.7	1.6	1.7	2.0	2.4	3.2	1.8
Switzerland	2.1	2.8	2.4	2.3	2.5	3.1	1.4
United Kingdom	8.0	9.8	12.8	13.1	12.5	14.5	5.5
Sum	100.3	111.5	128.1	129.3	140.3	184.6	85.1
U.S. Trade Balance with:							
Belgium	3.5	4.8	3.5	2.8	2.6	2.2	0.6
Canada	-4.9	-6.1	-6.8	-12.8	-13.9	-20.0	-8.6
France	0.8	2.2	1.4	1.6	0	-2.1	-1.3
Germany	-2.5	-0.7	-1.1	-2.7	-4.0	-7.9	-4.4
Italy	-0.6	1.2	0.2	-0.7	-1.1	-4.0	-1.6
Japan	-8.6	-9.9	-15.8	-16.7	-19.3	-33.5	-18.3
Netherlands	5.0	6.8	6.2	6.1	4.8	3.5	1.4
Sweden	-0.2	0.2	0.1	-0.3	-0.8	-1.7	-1.1
Switzerland	1.6	1.0	0.6	0.4	0.5	-0.5	-0.3
United Kingdom	2.6	2.9	-0.4	-2.5	-1.9	-2.3	-0.2
Sum	-3.3	2.4	-12.1	-24.8	-33.1	-66.3	-33.8

SOURCE: U.S. Department of Commerce, Bureau of the Census. Import data are Customs (or FAS) valuation.

prepared by Federal Reserve Board, Division of International Finance

Chairman FAUNTROY. Thank you. I want to yield now to the distinguished former Treasurer of the State of Delaware, now the Representative from the State of Delaware, Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

Chairman Volcker, welcome to the subcommittee. I would like to ask you to take a minute and explain to me at what level have real interest rates generally adhered to for much of this century? At what level have real interest rates adhered to during most of this century?

Mr. VOLCKER. I cannot say, off hand, for the first half of the century. For the period from the early 1950's through much of the 1970's, long-term interest rates, measured against some expectation of prices, were probably around 3 percent; short-term interest rates would fluctuate from close to zero to maybe a peak of 3 percent at isolated points during that period in our history.

Mr. CARPER. At what level have they risen or at what level have they been for the last 3 or 4 years?

Mr. VOLCKER. The Treasury bill rate now is 7½ percent, and the inflation rate as measured by the Consumer Price Index is 4½ percent, so the short-term real rate is 3 percent, which would be at about the peak levels that it was during the 1950's.

With long-term rates, you have much more trouble in deciding what the underlying inflation rate is, because you are dealing with what expectations are. If you just measured it against the current inflation rate, you would get an abnormally high real interest rate, no doubt about that, around 6 to 7 percent.

Mr. CARPER. Why have real interest rates been so high in the last several years, and why even now do they remain high?

Mr. VOLCKER. You have a $200 billion budget deficit that has to be financed and that exceeds our ability to finance internally. I would put that as a leading cause. Second, the country is coming off an inflationary period that left deep psychological scars. The longer we can prolong this progress toward stability, the more expectations will change; indeed, I think they changed enough to help bring down nominal, and to some extent real, interest rates in the past year or so.

But expectations are still very sensitive.

Mr. CARPER. Over the last several years I have been preaching, as I think you have been, that large Federal budget deficits lead to high real interest rates, lead to an overvalued dollar. We have seen, despite continued high budget deficits, dropping interest rates, even real interest rates, and we have seen the value of the dollar, particularly as you noted earlier, dropping rather appreciably.

Mr. VOLCKER. Yes.

Mr. CARPER. Why is that dollar dropping?

Mr. VOLCKER. Let me give you the most general explanation of how these phenomena could go together. The growth rate of the economy has been rather slow, and you would ordinarily expect that if the economy is growing slowly or if it is falling, that interest rates would decline; that is the normal behavior in the interest rate area and financial market area.

You have several things happening at the same time. You have the continuing high deficit—that was there before, and it is there

now. Before it was against the context of a rapidly growing economy. Now it is in the context of an economy growing much more slowly. You also had another year of the inflation rate not going up, so confidence, expectations, are probably changed some and most surveys show that. You have some offsetting developments that have pushed interest rates lower, even though the deficit itself pushes them up and keeps them high.

Mr. CARPER. At what point do you believe that a declining dollar will result in an outflow of dollars from U.S. banks and is there a conflict between our need in this country to fuel growth with the lower dollar and our need to fund the deficit with foreign deposits?

Mr. VOLCKER. That is the heart of the conflict that I have been trying to describe. I think there is a very definite conflict—a disequilibrium—that you have to go to the source of by dealing with the budget deficit. The first part of your question: What are the chances that money will be withdrawn from the United States as the dollar goes down, I think illustrates the point. On balance, everybody together cannot withdraw dollars from the United States more rapidly than we run a current account surplus. What can happen, however, as people seek to reduce their investments here, is that you get a change in the price we pay for holding those dollars in the United States, whether it is paid to the same person or whether it is paid to a new holder.

There are two dimensions to that price, the exchange rate and the interest rate. You can drive the exchange rates so low that people think it is a good buy; but you don't necessarily want to get to that point. You can change the interest rate; the fact that they want to get out of dollars itself tends to change the interest rate. So you run into those two risks, and those are the risks we are running so long as our need for that money is so high.

Mr. CARPER. My time expired again, thank you, sir.

Chairman FAUNTROY. I thank the gentleman.

The distinguished ranking minority member of the committee, Mr. McCollum.

Mr. MCCOLLUM. Thank you.

Mr. Volcker, you have been here quite a while and I don't know if any of us will ask many more questions, but I appreciate your being here to explore a couple more areas.

You indicated in an answer to a question earlier by Mr. Hiler to my left that the decline of the dollar over the last week has been rather sharp and I think most of us would conclude that it has been. Should the dollar continue to decline at the rate it has over the last week for any lengthy period of time, several weeks or whatever, do you foresee that presenting any problems?

Mr. VOLCKER. I do not think the decline so far has presented any problems, given the level it was starting from. If you extrapolate this far enough it would create a problem for the very reason we have been talking about; it has both an inflationary potential and a potential for undercutting any easing tendencies in the financial markets. That potential exists, particularly as long as the budgetary situation is in its current position. It exists whether it takes place now or sometime down the road a bit.

Mr. MCCOLLUM. Right.

Is there anything in your crystal ball in looking at the scenario as the Board members look at it, as the Open Market Committee looks at it, such as the aggressive decline in the value of the dollar, or factors that are looming on the horizon that would lead you to anticipate a sentiment among your Board members for any less accommodative monetary policy in the next few months, as opposed to the longer term?

Mr. VOLCKER. I cannot exclude that, but it would depend upon circumstances as they develop during those next months.

Mr. MCCOLLUM. There is nothing sitting there on the table today that would indicate a less accommodative policy? I am saying tighter as opposed to staying as it is.

Mr. VOLCKER. No.

Mr. MCCOLLUM. And not talking about——

Mr. VOLCKER. The thing on the table today is implicit in all this testimony. We have had a pretty big increase in M1, and we would not want to see that unnecessarily or unduly prolonged.

Mr. MCCOLLUM. But M1 is indeed being challenged as to its validity based on velocity and other factors; is it not?

Mr. VOLCKER. If we were running a policy entirely on M1 I presume we would have tightened up before now, but it is a matter of weighting it; it is used as a factor before going in that direction. I gave you one factor.

Mr. MCCOLLUM. You did indeed. But you would have to come back to the desire to rely on it or your members would, more than they are willing to at the present time, is that correct?

Mr. VOLCKER. I do not think it is a question of relying on it more or less than they are willing to at the present time. Everybody recognizes a certain amount of uncertainty in this. It is a question of what the numbers show. If you continued to have increases of the kind you had in May and June, that is one thing. If you had a kind of reversal which could well develop, that is another thing.

Mr. MCCOLLUM. Let me ask you this way. If M1 continued to grow like it did in May and June, but velocity didn't change or continued its trend or you had less turnover of dollars than historically, wouldn't even a monetarist begin to question whether M1 is valid as a measure and continue to downplay that?

Mr. VOLCKER. Sure, at some point he would have to. But there are lags in this process. At what point are you sure of that? Today velocity is going down but is that just presaging a burst in the other direction down the road? The longer that process goes on the more grounds you have, as you say for discounting it very heavily. But you do not have the luxury of doing a full-scale historic econometric analysis of how this incident will look for the decade of the 1980's when you are in the middle of the 1980's.

Mr. MCCOLLUM. I understand, all I am trying to do is not tie you down but to insure that I have a grip on this as we move on this, what factor that is, and that is a factor.

Mr. VOLCKER. As I said you are asking me questions as to whether we are ignoring M1 entirely; I am saying we are not, although we recognize the uncertainty associated with it. We are certainly not ignoring it.

Mr. MCCOLLUM. Let me ask one other question. Inventories in your statement, as you indicated, were basically flat. I saw yester-

day in the paper which I assume occurred after preparation of your statement that they declined.

Is this cooperative of your projections with respect to the economy picking up, in other words, the inventories would enhance that probability?

Mr. VOLCKER. If you look at that figure alone, you would conclude—it is going to be announced tomorrow, of course, and I do not know what it is going to be—that it might be that the second quarter figure will have to be pulled down some, but I do not think it affects the outlook adversely. You might well argue, as you just did, that it improves the outlook for the second half of the year.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Chairman FAUNTROY. The gentleman from Georgia, Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Chairman, there have been a lot of questions today that revolved around the value of the dollar. I hope I am not repeating the issue, but I would like to ask you the question, if the dollar were to decline to a level that was consistent with the trade balance, thereby largely ending the importation of foreign capital, how much inflation would this cause?

Mr. VOLCKER. You would have to make a large number of assumptions as to how much it would have to decline and what the impact is on inflation. The only thing I can tell you that is useful is kind of a standard rule of thumb that many economists use—that a 10-percent depreciation in our currency causes about a 1.5-percent increase in the Consumer Price Index in absolute terms. This takes into account indirect as well as direct effects, and this is not per year, but fully worked out over a 3- or 4-year period.

Now if you tell me how many 10-percent depreciations to attach to that, I can make the calculation. As I said earlier, I kind of think the first 10 percent is no problem in that respect since we never got the favorable price effects of the last 10 percent of appreciations.

Mr. BARNARD. Are you telling me there may be as much as 15- or 16-percent inflation?

Mr. VOLCKER. Certainly not 15- or 16-percent inflation.

Mr. BARNARD. What would the rate of inflation be?

Mr. VOLCKER. I am telling you that this standard rule of thumb is that the level would be 1½ percent higher, say, after 3 years that is one-half percent a year on the inflation rate at 10-percent depreciation.

If you said it had to come down 20 percent—it is already down 10 percent from the peak, or more—you would say over a period of time, depending on when it took place, you would add another 1½ percent. That takes care of presumably indirect effects, whether it affects the wage trend and all the rest of it. I am not sure it has all those indirect effects today. There is a wide range of uncertainty, but it clearly goes in that direction.

Where I would worry about it is if that inflationary impact was combined, say, with excessive monetary growth, excessively easy monetary policy. Then we have a problem, no question about it. If it is combined with other actions such as budgetary action in a restrictive direction, I think we could manage that transitional problem without disturbing the basic trend toward stability.

You might get some impact on the price numbers for a while, but they are not going to be of a size or character or have a lasting quality, that would have to concern us. But I think it is the greatest risk we have on the inflation front right now. I can imagine a combination of circumstances that would be very troublesome.

Mr. BARNARD. If this occurred, what monetary policy response would you recommend to the Open Market Committee under these circumstances?

Mr. VOLCKER. Let me say the natural result of that, I think, in almost any monetary policy, would be higher interest rates than you would otherwise have. Presumably, you also get some expansionary thrust in the manufacturing side of the economy. That is part of the reason you would expect higher interest rates than you otherwise have. I would certainly be concerned that the Open Market Committee conduct its policies in a way that takes account of that potential inflationary impact, and I would make sure that we do not inadvertently add to the inflationary forces.

Mr. BARNARD. Has the Open Market Committee—have they done any studies that would take some of these possibilities into consideration?

Mr. VOLCKER. The staff occasionally does long-range projections and studies that try to take this kind of thing into account; yes.

Mr. BARNARD. On another area, on page 25, you mentioned foreign loans, especially to Latin American countries. Are you satisfied with the rate of reduction in the amount of those foreign loans?

Mr. VOLCKER. American banks have pretty much turned off lending to the developing world, and the rest of the developed world, for that matter, which gives me a chance to say this. We talk about all this capital inflow; this big increase in net capital inflow we have is in considerable part because we turned off any gross capital outflow to Latin America or elsewhere. I think banks have to maintain some lending to these countries in the banks' own interest. If they really cut off the lending that is necessary to do refinancing or, in some cases, some new financing necessary so that these countries can adjust and grow, I think they would be undercutting the stability of the loans that are outstanding.

So, yes; I guess what I am saying is that under the circumstances I am satisfied. You have to balance the desire to reduce exposure with the necessity to be prudent and to work toward that goal so they do not undercut the value of the loans that they have.

The way this seems to be working out is you do not get much increase, but the ratios are declining. I am referring to the ratios of foreign loans to capital. I do not remember the exact numbers, but a good many of the lending banks probably have ratios of exposure to capital back to where they were in the late 1970's, when they were very eagerly making new loans, when the climate was quite different, and they were quite willing to increase exposure. Now the ratios are at that same level and banks would like to see the relative exposure reduced. But that is the nature of the game.

Mr. BARNARD. Thank you, sir.

Chairman FAUNTROY. I thank the gentleman. The gentleman from Indiana, Mr. Hiler.

Mr. HILER. I thank the Chairman.

Chairman Volcker, in your prepared testimony, and I believe in your remarks, you have indicated that the drop in discount rate that has taken place has followed a drop in the overall interest rate structure.

Mr. VOLCKER. I think it both followed and preceded. It followed some decline and, since the change, there has been further decline in market rates.

Mr. HILER. All right. So, in other words, the action that the Fed took to lower it was following a drop in the rate structure and there has been——

Mr. VOLCKER. And was in turn followed by further drops.

Mr. HILER. I guess I would ask at that point, then, why not drop the discount rate one-half or 1 percent at this time? If the rest of the market rates follow it down, then we have lower rates; if they don't follow it down in 30 days' time, you could lift it back up.

What would be wrong with dropping that discount rate?

Mr. VOLCKER. You ask a good, straightforward question. I am not sure, on this subject, you will get a good, straightforward answer.

Mr. HILER. The chairman doesn't like to talk about the discount rate; I have been able to ascertain that.

Mr. VOLCKER. Obviously, that is a tool which you fit in with your general posture toward the market, toward the provision of reserves.

We have not changed our posture in providing reserves this year, as I indicated in my statement.

Suppose the discount rate had the effect at least in the short run, of pushing market rates down. This would have the influence work in the direction of still more rapid growth in the money supply. You would have to ask yourself whether that is appropriate under all the circumstances we face at the moment, just following a big bulge in the money supply, with the dollar declining in foreign exchange markets, all the other information we have about developments in the economy with respect to prices. You ask whether it is appropriate. I think I can answer unambiguously that if we had thought it appropriate up to now, we would have announced it.

Mr. HILER. I perfectly understand you saying that. I guess I was not asking why you haven't done it; I was asking what would be the problem with doing it.

Mr. VOLCKER. Looking ahead, we take those factors into account.

Mr. HILER. I will close at this point with a short statement.

I think one of the reasons why we up here ask you lots of hypothetical "what if" type questions is because this is the only chance we will have to have you before us for the next 6 months.

Mr. VOLCKER. That is not quite true.

Mr. HILER. Well, on this particularly subject, in all probability, this will be the only time you are before this subcommittee and the full committee.

Many of us oftentimes are discouraged because everyone has to conjecture what the Fed's policies are going to be, and that is why I asked earlier today what kinds of things you would be looking at, inflation or capacity utilization or labor agreements or M1, or what.

Now, many of us would like to see the Fed announce its decisions that it reaches in the Open Market Committee meetings signifi-

cantly sooner than when you currently announce those decisions so we would all know what you are thinking, and we wouldn't have to play these games where we ask what if and you kind of dance around the questions, and so on.

Mr. VOLCKER. That is an old discussion. You can read the past decisions and try to say what position you would be in if you made it public the day after the meeting. I think you are going to find yourself asking the question, "What if?" after having read the decision—because the decisions are indeed often couched precisely in those terms, "Do this if that happens and do something else if something else happens," which we don't know now. So you will not resolve that question. That is what everybody would love to know: What are we going to do 1 month from now?

If we really knew what we were going to do 1 month from now, and we told you, the market would react immediately and you would have a different impact than what would be intended. But the fact is, we usually don't know whether we will reduce the discount rate 1 month or 1 week or 2 weeks from now, or how we will manage open market operations at that time, because it will depend on what happens between now and 1 month from now.

Mr. HILER. That is certainly one of the aspects of an extremely discretionary monetary policy. Is that all of——

Mr. VOLCKER. I think that is——

Mr. HILER. The 12 folks who vote don't know and we don't really have an inkling most of the time.

Mr. VOLCKER. I think you get a pretty good inkling. You are right; it is, in a sense, a characteristic of a discretionary monetary policy. But I think the argument in my mind—and I have a lot of sympathy when it is expressed this way—is not when they are released but the degree to which you can rely upon a rule which is announced in advance. One version of that rule would have been to have, say, the money supply increase by 6 percent this year. You know what that rule is and we know what that rule is, and we try our damnedest to keep it at 6 percent this year. I do not know what would have happened to the economy in that case, but that is one way of running monetary policy. We are not running it on the basis of that strict a rule.

You can think of any other rule, but you must think up a good rule. And, I have a certain skepticism that you can think of a rule that will make you or me happy enough over a period of time.

Mr. HILER. We probably wouldn't come up with the same rule.

Mr. VOLCKER. We might come up with different rules, but none of them may make us happy.

Chairman FAUNTROY. Thank you. We have been joined by the gentleman from New York, a member of the full committee, Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman. I appreciate the opportunity, as a full committee member but not a member of this subcommittee, to ask a few questions.

Mr. Chairman, my questions focus on a different issue. As we are sitting here, the Budget Committee conference is meeting and, as we know, it has been on a very rocky road in the past few weeks. Yet, you have had a tremendous influence on that budget process as early as, I believe, February 23, 1984, when you stated that a

$50 billion deficit reduction number was a good target for the committees to shoot for.

Before the Budget Committee on March 6, 1985, you said $50 billion would be a big bite; $50 billion a year needs to be taken out of the budget deficits.

As I ask you these questions and we sit here, the Budget Committee labored long and hard to reach those $50 billion, as you know. In the House and Senate, they both came about $6 billion higher than the $50 billion. And yet, right now the process could well break down, not for failure to reach the $50 billion number, but rather because one side, one House said we must reach $59 billion in 1 year, $280 billion in 3 years, and the other side says, No, $56 billion is what we ought to reach, $273 billion over 3 years.

I have three questions.

One, do you stand by the fact that a $50 billion number would still be significant?

Two, would you not agree that it would be far better for the House and Senate to agree on a number above $50 billion that might not be the highest possible number rather than have no agreement at all?

And, three, what do you think the consequences of no agreement between the House and Senate conference and thus no real budget would be?

Mr. VOLCKER. I still think a $50 billion reduction is significant. As the deficits get bigger and time passes, maybe it is less significant than it used to be, but it is still a nice, round number. Obviously, it is important to get agreement and it is important to get agreement on a substantial figure than worry about the last $2 billion or whatever you were saying.

I must interject a footnote here. You cite these figures. I know there is some skepticism around as to whether the real reductions in those programs are as much as advertised. I take it that that is part of what this discussion is about.

Mr. SCHUMER. That was probably true until the offer made by Chairman Gray today. There was one number that people considered soft money, the so-called $4 billion for contracting out. This offer is removed.

Now, basically, the parameters, the discussion between the two sides is really how much ought to be reduced.

There is a real danger that one House—not ours, and there is agreement, really, both the Republicans and Democrats in our House have been in agreement recently, praise the Lord—but that the other side might walk away and say the $56 billion number in 1 year, and particularly the $273 billion number in 3 years, is not enough, and leave us with no agreement.

Would you consider that advisable?

Mr. VOLCKER. I am not going to get into that kind of discussion while negotiations are ongoing at the moment.

Mr. SCHUMER. I understand.

Mr. VOLCKER. I would like to see as much as possible, as real as possible, as soon as possible.

Mr. SCHUMER. But $50 billion is still a significant number to shoot for?

Mr. VOLCKER. That $50 billion is still a significant number. It is obviously $50 billion more than zero.

Mr. SCHUMER. Thank you very much. I appreciate the indulgence of the subcommittee.

Chairman FAUNTROY. We thank the gentleman. The distinguished ranking minority member, Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I would just like, if I may, Mr. Chairman, to follow up on the questions and your answers, and I was here and I heard them. But this is a debate that has been going on ever since I have been in the Congress about the role of the Fed as far as the discount rate is concerned.

I guess it is fair to say the Federal Reserve has pursued a policy of monetary accommodation and lowered its discount rate, and I happen to think that it did contribute to the reduction in the prime and other interest rates and the lower value of the dollar in foreign exchanges.

A lot of people are speculating in meetings with me that I go to that you are following the market and that you are going to lower the discount rate again soon. Are you?

Mr. VOLCKER. If we were, I would not tell you.

Mr. WYLIE. All right.

Mr. VOLCKER. And I don't think I would lead you into that presumption.

Mr. WYLIE. That really is a decision made by the Board as to whether the discount rate will be lowered; is that fair to say?

Mr. VOLCKER. Yes, it is the Board of Governors. It is made based on a proposal by the Directors of one or more Reserve banks. The action has to be originated by a Reserve bank, but the approval is with the Board of Governors. That is basically a decision of the Board of Governors.

Mr. WYLIE. Will the meetings where the discount rate is being discussed be open to the public?

Mr. VOLCKER. No. We have the feeling that that might adversely affect the stability of the markets, and lead to a certain amount of unwarranted activity and speculation.

Mr. WYLIE. What about the Federal Open Market Committee? And, again, I heard Mr. Hiler's question. Why shouldn't meetings of the Federal Open Market Committee be open to the public?

Mr. VOLCKER. I think for two reasons. First, it would lead to a lot of speculation in the markets. It would also be inhibiting in a deadly way on the freedom of those discussions, and the ability and willingness of people to speak their minds freely, engage in a free-ranging debate, and change their minds, or be convinced by arguments by others in the middle of a discussion. I think those are all qualities that are absolutely essential to the decisionmaking of the Committee.

Mr. WYLIE. Do you think other people in attendance in the audience might intervene and might have an effect on the decisions?

Mr. VOLCKER. I do not think there is any question that people sitting in the audience would have an effect on the freedom with which you engage in discussion and debate. If you worry about how it is going to read in the papers, you do not freely change your mind. You do not like to ask questions that you think might, in

somebody's mind, make you look foolish. All these kinds of dynamics are at work in public meetings. And certainly in this complex technical area, it would just be disastrous, and undermine the decisionmaking process.

Mr. WYLIE. You probably wouldn't have enough telephones to accommodate all those who might want to use them.

Mr. VOLCKER. That is the external side of it. We would have to put a bank of telephones there. Every time somebody made a more or less persuasive argument in somebody's view, you would see the market wave one way or the other. It would create more uncertainty.

Mr. WYLIE. As I say, I don't necessarily disagree with your position on that, but it is a debate that has been going on for a long time and, I think, repetition serves to emphasize.

I thank you very much for your appearance.

Thank you, Mr. Chairman.

Chairman FAUNTROY. I thank you. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

I appreciate your appearance and the opportunity to address another question to the Chairman of the Federal Reserve Board.

Mr. Volcker, there has been a great deal of discussion about domestic credit demand, demographic characteristics of our population, impact on credit demand.

But the question I have, and it is one we have heard repeatedly in recent months as we have been examining the Treasury I tax reform proposal, and more recently, the Reagan tax reform proposal, and that is, of course, that these will cause an absolute reduction in interest rates of nearly 2 percent, that is to say, that they change the credit demand because of the less advantageous treatment of interest deductions. I know that you have yourself about six layers between any effect on interest rates and you are only just following the market—that is to say, that this traditional Federal defense has always been one that is a cat and mouse game.

Nevertheless, Mr. Chairman, I am interested in your views of tax reform and changes in tax structure, and maybe other factors, maybe demographics, if you want to comment on that. But I think it is especially apropos, given the discussion of this and what effect that may have on interest rates.

Will it have that type of dramatic effect on interest rates?

Mr. VOLCKER. I have not studied that closely. A 2-percent reduction would be very large. I really do not know what people have in mind in saying that. You still have the big deduction for individuals in that bill, as we now have. If you do not have that, that would have an effect on credit demand, and that provision itself would tend to put interest rates lower than they would otherwise be, but nothing like 2 percent, I do not think.

Mr. VENTO. I look at the Federal Reserve in terms of gaining insight into monetary policy and your staff as being the preeminent source in terms of review of credit and understanding of credit. And you are suggesting that this is not an issue which you have examined closely? It would have a tremendous impact in terms of monetary policies predicated on this 2-percent reduction. Yet, you suggest that you have no response or any evaluation of these particular proposals.

Mr. VOLCKER. I would not say we would be the preeminent judges of tax reform proposals, but the——

Mr. VENTO. I am not saying that. I am talking about credit.

Mr. VOLCKER. I am only pleading personal ignorance on this. There may be some staff work relevant to that. I do not know. I do not know in what degree of detail you wish.

Mr. VENTO. In terms of the review of this, the CBO, the Joint Tax Committee and others have come up with these types of savings, and I think it would be essential, I think appropriate, if we would consider requesting this type of evaluation from the Federal Reserve Board, Mr. Chairman.

I leave it to the Chairman's discretion, but I think that that would be helpful.

I thank the Chairman.

I also want to thank the Chairman of the Federal Reserve Board.

Chairman FAUNTROY. I thank you. I will respond positively to your request. We will enter that request for an evaluation of that.

[Chairman Volcker's response follows:]

Chairman Volcker subsequently submitted the following information for inclusion in the record of the hearing:

Effects of tax reform on interest rates.

Some analysts have indeed suggested, as Congressman Vento noted, that the provisions of the tax reform plan published by the Treasury last fall (Treasury I) would have lowered market interest rates by as much as 2 percentage points relative to levels with the current tax law in place. One such estimate was made by Mr. Makin of the American Enterprise Institute. It should be noted, however, that the President's tax proposal (Treasury II) is different in a number of respects from the earlier Treasury plan.

The earlier plan probably would have had much more substantial effects on observed market interest rates because it would have reduced substantially the deductibility of interest expenses from taxable income. Without such deductibility, borrowers would be less willing to pay rates of interest that would compensate lenders for the taxes owed on their interest income. The exact extent to which taxes are reflected in interest rates, however, is difficult to estimate because interest rates are simultaneously affected by so many other things, including federal and private credit demands, the availability of foreign capital and expectations of inflation.

The President's tax reform proposal provides for some limitations on the deductibility of interest, which would lower interest rates a bit, but these provisions are less extensive than in the earlier Treasury plan. The current proposal, on balance, might encourage some additional saving (some provisions would provide saving incentives while others might work in the opposite direction), thus also tending to lower interest rates. But the President's proposal also might stimulate demand for net new investment, which could tend to place upward pressures on interest rates. Most of the effect on investment, however, would seem to encourage more efficient allocation of investment among industries and types of capital. Thus, it seems possible that the longer-run effect from all provisions would tend toward somewhat lower interest rates than would otherwise prevail, but these effects probably would be small.

Chairman FAUNTROY. I want to thank you again, Mr. Chairman, for the exhaustive effort that has been put forth in your testimony today. I want to associate myself with the remarks of so many Members who have commended you for the tremendous job that you have done as Chairman of the Board, and to acknowledge that too much of the burden of managing our economy has fallen on the Federal Reserve Board. We have not had the kind of discipline and, I think, wisdom in the management of fiscal affairs that you and the Board have exemplified in the area of monetary affairs, and for that, you are to be commended. You have enriched the public service and exalted the public life in that regard.

Mr. VOLCKER. I appreciate that.

Chairman FAUNTROY. We will continue our hearings tomorrow at 9:30 in the morning. We will have a very distinguished panel of economists, including Nancy Teeters, Allan Sinai, Lawrence Chimerine, Michael Sumichrast, and Norman Robertson.

The committee is adjourned.

[Whereupon, at 12:20 p.m., the subcommittee adjourned, to reconvene at 9:30 a.m., on Thursday, July 18, 1985.]

[The "Midyear Monetary Policy Report to Congress," dated July 16, 1985, by the Board of Governors of the Federal Reserve System, pursuant to the Full Employment and Balanced Growth Act of 1978, and additional subcommittee written questions and Mr. Volcker's response follow:]

APPENDIX

For use at 4:30 p.m., E.D.T.
Tuesday
July 16, 1985

Board of Governors of the Federal Reserve System

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

July 16, 1985

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 16, 1985

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

TABLE OF CONTENTS

Section 1. Monetary Policy and the Economic Outlook for 1985 and 1986

The fundamental objective of the Federal Reserve in charting a course for monetary and debt expansion remains unchanged--to foster a financial environment conducive to sustained growth of the economy, consistent with progress over time toward price stability. In working toward those goals, developments with respect to the dollar and our external position have necessarily assumed greater prominence. More generally, while policy initiatives are stated in terms of growth rates of certain monetary and credit aggregates, the Federal Open Market Committee has emphasized the need to interpret those aggregates in the light of other information about the economy, prices, and financial markets. Moreover, the monetary targets for 1985 needed to be evaluated, and in the case of M1 adjusted, in light of the unusual and unexpected behavior of GNP relative to money during the first half of this year.

Economic and Financial Background

Economic activity continued to expand during the first half of 1985, but at a relatively slow pace. Real gross national product probably increased at an annual rate of less than 2 percent, falling short of the expectations of many forecasters and of the rate anticipated for the year by members of the Federal Open Market Committee when they formulated their annual monetary policy plans in February. While the economic environment was conducive to the containment of inflation within the 3-1/2 to 4 percent range of the past few years, there has been no further progress toward full employment of the nation's labor resources or industrial capacity. Indeed,

the unemployment rate has remained at about 7-1/4 percent, well below the peak of the 1981-82 recession, but still an historically high level.

The slowing of output growth, which began in the middle of 1984, has brought into sharper focus the unevenness of this business expansion and the significance of some basic structural imbalances in the economy. The federal budget deficit has remained in the neighborhood of $200 billion, rather than moving in the direction of balance as might normally be expected in the course of an upswing in economic activity. The heavy demands placed on the credit markets by the Treasury's financing activities have, in turn, been one factor helping to hold real interest rates at historically high levels. And those high rates have contributed to the strong demand of international investors for dollar-denominated assets and thus to the strength of the dollar on foreign exchange markets.

Although the dollar was little changed on balance over the first half, with a spike in its value early in the year being subsequently reversed the adverse effects on the U.S. trade position of the appreciation of the preceding several years, together with slow economic growth abroad, were very much in evidence. U.S. firms continued to face severe competitive pressures, and our exports fell while our imports rose. The widening current account deficit was mirrored in the continuing gap between the growth of domestic spending and domestic production. Moreover, the effects of this imbalance were felt with particular severity in the manufacturing, mining, and agricultural sectors of the economy, where profitability was squeezed overall and employment declined.

The lagging growth of production, relatively well contained inflationary pressures on resources, and the high value of the dollar on exchange

markets provided the backdrop for the conduct of monetary policy in the past several months. Reserves available to the banking system expanded substantially over the first half of the year, and the discount rate was cut by one-half percent in the spring. With the economic expansion slowing, interest rates--which had declined sharply from the summer of 1984 to early 1985--dropped somewhat further on balance by mid-year.

The declines in market interest rates in the latter part of last year and this year had substantial effects, lasting for a number of months, on the demands for assets contained in M1. Some savings apparently were shifted into interest-earning checking accounts (NOW accounts) from other instruments, and demand deposits also rose, as the cost of holding these accounts in terms of earnings forgone was reduced. As a result of the shifts of funds, M1 expanded at about a 10-1/2 percent annual rate over the first half of the year (measured from the fourth quarter of 1984 to the second quarter of 1985), well above the 4-to-7 percent range established by the FOMC in February. At the same time, however, the broader monetary aggregates remained within their designated ranges. Over the period, M2 and M3 expanded at 8-3/4 and 8 percent annual rates, respectively, as compared with their growth ranges of 6 to 9 and 6 to 9-1/2 percent. Growth in domestic nonfinancial sector debt over the first two quarters of the year was a little above its 9-to-12 percent monitoring range, as debt issued to finance mergers and otherwise retire stock issues continued stronger than earlier expected.

The rapid growth of M1 in the first half of the year was accompanied by a sharp drop in the velocity of the aggregate: M1 velocity--the ratio of nominal GNP to money--declined at about a 5 percent annual rate.

In some respects, that development is reminiscent of experience in 1982-1983, when a large drop in interest rates also was accompanied by a marked decline in M1 velocity, with the attractiveness of M1-type balances enhanced by the availability of explicit interest on NOW accounts. There is evidence from recent experience, as well as from research on the interest responsiveness of the demand for money, suggesting that such episodes might be expected as the economy and financial markets adjust over time to further progress toward price stability and as the inflation premium in interest rates consequently diminishes. As this occurs, likely in unpredictable spurts, the public's demand for M1 will tend to rise and the level of M1 velocity could drop more or less "permanently." However, there will be uncertainty about such a conclusion until it becomes apparent in the period ahead whether velocity is returning toward trend or whether it is tending to rise rapidly because the public is reducing its "excess" money balances by spending or investing them; in the latter case, the drop in velocity in the past two quarters could be reversed to some extent.

The recent developments affecting M1 illustrate the still considerable uncertainties about the shorter-run behavior and trend of its velocity. Over the last three and a half years, the income velocity of M1 actually has declined slightly on balance. In contrast, over the preceding three decades, velocity had increased by more than 3 percent per year, on average. Velocity changes are influenced by the behavior of interest rates, but the extent of interest rate impact is variable and may be changing as the public and depository institutions adjust to the new deposit instruments and deregulation of deposit ceiling rates of recent years. Moreover, the underlying trend of

velocity will also be influenced by the rate of financial innovation. While that may slow down once the adjustment is made to a deregulated environment and with lower interest rates, increased computerization could also work toward a rise in velocity over time as the efficiency of the payments system increases.

Ranges for Money and Debt Growth in 1985 and 1986

In reexamining its M1 range for 1985, and in setting a tentative range for 1986, the Committee expected that velocity, after its sharp decline in the first half of this year, would cease falling rapidly--while recognizing that much of the recent decline may not be reversed. Allowance also needed to be made for the high degree of uncertainty surrounding the behavior of M1 velocity, given the experience of the past few years. To take account of these considerations, the base for the range of M1 was shifted forward to the second quarter of 1985, and the range was set to encompass growth at a 3 to 8 percent annual rate over the second half of this year. This range contemplates a substantial slowing in growth from the pace of the first half, and the lower part of the range implies a willingness to see relatively slow growth should the recent velocity decline be reversed and economic growth be satisfactory.

The appropriateness of the new range will be under continuing review in light of evidence with respect to economic and financial developments, including conditions in foreign exchange markets. It was noted that, because of the burst of money growth in June, the current level of M1 is high relative to the new range. The Committee expected that the aggregate

would move into the new range gradually over time as more usual behavior of velocity emerged.

For 1986, the M1 range was tentatively set at 4 to 7 percent. The Committee recognized that uncertainties about interest rates and other factors that could affect velocity would require careful reappraisal of the range at the beginning of that year. In addition, it was noted that actual experience with institutional and depositor behavior after the completion early next year of deposit rate deregulation would need to be taken into account in judging the appropriateness of the ranges. At the beginning of next year, regulatory minimum balance requirements on Super NOW accounts and money market deposit accounts will be removed, and at the end of March 1986, deposit ceiling rates will be lifted entirely, affecting savings deposits and regular NOW accounts.

The table below summarizes decisions with respect to the ranges of growth for the aggregates for 1985 and 1986. Except for M1 in 1985, the growth ranges apply to one-year periods measured on a fourth quarter to fourth quarter basis. The M1 range for 1985 applies to the second half of the year, as noted above.

Ranges of Growth for Monetary and Debt Aggregates
(Percent change)

	1985	Tentative for 1986
M1	3 to 8*	4 to 7
M2	6 to 9	6 to 9
M3	6 to 9-1/2	6 to 9
Debt	9 to 12	8 to 11

* Applies to period from second quarter to fourth quarter.

With respect to the broader monetary and credit aggregates, the Committee reaffirmed the 1985 ranges for M2, M3, and domestic debt that had been established in February. It is recognized, as at the start of the year, that actual growth over the four quarters of 1985 might be toward the upper parts of the ranges, and it was felt that this would be acceptable, depending on developments in the velocities of the various measures, as long as inflationary pressures remained subdued.

The tentative ranges for 1986 for M3 and total debt embody reductions from 1985--in the case of debt by a full percentage point and in the case of M3 by one-half percentage point on the upper limit. The range for M2 was left unchanged. In the case of the monitoring range for debt, it was assumed that, while debt might well continue its tendency of recent years to grow considerably faster than GNP, its expansion would be tempered by a drop-off in the net redemption of equity shares that has boosted corporate credit use dramatically in the past year or two.

Economic Projections

All the monetary ranges specified were felt to be consistent with somewhat more rapid economic growth than characterized the first half of the year, as long as inflationary pressured remain contained. At the same time, Committee members felt that the present circumstances in the economy contain particular risks and uncertainties that can imperil progress over the next year and a half toward either growth or price stability. Clearly, the serious imbalances referred to earlier in this section cannot be remedied through the actions of the central bank alone. Attainment of fully satisfactory economic performance and minimization of risks will require timely action in other areas of policy, here and abroad.

The economic projections of the members of the FOMC, as well as of the Reserve Bank Presidents who are not at present members of the Committee, are summarized in the table on the next page. The central tendency of the forecasts for real GNP points to some pickup in the pace of expansion in the second half of this year. The expected strengthening, given the slow growth in the first half, still would leave the GNP expansion for the year as a whole short of the range reported by the Federal Reserve in February, and below the forecasts published by the Administration to date.

The FOMC members and the other Reserve Bank Presidents expect growth in the 2-1/2 to 3-1/4 percent range during 1986. Such a rise in output is seen as entailing substantial gains in employment, enough to bring about a small decrease in the civilian unemployment rate, to around 7 percent by the end of next year. With pressures in labor and product markets limited, most FOMC members and other Presidents foresee only a marginal increase, if any, in the rate of inflation, in 1986. It should be noted, however, that these projections are based on an assumption that exchange value of the dollar will not deviate substantially from its recent levels.

The projections for a pickup in GNP growth over the reduced rate of the first half of this year are based in part on the expectation that the declines in interest rates (and concomitant rise in stock prices) that have occurred over the past few quarters will be providing impetus to demand for goods and services in the months ahead. Consumer attitudes toward spending appear favorable, and housing activity already has shown improvement, although the FOMC members are somewhat concerned by the rising debt burdens of households and the increasing payment problems suggested by figures on consumer

Economic Projections for 1985 and 1986*

	FOMC Members and other FRB Presidents	
	Range	Central Tendency
1985		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	6-1/4 to 7-3/4	6-1/2 to 7
Real GNP	2-1/4 to 3-1/4	2-3/4 to 3
Implicit deflator for GNP	3-1/2 to 4-1/4	3-3/4 to 4
Average level in the fourth quarter, percent:		
Unemployment rate	6-3/4 to 7-1/4	7 to 7-1/4
1986		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	5-1/2 to 8-1/2	7 to 7-1/2
Real GNP	2 to 4	2-1/2 to 3-1/4
Implicit deflator for GNP	3 to 5-1/2	3-3/4 to 4-3/4
Average level in the fourth quarter, percent:		
Unemployment rate	6-3/4 to 7-1/2	6-3/4 to 7-1/4

*The Administration has yet to publish its mid-session budget review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

and mortgage loan delinquencies. In the business sector, inventory overhangs appear to be limited in scope and degree, and fixed investment seems to have picked up a little after exhibiting some weakness earlier this year; the lower cost of capital and desires to cut costs and maintain competitiveness are expected to keep investment on a moderate uptrend, even though pressures on capacity may not be great. Spending by the federal government and by states and localities is expected to grow rather slowly.

A key ingredient in many of the projections is the expectation that there will be a tendency in the coming year for our external position to stabilize, so that domestic production will more fully reflect the expansion of domestic demand. Developments in this area will, of course, depend in part on the course of economic expansion abroad. Were the U.S. external position to continue deteriorating as it has been, the sectoral imbalances in the economy would be exacerbated, creating further difficulties for many companies, their employees, and their communities. The draining off of income would jeopardize the sustainability of economic expansion, and the risks of economic and financial dislocations would intensify.

The FOMC members and other Presidents also assumed in their policy deliberations and in the projections that the Congress and the Administration would achieve deficit reductions in the range of those in the recent House and Senate budget resolutions. Failure to move forward with those proposals would run a serious risk of reversing the favorable effects that congressional actions to date have had on investor expectations, and would create a real impediment to the solution of the structural problems plaguing our economy today.

Section 2: The Performance of the Economy in the First Half of 1985

After a year and a half of extraordinarily rapid growth, economic activity decelerated abruptly in the middle of 1984, and slowed somewhat further in the first half of 1985. Growth in real gross national product is estimated to have averaged less than 2 percent at an annual rate so far this year; the unemployment rate has remained flat at about 7-1/4 percent. Inflation has held at the lower pace reached during the 1981-82 recession.

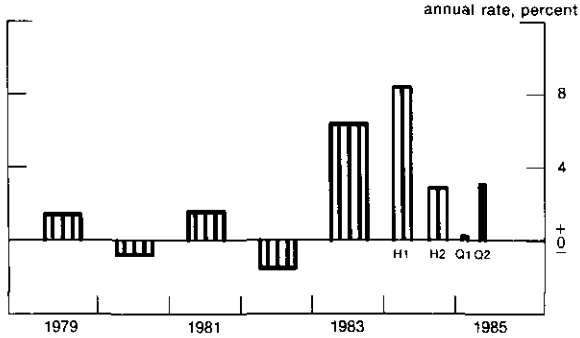
To some extent, the moderation in growth during the past year has reflected the slowing in household and business spending that often occurs after the initial phase of cyclical recovery. Pent-up demand for housing and consumer durables generally fades as an expansion period lengthens, and growth in business fixed investment often exhibits some cyclical deceleration over time. However, the recent slowing in growth also reflects factors unique to this expansion.

In particular, this expansion has taken place in the context of a highly stimulative federal fiscal policy. Real GNP grew more rapidly in 1983 and the first half of 1984 than in any previous recovery since the Korean War. Ultimately, some slowing in growth would have been required to avoid inflationary overheating of the economy. However, even before that point was reached, the initial effect of the fiscal stimulus began to wane, dissipated in part through its contribution to a worsening U.S. competitive position in international trade and diversion of demand away from goods produced in the United States.

The pronounced increases in the merchandise trade and current account deficits have occurred as enormous federal deficits and resultant

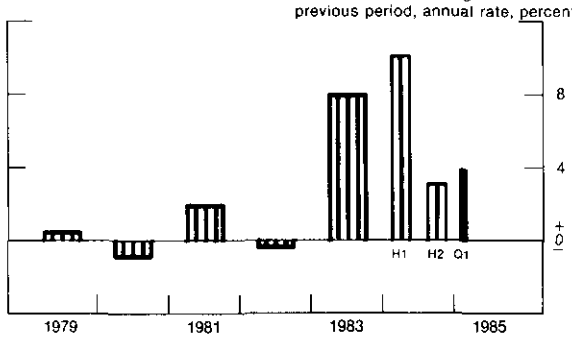
Real GNP

Change from end of previous period, annual rate, percent



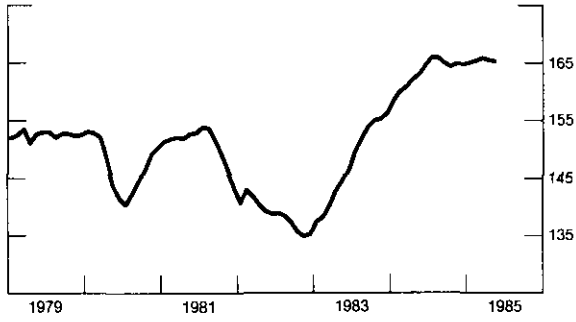
Real Gross Domestic Purchases

Change from end of previous period, annual rate, percent



Index of Industrial Production

Index, 1967 = 100



heavy borrowing by the federal government have added to other factors helping to keep U.S. interest rates at high levels, relative both to historical experience and to the rate of inflation. These credit demands have been met partly through a substantial inflow of foreign capital, which has been associated with a large appreciation in the foreign exchange value of the U.S. dollar. The strong dollar has encouraged U.S. consumers and businesses to increase greatly the portion of their expenditures devoted to imports, and at the same time has inhibited U.S. exports. Exports also have been restrained by slow growth in demand abroad. As a result, gains in domestic demand have outstripped those in domestic production by a wide margin throughout the expansion period.

The effects of the weakening trade balance in the past few years have been felt keenly in the manufacturing sector. Industrial production, which began to level off in the summer of 1984, remained stagnant in the first half of 1985, and employment in the manufacturing sector declined. The strong dollar also has exacerbated the economic problems of farmers, many of whom face difficult adjustments because of falling product prices and the need to service a large volume of debt accumulated during the inflationary period of the 1970s and early 1980s.

Thus far, however, the weakness in the manufacturing and agricultural areas has been more than offset by strong gains in other sectors. Domestic final demand rose at a 3-1/2 percent annual rate in the first quarter of 1985, about the same as in the second half of last year; second-quarter gains appear also to have been substantial. Spending in such interest-sensitive areas as autos and housing was particularly strong

in the first half of 1985, reflecting in part lower credit costs that have emerged since mid-1984.

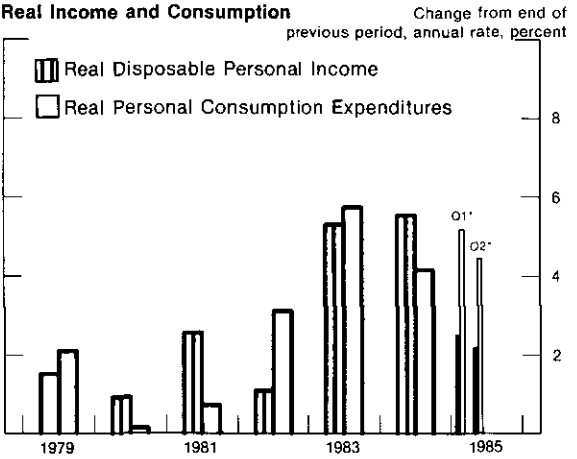
The strength of the dollar also has had a restraining influence on inflation, by reducing import prices and by forcing U.S. producers to adopt more competitive pricing strategies. Inflationary pressures have been limited, too, by the lack of pressure on resources here and the slack abroad. Most measures of overall price increase remained in the 4 percent range in the first half of 1985, but prices of manufactured goods rose little and significant downward pressures on prices were evident in markets for oil and basic commodities.

The Household Sector

Growth in real disposable income continued to slow in the first half of 1985, reflecting smaller increases in interest income as well as weakness in manufacturing payrolls and farm income. Nonetheless, gains in household spending, especially in the interest-sensitive sectors, were sizable, supported by continued heavy borrowing. As a result, the personal saving rate fell appreciably below last year's 6 percent level.

Consumer spending for new cars was particularly strong in the first half. Total auto sales averaged nearly 11 million units at an annual rate, with sales of domestic models around their highest level for a six-month period since 1979. The strength in auto sales was partly attributable to the improved availability of many popular domestic models since the strike-related disruptions in production last fall. In addition, auto demand was bolstered by generally lower interest rates compared with last year and by some special financing programs offered by manufacturers. Sales of foreign cars were

Real Income and Consumption



Total Private Housing Starts

* Consumption and income growth for 1985:Q2 are based on April and May data. Income in both 1985:Q1 and 1985:Q2 has been adjusted for tax refund delays.

held down in the first quarter because supplies of Japanese models were limited at the end of the annual period for the voluntary export restraint program. However, foreign car sales picked up in the spring and early summer when Japanese cars shipped after the start of the new annual period began to arrive at U.S. dealerships.

Meanwhile, activity in the housing market has rebounded since last fall. Housing starts rose to a 1.8 million unit annual rate on average in the first five months of 1985, retracing nearly all of the decline that occurred in the latter half of last year after rates on fixed-rate mortgages temporarily rose to the 14 percent range. Housing activity generally has been quite robust in this expansion period, despite high real interest rates. Demand for owner-occupied units has been buoyed by the movement of the "baby-boom" generation into its prime home-buying years, as well as by the beneficial effects of stable house prices and innovative financing techniques such as adjustable-rate mortgages on the affordability of homes.

The strong gains in household spending over the past two and a half years have been accompanied by considerable alterations in balance sheets. The ratio of household debt to income has increased rapidly, and is now well above its 1980 peak. However, asset growth has been strong as well, and the ratio of financial assets to income has risen sharply in the past year, owing in part to the rapid rise in stock prices.

The incidence of payment difficulties on consumer installment debt has risen somewhat in the past half year or so, from relatively low levels. Delinquency and foreclosure rates on home mortgages have been at high levels for some time, and they rose further in early 1985. The large number of

defaulted mortgage loans partly reflects the still high rates of unemployment and the weakness of home prices in many locales, which has left some homeowners with little equity to protect when they encounter financial difficulties. However, aggressive underwriting of some mortgages, including loans carrying lower payments in the first years, appears to be a contributing factor.

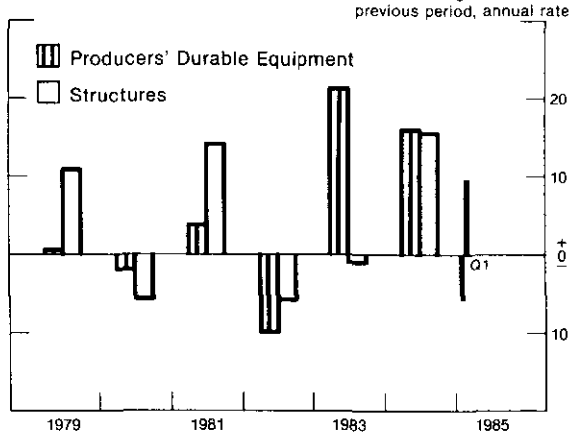
The Business Sector

Conditions in the business sector were mixed in the first half of 1985. Many industrial firms experienced pressures on profit margins in an environment of intense price competition and declining capacity utilization, and widespread financial strains continued to be present in the agricultural and energy sectors. At the same time, however, some other sectors of the economy recorded good gains in sales and income. Economic profits for corporations in the aggregate remained at the higher level reached after the sharp runup earlier in the expansion, with after-tax profits as a percent of GNP at the highest levels seen for any sustained period since the late 1960s.

Growth in business spending for fixed capital began to slow in the latter half of 1984, after a period of extraordinary expansion, and a further slowing occurred in the first part of 1985. The weakening has been most pronounced in equipment outlays, affecting both the high-technology categories and more traditional types of industrial equipment. Nevertheless, surveys of capital spending intentions taken in the first half of the year indicated that businesses still planned a healthy expansion in outlays for 1985 as a whole. A relatively large proportion of these expenditures reportedly was earmarked for replacement and modernization rather than

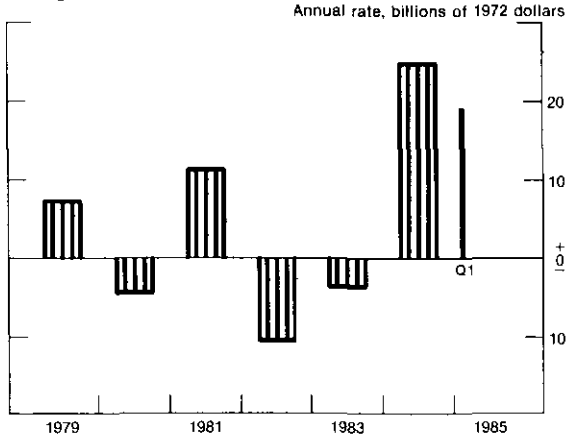
Real Business Fixed Investment

Percent change from end of previous period, annual rate



Changes in Real Business Inventories

Annual rate, billions of 1972 dollars



expansion of capacity, reflecting a desire to cut costs and improve competitiveness. Meanwhile, spending for nonresidential construction, particularly offices and stores, continued at strong rates in the first half of 1985, and construction contracts rose further despite very high vacancy rates in many parts of the country.

The pace of inventory accumulation in the business sector has been moderate in recent months. In real terms, business inventories rose about $19 billion at an annual rate in the first quarter of 1985, compared with an average gain of $25 billion in 1984; inventory accumulation probably was still lower in the second quarter. Manufacturers, especially those facing intense import competition, have continued to be cautious in adding to inventories. Total stocks in this sector declined in both April and May, and inventory-sales ratios for the most part remain near historical lows. In the trade sector--with the notable exception of the car industry--inventory-sales ratios have remained a bit high, though, and selected efforts to pare stocks have continued.

With slower growth in investment in the first half of 1985, the gap between capital expenditures and internal funds of firms remained moderate. Nevertheless, businesses continued to borrow heavily, reflecting a continued massive amount of equity retirements by firms engaged in mergers and other corporate restructurings. As a result, debt-equity ratios have risen for a number of firms, especially in the petroleum industry, where a major restructuring is currently taking place. However, for most other firms, equity additions through retained earnings or sales of new shares have been considerable. With rising stock prices, debt-equity ratios for

these firms, when their assets and liabilities are measured at current market values, have shown some decline in recent months.

Nonetheless, financial strains, in many cases related to the high foreign exchange value of the dollar, persist in some areas of the economy. In particular, low capacity utilization rates in a number of import-sensitive manufacturing industries, including machine tools, steel, some types of chemicals, and textiles have intensified pressures on profitability. In addition, large segments of the farm sector continue to suffer greatly from reduced exports, depressed land prices, and low incomes; many farmers face serious debt-servicing problems, causing problems in turn for agricultural lenders. In the energy sector, continued downward pressure on world oil prices has caused petroleum drilling to be curtailed, which has strained the earnings of many oilfield equipment and servicing firms.

The Government Sector

Federal tax receipts continued to rise substantially in the first half of 1985, but so too did outlays, and the fiscal year 1985 deficit likely will be around $200 billion. This represents about 5 percent of total GNP, and more than half of net private domestic saving. Federal purchases of goods and services, the part of federal spending that enters directly into GNP and constitutes about a third of total outlays, rose comparatively moderately in the first half of 1985; defense procurement, an area of rapid growth in spending over the past few years, grew at a reduced pace as outlays lagged more than is typical relative to appropriations. Real nondefense purchases (excluding the Commodity Credit Corporation) continued to be relatively flat.

Purchases by state and local governments were essentially unchanged in the first quarter, but evidently rose in the second, as construction outlays increased significantly in the spring. States and localities, many of which had serious fiscal difficulties in the last recession, generally have been cautious in raising spending throughout this expansion period, though they have been endeavoring to address the problem of an aging infrastructure. The combination of spending restraint and improved revenues owing both to legislated tax increases and to rising incomes, has resulted in a substantial rise in the operating and capital account surpluses of state and local governments since 1982.

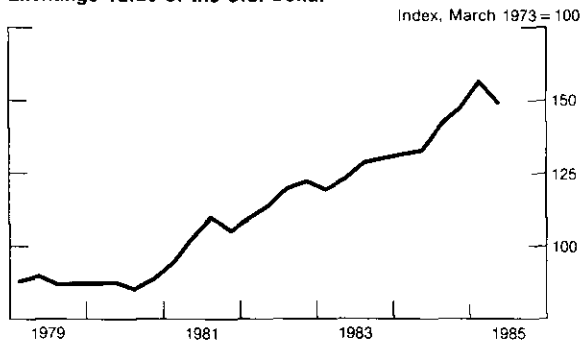
The External Sector

The external sector has come to play an increasingly important role in the U.S. economy. Merchandise imports have risen rapidly in this expansion, moving above 15 percent of real domestic expenditures on goods in the first half of 1985. The increase in import penetration has been widespread, occurring in both the consumer and capital goods sectors, as well as in industrial supplies.

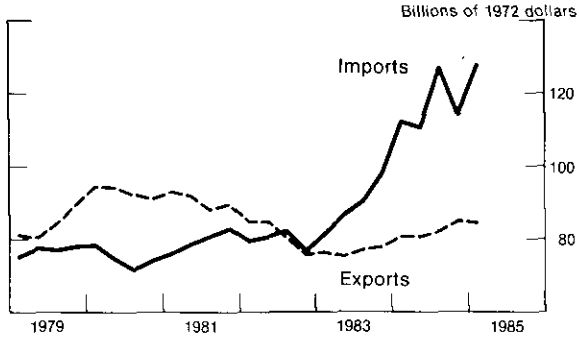
Although U.S. exports increased in 1983 and 1984, they grew much less than imports, and have not yet regained their previous peak. In the first half of 1985, exports, particularly of agricultural products, have declined somewhat. As a result of these trends, the current account deficit has widened dramatically over the past few years, reaching an annual rate of $120 billion in the first quarter of 1985.

Part of this imbalance reflects the stronger growth of demand in the U.S. economy since 1982 relative both to the other industrial countries

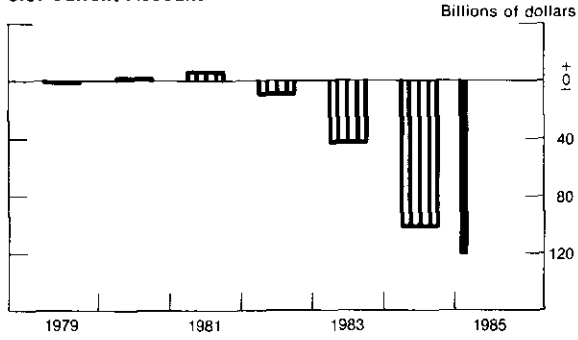
Exchange Value of the U.S. Dollar



U.S. Real Merchandise Trade



U.S. Current Account



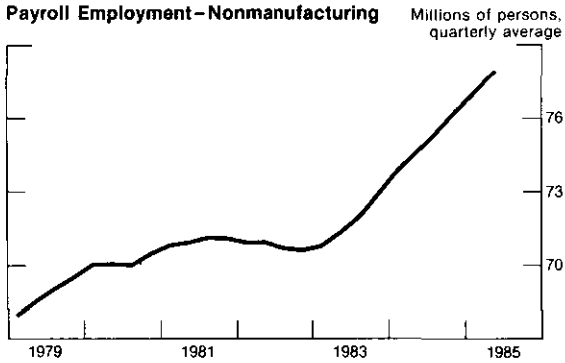
and to the debt-burdened developing countries. Although this influence has lessened with the slowing of the U.S. economic expansion since the middle of last year, there has been no acceleration in growth in the other industrial countries, and many developing countries have continued to face financial constraints. The greater share of the imbalance, however, probably is attributable to the substantial appreciation of the dollar over the past few years. On average during the first half of this year, the trade-weighted value of the dollar was roughly 70 percent above its level five years earlier.

The appreciation of the dollar and the underlying demand of investors for dollar-denominated assets and other claims on the United States has been partly associated with differentials between real rates of return on U.S. and foreign assets. The enormous federal budget deficits have been an important factor contributing to these differentials. The moderation in interest rates that has accompanied the slowing of the economic expansion in the United States since mid-1984 appears to have eased some of the upward pressure on the dollar; after rising sharply through the first two months of this year, the exchange value of the dollar has trended downward and is now around the level of late last summer. Nevertheless, the high level of the dollar continues to limit the ability of U.S. producers to compete both at home and abroad.

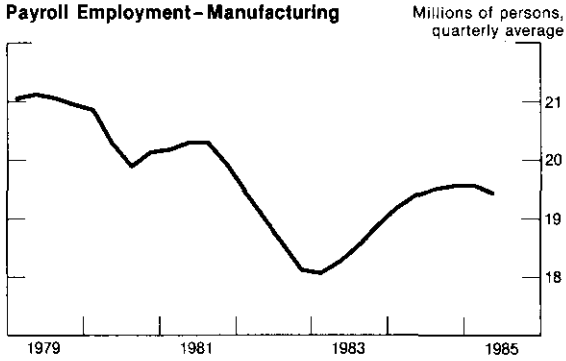
Labor Markets

Growth in labor demand generally remained strong in the first half of 1985, and the number of workers on nonfarm payrolls increased 1.4 million. The bulk of the job growth was in the service and trade sectors, in which

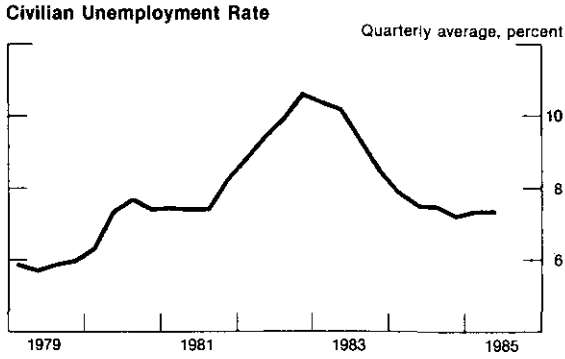
Payroll Employment–Nonmanufacturing



Payroll Employment–Manufacturing



Civilian Unemployment Rate



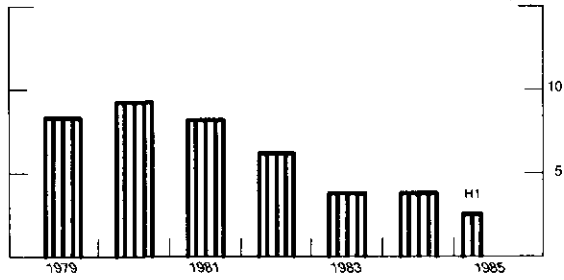
employment in the past six months has expanded at rates similar to last year's rapid pace. Increases in the restaurant and business services areas have been especially large. Construction employment also showed a sizable gain in the first half of 1985, along with significant growth in both residential and nonresidential construction. In contrast, manufacturing employment dropped about 220,000, with cutbacks in payrolls widespread among industries.

Despite the substantial gains in overall payroll employment, the unemployment rate has remained at about 7-1/4 percent, the level that has prevailed since last June. The labor force participation rate was up appreciably on average during the first half; the rise occurred primarily among adult women, who evidently were responding to the increase in job opportunities in the service and trade sectors, where 80 percent of adult women are now employed.

Wage inflation has remained restrained. Year-over-year changes in the employment cost index for wages and salaries, a relatively comprehensive measure for the private nonfarm business economy, have held steady at just over 4 percent for nearly a year. This is about one percentage point less than in 1983 and early 1984, and substantially below the peak rate of about 9 percent reached in 1980. The slowing in union wage increases over the past several years has been especially large. Union wage gains both in and out of manufacturing have been below the increases posted in nonunionized sectors for the past year and a half, causing a partial erosion of the differential that had built up over the years prior to the last recession. Major collective bargaining agreements negotiated in early 1985 indicate continued moderate wage growth in the unionized sectors.

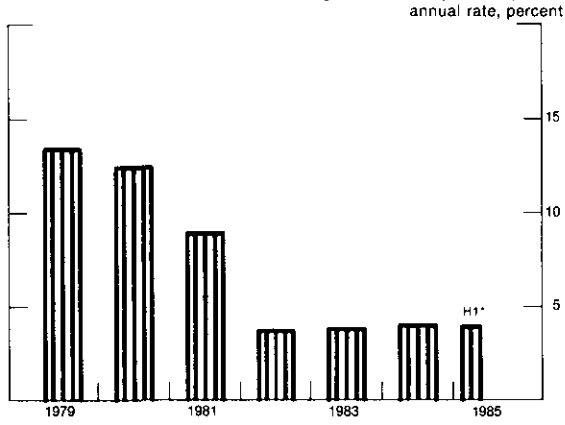
Hourly Earnings Index

Change from end of previous period, annual rate, percent



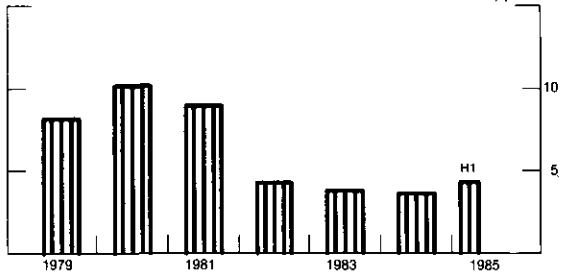
Consumer Price Index

Change from end of previous period, annual rate, percent



GNP Prices

Change from end of previous period, annual rate, percent



*Consumer price change for 1985:H1 is based on December to May period.

Productivity in the nonfarm business sector appears to have declined in the first half of 1985, following increases amounting to 4 percent in 1983 and 2-1/2 percent in 1984. Both the recent slowing in productivity and the substantial gains earlier in the recovery largely reflect the fact that employment tends to respond more slowly than output to changes in demand. However, improvements in productivity appear to continue to be a major priority of both workers and management, as evidenced by widespread reports of modernization of facilities as well as relaxation of work rules and other steps to enhance efficiency and hold down costs.

The combination of improved productivity growth and relatively restrained wage gains in this expansion has resulted in a sizable deceleration in the average rate of increase in unit labor costs relative to the previous several years. Although unit labor costs have risen this year in response to the downturn in productivity, they are still only about 3 percent above their year-ago level.

Price Developments

After slowing sharply in the recession, the broadest measures of inflation have held fairly steady at about 4 percent during much of the expansion. While the stability of the inflation rate during this expansion partly reflects some special factors, significant progress appears to have been made in reversing the underlying momentum of the inflationary process that sustained the wage-price spiral of previous years. Inflation expectations have been more subdued, and both labor and management have exhibited a better appreciation of the fact that gains in real incomes cannot be achieved simply by marking up nominal wages or prices.

The strong dollar has reinforced other factors holding down inflation in this expansion period, both directly by reducing the prices of imported goods and indirectly by forcing U.S. manufacturers to restrain price increases in order to remain competitive. Retail prices of goods excluding food and energy rose about 3-1/2 percent, at an annual rate, in the first half of 1985, about the same as the average rate of change in the two preceding years. Increases in prices of nonenergy services, which have not been affected nearly as much by import competition, have continued to be substantial, averaging a 5-1/2 percent rate in the last six months, the same as in 1984.

Energy prices have been quite volatile over the past year, mainly reflecting movements in gasoline prices. From the autumn of 1984 through February of this year, gasoline prices fell by about 3-1/2 percent, as refiners sought to reduce excess inventories. Production was adjusted downward as well, resulting in a spurt in prices in the spring. However, gasoline prices appear to have stabilized more recently, as inventory levels have returned to normal while crude oil supplies remain abundant. Food prices have risen only a little this year, reflecting the moderate rate of increase in processing costs as well as plentiful agricultural supplies.

Prices of basic industrial commodities, which rose markedly in the initial stages of this upswing in business activity, have been trending downward for the past year and a half. The demand for materials by U.S. manufacturers has been weak, and world supplies have been ample, owing in part to the expansion of capacity in many developing countries in the past decade and their need to maintain export revenues.

Section 3: Money, Credit, and Financial Markets in the First Half of 1985

In February of this year, the FOMC established target growth ranges for the year (measured from the fourth quarter of 1984 to the fourth quarter of 1985) of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9-1/2 percent for M3. For domestic nonfinancial sector debt, an associated monitoring range was set at 9 to 12 percent. The M1 range for 1985 represented a one percentage point reduction at the upper end from the range of the preceding year, while the range for M2 was unchanged. To reflect changes in the pattern of financial flows, the 1985 range for M3 was raised by a half point at the upper end, and the whole range for the debt aggregate was raised by a percentage point. It was expected that these ranges would be adequate to encourage further real economic growth at a sustainable pace consistent with containment of inflationary pressures and a movement over time toward reasonable price stability.

In implementing policy throughout the period, the FOMC emphasized the need to evaluate growth in the monetary aggregates in the context of information available on economic activity, prices, and financial market conditions. Among other factors, the strength of the dollar and the related sluggishness of manufacturing activity required attention. As an operational matter, the degree of pressure on reserve positions of depository institutions was relatively unchanged during the period, and the discount rate was reduced once.

Money, Credit, and Monetary Policy

The unusually sharp drop in velocity in 1982 and early 1983, when growth of M1 greatly exceeded that of nominal GNP, had led the FOMC to place

GROWTH OF MONEY AND CREDIT
Percentage changes

Period	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter to second quarter 1985	10.5	8.8	7.9	12.8e
Fourth quarter to June 1985	11.6	9.3	8.2	12.7e
Fourth quarter to fourth quarter				
1979	7.5	8.1	10.3	12.1
1980	7.5	9.0	9.6	9.6
1981	5.1(2.5)[1]	9.2	12.4	10.0
1982	8.8	9.1	10.0	9.1
1983	10.4	12.2	10.0	10.8
1984	5.2	7.7	10.4	13.6
Quarterly growth rates				
1984-Q1	6.2	7.2	9.2	13.0
Q2	6.5	7.1	10.5	13.0
Q3	4.5	6.8	9.5	12.6
Q4	3.2	9.1	11.0	13.4
1985-Q1	10.6	12.0	10.7	13.4
Q2	10.1	5.3	5.0	11.8e

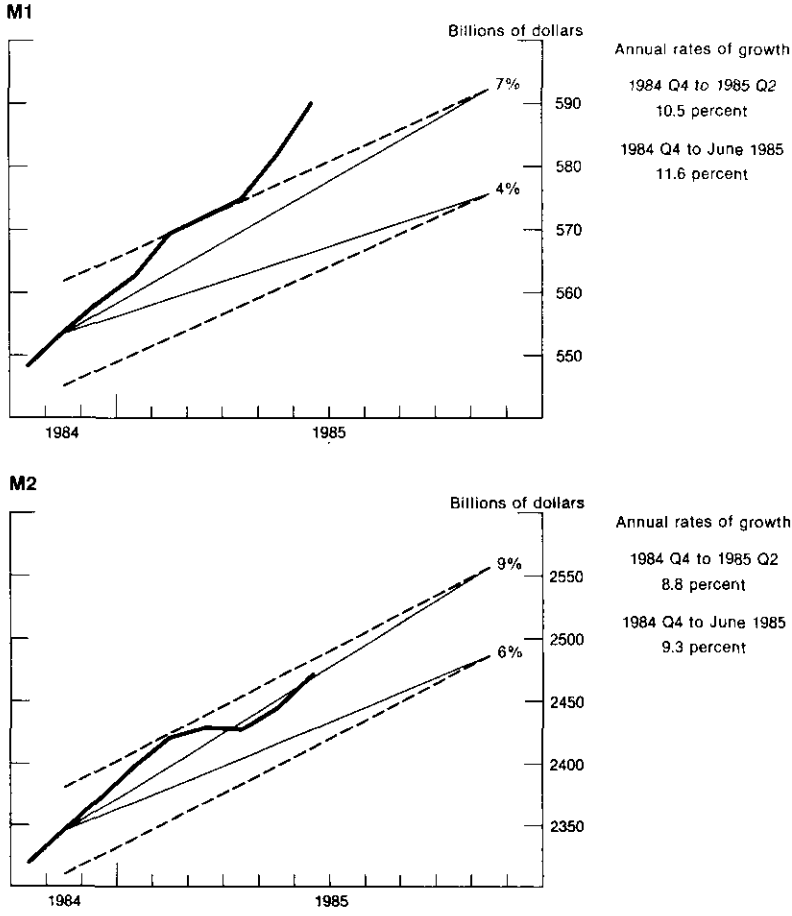
e--estimated.
1. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

less reliance on M1 as an operational guide to policy. During the latter part of 1983 and in 1984, however, the patterns of M1 growth relative to other economic variables proved more consistent with historical experience, and M1 was given more weight in the conduct of policy. Nonetheless, considerable uncertainty remained, in part because of limited experience with the impact of deposit deregulation and financial market innovations on the behavior of M1 under varying economic and financial circumstances. Similar concerns about possible changes in the account offerings and pricing behavior of depositories and the asset demands of households affect all the monetary aggregates to some extent. These factors accounted in part for the need to interpret movement in the aggregates in the light of other information, including evidence on shifts in velocity.

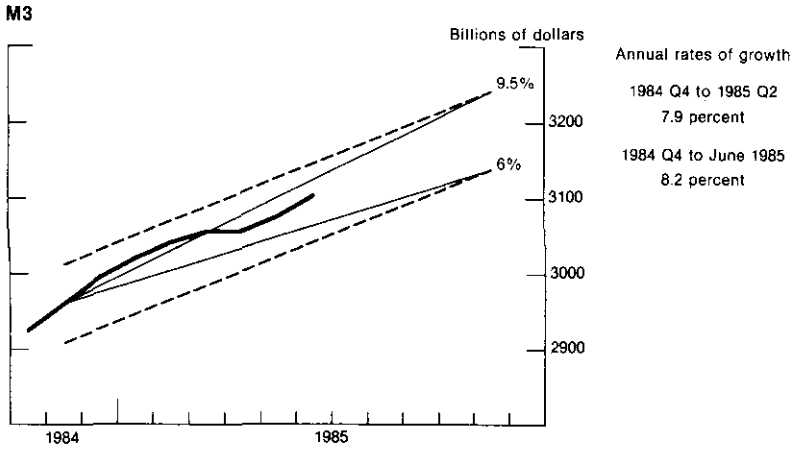
In the event, monetary policy during the first half of the year had to be adapted to a further slowing in economic growth, as manufacturing activity was essentially flat and the agricultural sector remained under pressure, to a continued high value of the dollar on exchange markets, and to a tendency for the velocity of money, particularly of M1, to fall. Price and wage pressures remained relatively well contained; indications of some acceleration in the early part of the year were followed by more moderate increases in subsequent months.

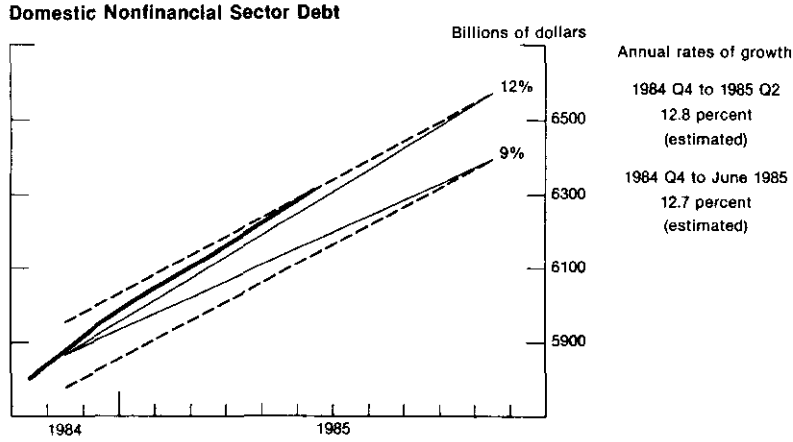
In that context, monetary policy basically accommodated the strong demands for reserves by depository institutions that emerged during the first half of the year. The total of adjustment plus seasonal borrowing varied within a generally narrow range over the period, though increasing for a time in the spring as a result of special situations affecting non-federally

Ranges Adopted in February and Actual Money Growth



Ranges Adopted in February and Actual Money and Debt Growth



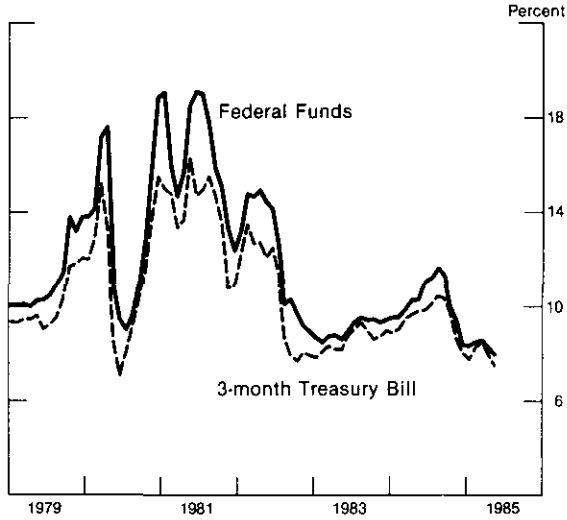


insured thrifts in Ohio and Maryland. Reserve positions had been eased considerably in the latter part of 1984 and the early weeks of 1985. With an easing of reserve pressures and a slowing in economic growth, interest rates had declined sharply from their late summer peaks through the very early weeks of this year.

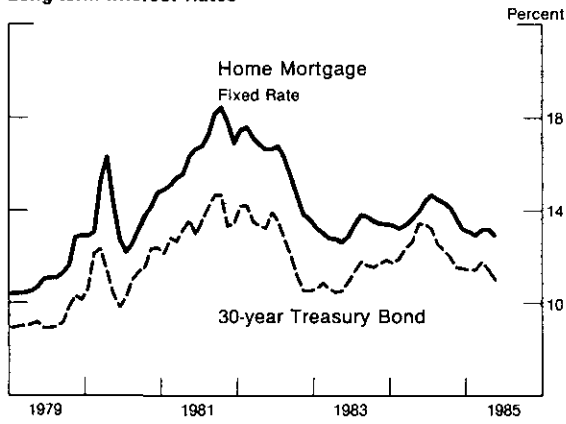
The decline of interest rates appeared to stimulate, with usual lags of some months, a sizable increase in demands for assets contained in M1, *principally interest-bearing checking accounts (NOW accounts).* Shifts of long-term savings and liquid funds out of market instruments and time deposits into these accounts in the early months of the year entailed a substantial rise in total reserves to support them. As the public's asset preferences shifted toward components of M1, its income velocity declined sharply, because holdings of these assets increased relative to the GNP. Only minimal effects on M1 growth likely resulted from shifts of funds into "Super NOW" accounts after the minimum balance requirement was reduced from $2,500 to $1,000 at the beginning of the year, because the bulk of the funds shifted appeared to come out of regular NOW accounts.

Most market interest rates rose by about a full percentage point from their January lows in the course of the winter, though the level of rates remained well below the 1984 peaks. Demands for credit remained strong. Economic growth had picked up in the fourth quarter and early data for the first quarter, though mixed, seemed generally consistent with moderate growth. While as noted reserve growth was sizable during the quarter to accommodate shifts in the public's asset preference, reserves were provided somewhat more cautiously through open market operations during the period of most rapid acceleration of M1 growth in the first quarter.

Short-term Interest Rates



Long-term Interest Rates

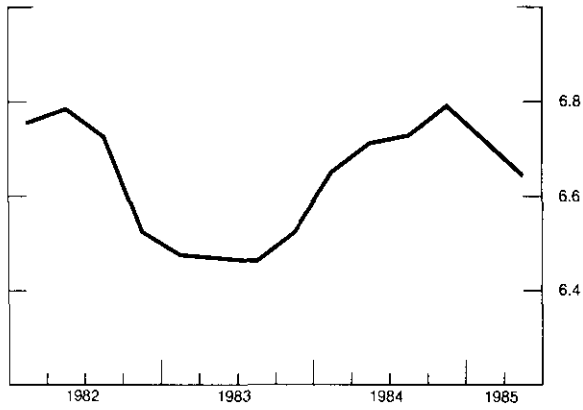


By early spring incoming economic data made it clear that the rate of economic expansion remained limited. Inflation rates continued generally low, prospects for further oil price declines helped damp inflation expectations, and the market responded positively to signs of possible Congressional action to reduce the budget deficit. Growth of M1 moderated substantially, and the aggregate began to decelerate toward its longer-run range in late winter and early spring. Interest rates reversed their earlier rise, as market expectations changed. Rate declines were also influenced by a cut in the Federal Reserve's discount rate in May by 1/2 percentage point to 7-1/2 percent, which took place in the context of continued signs of economic weakness, and against the background of restrained inflationary pressures, and a strong dollar on exchange markets. By midyear short-term rates were down to 3/4 to 1-1/4 percentage point from levels around year-end, while long-term rates had declined by about 1 to 1-1/4 percentage points.

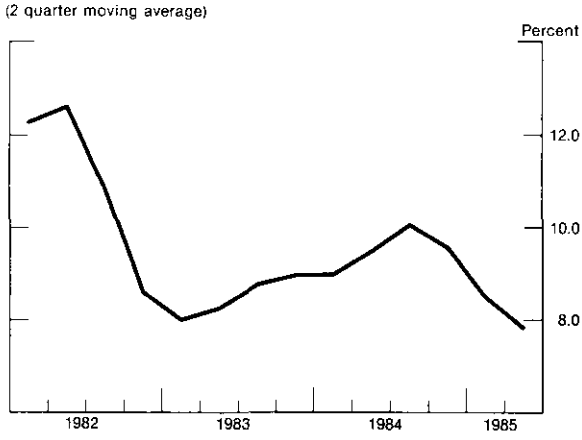
Growth in M1 spurted once again in the late spring. To some extent, interest rate decreases contributed to a strengthening of demand for M1-type assets during the latter part of the second quarter. Growth of NOW accounts, which had moderated in late winter, picked up, as offering rates on Super NOW accounts adjusted sluggishly to the renewed decline in market rates of interest. However, the strength of M1 also reflected an unusual surge in demand deposit expansion in May that extended into June at an even more rapid pace. The rise seems greater than is explainable by usual reactions to the reduced opportunity cost of holding such funds, or to adjustments in compensating balances, and may be partly related to sharp swings in U.S. Treasury balances. A question has been raised as to whether corporate cash

Velocity of M1 and Treasury Bill Rate

M1 Velocity



3-month Treasury Bill Rate
(2 quarter moving average)



management practices have become less aggressive in recent months, but there is no clear evidence on the point.

With the sharp late-spring expansion of M1, its velocity in the second quarter again declined, at about the same rate as in the first. The decline in the velocity of M1 over the first half of this year--and the lesser declines in the velocity of M2 and M3--are reminiscent of experience in 1982-83. Indeed, in both the first half of this year and over the one-year period from mid-1982 to mid-1983 the income-velocity of M1 declined at annual rates of about 4-1/2 to 5 percent. The drop in M1 velocity in both periods appears to have reflected, to a considerable degree and with usual lags, declines in market interest rates, although the magnitude of the declines was in both cases somewhat more than could be expected based on past relationships of money, income, and interest rates.

Episodes of velocity decline may be inherent in the disinflationary process. As interest rates adjust downward in reflection of lowering inflation rates, households and firms become increasingly less reluctant to tie up portions of their funds in lower-earning transactions balances. The adjustment has not been steady. Yield declines have been bunched in time, and the ensuing bunched additions to money balances have led to sudden drops in velocity. Unfortunately, the timing of such velocity changes is no easier to predict than is the timing of interest rate changes. Deposit deregulation may have contributed to the extent of velocity adjustments by making the demand for the group of assets in M1 more responsive to interest rate changes than it used to be.

While growth of M1 was quite high relative to its long-run range for 1985, the broader aggregates remained generally within their ranges.

Growth of M2 from the fourth quarter of 1984 to the second quarter of 1985, at an 8-3/4 percent annual rate, was a little below the upper limit of its range, expressed as a cone based in the fourth quarter of 1984. However, expansion of this aggregate in June brought its monthly average a little above the upper end of the range.

Given the deregulation of bank deposit rates, the growth of M2 should be less affected over periods of as long as a half year by interest rate developments because offering yields on most of its components are adjusted in line with market rates and many of the shifts of funds engendered by interest rate changes are among assets within this broader aggregate. But because the adjustments in offering yields tend to lag market changes, M2 does show considerable short-term responsiveness to interest rate changes. Deposit rates, especially on MMDAs, fell much less than market yields last fall, so M2 rose rapidly for several months. Then rising market yields in February and March held back M2. The nontransactions portion of M2 actually declined in April for the first time in 15 years, although this may have been partly the result of difficulties in seasonal adjustment owing to the limited experience with IRA accounts (which are excluded from M2) and with tax payments made out of MMDAs and money market funds. After rates fell back, M2 picked up again strongly in late spring.

M3 growth, meanwhile, was comfortably within its target range during the first half of the year. Issuance of large CDs has slowed substantially from last year at both banks and thrifts. Core deposit flows have accelerated while the rate of loan expansion has held about steady. Further-

more, perhaps in response to new Federal Home Loan Bank Board regulations raising net worth requirements for fast-growing institutions, thrifts have reduced net acquisitions of assets. In doing so, some institutions have taken advantage of declining yields by using the capital gains from asset sales to boost reported earnings.

Growth in total debt remained extremely strong in the past two quarters, averaging a bit above its monitoring range, though below the record pace of 1984. Federal government borrowing continued to absorb more than a fourth of total funds made available to domestic nonfinancial sectors. An increasing proportion of the Treasury's debt carries distant maturity dates; 90 percent of net marketable borrowing this year has been in issues of notes and bonds maturing in 2 to 30 years. Issues of 20- and 30-year debt, in particular, are increasing and now dominate the new issue market for taxable long-term bonds, accounting for over two-thirds of new offerings in that maturity class. This large volume of new long-term debt has changed the makeup of the secondary market as well. The supply of Treasury issues outstanding with 15 or more years remaining to maturity has doubled in little more than 2 years, while the amount of private issues in that maturity range has shown little net change.

Borrowing of state and local governments has been unexpectedly strong so far this year, but an unusually high proportion has been for advance refunding of existing issues, as governments have sought to take advantage of lower interest rates. Because the funds borrowed in such operations are reinvested in financial instruments, they have little net impact on credit market pressures. Indeed, most of these funds are required by law

to be invested in specially-issued Treasury debt, thus reducing the Treasury's need for public offerings. Single-family housing revenue bonds have slowed from the second half of last year. But last year's issues were heavily concentrated in the later part of the year because of delays in the reauthorization of such bonds; recent volume has been close to the 1984 average rate.

Business credit demands have remained strong this year. Slowing growth of both profits and expenditures for fixed capital and inventories has, on balance, had little effect on total borrowing needs. Corporate borrowing has been heavier in the short-term paper and loan categories than in bonds, but not to the same extent as in the early part of 1984, when interest rates were rising. In addition, while new issue bond volume has picked up in response to the lowest long-term yields in five years, maturities of new bond issues have been concentrated in the short- and intermediate-term areas, as they were last year.

An unusual portion of the borrowing, also like last year, has been used to finance equity retirements of one sort or another. Mergers, buyouts, share repurchases, and swaps with shareholders of new debt for stock have continued on the same massive scale as last year. Borrowing initiated with the purpose of financing these transactions may have accounted in gross terms for more than a percentage point of the growth rate of total nonfinancial debt over the first half. But such an estimate may overstate the net effects of recent corporate recapitalizations on debt growth. A number of firms involved in mergers or restructurings this year and last have recently completed large assets sales, some for the explicit purpose of repaying debt. Furthermore, merger activity may be indirectly responsible for some of the

increased new equity offerings because of its generally stimulative effect on stock prices as funds paid to shareholders are reinvested.

Household borrowing also has remained strong. Demand for mortgage loans has been buoyed by declining interest costs. At the lower rates, households have found adjustable-rate loans less attractive than last year, reducing from two-thirds to about a half the proportion of new conventional mortgages with these features. Installment debt continued to rise faster than income in the first half of the year, but the second-quarter data show some deceleration in line with signs of a slowing in the growth of consumption spending on large ticket items.

Other Developments in Financial Markets

Signs of strain in financial markets have persisted this year, but without causing major disruptions in general credit market conditions. Although the government securities market as a whole has been performing well, the failures of three secondary government securities dealers caused losses, sometimes substantial, for some of their customers. A number of local governments and savings and loans were among those hurt, and losses by one large thrift institution in Ohio had further repercussions, threatening to bankrupt the statewide private insurance system and, for a time, generating some concerns here and abroad about the safety of other financial institutions. Runs on privately insured savings and loans in Maryland, some of which also lost money as a result of the failure of securities firms, followed the problems in Ohio. Privately-insured S&Ls in both states were closed or limited to small withdrawals for a time, causing serious inconvenience to some depositors, and some institutions remain closed or restricted.

However, these various problems have been relatively well contained, without significant effects on other institutions and markets. A number of institutions have switched to federal insurance. And the Federal Reserve, acting in its role as lender of last resort, made advances to non-federally insured thrift institutions in Ohio and Maryland to help facilitate adjustments in the face of large deposit outflows. For a while, the borrowing affected the amount of adjustment credit at the discount window but, because of the special conditions, did not add to reserve market pressures as perceived by other institutions. After a time, the borrowings were classified as extended credit.

The thrift industry as a whole continues to suffer from low net worth and mismatched balance sheets, but the recent interest rate declines are improving earnings. The FHLBB has taken a number of steps, including increased capital requirements for rapidly growing institutions to encourage the stabilization of the industry over time. Capital requirements also have been raised for banks, some of which have suffered from a high incidence of nonperforming loans and loan losses in recent quarters. The troubled loans are concentrated in energy, agriculture, and real estate sectors and to borrowers of some foreign countries. Bad news about the loan portfolios of individual institutions and other reported losses have produced some ripples in market rates generally, but spreads between borrowing rates of financial institutions and the Treasury have been quite low for the most part. To some extent, loan losses reflect overly aggressive lending decisions, but the problems of borrowers in the hardest hit industries are partly a result of difficult adjustment to a higher value of the dollar and lower

rates of inflation than were expected when the loans were made. In the agricultural as in other sectors, investors and borrowers have discovered that the inflation of land and commodity prices can no longer be taken for granted.

In light of strains relating to agricultural credit, the Federal Reserve liberalized its regular seasonal borrowing program and initiated a temporary special seasonal program. However, there has been only relatively limited use of seasonal credit owing to the easing of money market conditions as the spring progressed.

With regard to conditions among nonfinancial businesses, the prospects of some of those in the weaker industries--especially those most adversely affected by the high dollar--are subject, of course, to considerable uncertainty. But, in addition, many firms have deliberately chosen a more precarious financial structure in order to enhance current market valuations of shares or to fend off undesired takeover bids. Nevertheless, financial markets have not shown generalized concern about corporate financial structure; notably, spreads between corporate and Treasury debt are unusually narrow, having shrunk since the beginning of the year.

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

July 26, 1985

The Honorable Paul A. Volcker
Chairman - Board of Governors
Federal Reserve System
20th and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Paul:

As always, it was a pleasure to have you appear before my Subcommittee and to testify as you most recently did for the Humphrey-Hawkins Full Employment hearings on the conduct of monetary policy. Thank you for your time and your testimony.

Following the hearings, Members were also requested to submit any additional questions which they wished to pose. They are attached on a separate sheet. Your early response would be deeply appreciated.

Please feel free to contact the Subcommittee if you have any queries about the attached list of questions.

With kindest regards and again, many thanks, I am

Sincerely,

Walter E. Fauntroy
Chairman

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

August 9, 1985

PAUL A. VOLCKER
CHAIRMAN

The Honorable Walter E. Fauntroy
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Walter:

Thank you for your letter of July 26 enclosing written questions in connection with the hearing held on July 17. I am pleased to enclose my responses to the questions for inclusion in the record of the hearing.

I hope this information is useful to your Subcommittee. Please let me know if I can be of further assistance.

Sincerely,

Paul

Enclosure

Question 1: Can the trade deficit be explained solely in reference to the strong dollar or is it symptomatic of a longer-term process at work? Is the current performance of heavy industry indicative of a changing international division of labor? Are these industries likely to shift the predominant portion of their production to Mexico, Brazil, and other nations in the longer-run? What implications does this have for employment and economic growth in the United States? Should these industries be protected? If so, how?

Answer: Our trade deficit has evolved in the last few years in large part because of our macroeconomic policies and those of our trading partners. While our economy has grown vigorously, our large structural budget deficits have induced imbalances in the U.S. economy, which have contributed to a strong rise in the exchange value of the dollar and a large merchandise trade deficit. In the short run, we have benefitted by less inflation and lower interest rates, and therefore more investment, at the expense of our manufacturing sector. As time goes on, distortions could become more severe unless we act quickly to reduce our large structural budget deficits. At the same time, there has been over the past several years an ongoing process of international division of labor. This is one of the many reasons why it would be a mistake to react to our trade deficit by increasing the protection of our industries.

Question 2: Let us assume for the moment that heavy industry and agriculture are facing structural problems brought about by the proliferation of international competition. Assume in addition that there is reason to believe that foreign governments are not observing the principles of "free trade." Would you advocate some type of industrial policy which would maintain these industries to offset foreign support? Or alternatively, should United States firms continue to participate using the principles of "free trade?"

Answer: Problems in heavy industry and agriculture reflect imbalances in our economy caused by our large structural budget deficit, as well as other factors acting to bid up the exchange value of the dollar. To the extent that we deal with these problems indirectly through some form of industrial policy rather than directly through reduction of the structural budget deficit, the burden of the imbalances will simply shift to other sectors of our economy. To the extent that foreign governments are not observing bilateral and multilateral trade agreements, their violations should be resolved through the auspices of the appropriate international agencies such as GATT.

Question 3: What is your assessment of the likely effects of the proposed $50 billion reduction in the federal budget deficit? How much do you expect interest rates to fall? Are there other factors which have been keeping real interest rates above historical levels? What are some of these? How certain is the Federal Reserve that deficits are the primary cause of the high interest rates?

Answer: Enactment of a deficit reduction of $50 billion would tend to lower interest rates from levels that otherwise would prevail and, at the same time, to relieve the pressures that have kept the dollar high on foreign exchange markets and contributed to the deterioration in the U.S. trade balance. Quantifying these impacts is a difficult task; expectational factors, in particular, would be very influential and in this regard I would underscore the importance of putting in place a budgetary program that provides assurance to investors that there will be continuing progress in coming years toward balance in the government's finances. The fluctuations in the bond markets that have accompanied developments on the congressional budget resolution have demonstrated the importance of expectations. I should think that the market action we've seen also suggests that those econometric models showing interest rate impacts of a percentage point or more for a permanent $50 billion deficit cut are in the right ballpark.

Obviously, the budget deficit is not the only factor determining interest rates. At a basic level, real interest rates reflect the net impact of all forces affecting the supply and demand for savings in the economy. What one can observe in recent years is that, while private investment has been a substantial user of available savings (spurred to a degree by tax incentives), the federal deficit has preempted an abnormally large share of the financial capital--one that has not shrunk the way it did in past cyclical expansions. Moreover, the prospect of continuing massive deficits has weighed heavily on the thinking of investors and tended to hold long-term rates unusually high relative to the current rate of inflation.

Question 4: In light of the decision of the FOMC to rebase M1 growth targets, how did the various components of M1 behave in the first two quarters of this year? Were they consistent? Did the decline in velocity influence the decision? Is the M1 proxy still a reliable growth target, given low inflation? If not, what additional targets is the Federal Reserve using at the current time?

Answer: All of the major components of M1 grew substantially during the first half of the year. The greatest strength, however, was evidenced by the deposit components, especially interest-bearing checking accounts. The composition of the growth in M1 is, we believe, consistent with our view that the strong demand for money--and the associated weakness in velocity--was in large part a reflection of the greater willingness to hold M1 balances in light of the decline in interest rates on other assets since last summer.

The decision to rebase took account of the decline in velocity and reflected the judgment that this decline likely was another stage in the process of adjustment to an environment of lower inflation and lower nominal interest rates. We selected a range for M1 that we believe is consistent with the maintenance of progress toward reasonable price stability, as well as with the furtherance of economic growth; the same is true of the targets for the other monetary measures, which we reaffirmed. Nonetheless, in light of the uncertainties surrounding the behavior of all the monetary aggregates, the FOMC will continue to take into consideration, in making its operational decisions, a broad range of economic variables--including the strength of the economy, the pace of inflation, and conditions in credit and foreign exchange markets.

Question 4A: Even with the rebasing, M1 remains above target. Is M1 likely to be rebased again at the end of this year? Is the situation in the economy unique insofar as the tremendous growth in M1 has been unaccompanied by either increases in economic growth and/or inflation? Or do you expect growth and inflation to accelerate at the end of the year? How will the Fed respond, given these circumstances?

Answer: The Federal Open Market Committee (FOMC) typically has used the fourth-quarter average level as the base for its annual target ranges, and it followed that procedure in establishing tentative ranges for 1986. The Committee will be reviewing those targets next February, at which time the specifications for growth rates and base periods will be reexamined in light of the experience with monetary behavior between now and then, consideration of the economic situation, and whatever information may be available regarding the consequences of the deposit deregulation that will be occurring early in the year.

The impacts of monetary expansion generally are felt with some lag, so the first-half pattern of economic growth and inflation is not remarkable in that respect. It is, in fact, the expectation of the FOMC members that there will be a pickup in the pace of economic expansion in the second half of the year, reflecting in part the easing of credit market conditions that has occurred. However, we do not see a significant intensification of inflationary pressures, owing to the slack in the domestic economy and the continuing impact of the earlier appreciation of the dollar. Were inflationary forces to become more substantial than we have anticipated, it certainly would be a concern and, all other things equal, would argue for a less accommodative approach to policy. Whether it would necessitate a downward adjustment of the ranges for money that we have set tentatively for 1986 would depend on the outcome of the broader analysis, to which I referred above, of the factors affecting the relationship between monetary growth and economic performance.

Question 5: What effect do you believe the distortions in the economy will have on economic growth and monetary policy during the remainder of 1985? How important a factor will the uncertainty of investors be in light of the looming twin deficits and the current state of agriculture and heavy industry?

Answer: One cannot say with any certainty what the effects of the distortions evident in the economy will be in the months ahead. It seems quite clear to me at this point, however, that the federal budget deficit and concerns about longer range fiscal prospects are contributing to the high level of real interest rates that still prevails; it also appears that the trend of deterioration in our trade balance has not yet been reversed, which has particularly negative implications for sectors like agriculture and manufacturing. Under the circumstances, it would not be surprising if investors manifested a degree of caution, which could further temper the expansionary forces in the economy. All of these phenomena will, of course, have to be considered by the Federal Reserve as it conducts monetary policy with a view toward supporting sustained growth in the context of continuing restraint on inflation.

Questions 5A & B: What are the effects of the distortions in terms of the narrowing of options in the conduct of monetary policy? Can the Federal Reserve effectively implement monetary policy given the need to sell the debt and the worsening trade deficit? In addition, please address the effect of both the employment and the potential withdrawal of foreign funds on the U.S. economy. How essential are these funds to the financing of investment and the selling of the debt? What implications would the withdrawal of foreign funds have on inflation, interest rates and the dollar? Would the withdrawal aid the performance of heavy industry and agriculture through weakening the dollar or would this be more than offset by the rise in interest rates which would follow?

Answer: In the face of the large increase in the structural budget deficit, which has led to an imbalance between national domestic savings and domestic investment, net private investment in the United States has benefitted from our access to foreign funds. If foreigners were to choose to place their funds elsewhere, then the economy would have to adjust to bring domestic savings more in line with domestic investment. The adjustment process might lead to a higher price level, higher interest rates, and a real depreciation of the dollar, in the absence of any independent action to reduce the structural budget deficit.

It is difficult to say precisely how much the performance of heavy industry and agriculture would improve with a withdrawal of foreign funds. Their sales in U.S. and foreign markets would increase as a result of the decline in the dollar's exchange rate, but the rise in interest rates and reduction in domestic demand would at least partially offset this gain.

Question 5C: How do you assess the net debtor status of the United States? What are its implications on future economic growth? Does it connote a trend or is it a temporary response given the unique circumstances at the current time? If it marks a trend, when will it become serious?

Answer: The movement of the United States into net debtor status reflects the necessity to borrow abroad to help finance both domestic investment and the government budget deficit. To the extent that we have borrowed abroad to increase investment and build our capital stock, our increased borrowing should help economic growth over the long run. However, in order to pay for this debt, we must now ship a larger share of our domestic output abroad. If our capital stock has not been increased commensurate with the build-up in our debt, the need to allocate a larger share of this output of a less rapidly growing economy will become increasingly burdensome over time.

Question 6: On page ten of your written statement, you say that productive capital has not been expanding at an adequate rate. Yet, the data indicates that a greater percentage of GNP is currently being utilized for fixed investment than at any time in the past twenty-five years. Do you continue to maintain that expansion is inadequate? On what do you base this analysis?

Answer: In my statement, I indicated a concern that "the expansion in the industrial base" is less than we will need "as we restore external balance and service our growing external debt." I was calling attention to the fact that we are at present consuming much more than we are producing domestically and that at some time in the future the foreign IOUs we've been incurring in effect will be called--potentially putting some strain on our productive resources as we attempt not only to meet domestic demands but also shift toward net exportation of goods and services.

The pressures in such circumstances are likely to be felt most strongly in the industrial sector, where activity is relatively sensitive to changing trade patterns. I should note that "industrial base" must not, in this context be interpreted too narrowly. The continuing weakness in industry may well be having an important effect on the long-term availability of trained labor and on marketing relationships. But even on the physical capacity side, one can see cause for some concern. Despite relatively strong investment in plant and equipment in the past couple of years (not as strong, I should point out, for net as for gross investment), capacity utilization in industry today is somewhere between 80 and 81 percent. Figures in the mid-80s for capacity utilization traditionally have been marked by a degree of tightness in markets. Given the enormous size today of our merchandise trade deficit, if we were to find it necessary to meet just our own domestic spending demands (let alone become a net exporter of goods) the implied level of the capacity utilization rate would be well into the range that has been associated with inflationary pressures in the past.

Question 6A: The strength of nonresidential fixed investment may well be due to the inflow of foreign capital and the current account deficit which is making this investment possible. If the current slowdown represents a return to historically more normal levels of investment, is it wise to expand money growth in the attempt to counteract this shift?

Answer: It is quite true that the ready availability of capital from abroad has helped to keep real interest rates from moving still higher and in that way has been supportive of strong business fixed investment. Some slowdown in the growth of investment after the enormous surge of 1983-84 has to be expected, but, obviously, pronounced weakness in this sector could be inimical to desirable economic performance in the months ahead. The Federal Reserve must take into account developments in the investment sector, as we assess the overall economic picture and the appropriateness of existing policy plans. However, we cannot be expected to fine-tune the economy on a sectoral basis and to ensure balanced economic performance. Over the long haul, the maintenance of a healthy level of investment will depend critically on our ability to deal with our federal fiscal imbalance; we cannot depend forever on an inflow of capital from abroad to offset the absorption of domestic saving by the federal government.

Question 7: How did the individual members of the Federal Open Market Committee vote when confronted with the decision to rebase the growth targets for M1?

Answer: The Federal Open Market Committee (FOMC) determined in 1976 that the records of policy actions taken at each of its meetings may be disclosed to the public shortly after the next regularly scheduled meeting. (See Sixty-Third Annual Report of the Board of Governors of the Federal Reserve System, p. 215.) Accordingly, the policy record of the FOMC's most recent meeting is now being prepared by the staff and will be available within a few days following the FOMC's meeting scheduled for August 20, 1985.

At the present time, I think it would be fair to say that, while there was general agreement that the target for M1 established in February was no longer a realistic one, various Committee members had different views on what approach might best be taken--and these were fully aired before the decision to rebase was taken.

Question 8: With regard to the farm debt crisis, what has the Federal Reserve done to implement the recommendations contained in the Subcommittee's Report on the Conduct of Monetary Policy? Has the Federal Reserve agreed to taking a lead similar to that undertaken in the international debt crisis? Additionally, what has the Federal Reserve done to: 1) further expand the seasonal lending program for agricultural banks through the discount window; 2) encourage the exercise of prudent judgments in bank examinations as to the solvency of agricultural banks that may be faced with questions about extending additional or renewed credit to farms; and 3) assist in expanding the number of investors in farm lending through the development of a secondary market for farm debt or equity instruments?

Answer: The Federal Reserve has continued to work actively with other parties--private and public--seeking to deal with the credit problems of the farm sector.

While no expansion of the seasonal credit program has been undertaken recently, Reserve Banks have made special efforts to ensure that banks are well acquainted with the modifications of the seasonal program instituted on March 8. The seasonal program, as modified, reduces the amount of a bank's seasonal needs for funds that it must meet from its own liquidity. This change was not limited to the 1985 farm production season and thus expands access of agricultural banks to seasonal credit in coming years as well.

For some time, it has been the policy of the Federal Reserve to exercise forbearance in the examination and supervision of agricultural banks while maintaining a proper concern for safety and soundness. Among steps that have been taken in this regard, examination reports are reviewed carefully by senior staff--before being sent to bank management and directors--to determine that loans are classified only after

careful review of the facts and to ensure that bank management is not subjected to criticism when it has exercised an appropriate and prudent degree of forbearance.

The development of a secondary market for farm debt or equity instruments is not an area in which the Federal Reserve System is by its nature particularly well suited to provide leadership. However, the private sector appears quite generally to be interested in developing secondary market channels and "securitizing" many types of debt instruments, and the Federal Reserve certainly would play a constructive role in dealing with the supervisory and regulatory issues that almost inevitably arise in these matters. The Farm Credit System, of course, already provides a vehicle for broad credit market access by agriculture; it sells its securities in the national credit markets, where they may be purchased by insurance companies, pension funds, and other entities, and channels the funds thus obtained to farmers.

CONDUCT OF MONETARY POLICY

THURSDAY, JULY 18, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 9:35 a.m., in room 2128 of the Rayburn House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Chairman Fauntroy; Representatives Neal, Barnard, Roemer, Carper, McCollum, Hiler, and Ridge.

Chairman FAUNTROY. The subcommittee will come to order.

This is the second day of our hearings on the conduct of monetary policy. Yesterday, Hon. Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve System, testified before us and presented the Semi-Annual Report issued by the Federal Reserve pursuant to the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. Today we will hear evaluations of the Federal Reserve's Report on Monetary Policy and its proposed policies from several distinguished economists.

In the hearings held in February and March of this year, we noted rather ominous clouds lurking in the seemingly bright economic horizon. We were encouraged by the low inflation rate and the remarkable growth of the economy which has ensued throughout the previous five quarters. Much of the economic expansion during this time was concentrated in the high-tech, defense, and service industries.

The distortions in the economy at that time included the continuing high unemployment rate, the burgeoning budget deficit, the worsening trade deficit, the strong dollar and the sectoral implications of all of these phenomena on agriculture, natural resources, and the manufacturing industries.

Several of the economists appearing at the hearing 6 months ago expressed concern with the the impact of the high budget deficits on the inflow of foreign funds, the strength of the dollar, the trade deficit and on long-term prospects for economic growth in the United States. The increasing influx of foreign funds into U.S. financial markets was viewed as a short-term panacea with long-term consequences which are difficult to evaluate

Five months have passed since the date of that hearing and the outlook has become increasingly troubled. The Department of Commerce has told us that for the first time since 1914, the United States has become a net debtor nation. In addition, economic growth in the last two quarters has slowed; unemployment has re-

mained between 7 and 7.5 percent; and trade deficits, in response to the strength of the dollar, have remained over $100 billion per year. Furthermore, in response to the strong dollar and the balance of trade deficits, industry and agriculture continue to face troubled economic times. Roughly 160,000 jobs were lost in the manufacturing sector during the first 4 months of 1985 alone.

At the same time, Congress and the President may be on the verge of cutting the budget deficit, though not by as much as was initially envisioned. Yet, we must still contend with the interest costs of past budget deficits, which add up roughly to $140 billion per year to Federal Government expenditures. The implications of the continuing deficits, together with the sizable interest payments, constrain the Federal Reserve in its conduct of monetary policy.

In recent weeks, the Federal Reserve has eased its control of the money supply, while lowering the discount rate, in an effort to stimulate the economy. I have asked the witnesses to address the outcome of this policy by the Federal Reserve, in terms of the following: Are we in a growth recession? Are there additional factors at work in the shift of Federal Reserve policies toward the easing of the money supply? What are the likely prospects for inflation and unemployment? What constitutes an "unacceptable" rate of inflation at the current time? What effects do the distortions in the economy, including the budget and trade deficit, the poor performance of heavy industry and the overvaluation of the dollar have on the conduct of monetary policy by the Federal Reserve? What implications will the inflow of foreign funds into the U.S. financial markets have in terms of both the conduct of monetary policy and the prospects for future economic growth? What is the meaning of the Federal Reserve's most recent action in rebasing M1?

To help us address these questions, we have with us today five prominent economists: Mrs. Nancy Teeters, director of economic research at IBM, and a former member of the Board of Governors of the Federal Reserve; Dr. Allen Sinai, chief economist with Shearson Lehman Bros.; Dr. Lawrence Chimerine, chief economist with Chase Econometrics; Dr. Michael Sumichrast, chief economist with the National Association of Home Builders; and Mr. Norman Robertson, chief economist and vice president of the Mellon Bank.

Ladies and gentlemen, we are pleased to have you, and before we hear your testimony, in the order given, let me yield to my distinguished colleague, Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman, and my commendations to you, first, for the selection of such an outstanding panel this morning to discuss what I think is one of the most serious subjects that we have got before us today, not only as a Congress, but as a people, and second, I certainly commend you on your fine opening statement.

All of the things that the chairman has indicated that he is concerned about and we are seeking answers to, I want to say that that does represent the sentiments of the total membership of our committee from both sides of the aisle.

Speaking as one committee member, though, I am really concerned. I just feel like we are before a real chasm of some kind. I have an uneasy feeling about the economy.

I hope that this morning in your testimony you will not only appraise the situation that we have got today, but be as positive as you can about what Congress needs to do. I know we need to reduce Federal spending. We need to approach at least the deficit problems very, very seriously. Sometimes I do not think we do it seriously enough, but I think it is time that Congress got the bad news. And we need to hear it from people like you who are students of the subject and who are working as conscientiously as we are in trying to keep our economy on a level plane. And so I look with enthusiasm to what you have to say this morning, and thank you very much for being here.

Chairman FAUNTROY. I thank the gentleman for his comments, and now we will proceed with our witnesses, as their names appear on the list. Dr. Teeters, we are very pleased to have you. You may proceed in whatever manner you chose.

STATEMENT OF HON. NANCY TEETERS, DIRECTOR OF ECONOMICS, INTERNATIONAL BUSINESS MACHINES [IBM], AND FORMER MEMBER OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mrs. TEETERS. I am delighted to be here today to discuss my assessment of the economy and policy issues. I am glad to be back in Washington, having spent most of my working life in this city, including some very busy years in the service of the Congress. For the past year I have been in the private sector, as IBM's director of corporate economics, which, hopefully, has given me some added perspectives. While I shall describe IBM's latest economic forecast, the views I express today are my own.

What is the current state of the economy? The strong growth phase of the first year and a half of the present business expansion—which was fairly typical in its overall dimensions of the early phases of a cyclical recovery—has been followed by a year of uneven, but essentially sluggish, growth. Real GNP over the past four quarters has advanced at barely 2 percent. And with the new numbers today, it is actually 1.3 percent. Our industrial production over the last year has been essentially unchanged, with output particularly weak in manufacturing and mining. These vital parts of our economy, along with agriculture, have been especially impacted by the strong dollar and our poor international trade performance.

Net exports of goods and services, as measured in current prices in the national income accounts, deteriorated dramatically from a surplus of $19 billion in 1982 to deficits of $8 billion in 1983, $66 billion in 1984, and probably more than $80 billion in 1985. The unemployment rate remains stuck at much too high a level, with the figure for the civilian workers close to 7.3 percent

To be sure, the overall economy has not turned downward and many forecasts of just a few months ago seem excessively pessimistic. Personal income and consumer spending are holding up relatively well and residential construction activity is showing some signs of strengthening in response to recent downward trends in the mortgage rates. Employment has been growing appreciably, but essentially only in the service-producing areas and only in line

with increases in the labor force. The inflation news, while not as good as in the fifties and sixties, remains distinctly encouraging in the context of more recent years.

As for the economic outlook, we at IBM prepared our last detailed forecast of the U.S. economy for 1985 and 1986 in May. Since that forecast is thus far holding up quite well, I shall use it as essentially reflecting my present expectations for the next 1½ years.

Underlying the forecast are a number of assumptions we made with regard to policy and external developments. The Federal budget deficit will approximate $220 billion in 1985 and $200 billion in 1986. Also, because of the huge accumulation of budget authority granted in previous years, actual defense outlays may turn out to be greater than is generally expected, and we have assumed that the House view will prevail on Social Security, with the COLA increase next January in accordance with current law. Some other expenditure cutbacks in both the House and Senate resolution will occur, but they will probably be smaller than anticipated even as late as a month ago. With smaller decreases in spending, we may have to go for a modest increase in taxes in the neighborhood of $10 billion to $12 billion in 1986. We have not yet factored in a major tax restructuring. For the next 1½ years, the Federal Reserve is seen as pursuing a relatively neutral stance, letting interest rates be primarily determined by market forces. OPEC prices will continue to decline moderately over the next several months in response to the current excess supplies and then essentially hold steady until the end of 1986. Most other industrial countries will achieve moderate rates of economic growth.

Using these assumptions, we generated our "base" or most likely forecast. As indicated in the attached table, this calls for sustained growth and no recession through the end of next year. Growth would be distinctly moderate, however, with real GNP rising at about 3 percent a year, insufficient to make any new progress against unemployment.

The upturn is maintained by further moderate increases in consumer spending, residential and nonresidential fixed investment, and defense outlays. The net export deficit remains high, but tends to stabilize when measured in constant prices. Viewed in nominal terms, the current account balance continues its deterioration, but at a more modest pace. Inflation remains in check, with consumer prices rising at about 4 percent annually.

As we prepared our base case, we were fully mindful that the current expansion continues, despite a major public policy imbalance. The size of the Federal deficit remains unusually high, creating a large demand for funds in domestic financial markets. We have been fortunate so far in two ways: First, U.S. banks have kept at home a large portion of funds that normally would be lent overseas, and second, there have been significant inflows of foreign capital into the United States which need not persist. Both developments have eased pressure on U.S. interest rates, but the price has been a strong dollar and a weakening of our net foreign trade position. Our base case assumes a marked deceleration of U.S. import growth. That could be an overly optimistic view.

In the risk case, highlighted in the table, we have assumed higher propensities to import and, therefore, a more pronounced

weakness in the domestic manufacturing sector. In addition, the household sector has accumulated over the current expansion, a significant amount of debt relative to current income levels. This could potentially restrain spending on consumer goods and services.

The prospects of business capital spending could easily sour in the context of rising imports, reduced domestic manufacturing, moderating profits and corporate cash flow and declining factory utilization. The result of combining these major exposures is a recession that could start as early as now, with a peak-to-trough decline of little more than 2 percentage points in real GNP. Such a scenario raises the unemployment rate to 9 percent by the end of next year and especially worsens the cyclically sensitive sectors of the economy and the budget deficit.

Let me turn briefly to some policy issues. With regard to the Federal budget, we are clearly not growing our way out of the deficit. Continued large deficits will persist unless more painful steps are taken on both the expenditure and the revenue fronts. Implementing some mixture of the outstanding budget resolutions, while definitely helpful, will, I'm afraid, fall short of what is needed.

Of course, there are some analysts who doubt that continuing large budget deficits constitute much of a problem. They point out that this fiscal situation has not prevented interest rates from declining appreciably over the past year. Also they stress that the fiscal stimulus has bolstered economic activity and that by strengthening the dollar, the large deficits have lessened inflation in this country. While I would grant much of the above, I believe that all things considered, persistent large negative budget balance is a major problem that must be addressed, and I am hopeful that the majority of those in Congress and the administration feel the same way.

The recent decline in interest rates seems primarily to reflect a distinct slowing in the pace of the business expansion and a moderate Federal Reserve response to that development. Nevertheless, rates remain high by historical standards, especially when expressed in real terms. As the expansion matures, rising private demands for funds in the context of huge Treasury financing requirements could produce upward pressure on rates with especially harmful effects on interest-sensitive activites, such as homebuilding, consumption of durables, and capital spending. A reversal of the flow of the foreign capital into the United States could potentially have a similar effect.

Relatively high interest rates have helped induce inflows from abroad, strengthening the dollar, which in turn has hurt the export and import-competitive firms. They have contributed to the plight of the debtor nations and the vulnerability of financial institutions. Also, European economic activity has been constrained by the tighter-than-desired credit conditions maintained to limit capital flight to the United States.

To promote a more balanced and sustained expansion, I, along with most economists, want to see less fiscal stimulus; this should foster easier credit conditions which would lessen dependence on international capital flows. The budget deficit must be properly addressed. Spending restraint is clearly needed, and in the defense

sector, I am disposed toward some reduction in new budget authority; the ratio of unspent budget authority at the beginning of the year to defense outlays has increased steadily from 60 percent to 84 percent over the past 4 years.

Unpleasant as it may be, Congress must recognize that the enacted spending cut will probably not be sufficient, and that taxes will have to be raised. I personally would urge that deficit containment actions be instituted reasonably quickly. You know that if you do not act quickly, and if the economy, in the meantime, slips into a recession, fiscal restraint will not be feasible, and the long-term deficit problem will be greatly intensified.

In the current environment, I see no reason for any significant shift in monetary policy. Our fiscal issues must be addressed first. With the imposition of substantial deficit reduction measures, I would expect the financial markets to respond favorably. Should the economy weaken substantially, I would expect that the monetary authorities—as they have in the past—will act to bolster business activity.

Thank you.

[The prepared statement of Mrs. Teeters follows:]

STATEMENT OF NANCY H. TEETERS,

DIRECTOR OF ECONOMICS

INTERNATIONAL BUSINESS MACHINES CORPORATION

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

U.S. HOUSE OF REPRESENTATIVES

JULY 18, 1985

Mr. Chairman, members of the Subcommittee, I am delighted to be here today to discuss my assessment of the economy and policy issues. I'm glad to be back in Washington, having spent most of my working life in this city, including some very busy years in the service of the Congress. For the past year I've been in the private sector, heading up IBM's corporate economics staff, which hopefully has given me some added perspectives. While I shall describe IBM's latest economic forecast, the views I express today are my own.

What is the current state of the economy? The strong growth phase of the first year and a half of the present business expansion -- which was fairly typical in its overall dimension of the early phase of cyclical recoveries -- has been followed by a year of uneven, but essentially sluggish, growth. Real GNP over the past four quarters has advanced at barely more than 2%. Industrial production over the last year has been essentially unchanged, with output particularly weak in the manufacturing and mining sectors. These vital parts of our economy, along with agriculture, have been especially impacted by the strong dollar and our poor international trade performance. Net exports of goods and services, as measured in current prices in the national income accounts, deteriorated dramatically from a surplus of $19 billion in 1982 to deficits of $8 billion in 1983, $66 billion in 1984, and probably more than $80 billion in 1985. The unemployment rate remains stuck at much too high a level, with the figure for all civilian workers at close to 7.3% for the past year.

To be sure, the overall economy has not turned downward and many forecasts of just a few months ago seem excessively pessimistic. Personal incomes and consumer spending are holding up relatively well and residential construction activity is showing some signs of strengthening in response to the recent downtrend in mortgage rates. Employment has been growing appreciably, but essentially only in service-producing industries and only in line with the increase in the labor force. The inflation news, while not as good as in the fifties and sixties, remains distinctly encouraging in the context of more recent years.

As for the economic outlook, we at IBM prepared our last detailed forecast of the U.S. economy for 1985-1986 in May. Since that forecast is thus far holding up quite well, I shall use it as essentially reflecting my present expectations for the next year and a half.

Underlying the forecast are a number of assumptions we made with regard to policy and external developments.

1. The federal budget deficit, unified basis, will approximate $220 billion in fiscal 1985 and $200 billion in fiscal 1986. These are higher, particularly for next year, than administration and congressional projections -- in good part because the latter are geared to economic growth rates in real terms that appear overly optimistic. Also, because of the huge accumulation of budget authority granted in previous years, actual defense outlays may turn out to be greater than is generally expected, and we have assumed that the House view will prevail on social security -- with the COLA increase next January in accordance with current law. Some other expenditure cutbacks in both the Senate and House resolutions, I expect, will probably turn out to be smaller than anticipated.

   Realization of less-than-desired progress through spending cutbacks was assumed to lead to a modest tax increase (perhaps $10-12 billion) effective in mid 1986 -- which I now would push into 1987. This could embody some revenue-raising elements of the tax reform proposals.

3. We have not factored in major tax restructuring.

4. For the next year and a half the Federal Reserve is seen as pursuing a relatively neutral stance, letting interest rates be primarily determined by market forces.

   OPEC prices will continue to decline moderately over the next several months in response to current excess supplies and then essentially hold steady until the end of 1986.

   Most other major industrial countries will achieve moderate rates of economic growth.

Using these assumptions, we generated our "base" or most likely forecast. As indicated in the following table, this calls for sustained growth and no recession through the end of next year. Growth would be distinctly moderate, however, with real GNP rising at about a 3% rate, insufficient to make any new progress against unemployment. The upturn is maintained by further moderate increases in consumer spending, residential and nonresidential fixed investment, and defense outlays. The net export deficit remains very high, but tends to stabilize when measured in constant prices. Viewed in nominal dollars, the current account balance continues its deterioration -- but at a much more modest pace. Inflation remains in check, with consumer prices rising at about a 4% annual rate.

As we prepared our base case, we were fully mindful that the current expansion continues despite a major public policy imbalance. The size of the federal deficit remains unusually high, creating a large demand for funds in domestic financial markets. We have been fortunate, so far, in two ways. One, U.S. banks have kept at home a large portion of funds that normally would be lent overseas. Two, there have been significant inflows of foreign capital into the U.S. (which need not persist). Both developments have eased pressure on U.S. interest rates. But the price has been a strong dollar and a weakening of our net foreign trade position. Our base case assumes a marked deceleration of U.S. import growth. That could be an overly optimistic view.

In the risk case (highlighted in the table), we have assumed higher propensities to import and, therefore, a more pronounced weakness in the domestic manufacturing sector. In addition, the household sector has accumulated over the current expansion a significant amount of debt relative to current income levels. This could potentially restrain spending on consumer goods and services. The prospects for business capital spending could easily sour in the context of rising imports, reduced domestic manufacturing, moderating profits and corporate cash flow, and declining factory utilization rates. The result of combining these major exposures is a recession which could start as early as now, with a peak-to-trough decline of a little more than two percentage points in real GNP. Such a scenario raises the unemployment rate to 9% by the end of next year and especially worsens the cyclically-sensitive sectors of the economy and the budget deficit.

IBM ECONOMIC FORECAST HIGHLIGHTS

	1984	1985		1986	
	ACTUAL	BASE CASE	RISK CASE	BASE CASE	RISK CASE
FOURTH QUARTER OVER FOURTH QUARTER:					
(Percent Change)					
GNP - Current Dollars	9.5	6.9	2.9	6.6	6.6
- in 1972 Dollars	5.7	2.8	-1.2	2.7	3.2
GNP Deflator	3.6	4.0	4.2	3.8	3.3
CPI	4.1	4.1	4.2	4.2	3.7
(Rate)					
Civilian Unemployment (fourth quarter)	7.2	7.2	8.0	7.3	8.9
CALENDAR YEAR:					
(Percent Change)					
GNP - Current Dollars	10.8	6.9	5.4	7.0	4.0
- in 1972 Dollars	6.8	2.9	1.5	3.1	0.3
GNP Deflator	3.8	3.9	3.9	3.8	3.7
CPI	4.3	3.8	3.9	4.4	4.1
(Rate)					
(Levels)					
Civilian Unemployment	7.5	7.3	7.6	7.3	8.8
Disposable Personal Income	10.1	6.7	5.7	6.8	4.1
Corp. Cash Flow	15.2	7.2	3.8	6.5	5.9
3-Month Treas. Bill Rate	9.5	7.6	7.7	7.2	6.8
Federal Budget Balance Unified, FY (Billion $)	-185	-223	-226	-203	-248
Current Account Balance (Billion $)	-102	-115	-120	-123	-136

Let me turn now to some policy issues. With regard to the federal budget, we are clearly not growing our way out of the deficit. Continued large deficits will persist unless more painful steps are taken on both the expenditure and revenue fronts. Implementing some mixture of the outstanding budget resolutions, while definitely helpful, will, I'm afraid, fall short of what is needed.

Of course, there are some analysts who doubt that continuing large budget deficits constitute much of a problem. They point out that this fiscal situation has not prevented interest rates from declining appreciably over the past year. Also they stress that the fiscal stimulus has bolstered economic activity and that by strengthening the dollar the large deficits have lessened inflation in this country.

While I would grant much of the above, I believe that, all things considered, the persistent large negative budget balance is a major problem that must be addressed. And I am hopeful that the majority of those in the Congress and the Administration feel the same way.

The recent decline in interest rates seems primarily to reflect a distinct slowing in the pace of the business expansion and a moderate Federal Reserve response to that development. Nevertheless, rates remain high by historical standards, especially when expressed in real terms. As the expansion matures, rising private demands for funds in the context of huge Treasury financing requirements could produce upward pressure on rates, with especially harmful effects on such interest-sensitive activities as homebuilding, consumption of durables and capital spending. A reversal of the flow of foreign capital into the United States could potentially have a similar effect.

Relatively high interest rates have helped induce inflows from abroad, strengthening the dollar, which in turn has hurt export- and import-competitive firms. They have contributed to the plight of debtor nations and the vulnerability of financial institutions. Also, European economic activity has been constrained by tighter-than-desired credit conditions maintained to limit capital flight to the U.S.

To promote a more balanced and sustained expansion, I, along with most economists, want to see less fiscal stimulus; this should foster easier credit conditions which would lessen the dependence on international capital flows. The budget deficit must be properly addressed. Spending restraint is clearly needed and in the defense sector I am disposed toward some reduction in new budget authority; the ratio of unspent budget authority at the beginning of the year to defense outlays has steadily increased from 60% to 84% over the last four years.

As unpleasant as it may be, Congress must recognize that the enacted spending cutbacks will probably not be sufficient, and that taxes will have to be raised. I personally would urge that deficit containment actions be instituted reasonably quickly.

You know that if you do not act quickly and if the economy should in the meantime slip into a recession, fiscal restraint will not be feasible and the long-term deficit problem will be greatly intensified.

In the current environment, I see no reason for any significant shift in monetary policy. Our fiscal issues must be addressed first. With the imposition of substantial deficit reduction measures, I would expect the financial markets to respond favorably. Should the economy weaken substantially, I would expect that the monetary authorities -- as they have in the past year -- will act to bolster business activity.

Chairman FAUNTROY. Thank you, Mrs. Teeters. We will have questions for you, of course, but we are going to hear the entire panel first, however.

Dr. Sinai.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST, SHEARSON LEHMAN BROTHERS, NEW YORK, NY

Mr. SINAI. Thank you, Mr. Chairman.

I want to pose some questions and, rather than go through the written statement, deal with them mainly by looking at the tables and materials in the appendix to the statement. The questions are along the lines of your inquiry in the letter having to do with, first the economic outlook at this time, second, whether the economy can rebound sufficiently from the declines of interest rates and the dollar that have happened so far this year to permit sufficient growth to satisfy the Federal Reserve and to give us an acceptable growth rate through 1986, third, how the so-called twin deficits—both budget and trade—are constraining monetary policy, fourth, some matters having to do with the recent testimony and statement of the Federal Reserve, and finally, fifth, the constraint that budget deficits and international matters now place on the financial authority.

Dealing first with the economic outlook, and looking at the same time at the Central Bank's new expectations on growth—this is done in table 1 in the appendix—we see that for 1985 the Federal Reserve has scaled back its own projections—the ones made in February—and is now expecting 2¼ to 3 percent growth as a central tendency for real GNP within a wider range of forecasts by members of the FOMC and several Federal Reserve presidents, from 2¼ to 3¼ percent. In February, the Central Bank expected something on the order of 3½- to 4-percent growth. Now the expectation is that the unemployment rate will not change much from what it is until the fourth quarter, and will range from 7 to 7¼ percent. Previously, the Central Bank had expected the unemployment rate to decline.

Our own forecasts are considerably more pessimistic than the Federal Reserve's and I think indicate a need for further easing by the Federal Reserve. We see the trade and manufacturing sectors as very weak, because the lags of response in our imports and exports to declining interest rates and the declining dollar are long; most research would indicate at least 6 months after good-sized declines in the dollar before you have any reversal. We also do not see signs in the manufacturing sector—those clients we talk to—of any improvement of any consequence so far.

The GNP data today tend to bear out this perception in that there was another $5 billion decline in our net export position; that is about a percentage point or more on real economic growth. Since the beginning of the U.S. economic expansion—we have lost $57 billion in real terms out of net exports. It is now costing us 2 or 3 percentage points a quarter in our growth to have this kind of weakness in the trade sector. It is for that reason and an expectation that consumer spending at the pace of the first half is unsustainable, that makes us relatively pessimistic about the second

half. Or, I should say, we expect growth to continue in the second half but rather slowly. For the Federal Reserve to reach their expectations, the expectations reported yesterday for the year in table 2 give you some idea of the kind of growth rates in the second half that will be required.

Table 2 was prepared before today's announcement on GNP and so our assumption—we were a little high—was 2.5 percent real GNP growth; the actual figure was 1.7 percent. Thus the growth we need in the second half to get to a 2¾- to 3-percent range for the year—the Federal Reserve expectation and hope—is at least 4 percent in the second half. A range of 4 to 5 percent is necessary to reach the lower bound of the central tendency of the Federal Reserve projection. It is going to be very hard to do given the situation and the economy today. I think the Federal Reserve is going to be disappointed in their expectations. My own view would be that the Central Bank is going to have to ease some more and probably the sooner the better.

But the kind of complex factors that are determining Federal Reserve policy will make it difficult for the Central Bank to do anything but move cautiously. The Central Bank is in an almost no-win situation with regard to the impacts of Federal budget deficits as it works through interest rates, the dollar, trade deficits, and the fallout on manufacturing, which is the major reason for slow growth in the economy.

The bright spot in lower interest rates, the lower dollar, and the slow growth that is occurring—is that with some luck it actually makes the outlook for 1986 look better. Lower interest rates already have induced some response in the housing and construction areas of the economy this year. Consumer spending has also been strong in the first 4 or 5 months of the year, especially in autos, which is interest rate sensitive. But in the kind of economy we now have today, lower interest rates alone, given the large Federal budget deficits in prospect, will not give us enough of a response to return growth to a steady rate of 3 or 4 percent. The dollar also has to decline further in order to reverse the trade deficits and the problems in the goods-producing sectors of the economy that stem from that trade deficit.

I think the figure on the second quarter is quite clear that we clearly have had—by standard definitions—a growth recession. More technically, the first half of 1985 will surely qualify as a growth recession—two quarters of below potential real economic growth. The only interruption in the quarters of below potential real economy growth was the fourth quarter of last year—where we had a 4.2-percent growth rate.

Why and how has all of this arisen and where does it lead us. I put a large portion of the blame for the sluggish growth in the economy at the feet of the huge Federal budget deficit; it is a very stimulative Federal budget policy that has been run in the past and the effects that it has had, including the necessity of the Central Bank running a relatively tight monetary policy. The phrase for this is something called policy mix which really refers to the stance of both fiscal and monetary policy at the same time. The policy mix in our history has not been studied that much because usually we run the same mix of policy. We will run an easy mone-

tary and an easy fiscal policy to stimulate the economy, or a tight monetary policy and sometimes tight fiscal policy to slow it down. But in the last 3 or 4 years we have been running a very stimulative budget and a nonaccommodative monetary growth targeting policy which has raised nominal and real interest rates to extraordinary levels which, in turn, has tended to attract funds to the United States strengthening the dollar. A strong dollar has surprising effects in lowering our inflation rate. Our low inflation rates have tended to keep real interest rates high. The high rates—real returns on dollar denominated investments—have kept the dollar strong. The strong dollar has kept inflation low, and so forth.

Out of that process comes increasingly weaker exports and a larger volume of imports as our exports get more and more expensive relative to foreign goods and our imports get less and less expensive relative to other countries' goods. All of this has showed up in the data very clearly, both with respect to the dollar and our trade debt, and also in the composition of economic activity in this country. If you look at the data on goods-producing sectors versus the services sectors—goods-producing where we employ about 25 percent of our people—you see a clear-cut recession; 6 months of declines in manufacturing employment and my guess is that with today's industrial production number, 3 months of declines in industrial production and manufacturing. If you were on the business cycle committee of the National Bureau of Economic Research and you looked at the goods side of the economy—in particular manufacturing, mining, and agriculture, that part of the economy—you would call it in a recession by the standards that the National Bureau uses.

On the other side, the services side, we have had good growth. Thus so I think we have slow, sluggish growth, because you have essentially a weighted average of a strong services sector, a weak manufacturing sector, and that is giving us this growth recession.

But it is the fallout from the impacts of the Federal budget deficit on interest rates, the dollar, and on the trade balance, that have created the current situations. And there is no end in sight to this process.

What goes on if there is no change in the Federal budget deficit, that is to say, if there is no major reduction in the deficit either through spending or tax means? What follows on the heels of the slow growth is a natural decline in short-term interest rates; a decline in the dollar; fears that the dollar will bring reinflation, reversing what happened in the past; and a self-cumulating feedback effect on the dollar which would keep it declining. Now, unfortunately, it takes a long time before a decline in the dollar can turn trade and manufacturing around to relieve the process, and that is where we are today—with the dollar down sharply over the last few months, the economy in a growth recession, inflation rates still low but under some pressure because of the declining dollar, and the Federal Reserve in a situation of having very difficult choices in terms of what it does.

Now, the Federal Reserve faced a major dilemma in its policymaking at its current meeting and that was super-rapid monetary growth in a world in which we have very slow economic growth. I think the Federal Reserve did the right thing to diminish the

weight of M1 in its deliberations and to rebase and reset the targets for M1.

There are two reasons for the rapid M1 growth: First, M1 now attracts funds because the interest rates on components of M1 are more competitive with other money market rates given that interest rates have fallen. Second, and something not noted in the Federal Reserve report—M1 growth is strong because we are buying not only domestic goods but foreign goods and you need to transact both types of goods with domestic money. But the imports that we buy with components of M1 do not show up as a positive in real GNP. So there is rapid growth in M1 but not very rapid growth in real GNP. In addition, the strong dollar has lowered our inflation rate considerably and that breaks the relationship between money growth, real GNP, and inflation as well. As a result, M1 is just not reliable as an indicator for monetary policy. The Fed has absolutely done the right thing in changing the target range and shifting the weights of focus on other matters.

I feel less sanguine about the large number of other matters that the Federal Reserve has decided to wait and watch in its deliberations. Virtually everything that has any impact, four of five factors now, are determinants of Fed policy. And, there is almost no way that all of those factors will give the Federal Reserve a clear indication of what to do and what direction to move monetary policy. For example, monetary growth is still one of the factors watched; it is exploding. The Federal Reserve cannot ease on the monetary growth factor. Real economic growth is very weak; we are in a growth recession. The Fed could ease on that information. Inflation rates are low. The Fed could ease on that information. But the dollar is sliding. The Federal Reserve cannot ease on that information because if it were to do so, the dollar might slide further and raise the problem of inflation later. I think this means that the Federal Reserve is hamstrung; it is caught; it is not going to be able to move much in one direction or another. All of this assumes that we still have the large budget deficits.

Now, a way out—which unfortunately stands at an impasse in the Congress now—is, at the least, for the House and the Senate to come to agreement and write a concurrent budget resolution on a package of spending cuts that is somewhere in between what each of the branches of Congress originally put forth. I think this is the greatest danger now to the outlook, both in the financial markets and to the possibility of sustaining growth in the future. If the budget process breaks down and they go to an item-by-item appropriations process, we estimate we will only get about 50 percent of the savings that are indicated. That will not be enough. And, the forces that have given rise to the imbalances and sluggish growth in the economy will prevent us from sustaining growth through 1986.

What should be done? Somebody should make sure the Congressmen get back together and that they write a concurrent resolution and do that quickly. They really are playing with fire on this matter and it is most unfortunate that the process has broken down. Unless there is a budget fix, the same factors existing now will persist. In our own forecast—summarized in the table—we have assumed that there is a significant budget tightening, param-

eters of which are somewhere between where the House and Senate started, and that in response over time the Federal Reserve will be more accommodative. That is a key pillar of our belief that we can keep growing through the rest of this year and have a greater growth rate next year. If it does not happen, we would have to reevaluate and, at the moment it is a big risk for the economy.

Out of this process of big budget deficits and the flowthrough effect on interest rates, the dollar, and trade deficits, has come a new dimension for the Central Bank—and you asked about this, Mr. Chairman, the international constraint. It is now a key element, I think, of monetary policy, as revealed in the statement of the Federal Reserve and the testimony of Chairman Volcker. The dollar now and its impact on trade and the manufacturing sector looks to me to be at least as important as M1 and maybe M2 and M3 in the making of monetary policy. For sure, growth is the most important factor that now drives the Federal Reserve. I think I, and many other economists, feel that targeting the growth of nominal GNP is actually a superior way to run monetary policy than targeting the growth of the monetary aggregates. We will get better results that way.

So, I would applaud putting primary weight on growth of the economy as the force behind the making of monetary policy, and I think the Federal Reserve has done it. But for sure the international constraint—particularly the dollar—will now loom in this very open U.S. economy with flexible exchange rates as one of the three or four key elements in the making of monetary policy and that means the issue of policy mix and what we do about our Federal budget deficits is more critical than ever before.

Chairman FAUNTROY. I thank the gentleman and without objection, your entire statement will be included in the record.

[The prepared statement of Mr. Sinai follows:]

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Monetary Policy at a Crossroads

by Allen Sinai
Chief Economist

Statement prepared for the Domestic Monetary Policy Subcommittee, House Committee on Banking, Finance and Urban Affairs, Hearings on the Midyear Humphrey-Hawkins Testimony of the Monetary Authority, July 18, 1985, Washington, D.C.

Monetary Policy at a Crossroads

by Allen Sinai

In mid-1985, monetary policy appears to be at a crossroads. Changing patterns in the relationship between money growth and the economy, a lopsidedness in economic performance, subdued rates of inflation, an overvalued dollar, a record weakness in foreign trade, depressed goods production, and a continuing impasse over the fiscal year 1986 budget present the Federal Reserve with a number of difficult choices. Indeed, the factors affecting monetary policy may be such that the central bank could be in a no-win situation, especially if there is no significant tightening of the budget.

- What is the economic outlook at midyear? Slower growth than was expected by the central bank earlier this year and a recession in U.S. goods production and manufacturing suggest the need for an easier monetary policy. But near- or above-target growth in the monetary aggregates – especially for M1 even after a rebasing and resetting of its 1985 target range – indicates a tightening.

- Will the economy rebound adequately from the declines of interest rates and the dollar so far this year to bring about the economic growth expected by the central bank?

- What is the role of the "twin deficits" – budget and trade – in the performance of the economy, and are the continuing large federal budget deficits narrowing the Federal Reserve's options so that no way out exists for the monetary authority to sustain growth over the longer run?

- Did the Federal Reserve do the right thing in rebasing and resetting the M1 targets for the rest of this year?

- Are too many factors now being considered in the making of monetary policy, in effect tying the hands of the central bank?

- How much of a risk do continuing large budget deficits and the recent slide in the dollar pose for the Federal Reserve in reviving growth and reducing unemployment while, at the same time, sustaining a less inflationary environment?

- How much of a constraint is international trade and finance now on U.S. policy?

In summary:

- The U.S. economy is growing anemically, weakened by depressed manufacturing, mining, and agricultural sectors that show no real signs of a turnaround. The current Shearson Lehman forecast shows only a 2.1% rise in real GNP for 1985, fourth quarter-to-fourth quarter – well below Administration goals and the latest expectations of the Federal Reserve.

- The economy is essentially in a growth recession, with average growth in the first half at only about 1½% and in the second half expected to be near 2½%. The main cause is weak trade, with a growing trade deficit and weak goods production offsetting the positive thrust from rising consumption, residential construction, business fixed investment, and government spending. No full-blown recession is likely, however, with the services side of the economy staying robust and some response in economic activity from lower interest rates and the recent weaker dollar.

- A positive effect of the current slowdown has been declines in interest rates and a fall in the dollar. But interest rates and the dollar have not yet fallen enough to reverse the weak momentum of the econ-

omy. Indeed, with the earlier promising progress on the budget now at risk because of the breakdown in Congressional talks, the factors that created the current weakness in the economy could intensify. Monetary policy would then be in an even more difficult position than now, caught between easing to promote growth and a need for tightening to prevent inflation from a lower dollar. The fallout on trade and manufacturing would continue, eventually leading to a growing threat of reinflation and a major collapse of the dollar. The hands of the central bank would be tied – much as is the case now – with the end result another period of stagflation, although less severe than the late 1970s.

- Continuing large budget deficits and the dollar pose great risks to the potential for sustained growth, a gradual reduction in unemployment, and continuing progress in keeping inflation rates low. Huge federal budget deficits, in the context of a monetary growth targeting policy, have been most responsible for the extraordinary levels of nominal and real interest rates that have occurred, the superstrong dollar, the rising trade deficits and trade debt, and much of the imbalances in goods and services activities that has arisen. A significant tightening of the budget – somewhere between the House and Senate versions of the budget currently being discussed in the Congress – would relieve pressure on interest rates and provide more leeway for the central bank to ease. The additional growth that might be induced by further relaxations in monetary policy would tend to prevent any dollar collapse and dollar-related reinflation. Without a compromise on the budget, however, the same forces would exist as previously to push interest rates higher, firm the dollar, and weaken trade. A related danger is protectionist measures that would be counterproductive for the world economy. Eventually, the failure to reduce the huge federal budget deficits in prospect would bring a free-fall in the dollar.

- The Federal Reserve made the right choice in rebasing and resetting the M1 targets for the rest of this year, essentially forgiving the bulge in money in the first half of the year. The relationship between M1 growth and nominal GNP, real GNP, and inflation is broken now, given the higher interest rates that are allowed for the deposit components of the narrow money stock and the unusual weakness in trade and manufacturing. M1 velocity growth is likely to remain below trend so long as deregulation permits interest rates to be paid on components of M1 that are competitive with other money market instruments. Also, with so great a siphoning of purchases abroad, transactions balances can grow rapidly without a corresponding rise in real GNP and inflation. The central bank apparently has learned its lesson, recalling episodes in 1982 and 1983 when slavish adherence to monetary growth targets resulted in a tighter monetary policy than was necessary.

- Probably the central bank is now considering too many factors in the making of monetary policy. These include the behavior of money and credit, the pace of real growth, inflation, the dollar, problems in financial institutions, and the weakness in manufacturing. It is unlikely that all these factors could provide an unambiguous signal to ease or tighten monetary policy at any given time. As a result, the central bank will have to move cautiously – perhaps too much so.

- The effect of international trade and finance on U.S. macroeconomic policy is great now, given the policy mix in place, a more open U.S. economy, and flexible exchange rates. The dollar and its fallout on U.S. goods producers has become at least as important to monetary policy as some of the monetary aggregates. In a showdown between growth and a declining dollar, the central bank certainly would ease to sustain growth. But the weak dollar that is accompanying slow growth prevents the Federal Reserve from easing as much as otherwise might be the case, given the potential rise of inflation that is a consequence of a declining dollar.

The monetary authority is operating under more constraints than usual, such as huge federal budget deficits, a sliding dollar, and the effects of international trade and finance on the goods sectors of the U.S. economy. The central bank is "between a rock and a hard place," since any further easing might lower the

dollar and be inflationary. But, without additional ease, the recession in the U.S. goods-producing sectors may worsen. Any tightening because of renewed growth or a possible reinflation would strengthen the dollar and would worsen the recession in manufacturing.

It is absolutely essential that the Congress proceed with a budget reconciliation, even if some savings are lost in the process. Should the deficit reduction discussions break down and the appropriations route be taken, the resulting loss in budget savings and the uncertainty surrounding the deficits could be disastrous for the financial markets and could exacerbate the downturn in the tradeable goods sectors. The House-Senate conferees are playing with fire and should try to reach quickly an agreement that preserves the bulk of the savings recommended by the Senate.

During the second half, the economy is unlikely to rebound enough to reduce unemployment, making very likely the need for some further easing by the central bank. The Federal Reserve should ease at least another notch to get both interest rates and the dollar down enough to stop the decline in trade and manufacturing. But the prospects of large deficits, too rapid monetary growth, and the current slide in the dollar make such an easing difficult and could even prevent it.

Foreign currency traders will not support the dollar forever under current conditions and prospects. At some point, momentum takes over when an expected depreciation of the dollar is factored into various foreign currency portfolio decisions. At that point, slow growth in the U.S. economy, lower interest rates, and expectations of a further decline in the dollar could cause a sharp decline in the domestic currency, preventing interest rates from falling further at a time when reductions might be needed.

Since the deficits – both federal and trade – interest rates, and the dollar are so intertwined, the solution of choice is to cut the federal budget deficit before it is too late.

The Economic Outlook

Table 1 shows the economic projections, by the Federal Reserve and by Shearson Lehman Brothers Economics, for growth, inflation, and unemployment.

Table 1
Economic Projections for 1985 and 1986
Federal Reserve vs. Shearson Lehman Brothers

	Federal Reserve*		Shearson
	Range	Central Tendency	Lehman**
		1985	
Percent change, fourth quarter to fourth quarter			
Nominal GNP	6 1/4 to 7 3/4	6 1/2 to 7	6.2
Real GNP	2 1/4 to 3 1/4	2 3/4 to 3	2.1
Implicit deflator for GNP	3 1/2 to 4 1/4	3 3/4 to 4	4.0
Average level in the fourth quarter, percent			
Unemployment rate	6 3/4 to 7 1/4	7 to 7 1/4	7 1/2
		1986	
Percent change, fourth quarter to fourth quarter			
Nominal GNP	5 1/2 to 8 1/2	7 to 7 1/2	7.2
Real GNP	2 to 4	2 1/2 to 3 1/4	2.6
Implicit deflator for GNP	3 to 5 1/2	3 3/4 to 4 3/4	4.5
Average level in the fourth quarter, percent			
Unemployment rate	6 3/4 to 7 1/2	6 3/4 to 7 1/4	7.1

* *Federal Reserve Board, "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978," July 16, 1985, p. 9*
** *Shearson Lehman Economics, July 17, 1985*

For 1985, the Federal Reserve has scaled back its projections of growth made in February, and is now expecting a 2¾% to 3% rise in real GNP as a "central tendency" within a possible range of 2¼% to 3¼%. The February expectation was 3½% to 4%. The unemployment rate would be essentially unchanged by the fourth quarter – at 7% to 7¼%. Previously, a 6¾% to 7% range had been indicated.

Table 2 shows the second half growth necessary to attain the various year-over-year possibilities in the Federal Reserve's range, assuming about a 2½% rise in real GNP for the second quarter. A substantial upturn in real growth is required – 4% plus to attain the central tendency of 2¾% to 3% – a difficult task. If second quarter real growth is less, an even greater rebound will be necessary in the second half.

Table 2
Possible Growth Rate for Second Half Real GNP

	1985:1	1985:2	1985:3	1985:4
I.				
Real GNP	1663.5	1674.0	1687.3	1700.5
Percent Change	0.3	2.5	3.2	3.2
Percent Change Year Ago				2.3
II.				
Real GNP	1663.5	1674.0	1690.6	1707.2
Percent Change	0.3	2.5	4.0	4.0
Percent Change Year Ago				2.7
III.				
Real GNP	1663.5	1674.0	1693.0	1712.2
Percent Change	0.3	2.5	4.6	4.6
Percent Change Year Ago				3.0
IV.				
Real GNP	1663.5	1674.0	1695.6	1717.2
Percent Change	0.3	2.5	5.3	5.3
Percent Change Year Ago				3.3

The Shearson Lehman Brothers forecast, summarized more fully in Table 3 and the accompanying assumptions, is much less sanguine on growth and employment. Real economic growth averaging 4% is very unlikely in the second half, and the unemployment rate could move higher rather than decline.

A continuation of the up-and-down pattern for real economic growth – in place since the second quarter of 1984 – is expected, stemming from a fading of consumer spending during the second half and a further worsening in trade and manufacturing activity. As a result, only an average 2½% rate of growth is indicated. The slow growth is expected to have a positive aspect, however, permitting sustained low inflation rates, lower interest rates, and a weaker dollar. With lags, the economy should benefit in 1986, growing at a greater 2½% to 3% rate, fourth quarter-to-fourth quarter.

Although trade and manufacturing are in a recession, the "services" side of the U.S. economy should remain strong. Services activities – defined as wholesale trade; retail trade; transportation and public utilities; government; finance, insurance, and real estate; and services (business services, health services) – comprise about 75% of total nonfarm payroll employment. Goods employment is about 25% of the total. With so big a chunk of the U.S. economy growing robustly, it is unlikely that the weakness in trade and manufacturing could drag the overall economy into a full-blown recession. There is some spillover effect from the weak manufacturing sector to other areas of the economy (for example, weakness in high tech and related services because of a decline in domestic capital goods spending). But services jobs are required no matter whose products are purchased. Servicing, marketing, and distribution activities must take place. So far this year, growth in nonfarm payroll employment has been a robust 1.4 million persons, with more than enough jobs created in services to offset those lost in

manufacturing. The more likely effect of the recession in manufacturing, mining, and agriculture is slow growth – the product of a kind of weighted average of strong services and weak goods activities.

Following the second quarter, economic growth should remain moderate, principally from a slowdown in consumer spending and a further deterioration in the trade balance.

Consumer spending, which has been a major driving force for the economy so far this year, is expected to slow from a 5.4% rate of growth in the second quarter to a 2.6% pace in the third quarter. Less growth in real income, an increasingly burdensome debt load, and an end to the accelerated tax refunds all indicate weaker consumption. Auto sales were down in June and early July, and consumer sentiment has been somewhat weaker over the past two months. Business fixed investment is projected to rise at only a 4% rate, with a considerable siphoning of capital goods spending abroad. The pace of federal government spending should slow to a 2.1% rate, compared with 8.6% in the second quarter.

Housing and construction should maintain a strong performance, given the lower interest rates of the last nine months. But, given that housing purchases are now more a shelter decision than an investment, any rises will be less than previously in response to the sizable declines of interest rates that have occurred. A small inventory build-up for manufacturing and trade is forecast – the result of reduced consumption and increased production.

Foreign trade – so far a big negative in U.S. economic growth – is expected to take another turn for the worse, moving from a net position of -$31 billion in the second quarter to -$36 billion in the third.

Beyond the third quarter, the lower profile of interest rates and a weaker dollar should begin to take hold and should arrest the downturn in trade and U.S. manufacturing. Though still negative, improvements in net exports are expected to contribute positively to real growth from the fourth quarter forward.

Fourth quarter growth is forecast at a 3.3% rate – the result of a positive swing in the trade balance and solid growth in the government and consumer sectors. The improvement in trade stems from the lagged effects on imports of slow U.S. economic growth and the weaker dollar. Real net exports move from -$35.8 billion in 1985:3 to -$22.6 billion during 1986:2, for a $13.2 billion positive contribution to real GNP over the period. Apart from the trade sector, other areas of the economy grow at modest rates – in a range of 2% to 3½%, producing an overall pace of growth for the economy of between 2½% to 3%, measured from the fourth quarter of 1984 to the fourth quarter of 1985 – a better performance than in 1985.

The rate of inflation is expected to remain subdued; indeed, less than the average 4% expected by the Federal Reserve. The Producers' Price Index is forecast to rise 1½%, the CPI-U is up 3.6%, and the implicit GNP deflator is up 3.8% – all equal to or less than the inflation of 1984. Such decelerating inflation in the third year of expansion is unusual.

Some upward tilt on inflation and interest rates is projected for late this year and in 1986, as a consequence of renewed growth and a weaker dollar. Dollar weakness is the main reason for higher inflation and higher interest rates through much of 1986.

A key assumption is that fiscal and monetary policies move toward a tighter budget and more accommodative monetary policy, twisting away from the previously loose fiscal-tight money policy mix. The implications of such a policy twist are a lower profile of interest rates, higher equity prices, and a weaker dollar – all likely to help in sustaining economic growth. These parameters already have appeared in the aftermath of the euphoria on budget matters during May.

Table 3
Shearson Lehman Economic and Financial Markets Forecast
July 17, 1986
(Probability=0.65)
Preliminary

	Quarters						Years				
	1985:1	1985:2	1985:3	1985:4	1986:1	1986:2	1984	1985	1986	1987	1988
Gross National Product-1972 Dollars	1663.5	1674.0	1683.1	1696.8	1713.4	1727.3	1639.3	1679.4	1729.3	1786.8	1859.4
Annual Rate of Change	0.3	2.5	2.2	3.3	4.0	3.3	6.8	2.4	3.0	3.3	4.1
Percent Change Year Ago	3.3	2.1	2.3	2.1	3.0	3.2	5.7	2.1	2.6	4.2	3.8
Consumption	1089.1	1103.6	1110.8	1117.7	1126.4	1131.8	1062.4	1105.3	1133.0	1172.4	1215.5
Annual Rate of Change	5.2	5.4	2.6	2.6	3.2	1.9	5.3	4.0	2.5	3.5	3.7
Business Fixed Investment	213.0	215.4	217.3	219.2	220.1	222.7	204.9	216.2	224.1	233.5	247.9
Annual Rate of Change	-1.6	4.6	3.6	3.5	1.7	4.8	19.8	5.5	3.7	4.2	6.2
Residential Construction	60.0	61.5	62.3	62.9	63.2	62.6	60.2	61.7	62.8	64.7	67.8
Inventory Investment	19.1	10.6	13.1	13.0	11.5	10.5	24.8	14.0	9.1	6.9	10.1
Net Exports	-28.4	-31.0	-35.8	-32.6	-28.0	-22.6	-15.0	-32.0	-22.0	-17.4	-12.4
Government-											
Federal	129.8	132.5	133.2	133.7	136.8	138.1	122.5	132.3	137.4	138.9	140.1
Annual Rate of Change	0.6	8.6	2.1	1.5	9.6	3.9	5.4	8.0	3.8	1.1	0.9
State and Local	180.9	181.4	182.2	182.9	183.4	184.2	179.6	181.9	184.9	187.9	190.4
Annual Rate of Change	0.0	1.1	1.8	1.5	1.1	1.8	2.2	1.3	1.6	1.6	1.3
Industrial Production (1967=1.000)	1.655	1.654	1.660	1.673	1.693	1.716	1.633	1.661	1.720	1.798	1.895
Annual Rate of Change	2.0	-0.2	1.5	3.2	4.9	5.5	10.7	1.7	3.6	4.5	5.4
Housing Starts (Mil. Units)	1.796	1.770	1.808	1.795	1.783	1.765	1.764	1.792	1.778	1.820	1.906
Auto Sales-Total (Mil. Units)	10.8	10.9	10.6	10.5	10.5	10.6	10.4	10.7	10.5	10.9	11.1
Unemployment Rate-Civilian (%)	7.3	7.3	7.4	7.5	7.4	7.3	7.5	7.4	7.2	7.0	6.8
Federal Budget Surplus											
Unified (Quarterly Rate, NSA, FY)	-58.8	-30.8	-42.2	-53.4	-64.9	-34.6	-185.3	-203.3	-192.5	-185.3	-155.0
Implicit Price Deflator (%CH)	5.4	3.3	3.5	3.9	4.0	4.2	3.8	3.9	4.2	4.9	5.3
CPI- All Urban (%CH)	3.3	3.9	3.8	4.0	4.0	4.4	4.3	3.6	3.9	4.9	5.1
PPI-Finished Goods (%CH)	0.9	2.2	3.2	3.6	3.8	3.9	2.1	1.4	3.4	5.5	5.1
Trade Weighted Exchange Rate	1.351	1.313	1.261	1.248	1.239	1.217	1.223	1.293	1.185	1.129	1.139
Annual Rate of Change	23.3	-10.8	-14.9	-4.1	-2.9	-6.9	7.1	5.8	-8.4	-4.8	0.9
Corporate Profits Aftertax (Bils. $)	137.6	142.5	143.6	146.7	149.5	152.9	145.9	142.5	153.0	164.9	180.2
Percent Change Year Ago	-9.0	-5.1	1.3	4.0	9.1	7.3	14.5	-2.3	7.4	7.8	9.3
Adjusted Profits Aftertax (Bil. $)	207.0	214.9	218.0	223.1	227.9	233.3	195.9	215.8	236.7	266.3	295.6
Percent Change Year Ago	12.1	10.1	9.1	9.4	10.1	8.6	31.1	10.1	9.7	12.1	11.4
Real Disposable Income	1181.9	1209.0	1216.2	1225.0	1232.8	1242.8	1169.0	1208.0	1245.6	1289.5	1345.7
Annual Rate of Change	-1.6	9.5	2.4	2.9	2.6	3.3	6.7	3.3	3.1	3.5	4.4
Personal Saving Rate (%)	4.7	5.3	5.4	5.5	5.3	5.6	6.1	5.2	5.7	5.8	6.5
M1 (Bils. $)	568.1	582.5	596.8	605.7	614.9	626.1	553.5	605.7	644.5	682.7	731.7
Annual Rate of Change	11.0	10.5	10.2	6.1	6.2	7.5	5.2	9.4	6.4	5.9	7.2
M2 (Bils. $)	2416.4	2448.4	2515.9	2563.6	2610.3	2661.0	2346.8	2563.6	2762.7	2949.1	3175.5
Annual Rate of Change	12.6	5.4	11.5	7.8	7.5	8.0	7.7	9.3	7.8	6.7	7.7
Federal Funds Rate (%)	8.48	7.92	7.15	7.30	7.45	7.75	10.23	7.71	7.71	7.71	8.24
Prime Rate (%)	10.54	10.20	9.30	9.00	9.28	9.57	12.04	9.76	9.77	10.22	10.82
New Top Quality Corporate Bonds (%)	11.97	11.78	10.85	10.58	11.12	11.32	12.44	11.30	11.29	11.45	11.52
30-Year Treasury Bond Rate (%)	11.58	10.99	10.12	10.05	10.40	10.60	12.39	10.69	10.60	10.86	11.11
Bond Buyer Index (%)	9.63	9.02	8.64	8.48	8.62	8.79	10.09	8.94	8.80	8.95	9.06
S&P Index of 500 Common Stocks	177.31	184.80	196.25	197.22	199.71	201.26	160.43	188.65	204.04	217.30	232.70
Annual Rate of Change	33.2	18.0	24.6	4.1	5.1	3.1	.0	17.6	8.2	6.5	7.1
Earnings Per Share - S&P 500 ($)	3.91	4.24	4.12	4.54	4.14	4.46	16.60	16.81	17.67	18.67	19.92
Price-Earnings Ratio - S&P 500	11.3	10.9	11.8	10.9	12.1	11.3	9.5	11.2	11.6	11.7	11.7

Forecast Assumptions:

Fiscal policy: The House-Senate conference on the budget resolution is assumed to eventually settle on a budget package before the August recess. The reported savings are $50 billion or more in 1986, with a FY1988 deficit of about $115 billion. The reported savings are overstated and deficits understated,however, because the Senate and the House are using too high a baseline for defense and economic assumptions that are overly optimistic. After correction for saving overestimates, the package is estimated to be worth about $130 billion in FY1986 and a cumulative $190 billion to $195 billion for fiscal years 1986 to 1988. Under the Shearson Lehman interest rate and real GNP forecasts, the deficits actually resulting from the conference on the resolution are then projected at $192 billion, $185 billion, and $155 billion for fiscal years 1986 to 1988.

Monetary policy: Accommodative to slightly easier through much of the rest of this year, with growth in the economy sluggish, monetary growth decelerating to within target ranges later, and subdued rates of inflation. The rapid growth in M1 has been finessed by reducing its weight in Fed deliberations, rebasing and resetting the M1 target limits. This makes clear the central bank's concern with sustaining the expansion and suggests that more attention will be paid to economic growth, inflation, and the dollar in the making of monetary policy.

Policy mix: A modest and gradual change in the "loose fiscal-tight money" policy mix that has characterized the economy is assumed to take place over the balance of this year – not enough to fully resolve the deficit dilemma and the imbalances that exist in trade, manufacturing, and the financial markets because of the policy mix, but sufficient to prevent any major sustained upward pressure on interest rates. The reductions in spending eventually embodied in the FY1986 budget and the somewhat more accommodative stance of the Federal Reserve constitute the third twist in the policy mix over the last four years and suggest a lower profile of interest rates, a weaker dollar, and a better equity market than otherwise would be the case.

Oil prices: As measured by refiners' acquisition costs, oil prices are assumed to drop $1 to $1.50 a barrel over the summer. A $1.50 to $2 drop in heavy crude and a smaller reduction in light crude oil are aimed at realigning price differentials. OPEC oil production continues to decline for a short time longer, then stabilizes with newly enforced production quotas for each member. The limits on production hold better because the situation is "do or die" for the OPEC cartel.

Wages and unit labor costs: In general, downward pressure on wages from deregulation, competition, and the decline in union strength persists. Contract negotiations are scheduled to go on through September. While these negotiations will be slightly more favorable to labor this year and next, a tough stance by management is assumed to keep labor cost increases modest – about 3% per annum in 1985 and 1986.

Third World debt and bank problems: The recent decline in interest rates greatly relieves debt-burdened third world nations. In addition, import restraints and increased exports help boost growth. U.S. bank failures at the regional level continue at a high rate, but the major money center banks are assumed to remain solvent. High reserves in the banking system and an accommodative monetary policy assure no liquidity crunch.

Growth in the rest-of-the-world economies: In 1985, similar or lower growth compared with 1984, as most western industrialized countries reach a growth plateau. Exports to the United States will continue to be strong and boost economic growth for the U.S. trading partners; unemployment will remain a major problem for most countries, but inflation rates are likely to keep subsiding. The Far East economies should remain strong. Latin America will see positive but small growth, adjusting to an enforced austerity because of debt problems.

Politics and shocks: Progress – though not definitive – on arms talks with the Soviet Union, but not enough to prevent a hard line on defense spending by the President because of the negotiations. Tax reform is likely by the first quarter of 1986. No major oil or agricultural shocks are assumed, although there is a one-in-five chance of a major breakdown in the OPEC cartel this year, with oil prices moving to $20 to $24 a barrel.

Alternative possibilities and probabilities: An alternative forecast to the baseline (Higher Rates scenario, probability = 20%) assumes above-target money growth and stronger-than-expected growth in the second and third quarters. The continuous higher monetary growth is associated with higher inflation and increased interest rates, then a recession by 1986. A second alternative forecast (Big Budget Fix-Lower Oil Price scenario, probability = 15%) assumes a quick major budget solution containing all of most of the Senate's recommendations and reforms as well as a tax increase. Oil prices are reduced sooner and by more, the inflation rate falls, and interest rates are much lower. There is a near-zero probability of a fizzling-out into a recession because of the goods-side weakness. Services activities should be strong enough to sustain growth and the Federal Reserve would take more moves to prevent a recession.

Although budget negotiations have stalled in the Congress, it seems inconceivable that the budget tightening in hand would be lost at the eleventh hour. Both the House and the Senate have gone too far and have expended too much effort toward reducing the budget deficits to permit the process to totally break down. It is not unusual for budget deliberations to occur through much of the summer before a budget resolution is passed, so that no strongly negative conclusions should be drawn yet from the impasse that has arisen. This sanguine view on the outcome of the budget process is a key assumption of the forecast. The risk to sustained expansion will be considerably greater if there is no agreement.

It should be noted that even the weak growth in the Shearson Lehman Brothers forecast requires lower interest rates and a lower dollar than currently exist. A Fed easing and budget tightening are assumed. The dollar declines, but does not collapse. These assumptions are in question now, given the budget impasse in the Congress and the big slide recently in the dollar.

If there is no budget tightening, the task of the Federal Reserve will be considerably more difficult. Less accommodation will be likely, the financial markets would worsen on expectations of a further deterioration in trade and a possible reinflation from a declining dollar. A "worst-of-all-worlds" configuration could result: slow growth, a collapsing dollar, and higher inflation.

Policy Mix, the "Twin Deficits," and the "Lopsided" Economy

The topic of policy mix – defined as the simultaneous stance of monetary and fiscal policy – has not been studied much. This is generally because both monetary and fiscal policy have moved in the same direction during the postwar period, with an "easy money-easy fiscal" policy combination at times of recession and early expansion and a "tight money-tight fiscal" combination in booms or at times of high inflation. Monetary and fiscal policy have only been at variance since 1981, with a stimulative fiscal policy – mostly from large tax cuts – and the nonaccommodative stance of monetary policy established in late 1979. The effects of such a clash on growth, interest rates, the dollar, inflation, trade, and the composition of economic activity between goods and services have been new for the postwar period. Given an increasingly open U.S. economy and a regime of flexible exchange rates, the loose fiscal-tight money policy mix of the early 1980s has been the primary source for the unusual pattern of behavior in the economy, money growth and trade, and the growing dichotomy between goods and services sector activities.

The "twin deficits" – budget and trade – and the emerging net debtor status of the United States are consequences of the stimulative fiscal policy of recent years and the generally nonaccommodative monetary policy of the Federal Reserve. The long string of huge U.S. federal budget deficits, record trade deficits, and increasing trade debt are intertwined. Large federal budget deficits, in the context of monetary growth targeting by the Federal Reserve, stimulate economic growth and raise nominal and real interest rates. Strong growth and higher interest rates strengthen the dollar. A stronger dollar holds down inflation and raises real interest rates. The dollar is strengthened further. With strong economic growth and a strong dollar, imports increase and the pace of exports decreases. A worsening trade deficit and increased trade debt result. *So long as the huge federal budget deficits remain*, the process continues until the trade sector becomes so weak that economic growth slows, interest rates drop, the dollar declines, and the process is reversed. With no intervention to tighten the budget, the eventual result is a lopsided, unbalanced economy, with numerous problems, including chronic federal budget deficits, an overvalued domestic currency, permanent erosion in the relative market shares of basic industries, stagnant economic growth, high unemployment, still too high inflation, high real interest rates, and a fallout of failures in beleaguered sectors, industries, and financial institutions. A growing erosion of goods activities and the siphoning of purchases abroad by consumers and businesses also can be expected, with a shrinking of the industrial base and services activities growing.

The U.S. economy currently is in the midst of the trade-induced slowdown that is a consequence of this process, with economic growth having tailed off into considerable weakness compared with 1983 and 1984.

What are the likely possible consequences now that weak growth and lower interest rates have driven the dollar down without significant reductions in the federal budget deficit? Most likely the dollar would firm, further worsening the trade deficit and depressing economic growth. But, with lags, the declines of the dollar would resume, eventually reigniting higher inflation. In the interim, bond yields would rise higher as inflation and a greater deficit were discounted into the financial markets.

Suppose there is a tightening of the budget. What then? In this situation, the likelihood of an easing by the central bank in order to sustain real economic growth at desired levels would be enhanced. In an open economy with flexible exchange rates, the tightening of the budget – especially if accompanied by an easing of monetary policy – should result in permanently lower interest rates, higher stock prices, and a weaker dollar – all pluses for sustained growth. The extent of the dollar's decline could well be limited or made only gradual, depending on how much growth was induced by an easier monetary policy and the interest rate response abroad.

The Midyear Report to the Congress and the Volcker Testimony

Table 4 shows the new target ranges set by the Federal Reserve for 1985 and 1986, the current performance of the monetary aggregates in relation to the targets, and recent trends in monetary velocity.

Table 4
New Federal Reserve Monetary Growth Targets, Current Performance, and Monetary Velocity

		1985		1986
M1*		3 to 8		4 to 7
M2		6 to 9		6 to 9
M3		6 to 9½		6 to 9
Debt		9 to 12		8 to 11
	Last Month	Last 2 Months	Last 3 Months	From Base Period**
M1 (as of 7/1)	20.6	18.3	13.8	20.0
M2 (as of June)	13.7	11.2	7.2	9.3
M3 (as of June)	10.5	8.9	6.0	8.2
		Trend Growth 1959:1 to 1985:1		1985E First Half
M1 Velocity		2.83		-0.17
M2 Velocity		0.03		-1.22
M3 Velocity		-0.89		-2.45

* *Second to fourth quarter.*
** *Base Period: M1, 1985 2, $582.5 billion.*
M2, 1984 4, $2345.8 billion.
M3, 1984 4, $2960 billion

The central bank rebased and reset the M1 growth targets. A 3% to 8% target range was set for the rest of 1985, with the second quarter as the base period. In so doing, about $15 billion of M1 was "forgiven" – wiped away by the action. Less weight was given to the Ms in Federal Reserve deliberations and more weight for growth and the dollar. The main reason was the unusual behavior of

M1 velocity (Chart 1). More practically, without such a change, a tightening of monetary policy would be indicated – just the opposite of what seems necessary at this time.

Given the irregularity between M1 growth and the growth of nominal GNP in recent years, the Federal Reserve did the right thing in detaching monetary policy from M1 growth. Targeting nominal GNP should prove to be superior.

As Chart 2 shows, the relationship between the growth in M1, real GNP growth, and inflation has been quite irregular in recent years. In the first half of 1985, the growth of M1 and of the economy is seen to be moving in opposite directions. The normal link between accelerated monetary growth and inflation clearly is absent.

In the midyear report, the central bank provided a correct explanation for the surge in M1: the reduced opportunity costs of holding NOW and SuperNOW accounts as market interest rates have declined. But a full explanation of the decline in velocity should include the irregular pattern of behavior for real GNP because of declining net exports since the expansion began. Since the fourth quarter of 1982, real net exports have declined $52.5 billion. The average decline in net exports over the first nine quarters of five previous expansions has been only $1.1 billion (Table 5). In each of the last three quarters, some two to three percentage points of real economic growth have been lost from weak trade. What has happened is that the strong dollar has prevented rises in real GNP *commensurate with the transactions* balances in M1 used to purchase goods here and abroad. Also, the disinflationary effects of the dollar, which are more considerable than generally realized, have reduced the growth of nominal GNP relative to M1. The result is the decline in M1 velocity over this business cycle expansion that is shown in Chart 1.

Chart 1
M1 Velocity and Trend
(Quarterly, *1960* to *1985:2*)

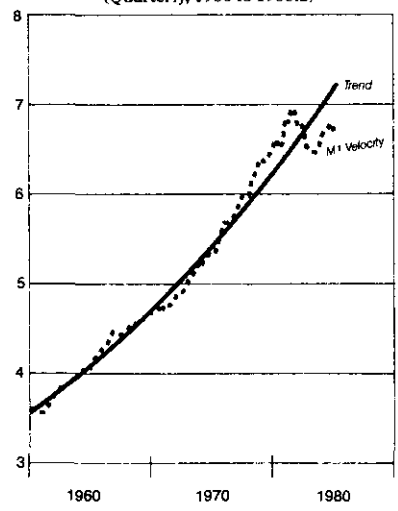
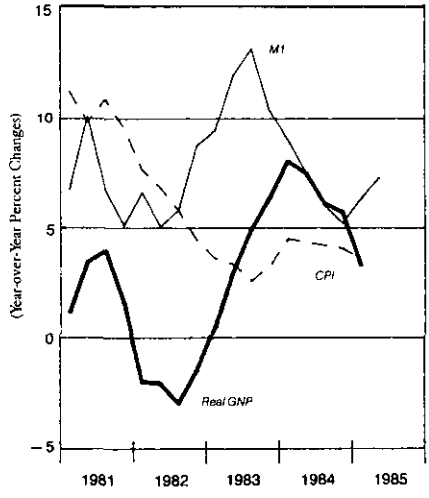


Chart 2
Growth in M1 Inflation and Real GNP



Source: Shearson Lehman Brothers Economics

Table 5
Performance of the U.S. Economy, by Sector

	Change Since 1982:4		Average Change* of 5** Previous Expansions	
	Billions of Constant Dollars	Percent Change	Billions of Constant Dollars	Percent Change
Real Gross National Product	184.7	12.5	99.9	11.6
Consumption	112.8	11.6	59.1	10.0
Investment	114.3	64.3	36.7	32.7
Fixed Investment	70.6	34.9	24.3	20.8
Nonresidential	51.5	31.9	11.7	14.1
Residential	19.2	47.1	12.7	37.4
Inventories	43.7	NM	12.3	NM
Government	10.1	3.4	5.2	2.6
Federal	5.0	4.0	−2.4	−2.5
State and Local	5.1	2.9	7.6	7.2
Net Exports	−52.5	−217.8	−1.1	9.1

NM = Not Meaningful

** Change is over nine quarters following each trough.*

*** The 1980-1981 expansion was excluded because its duration was less than nine quarters, and 1949-1953 was dropped as atypical.*

Under these circumstances, using M1 as an indicator for monetary policy would be an egregious error, leading to tighter monetary policy when just the opposite is required. Indeed, the tightening of monetary policy during the first half of 1982, in response to a surge in M1, and again – although less so – in the spring of 1983 turned out to be counterproductive.

Thus, the central bank is on the right track in detaching its policy from M1. As shown in Table 4, even M2 and M3 velocity are growing at less than trend, also reflecting the effects of the unusual weakness in trade on the relationship between the monetary aggregates and the economy.

While the decision to broaden the factors followed in making monetary policy is a good one, the central bank may have gone too far. Now, growth of money and credit, the economy, inflation, the dollar, and institutional fragility are all involved in the making of policy. With so many factors determining monetary policy, it will be almost impossible for the Federal Reserve to obtain an unambiguous reading on the direction for policy. A result will be only cautious movements in one direction or another – probably not sufficient either to arrest a weakening economy or to restrain one that is growing too rapidly. The central bank is eschewing much of the leeway it has by following so many different targets and having so few instruments of control.

Currently, weak growth in the economy and the fallout on manufacturing unambiguously indicate the need for more easing by the Federal Reserve. But M1 growth well above the new targets and M2 growth also above its target suggest no easing should be carried out. The large slide in the dollar also indicates that no further easing should be undertaken. Finally, low inflation rates indicate little risk for any easing by the Federal Reserve in terms of near-term reinflation.

By the Federal Reserve's own actions and targets, growth clearly is the key factor now driving monetary policy. De facto, the central bank has been targeting GNP for over a year now, easing when economic growth fell well below potential and tightening when growth rates were too high – the case in March 1984. A policy of nominal GNP targeting would be appropriate to follow in the current circumstances, with many of the positive attributes of monetary growth targeting retained but much less uncertainty because of a linkage problem between the indicator and the ultimate target.

The shift to an emphasis on growth as the key factor in Federal Reserve policy should be applauded and encouraged; the results will be better. But it cannot help on compositional problems stemming from an imbalance in both fiscal and monetary policy. The lopsided economy poses a major dilemma for the Federal Reserve: whether to ease in order to revive the weak trade and manufacturing sectors and how to do so without causing too strong growth in other activities.

The Central Bank – Between A Rock and A Hard Place

The current situation has the central bank between a rock and a hard place. The unbalanced policy mix has led to higher interest rates than otherwise would have been the case, too strong a dollar, increasing loss of markets in U.S. goods activities to the rest of the world, deteriorating trade, and a depressed manufacturing sector. Too rapid monetary growth has appeared – the result of many domestic purchases that do not appear in U.S. GNP. Reducing interest rates further to revive growth runs the risk of too much M1 growth – even under the new targets – and a sharp decline in the dollar, which would prove to be inflationary. Raising interest rates to slow monetary growth and to prevent a major slide in the dollar risks a recession.

Rebasing and resetting the targets for M1 is one way to escape the problem, eliminating one reason for a tightening. But, unfortunately, even after the change, the Ms remain well above targets, perhaps only buying a little time for the Federal Reserve but not providing a solution. M1 has grown at a 20% annual rate since the new second quarter base period. It is now $7.8 billion above the new upper target limit. M2 is slightly over target. The new targets do postpone a tightening. But the central bank cannot abandon the monetary growth targeting approach entirely, since fear of a caving-in on inflation could become quite pronounced.

With the dollar also sliding, the central bank is hamstrung in any further easing. Interest rates do not seem low enough yet to help the economy recover fully to the desired real growth rates.

Thus, the central bank has no easy way out. A tightening of the budget provides one escape valve. A significant decline in oil prices provides another. In the absence of these events, the central bank will find that little can be done to increase the growth of the economy, lower unemployment gradually, and simultaneously keep inflation pressures at a minimum.

The International Constraint

With the U.S. economy now so open and exchange rates so flexible, international trade and finance become a major constraint on domestic monetary policy. In particular, the dollar has become a key consideration in policy.

Table 6 shows the behavior of the dollar recently. Given the threat of reinflation from a lower dollar and a still stimulative fiscal policy, the recent slide in the dollar suggests caution in any potential easing. The declines in the dollar have varied from -12.2% against a trade-weighted average of foreign currencies to a large 35% versus the British pound.

While a drop in the dollar can prevent an easing, lags in the reaction of exports and imports to changes in the dollar will prevent the economic rebound that is desired from occurring soon. Without a turnaround soon, policymakers will be under increasing pressure from protectionist sentiment, as a second-best solution.

Current research is tending to show a much larger role for dollar appreciation or depreciation in inflation than had commonly been thought.[1] Some two or three percentage points of additional inflation is

[1] *See Allen Sinai, "The Dollar and Disinflation," to be published in* Challenge, *September/October 1985; also, Rudiger Dornbusch, "Exchange Rates and Prices," manuscript, July 1985*

possible within a year from a sustained 10% drop in the dollar, depending on the other factors that determine inflation. Dollar performance is thus more critical for the Federal Reserve, and this international constraint is beginning to loom as systematically more important to the central bank than ever before.

Table 6
Strength of the Dollar

Country	Latest 17-Jul-85	Week Ago 10-Jul-85	Year Ago 17-Jul-84	2 Years Ago 18-Jul-83	3 Years Ago 19-Jul-82	Dollar's High	Date	Dollar's Low	Date	August 1984
Canada	1.349	1.352	1.329	1.233	1.260	1.402	26-Feb-85	1.170	29-Jul-80	1.300
%		−0.2	1.5	9.5	7.1	−3.8		15.3		3.8
Japan	235.29	243.31	241.95	240.56	253.55	263.44	26-Feb-85	227.89	30-Jul-80	242.28
%		−3.3	−2.8	−2.2	−7.2	−10.7		3.2		−2.9
England	1.414	1.381	1.323	1.523	1.742	1.044	25-Feb-85	2.390	25-Jul-80	1.310
%		−2.4	6.9	−7.1	−18.8	35.4		−40.8		7.9
Germany	2.839	2.940	2.843	2.591	2.463	3.460	26-Feb-85	1.790	31-Jul-80	2.890
%		−3.4	−0.1	9.6	15.3	−17.9		58.6		1.8
France	8.605	9.008	8.725	7.795	6.855	10.595	26-Feb-85	4.160	31-Jul-80	8.860
%		−4.5	−1.4	10.4	25.5	−18.8		106.9		−2.9
Italy	1831.50	1879.70	1745.20	1533.74	1379.31	2164.50	26-Feb-85	843.88	31-Jul-80	1780.23
%		−2.6	4.9	19.4	32.8	−15.4		117.0		2.9
United States	123.7	126.4	124.5	112.2	105.9	140.9	25-Feb-85	88.4	31-Jul-80	111.2
%		−2.1	−0.6	10.2	16.8	−12.2		39.9		11.2

Note: All exchange rates expressed in foreign currency units per dollar except the pound, which is expressed as dollars per pound

% = Percent change to latest week.

** Morgan Guaranty trade weighted value of the dollar.*

We move now to our third witness, Mr. Chimerine. As I indicated, we will question all of you once the panel has completed its presentations. Mr. Chimerine.

Mr. CHIMERINE. Thank you, Mr. Chairman. I am delighted to be here. I have submitted a fairly lengthy statement, which I ask be included in the record.

Chairman FAUNTROY. Without objection, it will be included in the record.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS, BALA CYNWYD, PA, AND PRESIDENT, MONETARY POLICY FORUM

Mr. CHIMERINE. I will try to summarize briefly my statement this morning.

I might make one additional statement about my prepared remarks. They include, in addition to my own views, the views of the Monetary Policy Forum, of which I am the current president. I might add, that two of the other distinguished panel members here this morning are also members of the forum, and those views, as I mentioned a second ago, are included in my statement.

I would like to focus on two or three issues this morning, and do so in a way that does not duplicate what you have heard from Nancy Teeters and Allan Sinai. First, the current state of the economy; second, the appropriate monetary policy response; and, third, the subject of the Federal deficit.

I agree very strongly with your remarks earlier this morning, Mr. Chairman, and those of Mrs. Teeters and Dr. Sinai regarding the growth recession. We have been in a growth recession in the United States for about a year. During this period, we have not only suffered from extremely slow growth on an overall basis, but as has been mentioned earlier this morning, various segments of the economy, particularly manufacturing—excluding Defense—commodities, agriculture, and energy, have suffered badly and have actually experienced modest declines during the last 12 months. This even though, in most cases, they had not yet experienced a complete recovery from the long period of stagnation we had in the United States in the late 1970's and early 1980's. So the timing of this decline is very unfortunate for those industries because they were suffering to begin with, and conditions have gotten considerably worse in many cases.

Before we look ahead, it is important to understand why we have slowed so sharply from such a robust recovery during the first year and a half of this recovery phase—in fact, reaching the point about a year ago when a number of people, including some people based in this city, began talking about a new era of rapid economic growth, a new economic boom, and so forth. And, just about 2 days after those pronouncements were made, a growth recession developed in the United States. I think reasons are predominantly high real interest rates and the overvalued dollar, both of which have been discussed already this morning. In turn, both of those relate to large budget deficits.

The economy is now beginning to suffer from the pattern of extremely large and rising structural Federal budget deficits. They

were stimulative during the first year or year and a half of the recovery, but conditions are very different today—and have been over the last 12 months or so. When this recovery process began, much of the deficit was cyclical in nature rather than structural. Private borrowing was tremendously depressed; there was massive excess capacity in the economy and large pent up demands because of that long period of stagnation I talked about earlier. And, the Fed had the freedom to pursue a highly accommodative monetary policy, so that during the first year or so of the recovery, actually going back to the middle of 1982, they permitted money growth to accelerate very dramatically and made very strong efforts to push interest rates down.

Conditions over the last year have been very different. The deficits are now largely structural, and the structural portion continues to rise. Private borrowing has risen dramatically during the last couple of years, as it normally does during recoveries. And, it will be necessary for it to rise further if we are going to sustain the recovery process. A lot of that pent up demand and some of that excess capacity is used up. And, on a long-term basis, there is no way the Federal Reserve can continue to permit money growth and the monetary base and other measures of money and credit to expand at double-digit rates.

So, in today's environment, the deficit has fundamentally become counterproductive. On a net basis, it is holding back growth in the U.S. economy through its adverse effects on real interest rates and the dollar, which, in turn, are offsetting the direct stimulative impact of rising budget deficits.

I think many people tended to underestimate the impact of high real interest rates during the past 12 months because they make the argument, "Well, we recovered during the first year and a half with high interest rates, why cannot we continue to do that?" Again, it is a matter of timing. Conditions are different now because many individuals and many businesses already funded, their highest rate of return projects and their most necessary expenditures.

At this point in the recovery process, lower interest rates are required to stimulate expenditures for more marginal projects, particularly among industrial companies. Real interest rates for those companies remain extraordinarily high because, essentially, there is no inflation in the industrial sector in the United States. Even 9 or 10 percent interest rates are extremely high relative to zero inflation and are retarding the typical inventory cycle and causing capital spending projects to be deferred or canceled.

I think you can make the same argument for housing. Wages are now growing at only about a 4-percent annual rate. The gap between mortgage rates, even though they have come down, and income growth is still quite high by historical standards and, as a result, housing activity, while not extremely weak, is nonetheless, lagging behind the levels we experienced in the United States in previous periods.

Second, I think the overvalued dollar has been at least as important—as Allan Sinai mentioned, it in part directly reflects high interest rates in the United States. And, again, I think many people are underestimating the adverse effect of the dollar, or the overval-

ued dollar, on the U.S. economy. It is producing an enormous increase in import penetration on a widespread basis throughout the United States—hardly a manufacturing industry is not experiencing a sizable increase in import penetration.

It has also caused exports to remain quite sluggish and, third, and perhaps just as importantly, it has led to a profit squeeze in the United States, particularly among those industries trying to compete in world markets. It is not confined to those industries however—and I think I can tell you this from personal experience—it is now spreading through the rest of the economy because those industries are trying to push the impact back to their suppliers. They cannot raise prices so they are trying to force their suppliers to cut their prices. And, as a result, the spreading effect on profits of the overly strong dollar is spreading throughout the U.S. economy and is now short circuiting the investment boom we had going for a while. It does mean lower inflation. But the benefits of lower inflation resulting from a profit squeeze are not as favorable for the economy as the benefits of lower inflation from higher productivity. And, in fact, when you net out the full impact, the overvalued dollar has been a major factor retarding economic performance during the last 12 months.

I think we have all mentioned this morning that both high real interest rates and the dollar situation directly reflect massive budget deficits. Contrary to what many other people might have stated previously, in my judgment, Federal deficits have now become counterproductive for U.S. economic growth. Unless they are reduced dramatically, this process of slow and erratic growth, is likely to continue for as far out as we can see—certainly, for the next several years.

Now, what about the current situation? There have been hopes expressed that the economy is starting to respond to lower interest rates and to a softer dollar and that an acceleration in economic activity is taking place. In my judgment, there is basically no evidence at this point to support that view. The only strength we see is in consumer spending. And I do not believe consumer spending the numbers because they completely contradict the information we are getting from retailers around the United States. Second, even if the data are correct, it is not sustainable in view of the very slow growth in incomes that is currently taking place, some softening in consumer confidence, rising debt burdens, and a very low saving rate. Even after you adjust for the IRS tax refund problems, savings rates have dropped to extremely low levels in recent months. That is not likely to be sustained.

Even in housing, which has responded to some extent to the decline in mortgage rates, the favorable effect is being offset to some extent by massive overbuilding and high vacancy rates among apartments and condominiums, and by slow income and employment growth. No matter what mortgage rates are, people without jobs do not generally buy new houses. So that effect has even been very modest thus far. And, most importantly, the anticdotal evidence that we get from our clients, who include a wide spectrum of the U.S. economy, indicate to us that their situation has not improved. Most of them tell us sales and orders remain very soft and that no pickup has yet taken place.

Now, having said that, I do not think we are in a recession; I do not think we are going to have an actual recession. But, I would not be too optimistic about a new economic boom taking place during the second half of 1985. At best, we will see a modest acceleration in growth. In our judgment, the maximum we can get during this period will be in the 3-percent range.

Consumer spending is going to slow during this period—we are beginning to see it in autos already. Investment spending is not strong. Orders have been very soft. We still have a ways to go in terms of the trade deficit—even if the decline in the dollar thus far does eventually improve the trade deficit it will not happen for at least a year. So that will get worse during the second half of this year. Inventories have been corrected. There is likely to be less inventory liquidation. That will probably keep us out of recession. But the other factors I just mentioned suggest to us very modest growth at best during the second half of this year, with some increase in unemployment very likely, even under the best of circumstances. And if a recession does occur, unemployment could rise very sharply during the months ahead.

What about monetary policy and interest rates? Interest rates have declined, and so has the dollar, but I think it is important to recognize that perhaps the most important reason for these declines is the weakness in the economy itself. In my judgment, as long as these budget deficits persist, it will not be possible to sustain these declines in interest rates and the dollar if the economy picks up significantly.

What would likely happen under those conditions is that interest rates will start moving up again. Perhaps the dollar will strengthen and a few months later, the economy will begin to slow down again. The current situation is not sustainable. What this economy needs is lower interest rates, a lower dollar and stronger growth all occurring together. I do not believe it is possible as long as the Federal budget deficit situation remains the way it is right now.

I think that the policy shifts that the Fed has made in recent months are highly appropriate. The policy mix in the last year or two—the Fed not being restrictive but not being extremely accommodative, and a very loose fiscal policy—is what has caused our economic problems. I think the Fed is now doing their part on the policy side, but their part is not sufficient on a long-term basis. Without a reduction in budget deficits, interest rates will move back up at some point, or the dollar will strengthen, because, fundamentally, we are financing those deficits now with very easy money and with money coming from overseas. On a long-term basis, neither is an acceptable solution.

On the deficit, I feel very strongly, as I have told this committee several times in previous years, that the target should be about a $25 to $30 billion decline on a year-by-year basis in the Federal deficit. So that if the deficit this year is going to be around $220 billion, you should target next year at $190 or $185 billion. The year after, $150 billion, and so on, which would represent a dramatic change from the current upward trend on a current services basis.

To accomplish that, I think three things have to be done. First, some cutbacks or stretching out in the military buildup, particularly in the procurement process is necessary. Some of the weapon

systems have to be cut back or cut out—it is that simple. Second, the entitlements have to be addressed, particularly the health and pension programs. And, quite frankly, I think now is the time to explore whether we want to make some of those programs means tested. And, third, even after both of those are done, some tax increases will be necessary. That is an arithmetic statement, not a political statement. There is no way to get from here to there without it. I think we would better start recognizing that and very quickly, because the economy is languishing.

We can debate what kind of tax increases are best. My own judgment is a base-broadening kind of tax increase. And some of the things included in the tax reform proposal, quite frankly are ideas that ought to be explored. But, in any case, the sooner we do that, the better because the current situation is not sustainable on a long-term basis, and we are likely to see economic stagnation, or growth recession, or whatever terminology you want to use, continue until the budget deficit situation is resolved.

Thank you, Mr. Chairman.

[Mr. Chimerine's prepared statement and attached material of Monetary Policy Forum follows:]

Statement By

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and

President, Monetary Policy Forum

Presented to

Subcommittee on Domestic Monetary Policy
of the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C.

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My name is Lawrence Chimerine and I am Chairman and Chief Economist of Chase Econometrics. I am also President of the Monetary Policy Forum. The Monetary Policy Forum is an organization dedicated to the study of the relationship between monetary policy and the economy; its membership includes more than twenty-five well-known economists, business leaders, and financial analysts, representing a wide range of institutions and organizations. The Forum takes a very practical and pragmatic approach to policy issues rather than relying on a narrowly defined philosophic viewpoint. It is an honor for me to testify before the Subcommitte on Domestic Monetary Policy on the current economic situation and implications for the conduct of monetary policy.

Briefly, I will make the following observations:

(1) The economy at the present time is extremely sluggish, with little growth on an overall basis and with the industrial sector in a state of mild decline. This slowdown, which has been in effect for about a year, has come well before the economy experienced a complete recovery from the long period of stagnation in the late 1970s and early 1980s. Furthermore, while the weakness is concentrated in manufacturing, agriculture, energy, and other commodity producing industries, it is now spreading to other segments of the economy, especially high-tech and some services.

(2) The major factors limiting economic growth are the effects of the extremely high interest rates which have prevailed in recent years and the enormously overvalued dollar on foreign exchange markets. In turn, these are directly related to the large and growing structural Federal budget deficit. Thus, over the last year, Federal budget deficits have become counterproductive for economic growth, after helping stimulate the economy during the earlier part of the recovery.

(3) The Federal Reserve has shifted to a highly accommodative stance in recent months. This shift is highly welcome in view of the lagging economy. The Fed's policy options have been narrowed somewhat by the enormous stimulus embodied in large budget deficits and by the fact that a large fraction of those deficits is now being financed overseas. Until the Federal budget deficit is reduced, any major change in the willingness of foreigners to decrease their holdings of dollar assets would exert upward pressure on interest rates in the United States. Thus, the Fed has been trying to bring interest rates down but not so fast as to produce a sharp decline in the dollar, which would then exert upward pressure on rates.

(4) In my view, the outlook for the economy is not good. At best, a modest acceleration in growth will occur later this year — continued stagnation, or even a mild recession, cannot be ruled out. Thus, unemployment, which is already relatively high, will probably rise somewhat during the months ahead.

(5) The outlook for inflation is extremely favorable, however, although some upward pressure may occur if the dollar continues to decline sharply. However, the inflation rate is not likely to average significantly above 5% even with a dollar decline.

(6) The relatively low inflation rate, sluggish economic growth, the LDC debt situation, the large and growing trade deficit and resulting decline in manufacturing, and other factors suggest a need for a continuing shift in the policy mix toward a tighter fiscal policy and more accommodative monetary policy. This in the long run is the best way to get both interest rates and the dollar down to acceptable levels, while at the same time reducing U.S. dependence on foreign capital. It is important to emphasize that monetary policy alone cannot do the job in view of the outlook for the budget deficit. Nonetheless, it is imperative that the Fed remain accommodative and not attempt to offset the rapid growth in the basic money supply during the first half of this year. To do so would require slowing the growth in the basic money supply to about 3% during the second half of the year, which would likely cause significant upward pressure in interest rates and prevent the even modest economic pickup that I now expect. I would suggest that the Fed permit the basic money supply to grow at near or above the upper range of its current target during the second half of the year — this could be accomplished by rebasing the targets.

(7) The majority of the members of the Monetary Policy Forum also support the view that the Fed should continue to adopt an accommodative posture during the months ahead but that this must be supplemented by major reductions in the Federal deficit.

I. CURRENT STATE OF THE ECONOMY

On balance, the economy remains in the slow and erratic growth mode that has prevailed for nearly a year, with little evidence of any significant acceleration. While the flash estimate indicated an acceleration in real GNP growth to 3.1% in the second quarter, I view this as an exaggeration of current economic performance. This in part reflects a number of technical factors, such as the fact that defense spending declined in the first quarter but probably rose

significantly in the second quarter, and the smaller increase in imports in the second quarter than in the first quarter — both probably reflect erratic movements rather than any changes in basic trends. Thus, the average of the first two quarters (1.7%) is a better measure of current underlying growth than either the 0.3% increase in GNP in the first quarter or the 3.1% flash estimate for the second quarter. Furthermore, there is a strong chance that the preliminary estimate for second-quarter GNP will show a smaller increase than the flash estimate, especially since retail activity was weak in June; since the trade deficit in May and June may turn out to be larger than assumed in the flash estimate (it has already been reported to have risen significantly in May); and since many companies appear to be cutting inventories very sharply. Furthermore, most of the rise in second quarter GNP was due to the surge in retail sales in April, so that even with the May and June declines in sales, the second quarter average was significantly above that of the first-quarter. However, I believe that consumer spending is not as strong as the earlier retail sales data indicated because: (a) some of the earlier strength reflected temporary increases in auto sales due to low-cost financing and some makeup effect from last winter's General Motors' strike — auto sales are now beginning to decline; (b) the numbers appear to be inconsistent with the reports issued in recent months by the large chain stores; and (c) anecdotal evidence suggests that sales thus far in July are not especially strong. There has been an improvement in the underlying trend in housing activity as suggested by both new and existing home sales and new housing starts. The uptrend has been very modest, however; sales and starts actualy dropped significantly in the most recent month.

Most other recent data also indicate that the economy is still quite sluggish and that the manufacturing sector, in particular, remains quite weak. These include the following:

1. Despite a small increase in May, nondefense durable goods orders have trended down in recent months, and have not yet broken out of the stagnant pattern that has prevailed since early 1984. Furthermore, orders have actually been lower than shipments in several recent months, indicating that backlogs have actually begun to edge down for the first time since the economic recovery began.

2. Paperboard demand has traditionally been an extremely good coincident indicator. Paperboard shipments have been extremely weak since early this year, and while they appear to have stabilized in recent months, a significant upturn has not yet developed.

3. Labor markets remain very soft — the overall unemployment rate has essentially been stagnant for nearly a year. Furthermore, help wanted advertising has declined

significantly in recent months and initial claims for unemployment insurance have been somewhat higher in recent weeks. Spreading layoffs in the computer industry also indicate a weak pattern in labor markets.

4. Although the index of leading indicators rose in May, the index was revised downward for the two preceding months. Since it takes at least three months of increase to indicate an acceleration in economic growth, the May increase by itself is not meaningful. The components of the index which relate to manufacturing activity, such as the average workweek, new orders, vendor performance, plant and equipment orders, and changes in inventories, have been especially weak during the last year and in fact, have fallen by an average of more than 10%. This is not only consistent with the downward trend in industrial production during this period, but every major decline in the manufacturing related leading indicators has always been followed by a general economic recession. Thus, it will be particularly important to monitor these components in the months ahead.

5. The National Association of Purchasing Managers index remains very weak, with no significant acceleration at this point.

6. Early reports suggest significant weakness in second-quarter corporate profits — in fact, it appears that on an economy-wide basis, profits will be down significantly from year-earlier levels.

7. Financial market indicators, such as interest rates and loan demand, also suggest continued weakness.

8. Commodity prices generally remain very soft, despite the recent decline in the U.S. dollar — this in part reflects sluggish demand.

Thus, on balance, I believe that the evidence at this point does not justify the view that the economy is in the midst of a significant acceleration. Rather, it appears to be in a holding pattern, with the same general trends that have been in place for nearly a year continuing essentially as is.

II. WHATEVER HAPPENED TO THE ECONOMIC BOOM?

The slowdown in the economy that began last summer occurred just when many were beginning to proclaim that a "new era of economic growth," was upon us. At the outset, it should be recognized that there was no economic boom in the first place. The problem stems from confusion between the **direction** and the **level** of economic activity — while the economy was moving upward at a very rapid rate during the first half of 1984, economic activity was still considerably below its potential, reflecting the extremely weak conditions from which the recovery began. Thus, unemployment, capacity utilization, profits, and other important measures of economic performance were still far from satisfactory at that time, and in most cases, had not even returned to the relatively sluggish levels which existed in the 1970s. In fact, many industries and geographic areas were still extremely depressed, having experienced virtually no recovery at all.

Two other important aspects of the earlier stages of the economic recovery are also essential to help understand why rapid growth has been so short-lived. First, the recovery was not caused by tax cuts alone; to a significant degree, what was in place was a cyclical rebound caused by a number of relatively transitory factors, such as inventory rebuilding in many industries, the large amount of pent-up demand for consumer durables and other goods that had previously built up, and an extremely loose monetary policy. The stimulative impact of these factors, as well as of the tax cuts and rising budget deficits, was bound to diminish in magnitude. Second, the faster-than-expected recovery during 1983 and early 1984 was simply using up idle resources more rapidly than had been anticipated, rather than reflecting any major improvement in the long-term growth potential of the U.S. economy.

In fact, the major sources of long-term growth have shown no fundamental improvements:

1. The growth in the labor force has slowed markedly since 1980, in part reflecting a slowdown in the rate of increase in the participation rate. This has occurred despite the reduction in marginal tax rates in recent years, which was supposed to have stimulated more work effort.

2. The rate of increase in productivity has been below the rate of increase during the first two years of most previous recoveries. While productivity growth is exceeding its growth during much of the 1970s, the relatively modest rate of increase during the recovery thus far is somewhat disappointing in view of how rapidly GNP grew in its early stages and in

view of the emphasis on productivity enhancement and cost cutting. Most significantly, productivity growth has slowed sharply during the last several quarters, also suggesting that, at least at this point, the improvement in the underlying trend growth in productivity has been very modest at best.

3. Despite sharp cuts in marginal tax rates, the enactment of IRAs, Keoughs, and other direct savings incentives, extremely high nominal and real interest rates, and declining inflationary expectations, the personal saving rate during the last four years has averaged considerably less than in earlier years. Thus, even after adjusting for other factors which hold down savings, it does not appear that there has been any increase in savings as a result of policy changes in recent years.

4. Profits also remain depressed despite the sharp increase during the last two years. Profits as a share of GNP are still below the levels during much of the 1970s, although the quality of earnings has improved. Furthermore, profits have weakened during the last several quarters.

5. Despite the so called "investment boom" now underway, real net investment as a share of GNP has only recently returned to the levels which existed in earlier periods. Investment was extremely depressed in the early 1980s, so that the sharp increase in investment spending in 1983 and 1984 simply returned us to previous levels. In addition, a relatively large fraction of current investment is for short-lived assets, many of which do not add significantly to capacity. Most significantly, there is no evidence that net investment relative to GNP is now, or will be, any higher than it has been historically despite tax cuts and recently enacted investment incentives.

6. The U.S. competitive position in world markets has deteriorated dramatically in recent years, and is probably at its lowest point in the entire postwar period. This is certainly not a favorable development for long-term growth.

7. The unevenness of the recovery has also cast doubts on the new era hypothesis. Many industries, regions, and economic sectors have hardly participated in the recovery at all, indicating a high degree of imbalance and that the economy has not reached a fully prosperous and healthy condition.

So, for all of these reasons, the rosy extrapolations regarding future growth were premature and dangerous to begin with — the fact that economic growth has moderated thus comes as no surprise. What is highly disturbing, however, is the degree to which the pace of economic expansion has slowed. Growth over the year has not only lagged far behind the "New Era" expectations, but it has even been considerably below the long-term average of the U.S. economy, even though the recovery is far from complete. Why? In my view, in addition to the fading out of the temporary growth stimulants mentioned earlier, the slowdown in economic growth is also being caused by the enormous and growing Federal budget deficit which has in large part resulted from those massive tax cuts enacted in 1981.

How could the same factor actually help speed the recovery at one time and, at another, act to slow it down? In 1983 and much of 1984, when private borrowing was relatively low, when the Federal Reserve was relatively accommodative, and when a large fraction of the Federal deficit actually reflected the low level of economic activity (i.e., was cyclical in nature), large and growing deficits stimulated demand and thus helped propel the economy forward. More recently, however, these underlying conditions have changed — private borrowing has increased rapidly in tandem with the recovery thus far; the Federal Reserve is not on average permitting the growth in money and credit to continue at the relatively high rates experienced earlier in the recovery; and most importantly, the rising deficit now primarily reflects a growing structural imbalance between revenues and expenditures rather than cyclical factors. These growing deficits are keeping interest rates well above historical levels, which is primarily responsible for the increase in net foreign demand for U.S. assets which has caused the U.S. dollar to become so overvalued on foreign exchange markets. In effect, interest rates and the U.S. dollar are too high to permit more rapid economic growth and are thus the two principal factors preventing a faster completion of the recovery process — in turn, both are primarily caused by high and rising Federal budget deficits at a point in the recovery when they should be falling sharply. Federal deficits have thus become counterproductive for economic growth — the direct stimulus of such deficits is now being outweighed by the adverse effects of the excessively high interest and dollar exchange rate which they have caused.

Interest rates are especially high when measured relative to the inflation rate for goods (which strongly influences capital spending and inventory decisions) and relative to wage growth (which affects the demand for housing). These real interest rates have remained extremely high, despite the highly accommodative monetary policy in recent years (especially during the last several months), and despite the massive inflow of foreign capital from overseas and cutbacks in foreign lending by U.S. banks, because of the enormous amount of Treasury

borrowing. This is compounded by the economy's increased sensitivity to high rates because many of the most necessary and highest-return expenditures and investments were made earlier in the recovery — in more and more cases, those now being considered are not economical at current interest rates.

The situation with respect to the U.S. dollar is similar — although it has weakened some in recent weeks, it remains at least 25 percent overvalued on a purchasing power parity basis. The overly strong dollar exchange rate is now restraining economic activity in the United States in several ways: (a) It has been a major factor behind the very sharp and widespread increases in import penetration, which are causing enormous U.S. trade deficits despite falling oil imports. *Until now, most of the growth in imports has come from foreign-based corporations — however,* more U.S. companies are now beginning to shift production overseas, suggesting that substantial increases in imports from foreign operations of U.S. based companies, and more sluggish U.S. exports, are likely. Furthermore, import prices were not reduced when the dollar continued to strengthen in late 1984 and early 1985 — profits earned in U.S. markets by foreign companies just widened further. Thus, the recent decline in the dollar will probably not result in higher prices for imported goods, and therefore is probably not sufficient to significantly improve the competitive position of U.S. companies in world markets. Therefore, unless the dollar drops far more sharply, the trade deficit will become even larger in the months ahead. (b) As evidenced by recent earnings reports, the strong dollar is causing a profit squeeze by preventing most industrial companies from raising prices; this in turn is reducing the growth in capital spending. (c) Many companies are increasing their efforts to cut wages in order to at least partially offset declining profits — this, combined with the direct job loss in the relatively high-wage manufacturing sector, has caused a sharp deceleration in the growth in personal incomes, and thus slower growth in consumer spending. Furthermore, the benefits of relatively low inflation caused by the strong dollar are less than are commonly assumed, since they are largely offset by the squeeze on profits and/or cutbacks in wages — this source of disinflation does not stimulate economic activity to the same extent as does lower inflation caused by rising productivity.

Several industries have already been devastated by the high interest rate/overvalued dollar combination. In fact, while the woes of the agricultural sector have been heavily publicized, what has been less noticed is that the industrial sector, which accounts for about 30 percent of total economic activity in the United States, has stagnated since mid-1984. Furthermore, the squeeze is now beginning to spread. Even high-tech industries are experiencing a significant loss of orders due to the direct and indirect effects of high interest rates and the overvalued

dollar. And the service sector, which has thus far been relatively strong, will soon begin to be adversely effected. This will be true both for numerous business services, as demand from manufacturing companies falls, and for various household services, as the job and income loss associated with declining manufacturing and other interest and exchange rate sensitive industries increases. This will dispel the myth that the U.S. economy can continue to grow at healthy rates when a sizeable fraction of it is not growing, or is actually declining — in fact, exactly the opposite is the case.

So, whatever happened to the economic boom? Very simply, the small economic boomlet that did take place has given way to a period of slow and erratic growth that is being directly caused in part by the excessive tax cuts which were alleged to have produced the boom in the first place. Furthermore, this pattern of subpar growth, or worse, none at all, is likely to continue until the underlying fundamentals are reversed by much stronger action to reduce future deficits than is even now being contemplated. And, in view of the massive military buildup underway and this country's strong commitment to a social safety-net and to various entitlement programs, this will require reversing some of the excessive tax cuts enacted in 1981 in addition to the spending cuts that are likely to be implemented.

III. ECONOMIC OUTLOOK

The outlook for the remainder of this year and into 1986 depends on the following factors:

1. Is there an inventory overhang? The increased use of more sophisticated inventory control techniques, the dramatic shift in the risk-reward ratio resulting from extremely high real interest rates (high carrying costs relative to the potential appreciation of the prices of goods being held in inventories), and the uncertain sales and profits outlook, have resulted in a significant downsizing in desired inventory-sales ratios in recent years. However, actual inventories/sales ratios have gradually risen since early 1984, suggesting that some inventory overhang now exists. While this will represent a drag on economic activity during the next several months, it is not likely by itself to cause a recession because: **(a)** the magnitude of the overhang is fairly modest, **(b)** it is concentrated in only a few sectors (especially in segments of retailing and durable goods manufacturing), and **(c)** it will be partly offset by additional rebuilding of auto inventories.

2. Will the trade deficit continue to worsen? The recent decline in the value of the U.S. dollar on foreign exchange markets has raised hopes of an early turnaround in the U.S. trade deficit. However, I believe such an expectation is premature — my work suggests that the trade deficit will widen considerably during the remainder of 1985 and early 1986 in response to the strengthening of the dollar which occurred during 1984 and early 1985. In addition, the trade deficit during the months ahead will be aggravated by: **(a)** rising imports of autos in response to the elimination of voluntary quotas on Japanese cars, **(b)** some increases in oil imports now that refined product inventories have been reduced sharply, **(c)** continued relatively slow growth outside the United States, and **(d)** the continuing shifting of production by many U.S. companies to their foreign operations. Furthermore, the recent decline in the dollar has not yet *significantly affected the prices of most imported goods — its main affect thus far has been to* reduce the extremely high profit margins associated with sales of foreign products in U.S. markets. Thus, a much larger decline in the dollar is necessary for any major turnaround in the U.S. trade deficit even after the next several quarters.

3. Is the capital spending boom over? After surging earlier in the recovery, business investment has lost considerable steam, reflecting the following: **(a)** The surge in capital spending in 1983 and early 1984 came from an extremely low base, and thus in part was simply a makeup for extremely depressed spending during the prior several years. **(b)** The stimulative effect on the desired level of capital stock of investment incentives enacted in 1981 has in large part already been realized — therefore, they will not continue to contribute to the growth in capital spending. **(c)** Capacity utilization is falling in many industries as a result of weak demand and/or increased outsourcing. **(d)** *The sharp decline in profits in the last several quarters* has dramatically slowed cash flow. The slowdown in capital spending is highly evident from the recent pattern of nondefense capital goods orders (which have been on a downward trend since last summer), from recent plant and equipment surveys (which project little growth during the course of 1985 despite a significant year-over-year gain), from recent cutbacks in plant construction, and from signs that the commercial and office building construction boom of recent years is now beginning to taper off. It is thus clear that capital spending is not in a position to lead an acceleration in economic activity in the period ahead — its outlook depends heavily on the general economic and profits outlook.

4. Will tax refunds stimulate consumer spending? Consumer spending has been one of the bright spots in the economy in recent months. However, it appears that the underlying fundamentals are only moderately favorable, so that some deceleration in growth is likely in the period ahead. This reflects: **(a)** continued slow growth in real income, **(b)** the modest erosion in

consumer confidence which has taken place over the last few months, (c) continued sharp increases in household debt even after adjustments for the increased use of both credit cards and of longer-term loans, (d) the decline in the saving rate (adjusted for tax refunds) in the last few months, and (e) some slippage in auto sales now that the adjustment for the GM strike in late 1984 is over. These relatively negative factors will be partially offset by the rising value of household assets and by the stimulative effects on spending for household durables of the upward trend in both new and existing home sales now underway. On balance, consumer spending should grow enough during the months ahead to keep the economy moving forward, but not enough to trigger a major resurgence in economic growth.

The outlook for consumer spending will be relatively unaffected by the additional tax refunds because it appears that most of the late refunds have already been disparsed, and because the delay in refunds has not held spending down significantly in recent months since the short-term marginal propensity to consume is extremely low. Furthermore, the timing of tax refund payments is only a temporary factor and cannot affect the underlying trend in consumer spending.

5. Will the decline in interest rates stimulate the economy? The recent decline in interest rates has been triggered primarily by the slowdown in credit demands (especially from the business sector) in response to sluggish economic growth and by the Fed's dramatic easing in response to the lackluster economy. As of now, the impact of declining interest rates on the economy has been very limited, primarily reflecting the long lags. Housing activity has trended upward in recent months, despite a sharp decline in new starts in May, in direct response to lower mortgage rates. However, the rise in housing will be fairly modest because of various offsets to lower interest rates, especially the slowdown in income growth, the likelihood that employment growth will slow sharply in the months ahead in response to sluggishness in the economy during the last 12 months, and the weakness expected in multifamily construction in view of the high vacancy rates for apartments and condominiums in much of the South and Southwest. Furthermore, while consumer spending is benefiting to a limited extent from the decline in interest rates, this is partly offset by lower interest income.

I expect that the pickup in economic activity will likely cause some upward pressure on interest rates later this year and in early 1986, reflecting the direct effects of rising credit demands, and the likelihood that the Fed will pay increased attention to rapid growth in the basic money supply once the economy accelerates. The increases in rates at that time will be relatively modest because: (a) the magnitude of economic growth will be fairly moderate, (b)

even modest increases in interest rates will begin to slow economic growth again, and (c) at least some reduction in Federal deficits will take place (although considerably less than has recently been advertised).

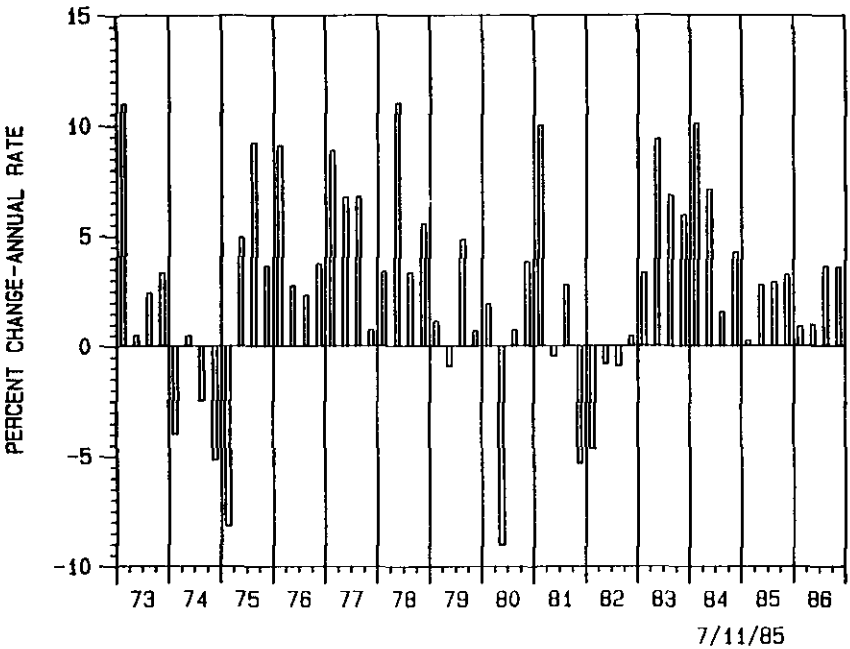
The net impact of the factors discussed above for the outlook are as follows: (a) I continue to believe that a recession is likely to be avoided, although the next several months are crucial. A sharp decline in consumer confidence or a sharper deterioration in the trade deficit than now expected are the two major near-term risks. (b) A rebound is not likely for several months because of continued inventory cutbacks and additional increases in the trade deficit. The economy will then begin to grow somewhat more rapidly, probably by the end of the third quarter, in response to recent declines in interest rates and the completion of the inventory correction. The pickup in economic activity later this year and in early 1986 will be fairly modest, however, because consumer spending is not likely to grow rapidly and because the trade deficit will continue to worsen. (c) For the remainder of 1986, the economy is likely to continue to grow at only a modest rate, reflecting a rebound in interest rates that is likely later this year or in 1986, and the effects of deficit reduction, which is likely to depress economic activity somewhat in the short term (although it is very favorable for the long term). If the dollar continues to decline sharply in the months ahead, economic growth will be stronger than I now expect during 1986. Thus, the risks for 1986 are more evenly balanced.

My most likely forecast for overall economic activity and some key economic indicators can be seen in the following chart and table.

IV. OUTLOOK FOR INFLATION AND UNEMPLOYMENT

In my view, the outlook for inflation remains highly favorable for at least the next few years. This reflects a number of factors: (a) the downtrend in energy prices now under way is likely to continue, reflecting substantial excess capacity in both the oil and natural gas industries; (b) food supplies remain extremely large so that any sharp acceleration in food prices during the next year or two is highly unlikely; (c) despite smaller productivity increases, cost-push inflation remains very low in view of the continued deceleration in rate of wage increases, especially in the manufacturing sector. Furthermore, while the growth in productivity has slowed, it does appear that there has been some improvement in the underlying trend growth in productivity relative to the 1970s; (d) capacity utilization remains relatively low in much of the economy, with no significant upward pressure likely in the foreseeable future. This is also true

REAL GROSS NATIONAL PRODUCT



FORECAST SUMMARY TABLE
(% CHANGE)

	1982	1983	1984	1985	1986	1987
REAL GNP	-1.9	3.3	6.8	2.6	2.2	3.5
INDUSTRIAL PRODUCTION	-8.1	6.5	10.7	1.6	1.4	4.0
REAL CONSUMPTION	1.4	4.2	5.3	3.9	2.8	3.5
REAL FIXED INVESTMENT	-4.7	1.5	18.0	6.2	3.9	4.1
CPI	6.2	3.2	4.3	3.8	4.3	4.5
GNP DEFLATOR	6.0	4.2	3.8	3.9	4.3	4.7
PRE-TAX PROFITS	-23.2	18.6	16.0	-1.6	0.0	9.6
UNEMPLOYMENT RATE (%)	9.6	9.4	7.4	7.2	7.6	7.1
PRIME RATE (%)	14.9	10.8	12.0	9.8	9.9	10.4
AUTO SALES (MILLIONS)	8.0	9.2	10.4	10.7	10.3	11.0
HOUSING STARTS (MILLIONS)	1.06	1.70	1.77	1.76	1.62	1.69

on a worldwide basis for most industries. Thus, it is unlikely that the kind of shortages and bottlenecks that are usually necessary to produce a major acceleration in overall inflation will occur during the next several years; (e) the economy remains extremely competitive, in part because of deregulation in many industries, in part because of the overvalued dollar, and in part because of large excess capacity. This high degree of competitiveness not only will limit any acceleration in inflation, but is encouraging more and more companies to intensify cost control efforts, which will also have a favorable effect on future inflation rates.

Some increase in the inflation rate is likely, however, if the recent downward trend in the U.S. dollar continues. This will not only eventually cause some increase in import prices, but many competing domestic prices will rise as well, as will various commodity prices. In my judgment, the impact on overall U.S. inflation will be relatively modest, however, so that even with a sharp decline, the overall inflation rate is not likely to substantially exceed 5% during the next several years. Furthermore, some acceleration is actually welcome under these conditions, since it will enable many U.S. industries which are now suffering a severe profit squeeze to experience some recovery.

With respect to unemployment, even my standard forecast, which includes a modest acceleration in economic activity later this year, implies that unemployment will rise by at least half a percentage point. If, of course, the economy remains stagnant or if a recession were to develop during this period, the rise in unemployment would even be sharper, probably bringing the overall unemployment rate to at least 8-1/2% by early 1986. In my view, any increase in unemployment during the period ahead would be a matter of great concern since unemployment is already too high because we have not had a complete recovery from the long period of economic stagnation in the late 1970s and early 1980s.

V. IMPACT OF THE FEDERAL DEFICIT

As I discussed earlier, the large and growing Federal budget deficit has now become counterproductive for economic growth. Furthermore, the outlook for the deficit is still extremely poor — the Federal deficit will continue to rise sharply in the years ahead in the absence of new spending cuts and/or tax increases. If this pattern were to occur, the pattern of slow and erratic economic growth that we have already experienced during the last year will continue, at best. Investment in particular will remain well below its potential level and, in fact, could drop sharply if foreigners decide to supply less funds to U.S. capital markets. Such a

change in the willingness of foreigners to hold dollar assets would probably offset the more accommodative Federal Reserve stance and cause upward pressure on U.S. interest rates leading not only to a decline in investment, but to weakness in other interest-sensitive industries as well. In effect, in the absence of significant reductions in future deficits, it will be virtually impossible for lower interest rates and a significant decline in the dollar to occur simultaneously (unless, of course, we experience a severe recession). But to sustain strong economic growth, it is necessary for both interest rates and the U.S. dollar to be significantly lower than current levels. Furthermore, any effort on the part of the Federal Reserve to offset the adverse effects on interest rates of growing Federal budget deficits on a long-term basis is likely to be counterproductive because it would require extremely rapid growth in money and credit on a sustained basis which in the long term will lead to a major acceleration of inflation, upward pressure on interest rates, and probably an even weaker economic environment.

In sum, the long-term consequences of Federal budget deficits would be as follows: (a) keep real interest rates and/or the U.S. dollar relatively high, (b) require larger and larger future tax increases just to service the rapidly growing Federal debt, (c) to the extent that foreigners hold an increasing share of that debt, interest payments will leak outside the United States, squeezing U.S. living standards. The net effect would be relatively slow growth and stagnant or declining living standards. Therefore, by far the most urgent policy priority in the United States is to adopt measures which would reverse the upward trend in deficits so that they are placed on a significant downward trend during the years ahead. In my judgment, this will require not only some significant cuts in all areas of spending, but it will also require some modest tax increases. The tax cuts that were enacted in 1981 were too large because of this country's continued commitment to a safety net, because of the current military buildup underway, and because of the difficulties of significantly reducing entitlement programs in the short run. While some of those tax cuts have already been reversed, additional revenue recoveries will be necessary. However, the net effect of spending cuts and tax increases which reduce future deficits will be positive in the long run because the loss of fiscal stimulus will be more than offset by the favorable effects of lower interest rates and a lower dollar. Furthermore, there will still be ample fiscal stimulus to promote a healthy and balanced economic recovery

VI. IMPLICATIONS FOR MONETARY POLICY

I give the Federal Reserve high marks for its conduct of monetary policy in recent months, particularly since it has become more accommodative despite the rapid growth in the basic money supply. It is important that a relatively accommodative monetary policy be continued for the following reasons: **(a)** The relatively strong growth in M1 in recent months should not be cause for alarm. This reflects the fact that the relationship between money growth and economic activity, which has never been very precise, has been distorted even further by the surge in import penetration in the United States. In effect, the money and credit needed to purchase imported goods are essentially the same as that needed to purchase domestic goods, so *that the growth in GNP will lag behind money growth when imports are rising rapidly. This is* precisely the situation that has occurred over the last year. Furthermore, financial market deregulation in recent years has made M1 a less reliable measure of spendable cash. The growth in other monetary aggregates have been much more moderate in recent months and are probably more meaningful guides to the availability of money and credit in the current environment. **(b)** As discussed earlier, the inflation outlook is extremely favorable. **(c)** Despite the decline in nominal rates in recent months, real rates still remain relatively high. It appears that lower rates will be necessary to stimulate an acceleration in economic growth. **(d)** Without a looser monetary policy, it is unlikely that the dollar will continue to declinein an orderly way in the months ahead. A lower dollar is essential to improve the competitive position of U.S. companies in world markets, although a dollar collapse prior to deficit reduction is very risky. **(e)** Stronger economic growth will be necessary to prevent the LDC debt crisis from flaring up in the months ahead.

Perhaps the biggest concern is that while a highly accommodative monetary posture is warranted now, it cannot be sustained on a long-term basis. However, large and growing Federal budget deficits, the net debtor status of the United States, and the international debt situation, are pushing the Fed into a corner by narrowing its option to become less accommodative if other factors so warrant. In my judgment, significant deficit reductions would overcome this problem by directly exerting significant downward pressure on interest rates — under these conditions, interest rates can be considerably lower, and the world economic situation considerably healthier, even with a more neutral monetary policy.

As indicated in the attachments, the majority of the members of the Monetary Policy Forum also highly support the view that the Fed should continue its accommodative stance in the months ahead because of their concern about the economic outlook. Furthermore, Forum

members are unanimous in their view regarding the need to substantially reduce Federal budget deficits.

VII. INTERNATIONAL FACTORS

A. Vulnerability of High Debt Countries to World Economic Conditions

It is clear that significant downward risks exist regarding the foreign debt situation. The base case scenario of modest U.S. economic growth, a pickup in economic growth in other industrialized countries (especially Europe), and continued low interest rates suggests that the debt crisis is manageable. If, however, interest rates should back up, or if the U.S. sinks into recession and/or Europe remains stagnant, it will be very difficult for many of these debtor countries to service their debts without significant further austerity measures in view of the difficulties they are likely to encounter in receiving more credits from outside financial institutions. A continued loose monetary policy in the United States, coupled with less fiscal stimulus, is the best macroeconomic policy approach for reducing the risk of a worsening of the LDC debt situation.

B. Exchange Rates

In my judgement, the overvalued dollar has become an impediment to economic growth not only in the United States, but in European countries as well . This reflects the fact that many of these countries have adopted relatively restrictive monetary and fiscal policies in recent years in order to prevent their currencies from weakening even further. Restrictive policies have kept domestic demand in those countries relatively weak, so that overall economic growth in Europe has been relatively slow, even with the sharp increase in their exports to the United States. In my view, therefore, a shift in the policy mix in the United States, resulting in lower

interest rates, would also result in speedier economic growth on a worldwide basis because it would give other countries more freedom to adopt more stimulative policies.

C. Net Debtor Status

The net better status of the U.S. economy represents another illustration of the fact that the current economic situation is unsustainable. The more that our debts overseas grow, the less likely that foreigners will continue to be willing to hold U.S. dollar assets. When that day comes, it will likely produce a sharp decline in the U.S. dollar on foreign exchange markets — while this would be welcome in order to improve our trade situation, it will have adverse effects on credit availability if the Federal budget deficit has not been reduced significantly. In my judgment, under these conditions, the Fed should provide whatever offset is necessary to prevent the resulting upward pressure on U.S. interest rates — this may be very difficult, however, if the resulting decline in the dollar becomes disorderly. The Fed may have to permit higher interest ratres to encourage foreign holders to keep holding their dollar assets, but the rise in interest rates would probably further slow economic activity in the United States. Furthermore, the more of a debtor nation we become, the larger the ultimate decline in the dollar will have to be in order to produce a trade surplus to enable us to service the foreign debt. This might be highly inflationary for the U.S. economy on a long-term basis. Again, a strong shift in the U.S. policy mix is the best way to reduce our reliance on foreign capital and thus prevent our overseas debts from growing to unacceptable levels.

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FORUM SAYS EASING OF MONETARY POLICY SHOULD CONTINUE

WASHINGTON, D.C., June 29 -- Despite the second quarter "flash" GNP estimate of rising economic growth, to a moderate annual rate of 3.1 percent, the Federal Reserve Board should continue monetary ease, according to the Monetary Policy Forum, a group of business, financial, and academic analysts.

In the June survey of the Monetary Policy Forum, a majority of the group's 28 members said that the Fed should continue to provide sufficient funds to enable the industrial sector to recover from its current slump.

"The economy is continuing to show a great deal of weakness with the industrial sector declining moderately," said Larry Chimerine, President of the Monetary Policy Forum, and Chairman and Chief Economist, Chase Econometrics. "Continued accommodation is also justified by the fact that the relationship between money supply and GNP growth are being distorted by rising import penetration and the fact that broad measures of money supply has not increased appreciably and the narrow money supply actually dropped sharply in the last week of June," Chimerine said.

"The Federal Reserve Board faces a major dilemma as it approaches its critical mid-year meeting -- how to cushing the decline of U.S. manufacturing in the face of increasing M1 growth and the recent evidence that the overall economy seems to be rebounding. If it takes seriously its M1 growth targets, no further easing or tightening of monetary policy may be called for. That, however, would strengthen the dollar and punish U.S. manufacturing even more. If the Fed moves to sustain growth in the 3 to 4 percent range then it will have to abandon M1 growth as a target," said Allen Sinai, Managing Director and Chief Economist, Shearson Lehman Brothers.

The June survey found a growing concern about apparent inaction on efforts in the Congress to reduce the federal deficit. Said Edgar Fiedler, Vice President and Economic Counsellor, The Conference Board, "The news on the budget reduction is discouraging. Once again we are seeing, as George Schultz observed many years ago, that the budget is a battle of the parts versus the whole and the parts always win."

The members of the MPF were pessimistic about chances of reaching the $56 billion proposed budget reduction. The majority said that the size of the actual deficit cut will be substantially lower, in the $30 to $40 billion range.

The most disturbing development has been the new record deficit in May reaching $42 billion. This is the first time in forty years that the federal government spent more than twice as much as it received.

"The budget deficit problem has not been resolved. As a matter of fact it may become more ominous assuming that the expected reduction package is smaller than expected and that the tax legislation turns out to be a major tax reduction

bill," said Leonard Santow, Managing Director, Griggs & Santow. This would result in a significant revenue reduction adding to the already unbearably high deficit.

The consensus of the group was that interest rates will bottom out in the current June-July period, but will not return to the mid-1984 levels in the next three years.

The group was about evenly split between those who felt that the U. S. economy will be in a recession next year and those who said that it will muddle through 1986 without a major recession. The major problem is the dollar and its impact on demand in the U. S. industrial sector and the need for a realignment of the world's currencies.

Said Robert Barbera, Chief Economist, E. F. Hutton, "I still think the dollar is the real problem."

Assuming the tax reform bill is passed this year, will it be

a.	Revenue Neutral	17%
b.	A small revenue reduction	53%
c.	A large revenue reduction	23%
d.	A small revenue increase	7%
e.	A large revenue increase	0

Both houses have passed a $56 billion expenditure reduction package, but with conflicting components. Assuming that some legislation is agreed upon by the joint conference, what will be the estimated size of the expenditure reduction?

a.	$10-$20 billion	3%
b.	$20-$30 billion	12%
c.	$30-$40 billion	53%
d.	$40-$50 billion	29%
e.	$50-$60 billion	3%

What month in 1985 are we likely to see the lowest short and long-term interest rates?

June	30%	Sept.	12%
July	30%	Oct.	12%
Aug.	4%	Dec.	12%

What month in 1985 will the prime loan rate and the 30-year Treasury bond rate be at their lowest levels?

June	30%	Sept.	12%
July	30%	Oct.	12%
Aug.	4%	Dec.	12%

Anytime in the next three years will short and long term rates return to their mid-1984 levels of 13% for the prime and 14% for long term Treasury bonds?

Yes	10%
No	90%

The Fed has not paid a great deal of attention to M 1 so far in 1985. Is this due to problems with respect to the accuracy or the quality of the statistics or is there a more basic move toward downgrading the importance of M 1?

Accuracy or the quality	16%
Basic move toward downgrading	62%
Neither	22%

If you were to characterize fed policy at the present time in terms of accommodation with 10 being the most accommodative and 1 being the least accommodative, what figure would you use?

Average - 7.2

Will the recent easing of fed policy be sufficien bring about economic growth in the 2nd half of 1985 that will b greater than in the 1st half of the year?

Yes	70%
No	30%

The economic indices are flashing a possible recession. Do you think a recession will take place in 1985 or 1986?

Yes	40%
No	60%

Chairman FAUNTROY. I want to thank you, for a sobering analysis of where we are, and your frank assessment of what we ought to be doing to handle the deficit in particular. We now move to Dr. Sumichrast.

STATEMENT OF MICHAEL SUMICHRAST, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS, AND VICE PRESIDENT/SECRETARY-TREASURER, MONETARY POLICY FORUM

Mr. SUMICHRAST. Thank you, Mr. Chairman.

I will try to limit my remarks to housing. I have prepared a short summary of my statement and I would like this to be included.

Mr. BARNARD [presiding]. Without objection, the entire testimony will be entered into the record, Doctor.

Mr. SUMICHRAST. I also would like to submit a short statement on housing which is appropriate at this time and I will sum it up in about 5 minutes.

First, let me say that there is very little I can add to what Allan and Chimerine have already said. I think we are in a growth recession. I think inflation is not an issue. The unemployment rate, in my opinion, is going to increase. We need lower interest rates. The Federal deficit is the major problem. We have seen a total realignment of interest rates among other industrialized nations and now only two countries, Switzerland and Japan, have lower interest rates than we have. It creates problems for us in terms of paying for the deficit with the supply of money coming from overseas.

I think the M1 is largely irrelevant in the current situation and I would urge that we look at the broader aggregate of GNP growth, unemployment, and interest rates other than try to run the size of the economy of the United States by simply looking at a narrow target as we used to do.

Let me briefly say something about housing because I think it is important to understand what's happening to housing and construction in general. First of all, the numbers are rather misleading; starts are fairly strong but you have a very uneven kind of recovery. You have some dozen States already down some 30 to 60 percent from last year. In particularly the oil, energy, and agricultural States are showing a very serious decline in the production of housing. You have Texas, minus 40 percent; you have Oklahoma, already down 60 percent; Wyoming, minus 55 percent; Alaska, minus 45 percent; West Virginia, minus 43 percent; Montana, minus 40 percent; and Colorado, New Mexico, North Dakota, all down more than one-third from a year ago.

The southern region is doing very poorly and as long as that continues, you cannot have a strong housing market either in 1985 or 1986. There is no way in the world you could have that. The southern region accounts for one-half of total housing production. What is holding housing up is the two things. One is the explosion in the use of tax-exempt revenue bonds; everybody is trying to use these before the tax rules are changed next year and there has been a tremendous activity in that area. Second, northeast region is doing

very well but it is a small part of the total production, roughly accounting for only, what, about 14 or 15 percent.

What's really happening in housing cannot be seen in the numbers coming out of either the Department of Commerce or some other type of activity. For one thing we have seen a decline in mortgage rates of 20 percent and yet housing is down 7 percent from a year ago. A 20-percent decline in the mortgage rate did not stimulate housing. Sales are marginal; the sales of existing homes are 1 million units below the previous peak. In the previous peak, we sold 4 million units and you are barely scratching 3 million units now. Second, you have a deflation in the prices of homes. I mean, when you really look at prices over the last 5 years, even at either average or medium price of a home without actual sales numbers, you could see that the existing home market prices are only about one-half as high as inflation rates. Prices of new homes are somewhat better but still below the inflation rate. As a result of it, we have seen a 20-percent jump in the foreclosure rate from a year ago.

The other increases in rates are also there. You have a very serious problem surfacing in the private insurance companies, which insure 10 to 15 percent of mortgages. They are losing—140 percent is the cost against the premium of 100 percent. Obviously, this cannot continue. It is affecting Fannie Mae; it is affecting Freddie Mac portfolios, and obviously it's affecting all the savings and loans. On the side of savings and loans, very curious things developed. In the first 5 months of 1985 the savings and loans have not received any new funds or practically none. A year ago the net inflow was nearly $30 billion and now they are ending up with practically no new money.

Well, what is happening? One problem is, of course, the Maryland-Ohio situation and I would like to also add, if I may, Mr. Chairman, a short one-page statement on the Maryland situation because it is pertinent to the total discussion I make.

Mr. BARNARD. Without objection, it will be included in the text.

Mr. SUMICHRAST. What is also happening is that the savings and loans started to be hit pretty hard by the Federal Home Loan Bank Board regulations against the high flyers; against the very expensive money and so forth. And as a result of it they were unable to attract money. In the first quarter of this year, the share of the savings and loan industry dropped below 20 percent. Typically, savings and loans always supplied one-half of mortgage funds. Now, they are down to 19.8 percent; something which has never happened, ever, in the history of the United States. So we do not have that part of support for housing. Then the rental vacancies are way up. We have a record number of rental vacancies in the south, 9.3 percent. In an area like Houston, the vacancies are in the high teens or 20 percent.

We have a very serious situation with inventory levels. We do not really know how many houses we have standing out there with a for sale sign but realtors are telling us that there are roughly about 3 million—we have about another 360,000 new homes and probably another 200,000 condos unsold, so when you tally it all up we have somewhere around 3½ million unsold homes. Now, that number would not be so bad if the sales would be as high as they

used to be in the previous recoveries. But the sales are 1 million below where they were before. So we have a serious situation in unsold inventory and that is not going to change; I don't see that.

On the side of nonresidential construction, we are seeing overbuilding, an oversupply, of office buildings which boggles your mind, simply. It is all over; anywhere you go, you can see that. Commercial buildings are also overbuilt in most parts of the country. You cannot have an explosion in these two areas continuing into 1986.

For that reason, when you sum it all up, I do not see any strengths in the overall construction activity for 1986 and I see very little of it in 1985. We are going to be sort of plugging along at the current high rates because of the tax-exempt revenue bonds. But we have some major and serious problems confronting us in 1986. What we have to do—as Larry mentioned—is do something about the deficit. That is our first priority as an association. We have done nothing other than try to convince the Congress and the public that this is a very serious problem. Second, interest rates are still way too high. We cannot sell houses with a 13- or 12-percent mortgage rate. At the 13-percent rate we can qualify only 15 percent of families; 15 percent of all families can qualify for 13-percent mortgages. And, finally, I am convinced now that we need to do something more on the budget side and possibly a tax increase is the only way we can go in the future.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Sumichrast on behalf of the National Association of Home Builders follows:]

STATEMENT

BY

DR. MICHAEL SUMICHRAST
CHIEF ECONOMIST
NATIONAL ASSOCIATION OF HOME BUILDERS
and
VICE PRESIDENT/SECRETARY-TREASURER
MONETARY POLICY FORUM

before the

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

on

SEMI-ANNUAL REVIEW OF THE CONDUCT OF MONETARY POLICY

BY THE FEDERAL RESERVE

JULY 18, 1985

Mr. Chairman, thank you for inviting me to this important hearing on the semi-annual review of the conduct of monetary policy by the Federal Reserve Board. I represent the National Association of Home Builders, a trade association of over 135,000 members. I also represent the Monetary Policy Forum as Vice President/Secretary-Treasurer. This organization is dedicated to improvement of the monetary policy of the United States. Attached is a recent MPF press release which includes a list of MPF members.

Here, in summary, are my responses to your questions:

In my opinion, we are currently at the border of a "growth recession." Clearly, we are in a recession in the industrial sector.

Inflation is not an issue. With worldwide commodity prices remaining flat, or declining, and our producer prices down 0.4 percent in the past 12 months, what's holding up the Consumer Price Index, for the most part, is services. But even so, the CPI is only 3.7 percent higher than it was a year ago--hardly a reason for alarm.

The unemployment rate is going to increase. We expect the unemployment rate to reach 8 percent in the first quarter of 1986 and then go to 8.3 percent during the last quarter of 1986.

What this tells us is that the Federal Reserve Board should continue its accommodative monetary policy and provide sufficient funds for our economy. Interest rates are still too high. We should make sure that we see a further decline in interest rates.

The deficit issue caused the Federal Reserve Board to keep interest rates high and the exchange value of the dollar is far higher than would be the case under a more restrained fiscal policy. The deficit, if not corrected, will eventually push us into an intolerable situation--with totally unacceptable alternatives such as: a sharp reduction in government expenditures, a sharp increase in interest rates and, thus, a deep recession; or the scenario could involve the printing of more money with a renewed high level of inflation (which would go far beyond anything we have seen before). The final outcome of this scenario is not fully predictable. However, there is sufficient precedence in the history of other nations which gives us a glimpse of the potential outcome.

The fact that foreign money is financing a large part of our deficit makes it rather difficult for the central bank to continue a policy of aggressive ease. A sharp decline in interest rates will affect the desire of foreigners to invest in the U.S. However, it is also clear that, until recently, U.S. interest rates have been quite high compared to most other industrial nations. Even today, the prime rate in both West Germany and Switzerland is 7.50 percent, while Japan's prime stands at 5.50 percent.

There has been a wide realignment of interest rates among the other industrialized nations in Europe and today most are higher than ours. This is due, in part, to the extention of the monetarist doctrine (largely abandoned by the U.S.), but still practiced to some degree in Europe. Simply put: fix money growth in a non-inflationary range, balance the budget and disregard unemployment and economic growth. For many years, Europeans have been waiting for their economies to recover and unemployment to decline. It didn't happen. The unemployment rate in Holland remained over 17 percent; in the United Kingdom it's at 12.5 percent and in West Germany it is over 9 percent--unheard of rates just a few years ago.

Let me make a few succinct observations:

* U.S. monetary policies should be guided away from mechanical monetarism. The M1 is largely irrelevant in today's world. As you can see from the attached Table 1, the current M1 is quite different than it used to be, particularly the inclusion of "other checkable deposits," which is becoming the dominant component of M1 compared to currency. By the end of the year, according to some predictions, this may be the largest component.

* The contention that the current M1 growth is suggesting the beginning of much faster economic growth cannot be confirmed by the data. Since deregulation, historical data offers no help. More fundamentally, the reasoning for the M1 targeting was never very convincing. Now it is even less so. It is suggested that this money is "transaction money," which is used to buy goods and services. However, its use has been quite volatile, as many of the innovations in the transfer of money within the financial system clearly demonstrates. This point has been well proven in the velocity numbers (see Chart 1).

What I am suggesting is that we cannot look the other way and hope that the transfixion with money supply is our salvation. As Professor James Tobin said: "History, since 1979, has not been kind to the monetarist prescription of stable policies blind to actual events and new information."

In the final analysis, what really matters is production and employment, as well as the level of prices. In this it is more important to pay attention to credit conditions and interest rates than some arbitrary set of numbers defined as M1.

* The net debtor status of the U.S. is a direct result of the strong dollar. That, in turn, is the residual of four years of record high interest rates in the U.S. In the long run, we must clear our books on the international balance sheet. If this status should continue, our living standard, and employment and investment in our industries will suffer.

The more obvious and generally understood impact is on employment. Less obvious is the long term impact on monetary policies. While the dollar remains strong this problem is not too apparent. But let us assume that eventually the dollar weakens, or becomes more volatile. Then our currency will be considerably more vulnerable than it is now. The central bank may get into a position of having to direct monetary policy to protect the dollar, thereby paying less attention to domestic developments. The potential danger of such a scenario is not well understood.

Housing activity continued strong through the first 6 months of 1985. This is due to declining interest rates and a heavy issuance of tax exempt mortgage revenue bonds (see Table 2).

However, housing activity differs appreciably from region to region. Compared to one year ago, housing is booming in the Northeast and dying in some of the Western and Southern states. Hardest hit are the energy-dependent states as well as the Midwest states where the economy depends on agriculture. The best growth states are those where the economic base changed in response to the changing economic climate (see Table 3).

Among the top 10 gainers, 5 are in the Northeast, 2 each in the Midwest and South, and 1 in the West. Among the top 10 losers so far, 5 are in the South, 4 in the West and 1 in the Midwest.

Mr. Chairman, again I thank you for inviting me here today to share my thoughts with you and the Committee.

TABLE 1

OTHER CHECKABLE DEPOSITS AS A PERCENT OF MONEY SUPPLY MEASURES
APRIL 1960-APRIL 1985
(in billions of dollars at seasonal rates)

April	Other Checkable Deposits[1]	M1	Total Money Supply (L)	Checkable Deposits as a Percent of M1	Checkable Deposits as a Percent of L
1960	$ 0	$140.6	$ 392.3	0.0%	0.0%
1965	0.1	163.7	553.5	0.1	*
1970	0.2	209.3	774.1	0.1	*
1975	0.6	279.4	1,278.6	0.1	*
1976	1.4	297.6	1,420.3	0.5	0.1
1977	3.1	319.9	1,579.5	1.0	0.2
1978	4.7	344.3	1,776.9	1.4	0.3
1979	12.5	371.7	1,994.6	3.4	0.6
1980	17.5	387.1	2,191.8	4.5	0.8
1981	63.4	429.7	2,420.3	14.7	2.6
1982	85.3	449.3	2,710.3	19.0	3.1
1983	114.7	497.9	2,980.0	23.0	3.8
1984	136.1	539.2	3,292.3	25.2	4.1
1985	155.3	574.9	3,626.3	27.0	4.3

1 Consists of Negotiable Order of Withdrawal and Automatic Transfer Service accounts at depository institutions, Credit Union Share Draft accounts and Demand Deposits at thrift institutions.

* less than one-tenth of 1 percent

Source: Federal Reserve Board; compilation by NAHB Economics Division.

Table 2

Sale of Long-Term Municipal Bonds for Housing, 1976-1985
(in millions of dollars)

Period	Total Housing Bonds	Veterans' Housing G.O. Bonds	Mortgage Revenue Bonds: State Multi-family	State Single Family	Local Multi-family	Local Single Family
1976	$ 2,744	$ 620	$1,420	$ 680	$ 21	$ -
1977	4,398	584	2,633	959	241	-
1978	6,946	1,155	1,748	2,792	735	619
1979	12,072	1,590	1,929	3,333	729	4,491
1980	14,048	1,332	1,379	4,974	839	5,524
1981	4,834	870	711	1,662	405	1,186
1982	14,626	480	2,784	5,493	2,360	3,509
1983	15,350	675	1,269	7,506	2,418	3,482
1984	20,348	2,211	1,387	9,269	3,072	4,340
1983						
Q I	$ 2,831	$ 50	$ 452	$ 651	$1,031	$ 647
Q II	3,453	300	183	1,429	878	663
QIII	4,488	150	180	3,013	219	926
Q IV	4,578	175	454	2,413	290	1,246
1984						
Q I	1,822	365	197	0	469	322
Q II	2,126	415	459	427	458	367
QIII	9,928	568	301	5,932	829	2,298
Q IV	6,872	863	430	2,910	1,316	1,353
1985						
Q I	$ 4,259		$ 582	$ 917	$1,787	$ 972
1984						
Jan	384	85	30	0	129	140
Feb	587	280	40	0	171	96
Mar	382	0	127	0	169	86
Apr	743	165	151	30	201	196
May	656	250	36	104	129	137
Jun	727	0	272	293	128	34
Jul	3,671	175	180	2,813	168	335
Aug	3,597	131	28	2,087	287	1,064
Sep	2,660	262	93	1,032	374	899
Oct	2,302	250	103	1,074	356	519
Nov	2,374	0	145	1,164	641	424
Dec	2,196	613	182	672	319	410
1985						
Jan	769	0	211	65	492	0
Feb	1,053	0	186	0	640	227
Mar	2,437	0	185	852	655	745
Apr	1,576	0	126	730	365	355
May	1,751	0	250	581	489	431

TABLE 3

CHANGE IN NUMBER OF BUILDING PERMITS ISSUED
(1st 5 months of 1984 vs. 1985)

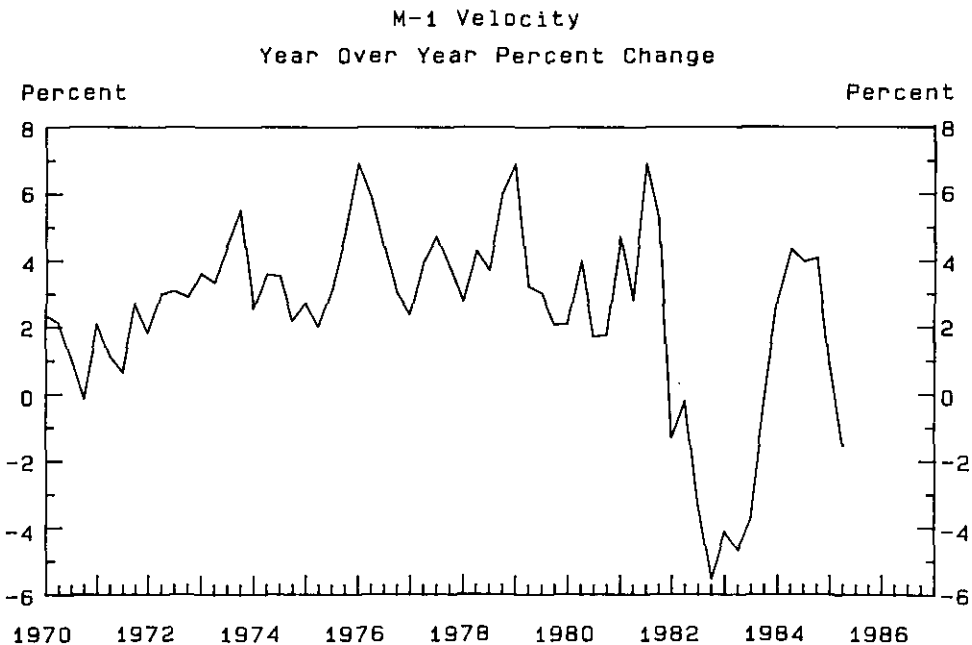
Biggest Winners		Biggest Losers	
New Jersey	7,014	Texas	-36,023
California	5,918	Oklahoma	-6,603
New York	5,682	Colorado	-5,847
North Carolina	5,183	Louisiana	-5,129
Massachusetts	5,082	Florida	-3,765
Pennsylvania	4,221	Arizona	-2,610
Michigan	3,447	New Mexico	-2,119
New Hampshire	3,225	Alaska	-1,311
Maryland	2,973	Minnesota	-1,299
Illinois	1,182	Mississippi	-1,128

PERCENT CHANGE IN BUILDING PERMITS ISSUED
(1st 5 months of 1984 vs. 1985)

Biggest Winners		Biggest Losers	
New Hampshire	93.0%	Oklahoma	-57.5%
Kansas	80.1	Wyoming	-53.8
District of Columbia	77.0	Alaska	-44.6
New Jersey	51.0	West Virginia	-42.8
Massachusetts	46.9	Montana	-39.9
New York	35.1	Louisiana	-37.2
Michigan	35.0	Texas	-36.0
Hawaii	33.2	North Dakota	-31.0
Pennsylvania	30.6	Colorado	-39.0
Oregon	25.7	New Mexico	-28.8

Source: Bureau of the Census; compilation by NAHB Economics Division

CHART I



Mr. BERNARD. Thank you, Doctor. We will now hear from Dr. Norman Robertson, Jr., chief economist for the Mellon Bank. Dr. Robertson.

STATEMENT OF NORMAN ROBERTSON, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, MELLON BANK, PITTSBURGH, PA

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

As the last witness, I am afraid that much of what I am about to say has been heard exactly four times before. Let me summarize my view of the economic situation.

I do not see any significant improvement in our economic performance for the balance of this year or even in 1986. I doubt very much that the drop in interest rates is going to inject new energy into this aging cyclical expansion. And as the other speakers have mentioned, the expansion is very lopsided with the service sector and the construction sector seemingly generating most of the growth in economic activity.

But I think we have to recognize that further gains in these area are going to be very hard to achieve given what has been done since 1982. So, even though I do not see a full-fledged recession either this year or next year, my own feeling is that the rate of economic growth is going to hover around 2 percent which, of course, is not going to reduce the unemployment rate which could, in 1986, begin to move upward again, possibly to around 7½ percent. So, what I would argue is that this growth recession is likely to persist well into 1986.

From a policy standpoint, of course, the crucial question now is whether the Federal Reserve should try to reenergize or reinvigorate an expansion which has dissipated much of its energy. Those who argue in favor of a much more stimulative policy by the Fed, rightly point to the dangers that a slowing U.S. economy would pose for the world economy and there is not any doubt that the growth of world trade and the health of the international financial system are contingent on what happens to the United States.

Having said that, I think there is a risk that if we adopt a significantly more aggressive monetary policy designed to keep the economy going, it could prove counterproductive since it could lead to more inflation which in turn could set the stage for a full-fledged recession. Now, I agree that the risks of a more expansionist monetary policy right now seem very small especially since there is low inflation today. Commodity prices are falling; energy prices are declining. We have low to moderate wage increases; we have a signficant margin of idle capacity. I do not deny any of that. In fact, I think that inflation over the coming year should hold at around 4 percent.

But having said that, I do not think we should be complacent about the outlook for inflation. Of some significance, the dollar is now declining and while, of course, that may ultimately help exporters and import competing industries, the shorter run effects could well be higher prices in this country.

Most of the studies that have been done would seem to suggest that a 10-percent drop in the value of the dollar will raise the inflation rate by roughly 1½ percent over a subsequent 3-year period.

So if we assume for the sake of argument that the dollar falls 20 percent this year, and it has dropped 15 percent already, we could be looking at an inflation rate of something close to 7 percent in, say, 2 or 3 years time. And, since the inflationary process generally tends to feed on itself, I do not think anyone can say how high the inflation rate might ultimately rise.

The other concern, I suppose, is that a weakening dollar could be accompanied by a diminished inflow of foreign capital which has helped finance the budget deficit and which had held interest rates below the level that they would otherwise have reached. So, unless we can reduce this enormous Federal budget deficit, it seems to me that a softening foreign demand for dollar assets would tend to push our interest rates upward since our supply of savings would be inadequate to finance both the deficit and private investment at the prevailing level of interest rates. And needless to say, if private investment is crowded out as a result of increased borrowing costs that, too, would increase the risks of a recession. So, quite simply, if we have a substantial or significant easing of monetary policy, that would risk an accelerating decline in the dollar which in turn would put upward pressure on our prices and interest rates.

We should also ask whether an easier monetary policy is justified at a time when the narrowly defined money supply is well above its target range. The conventional wisdom is that since the velocity of money or the turnover rate of money is falling, this rapid rate of money growth does not really have any serious consequences in terms of inflation.

And I think there's a lot to be said for the argument that since we do not know enough about the behavior of the money supply in a deregulated financial world, we ought to be cautious about using the various measures of the money supply as rigid policy guides. In fact, the whole thrust of Federal Reserve policy, so far in 1985, has aroused a good deal of speculation that the Central Bank has shifted its policy focus away from the monetary aggregates to nonmonetary objectives, including the growth of GNP and the exchange value of the dollar. The decision of the Fed to establish a new and higher base for M1, which of course allows the policymakers to ignore much of the rapid growth in money that has already taken place, seems to support the view that for the moment at least the monetary aggregates have been significantly deemphasized.

I think we can not ignore, though, the fact that time after time since the end of World War II, periods of rapid money growth although justified at the time, have been followed by reigniting of inflation. In the current situation I see some danger that the Federal Reserve, seeking to stimulate this lagging rate of economic growth, will push too hard on the accelerator and again spark a new round of inflation. While I would acknowledge the need on occasion to rebase M1, what would concern me is that if we continue to abandon targets or modify targets when their attainment appears difficult or the involvement of restrictive actions, that could raise some serious doubts about the Federal Reserve's commitment to combat inflation. Quite simply, I do not see much point in setting all these objectives and targets if there is no intention of reaching them.

All things considered, I think the Federal Reserve is facing a virtually impossible task. I can not think of any policy or set of poli-

cies that can guarantee us a steady, 3- to 4-percent rate of real economic growth year in and year out. And yet we seem to expect that the Central Bank with inadequate policymaking tools and confronted on all sides with conflicting pressures and constraints can somehow achieve this ambitious and ellusive goal.

Until very recently, the Federal Reserve was concerned with the need to sustain growth, reduce unemployment, and combat inflation. Now, that task, it seems to me, is difficult enough but it has become even more difficult because the Fed now has to consider the problems of manufacturing, the problems of agriculture and mining, the plight of the world economy, the problems of the debtor nations, and the fragility of the financial system, both at home and abroad.

Not only that, the unpredictable dollar has become the wild card in the outlook and represents, I think, something of a nightmare for the Federal Reserve as it struggles to keep the expansion going without reigniting inflation. The middle ground between a too strong dollar and a too weak dollar is very hard to define, and it is even harder to hold especially since markets are liable to overshoot the mark.

In summary, it seems to me that the Federal Reserve is carrying far too heavy a burden and I think the strain is beginning to show. The only way that burden can be eased is to reduce this enormous budget deficit and to reduce it sooner rather than later. If we can do that, it would have the beneficial affect of lowering or easing the intense pressures now being felt by the trade-related sectors of the economy while at the same time allowing interest rates to stay down and possibly to move down even further. As part of this process, the Federal Reserve could then continue to follow accommodating policies which would foster lower rates and sustained expansion without really contributing to a new round of inflation.

But as the other witnesses have indicated, I think the persistence of these deficits could have really very ominous implications for investment, for productivity, and economic growth. The cold fact is that these continuously large internal and external deficits are incompatible with noninflationary expansion and we should not expect the Federal Reserve to somehow overcome these barriers and allow us to escape what are going to be some harsh, economic consequences of a very undisciplined and irresponsible fiscal policy.

Thank you very much, indeed, Mr. Chairman.

[The prepared statement of Mr. Robertson follows:]

Testimony of

Norman Robertson
Senior Vice President and Chief Economist
Mellon Bank
Pittsburgh, PA

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 18, 1985

I appreciate the Subcommittee's invitation to discuss monetary policy options in the context of current and prospective domestic economic conditions, fiscal policy issues and the international financial situation. Before addressing the question of monetary policy, I believe it would be both helpful and appropriate to spell out in some detail my views on the current state of the economy and where it may be headed over the next year and a half.

The expansion is now more than two and one-half years old and, in my judgment, has lost much of its cyclical energy and vitality. Over the past four quarters, the economy's growth pace has averaged only a shade better than 2.25 percent, which by and large fits the description of prior "growth recessions" experienced in 1951-52, 1961-62 and 1966-67. The crucial question now, of course, is whether this slowdown will be followed by a downturn in economic activity, the resumption of vigorous growth or, as I believe, a more extended period of sluggish and unsteady expansion.

Despite the recent parade of generally weak economic statistics, I do not believe the U.S. economy is poised on the brink of a full-scale recession. Most recessions of the post-World War II era have generally been associated with a rapid -- and for the most part unintended -- buildup of business inventories, accelerating inflationary pressures, a tightening of monetary

policy and sharply higher interest rates. Today, however, economic conditions bear little or no resemblance to those which in the past have often been the harbingers of recession. For one thing, business inventories are in very good shape. Essentially, the combination of stable or declining prices, prompt delivery dates and the development of sophisticated, computer-based inventory control systems have enabled most firms to keep their inventories very lean, avoiding the speculative hedgebuying of goods and materials which has frequently set the stage for a downturn in economic activity. These factors, I believe, combined with some uneasiness regarding the outlook for sales and profits will continue to provide businessmen with a powerful incentive to keep a very tight grip on their inventory positions. So far as the behavior of prices is concerned, the inflation rate in the summer of 1985 is actually lower than it was when the recovery started more than two and one-half years ago. Finally, monetary policy has been eased, not tightened, and interest rates, which generally rise during the latter stages of a business cycle expansion, are in fact declining.

The avoidance of a recession, however, does not, in my opinion, mean that we will see the resumption of strong economic growth during the balance of 1985 -- or 1986. Many observers believe that falling interest rates will soon spark increased activity in the key credit-sensitive areas of the economy, including homebuilding, nonresidential construction, fixed investment

spending and outlays for consumer durables. After all, many interest rates have dropped more than two percentage points since late March and are at their lowest level in seven years.

In my view, however, the stimulative impact of lower interest rates in the third year of an economic expansion will be quite limited. Specifically, I doubt that lower borrowing costs are likely to generate a new burst of consumer buying for durable goods. Over the past two and one-half years the powerful rise in outlays for automobiles and other big-ticket items, although within the range of previous business cycle expansions, has resulted in a larger and faster-than-usual pileup of installment debt. For example, the closely watched debt-to-income ratio has now surpassed its previous peak, having climbed over three percentage points in just over two years -- a similar percentage rise in the 1974-79 expansion took four years. The present condition of consumer finances, to be sure, is generally good, and the high level of consumer confidence and buying plans is encouraging. I have the suspicion, however, that the families and individuals who benefited the most from rising stock and bond prices are, by and large, a very different group from those with the heaviest burden of debt relative to income. Thus, I believe that the recent boom-like expansion of installment credit reported during the first half of 1985 -- 24 percent on an annualized rate basis -- is unsustainable and is, therefore, likely to slacken appreciably during the latter part of the year.

In addition to the sizable debt burden, the increasingly sluggish growth of income and employment is also likely to dictate a much more cautious approach to both spending and borrowing. Declining payrolls in manufacturing -- down 145,000 since March -- have materially reduced the monthly gains in nonfarm employment from an average of more than 325,000 during much of 1984 to a second quarter average of 185,000. The June rise of 90,000 was one of the weakest in the recovery period. At the same time the loss of jobs in manufacturing along with a flattening trend of interest income -- stemming from the recent drop in interest rates -- have been primarily responsible for cutting monthly gains in personal income from an average of 0.7 percent in 1984 to less than 0.4 percent during the first half of 1985. Eventually the loss of manufacturing jobs and income will probably begin to curb the advance of service- and construction-related activities, with very negative implications for the growth of consumer spending and, indeed, the entire economy. All things considered, I see consumer spending growing at a very subdued and uneven pace over the next 18 months, with outlays for durable goods in the final quarter of 1986 essentially unchanged from the level reached in the second quarter of this year.

I also doubt that the decline in interest rates will encourage a stepped-up rate of spending for new plant and equipment. For most industries, particularly in the hard-pressed manufacturing sector, the drop in borrowing costs -- coming at a time of weakening

demand, lackluster earnings, low operating rates and chronic uncertainty regarding the economic outlook -- is not likely to produce much in the way of increased outlays, especially for major capacity expansion projects. At this stage of a business cycle upswing, operating rates are usually within the 85-90 percent range and consequently a significant drop in interest rates would likely be sufficient to induce businesses to activate plans for additional capacity. The situation today is very different. Much of the increase in domestic demand over the past couple of years has been accommodated by imports as opposed to domestic production. And as a result, the all-industry operating rate remains near the 80 percent mark, well below the level which in the past has been needed to generate increased outlays for capacity expansion.

Another consideration is that following a two-year period of record-setting expenditures, additional gains will be harder to realize. Since late 1982, real fixed investment outlays have soared more than 32 percent compared with an average gain of less than 17 percent recorded during comparable periods of previous post-World War II business cycle expansion. In fact, the 39 percent rise in outlays for equipment since late 1982 is the strongest reported in any expansion since World War II, while the 17 percent increase in spending for nonresidential building was the largest cyclical gain experienced since the early 1950s. The potentially negative impact of the President's tax reform plan,

which would reduce the incentives for investment, must also be taken into consideration. Until the tax issue is settled, which is unlikely any time soon, there may well be a tendency for many firms to delay or postpone a number of major capital projects. Although some advance indicators of capital spending are pointing to continued modest gains through the balance of 1985, I believe that the lengthening list of negatives in the outlook points to a flat or slightly downward trend of activity in 1986.

Might not the declining dollar revive activity in the domestic manufacturing sector and in time encourage a quickening pace of investment spending? Over the past three months or more, the drop in domestic interest rates along with mounting evidence of a faltering and increasingly tenuous economic expansion have been primarily responsible for the dollar's sizable decline on the foreign exchange markets. And certainly, there is no denying that over time a weaker dollar should gradually reduce the trade deficit and arrest the alarming deterioration in much of the nation's manufacturing sector. But for most industries, measurable relief from intense import competition is unlikely to be visible until late next year. And even then, the prospect of a relatively slow-paced economic expansion implies little strength in domestic demand and hence I do not see a vigorous rebound in manufacturing production and employment during 1986, even assuming that the flow of imports is in fact gradually reduced. Moreover, given the very modest growth prospects for many of our major

trading partners and the slow response of trade flows to movements in the exchange rates, the demand for U.S. goods abroad is likely to remain weak for some time.

The response of the housing market to lower interest rates should be more positive. The two percentage point drop in home financing costs since last July as well as the prospect of a further 50-100 basis point decline over the balance of 1985 should improve the already strong tempo of homebuilding activity. As a result of falling interest rates and a much slower rise in new and existing home prices, more people are now able to qualify for a mortgage loan than at any time since 1979. By the same token, however, housing affordability is still running well below the level recorded during the 1970s when home mortgage rates were in the 6-9 percent range. Thus, despite the evident strength of demand, I doubt that the annualized rate of housing starts will return to the peak 2-2.5 million zone experienced during the housing booms of the 1970s. While the housing outlook is generally positive, I am concerned that the President's proposal to severely limit the tax deductibility of mortgage interest on second homes has injected a new element of uncertainty into the construction outlook, and may in fact curtail activity in those parts of the country where the vacation or second home market is an important source of demand. I expect that housing starts in 1986 will be little changed from the near 1.9 million presently forecast for 1985.

In sum, the sizable drop in interest rates is not likely to inject new life and energy into the aging cyclical expansion. Activity in much of the manufacturing sector is likely to remain on the weak side, reflecting in part the lagged effects of the strong dollar on both imports and exports. Moreover, many of the nation's long-established industries have also been seriously weakened by the forces of structural change within the U.S. economic system as well as the increasingly powerful challenge of highly competitive industries in Asia and elsewhere in the world.

We should not, therefore, expect that a reduced flow of imports will automatically signal a perceptible strengthening of activity in basic manufacturing industry. Thus, despite the prospect of a rising trend of productivity in a number of industries, notably the high technology and defense-related groups, I see little overall improvement in the nation's manufacturing sector during the next 18 months. In fact, my forecast anticipates that the annualized growth of industrial production will be in the neighborhood of 1.3 percent over the next six quarters, which implies a flat or even declining trend of manufacturing employment.

In sum, I do not see any significant improvement in the economy's performance during the balance of 1985 or 1986. The expansion is very lopsided with the service and construction sectors generating most if not all of the growth in overall economic activity. But further strong gains in these two major sectors of the economy may

be increasingly difficult to achieve, given the unusually rapid growth recorded since 1982. Nonetheless, the odds continue to favor positive real GNP growth through most of 1986. But the rate of increase -- forecast at around 2 percent -- will not reduce the unemployment rate, which in fact could again move upward, possibly to the 7.5 percent zone. In a word, I expect that the United States will experience a "growth recession" through 1986.

From a policy standpoint, the question now is whether the Federal Reserve should endeavor to reinvigorate a cyclical expansion which has already dissipated much of its energy. Those who argue in favor of a more stimulative monetary policy by the Federal Reserve point to the dangers that a slowing U.S. growth rate would pose for the world economy. To a considerable degree, growth of world trade and the continuing health of the international financial system are heavily dependent upon sustained expansion in the major industrial economies, which in turn depends critically upon continued growth in the United States. Without such growth, there is little doubt that the international debt problem would quickly return to a "crisis status" with no assurance that widespread defaults with potentially severe economic consequences could again be averted.

That said, I believe there is also a considerable risk that the adoption of a more aggressive monetary policy, designed to keep the economy going, could well prove counterproductive since it

could lead to renewed inflation and thereby set the stage for a full-fledged recession. At first sight, of course, the risks of a more expansionist policy seem fairly small in today's environment of relatively low inflation, as evidenced by falling commodity prices, low-moderate wage increases and a sizable margin of idle resources. Indeed, my forecast calls for the annualized rate of consumer price increases to hold in the 4 percent range over the next year or so. Nonetheless, I see no grounds for complacency regarding developments on the price front.

Of particular significance, the dollar is now declining and, while this may ultimately help exporters and import-competing industries, the shorter-run effects may well be higher domestic prices. Most studies on this subject suggest that a 10 percent decline in the dollar will raise the inflation rate by roughly 1.5 percent over a subsequent three-year period. If, for the sake of argument, we assume that the dollar falls some 20 percent during 1985 -- a 15 percent drop has already taken place -- the result could well be an inflation rate of close to 7 percent in 1987-88. And since the inflationary process tends to feed on itself, no one can say just how high the inflation rate might ultimately rise.

Equally important is the likelihood that a weakening dollar will be accompanied by a diminished inflow of foreign capital which has helped finance the budget deficit and over the past year or so held interest rates well below the level that would otherwise have

been reached. Absent a significant reduction of the budget deficit, therefore, a softening foreign demand for dollar assets would tend to push U.S. interest rates upward since our supply of savings would be inadequate to finance both the deficit and private investment at the prevailing level of interest rates. Needless to say, a crowding out of private investment as a result of rising borrowing costs would raise the risks of a recession. Simply put, a further significant easing of monetary policy might well accelerate the dollar's decline and thereby put upward pressure on prices and interest rates.

To compound matters, the inflow of foreign capital is not without its problems. We are already a debtor nation and the rise in interest payments to foreigners will make it increasingly difficult to shrink the external deficit which is likely to persist well into the future. Of growing concern is the fact that without a substantial decline in the dollar -- which, as I have just noted, is by no means an unmixed blessing -- the United States will be hard pressed to generate the volume of exports now needed to service foreign debt. What has happened is that our growing foreign debt position has reduced our income from overseas investment, which in the past has helped offset the merchandise trade deficit. Over the longer term, the United States may be forced to become a net supplier of goods to foreigners. One final point. We are not borrowing for productive purposes, which was

the case before World War I, but rather to finance current consumption as represented by the enormous budget deficit.

We should also ask whether an easier monetary policy is justified at a time when the narrowly defined money supply is already well above its target range. Since the turnover rate of money (velocity) has been falling sharply, it can be argued that the recent torrid pace of M1 growth does not, in fact, raise the specter of renewed inflation. Then, too, much can also be said for the argument that, since we do not know enough about the behavior of the money supply in a deregulated financial world, we should be cautious about using the various measures of the money supply as rigid policy guides. Indeed, the thrust of Fed policy thus far in 1985 has aroused considerable speculation that the Fed may have shifted its policy focus from the monetary aggregates to nonmonetary objectives, notably GNP growth and the exchange value of the dollar. The decision of the Fed to establish a new and higher base for M1, which in effect allows the policymakers to ignore or forgive much of the rapid growth that has already taken place seems to support the view that, for the moment at least, the monetary aggregates have been deemphasized.

By the same token, however, we ignore at our peril the fact that time after time periods of rapid monetary growth have been followed by a reigniting of the inflationary fires. In the current situation, I see some danger that the Federal Reserve,

seeking to spur the lagging rate of economic growth, will push too hard on the monetary accelerator and thereby arouse new inflationary impulses. While acknowledging the occasional need to rebase M1, I am concerned that the abandonment or frequent modification of targets, when their attainment involves the pain of restrictive actions, could raise serious doubts about the Fed's commitment to combat inflation. Briefly stated, there is little point in setting objectives if there is no firm intention of achieving them.

All things considered, the Federal Reserve is facing a virtually impossible task. Even though there is no policy or set of policies which can assure a steady 3-4 percent real growth rate year after year, we seem to expect that the central bank, possessing inadequate policymaking tools and confronted on all sides with conflicting pressures and constraints, can single-handedly achieve this ambitious and elusive goal. Until quite recently, the Federal Reserve was primarily concerned with the need to sustain economic growth, reduce unemployment and avoid a new outbreak of inflationary fever. Those very formidable tasks, however, have become even more difficult as a result of additional elements which have now entered the decision-making process. The Fed now has to carefully consider the unique problems of manufacturing and agriculture, the plight of the developing countries and the fragility of the financial system, both at home and abroad. Not only that, the unpredictable dollar

has become the wild card in the economic outlook and represents something of a nightmare for the Federal Reserve as it struggles to sustain the expansion without reigniting inflation. Clearly, the middle ground between a too strong and a too weak dollar is extremely difficult to find and hold, especially since markets are liable to overshoot the mark.

To conclude. The Federal Reserve is carrying far too heavy a burden and the strain is beginning to show. To ease that burden requires that we reduce the budget deficit -- and soon. Such action would have the beneficial effects of reducing the intense pressure currently felt by the trade-related sectors of the economy, while at the same time allowing interest rates to stay down and possibly to decline further. As part of this process, the Federal Reserve could continue to pursue accommodative policies, fostering lower interest rates and sustained expansion, without running the risk of contributing to a new inflationary spiral later in the decade. On the other hand, the persistence of enormous budget deficits would have very ominous implications for private investment, productivity and economic growth. The cold fact is that continuously large internal and external deficits are totally incompatible with vigorous noninflationary economic expansion. And we should not expect that the Federal Reserve can somehow overcome these insurmountable barriers and allow us to escape the harsh economic consequences of an undisciplined and irresponsible fiscal policy.

Mr. BARNARD. Thank you, Mr. Robertson.

After listening to the testimony this morning, and I think all of it has been excellent, the only analogy I can make is trying to analyze our country as a drunk driver trying to straddle a white line in the middle of a highway. It's just about impossible to do it, because we seem to be going from side to side to side.

All of you have prompted some very interesting topics that we need to talk about. All of you have emphasized the fact that we have just got to reduce the deficits, and I think some of you have emphasized the fact that we've got to do it through reducing Federal spending. But let's say this, let's say we've come to an impasse, and Congress will not reduce Federal spending much more than we are now, what effect would it have on the economy to have some tax increases?

You know, there's quite a bit of division in the Congress on the Senate side as well as the House side. Now there's unanimity that we've got to reduce the deficits, but what to do with taxes seems to be the big question. Of course, the President has said he would veto any tax bill.

But we do need to reduce the deficit, so the question is what effect would a tax increase have on the economy, and what kind of tax increase would be the worst on the economy?

Mr. Sinai.

Mr. SINAI. A tax increase in any form or fashion, if unaccompanied by a compensatory easing by the monetary authority, would be restrictive and would slow growth in the economy, some more, some less. But I think one vehicle for raising tax revenues could be the current framework of the currently proposed tax reform, although politically very difficult since the President has said in no way will there be a tax increase. But rather the current bill, which looks increasingly to most people as a revenue loser rather than revenue neutral, could be turned into a revenue raiser simply by adjusting the marginal rates upward by 1 or 2 percentage points. It would still be a marginal tax reduction from where we are. It would still involve base broadening. The principles of the tax reform proposal would be protected, but it could be designed to raise the revenue to close part of the remaining deficit gap that is left, depending on where Congress gets in spending. You would then leave to the Federal Reserve with that budget tightening by raising taxes, the choice on when and how to ease. By lowering interest rates and stimulating growth, the rest of the missing deficit could be picked up.

Mr. BARNARD. Mr. Chimerine.

Mr. CHIMERINE. Thank you, Mr. Chairman. I would take a slightly different stance on that than Allan Sinai. I think a modest tax increase, phased in over time, coupled with spending reductions, would actually be very stimulative for the economy, although there may be some restrictive effects in the very near term. In my judgment, the benefits that it would produce through lower real interest rates and ultimately a lower U.S. dollar on foreign exchange markets on a sustainable basis, will outweigh the direct loss of fiscal stimulus resulting from some modest tax increases. Furthermore, I am not sure how appropriate the phrase "tax increase" is, because I think if we are realistic and honest, we have to admit

that the tax cuts of 1981 were too large. In view of the military buildup under way and this country's commitment to the entitlement programs and to a safety net, we cannot afford all of those tax cuts.

Now all I am talking about essentially is taking back some of those tax cuts. Tax rates will still be considerably lower, even with a modest tax increase enacted now, than they were back in 1980 or 1981, before the 1981 tax cut.

In the context of a total package to reduce budget deficits, a modest tax increase would be highly stimulative for the economy on a long-term basis and the kind of tax cuts I would recommend—tax changes I would recommend—are those that would not raise marginal tax rates. That would include base broadening such as some of the measures included in the tax reform proposal, such as those designed to eliminate some of the shelter activity, and reduce some of the exemptions and tax exclusions and deductions. Perhaps some excise tax increases, other consumption type tax increases should also be considered——

Mr. BARNARD. What about consumption taxes?

Mr. CHIMERINE. My reference would be within the income tax structure, because I am concerned we may be making the tax structure too regressive. Consumption taxes could make it worse, but I would not be adverse to some consumption tax increases. Certain excise tax increases or perhaps an energy tax increase deserve some consideration.

Mr. BARNARD. Mrs. Teeters.

Mrs. TEETERS. I am basically in agreement with both of them. I think the tax cut in 1981 was much too large. But if you look back at 1981, it was phased in very slowly. I think the first year it started in the fourth quarter.

Mr. BARNARD. Five, ten, and five.

Mrs. TEETERS. Yes; if we do need to raise revenue, I have a preference for the income tax and to use it to recoup the revenues that we lost.

I am also concerned about the corporate tax. I was appalled to learn that something like 225 to 230 of the Fortune 1000 had not paid taxes in one of the last 3 years, and there is one that has not paid any taxes in any of the last 3 years. Some loophole tightening, it seems to me, needs to go into any reform package. You do get services for your taxes, and people ought to bear their fair share of it.

I do not like the consumption tax, particularly, mainly because it is a sales tax or if you want to call it a value added tax it comes out to the same thing. The sales tax has been traditionally reserved for the States. If you put a consumption tax on top of some of the very high State sales taxes, like in New York, for example—it is 7¾ percent already—you end up with a very, very high sales tax, which could become very regressive, if you are not carefully with it.

Mr. BARNARD. Mr. Sumichrast.

Mr. SUMICHRAST. Of course, my first preference is not to raise taxes. A cut in expenditures seems to be impossible to achieve. I think one of the problems I have with the Treasury 1 and Treasury 2 is that they are revenue-neutral. I think they should have raised

some revenues in response to the budget deficit. I prefer a minimum tax, which would certainly be helpful in broadening the base. I think, as far as value tax is concerned, I do not particularly like the value-added tax. It is widespread in Europe, but I do not think it would be very helpful to us.

Mr. BARNARD. Mr. Robertson.

Mr. ROBERTSON. Well, Mr. Chairman, I suppose if we can't spend less, we have to pay more. The only point is that taxes should not be raised in a way that might retard or impede investment. I think we need to sustain the forward thrust of investment in this country, and anything that would jeopardize this process should be avoided.

There is a risk, of course, that if you raise taxes at this late stage of the business cycle, that simply reinforces some of the weaknesses that we see at work in the economy. I think that the tax hike would be offset, however, by the drop in interest rates that would probably accompany some firm action on the fiscal front. If taxes must be raised, I think the primary burden should be placed on consumption with energy a possible target.

Mr. BARNARD. Thank you very much. My time has expired on this first round, so I recognize the distinguished ranking minority member of the committee, Mr. McCollum. Welcome to the hearing.

Mr. MCCOLLUM. I thank the gentleman from Georgia.

Mr. BARNARD. We've missed you.

Mr. MCCOLLUM. Well, actually, I've been in and out of this hearing.

Mr. BARNARD. Oh, you have?

Mr. MCCOLLUM. Yes. You've just not been watching me carefully.

Mr. BARNARD. I've been listening to the testimony. [Laughter.]

Mr. MCCOLLUM. Well, I fortunately have heard most of it. I didn't get to hear Mrs. Teeters, but I did get to hear everybody else, and I appreciate that fact.

But I wanted to follow up on this tax question just a little bit, make one observation. It has always occurred to me that the tax reductions that you gentlemen were talking about in discussing Mr. Barnard's question that we had, were more than offset by tax increases, if you include the Social Security increase that we've had since then. That, in fact, we've had at best a net wash on the overall tax burden.

It has also occurred to me that any significant increase in taxes, you're going to do what Mr. Sinai suggested, and that only an accommodationist policy by the Fed is going to result in anything, and that that, in turn, too much accommodation with too much tax increase, would surely lead to an increase in inflation, which is where we were back when. But you know, that's just a comment. A question I really have on the tax area, and I'll ask it to Mr. Chimerine, just how much tax increase in any given year for the next few years can we have, in your opinion, without forcing, in this climate where we presently exist, a recession?

You say we don't have, and you're hopeful that the—though you called it a growth recession, we don't have a true recession in the total sense. You're hopeful that inventory situation will keep us from going into one this fall. And you say it's very healthy to have a tax increase for the long run. And maybe it is, so maybe in the

end, that may absolutely have to happen. But how much can the economy sustain before we result in going in there. Just how far can we go?

Mr. CHIMERINE. Congressman, can I make two very quick comments before I answer your direct question?

Mr. MCCOLLUM. Sure.

Mr. CHIMERINE. First, even if you take into account the 1982 and 1984 tax and Social Security tax increases, the total tax burden on the U.S. economy is lower today than it was back in 1980, before the 1981 tax cuts. Not massively lower, but it is somewhat lower.

Mr. MCCOLLUM. That's good to know.

Mr. CHIMERINE. You also have to look at taxes in terms of what we are spending. The argument that taxes should be what they were 50 years ago is not relevant, if we are spending two or three times as much, relative to GNP, as we were 50 years ago. And, we have built in a permanent 4- to 5-percent structural deficit with current tax levels and current expenditure levels. We all agree that it is essential that we eliminate that.

Second, we all agree that it is best to do it on the spending side. But spending cuts can also be potentially restrictive at any given point in the economy. However, I do not think the Fed will have to be more accommodative. In my judgment, large deficit reduction would reduce interest rates significantly, below what they currently are, and keep them there, even if the Fed maintains the same reserve posture it now is following. In fact, it makes it easier for the Fed to pursue a noninflationary policy, because it is a much better way to keep interest rates lower on a sustained basis than excessive money growth. The latter can work for a year or two, but that is not going to work on a long-term basis.

Now your point about how large of a tax increase is needed. I think whatever is left between the spending cuts you can get and the target that I described a few moments ago for the total deficit is the nature of the tax increase you are going to need, and I think it is perfectly plausible. For 1986, we are probably talking about something in the range of $10 to $15 billion of tax increases on top of the budget cuts, and that number will have to get somewhat bigger as we go further out in time, but it still represents a relatively small share of GNP and a relatively small portion of the tax cuts of 1981.

Mr. MCCOLLUM. Let me ask one other question of you gentlemen.

We had Mr. Volcker testify to us yesterday that we are now sustaining our current existing deficits by foreign capital, and that if we, in fact, enact trade protectionist legislation, such as some of my colleagues have proposed, basically disasterville will really strike. It will compound the problem immediately of the problems that we already have in the economy.

Does any member of the panel care to jump in and respond to that, or—do all of you agree with that? Is there a problem with trade protectionist legislation at this time? Mrs. Teeters.

Mrs. TEETERS. Mr. Congressman, let me reveal to you something that we did to evaluate this. We actually went back and took a look at what happened in 1930, 1931, and 1932. The protectionist bill—the Smoot-Hawley legislation—was part of the 1928 campaign, and it called for protectionism of agriculture. Hoover called a special

session of Congress and passed it in June 1930. The retaliation in the next 3 years against American products was astonishing. In Spain, for example, by 1933, the volume of U.S. automobiles imported into Spain was 5 percent of what it was in 1930.

Once you start playing this game, you are inviting retaliation of every form around the world. With the subsequent events, the market crash, of course, in November 1929 and the international financial system collapse in 1932, you eventually brought almost all world trade to a halt and caused the Great Depression.

In my opinion, that combination of events, starting out in 1928 and carrying to 1932 is the major cause of World War II.

Mr. McCollum. Is there any member of the panel who disagrees with the premise Mrs. Teeters made or that Mr. Volcker did? I don't want to ask everybody a question, and my time is expiring. But is there anybody here who thinks that there is no problem or that the problems of trade protectionist legislation wouldn't be that severe?

Mr. Sinai. I think what Mrs. Teeters has decribed is qualitatively what the problem would be in a wave of protectionism, which is going to be inevitable in this country, unless we fix the budget deficit. But the 1930's was a particularly severe instance. We probably would agree it would not be that severe, but it would be disruptive enough to threaten worldwide recession.

Mr. McCollum. Thank you. Thank you, Mr. Chairman.

Mr. Barnard. I think it is a policy of the Chairman to recognize members as they have appeared on the rostrum, so I'll now recognize Mr. Hiler.

Mr. Hiler. The gentleman is very kind. Thank you.

I have two or three quick questions. I'll direct the first to Dr. Sinai.

In the last half of last year, the Fed began to clamp down on M1 growth. I think it was maybe like a 4½-percent growth rate in the third quarter and 3.2-percent growth rate in the fourth quarter.

Some at that time suggested that the Fed was targeting real GNP growth. The fact that there had been very fast growth in the first quarter and fairly fast growth in the second quarter led to the Fed deciding to clamp down on the money supply.

In hindsight, and of course, everyone has 20/20 hindsight, but in hindsight, do you think that the dramatic slow down in the growth rate of M1 in the last half of last year, has contributed to any of the problems that we face today?

Mr. Sinai. No; I really do not. I think the link between M1 growth, the economy and inflation has been broken this time around, because we have had such an unusual pattern in the foreign value of the dollar, foreign trade, and manufacturing. Chart 2 in the appendix shows the growth rate of M1. It also shows the growth rate of real GNP and inflation, and you just can not see the standard links subscribed to monetarists.

Now I think the Federal Reserve, de facto, has for a good year now really been targeting nominal GNP, because they have felt that link was broken. They tightened in March 1984, on very rapid growth in nominal GNP, even though the monetary aggregates were not exceeding their targets.

The slow growth in M1 in the second half of last year that you referred to, I think, came more from a reduction in the demand for money, because the economy was very weak and slowing down at that time, then it did from the Federal Reserve clamping down. The rising interest rates of the first half of the year helped bring down monetary growth in the second half of the year, but you may recall that in late summer and through the fourth quarter, the Fed actually eased. In the face of that slower growth in the economy and money, they cut the discount rate a couple of times between September and the end of the year.

Mr. HILER. It sticks in my mind that the M1 growth was about 3.2 percent for the fourth quarter of 1984 and about 4½ percent—ended up 5½ percent on the year.

Mr. SINAI. Yes; it was very weak. And I think, in your sense, the clamping down actually occurred in the first half of the year. They really did clamp down. They pushed interest rates higher. They did that in March 1984. But, there is a lagged effect on the money growth.

Mr. HILER. And you think that was in hindsight a good thing. The targeting of nominal GNP——

Mr. SINAI. I have a biased opinion here. I think the right aggregate to target is nominal GNP, and in point of fact, the Central Bank is shooting to control the growth of nominal GNP—real growth and inflation anyway—and so I argue, why go through the monetary aggregates to do that? It will not matter if the M's are a good proxy for nominal GNP, but when they stop there is a problem.

Mr. HILER. Mr. Robertson, some say that—Chairman Volker, when he was before our committee yesterday, said that the Fed drops the discount rate when market rates are going down, which would indicate that the discount rate should fall. Some say that the Fed should drop the discount rate and that will help lead market rates lower; if they do not go lower, then the Fed could raise the discount rate back up.

Would you think that in today's environment, it would make sense to drop the discount rate, to try to lead rates down further? Or, do you believe that if we drop the discount rate, it would be down there by itself and market rates would continue at the relatively stable level where they are today?

Mr. ROBERTSON. No; I think if you wanted to see significantly lower short-term rates, a drop in the discount rate would probably accomplish that objective. The Fed, I think, somewhat ingenuously, always says that when they drop the discount rate, they are merely following the market. And, whether that may be true, the fact remains that a decline in the discount rate which sends a strong signal to the markets, both at home and abroad, generally does lead to a drop in market rates.

My own feeling is that, right now, it may be a little premature to take another step toward ease. As I tried to emphasize, I think the Fed is really walking a policy tightrope at the moment. Undoubtedly, there is a need to encourage rates to move lower as a means of stimulating the economy. By the same token, however, an overly rapid growth of money, designed to speed the economic growth rate, might set the stage for renewed inflation down the road.

Mr. HILER. Coming from the Midwest and having a fairly large amount of both agriculture and manufacturing industries, I guess the inflation's out there, but we don't see it.

Mrs. Teeters, I will just conclude my questioning now. The Federal Reserve has claimed many times that it cannot—or I should say, the Chairman of the Federal Reserve anyway has claimed many times it cannot release the notes from the Open Market Committee meetings until after the following meeting due to the disruptive effect of an earlier release on financial markets.

And the Chairman went on to say yesterday in a direct question that it wouldn't make sense to have immediate disclosure of the decisions of the Open Market Committee because they are always, the decisions are hinged on a lot of "if" clauses. "If this happens, then we do this." Or, "If that happens, then we do that."

Given the lack of reaction apparently in the market following the release of the Fed's monetary policy report earlier this week, which explained changes made by the FOMC in last week's meeting, do you see any reason why the release of future meeting notes should not be made directly following the meetings?

Mrs. TEETERS. Mr. Congressman, for many years, I have been a strong advocate of immediate release of the minutes of the FOMC meeting. The old arguments that it would disturb the markets, that unsophisticated people would not know how to use it, and so forth, strike me as not being very relevant any more. In the 1970's when they were targeting Fed funds, the market usually found where the Fed was by noon on Wednesday the next day—so it was not that. They really were not keeping the information confidential.

However, the one thing that I can see that would be a problem is the time that it takes to collate the minutes, check them, make sure they are accurate. So it may not be an immediate release on, say, Wednesday morning, or 5:30, Tuesday afternoon. But, it has been my personal position for a long time that that delay is not necessary.

Mr. HILER. Thank you. Just maybe a 10-second question. Are there others on the Open Market Committee, or the Governors——

Mrs. TEETERS. I cannot speak for other members of the FOMC.

Mr. HILER. I didn't think you would. Nice try anyway. [Laughter.]

Thank you.

Chairman FAUNTROY. The time of the gentleman has expired. Mr. Roemer.

Mr. ROEMER. Thank you, Mr. Chairman. I thank our witnesses this morning, and I heard you loud and clear on unanimous belief that to reduce the deficits would be the first and most important step we could take. I have no hope that we will do that. Congress has absolutely no guts. None. I notice that in the current budget negotiations, we are talking about taking the highest defense figures and the highest entitlement figures, with no taxes.

So you can take your deficit dreams home with you, which leads me to my question. It seems to me that our goal, in Humphrey-Hawkins or in this Congress, is jobs for our children and for America to be competitive again.

Now I'm sure deficit reduction would go a long way toward that goal. Such things as taking an overvalued dollar down to you, Mr. Robertson's, middle ground where it ought to be. Such things as not relying on foreign capital. Such things as would a lower deficit yield.

But I'm wondering if you could take it a step further with me. You don't have to share my pessimism, I'll get over it. But, let's be optimistic for a second and say that we will have leadership, we will be courageous, we will treat each other as human beings, and work together to make this country strong again.

Making that assumption, what might we do beyond the deficit talk to do that?

Let me give you one example. Shouldn't tax reform be about jobs? Shouldn't tax reform really be about competitiveness? Such things as improving the savings rate in America?

The figures I see economically, whether they be from Lester Thoreau or from some of you, are that, in terms of productivity, we are losing ground; even in the early stages of our economic recovery of 2 years ago, although our productivity figures went up, they still were below our major economic allies and competitors in the marketplace.

What could we do beyond deficit reduction—leave that aside for a second—that might restore our competitiveness?

Could tax reform play a legitimate part of that?

I know it's a new angle. The President would never mention it. But, I think we ought to. What do you think? Anybody who thinks. Yes?

Mr. ROBERTSON. The President really has mentioned it, Congressman, but in a rather unfortunate way. I didn't talk about tax reform, since that really wasn't the subject for discussion this morning. But, I'm particularly concerned that the President's tax proposals would seriously damage capital formation in this country. I think they would impede investment spending in many industries.

And it's my own view that one way to raise productivity, to become a lot more competitive, is to have better tools with which to work. For many years the tax policy has generally favored consumption and acted as a disincentive for investment.

And, of course, the President's tax proposals would withdraw those, or certainly reduce them.

Mr. ROEMER. Right. And without much lowering of the marginal rate through middle class America. I appreciate your comments, and you don't have to agree with me, by the way, in your comments.

Yes, Dr. Sumichrast.

Mr. SUMICHRAST. I would like to add to that. When you go overseas and you talk to bankers and fellow economists, and you look at the data, particularly in Europe, you are struck by one interesting development. That is, since the 1981 tax proposal which was designed to stimulate investment—and we have done great—we are the envy of the world really in that sense, particularly Europeans. They look at their unemployment rates and they are higher than before. Some countries' unemployment rates have not changed from 17.5 percent. They have got a source of problems way beyond

what we have. Essentially it is a result of the emphasis on investment, which we started with the 1981 tax reform. And now, the same argument we're facing, he is planning to say that that is all wrong, we should be emphasizing investment and we should do something.

I think Mr. Robertson is absolutely right. If anything, we should have more investment. When you look at the expenditures for factories, and you look at total expenditures for nonresidential, the office, the white collar, the retail is growing like crazy in a sense. You have never seen anything like it. But, yet, when you look at the factory expenditures, they are actually down on an annual basis. We have not really put much—so we need more rather than less investment. I think if we do anything in a tax proposal, it should be centered once again on helping to provide jobs for the children, which you mentioned. That could be not only through some continuation of investment incentives.

Mr. ROEMER. Thank you. Mrs. Teeters.

Mrs. TEETERS. We have done a very careful analysis of the tax proposal. In the long run, it does not increase taxes on investment, it raises taxes in the corporate area, but in very specific places—on banks and insurance companies.

If you take the drop in the rate and the removal of the investment tax credit, in the long run, the proposal is not a deterrent to investment.

We may have some problems in a transition to the newer, lower marginal rates. But the thing washes out pretty much over a period of time. It is a matter of readjusting as you move along.

Mr. ROEMER. Would you be prepared—and I appreciate that comment—would you be prepared to take it a step further? You've made the point of its neutrality on investment, generally.

Would you take it a step further and put yourself in a policy position of what it ought to do for investment or savings, and/or productivity? Have you got a thought on that?

Mrs. TEETERS. I think that the loss of competitiveness of the United States in the past 4 years is more a function of exchange rate than it is any tax incentives in the United States. I mean, that the dollar exchange rate change has been very severe.

I would also point out to you the 1981 law was highly touted to increase savings, and it did not do a thing. So that in trying to encourage increased savings in this country, I think it requires something greater than just tax incentives. It takes a different orientation toward the world.

If you look at Japan, they have this enormous savings rate. Until recently, they did not have an adequate social security system. Consequently, there was an enormous amount of savings for old age in Japan. Now that their public social security system is beginning to expand, you would expect their savings rate to come down. But, apparently, they do not yet trust the social security system as being an adequate substitute for private savings.

Mr. ROEMER. And their tax laws do encourage their first $50,000 tax free.

Mrs. TEETERS. That is correct. We also have——

Mr. ROEMER. There might be some small relationship between taxes and savings.

Mrs. TEETERS. *What I can see happening with Keogh and the* IRA plans is that, basically, you have shifted it from one form to another. You did not actually increase the total volume of savings.

Mr. ROEMER. Fair enough.

Mrs. TEETERS. I would like to make one technical comment. I think that, probably, we are not measuring our total real output correctly. There will be large benchmark revisions at the end of the year in the GNP account. It is quite possible that some of the productivity problem has been an estimating problem.

Mr. ROEMER. So you don't think that we have a productivity problem?

Mrs. TEETERS. I think we have a productivity problem, but I *think that it is not being measured adequately—they are not pick*ing up all of the output.

But, remember, that in the past 15 years, our baby boom grew up. And one of the outstanding features that we managed to accomplish—and we tend to forget about it—is the vast bulk of those young people found jobs. A good deal of the problem in Europe is the fact that their baby boom is 5 years behind ours, and they have not been able to increase production enough in order to absorb those young people.

Mr. ROEMER. My time's short, but I have two more, Mr. Chairman. No more questions but two more responses, if I could.

Mr. CHIMERINE. Congressman, can I make a quick response?

Mr. ROEMER. Certainly, Doctor.

Mr. CHIMERINE. I do not want to divert attention back to the deficit, but I think it is important to recognize there is nothing else this Congress and this administration can do that will better improve our long-term competitiveness and better improve the long-term economic outlook than cutting the budget deficit. And, in fact, if you exclude problems with the deficit for a moment and look at other aspects of the economy such as the underlying fundamentals that will determine long-term economic performance in the United States, most of them have become quite favorable, at least relative to the 1970's.

Productivity growth is not great but it is better on an underlying basis than it was in the seventies. Some of the factors that held it down during that period are gradually fading out. And the demographics are favorable for long-term growth.

I think, the more conservative approach to government and the better balance between union and management in most industries are favorable. The energy situation is far more favorable than it was in the seventies. If you can get deficits down and get the dollar and interest rates down on a sustained basis, you will help make the United States much more competitive in world markets, both because of a lower dollar and lower interest rates. High interest rates hurt our competitiveness in world markets. The Japanese have a much lower cost of capital; that makes it much easier for them to invest. And, second our problem is not inadequate savings. It is that too much of it is being used up by the deficit. I think the focus should be on the deficit.

The next best—and it is a distant second—is deregulation. The more you continue to deregulate the U.S. economy, the better our

competitive performance will be in the long-term. But there is nothing you can do to substitute for inaction on the deficit.

By the way, I think you are being a little too hard on yourself, Congressman. I think the Administration shares some blame for the situation we have reached at this point. It is not just the Congress.

Mr. ROEMER. I thank you. Dr. Sinai.

Mr. SINAI. I think that it is good that you sobered us up on deficit reduction. But I would be remiss if I did not sober everyone up on deficit reduction. It is a very serious problem. Much of what we see today, the imbalances we have been talking about, really stem from that problem. We would settle for a concurrent resolution. And maybe you will tell me at least that we could have that.

Mr. ROEMER. The check is in the mail, right.

Mr. SINAI. It is a significant dent if we get a concurrent resolution. Failing to get that, that is really very negative.

One minor point on productivity growth. It is better than it has been since the 1960's but still not satisfactory. It is difficult in what has become an increasingly services economy to properly measure it. Services productivity is really very difficult to ascertain.

Finally, on tax reform and capital spending, we find in our study that the removal of the business tax incentives, or all of the business tax changes in the President's plan, considering those alone, would cost some $50 billion in real terms in 5 years in equipment and plant spending. That is a high number because you have to plug in the extra consumer spending and sales and what that does to business investment from the reduction in personal income taxes that will come about. But, I think, intuitively, it is inconceivable to me that one could take away targeted tax subsidies to business equipment and plant spending and not get a reduction in capital spending.

I do not have any trouble with that if you tell me there is no national goal to promote capital formation and the increase in productivity that would go with it. But, in 1981, it looked like it was a national goal. There was an implicit contract between the business community and the administration on that score. And 4 years later, it simply is being withdrawn.

So I think, in the tax reform proposals the thing to do is not to fully eliminate the investment tax credit. It could be phased out. It could go to five rather than zero. And the ACRS could be modified to be a little more generous.

The windfall recapture tax is just an increase in corporate profits taxes, which would certainly hurt the corporate sector. It is very hard to justify that.

The problem is, if you do anything that I have recommended, the bill becomes a revenue loser and you are back with all the same problems. Why not raise the level of the proposed tax reductions—how about 17.5 percent, 27.5 percent and 37.5 percent and get back some of the revenues that way? You would still have a net tax reduction.

Mr. ROEMER. Well, I thank you for your time.

Thank you, Mr. Chairman.

Chairman FAUNTROY. We thank you.

Mr. Neal.

Mr. NEAL. Thanks, Mr. Chairman.

Just a comment. In listening to the responses to the last couple of questions, it sounds like you're almost saying that the free enterprise system will only work if you subsidize it. Mrs. Teeters just mentioned that a huge percent of the biggest companies don't pay any taxes. And then there's the recommmendation that they pay even less. I don't know quite what to do about it.

It would be most desirable, it seems to me, to create sort of a level playing field and not discourage investment and see what happens. Our most successful periods of our economy during the 1950's and 1960's, I guess, were more along those lines; weren't they? Weren't depreciation schedules——

Mr. SINAI. They actually were accelerated in the early 1960's when the tax credits and the accelerated depreciation measures were first used. There is a way to recapture revenue that is not paid by the number of companies in the top 1,000 and it would be to enact a minimum corporate tax and alternative minimum corporate tax in which the various subsidies that I mentioned would be lumped together and a minimum tax paid on them. So you can get revenue back. There are very large inequities in the tax system. We have so many companies paying no tax and so many other companies paying a lot of tax.

Mr. NEAL. Well, anyway, my real question has to do with the relationship between money growth and inflation and in testimony only Mr. Robertson, I believe, expressed any concern about that. And maybe my concern is not well-founded, but I tried to understand this over the years. The almost only lasting and predictable relationship I can find throughout history is this one between money growth and inflation; whether the money's gold or paper or whatever it is. And I don't understand why that relationship appears to have broken down in the last 2 or 3 years.

I wrote Dr. Milton Freidman, thinking that the great guru of this theory would have a good answer for me. He wrote back and said he didn't quite understand it either, but was working on it; and others say the same sort of thing. Certainly I don't understand it but I'm still a little leery of ignoring the historical record on this subject, which we appear to be doing now. Money growth has been rather dramatically outside the target ranges—rather dramatically higher than growth in the economy—for long periods of time over the last several years, and we don't appear yet to have paid a price, but I'm still wondering if we might not have to pay that price at some point down the road, especially if the dollar continues its decline relative to other currencies and we have those pressures on prices that would result from that.

Don't you all share any of this kind of concern about a future inflation as a result of excessive money growth?

Yes, sir.

Mr. SINAI. There has always been until very recently a very substantial correlation between money growth and nominal GNP growth and high inflation rates. The lags the monetarists have cited, which are 6 to 18 months, have generally worked out, however it happened.

I think I would just suggest you look at that chart, too, which shows a very rapid average M1 growth over the last 4 or 5 years

and a steadily declining rate of inflation in the Consumer Price Index.

The relationship has broken down and I think what is going on—and it is without precedent in the postwar period—is that Americans are buying so much abroad, both American consumers and businesses. They do have to pay for it initially with checking accounts or funds that are in M1, but the purchasing, the demands, leaks abroad and whatever inflationary pressure that comes from those demands impacts abroad which, at the current time is so slack the pressure is not felt. American producers, are losing more and more of the purchases that go on that are financed with M1 and so we do not see at this time inflationary pressures here.

Now, can it get us in some unforseen way? I think the answer is yes. The way inflation comes back to haunt us is that at some point you are going to generate some capacity pressures abroad—Great Britain's inflation rate is back up to 7 percent. Americans are buying a lot of goods in Great Britain though the dollar is coming down out of this process and there is a reinflation on that score.

But, at the moment, the M1 relationship has broken down and I think for the Fed, the only prudent thing to do is to temporarily cut down the weight it gives to M1 because if they do not, if M1 is followed, the Fed would do what they did in 1982 and 1983, they would tighten. What would happen if monetary policy were tightened now? Interest rates would rise and the dollar would strengthen, What would happen to manufacturing and trade? The problem would get worse; the split-personality U.S. economy would intensify.

Now, that is an incredible problem for the Central Bank and I think they are making the best of a bad situation. I agree with you, they cannot abandon those aggregates forever because then ultimately we would be back in some reacceleration of inflation world wide.

Mr. CHIMERINE. Congressman, I think at the outset it is important to recognize that the historical relationship between money growth and inflation has been far from perfect, particularly over short periods of time. There has been some correlation over longer periods of time but in the short run, movements have not been correlated that closely. Second, even to the extent there was some correlation, M1 today is differently defined than M1 was 5 or 10 years ago; it is affected by some of the factors Allen Sinai just talked about. In addition, it now probably includes funds which are really savings, and as various kinds of interest-bearing checking accounts which did not exist 5 or 10 years ago. So it does not have the same meaning.

Mr. NEAL. Excuse me for interrupting but doesn't the Fed make a real serious attempt at juggling those figures so that M1 does closely approximate a historical meaning of that term?

Mr. CHIMERINE. You can do that and if you do that and make adjustments for these factors, you probably come out with much less M1 growth over the last 2 or 3 years .

Mr. NEAL. What I mean is I think that the Fed, as I understand it, includes a certain percent of the NOW accounts, for example, in the M1 figure.

Mr. CHIMERINE. Yes, and you can take that out. What I am saying is that if you do—because they have grown so rapidly—you get much slower growth in M1 than we had over recent years, so that concern would not be as strong as I think is being suggested by the people who focus on M1 without making the adjustments. I think the most important thing—and it is something you raised in your question—is that there is no black box here. There is no magical relationship as to its impact on the economy. You must take into account conditions that exist in the economy. Right now, we have an underutilized world economy with a lot of excess capacity, a lot of unemployment, probably at a record high on a worldwide basis. We have an overvalued dollar which you talked about and we have had massive deregulation. We have an economy in the United States that is probably more competitive now than it has been in the last 20 or 30 years. So under these conditions, rapid M1 growth over short periods of time is not going to have the same inflationary consequences it might have if the economy was closer to full capacity and if other conditions were different.

But having said that—this is why it is so important to get deficit reduction—we cannot continue to permit most of the measures of money and credit availability to grow at or near, double-digit rates forever. Eventually, it will be inflationary. And I think that is the box we have put the Fed in here. Because in order to keep interest rates at reasonable levels with these big deficits, they have to permit rapid credit growth. But that can work for a couple of years without generating inflation. That is why, reinforcing the point we have all made four times already today, it is so important to get the deficits down.

I guess my answer is, I am not too worried about the inflationary consequences of strong monetary growth right now but I would not propose that the Fed keep doing this for the next 3 or 4 years.

Mrs. TEETERS. Mr. Congressman, I have a somewhat different point of view, and that is that money can facilitate inflation, and monetary policy can stop it. But money in and of itself is only the vehicle because you can have inflation even with a zero growth in money supply if velocity changes enough. That is essentially what was happening in Germany in the 1920's.

Most inflations comes from other sources, either excess demand or a major shortage of a commodity, like oil. The mechanism of a financial systems will adjust to the inflation either by changing the velocity or changing the rate of growth in money supply. If you have had excess increase in the growth of money supply over a long period of time, then the velocity does not have to go up so much to accommodate inflation.

I certainly agree with Larry Chimerine, I did not think the relationship was ever that strong to begin with. It involved an enormous number of lags over a very long period of time and if you put in enough lags over a long enough period of time, it becomes a tautology because you have to get the money someplace to finance the current dollar GNP.

Money growth is obviously something that the Central Bank should watch and should take into account in settling the amount of reserves it supplys to the economy, but it is not the only thing

going on out there. As a result other things do occur that have to be considered.

I would like to comment on one thing that has been said repeatedly; "The Fed is focusing on nominal GNP." They always did to some extent, even back as early as nearly 30 years ago when I had my first association with them. The problem with saying "focus on nominal GNP" as your sole guide, is that it does not tell the trading desk at the New York Federal Reserve Bank what to do on a day-to-day basis. You cannot say to the trading desk in New York, get 6-percent growth in nominal GNP, because it literally does not tell them when to inject or take out reserves.

Mr. SUMICHRAST. I have prepared in my testimony a short table which I think answers part of the question and that is that the narrow definition of M1 has changed over time quite dramatically.

The category "other checkable deposits" was nonexistent just 5 or 6 years ago; it is now one of the biggest items in the M1 definition. And, by the best estimate of the Fed by the end of 1985, they would probably be over 50 percent. So there is a change in the total definition.

Obviously, if you start printing money the way they did it in Europe in the 1920's and so forth—you obviously run a risk of total financial collapse. And I tried to describe our industry not doing well in terms of prices. On the contrary, as I have already said, we have actually had deflation in prices of real estate and I think this is pretty widespread, including commodity prices worldwide. I am not really terribly worried about the inflation.

I am worried about what Henry Kauffman described as the explosion of credit or all credit which is partly due to government and to private expansion. It is a very difficult and potential problem for us. But insofar as inflation is concerned—I am not really terribly concerned about it.

Mr. ROBERTSON. I do not know that I have anything more to add, really, other than what I noted in my testimony.

I find it a bit odd, though, that nobody seemed to be very worried about inflation; that has always been the fatal error, it seems to me, in the past.

It is also worth pointing out that even though we have underutilization of resouces, falling oil prices, stagnation in Europe and all the other problems which would seem to suggest that we need not worry about inflation at all, we do have an inflation rate which is 3 or 4 percent.

And the inflation rate today is certainly very good when you compare it with the 1970's but it is not at all good when you compare it with the rest of the peacetime post-World War II period.

The average annual increase in, let's say, overall consumer prices during much of the 1950's after the Korean war, and before the war in Southeast Asia, was about 1½ percent.

So we really are not doing all that well relative to other peacetime years since World War II.

And that was my point that we should be just a little cautious about what I call stepping on the accelerator.

Mr. NEAL. Well, it is higher as a matter of fact, than it was in 1972 when President Nixon felt it was so high that we had to impose wage and price control.

Mr. ROBERTSON. Very close to it, sir, yes.

Chairman FAUNTROY. Thank you, Mrs. Teeter and gentlemen.

The current recovery is often characterized as uneven because of the decline in productivity and lack of increase in the manufacturing sector have causes losses, by some estimates, of over 220,000 jobs. While there have been increases in the service sector part of the economy, the jobs created there have not matched the losses in other parts of the economy. In addition, the deficit—that is a lack of any real progress to reduce it—continues to be a real concern to me. To set the background for my questions, let me simply say that I have been wedded to a three-word history of America, that is, the following: farmer, worker, clerk. With the sharp drops in productivity and in manufacturing, I have the feeling that we are, in 1985—with respect to the transition from worker to clerk, from manufacturing to service orientation—where we were at the turn of the century with respect to the transition from agriculture to worker to industrial society.

Over the past 5 years, I have been author of something called a Congressional Black Caucus Alternative Budget which had been consistently designed to reduce the deficits by two means: First, by focusing cuts in spending on the military budget but, more important, protecting programs that meet the needs of the people who are hurt most in a transition, namely those 220,000 who lost their jobs—many of them black—in labor-intensive manufacturing areas that have moved to cheaper labor markets abroad, and second, to provide in our package tax reform that penalizes nonproductive investment and rewards investment that would deal with our realistic employment needs in this country given our world-competitive status.

With that as background, I would like you to address yourselves a number of questions. What industries ought we seek to save in terms of meaningful job opportunities for the American citizens and, how ought we to fashion tax reform to deal with two realities that have come to my attention in recent months.

The first reality is perhaps illustrated by an executive over in our major corporations who said, I have analyzed the Reagan proposals and have concluded that I would gain from them $125,000 in tax relief. He said, "I don't need that so I don't think that ought to be implemented even though it would benefit me." That is one kind of situation. Many corporations that pay no taxes have been searching for ways to give away some money so that they will not look so bad when it is reported that they paid no taxes. What kind of tax reform can we shape that would eliminate that kind of problem for the corporation and for the individual executive, and at the same time that would reward those who invest in areas of productivity that are important for the workers in this country.

The second reality is my concern that the present package is geared toward the service areas. Those in the computer industry are boasting about their tax breaks. When services are moving the market forces anyhow, they do not need any incentives. Can you suggest to me what I can say to the minority worker who has lost his steel job or his textile job or his job in mining. What can I say to him about where we are going as a country, from worker to

clerk, in a fashion that he can be included as a worker or he can get training to move into service areas.

I have given you a large question but I need to see if you can come out where I come out in the Congressional Black Caucus Constructive Alternative Budget.

Mr. CHIMERINE. Can I take a crack at that, Mr. Chairman?

Chairman FAUNTROY. Certainly.

Mr. CHIMERINE. First, I would like to address the issue of this split personality, the shift from manufacturing to services that you talked about. Many of us have referred to it this morning. I think there has been a myth spreading that it is alright if manufacturing, agriculture, and energy, collapse because we will make up for it in high-tech, services and construction. I do not believe there is any way this can happen.

That is possible on a gradual basis over a long-term period, but it is not possible if it has to happen rapidly in the very short-term. For a number of reasons we are seeing evidence of this already. First, many of the high-tech companies depend heavily on manufacturing for their orders. Second, the loss of high-paying manufacturing jobs, those people cannot buy services and they are not going to buy new homes.

The manufacturers themselves are cutting back on purchases of business services. So we are already beginning to see the effects of the sharp weakness in those industries spread to the so-called strong sectors of the economy. Inevitably, they are going to drag those down with them. They will not do as badly as some of the manufacturing and commodity producers, but they will be negatively affected by it if we have to make that transition very quickly. You cannot retrain the manufacturing workers you talked about to become programmers overnight. On a long-term basis, slower growth in manufacturing can permit faster growth in the other sectors as the new members of the labor force move more heavily in that direction. But you cannot shift that quickly.

Second, what industries should we try to save? I think it is up to them. I think it is the job of the administration and Congress to provide the proper environment, meaning interest rates that are conducive to capital formation and risktaking in the United States, and exchange rates that allow us to be reasonably competitive on average in world markets. For those industries whose cost structure is lopsided, it is up to them to get it back in line or else they are just going to disappear. But that is all I think you should be focusing on, providing the proper kind of environment.

Third, with tax reform, I agree with your objectives 100 percent. I was privileged, as you may or may not remember, to review your budget in the last year or two at your request. I think some of your recommendations are excellent. As a perfect example, I have never personally been able to understand why we permit capital gains on the sale of paintings or other such assets.

One thing to consider to perhaps raise more money and still promote productivity growth is to narrow the focus of some of the tax incentives that we provide. Second, eliminating some of the gross distortions in the tax system would be very desirable.

It seems to me illogical that we should be building apartment buildings and office buildings in some areas when vacancy rates

are already 20 percent. The reason more are being built is because enough is earned on the tax benefits even if they do not rent the building out.

Those things have to be changed. And they should be done in a way that simultaneously brings in some revenue, in my judgment, to address the other major issue, which is the budget deficit. But I think a tax structure with the goals you laid out in your question are absolutely the right objectives.

Mr. ROBERTSON. Mr. Chairman, I'd like to make one point about this malaise in manufacturing. We have lumped all of manufacturing together and said that we have problems in manufacturing.

The primary area of concern is basic manufacturing industry. The production of basic industry in this country is roughly 2 percent above what it was 11 years ago. In other words, output has been stagnant over an extended period of time.

This malaise reflects not only the recent flood of imports but some deep-seated structural problems as well. Irrespective of what happens to the dollar, we should recognize that many of these basic industries are facing an enormous challenge from the low cost highly productive industries of Southeast Asia and elsewhere in the world.

Many of our manufacturing industries are alive, well and prosperous. It is the basic industries of this country, many of which have powered the expansion over the last 30 years, that are in trouble.

I think, too, that we will shortly see whether the growth of service-related activities require a thriving manufacturing sector. If they do, we could face the prospect of a dramatic slowdown in the growth of service employment.

I don't think that it would be advisable for the Government, or indeed anyone else to identify those industries which should receive taxpayer support. I think it is the appropriate function of Government to provide the right climate and the right environment in which business can invest and can grow.

So the other point is that we need to address with greater vigor the issue of job training and retraining. It's all very well for people to talk as I do sometimes about problems of industrial dislocation and transitional costs, but this is economic jargon.

There are a lot of people who have been unemployed for a long period of time, and are going through a period of very severe economic distress.

So, maybe, if we could address the issue of improved training for displaced workers, I think that would be helpful.

Mr. SUMICHRAST. Mr. Chairman, I think I agree with Larry and Norman that we need to provide a climate. But, beyond that, I think we have some responsibility as a society and the Congress has some responsibility to at least part of the population. In particular, I am concerned for housing because the lumber industry has not done well. That is a function of the dollar. We are importing nearly half of our lumber usage now from Canada and with the Canadian dollar being less—obviously it makes importing lumber much more attractive.

Beyond that, I think, for housing, what we need mostly are lower rates. But beyond that I think there is one segment of the housing

industry we should require more rather than less involvement, and that is in low-income housing. We have not done much of anything to help or even to get to first base in really doing something fundamental. There are a lot of people who cannot afford to rent or buy homes. And the Government programs have been dismantled over the years. I have never really supported a major expansion of Government programs, but there is nothing you can do for a large number of people in the United States other than to help them to place a roof over their heads. And we are not doing that. So I think it is a source of responsibility rather than anything else. And the tax changes must reflect that kind of a shift.

Beyond that, I think what we need also is a very long-term change in sewer and water expenditures, which are going to hit us hard in the near future. When you really look at it over the last 20 years, we are doing less rather than more. One area where tax money is doing quite well now, is for highway construction. You can see some improvement as a result of the legislation which you passed—the 5-percent tax.

But, in construction, in all cities—the sewers, the waters and all these other things, our bridges—need a lot of work in the future. And these are the kind of areas where you could do a lot of good in the future.

Chairman FAUNTROY. Mrs. Teeters, do you have any reaction to that?

Mrs. TEETERS. I will expand on what was said earlier. I liked SETA. I think we have an opportunity now with the lower school-age population to use some of the funds in education to change the orientation to increase the job training that is going on.

The other thing I would like to point out to you is that New England is doing very well, though I have not studied intently what has happened in New England in its revitalization. The area has switched from being a textile and shoe manufacturer to being basically high-tech. A variety of things went on up there. I think there are lessons to be learned, because that area is our oldest industrial area, and it is doing very well at the present time.

Chairman FAUNTROY. You say "lessons to be learned".

Mrs. TEETERS. Lesson one is basically the reorientation of the labor force—the cooperation that developed between the local governments, the State governments, the universities, the banks, and the financial system—in trying to find a solution to what was the most depressed area of the country. There was some outmigration. At one time after World War II their average wages were about 25 percent above the national average. They are now at the national average. But the wages never actually went below the average. They used education to bring in and attract new industries.

Another area of the country that is doing extraordinarily is the Southeast. It is a different type of high-tech. It is into medical biology high-tech, the green revolution of the agriculture, the pharmaceutical and chemical revolution. It is like neighborhoods—I am not sure of the proper name, but something like the Neighborhood, Inc. That organization has redeveloped successfully lower middle-class neighborhoods. They have taken what they have learned starting with Baltimore, MD, and Berkeley, CA, and have literally

lifted their technologies and used them in other places. We do have some very good examples of this.

Chairman FAUNTROY. Any other reactions to that?

[No response.]

Chairman FAUNTROY. Let me then move to Congressman McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman. I know we're rapidly coming to a close to the hearing, but I would like to ask two follow-up type areas that I don't think have been explored that much. Early on, there was comment, I believe Mr. Chimerine and Mr. Sinai made, with respect to the growth of the economy as far as GNP goes in the second half of this year not being nearly so optimistic.

I understand, well, first of all, let me lay the predicate of saying:

In the Federal Reserve's Economic Projections that were presented to us yesterday for the second half of this year, in that report, we saw that they expect, based on quarter to quarter for the entire year, the calendar year 1985, that GNP would grow between 2¾ and 3 percent.

There were some variations but that's the median of the opinion, I guess, out of the open market committee or the President's, or the Fed, or wherever—maybe out of some of you policymakers down there in this line.

Now, the interesting thing about that, as you know, is the fact that we had a next to flat—what?—three-tenths of a percent growth in the first quarter? And I understand this morning we've downward pushed the projections of what has happened in the second quarter to 1.7 percent.

By my calculations, that averages about 1 percent annualized for the first half of this year.

In order to achieve a 2¾- to 3-percent growth rate, it seems to me that the entire balance of the year would require a 5 percent or better growth. That's my mathematics. I may be off. I was doing it by hand up here, no calculators this morning.

Yesterday, Chairman Volcker said he wouldn't project that high a growth for the second half, and I asked him that. He said he would project a 4 percent plus growth though for the second half. That's his opinion, I think.

What I want to know is two things. No. 1 is, in light of everything we know and you know, do you conclude, as I begin to think I am, that 2¾ to 3 percent is an unrealistic projection the Fed gave us yesterday for the entire year?

Number 2, what is your opinion about what growth we can realistically expect in this second half? Is 4 percent plus in GNP, as Chairman Volcker indicated he thought it would be, too rosy a scenario? Or, can we achieve that or better?

And I'd just like to go down the panel, starting with Mr. Robertson, and see if we can get an opinion on this; because I think it's important for us to understand, you know, what can we really expect—not just in the long term, but in the immediate short term.

Mr. ROBERTSON. Congressman, as someone else said a long time ago:

"There are lies and there are damned lies and there are statistics." [Laughter.]

Mr. McCollum. That's a good comment.

Mr. Robertson. I think, in terms of the growth rate, there is a good chance that we could bounce back in the third quarter, partly because I think we should see some pickup in the rate of inventory building. We should have less of a deterioration in the trade balance.

So that, from a statistical standpoint, it's easy to get to a 4-percent rate just on the basis of a less negative impact of the trade balance plus some pickup in the rate of inventory building.

Consumer spending still looks fairly strong. As for housing, although the figures that came out the other day were not quite as positive as I thought they might be, homebuilding should be a sustaining force.

Possibly we could have 4 percent growth rate in the fourth quarter, but looking ahead to 1986, I doubt that lower interest rates will spark a new burst of activity. And my own forecast shows a fourth quarter 1985 to fourth quarter 1986 rate of real GNP growth which is under 3 percent.

Mr. McCollum. For the entire year?

Mr. Robertson. No; by the end of the year and going forward into 1986. But I think the immediate quarter or two could be reasonably strong. But if we assume that we are then out of the woods so far as the economic outlook for 1986 is concerned, that would be a mistake.

Mr. McCollum. Dr. Sumichrast.

Mr. Sumichrast. No; I will give you numbers though I do not have a great deal of trust in this: For the second quarter, 2 percent; third quarter, 2.5 percent; the last quarter, 2 percent; the first quarter 1986, 0.2 percent; second quarter, 1.1 percent; the third quarter, minus 0.5 percent. And the last quarter of next year, minus eight-tenths of 1 percent.

Mr. McCollum. That is the projections you would have for where we're going in GNP growth?

Mr. Sumichrast. Correct.

Mr. McCollum. You say you don't have much confidence in those figures. Do you think——

Mr. Sumichrast. Well, they may be on the high side rather than on the low side.

Mr. McCollum. Mrs. Teeters.

Mrs. Teeters. One of the phenomenons that strikes you in the last four quarters of growth is that total domestic expenditures have been growing nicely—in the 3- to 4- to 5-percent range—which is taking total domestic production and adding back in imports—net of the imports and exports. What is really depressing the economy is the rapidly growing volume of imports and the very slow or declining volume of exports. The demand is there but it is being increasingly satisfied by overseas production. What the GNP numbers actually come out to be depends upon what happens to the imports.

Mr. McCollum. Well, now, yesterday, Chairman Volcker said that the drop in the value of the dollar is not, even though it's been significant, not been enough in his judgment to really be reflected in any major change in what you're taking about.

Is that your opinion as well?

Mrs. TEETERS. I think it has a long way to go. I wish the dollar would decline a little slower—1 percent a day is upsetting.

But, to get back to purchasing power parity, at the present time, where you have taken into account the exchange rates and the differential prices and so forth, that would have us trading at about $2.20 against the German mark instead of the $2.85 or $2.83 as of yesterday. Thus there is still a long way to go to put us back into an internationally competitive mode. But, at this point, however we got there, and I agree with the analysis that our most pressing short-term problem is the high level of the dollar on the foreign exchange market.

Mr. MCCOLLUM. Dr. Chimerine.

Mr. CHIMERINE. Congressman, to answer your question directly, I think the best we can do during the second half of the year would be about a 3-percent rate of increase, which, using your arithmetic, would mean for the year as a whole, fourth quarter to fourth quarter, we would average 2 percent. This is about a percentage point below the Fed's estimate. I do not think you can fault the Chairman too much because he was not aware of the downward revision in the second quarter number when he gave you that forecast.

Mr. MCCOLLUM. Well, let me say though, he did tell us yesterday—my ears were open—he said:

> Tomorrow, it's going to be a downward projection, and I'm going to make up for that in my analysis, and I think the inventory drop is the reason to make up for it.

He says, "That would make up for the difference."

So he did not maybe know the exact figure, but he knew it was going to be a big drop.

Mr. CHIMERINE. Then he is expecting a fairly significant acceleration in the second half.

I do not think it will happen to that extent because I think import penetration will continue to rise, and consumer spending is in the process of slowing in terms of growth, in my judgment. We have talked about a number of other things—We have capital goods orders that are not that strong. Thus I think the best we can do is about 3 percent.

I might make one quick comment about it though. A lot of people in this country became exuberant after the first 1½ years of this recovery, and kept talking about the speed of the recovery and the fact that, at least at that point, it was the fastest we had experienced in the entire postwar period. That may have been true, but, nonetheless, it was a significant overstatement of the health of the U.S. economy because of how low or how poor conditions were when the recovery process began.

I think people frequently confuse the rate of increase with the level of economic activity. You know, we fell down a big hole during the late 1970's and early 1980's, and we came part of the way back up. But I think you have to put in perspective this slower growth we now have in the context of an economy that is far from healthy to begin with. We need much faster growth in order to get this economy, particularly the industries which have not participated in the recovery yet, to get them back to reasonably healthy conditions. It is a very troublesome to me that we are not growing more rapidly.

Mr. McCollum. Dr. Sinai.

Mr. Sinai. No, we can not do it in our view. The main reason is there is an underestimation of the weakness in trade and manufacturing. The data never really give you the full sweep of the story of what is really going on out there. Trade and manufacturing are still being punished immensely, and the dollar has to fall a lot more. And, even then, there are lags before we could get an improvement.

Mr. McCollum. So you don't see a 4-percent plus growth in the second half of this year?

Mr. Sinai. No, our forecast has consistently been in the low 2-percent range and we are still there, at 2.1 percent. That is far below where they are. I think there is one way to get it. Chairman Volker does have the trump card. If the Federal Reserve eases aggressively on monetary policy and engineers sharply lower interest rates between now and the end of the year, then we may get those figures. There can be an inventory rebound in the third quarter, but that would only be transitory.

Mr. McCollum. I assume nobody here was surprised by the downward adjustment of the GNP today?

Mr. Sinai. I think the consensus was around 2 to 2½ percent—it was low.

Mr. McCollum. Mr. Chairman, I have a lot of other things I could ask, but in the interests of my seat and everybody else's sitting, I will yield back, and thank you.

Chairman Fauntroy. Well, the seat can absorb what Mr. Barnard and what Mr. Carper will ask. Mr. Barnard.

Mr. Barnard. Let's get back to the deficit. In 1984, there were about six budget proposals offered the House of Representatives. Mr. Roemer's proposal was called a 2-percent reduction. At least we thought it was a 2-percent reduction, but we finally called it a 2-percent budget, because he got about 2 percent of the vote. [Laughter.] But anyway, I voted with him. And after I get through this, you're going to find out that I'm not a Member of the majority of the House of Representatives.

This past year, we had three or four proposals that were made. Frankly, I voted with Mr. Leath's proposal. Did you vote for Mr. Leath's proposal?

No, you voted with your proposal. [Laughter.]

Chairman Fauntroy. I did not vote, and I won't go into the reason why, but go right on. [Chairman Fauntroy has no vote on the House floor.] [Laughter.]

Mr. Barnard. Anyway, that particular proposal was—I think we got about 59 votes on that too.

But I believe, Mr. Chimerine, if you had been a Member of Congress, from what you said this morning, you'd have voted for our budget. And the reason is, you designed little parameters about what you do to reduce Federal spending. You would address military spending.

But the thing that really caught my ear was, you said we ought to have more means tested programs. That's true. What's happening is, we don't have the appetite, the political appetite to readdress the priorities of this country. We do have definite needs, but we continue to want to satisfy every demand that's out there. And

we've got a constituency for every one of these budget items. But we have got to reassess what our capabilities are. We cannot, as a government, as an economy, as a nation, do everything like we wanted to do.

Why don't we readdress the Consumer Price Index? I mean, why don't we do some things that would bring some of these programs back into some perspective. I don't think we've adjusted the Consumer Price Index in years, and yet we've got inflation down to, what? 2 percent? 3 percent?

Mr. CHIMERINE. Three to four percent.

Mr. BARNARD. But see, that's what what we get hung up on. It's just amazing to me that we don't be realistic about that. I guess I'm not asking a question. I'm just telling——

Mr. CHIMERINE [laughing]. It is amazing to me.

Mr. BARNARD. But don't you think that we have got to address some of these good social programs which were absolutely wonderful when we put them in in 1966 and 1968, but we can't afford today?

Mr. CHIMERINE. I agree with you, Congressman. I think the Congress has done an admirable job on the nonentitlement programs. In fact, in some cases, my own view, is that they have probably cut some of those too much. I am particularly talking about some of the education programs and some of the welfare programs that are directly targeted to the very poor and the very needy. What is left, forgetting defense now, are the entitlements. My own personal view is that programs, like Social Security benefits, to be honest, and some of the Medicare and other health programs, should be made means tested program, so that people with high incomes or large assets do not receive the same benefits as others. That is one way of cutting the growth in spending without limiting spending to those people who really need it.

It is going to take a lot of courage. It is going to be very difficult to do, but that is one thing that can be done. I would caution you, though, that while the savings accumulate, so that they will be very large 10 or 20 years down the road, by itself that is not the solution to the deficit program during the next several years. You will still have to do something on defense, and you will still need some revenues. But on a long-term basis, I agree completely, and I do not know how you are going to get there, but I think it is essential that it be done.

Mr. BARNARD. I give back the balance of my time.

Mrs. TEETERS. Just one other comment. You're being eaten alive by the interest. With those huge deficits piling up you're going to crowd out everything, if you don't stop the growth in the outstanding public debt.

Chairman FAUNTROY. True, and that is why new revenue is important.

Mr. Carper.

Mr. CARPER. I'd like to thank the first baseman from the District of Columbia for yielding to me. [Laughter.]

I also want to commend our chairman for the excellent panel that he's presented to the subcommittee and thank all the witnesses for their testimony.

I just might observe that although my colleague from Georgia has left it, there are three members sitting here—who were sitting here, who actually voted for this so-called Leath amendment, which attacked the deficits on all fronts, including entitlement spending, defense spending, and revenues. And there were only, unfortunately 53 others in the entire House who joined forces with us to do that.

Let me just ask a couple of questions. I'd like to go, first of all to, is it Dr. Sumichrast? I don't want to butcher it too badly.

Mr. CARPER. Dr. Sumichrast, you mentioned that there was enormous growth of credit demands on the part of the Federal Government and on the part of American consumers. Who was continuing to finance that demand for credit? I don't see any substantial growth of savings in this country? I don't assume it's all coming from abroad. So where is the money coming from to finance our demand for credit?

Mr. SUMICHRAST. I think the Henry Kaufman papers would explain that in some detail. He has made a very strong presentation on that subject and also in the Chairman's testimony. I think the best guess, and maybe Allan knows better, about $120 billion comes from overseas. The Federal Reserve Board publishes the data and it gives you some definition of where the money is coming from. Essentially, other than foreign money, we depend on personal savings. Businesses do not save money. They typically desave. So it is a function of savings. And, our as savings rate remains low, 5 percent, which, by the way, is a disgrace anyway you look at it. By any international comparison, we are not doing well at all. But the explosion I was referring to was somewhat similar to what the Chairman mentioned, that productive and nonproductive use of capital, all these mergers, and the leverage buyouts, and all these things are absorbing an enormous amount of money. And Kaufman made pretty much the same point. When you take a look at the period between 1978 and 1982, you will see that we typically raised less than half a trillion dollars every year, roughly. Roughly, given, less than $500 million. Since that time, we have seen the need for credit practically doubling. In the last quarter of last year, the total credit raised was over $1 trillion. It was an enormous increase, and a lot of it was, of course, in mortgages. I agree that $1 billion of that increase in the last couple of years was in the mortgage market, both residential and nonresidential.

Mr. CARPER. OK. Let me interrupt you, if I can.

Mr. SUMICHRAST. Yes.

Mr. CARPER. I understood you to say that roughly $120 billion of our—is that combined Federal and——

Mr. SUMICHRAST. No, I am not talking about debt; I am talking about the funds raised in credit markets, which have been allocated to U.S. Government securities, State and local, mortgage market, consumer credit, and so forth. What I am referring to is that we have seen a very rapid increase in the total credit market, and consequently, also, the movement from equity into the debt.

One of the greatest problems we are facing, and we do the same thing in our industry—we have been told by a lot of people that we should move from debt into equities. That was about 2 or 3 years ago. It did not make sense to go after public money and raise

money to build large complexes or stores or office buildings, but yet exactly the opposite has happened. What we have seen is a very large increase in debt. Everybody is borrowing money, because obviously, the tax structure of the United States is supportive of that direction.

The point I am making is that we have seen a major explosion in total credit and an explosion in debt as well. And when you chart these numbers, you can see that the GNP is here and the total debt is going over in this direction. And the gap is widening. And there is some serious implications, which I guess Allan would be able to answer better than I can.

Mr. CARPER. Again, to any member of the panel, my question—let me just try to make it clearer.

I understand that there is an explosive growth of credit demand from within our country. I am trying to find out how it is being financed. I think you suggested that $120 billion of it was being financed from abroad. I think that's what you said.

Mrs. TEETERS. That is correct. If you look at the capital flows for 1984, the largest source of the financing was the reduction in American banks lending abroad. It went from close to $100 billion to well below $10 billion. That is money which previously had gone primarily to Latin America. So you have cut credit, basically, to the Latin American areas. In addition there was a substantial increase in foreign holdings of U.S. Government Treasury securities. There was a substantial increase in direct investment by foreigners in the United States. Then there is a lovely animal called the statistical discrepancy, which out of the $120 billion, totaled $35 billion. When you scratch at that statistical discrepancy, which increased substantially over the previous year, it looks to be very short-term money, is probably coming in through the banks, and is being invested in mutual funds. But you can not trace it, and it is very difficult to find.

My own reaction to this statistical discrepancy is that it probably is very short-term investment money. And, it is probably hot, in the sense that if there are higher rates of return someplace else, it will flow out equally quickly.

Mr. CARPER. One other question, and that is, as the dollar trends down—I am going to assume for a moment, maybe wrongly, that the dollar will continue to trend down, and if that does, indeed, happen, how will that affect our ability to attract funds to continue to finance the continued growth of our Federal debt and our consumer credit demands?

Mr. SINAI. That is one of the very big risks that exist that Chairman Volcker and others have referred to. Once the process starts to go, it fundamentally suggests dollar declines, slow growth, and lower short-term interest rates. Then what takes over is a momentum effect. As foreign currency holders begin to expect the dollar to decline, they calculate their total expected returns that way and then look elsewhere.

Mr. CARPER. Do we then have to raise interest rates?

Mr. SINAI. It is definitely a force that would push interest rates higher at a time when that would be the last thing you would want to have happen.

Mr. CARPER. OK. Thank you all.

Mr. ROEMER. Well, on that point, we either raise interests or cut the deficit.

Mr. CARPER. That's correct.

Mr. SINAI. Again, you are right back to the deficit. You take the pressure off this whole process if you cut the deficit.

Mr. CARPER. That's correct.

Chairman FAUNTROY. I want to express our appreciation to the entire panel. You have certainly contributed much to our understanding of what our problems are and where we need to go. I wish that every Member of the Congress could have been here to benefit from your wisdom and from your considerable experience in this area. We appreciate the care with which you prepared your testimony and the time that you have spent here to present us your thoughts. I certainly speak for every member of this subcommittee that we have benefited greatly as individuals.

With that, we bring our hearing to a close. Thank you so much.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[The following chart, "Growth of the Monetary Aggregate," was submitted by the subcommittee for inclusion in the record:]